

# Cadent response to the Ofgem RII02 sector specific methodology consultation.

## Foreword


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Society's expectations of energy companies have increased significantly and it is now more important than ever to achieve public legitimacy for our business and industry in the eyes of consumers. It is into this environment that Cadent, as the largest Gas Distribution company, provides an essential service that keeps the energy flowing to over 11 million homes, offices and businesses from the Lake District to London and from the Welsh Borders to the East Coast and helps keep society and our customers safe and warm. Cadent is now a standalone gas distribution business, with new ownership and a brand new identity not yet two years old. We have the opportunity to significantly transform and re-focus the long history of custom and practice that we inherited to meet these needs.

Under our new ownership, we are undertaking an unprecedented level of engagement with our customers and stakeholders across our regions to understand their priorities and we are using this insight to develop a business which meets their expectations. We have also established a highly skilled independent Customer Engagement Group to challenge us on the ambition of our plans and bring experience from different business sectors into our thinking.

Building on our research, our vision is to set new standards on the quality of the services we deliver to **all** of our customers, stakeholders and communities particularly those that find themselves in vulnerable situations. Whilst we will never compromise on safety, we need to develop a customer first approach that has an ethos of constantly maintaining availability of gas supplies to our customers by developing appropriate techniques and using innovative ways to achieve this goal. We will also push the boundaries on our role in supporting safety of customers in the home, helping alleviate fuel poverty and making our services more accessible to all types of customer.

We are driven in our desire to improve the environment and continuing to play a leading role in creating the vision of the transition to a sustainable energy system through our pioneering innovation projects. We will continue to focus on delivering an affordable service to current and future customers by driving the efficiency of the business. We also recognise that we need to deliver these outcomes in a way that builds trust in how we operate, making a real and sustainable difference to the communities we support. For example, we will go beyond our traditional boundaries and embrace the need for a wider social responsibility that delivers better, sustainable outcomes for all through collaboration and innovation. In addition, we will be transparent in our operational and financial performance.



We are aware that we are a long way from achieving this goal at present and the journey we have in front of us to transform the business has only just begun. Our plans will transform the business and we want customers to feel the change that this will bring; that we are committed to understanding their needs and courageous in changing our processes to make their lives easier. We will develop a real sense of community both within Cadent and for the regions that we serve by working more closely with them. We want to be a company that is known for its forward thinking and that delivers for all of its customers particularly those in vulnerable situations, a company that recognises that without gas all customers are vulnerable.

We appreciate the scale of challenge we have as a business. However we are fully committed to realising our ambition to become the leading energy infrastructure business in the UK, judged by setting standards that will delight customers and that bring value and prosperity to the communities we serve. We recognise that actions speak louder than words and we will set out our plans and the outcomes we are targeting to achieve in this pursuit of excellence.



Steve Hurrell  
CEO, Cadent

## Executive Summary

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The RIIO-2 price control comes at a key time. The energy industry, as a whole, needs to be ambitious in relation to customer service, engagement and in tackling decarbonisation of heat and transport, whilst still delivering a resilient, modern, well-financed and efficient network for our customers present and future. It also comes at a time where it is more important than ever to ensure the legitimacy of our industry in the eyes of consumers. Ofgem's December 2018 consultations proposes a framework that needs to be a key enabler of the above aims.

We positively support the need to re-balance the regulatory arrangements to ensure that benefits are seen to be fairly shared between customers and companies. We welcome the enhanced role for consumer engagement throughout the process and the focus on transparency, evidence and rigor in determining what customers' and stakeholders' value. This enhanced engagement is challenging us to deliver a huge step change in the transparency of plan development and information. We also support the three key outcome themes of the framework notably; on meeting the needs of all customers including enhancing the focus on those customers in vulnerable situations, the focus on enhancing the environment and the priority to develop resilient networks for now and the future. We have set out our views on the outputs and priorities for each of these outcome areas and we believe we can be more ambitious for customers in considering some enhancements to the outputs particularly surrounding customer service, the environment (in particular innovating to keep momentum in the decarbonisation of heat and transport) and for customers in vulnerable situations.

We welcome and support the following additional mechanisms included in the current proposals:

- Introduction of RPE indexation to address concerns of energy networks benefiting from macro-economic issues outside of management control.
- Targeted use of price control deliverables to remove potential to benefit from not delivering outputs or from customer requirements changing.
- Use of the Network Asset Risk Measures to ensure the capital plans of networks deliver the risk committed to in the plan.
- Introduction of Return Adjustment Mechanisms as a backstop to address any structural errors that lead to windfall under-performance or out-performance (however we have provided our view of the best method to apply)

However, we believe that the proposed package does not provide sufficient positive incentive to stretch performance for the benefit of customers. Taken together the proposals introduce unnecessary duplication, significantly increased complexity, increased risk for all, and uncertainty for investors and they also will undermine incentivisation and collaboration, all of which is ultimately to the detriment of current and future customers. We believe that it is possible to have a framework in place for RIIO-2 that reaches the right balance for customers, stakeholders, network companies and investors and we want to work with Ofgem to do this. There are three main areas that we believe need focus:

