Scottish & Southern Electricity Networks

RIIO-2

Consultation response

RIIO-2 Framework Consultation

Scottish and Southern Electricity Networks

2 May 2018

Executive Summary

Scottish and Southern Electricity Networks (SSEN) welcomes the opportunity to respond to the Ofgem's RIIO-2 Framework consultation. The first RIIO price controls (2013 – 2023) have generated considerable benefits for stakeholders. In transitioning to RIIO-2 we encourage Ofgem to carefully consider whether revisions to the RIIO framework improve outcomes for energy consumers.

The principles of better regulation; transparency, accountability, proportionality, consistency and targeted action only where needed, offer an excellent test by which options for change can be assessed. Our evaluation of RIIO1 is that it is a strong framework which will continue to deliver significant customer benefits. Where discrete areas of improvement are required, these can be addressed within the existing framework. **We consider this justifies the case for evolution, not revolution.**

We recognise the increased public interest in the role, cost and benefits of energy networks. We need to restore confidence in our industry and accept the challenge of restoring legitimacy, delivering not only an uplift in confidence, but also redoubling our efforts to deliver a smarter, more efficient and modern network, that is able to adapt and support our economy and all customer's needs going forward. In this context, we believe it is even more important that the framework adopted for RIIO-2 is clear and evidence based to ensure that the outcome is aligned to Ofgem's duties as an economic regulator. We wish to maintain a strong and constructive dialogue going forward. We commit to play an active role in the RIIO-2 process, building on from the successes achieved in RIIO-1.

While price control reviews contain many moving parts, we believe the critical issues relevant to this early stage in the process are as follows.

- <u>Shorter price control:</u> setting a 5-year period **addresses the issue of uncertainty** as the industry moves through periods of change. A shorter period also **reduces the risk of errors for all parties**.

- <u>Returns need to be in context</u>: the anticipated transition to a smarter flexible energy system and lower carbon future while focusing on the end cost to the consumer means the **challenge facing licensees** has never been greater. **This must be reflected in the final calibration of returns.**

- <u>Avoid premature decisions:</u> it is **too early to determine many factors** which should be held open until the sector specific or calibration stages.

- <u>Cost of equity:</u> we believe that the **current proposed range is too low**. Our assessment of the evidence concludes that a more realistic range would be **5.5-6.3%** (RPI-real).

- <u>Need for failsafe mechanisms:</u> the **case for additional failsafe return mechanisms has not been made.** Further discussion of the need for and design off **should be at the sector specific** stage and **must avoid relative** mechanisms.

We continue to support the RIIO principles and many of the proposals being considered by Ofgem in advance of RIIO-2. Where we have concerns with regards to the Framework consultation we highlight these below and in the individual question responses which follow.

A strong consumer voice: We are looking forward to working with our Ofgem, consumers, wider stakeholders and the industry as we prepare for the next regulatory period, set out comprehensive and challenging business plans and agree a robust price control settlement. Ofgem's introduction of a framework to enhance consumer engagement is welcome. We support the roll of independent panels working with the licensees to inform and

Scottish & Southern Electricity Networks

critique business plans, commitments, outputs and incentives. Within this response, we suggest further ways this framework could be improved to achieve a better outcome for stakeholders.

- **Some concerns over timescales** and challenges in ensuring stakeholder engagement groups are effectively implemented.
- The consumer voice must be heard and be permitted to **inform the RIIO-2 outcome**.

Building on RIIO-1

Fair returns: The RIIO-1 has delivered benefits for consumers and wider stakeholders. Setting clear consumer driven outputs, accompanied by targeted benchmarking of allowances and tailored incentives has delivered real outcomes which will endure well beyond RIIO-1.

We believe it is important to review and then improve on the regulatory framework; no price control is without areas for improvement. It is, however, essential that Ofgem should only consider targeted modifications in response to evidenced failings and where the improvements can be shown to benefit consumers. Reacting to perceived areas of deficiency without understanding the cause and the impact of the action is not good regulation. As an industry, accepting a 'least worst option' is not in our consumer or wider stakeholder's interest. These actions risk introducing unintended consequences which could be greater than the issues.

Delivery of outputs, improved efficiency, enhanced innovation and a stronger consumer voice have all been achieved within the expected range of returns. We have not benefited from returns which lie outwith the permitted ranges as established at the start of RIIO-1. This is a critical point when considering whether failsafe mechanisms are required within the RIIO-2 framework. With targeted adjustments to allowance mechanisms, incentive rates and the strong linkage of outputs to funding any of the perceived RIIO-1 issues can be addressed without the need for failsafe mechanisms.

It is imperative that a robust and transparent price control delivers what our stakeholders and customers require and that investor confidence in the sector is maintained. We caution against any modifications that slow, or reverse, the improvement in regulation and limits the benefits that the customer receives. Any changes to RIIO-2 must be based on evidence, with clear policy intent and derived from the requirements of our stakeholders; there is a balance to be struck between rewriting the price control and refining.

- **RIIO-1 outcomes are in consumer interest**, conclusions on perceived failing areas must be more robust.
- **RIIO has the current tools to remedy any shortcomings** – they just need to be better defined, measured and monitored.
- **Modified RIIO mechanisms must improve outcomes for customers**, without risking stifling investment, innovation, cost reduction and improved customer service.

The evolution of RIIO-1

How networks are used: We acknowledge the arguments on reducing the price control period from eight to five years. While we recognise concerns over the treatment of uncertain outcomes or the ability to set allowances almost a decade ahead, we believe these could have been adequately addressed within the framework. However, we agree similar good outcomes for customers can be achieved within a five-year period.

We would encourage Ofgem to recognise that increased frequency of price control reviews will address concerns surrounding benchmarking allowances and the treatment of uncertain events. This is one further argument against the need for return failsafe mechanisms.

Simplifying the price controls: Ofgem has indicated the potential to remove Fast-track from the transmission price control process. The strong incentivisation of company business plans is a logical response to residual concerns over information asymmetry and is in line with the RIIO principle that in driving efficiency customers stand to win in subsequent price control periods. Regardless of whether the tool to encourage high quality business plans is the existing IQI model, a modified version or a new mechanism, the incentive strength must be maintained or strengthened. We look forward to working with Ofgem in the sector specific process to design a solution which achieves these aspirations.

- There seems to be an **increase in complexity** in the framework proposals. We are willing to work to reduce complexity, as we believe this is in everyone's interests.

Driving innovation and efficiency: Innovation is recognised as delivering real benefits for consumers during RIIO and previous price control periods. We strongly encourage Ofgem not to dilute a mechanism which, as we move into a period of significant change across the energy sector, is more necessary than ever. We believe that if innovation is considered as a business as usual activity and the benefits of change are to be funded through discretionary Totex then networks have a legitimate expectation to retain a higher proportion of those benefits in order to preserve the innovation incentive strength.

Competition already has a central role to play in the activities of all network companies. Through well-defined and tested procurement processes networks will have been seeking to secure Totex performance improvements during RIIO-1. Customers benefit through the Totex incentive mechanism in RIIO-1 and through benchmarking into RIIO-2 and beyond. We have set out our concerns that current proposals to introduce competition for large capital projects to onshore transmission and then beyond into other sectors have not been appropriately developed, do not appear to be based on an assessment of net benefits and are being considered without guidance from Parliament. We have responded within other consultations [SSEN Hinkley-Seabank Response, 20 March 2018] and would strongly encourage Ofgem to review and respond to the arguments and evidence we have submitted.

Financing a fair price control settlement

Financeability: Through our work with the ENA and independently we have already demonstrated the wealth of evidence and financial arguments which must be considered prior to deciding final methodologies which will set the RIIO-2 financial parameters. Our concerns are set out in Section 3. We would encourage Ofgem to reflect on the learning lessons of the RIIO-ED1 CMA appeal and ensure the positions adopted are founded on open consultation and robust evidence. We strongly encourage Ofgem to do the right thing and consider the substantive evidence before making any decisions in this area.

- Finance – **We are cautious on locking down elements of the price control too early**, or defining methodologies too early, that risk undermining the process.

- We agree with Ofgem's characterisation of the **price control settlement as being an 'in the round'** settlement. For this reason, we believe the correct point at which financing parameters can be established is once allowances, outputs, incentives and risks have been identified.

- We believe that there is **considerable evidence available to Ofgem** and the industry which can be brought into the review of finance parameters and would encourage Ofgem to consider the arguments included in this response further.

We accept that Ofgem has powerful tailoring options open to it and we encourage the use of these. A price control should improve on what preceded it, and therefore it should be an evolution rather than revolution.

We will maintain a strong and constructive dialogue going forward and commit to play an active role in all the RIIO-2 reviews, playing our part in building on the successes achieved in RIIO-1.

We recognise that the formal RIIO-2 process is just starting and that there will be discussions on all aspects of the price control going forward. However, at this stage, we reserve further comments until details are released to allow a more detailed examination, either through sector specific guidance, bilateral discussions or industry workshops.

Our Executive Summary is followed by our comments on what we consider to be three key price control topics for the Framework stage.

- **RIIO-1:** the case for change
- **Fair Returns:** the merits of introducing failsafe mechanisms
- **Finance:** establishing fair financing parameters calibrated to the individual sector plans

Our reading of the Framework consultation would suggest Ofgem is proposing to make decisions on these topics which cannot be shown to be proportionate, consistent or targeted by the need for action. We believe this failure arises as the correct time for decisions on both failsafe and financing parameters is later in the price control process, either as part of the sector specific strategy or as part of the price control calibration stage.

We believe that looking back at what has happened is the correct starting point. Ensuring that changes are proposed for the right reasons is essential to avoiding action which is not targeted at a need. Failing to do so exposes consumers to unexpected and detrimental outcomes.

Secondly, consideration needs to be given towards the future; specifically, what are the options, what is being targeted and is it proportionate? This step is critical to ensure that any identified shortcoming, or failure, is addressed in the best way. This builds into the concept that price controls should build on from improvements made in previous price controls.

Thirdly, the impact has to be discussed and evaluated. Any changes might have positive or negative impacts. We broadly agree that no price control is ever perfect, but we must consider carefully changes and make decisions based on the best available information.

Key price control issues

1. RIIO-1 Performance and the case for change

We believe that RIIO-1 is delivering positive results and it will continue to do so; we will deliver on our commitments, and wherever possible exceed them. It is accepted that RIIO delivery is broadly in line with expectations. However, there are areas where improvements can be implemented for RIIO-2. It would not be right to ignore these.

We accept that, where evidence demonstrates movements have been contrary to expectations, action will be required. It is important that this is only in those areas, and at such time as impacts have been evidenced and responses evaluated in the context of the overall package, and that kneejerk reactions are not taken. We commit to addressing these shortcomings and will engage in discussions with Ofgem, but we caution against implementing changes in areas not required.

This short section examines the RIIO-1 performance evidence presented by CEPA and highlights that Ofgem can adequately address these and similar concerns within the existing RIIO framework. It concludes that RIIO-1 has delivered good customer outcomes and that the appropriate response to perceived failings of RIIO-1 should be through targeted revision of existing price control mechanisms.

2. Fair Returns

We have considered the implications of the current ‘failsafe’ proposals on fair returns and highlight that we have concerns around all the options currently on the table. The requirement to implement ‘failsafe’ mechanisms must stem from a quantified need rather than a response to the perception of ‘unfair’ returns. We do not believe the RIIO framework is broken, rather, as shown in the preceding section, the tools to address the perceived failings already exist, are clear and transparent.

We therefore call for a rational evolution of RIIO, rather than revolution. RIIO-2 will be an incremental improvement on RIIO-1 and we caution against implementing a mechanism that undermines the positive steps taken and risks jeopardising the journey the industry has come on and still has to go. Our enclosed response demonstrates our concerns and looks at the options in more detail.

3. Financing RIIO-2

We believe that financing requirements for RIIO-2 need to be considered in the round. We acknowledge that RIIO-2 is being developed in a more political context and therefore demonstrating how returns can be considered fair is essential. However, this must be a symmetrical objective, fair must also incorporate considerations of future investment requirements, changes in risk and the legitimate expectation of our investors.

We will look at proposals as they are developed and comment back accordingly. We will challenge the assertion that returns need to be lower, we believe that high returns are not bad for consumers in all cases. We remain of the opinion that low returns could be worse for customers both now and in the future. Any changes in the prevailing methodologies for cost of equity, debt, or wider financing parameters must be consulted on, their impact assessed and decisions made in the context of the wider price control package.

Section 1 - RIIO-1 Performance and the case for change

Regulated frameworks should be grounded in the Principles of Good Regulation. The case for changing the RIIO-2 framework should therefore be based on the assessment of evidence of RIIO-1. We have reviewed the CEPA report, commissioned by Ofgem and relied upon in its consultation, alongside our own assessment of how Price Control parameters were set.

We apply a straightforward, principled and clear test to assess whether the case for additional measures outwith the existing framework are required:

- Are the identified issues confined to RIIO-1 or could they require action in advance of RIIO-2?
- Can they be addressed through established mechanisms or additional options may be required?

This is consistent with regulatory best practice whereby cost and performance discovery alongside lessons learnt will form the development of future price controls. We have only commented on RIIO-ED1 and T1 at this stage of our review of RIIO-1.

What is the perceived issue with RIIO-1?

We recognise that the current regulatory and political environment across utility sectors has become charged in relation to the perceived rates of returns earned by regulated companies. The fairness of returns and the practices of companies has become the centre of the debate both in Energy and in Water[1]. This has been termed the "legitimacy" of the regulated utility and the frameworks they operate within and has been debated in the context of political policies that advocate for re-nationalisation of these regulated entities.

It is in this context that Ofgem has set out in their RIIO-2 Framework Consultation Ofgem stated "We are also proposing measures that will provide more protection for consumers against companies earning higher than expected returns[2]." It is therefore fundamental that we consider the context in what was expected in RIIO-1 and if the range of outcomes has exceeded those expectations. This is forgiving any assessment of the net benefit to consumers over the short and long term of a highly power incentive framework and how that relates to customer bills. We would draw attention to the evidence that consumer bills have fallen in real terms over the long term while customer service and network reliability has improved. The consensus is that perceived high returns for Energy Networks correlates with higher consumer bills during RIIO-1. Additionally, it appears that the two assertions that have been levied by Ofgem is that the absolute level of returns is too high and that these returns were due to errors, information asymmetry and unexpected outcomes at the time of setting the price control. Ofgem contend that this is an issue as they believe there are windfall gains for companies who are indeed not performing well i.e. the poor performers are earning higher returns as if they were good performers. They believe that this has led to the clustering of returns above their expectations due to such errors. **Ofgem's conclusion is therefore collective returns across sectors are too high due to systematic errors in setting the price control.**

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1 On 9th April 2018[1], Ofwat's Chairman Jonson Cox outlined the actions Ofwat will consider to ensure the sector is fair, open and reliable for customers. This included dividend policies, executive pay, board leadership, transparency and complex financial structures.

2 Ofgem (2018) RIIO-2 Framework Consultation, page 3

We have sought to review this assertion in our review of RIIO-1 bearing in mind what Ofgem set out in the RIIO Handbook and RIIO-1 Strategy Decisions for each sector. Firstly, we have sought to review what evidence is available to draw these conclusions prior to considering what the issues are.

What was the expected range of outcomes for RIIO-1?

At the outset of RIIO-1, the RIIO Handbook[3] stated that "The way the price control will be set is intended to ensure that network companies will earn higher returns for good performance in line with consumer expectations and lower returns for poor performance. Incentives will be calibrated to ensure they provide long-term value for money and to ensure the package is consistent with our financeability principles." Therefore RIIO was designed to allow, and incentivise, all companies to perform well. This is consistent with customers' expectations where no customer wants a Network who performs poorly.

On this basis clustering is thus a rational expectation from the price control as all companies strive to perform well, which is in the interests of customers. Poor performance of Networks (including clustering at the "low end" of expectations) would be a sign of price control failure, or company failure which would be likely to lead to a "market intervention"[4]. CEPA support this where they state that "Customers (and other stakeholders) reasonably expect that network companies would only earn additional returns if they deliver exceptional performance. Evidence to date suggests that RIIO-1 has succeeded at incentivising network companies to better deliver outputs for customers. Our analysis shows that high returns are, in part, a result of network companies improving their efficiency and their performance against output targets. Those are positives that reflect the ways in which the RIIO framework is working effectively".

It is clear that at the outside of RIIO-1 there was the possibility that if all Networks responded as hoped and intended, the level of returns would be at the upper end of the expected range. **The clustering of returns was therefore an expected outcome of RIIO-1 if all companies responded**.

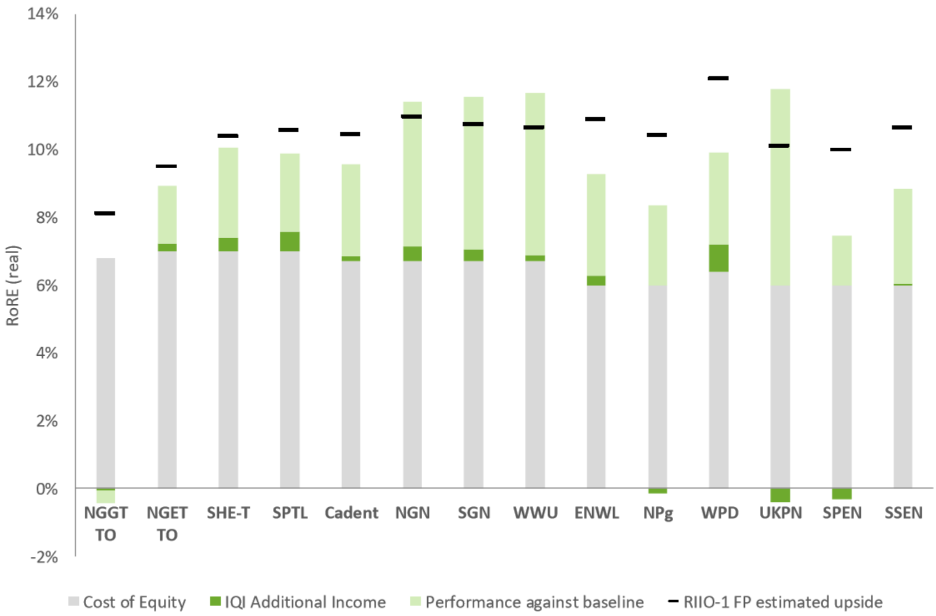
CEPA capture the current view of returns compared to Ofgem's initial expectations for each sector (and settlement) of RIIO-1 by way of the following figure.

