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RIIO Team
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14th March 2019

Dear RIIO Team,

Response to Ofgem's "RIIO-2 Sector Specific Methodology"

I am writing on behalf of ESP Utilities Group ("ESPUG") (comprising the licensed companies ES Pipelines Ltd, ESP Connections Ltd, ESP Networks Ltd, ESP Pipelines Ltd and ESP Electricity Ltd). We welcome the opportunity to respond to Ofgem's "RIIO-2 Sector Specific Methodology" consultation paper ('the 'Consultation Paper'), dated 18th December 2018.

In summary, ESPUG broadly supports the proposals as they stand with the following observations and caveats:

- The RIIO 2 price controls face unprecedented challenges as a result of decarbonisation. Each of the networks under price control faces a different challenge:
    - Gas Distribution Networks (GDNs) will need to support local energy projects, and ensure their networks are able to safely deliver gas to customers from new sources such as Hydrogen and bio-gases. It is likely that this will come towards the middle or end of GD-2.
    - Electricity Distribution Networks may need to invest in their networks and systems to support increased uptake of EVs as a result of Government's Road to Zero strategy, and the potential electrification of heat.
    - Redistribution of generation and capacity across the grid will lead to greater business planning complexity and volatility.
    - The System Operator will face challenges from the impact of storage and large scale renewables.
    - For all the networks there will be more data about consumption than ever before.
- We are expecting a single price control approach to provide solutions for the diverse list of challenges listed above. There are a common set of issues that we believe Ofgem should give consideration to, and appear to be missing from the consultation:
    - Notions of efficiency - these will need to be recalibrated as consumer utilisation of networks will change. It is likely that there will be a certain amount of network capacity that will only be used periodically (e.g. as a

result of renewable generation), but the fixed costs of providing network availability remain, regardless of whether the network is used or not.

    - Demand is inelastic in the short term – this is particularly important to consider for some vulnerable groups of consumers. From this it follows that networks will continue to invest in capacity for demand that cannot be shifted either by location or time.
    - Issues associated with customer service remain key. Any allowances that have funded excellent service for the networks should continue where there is a clear benefit to customers.

- Independent Gas Transporters and Independent Distribution Network Operators have not featured in the price control and in the Impact Assessment in particular. Competition in this sector will undoubtedly be influenced by the control, as will the value of the existing networks.

Finally we would point out that this approach to price control creates a highly complex process. The consultation itself is 215 pages of text alone without the supporting documentation. We would suggest that a concise summary document should be developed once final decisions have been made.

Our detailed comments are set out in the appendix to this letter. If you wish to discuss any of the issues raised in our response or have any queries, please contact Sebastian Eyre on 01372 587500.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

Sebastian Eyre
Regulation

ANNEX
Answers to consultation Questions

CSQ1. Do you have any view on our proposed approach for considering the extent to which a successful appeal has consequences, if any, on other components of the price control?

We agree with a case by case approach. We would hope the CMA would consider the price control as an overall package.

CSQ2. Do you agree with our proposed three new output categories?

We broadly agree with the output categories defined on page 24. We note that meeting the needs of consumers and network users would also include environmentally sustainable consumers a safe and resilient network. Are they subsets of each other?

CSQ3. Are there any other outcomes currently not captured within the three output categories which we should consider including?

We can see no obvious new category.

CSQ4. Do you agree with our proposed overarching framework for licence obligations, price control deliverables and output delivery incentives?

Yes we broadly agree. Using both ODI (Output Delivery Incentive) and PCD (Price control Deliverables) makes sense. We would suggest that in practice Ofgem seek to limit themselves to one or other of the incentives if at all possible to avoid increasing complexity.

CSQ5. Do you agree with our proposals to introduce dynamic and relative incentives, where appropriate? Are there any additional considerations not captured in our proposed framework which you think we should take into account?

