



Annex: Cross sector questions

Northern Powergrid's RIIIO-T2 and GD2 methodology response

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1. Output categories 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?

1. The proposed mechanism is unnecessary and would undermine the statutory role of the Competition and Markets Authority and the integrity and transparency of the appeal process.
2. The Competition and Markets Authority (the “CMA”) is the ultimate arbiter in respect of price controls. The appeal mechanism set out in the Electricity Act 1989 (the “Act”) provides that those with appeal rights may challenge any aspect of a price control decision by the Gas and Electricity Markets Authority (“GEMA”). But Section 11E(4) of the Act provides that the “CMA may allow the appeal only to the extent that it is satisfied that the decision appealed against was wrong ...”. This balances the rights and interests of customers and investors.
3. The proposal in the Consultation seeks to undermine this position and curtail the way in which GEMA’s decision can be meaningfully scrutinised by prescribing in advance a mechanism by which GEMA may recut its original decision following a determination by the CMA that the decision was wrong. The proposed mechanism would undermine the statutory role of both the CMA and the appeal process.
4. Section 11F(2) provides that, where the CMA makes such a determination, it must do one or more of the following:
 - a. quash the decision (to the extent the appeal is allowed);
 - b. remit the matter back to [GEMA] for reconsideration and determination in accordance with any direction given by the CMA; or
 - c. substitute the CMA’s decision for that of GEMA (to the extent that the appeal is allowed) and give any direction to [GEMA] or any other party to the appeal.
5. Options (a) and (c) do not allow GEMA to take any further decision or exercise any discretion. Option (b) is clear that, where the CMA remits the matter back to GEMA to re-determine, GEMA must do so in accordance with any direction given to it by the CMA. The proposal in the Consultation seeks to fetter the CMA’s discretion by setting out in advance how GEMA would respond where the decision was remitted.
6. The proposal in the Consultation cites the twin objectives of (i) “maintaining a coherent regulatory settlement” and (ii) providing “further transparency for stakeholders”. It would not, however, enhance either of these objectives.
7. The appeal process, as set out in the Act, the Energy Licence Modification Appeals: Competition and Markets Authority Rules (the “Rules”) and the Energy Licence Modification Appeals: Competition and Markets Authority Guide (the “Guide”), already allows the CMA to take a decision which is transparent and which takes into account the coherence of the regulatory settlement.

8. Section 11E of the Act provides that:

In determining an appeal the CMA must have regard, to the same extent as is required of [GEMA], to the matters to which [GEMA] must have regard —

- a. in the carrying out of its principal objective under section 3A;*
- b. in the performance of its duties under that section; and*
- c. in the performance of its duties under sections 3B and 3C.*

9. Consequently, to the extent GEMA must consider the coherence of the regulatory settlement; the CMA is bound to consider it too.

10. The CMA is well aware of this aspect of its role, explaining in paragraph 8.25 of the Final determination in the *Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation* appeal that:

In the ED1 Determinations, we recognised the risk of knock-on effects changing one aspect of a complex regulatory decision might have. The principle we adopted in those cases and we adopt here is to consider on a case-by-case basis any evidence submitted to the CMA regarding links between the parts of the decision which are challenged and parts which are not.

11. Furthermore, the CMA's process includes a provisional determination stage. Rule 19.1 provides that: *"The CMA will normally issue a provisional determination stating its provisional conclusions on the appeal"*. Rule 19.4 goes on to explain that: *"The provisional determination will normally contain: (a) the CMA's provisional findings on the grounds of appeal raised by the appellant; (b) an explanation for the CMA's provisional conclusions and findings; and (c) the relief which the CMA is proposing to grant."* Paragraph 5.1 of the Guide provides that:

The CMA will normally issue a provisional determination stating its provisional conclusions which will be notified to the parties to the appeal, including interveners. The purpose of a provisional determination is to allow parties to comment on the CMA's reasoning and accuracy of arguments. It may also establish a context for any necessary consideration of remedies.

12. This allows both parties to make representations in respect of any purported inter-relationship between the CMA's provisional determination and any other element of the price control and for the CMA to consider those representations before making a final determination. This is entirely transparent.