3 RIIO Handbook (October 2010) para 5.7

4 If a company was failing to perform, it is likely that there would be to possible interventions; either a change in management or a change in ownership

Scottish & Southern Electricity Networks

Figure 1.1: Estimated returns and estimated upside for RIIO-1 (eight-year average)[9]



Source: CEPA analysis of Ofgem data

Note: Performance against baseline represents actual outperformance (or underperformance) to date and forecasts for the remaining years of RIIO-1.

With the exception of parts of GD1 and one DNO group, this figure illustrates that current forecasted performance by Networks is within the range of returns expected by Ofgem when setting each price control. Ofgem designed the price control that this outcome may occur, albeit their hypothesis is that the collective level of returns are too high due to systematic errors in setting the price control. It is therefore necessary to assess if an issue exists by considering whether errors resulted in windfall gains and that the returns set out in the above figure correspond to true efficiency or output performance. We have therefore reviewed this based on our own knowledge of ED1 and T1 (only) and the issues set out by CEPA bearing in mind the stage of RIIO-1.

What issues have been identified and how are they addressed?

In CEPA's review of RIIO-1, they believe they have identified "implementation issues that resulted in added returns for Network companies"[5]. We have summarised these issues below briefly.

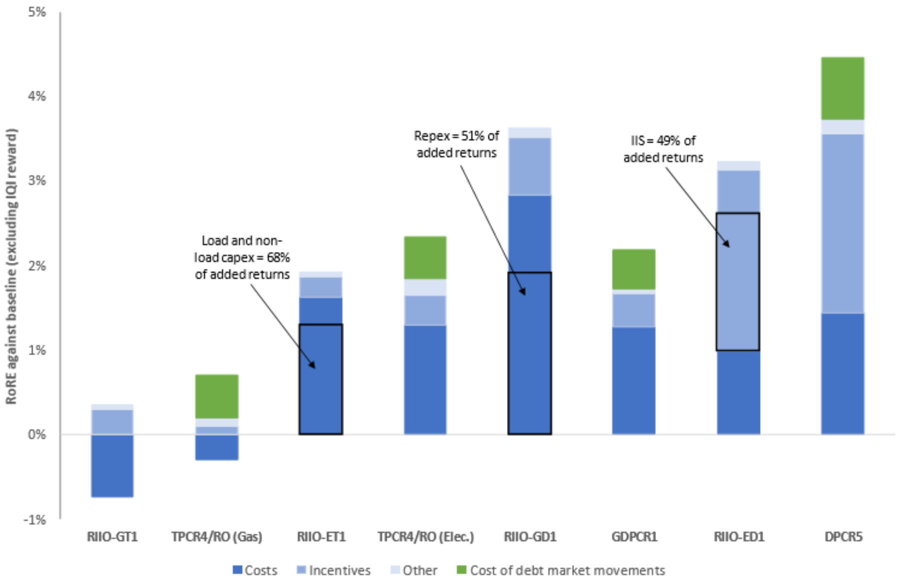
- Allowances for non load-related (NLR) capex for National Grid Electricity Transmission (NGET) are not linked to outputs
- The decision to grant Gas Distribution Networks (GDNs) more secretion in the iron mains replacement programme (Repex) without adjusting cost allowances
- Calibration of the Interruptions Incentive Scheme (IIS) for RIIO-ED1 was based on outdated data
- Inappropriate risk allocation mechanisms for items outside Networks control leading to excess returns, namely:
    - Real Price Effects (RPEs) cost allowances across RIIO-1 were higher than outturns based on revised forecasts
    - National Transmission System (NTS) exit capacity incentive for GDNs prices and volumes lower than Ofgem forecast

5 CEPA Review of the RIIO Framework and RIIO-1 Performance (March 2018), section 2.1, page 18-19

- o Scottish Transmission Operators (TOs) ex-ante cost allowances for new generation driven projects
- More robust use of modelling, analysis and assessment when setting ex-ante allowances to avoid forecasting errors when setting cost allowances or incentive targets

CEPA argue that these elements are the sources of added returns for Networks akin to unearned rewards. They value these using Ofgem's measure of returns, namely, Return on Regulated Equity (RoRE) and summarise in the following figure.

Figure 2.3: Sources of RoRE performance against the baseline (excluding the IQI reward) – RIIO and RPI-X price controls



Source: CEPA analysis of Ofgem data from 2016/17 RIIO annual performance reports and closeout reports for previous price controls.

Note that the above chart does not control for differences in notional gearing between companies/ price controls, nor for different incentive rates on over/under-spend.

With regards to their conclusions we have identified several observations where CEPA has failed to capture in their analysis. We have broadly categorised these issues as follows:

- Mechanisms in RIIO-1 to handle issues
- Price Control elements unfavourably set by Ofgem
- Evidence of misforecasting (and target setting)

Mechanisms in RIIO-1 to handle issues

In relation to allowances set for NGET for NLR capex, Ofgem has recently published its Network Output Measures (NOMs) consultation[6] in relation to the RIIO-1 incentive mechanism. NGET's NLR capex allowances will be part of that close out process and therefore there is already an established mechanism for Ofgem to

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6 Ofgem Consultation on the Network Output Measures (NOMs) Incentive Methodology (March 2018)

review the NLR expenditure for all TOs. **The conclusion in the CEPA report fails to recognise these close out mechanisms.**

For the Scottish TOs ex-ante allowances for new generation driven projects, CEPA are not clear whether their assessment is based on the generation connections volume driver[7] or the ex-ante allowance for Sole Use Exit and Entry expenditure for Transmission Connection Assets (TCA). Regardless of this however, the uncertainty mechanism for generation connections is a volume driver and SHET plc only obtains additional allowances if the generation thresholds are exceeded in relation to the baseline allowance. SHET plc is exceeding the thresholds set for RIIO-T1 and the allowances are therefore tied directly to outputs being delivered. **Therefore, CEPA do not evidence any windfall gains in allowances and their conclusion fails to consider whether there is unit cost efficiency in the delivery of load related outputs.**

For Sole Use Exit and Entry for TCA, the ex-ante allowance is subject to a true-up mechanism and will form part of a separate close out process. Neither of these issues appear to be adequately represented in the CEPA analysis.

In relation to RIIO-ED1, the only element which CEPA identify as a potential issue is in relation to UKPN's totex outperformance. As we have set out further below, it is too early to determine whether there will be an outturn issue at the end of RIIO-ED1. If there is an issue with outputs then the NOMs close out process for failure to deliver outputs will apply. Additionally, it is worth noting that CEPA has not undertaken any adjustment of RoRE in their assessment for the load related expenditure (LRE) reopener for RIIO-ED1 which comprises another close out mechanism to handle output delivery similar to DPCR 5.

Price Control elements unfavourably set by Ofgem

CEPA acknowledge that the IIS incentive target setting was unsuccessfully appealed to the CMA and yet include this in their analysis that this was an error on Ofgem's part. We do not think that can be appropriate particularly since they do not include the opposite effect of the NPg appeal on slow track DNOs[8]. The outcome of RIIO-ED1 is not yet fully known and the performance on IIS will lead to future refinements in target setting in RIIO-2. CEPA have not identified this as the outcome of incentive based regulation and the nature of price controls for target setting.

Although the CEPA review of RIIO-1 mentions the CMA outcome for IIS, it does not cover the outcome of the Northern Powergrid Limited (NPg) appeal to the CMA[9] where the CMA concluded that the on one of the grounds in relation to Smart Grid Benefits (SGB) adjustment at Final Determination was quashed. This resulted in a £42m adjustment to cost assessment adjustments for NPg leading to a £31m reduction in totex cost allowances. The remaining slow track DNOs were not affected by the CMA decision and the remaining £280m reduction in cost allowances are part of their price control settlements incorrectly.

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7 SHET plc's Special Licence Condition 6F Baseline Generation Connection Outputs and Generation Connections volume driver

8 The CMA concluded that: "Our assessment does not support a view that the IIS targets set by [Ofgem] will systematically reward slow-track DNOs for maintaining current levels of performance. (see: CMA, British Gas Trading Limited v The Gas and Electricity Markets Authority, Final determination, 29 September 2015, para. 5.58).

9 CMA Final Determination on NPg appeal to the CMA (September 2018)

Evidence of misforecasting (target setting)

The evidence of incorrectly setting allowances is not clear from the evidence presented by CEPA. There is not clear rationale for why totex efficiency or underspend is being driven by incorrectly set allowances compared to cost efficiency. As we set out below, in the absence of complete evidence no conclusion can be made in relation to totex efficiency. However, it is worth emphasising that totex efficiency is part of the incentive framework and leads to lower network costs and therefore customer bills as part of the cost discovery process. This in turns informs future price controls and therefore in the long run cost efficiency is in the best interest of consumers.

CEPA conclude that RPEs were inappropriately set during RIIO-1 and that has led to windfall gains. At present the RIIO-1 price controls are not yet complete and therefore no real conclusions can be drawn. What is clear is that a significant shift in markets was reflected in RIIO-ED1 if you assume CEPA's analysis was correct in which case had this been known at GD1 and T1 this would have been captured. However, the opposite impact could have occurred, whereby markets may have shifted in the opposite direction. We believe this uncertainty may be more appropriately handled in RIIO-2 given the allocation of risk and management of uncertainty could be improved.

Can we draw conclusions at this stage of the RIIO-1 price controls?

RIIO-T1 and GD1 started on 1 April 2013 and are to conclude on 31 March 2021 with ED1 starting and finishing two years later i.e. 1 April 2015 and 31 March 2023. Each price control is therefore completed five years and three years respectively of eight year price controls, meaning we are less than 50% of the way through the period on average. We would contend that it is too early to draw conclusions on the outcome of RIIO-1 and that the evidence being used to assess RIIO-1 is incomplete and based on forecast information. In our review of the CEPA analysis, we also note that they have acknowledged the limitations of their assessment of RIIO-1 where "given the limited number of years available to inform our assessment, the views presented in this report represent a provision view of the successes and failures of RIIO-1 price controls.[10]". With regards to this limitation, as well as omissions in CEPA's analysis, we do not believe the evidence supports wholesale or fundamental changes to how RIIO-2 will operate. In the absence of more evidence or justification, we see more of a case for refining RIIO-1 into RIIO-2 over the coming period while maintaining options throughout the development of RIIO-2.

Will a price control ever be perfect?

We believe that it is well established that no price control will ever be perfect, or seen as having been perfect in its design when its effect is reviewed, and that improvements must be made at each price control. The importance of learning and applying lessons is paramount, and making improvement based on experience, evidence and impact. This is one of the strengths of price control mechanisms, and so RIIO-2 should learn from the lessons of RIIO-1 where they are appropriate. RIIO-2 will also have to evolve to handle new uncertainties and policy drivers and therefore there will continue to be a need for learning on an iterative basis. There are elements of RIIO-1 that can be addressed in RIIO-2 and these should form part of the sector specific stage of RIIO-2 in parallel with wider policy developments. No conclusions should be reached particularly given the stage of RIIO-1 and the fact we are starting out on RIIO-2 development several years in advance of the start date. We have reviewed the limitations of any analysis on RIIO-1 and have set out our thinking below including considering CEPA's review of RIIO-1.

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10 CEPA Review of the RIIO Framework and RIIO-1 Performance (March 2018), page 3

Conclusions on issues identified in RIIO-1

Following our review of the evidence, as it is available to date, we have not identified any systemic error or structural design flaw in RIIO-1 or indeed outcomes beyond expectations at the outset of RIIO-1. In our review of the CEPA evidence and the RIIO-1 framework, we have not identified any areas which adequately justify new mechanisms, albeit we acknowledge the information is incomplete on RIIO-1 due to the stage of the price controls.

As with any price control, refinement and improvement is expected based on the lessons learned from the previous price control. We believe RIIO-1 is no different. We do not believe there is evidence that there is a need to undertake a fundamental change in the Price Control without further analysis and discussion as part of developing RIIO-2. We have reviewed these "fair return" or fail-safe mechanisms separately.

Section 2 - Fair Returns

Introduction

Ofgem has stated that it considers there is a need to restrict overall returns at RIIO-2 relative to RIIO-1. Ofgem's view is that, while some of the outperformance observed so far in RIIO-1 may be due to efficiency improvements, some of it may also be due to "factors that could not be anticipated at the outset."[11] In light of this, Ofgem has set out a number of options which it considers might help to achieve its objective of "ensuring fair returns".[12] We have set out how we have considered these options and propose a way forward in developing RIIO-2 into the sector specific stage.

What is the overriding objective of Ofgem's proposed 'failsafe' mechanisms

To fully assess whether Ofgem's objective is achieved for these failsafe mechanisms we need to consider what is this objective and is it justified. In the RIIO-2 Framework Consultation Ofgem stated that:

We are also proposing measures that will provide more protection for consumers against companies earning higher than expected returns[13].

Ofgem then state throughout their document (and in various workshops[14]) that 'legitimacy' and 'trust' in the regulatory framework is critical to maintain the structure of the industry and re-assert stability with customers and stakeholders. We agree that stability and trust is important both for customers and investors but that balance must be struck in setting the price control to ensure investment is maintained (and increased where relevant), service and efficiency improvements are a priority, and ultimately the outcome is of the greatest net benefit to customers over the long term.

At this stage we believe Ofgem has not undertaken sufficient analysis or is at an advanced enough stage of the price control to conclude on the appropriateness of the options being proposed. We have set out our assessment of the proposed options at this stage based on:

1. **What is the problem with RIIO-1 and does the evidence merit considering fail safe options?**
2. **An evaluation of these options against Ofgem's objective and the Principles of Better Regulation.**
3. **How would these options work in practice with the wider regulatory settlement?**

Conceptually we have considered these mechanisms using our own assessment through the use of stylised examples as a "walkthrough" of the consequences of each option. In the absence of detail of these mechanisms and how they will operate in elements of each sector compared to alternative already established mechanisms, we continue to advocate that it is too early in the development of RIIO-2 to conclude on their appropriateness. Nonetheless we have sought to contribute to the thinking of these mechanisms and set out a way forward for RIIO-2 development.

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11 Ibid., para 7.114 – 7.115

12 Ofgem (2018) RIIO-2 Framework Consultation, section 7, para 7.103 – 7.143

13 Ofgem (2018) RIIO-2 Framework Consultation, page 3

14 See in particular 1) Ofgem's 11th December 2017 workshop, "RIIO-2 Managing uncertainty & ensuring fair returns" and 2) Ofgem's 28th March 2018 workshop, "Information Revealing Devices (IRDs) and Return Adjustment Mechanisms (RAMs)"

Scottish & Southern Electricity Networks

Ofgem's RIIO-2 'Fair Returns' proposals

In our review of Ofgem's proposals we have undertaken our initial evaluation of these options using the Principles of Better Regulation as an appropriately recognised criteria as well as considering Ofgem's own stated objectives for these options as well as their own statutory obligations. We would like to highlight that we would support and advocate Ofgem identifying in consultation with industry a set of principles against which it can then evaluate the fair returns options during the sector-specific consultations. This would ensure that a proper evaluation "framework" is identified in advance of further work. That would also demonstrate that the assessment has been objective and impartial, and that the mechanisms are then designed having regard to suitable principles. We set out our thinking on those principles in the next sub-section, noting that substantial further work is needed on this topic and that this may reveal additional important principles. We have also set out our other observations in relation to the issues surrounding these options.

Evaluation framework of principles

There are a number of key principles that any change to incentive regulation should meet. We have outlined what we think would be reasonable principles against which to assess options.

- **Grounded in the principles of Better Regulation.** These principles are that regulation is transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed, and have regard to any other principles that appear to represent best regulatory practice.[15] In the context of incentive mechanisms, we interpret this as follows.
    - Any new mechanisms must be **practically and transparently implementable**. This means that there should be minimal scope for discretion, arbitrary judgements and retrospective action by the regulator. Discretion should be limited both in how models are calibrated and how they are applied.
    - Mechanisms should **not be overly burdensome or complex**. Some of the current proposals are likely to add significant burden for Ofgem - whether that is the challenge to develop and calibrate models at the price review; or to implement the models during the price control period itself.
    - Outcomes should be **predictable, and known in advance as far as possible**. For instance, companies should know what benefit they will receive for a given level of cost reduction or performance improvement (i.e. the marginal incentive rate), to enable them to trade-off the costs and benefits associated with improving customer outcomes. Where mechanisms create uncertainty rather than clarity this will stunt incentives.
- The fair returns models must be **consistent with Ofgem's obligations and duties.** Two of these duties are particularly important in respect of the fair returns proposals.
    - First, Ofgem must implement regulation which protects customer interests (e.g. by avoiding windfall gains/losses). Importantly, this is not only current customers, but also customers in the future.
    - Second, Ofgem must to ensure network companies are able to recover efficiently incurred costs, and earn a sufficient level of return to finance their licensed activities.
- **Incentivises economic efficiency in the short run and the long run.** This will ensure companies are incentivised to provide the services that customers want, and that customers do not overpay for the

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15 Based on the Gas Act 1986 and the Electricity Act 1989. These are reflected in guidance given by the Better Regulation Executive. See for example Ofgem's Impact Assessment Guidance, para 2.1 and 2.2: https://www.ofgem.gov.uk/system/files/docs/2016/10/impact_assessment_guidance_0.pdf

service they receive (or, equally, underpay and as a consequence receive insufficient levels of service). In practice, this means the following.

  - As far as possible, incentives should be **calibrated based on customers' marginal willingness to pay**, or based on incentives that reflect customers' valuation.
  - Incentives should be based on encouraging companies to achieve the **lowest long-term cost to serve** and **performance improvements that are valued by customers**.
  - Regulation should **minimise distorted or perverse incentives**, e.g. to favour one type of cost over another; or to unduly bias network activity towards costs vs. outputs; or towards specific sub-sets of outputs at the expense of others.