In theory this looks like a good idea and we broadly support. In practice this proposal may unintentionally create a certain amount of uncertainty in the form of regulatory risk if the drivers for a networks performance are beyond their control.

Furthermore dynamic and static incentives need to take account of the prevailing conditions within a network's region and the relative cost of customers getting the same service for networks with different customer densities.

CSQ6. Do you agree with our proposals to allow network operators to propose bespoke outputs, in collaboration with their User Groups/ Customer Challenge Groups?

Yes we see no difficulty for networks to propose bespoke outputs with the CCGs.

CSQ7. When assessing proposals for bespoke financial ODIs, are there any additional considerations not captured which we should be taking into account?

No.

Enabling whole system solutions questions

CSQ8. Do you feel we have defined the problem correctly?

Yes.

CSQ9. What views do you have on our proposed approach to adopt a narrow focus for whole systems in the RIIO-2 price control, as set out above?

Ofgem's approach is pragmatic but may ignore some of the wider benefits of thinking about networks and generation *combined*.

CSQ10. Where might there be benefits through adopting a broader scope for some mechanisms? Please provide evidence.

We have not identified any benefits of adopting a broader scope as this identification was not a priority right mow.

CSQ11. Do you have reasons and evidence to support or reject any of the possible mechanisms outlined in this chapter? Do you have views on how they should be designed to protect the interests of consumers?

We have no reasons to reject this view. The success or failure of the proposal is linked to effective coordination.

CSQ12. Which of the possible mechanisms we have outlined above could pose regulatory risk, such as additionality payments or incentivising the wrong behavior?

We have no preference. However good and explicitly detailed regulatory design will be key for each of the options presented.

CSQ13. Are there obstacles to transferring revenues between networks that disincentivise those networks from using a coordinated solution (please give details and suggest any changes or solutions)?

Whole systems benefit will often relate to avoided costs that might be difficult to convincingly prove.

CSQ14. Can you recommend approaches that would better balance financial incentives between networks to enable whole system solutions?

Not at this time. The issue relates to an effective coordination incentive and contract design between parties.

CSQ15. Are there other mechanisms that we have not identified that we should consider (please give details)?

No.

CSQ16. Are there any additional framework-level whole system barriers or unlocked benefits, and if so, any price control mechanisms to address these?

We do not see any at this moment.

CSQ17. Are there any sector specific whole system barriers or unlocked benefits, and if so, any sector specific price control mechanisms to address these?

N/A

CSQ18. Which of the proposed mechanisms would be most suitable in circumstances where a broader definition of whole system is likely to deliver benefits to network consumers?

We think generation and storage should be considered more explicitly and under a broader definition of whole system to deliver benefits to network consumers. This would lend itself to a business plan incentive.

Asset resilience questions

CSQ19. Do you agree with our proposals to use monetised risk as the primary basis for network companies to justify their investment proposals for their asset management activities?

Yes we broadly agree.

CSQ20. Do you agree with our proposals to define outputs for all sectors using a relative measure of risk?

Yes we broadly agree. We note that Figure 1 p44 is slightly stylised in that there will be a downward pressure on risk though natural life of asset replacement not linked to an active NARM strategy.

CSQ21. Do you agree with our proposals for defining outputs using a long-term measure of the monetised risk benefit delivered through companies' investments?

Yes we broadly agree but we note significant work is required to develop these proposals.

CSQ22. Do you agree with our proposed approach to setting allowances and outputs?

Yes we agree.

CSQ23. Do you have views on the proposed options for the funding of work programme spanning across price control periods?

This will be critical for the networks as any transition to Hydrogen may start to occur towards the end of GD-2 and the start of GD-3. This leads us to support option 2 (6.33 p46).

CSQ24. Do you have any views on the options and proposals for dealing with deviation of delivery from output targets?

We agree with Ofgem's incentive mechanisms.

CSQ25. Do you have any views on the interaction of the NARM mechanism with other funding mechanisms?

No.