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

13. Ofgem's new grouping of outcomes is simple, clear and focussed. We support it.
14. However, we do not support the over-arching approach to incentive mechanisms that is apparent throughout the proposals in the Consultation.

15. Ofgem has previously focused on creating a stable commercial framework within which the network companies can operate. Ofgem stuck to its key task - the creation of this stable framework by setting clear, transparent, high powered ex ante incentives that align the interests of the investor and the consumer. Ofgem has then left the networks to work out how to deliver against this framework, rather than inserting itself into operational decisions.
16. This approach has been a key driver of the success of economic regulation in the UK over the years. According to Ofgem's own research, the UK energy networks have outperformed the productivity performance of the UK economy by around 1% per year over the past 30 years.
17. On the first page of the Consultation Executive Summary Ofgem claims that it wants "to continue to use strong incentive-based regulation to align the interests of companies and consumers". But there is scant evidence to support this claim in the remainder of the document.
18. The ex ante nature of the deal has been replaced at each opportunity with reopeners, retrospective assessments and indexation. Many of the incentive mechanisms have been watered down. When companies aren't rewarded for improved performance, productivity will stagnate.
19. Ofgem appears paralysed by the presence of "asymmetric information". Yet Ofgem's response to this challenge is to both reduce incentives for information revelation and reduce incentives for efficiency enhancement. Neither measure will work.
20. On numerous aspects of its proposed incentive framework Ofgem must think again, change direction and reaffirm its genuine commitment to established and coherent price control principles.

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

21. No.

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

22. Yes, we support the overall framework design (clearly distinguishing license obligations, price control deliverables and output delivery incentives). This is a good build on the ED1 approach, which was the best-developed of the three RIIO-1 price controls.
23. However, it is critical that Ofgem chooses wisely when deciding if and when to use Price Control Deliverables or Licence Obligations, if it is to avoid stunting incentives to drive service improvement and to search hard for cost saving innovations.
24. While Ofgem describes Price Control Deliverables as outputs, paragraph 4.16 of the consultation makes clear that price control deliverables are in fact highly likely to be "input activities". These are, by definition, not "outputs".
25. The concern is that Ofgem ends up regarding Price Control Deliverables as lists of inputs (not outputs) that would be agreed upfront. At the end of the price control, Ofgem could check whether

each input on the list had been delivered and, if some had not, would clawback the related allowance.

26. This creates the risk that companies end up with a strong incentive to simply stick to the original plan and deliver the inputs regardless of whether new information comes to light that might reveal a more efficient alternative. Companies avoid the potential for Ofgem to clawback revenue ex post, and consumers foot the bill of the company building things that are not needed.
27. Price Control Deliverables may then become akin to input regulation, further stunting the incentives for innovation and discovery.
28. Ofgem seems to be alive to these risks, as it refers to feedback already received in paragraph 4.21. In our view it needs to go much further than this paragraph signals however, committing to limit the use of Price Control Deliverables to cases where the monitoring of inputs is justified, and in ensuring that incentives for innovation and efficiency are not stunted by being clear how it will conduct its (necessarily ex post) review of delivery.
29. Licence obligations should be used where there is a consensus that service standards have already reached a level that is optimal for consumers and where it is clear that further improvement would not be cost efficient. Examples of areas that are currently subject to an incentive that we think could be safely transitioned to a licence obligation are the stakeholder engagement and consumer vulnerability incentive, the incentive on connections engagement and the losses discretionary reward.
30. The emphasis placed on price control deliverables and licence obligations adds to a worrying impression that Ofgem is abandoning light touch, high powered incentive regulation in favour of micromanagement. The inescapable vision is of work programmes and standards of performance agreed ex ante with Ofgem, with delivery against this Ofgem sponsored plan checked off ex post. Plans would be ossified, with the risk of ex post scrutiny creating a strong incentive to simply stick to the plan, something that weakened ongoing incentives would be unlikely to counteract.
31. Input regulation needs to be used sparingly precisely because it badly damages incentives. The RIIO handbook is clear on this point when it says *'The use of secondary deliverables brings potential risks of micro-management and may encourage companies to adopt an approach that turns out not to be in consumers' interests.'*¹
32. Ofgem has invited companies to submit PCDs as part of their business plans. When considering these PCDs, Ofgem should follow its own guidance, as set out in Table 4 of the RIIO-handbook. As far as we can tell, Ofgem has not consulted on a departure from this guidance, yet the Consultation fails to acknowledge its existence.
33. This guidance includes various important steps. Tellingly it acknowledges that PCDs can in fact be costly to consumers when it says that they are accompanied by a *'risk that consumers pay for a*