- Respects and does not undermine the right **to invoke statutory appeal rights** in relation to any adopted model, by practical and effective appeal to the CMA on its merits, at the time licence modifications are made. Appeal rights act as a fundamental protection both for investors and for customers and third parties (who can also appeal). They are intended by Parliament to be comprehensive and to have practical efficacy. If the effect of regulation cannot be known or anticipated until after the event, these appeal protections become meaningless, the scope for regulatory error increases, and confidence in the regime is diminished.[16]
- Ofgem should be conscious of the need to **preserve incentives for companies to collaborate and share knowledge** wherever this generates the most benefits for customers. Many of Ofgem's current proposals will entirely undermine incentives to collaborate.
- Ofgem should be confident that there is **not alternative established or less intrusive option** than the one it is considering that achieves better outcomes. In other words, a mechanism should only be deployed where an issue has been identified that cannot be suitably remedied by an already established mechanism, or by a less intrusive alternative. Principles of regulatory proportionality demand no less.

The above evaluation principles may not represent an exhaustive list.

Initial evaluation of the proposed options against the framework criteria

At present Ofgem has provided only an indication of how its options may operate, and essentially no detail on how they would be calibrated. This naturally hampers our ability to provide a full analysis of the likely effects of the different mechanisms particularly prior to the sector specific stage of RIIO-2.

Nevertheless, our initial analysis reveals that the fair returns proposals suffer from several serious flaws as currently set out by Ofgem, when evaluated against the criteria outlined above. Some particularly evident issues are identified below. These illustrate how these mechanisms do not achieve the objective set by Ofgem, other requirements of a good regulatory practice and potentially their statutory obligations.

Sculpted totex incentives or hard cap/floor.

The hard cap/floor proposal is a specific version of the more general idea of 'sculpting' incentives (i.e. where the incentive rate beyond a given level is zero, effectively a cliff-edge sculptor). Ofgem itself has noted that a

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[16] For example, therefore, the control mechanisms should not introduce significant exposure to regulatory discretion (potentially creating asymmetric risks) where the full reasoning for a regulators' judgement may not be known or knowable, or may only be known after the fact (albeit we note that recourse to Judicial Review may be available in such instances).

cliff-edge model would entirely eliminate incentives to make incremental improvements above the cap. The same effect will apply for sculpted incentives, albeit to a lesser degree[17].

It is worth noting that this stunting of incentives to really push forward continuous improvement would act mostly on the most innovative and effective companies, who would be most likely to outperform and move into areas where incentives are sculpted or switched off.

In all likelihood, sculpting will simply mean that the networks may delay implementing or revealing innovation and efficiencies, until the evaluation period for returns is re-set. That distortion to incentives is detrimental to customers in the short and long term. Perhaps more significantly, companies would still benefit (or lose out) as a result of mistakes in Ofgem's allowance-setting. This is central to Ofgem's rationale for these options whereby they believe they will not be able to calibrate accurately the price control due to unforeseen circumstances and therefore this option does not avoid that error and is likely to lead to supplemental errors in calibration.

- Conclusion: this proposal fails the criteria to **Incentivise economic efficiency in the short run and the long run.**

Discretionary adjustments.

The risk with this approach is that it descends into a form of ex post micro-management by the regulator, with choices made by companies second guessed by the regulator after the event. This approach would then represent a material increase in regulatory risk, a higher cost of capital and a fundamental weakening of incentives.

Networks will be less likely to seek efficiency or service improvements if there is a realistic prospect of Ofgem clawing back the resulting benefits, thereby creating an incentive for companies to ignore information revealed during the price control that might point to efficiency improving re-optimisation, in favour of just sticking to whatever plan was agreed with Ofgem akin to input regulation. Even if Ofgem seeks to tie its hands by limiting the scope or materiality of such adjustments, this will be difficult to limit completely, and investors are still likely to perceive material risks.

- Conclusion: this proposal fails the following criteria
  - It does not **incentivise economic efficiency in the short run and the long run**
  - It is not **practically and transparently implementable**.

Zero-sum incentives for outputs

Mechanistic zero-sum benchmarking can only be effective if there are a sufficient number of comparators in the set, effectively ruling out the use of this model in electricity and gas transmission. Even in distribution sectors, the relatively consolidated ownership groups could create unintended distortions in zero-sum models. For example, in electricity distribution, four out of fourteen licensees are owned by WPD. Illustratively, these four licensees would therefore make up c.30% of any benchmark set using zero-sum incentives (although we note that Ofgem has not clarified how company weights would be determined under the zero sum incentive proposal). If Ofgem were to set the zero-sum benchmark at the sector average performance level, WPD would face materially weaker incentives to make improvements relative to, say, ENW, which only has one licensee.

[17] CEPA, Review of the RIIO Framework and RIIO-1 Performance section 4.7 supports this view that these mechanisms have a negative impact on incentives and summarised in their executive summary (page 9) "it is essential that ofgem models network companies behaviour under the proposed framework for the price control. Individual policies/mechanisms that may be well-intentioned and appropriate on their own could have a combined effect that results in perverse incentives, which Ofgem should seek to identify and mitigate against.."

This is because any improvement made by WPD would shift the zero-sum benchmark materially (i.e. by 30%) whereas any improvement made by ENW would have a much smaller effect on the benchmark.

Further, it is not clear for which outputs Ofgem considers there would be sufficiently reliable or comparable data, which is necessary in order to avoid arbitrary outcomes. As a result, it seems likely that zero-sum models could breach Ofgem's financeability duty, unless very carefully designed/calibrated and combined with various iterations of other mechanisms. The pronounced risk of entirely arbitrary penalties/rewards in a zero sum model therefore creates additional complexity and would likely require additional "safeguards" to company financeability (which inadvertently increases the cost of capital despite Ofgem attempts to propose some form of "revenue floor" – see our response in relation to the financeability proposals in this regard).

We also note that while this may be evident during the price control process, hence allowing the scope for merits based review, it is possible that such a breach of duty might only emerge during the price control period, once appeal windows have closed. This approach will also undermine any incentive to collaborate across the sector, and therefore should only be implemented for outputs where knowledge-sharing is not beneficial for customers if at all.

- Conclusion: this proposal fails the following criteria:
  - It would not **incentivise economic efficiency in the short run and the long run**
  - It is not **practically and transparently implementable**
  - It is likely to **be overly burdensome or complex**
  - It is likely to result in a **breach of Ofgem's financeability duty**
  - It does not **preserve incentives for companies to collaborate and share knowledge**

Fixed incentive pots for outputs

The illustrative examples presented in the CEPA paper[18] and by Ofgem (at the 28th March workshop) are only superficially functional. It is not difficult to envisage a number of scenarios in which the algebra used to share the pot in those models fails – for example, if all companies meet their targets but one company generates only minor outperformance; or if the sector as a whole underperforms targets.

We do not think this model actually generates any of the three benefits identified by CEPA i.e. as currently specified, the proposal:

- does not retain ex ante incentives for network companies to improve outputs performance (networks might in fact realise that it is not in their interests to compete for the pot, since all incremental units of performance that are achieved reduce the value of further incremental performance);
- it is not clear that it generates competition between the companies (since one company might be a clear winner, meaning all other companies see little value in attempting to claim a share of the pot);
- nor does it obviously mitigate the risk of returns that are higher than expected (since, as evident by Ofgem's example from the 28th March workshop, individual companies can in fact receive an unlimited upside, to the extent that other companies under-perform).

Further, there are potentially some challenging distributional consequences of this model, whereby customers of under-performing companies effectively transfer revenues to outperforming companies, paying for a level of service they never received (as clearly illustrated in Ofgem's 28th March workshop illustrative example). This is likely to require calibration to balance the differences between Networks fairly to maintain incentives and

18 CEPA, Review of the RIIO Framework and RIIO-1 Performance, Section 4.7.

fairness at each price control. This is forgiving the intergenerational equity issues between customers and the propensity for distortions in gains and losses.

- Conclusion: this proposal fails the following criteria:
  - It would not **incentivise economic efficiency in the short run and the long run**
  - It is not **practically and transparently implementable**
  - It is likely to **be overly burdensome or complex**
  - It is likely to result in a **breach of Ofgem's financeability duty** as well as the need to ensure fair outcomes for customers
  - It does not **preserve incentives for companies to collaborate and share knowledge**

RoRE sharing factor.

This proposal would have the same effect as simply refining the incentive rates and targets on individual output and cost incentives. However, applying the sharing factor at the aggregate RoRE level has the potential to significantly distort incentives between cost reduction and outputs.

This also feeds the misconception perpetuated in the review of RIIO-1 that increasing returns are negative for consumers and stakeholders. If incentives are appropriately calibrated then Networks should respond to that incentive. This leads to better service, greater cost efficiency and typically lower customer bills compared to a counterfactual of higher costs and lower returns. As we note in our review of the CEPA paper, the outcomes for RIIO-1 are within the range expected at the time of setting these price controls.

- Conclusion: this proposal fails the following criteria:
  - It would not **incentivise economic efficiency in the short run and the long run** – in particular creating distortions between costs and outputs
  - There is a clear alternative which has the same effect without creating those distortions.

Anchoring returns.

A clear weakness of this proposal is that any mistakes made by Ofgem in setting allowances or targets for one network company, will have a knock-on effect on the returns earned by every other company in the sector. This serves to exacerbate the problem Ofgem has identified, namely that cost allowances are difficult to set, rather than rectify the problem.

Based on the limited information disclosed so far by Ofgem, our view is that its anchoring proposal would therefore breach its financing duty. The variants presented in Ofgem's 28th March workshop only serve to introduce added complexity and further distortions. The calibration challenge is more pronounced for this particular option whereby errors in setting the price control will adversely affect or benefit network companies outside their control, leading to a compound adverse impact of anchoring based adjustments.

- Conclusion: this proposal fails the following criteria:
  - It would not incentivise economic efficiency in the short run and the long run
  - It is likely to result in a breach of Ofgem's financeability duty

A fundamental shift away from incentive-based regulation may not be in the best interests of customers

The options put forward by Ofgem therefore represent a fundamental shift in the direction of GB network regulation. However, Ofgem is yet to propose detailed calibrations of these mechanisms, which makes it impossible to complete a full and detailed appraisal or impact assessment[19]. Despite this, it is already clear from our high level review that all of Ofgem's 'fair returns' proposals have the potential to significantly dampen the principles of high-powered incentives, which have been at the core of the long term success of GB regulation. Ofgem has latently referred to these 'fair returns' proposals as 'failsafe mechanisms' to protect the interests of consumers of unexpected outcomes and Ofgem or the Networks getting it wrong[20].

In our opinion there clearly is a lot to lose from making wholesale changes particularly in the absence of any relevant evidence that the existing model is fundamentally broken. The prevailing model has delivered impressive results over the medium to long term – including both RIIO and its predecessor, RPI-X. CEPA[21] concluded that "evidence to date suggests RIIO-1 has succeeded at incentivising network companies to better deliver outputs for companies. Our analysis shows that high returns are, in part, a result of network companies improving their efficiency and their performance against output targets. Those are positives that reflect the ways in which the RIIO framework is working effectively."[22] It is also worth noting that Ofgem agree with the CEPA conclusion in that RIIO-1 has been successful and that there are lessons to be learnt in the application of RIIO-1 for RIIO-2.

While focusing on RIIO-1, the transition to a strongly incentivised framework over a longer period (8 year price control period) has led to some perceived concerns by Ofgem and interested stakeholders. We understand why, in the present political climate, Ofgem may want a 'fail safe' mechanism to limit the returns earned by network companies, particularly for returns that are earned as a result of material forecasting errors or incorrectly calibrated targets. Returns at the RIIO-1 level, regardless of whether they are deserved or not, have attracted negative media coverage which we perceive both as a function of communication of the performance and the impact on consumers. We believe it is unhelpful for all concerned in the current climate when the legitimacy of the regulatory framework is called into question in the absence of a balanced review of the evidence and impact on consumers. It is important to balance short-term pressures around perception of company returns against the imperative for Ofgem to secure long-term customer benefits through well designed incentive regulation.

The issues identified by CEPA could be corrected on a more targeted basis - generalised "fair returns" modifications are not needed

Leaving aside the fact that we dispute some of CEPA's specific conclusions and analysis, even viewed on its own terms, CEPA's review of RIIO-1 does not, in our view, identify fundamental flaws with the principles of high powered incentive regulation that have underpinned energy network regulation for decades, and benefitted customers. Instead CEPA identifies specific areas where improvements could be made.

Ofgem should learn from lessons to improve regulation at RIIO-2, in much the same way Ofgem has learned and improved the regulatory model at every price control since privatisation. This should involve a balanced review of the policy decision, range of expected outcomes, actual outcomes and any evidence of lessons to be learnt to improve RIIO-2.

Improvements in the execution of future price controls, for example in areas identified by CEPA - when coupled with the signalled reduction in price control length - would go a long way to addressing Ofgem's concerns around the level of returns, and the period of time over which high returns are earned. We would highlight

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19 Arguably, the scale of changes being proposed by Ofgem merits a full Impact Assessment, in line with Ofgem's Guidance published here: https://www.ofgem.gov.uk/publications-and-updates/impact-assessment-guidance

20 Ofgem (2018) RIIO-2 Framework Consultation, paras 7.109 – 7.110; 7.114 – 7.115 and 7.119

21 CEPA (2018) Review of the RIIO Framework and RIIO-1 Performance for Ofgem, page 3 Exec Summary

22 CEPA (2018) also note limitations of their study where they have only been able to use partial data sets given the RIIO-1 price controls are only part of the way through the price control period. We also note that there are some omissions and inaccuracies in CEPA's review which we have summarised separately.

that the items identified by CEPA would be expected to be addressed by the normal process of setting the next price control bearing in mind that some of these elements could have been or are being dealt with in RIIO-1.

It is too early for any firm decisions to be made by Ofgem on the proposals

We would urge Ofgem to conduct the most thorough analysis possible of the likely effects of its ‘fair returns’ proposals, and the alternatives, before adopting any decision committing to implement any of them. This detailed analysis is appropriately conducted and evaluated at the later stages, during the separate processes for each sector, when the business plans are more developed and broader and deeper stakeholder engagement is underway. Any conclusion on the merits of these failsafe mechanisms would be premature in the absence of such detailed analysis.

In fact, Ofgem may conclude that it does not require any fail safe mechanisms once the calibration of incentive targets and totex are reviewed in the context of consumer benefits and other regulatory mechanisms such as uncertainty mechanisms and reopeners. It is then at this point Ofgem should consider if there are merits in implementing such a failsafe in a way that is most likely to be a net benefit to consumers and which provides the highest degree of clarity to investors. To do this promotes fair and justified action, and the legal defensibility of that action. To do otherwise risks undermines these, harming Ofgem’s reputation for developing well targeted and well justified regulation in line with the Principles of Better Regulation and their statutory responsibilities. Credibility built up over decades can be lost very quickly under such circumstances.

How will these measures fit into the wider package?

When taking options forward during the sector-specific price controls, Ofgem will need to carefully consider how each of its potential mechanisms will work, not just in isolation but also in the context of the overall package and wider regulatory framework. Although Ofgem suggests that these mechanisms could act as a backstop protection (to customers and to Networks) due to the difficulty with forecasting costs accurately, none of the proposals should be considered a substitute for improving forecasting, target-setting, and other elements of the wider framework (in line with some of the issues CEPA identified).

Ofgem will need to first determine exactly how each of the proposals will be calibrated, and to which outputs and incentives they will apply. Interactions between any mechanisms that are applied in parallel must also be fully understood. At present, not enough information has been provided to fully evaluate each of the options presented. The details of how they are implemented will matter profoundly including where they are implementable. Considering the objective Ofgem has set against RIIO-1 evidence and the backdrop of their statutory obligations it is unclear how these mechanisms achieve the outcomes in the absence of this analysis.

There is also a wider issue of complexity. Far from Ofgem’s aim of “simplifying the price controls”, the current suite of proposals has the potential to add many layers of complexity to the existing framework. For companies to respond as intended to incentives, the mechanisms need to be transparent and relatively easy to understand. The current proposals, depending on how they are packaged together, could create unintended consequences by creating distortions and arbitrary boundaries across which incentives change.

In addition, in line with the principles of good regulation, Ofgem should set a clear process for how its proposals will be developed, and when decisions will be taken. This will ensure that Ofgem sets expectations appropriately, and applies constraints on itself, to give investors and other stakeholders confidence in the process and the outcomes. The process plan should include timelines for when decisions will be made in each sector review; as well as how and when any mechanisms will be implemented during the price control - for example, linking this to the Annual Iteration Process or as part of a close out process.

Summary of evaluation conclusions

From this initial review it is clear that all of the fair returns options proposed by Ofgem have the potential to significantly dampen or remove incentives for cost reduction and service improvements, and fail to meet a number of elements when using a relevant evaluation criteria. We note that our review at this stage is only initial – we have not undertaken a complete assessment of the options vs. an agreed evaluation criteria instead using an appropriate starting point - we believe this illustrates that Ofgem undertake the appropriate next steps in evaluating these options during the sector-specific stage.

Should any of these be pursued, significant further work is required during the sector specific stage of RIIO-2 particularly considering that none of the above options achieve Ofgem's intended objectives:

- **Ofgem will need the most careful design and calibration of these mechanisms** to manage the risk of unintended and perverse consequences. The irony is not lost that Ofgem intend to calibrate complex mechanisms in case they cannot calibrate the RIIO-2 price control accurately. This will likely lead to more unfairness between Networks and customers.
- **Ofgem's proposed options are contradictory to their objective**. Many of these proposals would represent a reversal in delivering cost reductions and service improvements. The downside risks of getting this wrong are considerable, and there is significant risk of unintended outcomes that would be damaging to customers. Ofgem has been careful to identify and reduce incentive distortions in the past (for example moving towards totex benchmarking and incentives). This is therefore likely to harm customers instead of protecting them as well as discourage future investment in energy networks as also noted by CEPA.
- **Timing and risks** are key elements not yet considered by Ofgem including a full and robust Impact Assessment. It is unlikely Ofgem will be able to apply these mechanisms during the price control as it must wait until the final outcome is reached at the end of the period. As such, the proposals are likely to require a comprehensive close out process to conclude on the discretion required in these mechanisms. Given that will occur 4-5 years after the setting of the next price control, i.e. during RIIO-3, the uncertainty of cash flows and outcomes therefore extends over a period of 5-10 years between setting the price control, closing out the price control, and perpetuating into the following price control. This will have a material impact on investor risks and likely an adverse impact on investment and the required rate of return (WACC). This requires careful consideration and modelling after the sector specific phase of RIIO-2 before the impact is known. This is forgiving the intergenerational equity issues between customers which have not yet been considered.