CSQ26. Do you have any views on ring-fencing of certain projects and activities with separate funding and PCDs? Do you have any views on the type of project or activity that might be ring-fenced for these purposes?

Yes it makes sense to ring fence some high value projects. We hope this will include decarbonisation projects such as the roll out of hydrogen networks.

Workforce resilience

CSQ27. Where companies include a sustainable workforce strategy as part of their Business Plans, what measures do you think could be established to hold companies to account for delivering these plans, without distorting optimal resourcing decisions?

We agree with the proposals set out on p55. We think this is a strategic issue and networks can choose to skill their workforce in house and use NVQ qualification route for a larger number of roles.

Physical Security Questions

CSQ28. Do you agree with maintaining the existing scope of costs that fall under Physical Security, i.e. costs associated with the PSUP works mandated by government? Please explain your reasons and suggest alternative definitions you believe should be considered.

Yes. We suggest it is a legitimate cost of doing business no different conceptually to passing through mandated requirements by the HSE.

CSQ29. Do you agree with our proposed approach of ex ante allowances for PSUP works mandated by government? Please explain your reasons and suggest alternative approaches you believe should be considered.

We agree and see little scope for any significantly better alternatives.

CSQ30. Do you agree with our proposal to include a reopener mechanism to deal with costs associated with changes in investment required due to government-mandated changes to the PSUP?

Yes.

CSQ31. We would also welcome views on the frequency that is required for any reopener, e.g. should there be one window for applications during RIIO-2 and, if so, when?

This should be on a case by case basis not constrained in advance.

Cyber Resilience

CSQ32. Do you agree with the scope of costs that are proposed to fall under cyber resilience, i.e. costs for cyber resilience which are (1) incurred as a direct result of the introduction of the NIS Regulations, and (2) above 'business-as-usual' activities? Please

explain your reasons and suggest further or alternative costs you believe should be considered.

Yes as the security standards are relevant given the importance of the network to the country.

CSQ33. Do you agree with our proposed approach of ex ante 'use-it or lose-it' allowances? Please explain your reasons and suggest alternative approaches you believe should be considered.

Yes.

CSQ34. Do you agree with our proposal to include a re-opener mechanism for cyber resilience costs? Please also provide your views on the design of the re-opener mechanism.

Yes.

Real price effects

CSQ35. Do you have any views on our proposed factors to consider in deciding on appropriate input price indices? Do you have any evidence justifying the need for RPEs and any initial views on appropriate price indices?

No. The key issue relates to the degree of representativeness of the indices on network costs.

CSQ36. Do you agree with our initial views to retain notional cost structures in RIIO-2, where this is an option?

Yes.

CSQ37. Do you agree with our initial views to update allowances for RPEs annually and to include a forecast of RPEs in allowances? Do you have any other comments on the implementation of RPE indexation?

Yes. However, there may a case to be made for requiring higher allowances on a yearly basis that diverge from RPE indices.

Ongoing efficiency questions

CSQ38. Do you agree with our proposal to use the EU KLEMS dataset to assess UK productivity trends? What other sources of evidence could we use?

Yes.

CSQ39. Do you think there is a need for a utilisation incentive at the sectoral level? If so, how do you think the incentive would operate coherently with the proposed RIIO-2 price control framework for that sector?

No. We do not see a case for its introduction.

Managing the risk of asset stranding questions

CSQ40. Do you have any views on our direction of travel with regard to anticipatory investment?

We think the direction of travel is helpful and in particular developing links between Government and the regulator similar to the ENSG.

CSQ41. What type of projects may be appropriate for a risk-sharing approach?

We would expect projects that have a clear link to energy policy that would not otherwise be funded by the networks. In particular hydrogen network investment trials through industrial policy would be an obvious project type.

CSQ42. How can we best facilitate risk-sharing approaches for high-value anticipatory investments?

We suggest providing the networks with incentives consummate with the risk involved. This is likely to be a high rate of return for the investor in any sharing factor or there is no incentive to take risks.