¹ RIIO-Handbook, paragraph 6.40

secondary deliverable that does not represent value for money in the long term'. It recommends Ofgem consider uncertainty mechanisms instead, specified in a way that would reduce this risk.

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?

34. Ofgem should set challenging, evidence based, targets for network companies, on a fixed (but not necessarily flat) profile between regulatory resets.
35. Where benchmarking data is available, and performance is comparable, Ofgem should use this at the price review periodic reset. In doing so it should consider carefully whether there are reasons that performance may not be fully comparable across companies.
36. Where there is evidence to show that productivity improvements are likely to be achieved over time, or are being funded through cost allowances, Ofgem should reflect this in a declining profile of target.² Ofgem should always try to maintain strong incentives to improve performance throughout the price control period. In some cases it may be appropriate to use a rolling incentive based on historical performance in order to achieve this.
37. With all the tools available to Ofgem, there should be no reason to expect, a priori, outperformance by a sector as a whole, especially in those sectors where Ofgem is able to make effective use of the tools of comparative regulation.
38. The use of dynamic and relative incentives, **where appropriate**, is non-controversial. They have already been used multiple times by Ofgem in R110-1 and previous price controls. For example at ED1 the:
 - a. cost benchmarking, in conjunction with the IQI, introduced a relative incentive on business plan cost levels at the price review stage;
 - b. IIS incentive included an improvement factor that makes the targets dynamic; and
 - c. time to connect incentive includes a mid-period reset and allows for dynamic target setting within the period.
39. We do however offer additional considerations below regarding when and in what form they are appropriate, as there are risks related to their deployment that could give rise to unintended negative consequences.
40. Setting *cross sector benchmarked* targets (dynamic-relative targets in Ofgem's terminology) would introduce uncertainty around the benefits of investments, could potentially penalise good performance and would discourage collaboration. It would also make non-comparability between companies an even bigger issue. If dynamic targets are used, this creates a risk that if Ofgem fails to

² While ensuring it does not double count with its productivity assumption on costs

set targets fairly for all in the sector then windfall gains for some may be turned directly into windfall losses for others.

41. Cross sector benchmarked targets should be avoided. But if they are implemented, the heightened risk for companies in these sectors should be recognised in a higher allowed cost of equity (compared to the cost of equity Ofgem allows in sectors with no such risks).

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

42. No, we do not. While we support the desire to enhance consumer engagement, including through companies taking input from consumer engagement groups (“CEGs”), Ofgem must keep in place its own firm assessment and decision making process, so companies are disciplined to reject stakeholder proposals that are not in the interests of consumers. Otherwise Ofgem’s decisions are vulnerable to appeal.
43. In light of this, Ofgem’s proposal for bespoke outputs is deeply flawed.
44. There should be no need for company specific bespoke outputs. Ofgem’s existing framework already incentivises delivery across key areas. If a new candidate output incentive is discovered in the course of consultation on RIIO-2, and judged to be beneficial to energy consumers in one part of the country, it should be introduced across the whole country as part of a consistent incentive package, through a rigorous Ofgem led process of national consultation and evidence evaluation.
45. If Ofgem follows this approach, then almost by definition any candidates for bespoke outputs are likely to bring at best limited incremental value for consumers, as all material items will already be captured by the common, core outputs framework. Bespoke outputs will therefore most likely bring unnecessary complexity and administrative burden to the price control and dilute the relative incentive strength of core output delivery incentives (“ODIs”) that carry the greatest value to consumers. The more complexity Ofgem introduces in terms of bespoke outputs, the more likely its settlement will “leak value” to specific companies or stakeholder groups, to the detriment of energy consumers.
46. If Ofgem wishes to retain the option for companies to propose bespoke outputs, it must set a high bar when appraising them.