It is likely that further issues and challenges will be identified as the specifics of Ofgem's proposals are developed further. We are happy to share further thinking with Ofgem and have outlined a way forward for RIIO-2 below.

Way forward

Ofgem has set out a range of initial proposals for consideration, but there is a lot more work that needs to be done before decisions can be made. The current proposals cannot be fully evaluated in the abstract – specific proposals will need to be put forward at the sector-specific framework consultations, with enough detail and clarity for the consultation process to be legitimate.

Given this, in our view Ofgem's summer decision should adopt the following approach.

At this stage, Ofgem should keep its options open. This will allow the mechanisms to be explored fully by Ofgem and stakeholders, as well as allowing for an understanding of how different elements of the framework might fit together. This flexibility will be important because different mechanisms may be more or less appropriate for different sectors, and more limitations and benefits of the mechanisms will inevitably come to light as they are further developed. It will be useful to gather initial views on the proposals now, but recognise that the options need to be evaluated in much more detail in sector-specific processes.

However, the option set Ofgem takes forward should include **the option not to implement any of the fair returns proposals**. We consider it is entirely possible that Ofgem will decide that 5-year price controls coupled with improvements to cost evaluation and output target setting will be sufficient to protect customers without having to introduce any additional (and potentially damaging) "fail safes".

Ofgem will need to develop a framework against which it can evaluate the fair returns proposals against alternative well established mechanisms before it can conclude on what is the most effective manner to address issues identified in RIIO-1.

Section 3 – Establishing fair financing parameters

In this section we summarise our position to date on financial parameters and signpost the additional evidence and factors which Ofgem should consider as it seeks to set fair outcomes for RIIO-2. We focus on the following topics and reference our response to chapter 7 of the consultation to this section.

- Cost of Debt
- Cost of Equity
- Financeability and Notional Gearing
- Treatment of Corporation Tax
- RPI/CPI and CPIH
- Regulatory Depreciation / economic asset lives
- Capitalisation Rates
- Notional Equity

As we have set out in our response, we believe it is too early in the process of developing RIIO-2 to conclude on any of these elements and that Ofgem are required to undertake a full review over the course of the Price Control. This is consistent with best practice and prevents early decisions being taken unnecessarily[23]. We have reviewed each element set out in Ofgem's framework consultation.

Cost of Debt

The general principles for setting the cost of debt allowance in a price control are well-founded on the basis that Networks (or generally regulated entities in the case for Ofwat and the CAA) should be able to finance their investment based on an efficient cost of debt. Correspondingly, customers are therefore only expected to pay whatever the efficient cost of debt is to finance Networks. Prior to RIIO-1 the cost of debt allowance was set ex-ante with an estimate for inflation, new financing requirements and generally stable interest rates. In RIIO-1 Ofgem transitioned away from an ex-ante cost of debt and adopted the use of an indexation mechanism. Ofgem elected to use a 10 year trailing average of A/BBB non-financial corporate bonds indices. This index was selected due to the tenor of bonds and also the make-up of constituents in the index being representative of utilities. As such, the cost of debt indexation mechanism has been effective in tracking market movements in the cost of debt for when interest rates fall and correspondingly if they were to rise[24]. The mechanism has therefore been successful in ensuring that customers have only contributed to efficient debt costs.

We have reviewed each cost of debt mechanism set out by Ofgem below, compared these to the RIIO-1 arrangements also considering Ofgem's stated policy objectives and relevant principles[25]. The options set out by Ofgem are as follows[26]:

- Option A: Re-calibrate the RIIO-1 indexation policy
- Option B: A fixed allowance for existing debt plus indexation for new debt only
- Option C: Pass-through allowance for debt

23 RIIO-T1 Strategy Decision (March 2011) and RIIO-ED1 Final Determination (November 2013)
24 CEPA Review of Cost of Capital Ranges for Ofgem's RIIO-2 for Onshore Networks (February 2018)
25 RIIO-2 Framework Consultation (March 2018) para 7.11
26 RIIO-2 Framework Consultation (March 2018) Chapter 7, para 7.17 – 7.28

Firstly we have reviewed the RIIO-1 mechanisms based on how and when they were established compared to Ofgem's stated policy objectives.

RIIO-1 Mechanisms

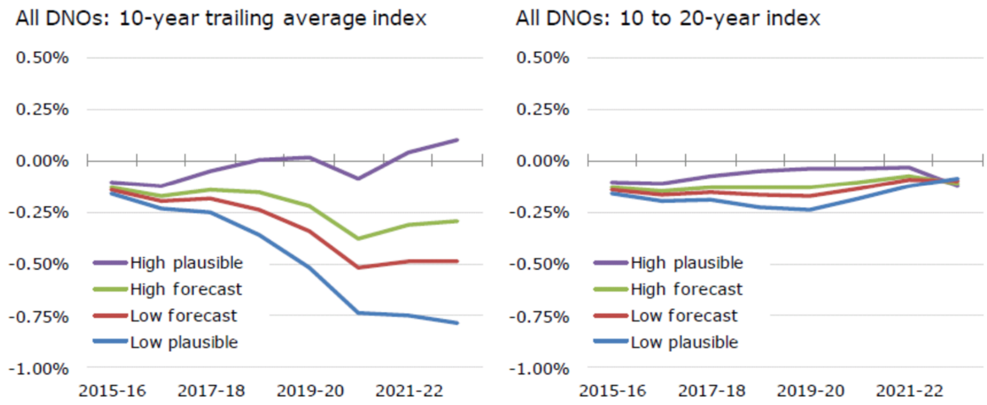
In setting the cost of debt for RIIO-1, Ofgem used several different approaches in RIIO-1 with T1 and GD1 adopting two different methodologies. For GD1, Scottish Power Transmission (SPT) and National Grid Electricity Transmission (NGET), Ofgem used a 10 year trailing average of the iBoxx indices. For SHET plc, a bespoke cost of debt mechanism was used based on a weighting of investment through measuring the change in the nominal RAV on an annual basis. For RIIO-ED1 fast track, the 10 year trailing average was used for Western Power Distribution (WPD), whereas for slow track Ofgem elected to move away from the 10 year trailing average at Draft Determinations and transitioned to a "trombone" index, where the first year was anchored in 2005 with an additional years index data added throughout each year of ED1. Therefore by the end of ED1 there would be 17 years worth of data being used to set the average cost of debt index allowance for slow track DNOs[27].

In reaching Final Proposals for each RIIO-1 sector, Ofgem and the industry considered a range of evidence and calibration options. In ET1, Ofgem maintained options by way of allowing Network companies to propose alternative cost of debt mechanisms based on their circumstances and justification[28]. Following this justification, Ofgem approved the RIIO-T1 adjusted Cost of Debt mechanism for SHET plc as outlined in their Fast Track Decision[29] based on the business plan submission at the sector specific stage of RIIO-1.

For RIIO-ED1, Ofgem undertook a range of interest rate scenarios to test the calibration of the trombone mechanism compared to a 10 year trailing index and the option selected was based on that evidence. This is effectively summarised in the below figure.

Source: Ofgem Draft Determinations: Financial Issues (July 2014)

Figure 2.1: Forecast cost of debt allowances less forecast debt costs



This allowed Ofgem and Networks to ensure that the cost of debt mechanism was set appropriately, while also mitigating the risk of interest rate volatility compared to embedded debt and new financing requirements. It balanced the cost of debt allowance to finance efficient debt at an industry level, retained strong incentive properties, and avoided unfair distribution of costs across customers based on their DNO region.

27 RIIO-ED1 Final Determinations (Nov 2014)
28 RIIO-T1 Overview Paper (March 2011) para 8.30
29 RIIO-T1 Fast Track Decision (January 2012)

Bearing in mind the price controls do not commence until 1 April 2021 and 1 April 2023, there is time for further evidence to come to light and options that may have merit for consideration. We therefore believe Ofgem should review the Options they have set out but also consider other options as they have previously done. As with any price control, the calibration of this mechanism or setting of the cost of debt was under review in each sector specific price control and was not concluded until final determinations.

RIIO-2 options

Having considered the success of the RIIO-1 approach along with the enduring policy objectives and principles set out by Ofgem, we do not see any need for deviation from this approach to setting the RIIO-2 cost of debt allowance mechanism. We believe the approach taken should therefore follow:

- Assessment of the most appropriate cost of debt calibration by sector as was undertaken in RIIO-1;
- Leave all options (including those not yet considered) available until at least initial Proposals stage or Final Proposals which was particularly relevant for ED1 where Ofgem considered all options and refinements up to that point;
- Review new evidence and proposals from Networks to ensure the appropriate methodology is applied in RIIO-2 as part of the sector specific stage;
- Test that options considered and taken forward satisfy the high hurdle set for the policy objectives and relevant principles; and,
- Consider appropriate adjustments to a general methodology where justified if it reflects the circumstances for each Network. Network specific methodologies may be appropriate as was the case in RIIO-1, for example ED1 Trombone or SHET plc's RAV weighted cost of debt mechanism.

Using our own assessment of the options and evidence to date, we have considered Ofgem's proposed options in reverse order on the basis Option C (Pass-through) is the most significant deviation from the RIIO-1 policy. Then we consider Option B (Embedded debt and new debt indexation) followed by Option A (Refinement of RIIO-1).

Option C (Pass-through)

We do not believe considering Option C is appropriate in the setting of the cost of debt mechanism in the absence of further evidence or impact on customers. Although we acknowledge there is a rationale for opting for this approach, we do not believe it fits with the policy objectives and principles set out by Ofgem. This option will not necessarily mean consumers pay only the efficient cost of debt and the incentive for financing efficiently may be removed, while also permitting higher than normal cost of debt. There will also be regional variations to costs to consumers.

Option B (Embedded debt and new debt indexation)

Option B suffers from similar weakening of efficient financing incentives as Option C also suffers from regional variations whereby consumers would be paying substantially more or less depending on their Network provider (particularly for Distribution). Adopting an "industry average" approach as undertaken in ED1 for calibrating the cost of debt has the same net cost to consumers across the UK but avoids regional variations while retaining the strong incentive properties of RIIO-1. This is particularly relevant if circumstances permit re-financing of any embedded.

Option A (refinement of RIIO-1)

On this basis Option A is the most appropriate starting point for RIIO-2 as it is more closely aligned with Ofgem policy objectives and principles, as well as the approach adopted for RIIO-1. For example, this retains the incentive properties of cost of debt indexation including for embedded debt, while not adversely affecting customers across the UK. It avoids judgement on whether pass-through costs are efficient or fair, and mitigates any transfer of value between customers. We do have concerns regarding the elements Ofgem has outlined for Option A and that any change must be consistent with the price control overall as well as passing the high hurdle set for RIIO-1. We have summarised these as follows:

- **Inconsistent application of credit rating:** Using an A-rated benchmark for cost of debt indexation yet undertaking financeability tests using a BBB crediting rating is not appropriate[30].

- **Evidence of the halo effect:** Setting the cost of debt mechanism because of a perceived halo effect would be inconsistent with RIIO-1 whereby Ofgem acknowledged in Final Proposals that this effect was diminishing. Additionally, this fails to consider transaction costs or costs of carry which were included in the evidence base up to the point of Final Proposals, but do not appear in the RIIO-2 Framework Consultation although CEPA state there is evidence of transaction costs[31].

The approach therefore adopted by Ofgem will require significant further assessment with other options yet to be proposed based on individual sector business plans including in particular RIIO-ED2. Until business plans, uncertainty mechanisms, incentives and penalties, and other elements of the price control are further advanced in the process, we do not believe these options can or should be narrowed. This is forgiving the changes that may be caused by whole system energy requirements, the impact of competition, or the fair return mechanisms on credit ratings and financing uncertainty.

Conclusion

Our conclusions on the Cost of Debt at this stage are summarised as follows:

- **Consider additional options not yet presented at the sector specific stage of RIIO-2.** During previous price controls the cost of debt mechanisms were developed up to the point of Initial and Final Proposals. This yielded more appropriate outcomes for Network companies and customers and Ofgem should not restrict options at this early stage of RIIO-2.

- **Maintain a high hurdle for changing the approach to setting the cost of debt.** Ofgem has set out its policy objectives and principles for the cost of debt mechanisms. These should be central to any assessment of different mechanisms or refinement of existing approaches.

- **Monitor the evidence and apply financeability assessments consistently throughout RIIO-2.** Ofgem should monitor evidence up to the latest point of the price control in line with RIIO-ED1 to ensure the most up to date evidence is considered. Ofgem should also apply its financeability approach and tests consistently in calibrating the cost of debt mechanism including use of the appropriate credit rating and gearing.

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30 This is also the case in relation to setting the cost of equity whereby setting the equity beta relies on the gearing ratio which Ofgem has not set out in the RIIO-2 Framework Consultation (March 2018) including outlining their cost of equity range of 3% to 5%. In the CEPA report the 3% and 5% cost of equity point estimates use two different gearing assumptions i.e. 65% and 50% respectively.

31 CEPA Review of Cost of Capital Ranges for Ofgem's RIIO-2 onshore networks (March 2018) page 39-40 section 4.8

At this stage, we do not see the need for a conclusion on the cost of debt approach other than one size does not fit all as evidenced during RIIO-1. Therefore, options should be presented as part of business plans during the sector specific stage and assessed on their merits in line with previous regulatory practice.

Cost of Equity

In considering the cost of equity allowance for RIIO-2 we have considered the evidence presented by Ofgem through the UKRN Study[32], and the CEPA report[33]. We have also utilised evidence presented by Oxera[34] which was provided to Ofgem in advance of the RIIO-2 Framework Consultation bilaterally as well as being published by the ENA. Oxera[35] has undertaken a review of the documents published by Ofgem; studies by UKRN and CEPA contributing to the body of evidence required to inform the setting of the cost of equity allowance. **Oxera[36] recommend that a range for the cost of equity for RIIO-should be between 5.51% and 6.34% (RPI-real) based on evidence. As RIIO-2 progresses into the sector specific stage, evidence should continue to be monitored and considered prior to setting the cost of equity for RIIO-2.**

These reports are not the only sources of relevant evidence that have been or will be presented and Ofgem should continue to recognise and consider the wide range of evidence as it emerges during the RIIO-2 process. Prior to reviewing the technical aspects of the UKRN and CEPA reports, we have summarised what principles and evidence should be considered as part of RIIO-2. This is based on the conclusions of the Oxera report presented in February in advance of the RIIO-2 Framework Consultation; several of their conclusions are consistent with UKRN and CEPA reviews.

- **Cost of equity must be considered in the round after setting the other parameters of the price control consistent with previous price controls, other regulators and generally regulatory best practice:** There is a substantial amount of evidence that requires review and consideration and at this stage of the development of RIIO-2 there is no need to conclude on ranges or exclude evidence.

- **Use of the CAPM and alternative models:** We recognise the need to use a range of techniques to assess returns in the round, including consideration of market conditions. As part of this, in setting the cost of equity we consider that the CAPM model should be the relevant anchor point when setting the cost of equity allowance for RIIO-2. Other models may provide additional context and contribute to the evidence but we believe more weight should be given to the CAPM.

- **Use observable data:** We believe each individual component must be grounded in observable data where possible. For example, any forecasting as used by the Dividend Discount Model (DDM) carries potential risks of mis-estimation. This is something which Ofgem has set out it wishes to avoid in other elements of the price control and care should be taken when interpreting this information.

- **Balance the use of discretion and judgement:** Using observable data is more appropriate albeit it may not always provide a complete picture. Some application of judgement may be required when reading observable (or unobservable) data and weight must be placed more on what is observable.

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32 Estimating the cost of capital for implementation of price controls by UK Regulators: an update on Mason, Miles and Wright (2003) by Stephen Wright, Phil Burns, Robin Mason, and Derry Pickford (March 2018)
33 CEPA Review of Cost of Capital Ranges for Ofgem's RIIO-2 Onshore Networks (February 2018)
34 The cost of equity for RIIO-2 by Oxera prepared for the Energy Networks Association (ENA), (February 2018)
35 Review of Ofgem's initial cost of equity proposals for RIIO-2 by Oxera, prepared for the ENA (April 2018)
36 The cost of equity for RIIO-2 by Oxera prepared for the Energy Networks Association (ENA), (February 2018)

- **Be consistent in the application of elements affecting the cost of equity:** At the sector specific stage of RIIO-1 Ofgem set a range for the cost of equity alongside details of gearing, financeability, use of RPI or CPI, incentives ranges, indications on uncertainty mechanisms and many other aspects of the price control. These elements are heavily interrelated as highlighted by the UKRN, CEPA and Oxera work as well as general finance theory and regulatory precedent (and best practice). As such Ofgem has not set out the parameters that underpin the cost of equity allowance ranges in the framework consultation. The CEPA and UKRN report are not consistent in their application of the evidence and how that relates to the key parameters of the CAPM and in particular CEPA use a 65% and 50% gearing to reach the 3% to 5% cost of equity range[37]. There are also other inconsistencies identified in the application of CPI and RPI between these reports and conclusions reached represent structural breaks in regulatory precedents.

- **Be cautious of introducing complex and opaque empirical modelling techniques:** By way of the UKRN report Ofgem has introduced the GARCH approach to estimating the equity beta for regulated networks. This is in addition to use of Ordinary Least Squares (OLS) approach for estimating equity beta. Any introduction of new evidence or techniques needs to be well considered, balanced and defensible.

- **Cost of equity indexation should be considered carefully:** Indexation of the cost of equity is a new mechanism if it were introduced and careful consideration is required of how it would be designed, its merits and its practicalities. Ofgem should be mindful of any unintended consequences such as increasing the cost of capital through explicitly aligning Network company returns with wider market returns. Although the cost of debt indexation approach is grounded in observable data, the cost of equity methodology is nowhere near as observable and requires a degree of interpretation. We would be cautious of only considering those elements which are not subject to observation or estimation risk if construction the cost of equity indexation and significant further work is required for this to move forward into the sector specific stage. We have set out our views on indexation below.