- a) The overall balance of risk and reward so that companies have strong positive incentives to deliver enhanced performance for customers
- b) Ofgem's proposals on financing which require a significant correction to avoid damaging long term financeability and increasing costs to consumers in the short term
- c) Helping stakeholders to understand the impact of the proposals given their complexity

### Overall Balance of risk and reward

We do not think that the mechanisms proposed all work together in the best interests of customers. The final framework for RIIO-2 needs to balance the expectations of customers and other stakeholders to achieve short term reductions in network charges against the strategic need for continued innovation and investment for the benefit of future generations of customers. The most significant areas we believe need addressing to encourage better outcomes for customers are:

- a) Greater positive incentivisation to reward network companies who outperform and deliver greater outcomes for customers.

The proposals should create a strong incentive package with upside reward for outperformance and an equal penalty for underperformance with a balanced likelihood of achieving – this will ensure that the sector maintains and drives ambition to deliver the best outcomes for customers and strives to achieve significantly in excess of minimum standards. The current proposals risk creating little positive encouragement for network companies to be ambitious and push to outperform the targets. We have set out in the detailed answers where we think the incentive framework can be enhanced.

- b) The proposals should seek to set absolute targets wherever possible to encourage collaboration for the benefit of customers

We have set out in our response the value that collaboration has driven in RIIO-1 and propose that Ofgem look to reset absolute targets for incentives wherever possible to encourage collaboration and improvement for all customers.

- c) The Business Plan Assessment framework should be recalibrated.

We believe that Ofgem needs to look at recalibrating the Business Plan Incentive mechanism to ensure there is a clear and strong reward for an ambitious plan (i.e. removing the uncertainty of shared upside benefits). Additionally, such incentive should acknowledge the inaccuracies of the

benchmarking in the cost assessment process by using a range of estimates to cross check assessments and remove “cliff edges” in assessment criteria. We also suggest that workload disallowances should not be treated as inefficiency in the assessment. These refinements together will encourage networks to be ambitious with their plans

### Financing Proposition

We support indexation of the risk free rate of equity and have made some suggestions of how the index might function.

We support full indexation of debt allowances and have set out how we believe the methodology can be updated to reflect the sector cost of debt and longer term averages and to ensure NPV neutrality in adjustments for inflation.

Other proposals however contain some methodological and evidential errors that need to be corrected. Most notably the following:

- a) We estimate the proposed 50 basis point deduction for the “allowed vs expected return outperformance wedge” is akin to an additional totex stretch target of 5%-6% for the gas distribution sector. The proposed mechanism deviates from regulatory precedent and is duplicative to other proposed mechanisms and hence not justified and we believe should be removed.
- b) There are significant errors and methodological issues in Ofgem’s treatment of gearing in the beta estimate. When substituting the corrected equity beta into the CAPM calculation, the cost of equity would be more than 1% higher than Ofgem’s quoted range.
- c) We set out further evidence as to why we believe Ofgem’s quoted range for Total Market Return is understated due to a lack of relevance and reliability of the cross check evidence Ofgem is relying on.
- d) We consider that the onus is on Ofgem to ensure that the long term financial profile of the notional company is able to support stable and strong credit ratings and that the framework requires sufficient headroom for networks to adequately absorb risk. We note the concern of credit rating agencies that the introduction of the proposed cash flow floor could undermine the long term credit quality of the sector. In addition, the consideration of any transition from RPI to CPI indexation should consider the right balance between customer bill profiles and financeability ahead of simplicity. We think Ofgem needs to do further work on these areas to understand and achieve a better balance between the impact on customers and financeability of the networks.

### Helping stakeholders understand the impact of the proposals given their complexity

The complexity of the proposals makes it very challenging for all stakeholders to assess the impact on acceptability. In light of the significant changes from the principles established in RIIO-1 through the extensive RPI-X@20 consultation process, it would be helpful for all network companies, and other affected industry participants, to see an overall regulatory impact assessment of the proposals taken together to try to better understand the rationale behind the interrelationship of the proposals and assess their impact on current and future customers. This would help with delivering the aim of building trust, transparency and legitimacy of the regime in the eyes of the public and other stakeholders.

It is also important to note that the time between framework consultation and decision and plan development is extremely compressed and considerably shorter than previous or similar price controls. Ofgem is intending to publish its conclusion on the framework consultations just one month before the companies have to publish their draft plans to the RIIO2 Challenge Group. Hence it will be impractical to assume that all the elements of the defined framework will have been able to be assimilated into these draft plans.

## **Next Steps**

We are committed to working with Ofgem to define the right framework to support the delivery of great outcomes for our customers and have been feeding our views into Ofgem's ongoing stakeholder engagement process. The remainder of this document addresses the consultation questions in full. We would be happy to discuss any aspects of our response further if it would be helpful when considering further the appropriate framework for RIIO-2.