CSQ43. How can we guard against network companies proposing risk-sharing arrangements for project they may have undertaken as business as usual?

Under the proposed surveillance regime it would seem unlikely that this could happen (i.e. business plan scrutiny, CCG etc.).

CSQ44. Do you agree with our proposals to encourage more innovation as BAU?

Yes.

CSQ45. Do you agree with our proposals to remove the IRM for RIIO-2?

No. The pace of technological change may mean that even in a five year period, this mechanism may still have a useful role.

Innovation questions

CSQ46. Do you agree with our proposals to introduce a new network innovation funding pot, in place of the Network Innovation Competition, that will have a sharper focus on strategic energy system transition challenges?

Yes.

CSQ47. Do you have any views on our proposals for raising innovation funds?

Innovation is often the application of a solution in one sector to another. This should be encouraged by the funding arrangements.

CSQ48. Do you think there is a continued need for the NIA within RIIO-2? In consultation responses, we would welcome information about what projects NIA may be used to fund, why these could not be funded through totex allowances and what the benefits of these projects would be.

Yes, we see a valuable role for this funding. We would envisage the funding mechanism financing small projects in a flexible and efficient manner. Using totex would potentially diminish the incentive to innovate using small projects as the effect of the incentive is to ring fence funding up front.

CSQ49. If we were to retain the NIA, what measures could be introduced to better track the benefits delivered?

The regulatory accounts should identify the projects.

Competition Questions

CSQ51. Have we set out an appropriate set of models for both late and early competition to explore further?

Yes. We would favor a model closer to the PJM model.

CSQ52. Do you agree with the proposed criteria we have set out for assessing the suitability of late competition models? Would you suggest any other criteria, and if so, why?

Yes. The key criterion for competition is the degree of contestability in each part of the project process in this model.

CSQ53. Do you have any views on the costs and benefits we have used for our draft impact assessment on late competition?

No. Proposals should allow for competitive pressures to reduce costs.

CSQ54. Are there any considerations for a specific sector we should include in our IA?

No.

CSQ55. What are your views on the potential issues we have raised in relation to early competition? How would you propose mitigating any issues and why? Are there additional issues you would raise?

Early competition is a logical extension to opening out projects to reveal true market costs.

CSQ56. Are there other potential drawbacks of early competition?

Yes, if the identification of need/design stages could not be feasibly implemented in practice.

CSQ57. Do you consider that there are any existing examples of early competition (including international examples or examples from other sectors) which demonstrate models of early competition that could generate consumer benefit in the GB context?

The consultation cited the Artificial Island project. We would suggest the PJM early two stage model.

CSQ58. What are your views on the advantages and disadvantages of the high-level approaches to early competition outlined? How would you recommend mitigating any disadvantages?

As in question CSQ56, only if the design solutions were found not to be feasible in practice.

CSQ59. Do you have any views on the potential criteria for identifying projects for early competition discussed above? Would you suggest any other criteria, and if so, why?

No views as yet.

CSQ60. Do you agree with the criteria we have set out for assessing who should run competitions? Based on these criteria, which institution do you consider is best placed to run early and late competitions?

We agree with the criteria set out in 8.82-85 (p79). The ESO companies may well be best placed to run the competition given their neutrality, though this may present difficulties for GDNs.

CSQ61. Do you agree with how we have described native competition? Do you agree we should explore the proposals described above to enhance the use of native competition? Are there any other aspects we should consider?

Yes.

CSQ62. How do you think competition undertaken by network companies should be incentivised? Is the use of totex the best approach? Will this ensure a level playing field between network and non-network solutions including the deployment of flexibility services?

We would broadly favor the totex approach.

CSQ63. What views do you have on an approach where totex allowances would be based on costs revealed through competition, with a margin or fee for the competition-running entity?

This seems a sensible approach.

CSQ64. Do you think the ESO could have a role to play in facilitating competition in the gas sectors?