Our observations are not limited to those above, but we believe these principles would be appropriate in setting the cost of equity allowance. We have set out our specific concerns alongside the reports provided by Oxera through the ENA.

<u>Timing of setting the cost of equity</u>

We are concerned about narrowing the methodology or range of evidence under consideration in the absence of substantially further work and analysis around cost of equity parameters. Oxera has set out several issues in their critical analysis of the CEPA and UKRN analysis of the evidence particularly given that a substantial number of the price control elements have not been set out in sufficient detail to be able to adequately conclude on the cost of equity. Also, **we consider this can only be achieved on a sector specific basis when all of the price control parameters are fixed.**

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[37] Oxera identify several elements which fail to be considered in relation to the cost of equity in a consistent manner as has been the case in past price controls.

UKRN and CEPA critique

Oxera has provided an analysis of the key elements of the CEPA and UKRN work which are inconsistent with its reading of the evidence including considering regulatory precedent in applying this evidence. Oxera has carefully reviewed the evidence and identify several issues which require further explanation or may even need discounted in the evidence base.

- **The indicative range for the cost of equity estimate is inconsistent with the cost of debt:** Oxera specifically identify that the implied risk premium on unlevered equity is lower than the risk premium on debt, which is inconsistent with the relative priorities of claims in the event of distress or default. This is counter to finance theory where the risk premium on debt must be lower than that of equity due to the security ranking of debt.

- **The risk free rate (RfR) is unreliable:** as it is based on observed spot rates on index-linked gilts (ILG) instead of considering forward rates for the RIIO-2 period. This is inappropriate if setting the cost of equity on an ex-ante basis.

- **Interpretation of Total Market Returns (TMR) evidence between UKRN and CEPA is problematic:** CEPA (and therefore Ofgem) implicitly assume that investors in UK regulated utilities base their return expectations on CPI as a measure of inflation instead of RPI absent of any justification or evidence. The TMR proposed by UKRN is 6.0% - 7.0% real without denoting what basis of inflation has been used. CEPA and Ofgem are minded to deduct an assumed wedge between CPI and RPI to estimate the forward expectations of investors using nominal TMR before reaching a 5.0% to 6.5% TMR. This represents a significant leap or structural break in methodology and is not net present value (NPV) neutral and assumes that investors in UK utilities have also made this transition to evaluating returns relative to CPI.

- **Ofgem has placed weight on geometric averages on historical TMR based on an incorrect interpretation of the UKRN report:** UKRN states that regulators should place more weight on arithmetic averages for estimating equity market returns on a consistent basis over time. However, Ofgem's re-interpretation of the historical evidence on equity market returns is inconsistent.

- **CEPA's places significant weight on the Dividend Discount Model (DDM) which is sensitive to inputs:** When estimating the TMR using the DDM, CEPA use growth expectations for companies on the FTSE All-Share index which is inconsistent with those TMR estimates used by Oxera's February 2018 report constructed with reference to the methodology developed by the Bank of England. The point estimate is below the 7.5% presented in the Oxera report illustrating the sensitivity to input assumptions. More weight should be placed on long term observable evidence when estimating the TMR.

- **CEPA have excluded observed betas for European Energy Networks**: CEPA do not justify why these are excluded other than they are not relevant in estimating the risks faced by UK regulatory frameworks, and instead rely on three water companies and NGET (who themselves are faced materially by US regulation). In considering European Energy Networks data, Oxera identify that the asset beta is more in line with the top end of CEPA's range of 0.40.

- **Ofgem and CEPA have placed weight on the use of GARCH methodology for estimating Betas:** The UKRN report advocates for using more sophisticated econometric modelling to estimate the beta for regulated energy networks instead of the OLS approach as commonly used. They ignore any other model and employ a technique that is not widely used by capital market participants and academic practitioners. to estimate the cost of equity. Oxera find that changing the frequency and time period of data i.e. daily and five-year akin to the approach adopted in OLS the beta estimates are closely aligned. There is no clear rationale for using these inputs.

- **CEPA do not re-lever the upper end of their proposed asset beta range to compare like-for-like with their lower range:** CEPA have used a 50% gearing assumption to reach the top end of their range of 5% for the cost of equity. However, CEPA have used 65% for the bottom of their range. When this is done, the range is 3.0% to 7.5% compared to 3.0% to 5.0% set out in the CEPA report and Framework Consultation. The mid-point is closer to the bottom end of Oxera's[38] attenuated range as set out in their February 2018 report whereby **Oxera recommend that a range for the cost of equity for RIIO-should be between 5.51% and 6.34% (RPI-real) based on the evidence.**

Cost of Equity Indexation

Ofgem set out a range of options under consideration in relation to the Cost of Equity indexation. Cost of equity indexation is being considered for RIIO-2 on the basis of the success of the cost of debt indexation and also to ensure market conditions are reflected appropriately into the rates of returns earned by Network companies. However, in considering these options, **care must be taken as to whether (and how) to index one or several, of the cost of equity parameters.** The design of any indexation will have to involve a higher degree of subjectivity than the equivalent cost of debt mechanism and therefore where possible **observable and stable data should be used.** Therefore, we believe a high hurdle is required before proceeding down this route. **We believe this would be a material shift in the setting of the cost of equity allowance** and therefore an Impact Assessment is required to assess the impact on current and future consumers, investors, and network investment. We have set out our initial view of the options presented by Ofgem including drawing on the evidence present on setting the cost of equity allowance as set out by Oxera, UKRN and CEPA.

- Indexing the risk-free rate (RfR) only
- Indexing the RfR with offsetting adjustment for the equity risk premium (ERP)
- Index the RfR and the TMR

Indexing using the RfR only will be relatively immaterial if equity beta is close to one. As set out by Oxera, UKRN and CEPA, the only observable element is the RfR with the remainder of elements subjective and open to a degree of interpretation. As such this is the most simple and observable approach to index the cost of equity allowance. If the equity beta is close to one, as presented by Oxera and the upper end of CEPA's range[39], then the outcome of indexing will be relatively immaterial and therefore will make little to no impact on the cost of equity allowance. This illustrates that the ex-ante estimate of equity beta becomes a critical component but given the clear complexity in estimating the equity beta this is not a viable option for indexing at all.

The ERP is not a stable parameter and moves as a function of the RfR and the TMR. Indexing using the ERP and RfR that results in adjusting the ERP to ensure the TMR remains constant is in essence the same as indexing the RfR with ex-ante TMR and equity beta estimates. Since the TMR is constant over time as set out by UKRN and Oxera, there is little value in indexing using this approach.

The TMR is considered stable over time, and indexing this value would lead to a similar outcome to indexing using the RfR only. We have seen that the TMR is stable over time and that volatility would only be present if the observation period was reduced significantly to allow for market movements to affect the moving average.

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38 The cost of equity for RIIO-2 by Oxera prepared for the Energy Networks Association (ENA), (February 2018)

39 CEPA use a 50% gearing to reach the upper end of their range (5.0%) on the cost of equity, but if re-geared to 65% in line with the low end of their range, the equity beta is greater than one.

However, this suffers from significant statistical error and volatility meaning Network company returns would move in sync with market movements. This would have an impact on the forward looking estimate of equity beta and would introduce intergenerational equity issues between consumers. There is also the issue of over and under investment whereby opting to index the TMR over the price control could attract significant underinvestment and overinvestment depending on the outlook of investors and market movements. This also has financeability implications as Network revenues would become more volatile and unpredictable. We do not believe there is any case that warrants this outcome.

At this stage of RIIO-2 significant further work including an Impact Assessment would be required prior to considering indexing any elements of the cost of equity allowance and the only element which appears suitable for indexing given it is observable similar to the high hurdle akin to the cost of debt is the RfR. **All other elements are subjective and caution must be applied when considering indexing using any other elements of the CAPM (i.e. Beta).**

Market to Asset Ratios (MARs)

Ofgem cite other evidence by virtue of MARs and in doing so Ofgem make a number of conclusions based on the CEPA and UKRN reading of the evidence albeit one of the co-authors of the UKRN Study (Phil Burns[40]) disagrees with the conclusion reached by UKRN on MARs. We believe Ofgem should err on the side of caution when interpreting this evidence given the ambiguity. We have considered the implications of the recent Cadent Gas transaction as analysed by CEPA, whereby they conclude the implied cost of equity is 3.1% to 6.3% (RPI linked)[41]. In reaching this conclusion CEPA estimated a range of input assumptions for the future performance of the business, price control settlements, and then back-solved to reach the cost of equity implied by a 53% premium to RAV. In doing so CEPA make a number of adjustments and when amending these for other factors not reflected in their analysis, the implied cost of equity at 65% gearing is 4.9% to 9.7%[42]:

- Refining assumptions increases the bottom and top of the range by 0.6% and 1.3% respectively:
    - Excluding mark-to-market rates on existing debt
    - GD1 forecast outperformance (costs and cost of debt) are lower than potential benchmarks
    - The entire range of gearing is below the level reported at the date of acquisition;
- Adjusting the gearing based on enterprise value from 50% to 65% increases the range by 1.2% and 2.3%;

Alongside the UKRN study appendix by Phil Burns, it is relatively clear that this evidence is complex and suffers from a lack of observation such as buyer optimism and winners regret. **This evidence therefore cannot be fully relied upon to draw conclusions on the how to set the cost of equity for RIIO-2.**

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[40] In appendix J of the UKRN Study, Phil Burns refers to tax arbitrage as a potential factor driving up the MARs including indicating this as part of the premium paid by Cadent Gas to National Grid.

[41] Based on the National Grid announcement on December 8 2016 and the estimated RAV at March 2017.

[42] This is based on a review of the evidence for debt, details of the announcement and a review of the GD1 Annual Reports

OFTO evidence

Ofgem cannot rely on OFTO evidence due to unobservable assumptions and reliability of implied IRR estimates. Ofgem and CEPA also refer to the equity returns estimated from the Offshore Transmission Operator (OFTO) regime. NERA[43] reviewed the CEPA estimates for competition in new onshore network assets[44] and considered the evidence of OFTOs in reaching conclusions on the range of returns for new assets. As such, the evidence is inconclusive and suffers from a lack of observation. NERA identified that CEPA did not present any evidence on how they reached the implied IRRs. CEPA's conclusion also contradicts the National Audit Office (NAO)[45] who estimated the equity IRRs of 10 to 11 per cent in their review of the OFTO regime. CEPA quote this as 9 to 11 per cent equity return in reading the same evidence.

As we set out in our response to the Hinkley-Seabank Consultation[46], and summarised by NERA, to calculate the implied IRR for OFTOs a number of input assumptions are required such as forecast opex and capex costs, tax and cost of debt including gearing. However, CEPA do not provide these crucial assumptions and Ofgem actually refer to operating costs as being out of scope of their OFTO Cost Assessment Guidance. It is therefore unobservable and therefore cannot be relied upon.

Additionally, the NAO states that "The Authority included this tax saving [on financing] as its remit is to consider the impact on consumers. However, this saving to consumers is likely to be matched by a corresponding additional cost to taxpayers"[47]. Given the gearing and financeability obligations placed on Network companies as well as the proposals Ofgem has outlined for the treatment of corporation tax, it would not be appropriate to rely on OFTO evidence in setting the cost of equity.

Conclusion

In reviewing the cost of equity evidence as set out by UKRN, CEPA, Ofgem and the work done by Oxera, we conclude the following;

- **It is too early to set the cost of equity, exclude evidence or narrowly define the methodology being used at this stage of RIIO-2.** Ofgem should apply caution when introducing new estimation methodologies such as GARCH for beta estimation and when making assertions on the interpretation of RPI and CPI on TMR.

- **There are flaws in the interpretation and application of the evidence as identified by Oxera.** The application of the UKRN evidence by CEPA and by Ofgem is inconsistent and the CEPA range is inappropriately calculated using different gearing assumptions. Oxera have identified material concerns with the CEPA estimation methodology and point estimates particularly compared to market evidence and finance theory around asset and debt risk premiums.

[43] NERA Review of Ofgem proposed WACC for Competition Proxy Model of delivering new onshore capacity investments (March 2018) A report for SHET plc and SPT plc.
[44] CEPA Review of Cost of Capital Ranges for New Onshore Network Assets (January 2018)
[45] NERA quote these findings in section 3.2.1 of their report. Original reference is NAO (June 2012), Offshore electricity transmission: a new model for delivering infrastructure p.29
[46] See SSE response to that consultation (March 2018)
[47] NAO (June 2012) para 3.18

- **Oxera proposes a range of 5.51% to 6.34% (RPI-real)[48] for the cost of equity compared to CEPA's 3% to 5% range.** When re-gearing the top end of CEPA's range from 50% to 65%, the cost of equity is 7.5%. The CAPM parameters used by CEPA at the top end of their range are similar to those identified by Oxera.

- **CEPA do not re-lever the upper end of their proposed asset beta range to compare like-for-like with their lower range:** CEPA have used a 50% gearing assumption to reach the top end of their range of 5% for the cost of equity. However, CEPA have used 65% for the bottom of their range. When this is done, the range is 3.0% to 7.5% compared to 3.0% to 5.0% set out in the CEPA report and Framework Consultation. The mid-point is closer to the bottom end of Oxera's[49] attenuated range as set out in their February 2018 report whereby **Oxera recommend that a range for the cost of equity for RIIO-should be between 5.51% and 6.34% (RPI-real) based on the evidence.**

- **Cost of equity indexation requires significant further analysis and an Impact Assessment if to be considered appropriate for RIIO-2.** The options present by Ofgem have significant flaws and require subjectivity whereby a high hurdle should be set when considering indexation of the cost of equity allowance similar to cost of debt indexation. Only observable data should be used when indexing the elements of the CAPM.

- **Evidence on OFTOs and MARs is unobservable and require a significant number of input assumptions.** Ofgem cannot rely on OFTO and MARs evidence to draw conclusions on the cost of equity allowance due to the unobservable and ambiguous analysis of transactions. A number of input assumptions are required which materially affect the conclusions drawn as we have set out and Ofgem must be cautious when relying on this evidence.

Financeability and Notional Gearing

As set out in the Energy Act 2004, one of the principle objectives[50] of The Authority is "the need to secure that licence holders are able to finance the activities". In RIIO-1, Ofgem fulfilled these obligations through undertaking a financeability test on a range of scenarios for each Network company. Where there was deemed a financeability concern, adjustments to the financial parameters were made for example in the following price controls and Network company instance:

- RIIO-T1: SHET plc's capitalisation rate was 90% compared to an expected split of capital and operating costs of 95-98% capital costs. Also the notional gearing was set at 55% and the asset lives were transitioned over two price controls. This was due to the circumstances set out in the SHET plc business plan and the scale of the capital investment programme compared to the size of the business (i.e. totex to RAV ratio)[51].

- RIIO-ED1: Electricity North West Limited (ENWL) made NPV neutral adjustments to the profiling of their revenue as well as having a period of transition to 45 year asset lives[52].

This was based on an assessment of credit rating metrics and qualitative judgements as expected under Moody's and Fitch credit rating methodologies for regulated networks. For RIIO-2 it appears Ofgem proposes

48 Oxera set this range based on a gearing of 60%, and when re-geared to 65%, the cost of equity range is 6.3% to 7.2% (RPI-real).
49 The cost of equity for RIIO-2 by Oxera prepared for the Energy Networks Association (ENA), (February 2018)
50 The Electricity Act 1989 as amended by the Utilities Act 2000 and the Energy Act 2004 - Section 3A.(2)(b)
51 SHET plc Business Plan 2011 and Ofgem Fast Track Decision (January 2012)
52 RIIO-ED1 Draft Determinations on Slow Track DNOs (July 2014) and Final Determinations (November 2014)

to do something similar albeit undertake further stress testing and have stated they have "conducted initial tests on the impact of the lower cost of equity and assessed the impact that the reduction will have on financial ratios and credit ratings. These tests indicate that – all else being equal – company performance on financeability metrics may deteriorate since returns and therefore cash flow, will be lower than that derived from current levels of allowed return"[53]. We think Ofgem should have considered publishing some of those tests and also consider what impact that has on the cost of capital particularly given the other proposals outlined in the consultation document around failsafe mechanisms. For the options Ofgem has set out we have considered these in turn:

- Option A: Adopting a nominal return instead of a 'real' return
- Option B: Putting the onus on the companies
- Option C: Introducing a licence-backed revenue floor
    - Variant 1: Maximum penalties
    - Variant 2: Minimum coverage ratios

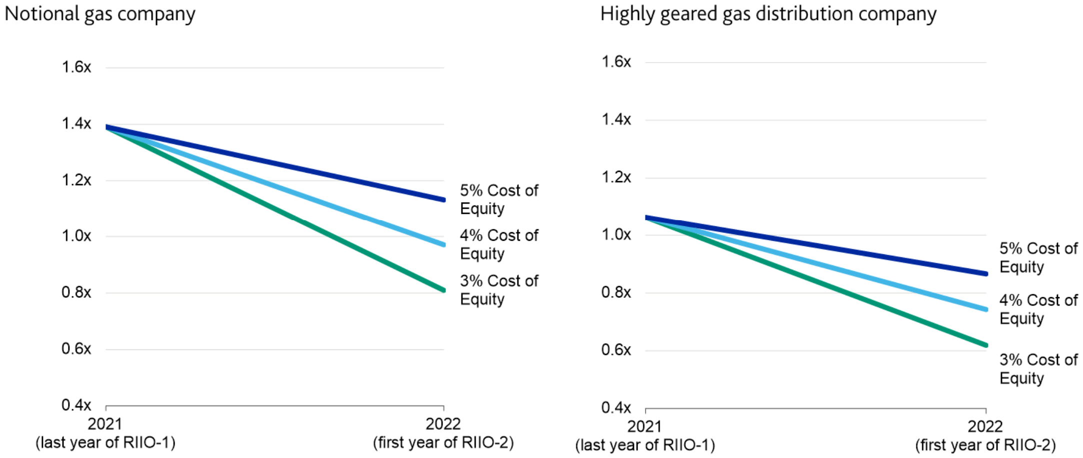
We have also set out why we do not believe these mechanisms are appropriate to use considering the stability of the framework, being able to <u>attract investment</u> (i.e. compete for capital), <u>consistency with other regulatory frameworks</u>, and <u>protect consumers</u> from higher charges unless it is necessary <u>both in the short and long term</u> (i.e. consumers today and in the future). In considering these options, we have only considered what the stylised implications would be based on a notional Network company and drawing on evidence from the credit rating agencies in relation to RIIO-2. We have reviewed these in reverse order of their merit.

In a note before the RIIO-2 Framework Consultation, Moody's[54] stated that "lower returns on regulated network assets from 2021" is a "credit challenge". After the consultation was issued, by Moody's[55] noted that RIIO-2 was "credit negative" due to "a cut of up to 55% in the allowed cost of equity, on a comparable basis, and less cope for outperformance". In their analysis, they identify that "even a company leveraged close to regulatory assumptions would come under pressure in RIIO-2". They illustrate this effectively by way of the graph for a notional gas distribution network company.

53 RIIO-2 Framework Consultation (March 2018) para 7.74
54 Moody's Update to credit analysis for SSE plc (August 2017)
55 Moody's News and Analysis (March 2018), page 13-14

EXHIBIT 1

Illustration of Moody's-adjusted interest coverage ratios at a notional and highly geared gas distribution company



AICR for notional company is based on 65% gearing and 25% inflation-linked debt; for highly geared company, AICR is based on 85% ratio of net debt/regulated asset value, 25% inflation-linked debt and performance in line with regulatory assumptions.

Source: Moody's Investors Service

When considering Ofgem's financeability options, Moody's do not consider the uncertainty impact on cash flows that fail safe mechanisms or "fair return" mechanisms (latterly Ofgem is referring to these as Return Adjustment Mechanisms or RAMs). They note that "a revenue floor mechanism would allow companies to raise additional revenue if necessary to meet debt repayments, which could support operating companies' credit quality but at the price of blocking dividend distributions under some scenarios, which would be credit negative..". **The revenue floor mechanism is unlikely therefore to achieve the objectives it was intended to do in the long run which should rule out Option C overall.**

In relation to Option A (nominal return), this would be inconsistent with other regulatory frameworks and could have a long term material impact on attracting investment. There are already established mechanisms which can address company financeability issues which must be finely balanced and well justified. **We also see Option A causing longer term financeability issues.** With a corresponding short term **increase in costs to consumers, this would cause inter-generational issues between current and future customers potentially undermining Ofgem's attempt to strengthen legitimacy of regulated energy networks.**

Option B would be more akin to Network companies taking their own action to address company specific financeability concerns. In the short term i.e. 1-2 years during a price control, this is standard practice and would be the obligation of management, however, if for a duration of a price control, why would it be appropriate to have a notional gearing higher than actual gearing. Notional gearing should be set at the most appropriate level based on financeability assessments and therefore there should be no divergence where possible. The assumption is that a notional Network company can differ from the actual Network but should not be materially different. Option B is therefore inconsistent with the principle of setting the price control using a notional Network company and only making very specific adjustments based on company specific circumstances, not systematically applying a mechanism by virtue of the back door.

Conclusions

Ofgem should be careful when proposing approaches to handle financeability issues and as with RIIO-1 these need to be well justified by the Network to use as opposed to a standard tool that forms part of all Network companies price controls. If Ofgem calibrates the RIIO-2 framework accordingly then there should be no financeability issues except for periods of sustained under performance by Network companies. Balancing costs to consumers and returns to investors can be achieved in RIIO-2 without causing systematic financeability issues. **We believe that Ofgem should be mindful of their obligations and ensure that any conclusion on financeability mechanisms should actually be a last resort at most.**

In considering the Ofgem's proposed options, none of the mechanisms are appropriate when using a reasonable criteria to justify their inclusion and therefore must pass a high hurdle of financeability assessment. This should therefore not affect Energy Networks as a whole or by sector and there are already well established tools used to address company specific issues that are well understood, part of an established framework, consistent with other regulatory best practice. In essence, **it would be for the Network company to ensure it undertakes the necessary steps including justifying any proposals contained in their business plan to manage financeability.**

Treatment of Corporation Tax

In RIIO-1 Ofgem adopted a comprehensive tax modelling approach to set tax allowances based on the notional company. This was based on the calculations set out in the Price Control Financial Model (PCFM) and Price Control Financial Handbook for each sector. This approach was based on deriving an appropriate and fair taxation allowance for Network companies based on the corporate tax liabilities expected from regulated activities[56]. This was based on an estimate of corporate tax using tax legislation and designated accounting standards as set out in the financial issues annex for RIIO-1.

Ofgem have identified areas of corporation tax they wish to review as part of RIIO-2 covering the following:

- Calculating the impact of tax costs on incentives and RoRE
- Checking for tax benefits as a result of financial restructuring or irregular accounting adjustments
- Reconciliation between allowances and tax payments, regulatory accounts, RIIO Accounts and HMRC tax returns (CT600s)
- Reviewing company-by-company (or spot checking) group tax relief and sharing of tax losses
- Historical agreements with HMRC

In undertaking the above analysis Ofgem should only be seeking to ascertain what is the most appropriate tax allowance policy for RIIO-2 and not seeking to act as HMRC. As such, there are a number of areas above which are either unnecessary or already captured by other requirements. For example, group tax relief is actually covered by the EU Cross Subsidy audit requirements as part of the Regulatory Instructions and Guidance (RIGs) requirements. Payments for tax on regulatory activities is an appropriate area to consider bearing in mind any unique arrangements in place that Ofgem feel is relevant in setting their options for RIIO-2.

The most important aspect we believe Ofgem has failed to consider is the value attributed to Network companies for clear and transparent corporation tax policies. As part of the SSE plc group, we have been

[56] Ofgem RIIO-T1 and GD1 Financial Issues (Annex to Strategy Decision) (March 2011), Chapter 5

designated a Fair Tax Mark and were the first FTSE listed company to achieve such recognition. This is referred to as "a business with the Fair Tax Mark is certified as paying the right amount of tax in the right place at the right time and applying the gold standard of tax transparency"[57]. We believe that this has been omitted by Ofgem in consideration of their options, whereby recognising this transparency is something our customers value and so should Ofgem. The options set out in the Framework Consultation only refer to:

- Option A: Notional allowance with added protections
- Option B: Actual payments to HMRC
- Option C: The 'double-lock': the lower of notional and actual

In considering these options we have considered our own position in relation to corporation tax and the outcomes these options would deliver for customers. In doing so, we see option B as a pass-through which is potentially the most appropriate but may require substantial reviews of Network company tax calculations. Option C is a complex mechanism which encourages companies to be at least no higher than the notional tax allowance to avoid penalties. This requires Ofgem to calibrate the notional tax allowance high enough and becomes more akin to a pass-through like Option B. Option A is the current arrangements but require some form of trigger or assessment of corporation tax. The existing arrangements are around the tax trigger deadband and also the tax clawback mechanism for excessive gearing. We would perhaps like to see Ofgem consider how it could encourage companies to implement more transparent tax policies otherwise, it seems pass-through is the only appropriate option.

Given the implications for tax treatment in the price control for incentives and in setting the appropriate cost of equity, it appears this issue will need to be reflected in a review of that evidence. For example, in the event tax arbitrage has played its part in high MARs as outlined by Phil Burns in the UKRN study[58], then would these MARs persist if tax arbitrage is removed? This issue therefore has other implications and must be considered as a first order issue in reviewing the financial parameters for RIIO-2.

Inflation – RPI and CPI/CPIH

Ofgem have long considered a change to CPI or CPIH from RPI as the means to index the Regulatory Asset Value (RAV). This was based on the credibility concerns raised by the Office of National Statistics (ONS) in 2013 where it believed that the formula used for RPI does not meet international standards following which it was de-designated as a national statistic by the UK Statistics Authority (UKSA). Despite this a substantial number of assets are still linked to RPI including pension schemes, government gilts, corporate bonds, and regulated assets. Therefore RPI has persisted to be generated by the ONS and used by several government and private institutions.

The change to CPI/CPIH was considered at an early stage of RIIO-1 before Ofgem then opted to retain RPI. Following this Ofgem made an adjustment to the cost of equity in RIIO-ED1 to reflect what is termed the RPI formula effect[59]. This was to reflect an upward bias estimated by the ONS due to the use of the Carli formula[60].

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57 Fair Tax Mark website

58 In appendix J of the UKRN Study, Phil Burns refers to tax arbitrage as a potential factor driving up the MARs including indicating this as part of the premium paid by Cadent Gas to National Grid.

59 RIIO-ED1 Fast Track Decision (November 2013) and Ofgem consultation on equity market returns (December 2013)

60 Ofgem Equity Market Returns Consultation (December 2013)

Recent Regulatory Developments

There has been substantial debate centred around the formula effect and the wedge between RPI and CPI/CPIH and whether this is a) constant, b) predicable or c) priced into investor expectations. Even during RIIO-ED1 the question of what level of returns investors expect for RPI linked assets formed part of the adjustment for the RPI formula effect reflected in the cost of equity estimate.

More recently Ofgem consulted on what inflation measure it should index new offshore assets i.e. OFTOs and Interconnectors[61]. In doing so Ofgem considered the balance of evidence and a number of similar issues as raised in the CEPA report, for example:

- Absence of a CPI-linked capital market
- Existing RPI-linked obligations
- Complexity of forecasting and applying CPI

Without reviewing this evidence in our response we have considered what would be the more appropriate means to take the debate forward bearing in mind that their remains an appetite for Ofgem to transition to CPI/CPIH and the impact that will have on companies and consumers. Additionally, the interrelatedness of inflation measure to everything from cost of debt, cost of equity, real price effects, pension scheme funding, and general investor returns means the inflation choice is a critical element in RIIO-2. **Therefore, we believe Ofgem need to undertake a fundamental review of the existing evidence, whether transitioning to CPI/CPIH is practical, is it in the best interests of consumers, and if that hurdle is met, then how would it apply any transition to CPI/CPIH.**

NPV Neutrality and Investor Expectations

One of the critical elements for implementing a change to CPI/CPIH is around how it will be applied to the cost of capital, in particular, the cost of equity[62]. The interpretation of the evidence in the UKRN and CEPA report is inconsistent as set out in our response to the cost of equity following a review by Oxera. The interpretation of a patchwork of inflation measured over a long series for the nominal market returns (TMR) and investor expectations is of particular concern. Oxera summarise this in their executive summary whereby "Ofgem and CEPA implicitly assume that investors in UK regulated utilities (and, in particular, GB energy networks) target returns relative to inflation measured by CPI rather than by RPI, without good supporting evidence.". **We agree with Oxera that Ofgem's position to deduct the wedge between RPI and CPI from the TMR estimated by UKRN is not appropriate due to not being NPV neutral or a consistent application of standard finance theory.**

Absence of a CPI Linked capital market

CEPA identify a few issues in relation to a CPI linked capital market, whereby the Debt Management Office has not issued CPI linked products due to a lack of demand for such products. Therefore, it is difficult to quantify the real risk free rate or breakeven inflation when there are no CPI linked government gilts. Additionally, this

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61 Ofgem decision to retain RPI as inflation index for OFTOs and Interconnectors (March 2016)

62 Although inflation materially impacts on the estimate of the real the cost of debt we believe the current complexity is in relation to the application to the cost of equity particularly considering the UKRN and CEPA reports on the cost of capital as well as how Ofgem have interpreted these reports.

makes it challenging to estimate the wedge over the long term due to the lack of evidence on CPI linked debt. **The lack of a liquid CPI linked debt market is a fundamental part of why Ofgem reached their decision for new OFTOs and Interconnectors which is consistent with the evidence presented by companies in response to that consultation.**

Existing RPI-linked obligations

CEPA note that any existing obligations like RPI linked debt or liabilities would be part of Network companies business plan proposals (by way of stating "we would expect Ofgem would receive similar arguments again" [to those received in the 2015 consultation]). **In the absence of any analysis of the implication of changing to CPI/CPIH, we do not believe Ofgem can conclude on this aspect of the price control at this stage without further analysis.**

Application to the regulatory framework

The change to CPI/CPIH would constitute such a material change in the regulatory framework that a full impact assessment is required in line with best practice. The complexity of issues covering CPI wedge estimation, application to capital markets and cost of debt index, existing RPI-linked obligations and setting the cost of equity means this is not a straight forward issue to be handled so early in the RIIO-2 process.

Previous regulatory decisions that transition away from RPI include Ofwat, the Water Industry Commission for Scotland (WICS) and Ofcom. All adopted a different approach in handling the transition and these need to be considered fully on their merits and the impact on customers and Network companies. For example, Ofwat applied a transition period of indexing the RCV on a 50:50 split between RPI and CPI (or CPIH) from April 2020; WICS used nominal estimation until moving to CPI after a period of three years; and, Ofcom are using the nominal cost of capital for the foreseeable.

What is clear from considering transitioning from RPI, regulators have adopted the following principles based on our interpretation of the issue:

- Stability of the regulatory framework is required for investors and consumers;
- Investors are seeking returns which are NPV neutral to RPI or CPI, meaning the real cost of capital will be adjusted by the calculated wedge; and,
- Care has been taken to protect companies and consumers over the period of transitioning including signalling the change and undertaking an impact assessment.

We would encourage Ofgem to adopt the same principles and avoid making discretionary adjustments or adopting unique unsupported positions which are inconsistent with the above principles. This is particularly apparent in Ofgem's (and CEPA's) application of the RPI-CPI/CPIH wedge in setting the cost of equity allowance and careful consideration of the evidence and impact must be undertaken accordingly.

Regulatory Depreciation, Capitalisation Rates and Notional Equity

The other elements of the RIIO-2 financial parameters which receive little attention in the framework consultation are most appropriately dealt with in the sector specific stage. This is particularly the case for capitalisation rates which are a function of historical and future capital to operating costs for each Network company. This cannot be concluded until that stage and should form part of the business plan submission based on a balance of financeability, spreading of costs across consumers, and reflective of actual investment practices.

In relation to the notional equity or conversely the gearing assumption, as this is being deferred to the sector specific stage of RIIO-2, we believe that the cost of equity and debt allowances must also wait until that time. This is consistent with our view in our response on these elements as well as being part of the financeability framework.

In relation to regulatory depreciation, Ofgem acknowledge that this was extensively reviewed in RIIO-1 before being subject to an appeal at the CMA by BGET. Ofgem has not set out its view on this element of the price control or undertaken any work on the basis that the CMA did not conclude it was wrong in process or justification in reaching its decision. We would consider it may be appropriate to consider asset lives as part of financeability but that a high hurdle would need to be met to justify a move away from the previous policy of 45 year asset lives and the transition periods agreed.

Section 4 – RIIO-2 Framework consultation question responses

The remainder of our document addresses each of the questions raise by Ofgem in its Framework consultation. Where detail has been addressed in the key price control topics in sections 1-3 these are cross references.

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?

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

We need to deliver what our customers want. We need to embrace stakeholder engagement and ensure that we are able to react to the changing environment and provide a modern network which reflects the energy mix that is required. We welcome the plans proposed and look forward to implementing an enhanced engagement, in addition to our current stakeholder engagement, to listen to and address the concerns of our stakeholders. We have already discussed and fed back some initial thoughts on the guidance, in light of the time constraints particularly in relation to RIIO-ET2. We welcome Ofgem's recognition that the Transmission licensees are more removed from consumers and therefore the User Groups should have a stronger role in informing plans for RIIO-2. As we move into the sector specific process we are keen to understand whether Ofgem or licensees will be responsible for establishing consumer willingness to pay.

We seek assurance that the output from both panels will inform our final settlement and how we support and organise both groups. We believe the level of engagement will suffer if we cannot demonstrate to the panel members how their time and effort translates into the RIIO-2 outputs, allowances and commitments. We strongly encourage Ofgem to continue to engage with networks and all interested stakeholders on this issue with a view to providing clarity before the sector specific consultation process.

We request clarity on both the Open Hearings and the RIIO-2 Challenge Group. What is the remit, terms of reference and broad expectations of each? We recognise that differences might exist between parties, but we want to ensure effectiveness of discussions and know where decisions and views ultimately lie. A clear understanding of how parties will be able to contribute to the hearing process, and questions raised by it, will also be valuable.

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?

From the outset we value stability in any review. We liked the certainty of the longer eight-year regulatory period. However, we recognise setting a five-year period addresses the issue of uncertainty, as the industry moves through change. A shorter period also reduces the risk of errors for all parties. We would expect Ofgem to acknowledge that the reduced length naturally minimises the types of issues Ofgem is concerned over and therefore also reduces the need for additional measures to adjust for returns. However, we need to careful that risk is not assumed to decrease, or at least at this stage, without knowing what the plan looks like.

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

A price control is typically set ‘in the round’ and we believe that there are limited opportunities to split across different periods. However, we are not against this in principle. Ofgem cannot allow for allowances over future price controls in isolation, as companies would need to understand the revenue mechanisms and capital allowances. We would expect this to be developed further under sector specific strategy. It is important to recognise that stakeholder views need to be checked regarding the setting of allowances and targets over longer periods.

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

We expect this to be issue specific.

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

We believe that the RIIO-1 framework was designed to achieve this. We do not accept that RIIO-1 did not and is not delivering what it was designed to do. We believe that the RIIO-2 framework consultation focusses on adopting behaviours which encourage the opposite of RIIO-1 principles. We are concerned with relative incentives / targets, shorter allowance windows, indexation of key parameters, the movement of innovation to BAU and ex-post adjustments. Ofgem must consider the serious negative impact of its framework proposals and whether it is creating the right framework for the next decade. We accept that longer allowances are possible, but all parameters must be known to the licensee, including allowances, cost of capital, incentives strength, and these cannot be open to ex-post adjustments.

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

No, we prefer a 5-year review period to a 4+4 arrangement. We do not believe that longer price controls should increase the requirement for more extensive mid-period reviews (MPR), but rather we contend that it is the control mechanisms, such as uncertainty, strong targets linked to allowances, clear close out arrangements and the appropriate use of volume drivers, that allow for longer price controls without wide ranging MPRs. The effective design of a price control should, over time, reduce errors and improve the outcome for customers. This must be seen as an evolution over time.

v. What impact might the alternative option of an eight-year price control with a more extensive MPR have on how network companies plan and operate their businesses?