There is no theoretical reason why the ESO could not be used for the administration of the competition.

Business and totex plans

CSQ65. What are your views on our proposed approach to establishing a Business Plan incentive? We provide further information on our approach to setting Business Plan and totex incentives in appendix 3 and the questions below repeat those we ask in this appendix.

We welcome the development of a business plan incentive. We note that the incentive if too prescriptive could potentially limit the diversity and scope for innovation of plans that are likely to be drafted.

CSQ66. Under the blended sharing factor approach, should the scope of stage 2 evaluation of cost assessment be based on the entire totex or only on cost items that we consider we can baseline with high confidence?

It might not always be possible for Ofgem to determine with certainty the true extent of its high or low confidence in cost assessment.

CSQ67. What should be the method for categorising cost forecast as High, Medium or Low? Are the indicative boundaries of 1.0 (High to Medium) and 1.04 (Medium to Low) appropriate?

Yes, the boundaries seem appropriate.

CSQ68. What should be the range for the Business Plan reward/penalty? Is the range of ±2% of totex equivalent appropriate for incentivising high quality and ambitious Business Plan submissions (e.g. Value or Good Value)?

Yes, the range of incentives seems appropriate.

CSQ69. Do you agree with our assessment of the IQI? (If not please provide your reasons). Do you agree with our proposal to remove the IQI?

Yes. We would note that the IQI is a comprehensive and now well understood reporting mechanism. However, it is not clear if the underlying issues have been addressed.

CSQ70. Do you have views on the effectiveness of the blended sharing factors approach and in particular the incentive it provides on companies to submit more rigorous totex submissions?

No. We do however agree with the general principles outlined on page 91 of the document 9.36- 9.38.

CSQ71. Do you agree with our assessment of the blended sharing factor in comparison to the Ofwat cost sharing mechanism? If not, please provide your reasons.

We ultimately prefer Ofwat's sharing factor approach in option 2. This is well tried and tested and if adopted would create a trend toward aligning price controls between networks. It also promotes shared understanding of costs and cost structures.

CSQ72. Considering the blended sharing factor, what are your views on the factors (e.g. predictability, ability to effectively deal with uncertainty) or evidence that could be used to distinguish between costs that can be baselined with high confidence and other costs?

The factors identified in the consultation appear correct. The only issue would be to consider for example various evidence of market testing such as tenders.

CSQ73. Do you have any views on the level of cost disaggregation we should apply to calculate the blended sharing factors approach on (regulatory reporting pack level or another level)?

No comment.

CSQ74. Do you have any views on whether the proposed Business Plan incentive coupled with the blended sharing factor will drive the right behaviours?

We see no reason why this approach will not drive the right behaviors in general.

CSQ75. What views do you have on our assessment of the sharing factor ranges?

We would suggest setting sharing factors that represent incentives for the networks to real savings. We support a 50% factor.

CSQ76. Are there any other factors that you think we should take into account in the design of sharing factors?

No comment.

CSQ77. Do you have any evidence on the scope for productivity improvements in the different sectors?

No comment.

CSQ78. Do you have views on whether adjustments to sharing factor levels after the price control is set are desirable or necessary?

There may be circumstances where this is the case due to factors outside the *industries* control. In these cases it is both desirable and necessary.

CSQ79. Under which circumstance do you consider such adjustments should take place?

In cases of higher general inflation than predicted or shortages of specialist materials, or changes to the cost of capital would have an impact on the calculation of sharing factors.

CSQ80. When do you consider an adjusted sharing factor should be calculated?

This would be on a case by case basis but agree with Ofgem this is likely to be within the close out period.

Ensuring fair returns questions

CSQ81. Do you agree with our comparative assessment of RAMs set out in Table 18 in Appendix 4?

No. The use of RAMs can create regulatory uncertainty even if they are defined in advance.

CSQ82. Do you agree with our proposal not to give further consideration to using discretionary adjustments?

Yes this would seem prudent.

CSQ84. Do you agree with our proposal to introduce a sector average-based adjustment approach (Class 2) for the GD sector?

Yes.

CSQ85. Do you agree with our proposal we should not adjust companies downward if they perform below their base cost of equity or upwards if they perform above their base cost of equity?

Yes.

CSQ86. Would a return adjustment threshold of ±300bps RoRE achieve a good balance between providing scope for companies to outperform and ensuring return levels are fair?

Yes. This should however depend on the reasons that explain the networks underlying performance.

CSQ87. What are your views on the proposed use of RoRE as a return adjustment metric? Would it be suitable for the gas and electricity transmission sectors and the gas distribution sector?

We agree it can be used for distribution networks, though this is on the basis that RoRE is equivalent to RAV.

CSQ88. Should we include financial performance within the scope of return adjustments? If not, what is the rationale for excluding financial performance?

Yes.

CSQ89. Should we implement adjustments through a 'true-up' as part of the annual iteration process or at the end of the price control as part of the close-out process?

Yes. We would prefer it as part of the close out process.

CSQ90. Do you agree with our assessment of the measures we have identified to make the price control more accurate?

Yes we agree.

CSQ91. Are there other measures we should take to improve the accuracy of the price control?

There should be more consideration of the impact of Government energy policy and the networks as this represents a strategic risk to the control.

CSQ92. Are there other steps we could take to simplify the price controls, without significantly affecting the accuracy of the control?

It may not be possible to simplify the control without losing accuracy. However, we would suggest a focus on explaining and summarising the numerous incentive mechanisms to wider stakeholders, with limited resource.

CSQ93. Do you agree with our consideration of the risks facing these companies? Do you think the measures we are proposing will mitigate these risks? Does the expected level of return indicated by our proposals reflect these risks?

We broadly agree with the treatment of risks. While using CAPM Ofgem needs to consider its known limitations. These are contained within its assumptions i.e. the degree of rationality of the market, the extent to which markets are perfect and the assumption of linear relationships.

CSQ94. Have we achieved a reasonable balance with our proposals in seeking to achieve an accurate price control with return adjustment mechanisms only being used as a failsafe? Should we instead have a simpler price control and put more reliance on return adjustment mechanisms?

We have no objection in principle and indeed is a workable form of control, but this is very much a failsafe. We note that for over eighty years price controls in the US were based on a simple rate of return regulation with networks presenting their spending plans in rates hearings in front of judges or commissioners (e.g. Californian Public Utilities Commission).

CSQ95. Have we achieved a reasonable balance in our proposals in considering return adjustment mechanisms alongside the expected-allowed return wedge? Should we instead only rely on one mechanism? What additional value would this bring?

The adjustment mechanisms (RAMs) potentially present a risk for network investment if it appears to be outperforming its business plan. Equally a RAM would be useful for business under stress. We question whether a reopener would be a more effective regulatory solution to this problem.

CSQ96. Have we got the right focus on the areas that are of most value to consumers?

No comment. We believe the consumer research is likely to reveal the answer to this question.

CSQ97. Are we proposing a methodology that allows us to achieve a reasonable balance between the interests of different consumer groups, including between the generality of consumer and those groups that are poorly served/most vulnerable? Are we missing any group?

This is a public policy question. Networks act in the same way as taxation as utility charges cannot easily be avoided. It follows there may never be an enduring or correct answer. If the control wants to protect vulnerable consumers it may look like it is technically efficient. This is because an efficient network may not always imply 100% coverage or even utilisation. This does not matter as there is a primary duty of the regulator to encourage this. However, if the regulator starts to compare network performance in the rest of the price control it must take this into consideration.

CSQ98. Are we proposing a methodology that allows us to achieve a reasonable balance between the interests of existing and future consumers?

We suggest that this relates to the regulators expectation of different take up of new technologies that will shape network usage.