We prefer a 5yr control period.

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?

SSEN agrees that there needs to be targeted reform. The adoption of a whole system approach is essential to delivering an efficient transition to a low carbon economy. The current structure of the price control does, to a certain extent, allow for the delivery of whole system outcomes. Through the RIIO-1 framework we have worked together with the SO and our DNO business on whole system solutions. As DSO, SSEN considers it is best placed to facilitate and promote the development of whole system solutions and is committed to its enduring role in this area.

We accept that there is no need to align transmission and distribution price controls to enable delivery of whole system outcomes. There is not a significant issue with the boundary between the two that cannot be considered through the ongoing reform in the energy system or through individual licence arrangements. The key challenges facing each sector are different and we expect this to be addressed through the sector specific process. We believe that, irrespective of what part of the system, companies should be incentivised to deliver whole system outcomes.

i. If there are barriers, how do you think these can be removed?

The main barriers to whole system planning and operation at present are that: (i) the DNOs have no incentive at present to consider their system impact beyond their distribution on the wider network and to react accordingly; and (ii) the price signals for parties connecting at distribution are not consistently or accurately cognisant of the wider system impact.

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

In order for the RIIO-2 framework to deliver these outcomes and to make whole system planning business as usual will require action in the following areas:

- Scenario planning
- Information sharing
- Coordination of planning activity
- Broader scope of assessments
- Changes in planning standards and approaches

Significant progress is being made in these areas through improvements driven by industry through, for example, the ENA Open Networks Project.

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 with Ofgem's minded-to position to retain the current start dates for the electricity transmission and electricity distribution price controls and not aligning them. We disagree that not aligning price control start dates creates a risk of policy gaps or locked-in investment for the earlier price control. We believe there needs to be an understanding of the underlying tensions between the two sectors and that designing the most appropriate uncertainty mechanism for each issue is more relevant to the framework than aligning the start dates of the Price Controls. Our stakeholders have raised concerns if the price controls were to be aligned.

However, Ofgem needs to avoid creating a 'second in line' problem for the ED2 price control and its specific design must be considered alongside ET2 and it should not just pick up the left overs. There is not a one size fits all solution.

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 believe that the 'whole system' definition could be taken to represent a wide range of interrelated topics and sectors. The primary focus of 'whole system' for RIIO-2 should be on the interactions between the Electricity Transmission and Electricity Distribution sectors. This is due to the fact the electricity industry is in the process of trying to envisage the issues that will require cross sector interaction between Transmission and Distribution. We believe that to cast the net further in one Price control could lead to poor outcomes for the consumer. In terms of the longer-term objectives of 'whole system' could be extended to the gas networks, heat and transport but this would need to be considered further through learning from RIIO-2.

i. Are there any implementation limits to this definition?

The lack of clarity and specifics within the national policy does not help here. There are wider issues to consider and these are not simply sector specific issues.

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 agree that there should be clear legal and regulatory separation of the Electricity System Operator (ESO) within the National Grid Group. Given its remit across the whole of GB, it is important to ensure that the ESO is sufficiently independent to allow it to adapt to the ongoing changing nature of the electricity industry. The legal and regulatory separation of the SO will also support Ofgem with its ambition to make the new ESO company more clearly accountable to its customers and stakeholders. Separately, we believe there are also benefits in creating a more level playing field across the TOs.

However, SO and TO separation is differentiated from the DSO to DNO relationship and these issues will be explored in the relevant Open Networks forum.

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

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

We believe that the general principle holds that the remuneration models for the electricity SO should be aligned with the policy objective of the price control, and as such, have emphasised the need to decide on what the policy objectives are for the ESO, initially and then with RIIO-2. A key consideration for the remuneration model for the ESO will be how it interacts with the RIIO-2 price controls for transmission and distribution network companies. It is vital that all these regulatory regimes interact effectively to ensure all parties work together to deliver more efficient whole system outcomes. We support Ofgem trying new approaches to regulating and incentivising the ESO which are more aligned with its future aims. However, we recommend that Ofgem carries out a review of this regulatory and legal arrangement in 2020/21 to ensure the development of a single, consolidated regulatory scheme for the ESO under the RIIO-2 framework. Ofgem carries out a review of this regulatory and legal arrangement in 2020/21 to ensure the development of a single, consolidated regulatory scheme for the ESO under the RIIO-2 framework.

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

As highlighted in the previous question, we support Ofgem trying new approaches to regulating and incentivising the ESO. However, we again recommend that Ofgem carries out a review of this regulatory and legal arrangement in 2020/21. This is to ensure the development of a single, consolidated regulatory scheme for the ESO under the RIIO-2 framework.

i. If so, why and what models?

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?

This is a sector specific issue. SSEN have concerns about the impact from a Transmission perspective at this stage, with regards to utilisation. The issue requires a judgement on what it is reasonable for a licensee to 'know' and how it should create and manage forecasts. It is important to recognise that a licensee should not be penalised for making the logical decision at the right time. We do not believe it is right to be held accountable for a later change in consumer/ or stakeholder behaviour.

We accept that getting the balance on what is incentivised is complex and difficult to get right. We believe that a licensee exposure should be limited to the factors that it could reasonably be expected to take into account. We have asked our stakeholders on this and will not know their feedback until later this year. We note that there are already mechanisms to address uncertainty, such as SWW and NOMS, which allow an ex-post view on whether the network made the right decision.

If SSEN was to take on additional utilisation risk then we believe that there would need to be a corresponding adjustment to the return profile.

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?

This can only be a framework decision to consider whether Networks can have a role. The actual role would be contingent on a number of factors, including what the obligations are on networks, how they might be remunerated, where the risks lie and the creation of additional powers / flexibility to enable such outcomes. We view this as a sector specific issue, with more of a DNO and GDN dimension.

However, we believe that with the right licensee arrangement, Networks should be afforded the opportunity to encourage these policy outcomes.

There are broader considerations around what is the policy objective that licensees might have to encourage? Is there a balance between Westminster and Scotland policy differences? Is it just energy use or should it include environmental objectives (of different parts of the GB).

i. What could the potential scale of this impact be?

We believe that you cannot consider the scale of an impact, without articulating the policy objective.

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 in principle with the move of innovation to business as usual. However, we believe there is still a need for general innovation funding and we continue to look to Ofgem to encourage the embedding of innovation across the industry. We support the dedicated funding for some of the material industry issues which are anticipated over the next decade. This recognises the need to maintain pace and consistency in the industry approach. We believe that there needs to be a short-medium term focus on innovation to ensure that it is embedded. We need to ensure that calibration of this is appropriate to encourage innovation.

There is a risk that in removing this funding stream for 'general innovation' the deployment of innovative solutions may take a step backwards. One of the advantages of investing in an innovative solution is the 'optionality' it offers, i.e. it may offer a lower cost opex solution. If the network constraint turns out to be a short-term constraint, more expensive traditional reinforcement can be avoided. However, if it is a longer-term constraint, paying for optionality on top of the ultimate reinforcement is less attractive. Without appropriate support, network companies may be more inclined to forego this optionality?

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 broadly support the three areas noted.

i. We support innovation funding targeted at transitional issues. We request that this is developed in the sector specific strategy.
ii. In principle we support greater coordination with wider public sector funding. However, we need to ensure that the objectives and mechanisms are aligned.
iii. In principle we do not block third party access. However, previous price control experience demonstrates that the balance of risk and opportunity must be well developed. We would like to explore in the sector specific guidance how third parties are incentivised / remunerated and whether the leaning must be shared with industry. The assigning of risk and where the obligations / licence conditions need changing also need to be considered.

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?

As you note, this is a sector specific question. We will look to engage on this between May and October 2018.

We are minded to look at the outcomes that are being encouraged through innovation, rather than the original issue which, as the question suggests, may create a bias towards an innovation type. This must allow the parties involved the opportunity to flex their response to innovation challenged.

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)?

We believe that closer strategic working between funding bodies would be beneficial. These always need to be considered with a clearer view of the 'bigger picture' and how these initiatives are identified and funded. We also need to be cognisant of the basis for the external funding. Consideration needs to be given around any issues raised by Brexit and also how to treat in parallel with a totex environment. We also remain interested into how incentives are managed and set.

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?

It is important that third party engagement is encouraged. We believe that third party involvement remains contingent on the benefits that they can be expected to receive, rather than the benefits being delivered to the customer. Including the commercial market outcome adds a level of complexity to the overall consideration, but it is important they are encouraged to participate. We believe that Ofgem needs to ensure that there is transparency and certainty for the third parties. This will be increasingly difficult to provide in the future if uncertainty is increasing, particularly if the framework is considering adjustments for returns, asset stranding and relative performance measures. In this scenario it remains difficult to measure what performance opportunities remain for licensees and providers, which would be seen as a barrier to innovation rather than an opportunity.

Q14. What form could the innovation funding take.
What would be the advantages and disadvantages of various approaches?

Whilst noting our responses to Questions 11 – 13, we do not have a view on the form of funding at this stage of the process.

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?

We want innovation to occur in all areas of our business. We recognise that not all innovation can be tackled as BAU and larger problems require more complex solutions. If innovation is no longer funded by the customer, then the benefits must flow back to the licensee, and a higher share of the benefits would be expected by the companies involved. This doesn't fit into the concept of limited returns, particularly with regards to the risk profile, with customers having access to all the benefits and no risk. This is another calibration issue that needs to be addressed.

In terms of monitoring, we could develop benefits monitoring through use of Stakeholder panels, perhaps similar to the stakeholder engagement process. However, if innovation is being pushed into business as usual then there would be no reason to monitor.

Competition

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

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

It is important to recognise that competition already has a central role to play in the activities of all network companies. This is achieved through well-defined and tested procurement processes. We note Ofgem's commitment in RIIO-2 to consider what further role competition could play across the electricity and gas, transmission and distribution sectors. We are broadly supportive of competition where, as outlined by Ofgem in this consultation, it is appropriate and provides better value for consumers. However, we remain concerned that despite Ofgem stating that it intends to use the RIIO-2 framework to consider what further role competition will play, it is already in the process of developing models for introducing competition to onshore electricity transmission, with very little stakeholder engagement. This piecemeal approach creates considerable risk and uncertainty for the market as a whole. Without effective stakeholder engagement and the appropriate legislative and regulatory framework, there is a significant risk that models to introduce competition will be implemented poorly leading to detrimental impacts across all sectors. We have most recently highlighted these concerns in our 20 March 2018 Hinkley-Seabank response and are continuing to engage with Ofgem on such matters.

In our view, the best way to approach the proposed extension of competition across the sectors is through engagement with all affected stakeholders, including extensive consultation and a full Regulatory Impact Assessment. We think it is important for Ofgem to clearly set out the end-to-end process it proposes to operate to ensure that it takes an evidence-based decision on whether or not competition is the most appropriate policy intervention on a sector by sector and also a project by project basis. This will allow all stakeholders who may be affected by any such decision to make the appropriate representations.

We remain a strong advocate of Ofgem's ongoing ambition to secure primary legislation to underpin the extension of competition in transmission and we would encourage Ofgem to continue to work with Government to bring the necessary legislation through parliament. Our views on this are consistent for the proposed extension of competition across all sectors, that is, primary legislation is the appropriate vehicle to extend competition across the energy sectors.

We are committed to working closely with Ofgem in this area to ensure that customers wishes are reflected and the best outcomes delivered.

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

i. If so, what alternative criteria might be suitable?

It continues to be our view that any significant regulatory development of this nature must deliver meaningful benefit to consumers and that the regime introduced is robust, workable and developed in conjunction with those industry parties most likely to be affected. The 'new, separable and high value' criteria were developed for onshore electricity transmission through a process of stakeholder engagement, underpinned by a commitment from Ofgem to secure primary legislation. Although progress has been made through previous consultations and a series of expert working groups, there is significant work still required to develop a detailed, robust and workable framework for competition for onshore electricity transmission and the other sectors. We have previously raised our concerns regarding the benefits that Ofgem expects to realise through running of a competitive tender for onshore electricity transmission and that that further work was required to test the assumptions within the 2015 Impact Assessment to determine a more appropriate 'high value' threshold. We have also previously shared our views that Ofgem's criteria for competition is incomplete (most recently in our 20 March 2018, Hinkley-Seabank response), and that critically, a decision on the suitability of competition must be made subject to an evidence based assessment as to whether it is in the best interests of consumers and other affected stakeholders. We continue to believe that an approach which tests the potential benefits on a case-by-case basis would lead to a more meaningful assessment of the likely costs and benefits of any competitive approach and therefore provide a more appropriate justification of whether or not it is appropriate to tender a given project. This was the conclusion from the pre-legislative scrutiny of the Government's draft legislation on energy Sixth Report of Session 2015-2016[63].

At this stage we do not believe that Ofgem has suitably addressed the benefits of extending competition, and assessing whether the current 'new, separable and high value' criteria is suitable, across all four sectors. Ofgem needs to identify how the net benefit, if there is one, is realised. We would like any extension of competition to be subject to guidance from Parliament to Ofgem, such that decisions taken would be consistent with wider Government energy policy and the public interest. Currently, there is not a clear legislative and regulatory framework against which its merits can be judged, with the proper levels of scrutiny and challenge afforded by that process. This needs to be considered by each individual sector and be conditional on the guidance from Parliament on the policy objective of competition, which are all missing currently.

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

i. What are the key challenges in the implementation of such models, and how might we overcome them?

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[63] Pre-legislative scrutiny of the Government's draft legislation on energy Sixth Report of Session 2015-2016, published 4 May 2016 (https://publications.parliament.uk/pa/cm201516/cmselect/cmenergy/776/776.pdf)

As outlined above, significant work is still required to understand what role competition should play across the sectors. In the absence of a well-established and understood policy framework, the development of potential models for early or late stage competitions is premature.

In light of this, we think it is important to take this opportunity to highlight our concerns with Ofgem's ongoing work on developing models for SPV and Competition Proxy which are being considered outside of the RIIO-2 programme. SSEN are a strong advocate that this parallel work should cease and instead be addressed as a package of work as part of the RIIO-2 framework, where all interested parties can input into its development.

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?

i. When might relative or absolute targets for output delivery incentives be appropriate?
ii. What impact would automatically resetting targets for output delivery incentives during a price control have? Which outputs might best suit this approach?

We note that Ofgem intends to continue using outputs and incentives, but is considering how to modify this going forward. We would welcome simplification rather than additional levels of complexity. We recognise that a price control is complex, with many moving parts. It is important to acknowledge that the totality of the price control is viewed 'in the round', as noted in 6.14. We expect Ofgem to remain consistent with this principle. We are yet to be convinced that there is a need to change from the principles introduced in RIIO-1.

There is a significant risk that this could blunt incentives and it therefore needs to be considered as part of the overall package proposed.

i. Our view on the proposed model, with the consideration of additional measures to determine relative or absolute targets, with additional moving yearly targets, is excessively complex. We will look at the detail within the sector specific consultations to provide a view on absolute and relative targets.
ii. At this stage without details this concept is hard to critique, but recalibrating during the price control period also adds to uncertainty.

Our approach to setting cost allowances

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

We support the use of uncertainty mechanisms, ranging from volume drivers to re-openers. These mechanisms are all available to Ofgem in the current RIIO-1 framework and we encourage their continued use in RIIO-2. We accept that there will be areas of improvement proposed, where the need can be justified, and as such we continue to see RIIO-2 as an evolution, rather than revolution.

We reserve our comments on cost allowances for the sector specific consultations, rather than at the framework stage. We remain generally supportive and look forward to debating the material components within the context of each sector.

Our position remains that changes to the general approach must be grounded on evidence that the customer will be better served by an alternative arrangement. This must recognise the new risks introduced as mechanisms are change or replaced.

As Ofgem seeks to drive out uncertain outcomes, through uncertainty mechanisms, there is an argument that what remains should not be expected to experience the same levels of efficiency. It doesn't hold that past performance improvements will be the same in the future. We would expect to discuss this going forward.

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

We are not opposed to the use of indexation as a tool, with regards to RPEs. In 2014, our response to the consultation on the implementation of RPEs was primarily associated with the late timing of the introduction as part of the RIIO-1 process. If the evidence supports indexation as an improvement, ahead of the previous ex-ante allowance, then we would accept this as a better measure. We would strongly encourage Ofgem to consider what the impact on RIIO-1 would have been with indexes, at that point in time. We believe that the best decision was made, with the available information and forecasts. If in RIIO-2 the evidence supports a different approach, then we will consider the modification.

We do not believe that re-opening during a price control is good for regulation and confidence in settlements. Improvements can and should be implemented where there has been a failing, but we believe this should not be in-period, but rather in preparation for RIIO-2.

Should there be a risk that price controls can be re-opened and materially changed during a period, this would increase the level of uncertainty and make companies harder to finance.

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 believe that resetting cost allowances must be considered alongside questions of uncertainty, cost of capital and the longer term view of the sector.

We view there to be significant risks in the potential introduction of continuous 'mini-price controls', if cost allowances are reset in period. This introduces uncertainty which can increase costs. Ofgem would be required to continually assess what is controllable and what is not. Ofgem notes it is unable to set allowances without introducing errors and by increasing interactions, the risk of errors increases, rather than decreases.

We acknowledge that Ofgem is attempting to drive competition within the sector, and increase efficiency and reduce costs. However, rather than addressing this on a company by company basis as in past price controls, and drive each company to improve over the period, Ofgem wants to add a level of complexity that could drive the wrong behaviours and not be in the customer's best interests. There is a risk that any change could lead to perverse incentives, leave vulnerable to gaming in the short term and also raise the possibility of windfall gains/losses.

In terms of competition, how would this impact projects that have been through the process and secured funding based on the information at the time? We would be concerned if this impacted on allowances going forward.

We favour and advocate an 'in the round' approach to regulation. With a shorter price control there seems to be less logic behind correcting in period, as performance will be monitored over a shorter period and the risk of errors should be reduced and corrected more rapidly than in an 8-year model.

Information-revealing devices

Q23. Do you agree with our assessment of IQI?

We believe companies will react and respond to incentives for information sharing. Ofgem needs to consider additional factors in evaluating IQI effectiveness, as highlighted at the recent workshops on this topic.

We urge that Ofgem ensure that it does not close its mind but keeps the options open, and considers whether amendments to IQI are needed at all.

The indication from the recent workshop was that IQI was not overly complex, rather that Ofgem has failed to undertake a proper review on the effectiveness. We again note that in order to implement or consult in changes in the regulatory framework, Ofgem should be undertaking this analysis prior to consulting on any changes. Once the analysis has been undertaken, we would like to be able to comment on the effectiveness of IQI, on the basis of observed and quantifiable evidence.

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

We accept the position that fast tracking could be replaced. However, this is contingent on a suitable reward/penalty mechanism being introduced to deal with the quality of business plans.

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

i. How might these apply in the different sectors?
ii. Should we retain the IQI, amend it or replace it entirely?

As demonstrated in our responses to Q23 and Q24, SSEN values strong incentives. We do not believe there to be strong evidence to remove IQI and, if fast tracking was also to be removed, we believe a suitable reward / penalty mechanism should be introduced to measure the quality of business plans.

We would like Ofgem to present an assessment of IQI and fast-tracking before deciding that these measures are not fit for purpose, or consulting on any changes in the RIIO-1 framework. We caution against drawing a conclusion and for considering a range of options without ascertaining what the issues are.

We are happy to consider simplification as part of the overall assessment, but at this stage we are unable to comment further without details.

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 need to hear what Stakeholder's requirement are. If Ofgem is to assess stakeholder differentiated plans, then it suggests it needs to create a strong incentive for networks to fully justify and evidence their plans. This is likely to be developed under sector specifics, once it can be considered in the context of what stakeholders require from licensees, what outputs/targets are being considered and where the risks lie.

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 that IQI should be retained. We do not offer at this stage a view on how Ofgem should differentiate plans, or the factors to be considered. We recognise that Stakeholder Panels can offer a good guide to differentiate efficiency incentives as they are in a good position to determine the quality of business plans, the level of risk the companies are taking in their approach to delivering outputs from the allowance it is proposing.

However, there are issues by limiting the Stakeholder Panels ability to consider the network companies risk in its entirety. Unless cost of capital is discussed to ensure that the panel have a holistic view of how well the business plan is constructed as a package. Ofgem may wish to include a measure based on the Littlechild principle?

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

We believe that an explicit upfront financial reward is required to incentivise network companies to submit high quality business plans. The real issue for the industry is introducing and implementing the tools to provide confidence that the business plans do represent high quality and not information asymmetry. The role of stakeholder engagement groups scrutinises and challenges business plans to ensure they are based on robust assumptions with strong evidence. The success of the IQI mechanism can be demonstrated in the RIIO-1 price control. Ofgem's assessment of outturn performance against forecast in RIIO-1 highlight that companies were performing better than forecast and Ofgem believe this questions the effectiveness of the upfront reward incentives as the initial forecasts were inaccurate. However, this is exactly what they are required to do. The delivery of performance improvements and the Totex Incentive Mechanism (TIM) should lead to this outcome. This highlights that this variation in performance should be viewed as a failing of the IQI mechanism, but in fact delivered the desired outcome.

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

We do not support this view. We would expect an assessment to be undertaken to consider whether fast tracking delivered benefits. There has also been no attempt to assess the cost and benefits of removing fast-tracking. We await further details from the sector specifics to highlight what efficiency incentives would be in place, should fast tracking be removed and only one business plan submission be required.

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 noted in Q29, we believe that due to the lack of substantive views or evidence present by Ofgem in the consultation it is challenging for us to offer a view on the matter. At present, we would have to make too many assumptions to arrive at our position. SSEN are supportive of the role of enhanced engagement from stakeholders for Network companies producing better Business Plans, but we strongly oppose the view that there is a need to remove upfront rewards, such as IQI or FT, as an incentive.

Annual reports/reporting

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

We welcome steps to improve reporting. We encourage simplification where possible, removal of duplication and upfront agreements for any changes in reporting requirements.

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

Our view on annual reporting requirements is that they are the by-product of the price control framework and sector settlement that is reached. The reporting requirements can be designed to meet each mechanisms requirement within the Price control. Ultimately it should be easy to understand and translate to something that each stakeholder would recognise.

The overriding objective should be to reflect the learning from the Enhanced Engagement process. A key question is what did stakeholders value in the engagement process and how effective were the network companies in communicating the objectives and justifications of its RIIO-2 proposals. The industry should be responsive to adopting and implementing alternative solutions as the process develops. We have previously made it clear that describing network performance using the most relevant metric for Stakeholders is key. SSEN consider RORE to be of limited use and we strongly encourage the industry to reflect the actual return of capital which, ultimately, the customer is contributing towards.

In communicating performance, we believe there should be linkages to outputs and commitments. This would help inform our stakeholders. We should endeavour in all our documents to use plain English and remove technical language they might not understand.

Chapter 7 – Fair returns and financeability

We believe it is too early in the RIIO-2 process to conclude firm or constrained policy positions on any of these elements and encourage Ofgem to undertake a full review over the course of the Price Control. This is consistent with best practice and avoids unnecessarily early decisions being taken which in turn would limit the review of the price control in the round.

Cost of debt

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

We have set out our response to the policy objectives and principles in section 3 of our response.

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 have set out our views of the options in section 3 of our response and why our proposal is the most appropriate to move forward absent any form of impact assessment or further evidence.

Cost of equity

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

Our response in section 3 clearly demonstrates the issues identified with Ofgem's proposed methodology albeit this is not really a clear methodology being proposed. This is using work undertaken by Oxera for the ENA in reading the evidence including the UKRN study and CEPA review.

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

i. Do you have views on our proposal for indexation?

Cost of equity indexation is a complex area and requires significant further review and an impact assessment. We have therefore detailed our response in section 3 of this response.

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 do not see the benefits of transitioning to any form of financeability adjustment in the absence of any justification from Network companies. Our view is in line with Ofgem's previous best practice in that financeability is a test and not a standard mechanism to be deployed in a price control unless justified. The options being proposed are flawed and are being outlined as standard mechanisms without adequate evidence, Impact Assessment or justification in Ofgem's documents.

Our response is in section 3.

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

This is addressed in section 3 of our response.

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

This is addressed in section 3 of our response.

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)?

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

This is addressed in section 3 of our response.

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)?

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

This is addressed in section 3 of our response.

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?

This is addressed in section 3 of our response.

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?

This is addressed in section 3 of our response. This is an area reviewed as part of business plan preparation for RIIO-2 and not something which warrants review 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?

Scottish & Southern Electricity Networks

Further analysis is required to ascertain under which circumstances additional revenue will be invoked to support further fundraising, or whether this is more appropriately handled in generic and extreme circumstances which may or may not persist into RIIO-2 and may form part of sector specific consultations as these develop.

This is addressed in section 3 of our response in more detail.

Ensuring fair returns

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

We have considered the models proposed and present a critique of each in Section 2 of this response.

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

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

There are several metrics in which Ofgem and other parties should consider when measuring the performance of Network companies. We see it as an important output of the RIIO-2 (and part of RIIO-1) to ensure that the most appropriate, accurate, informative and fair presentation of performance is provided to stakeholders. We believe their resides a gap in interpretation and presentation of information on financial performance and that this would benefit all stakeholders to develop and clarify.

For example, when considering the performance of Network companies, the EICU utilised a measure of operating profit which fails to recognise the capital investment undertaken during the same period and any injection of equity from shareholders. Similarly, Ofgem have continued to use RoRE while also developing RIIO Accounts separately during RIIO-1. When we consider our engagement with internal and external stakeholders, we have identified a number of issues with any single approach in considering Network company financial performance. We have summarised these below.

§ Use of a common, well understood, metric for estimating financial performance;
§ Timely presentation and communication of financial performance to stakeholders;
§ Avoiding complexity while retaining the richness of information for stakeholders; and,
§ Applying any framework consistently across all Networks, while identifying other metrics such as customer bills, network reliability and customer service to outline Network performance.

In terms of proposing options for consideration, we have and continue to advocate for use of a Return on Capital Employed (ROCE or Return on Investment – ROI). The RoRE is a proxy for the Return on Equity but fails to consider the rate of return on investment and as such ignores the capital investment, scale of the business (through the RAV) and the impact on consumer bills through the use of the cost of debt mechanism selected. SSEN refer to this as our post tax real return or post tax WACC which includes any impact on of incentives and outputs in the RIIO model. We believe this would also have the advantage of consistency with other return metrics which are commonly used across adjacent industries that underpins investment decision making financial criteria. We believe this will help stakeholders and customers understand how much they have paid similar to interest on their mortgage or a rate of return they expect on these investments. There are other measures worth considering regarding holistically capturing the rate of return, however, we do not believe they are superior compared to using the rate of return on capital invested.

Chapter 8 – Next Steps

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

SSEN believes that RIIO-2 needs to build on from the excellent work undertaken in RIIO-1. At this stage in the process, it is fundamental that Ofgem recognise the positives and the negatives and takes steps to implement changes where necessary that will build a stronger framework to further improve RIIO. We recognise that much of the detail will only come out later in the sector specific proposals and we reserve further judgement on the impact of any modifications until this time. We would caution against any broad changes that risk imposing further regulatory burdens at the expense of the improvements already delivered.

We have real concerns that Ofgem may be understood, or consider itself, to be proposing to make decisions on price control components at this early, framework stage in the context of aspects which are highly interdependent on the outcome of the sector specific process, the position as to evidence and impact, and overall calibration of the price control package as a whole.

SSEN considers Q47 to be of fundamental importance in relation to ensuring RIIO-2 is calibrated correctly and follows the appropriate steps. We have sought advice and in the following section highlight some of our concerns, particularly in relation to the language used. We seek clarification on the proposed decision points and the interlinkages of the positions in relation to the overall package.

Concerns

Under the heading "Confirming our decisions on issues considered in this consultation" (emphasis added):

(1) Ofgem begins (§8.6): "We have set out our proposals for our RIIO-2 framework in this consultation as well as seeking early views on a number of other issues. We aim to reach a decision on the RIIO framework as a package of measures in summer 2018".

(2) It adds (§8.6): "However, our thinking on the detailed design of the individual price controls will need to be developed further as part of our sectoral proposals".

(3) Ofgem then refers again to "our decision on the RIIO-2 framework in summer 2018" (§8.7), saying "we will make a decision on" certain matters which are described in 15 bullet points (for clarity, "8.7BP1" to "8.7BP15").

(4) Next, Ofgem says (§8.8): "As we develop the sector-specific price controls, we will then confirm our position on a number of other topics, including issues we have raised in this consultation. Through this process we will consider interlinkages and interactions of a number of policy areas" which "policy areas" are then described as "including" a further 15 bullet points.

(5) Ofgem continues (§8.9): "Confirmation of our positions on the above issues will form part of our overall package of proposals to be developed, in conjunction with stakeholders, through the sector-specific stages and beyond".

(6) As to that later sector-specific "confirmation", of "positions" on "the above issues", Ofgem identifies four themes (§8.9) (numbering added for convenience):

"This will consider in more detail (i) what we expect network companies to deliver; (ii) what their role will be in managing the energy transition; (iii) how companies will be financed for these activities; and (iv) how network companies use the business planning and stakeholder engagement processes to demonstrate how they will deliver at an efficient cost for current and future consumers."

(7) Ofgem then says (§8.10): "We have outlined some of the interlinkages between related components of price control in this Framework consultation and <u>in developing the price controls we will be considering these interlinkages further</u> to ensure that the impact on network companies, investors and ultimately on customers are <u>considered based on the whole package of measures</u>".

(8) Ofgem then invites views as follows: "We welcome views on <u>what we have set out so far</u> and <u>what we will need to consider</u> in developing the sector-specific proposals".

(9) Finally, Ofgem's question (Q47) on "Next steps" is this: "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?"

SSE wishes to address with Ofgem the concern that some of this language could be read as suggesting that Ofgem is envisaging it will (i) proceed to reach a <u>fixed and closed-off</u> "decision" in summer 2018 on a first category of questions (§8.7), while it would (ii) keep its thinking on a second category of questions <u>unfixed and open-minded</u> (§8.8).

SSE does not believe that this is what Ofgem actually intends to do, nor could legitimately do. There would be very significant problems with this. Ofgem needs to be clear that it is not envisaging fixed determinative decisions on key features of the price control, at this framework stage. Because it is an important point, SSE will address in more detail whether Ofgem is proposing (March 2018) a fixed and closed-off set of decisions (summer 2018). That could not be right.

(1) It would mean that Ofgem would be stating a position, at this very early stage, which commits to its thinking on fifteen important topics (8.7BP1 to 8.7BP15) becoming fixed in the summer of 2018. That would mean Ofgem is saying, in the spring of 2018, that as at the summer of 2018 (a) it will no longer have an open mind (b) it will be unwilling to revisit its thinking (c) it will be unwilling to consider evidence and (d) it will be unwilling to listen to representations. The decisions on the 15 topics would be cast in stone.

(2) This could not be right in principle. It would mean issues had been closed off and predetermined, before any proposals have been put forward for any specific sector, with any evidence base, and with any impact assessment. It would also present those who disagree with Ofgem's position (on the substance, or the process, of it having adopted that fixed position) with a dilemma of principle, as to (a) awaiting the further decisions on price controls with a view to exercising the statutory rights of appeal or (b) having to bring a judicial review of a framework decision. Is Ofgem really wishing to encourage judicial review, at the start of the price control consultation processes, because it has foreclosed on important issues and those affected need to vindicate their rights? SSE suggests that this would be in nobody's interests.

(3) It would not make sense in the context of seeking to identify a "framework". Indeed, it would be unprecedented for Ofgem to use a "framework consultation" so as to fix decisions on key issues. It would also be particularly unsatisfactory in the context of a price control, where moreover it is very well recognised that the stage at which focus and crystallised thinking is appropriate are "the sector-specific stages and beyond" (§8.9). That is when there will be evidence and submissions relating to the particular sector, in the context of particular proposals and against a backcloth of evidence and impact assessment. It would be entirely out of step with the experience of price controls for key issues to be cast in stone at a broad, initial stage. It is only at the "sector-specific stages" that Ofgem will have confirmed "positions", in which there will be an "overall package" (§8.9). The different aspects of that package will interrelate in an integrated whole, and it will be essential to consider adjustments in components of the package. It

would be artificial and constraining if some parts of the "package" were evaluated with open-mindedness, while others were not. That fixed approach would, moreover, be inconsistent with an "overall package <u>of proposals</u>", where there are to be those "proposals" are "developed, in conjunction with stakeholders" at "the sector-specific stages" (§8.9). The idea of "proposals" is inconsistent with fixed decisions cast in stone.

(4) The questions at §8.7 are not, by their nature, apt for a fixed and final decision to be made at this stage. Nor, looking at the language of them, can casting them in stone in summer 2018 be truly what is envisaged. If Ofgem wishes to identify "enhancements to … models for stakeholder engagement" (8.7BP1), there is absolutely no reason why this ought to be the last word on what "enhancements" and "engagement" is appropriate. If Ofgem is identifying a "default" position as to "length of price control" (8.7BP2), that could be no more than its thinking as to a presumptive starting-point. Similarly, "updates" to an "indicative range" (8.7BP10) are by nature provisional. To identify "a position" on something (8.7BP3) or an "approach" to something (8.7BP7, 8.7BP8), or a "methodology" for something (8.7BP10), does not mean the position, approach or methodology is free from review, re-evaluation and modification as the thinking, evidence and concrete integrated proposals emerge and develop. The same point can be made of descriptions of Ofcom "retaining" something (8.7BP5), or that Ofgem "will extend" something (8.7BP6). To identify a "direction of travel" (8.7BP3, 8.7BP5) involves, by its nature, that a change of direction is possible, before any destination of travel is arrived at. When Ofgem speaks of what it envisages it will "propose" in summer 2018 (8.7BP9, 8.7BP10, 8.7BP11, 8.7BP12, 8.7BP13) that makes the point: the decision will be to make a proposal. Similarly, to speak of "options" which Ofgem may "propose" to "develop further" (8.7BP9) or "take forward" (8.7BP10, 8.7BP11, 8.7BP12) does not and cannot mean that Ofgem has identified options which are being determinatively ruled out.

(5) This position is reinforced by Ofgem having stated that, in confirming its "position" on issues which "form part of our overall package of proposals" which are "to be developed, in conjunction with stakeholders" at the "sector-specific stages and beyond", Ofgem will "consider in more detail" these four key questions: "(i) what we expect network companies to deliver; (ii) what their role will be in managing the energy transition; (iii) how companies will be financed for these activities; and (iv) how network companies use the business planning and stakeholder engagement processes to demonstrate how they will deliver at an efficient cost for current and future consumers." The bullet points in §8.7 are topics which directly relate to these four key questions, on which the imperative for open-mindedness and ongoing consideration has been recognised at §8.9. The same is true of the "interlinkages" to be considered further after summer 2018 "to ensure that the impact on network companies, investors and ultimately on customers are considered", based on the "whole package of measures" (§8.10) which is itself described as the "overall package of proposals" (§8.9).

(6) Finally, this approach would explain why Ofgem has only asked the single question at Q47. The "interlinkages and interactions" in the question (Q47) must be taken to be a description of the whole preceding passage (§§8.6-8.10), including the bullet points at §8.7. Otherwise, Ofgem would inexplicably have asked only about its approach to the questions §8.8 (which it was supposedly leaving open), and not to those in §8.7 (which it was supposedly fixing). That would be illogical, indeed bizarre. Once it is recognised that "the interlinkages between related components of the price control" is a description of all of §§8.6-8.10, then everything falls into place: that broad category of "interlinkages" are precisely what Ofgem says "we will be considering further" when it comes to "developing the price controls" (§8.10).

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

We remain cautiously supportive of improving RIIO-1 and implementing changes, where justified. We look forward to discussing these points as they are revealed in the sector specific documents. We repeat the points made above in the context of Q47.

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?

We remain cautiously supportive of improving RIIO-1 and implementing changes, where justified. We look forward to discussing these points as they are revealed in the sector specific documents.

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 are aware of the pressures on RIIO-2 timescales, particularly in relation to Transmission. We note that we will strive to achieve the best outcome in the time available. There are less concerns over the ED2 timings. We caution against drawing conclusions on RIIO-1 outcomes, where the price control is still in progress.