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

47. Ofgem should question the motivations of network operators who support this proposal and whether they may secure additional returns from a badly calibrated output incentive.
48. If a particular stakeholder group supports a bespoke financial ODI, Ofgem should also consider whether their interests represent those of consumers in general. They may instead represent a narrow constituency that would enjoy a better service at the expense of wider consumers, which makes consumers as a whole worse off. Ofgem should consider whether it is appropriate to give

that constituency preferential treatment when it has no duty to do so, and when the outcome that results may be contrary to its principal objective.

2. Enabling whole system solutions questions

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

49. We agree with Ofgem that cross-network co-ordination is likely to result in lower long-term costs to consumers. In saying this, we note that:
- a. the regulatory framework built by Ofgem in the decades since privatisation has many aspects that are well suited to enabling whole system solutions at the least cost; and
 - b. as patterns of network usage change, incremental adjustments will allow the current system to adapt to that change.
50. Ofgem's hypothesis for where a '*problem may lie*', in paragraph 5.10, is broad enough that it should capture all potential issues. We do not, however, think that these issues will apply uniformly to all sectors.

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?

51. Ofgem is sensible to propose '*a narrow focus on coordination of investment planning and operational delivery between the ESO, the GSO and the four network sectors (gas transmission, electricity transmission, gas distribution and electricity distribution)*'.
52. We endorse this approach, which creates a clear and simple delineation between network issues and the activities of network users, as long as it does not prevent end users from deriving value from their optimisation decisions (including where this value comes from responding to signals from energy networks).
53. Ofgem refers in paragraph 5.13 to legislative limitations. We cannot be certain what this refers to unless Ofgem provides further details. Our general observation is that the legislation is typically well drafted and offers a number of ways in which whole system solutions can be accommodated. For example, 3A(4) of the Act allows GEMA to have regard to the interests of consumers in respect of other utilities (gas, water and sewerage and communications) in carrying out any function under Part 1 of the Act.

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

54. The Consultation states '*A broader scope could include other parts of the energy system (eg heat), as well as other sectors (eg transport, waste).*'

55. We think it is important to distinguish other energy networks from end users (and how they optimise their decisions and interact with energy network companies).
56. The CMA has recommended that heat networks be brought within Ofgem's regulatory remit. In due course we expect Parliament to take up this recommendation, amend the relevant legislation, and at this point Ofgem should incorporate heat networks into its 'narrow' definition.
57. Turning to end users:
- a. Networks interact with end users at the point of connection, through the terms of connection and through ongoing charges. This allows for feedback in both directions, and end users will (and already do) optimise between different fuel sources.³ Networks will need to adapt to any changes in historical patterns of such interaction, but this doesn't require a broad definition of whole system.
 - b. Networks should not be given a remit for co-ordination of transport or waste activities, nor should these activities be granted some kind of special status. There has never been a realistic suggestion that network companies should have some kind of additional co-ordination role in respect of sectors that use a lot of energy conveyed by networks, such as heavy industry or domestic households, beyond the interaction at the point of connection (as described in point a. above).

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?

58. Ofgem's whole system proposals break down into two classes:
- a. Approaches consistent with the cornerstones of the RIIO-framework (in particular strong incentives and innovation) and which represent incremental additions that may improve on the existing framework (proposals 1, 2 and 4); and
 - b. Highly damaging and distortionary mechanisms to re-allocate accountability and funding on an on-going basis, subject to discretionary within-period decisions, which will create perverse incentives to focus more on lobbying than achieving low costs and leave it unclear as to who is to blame when things go wrong (proposals 3, 5 and 6).
59. We support the first set of proposals. These would build on the current arrangements and allow Ofgem to establish clear accountability for issues, giving totex allowances to the accountable party. The framework should then allow for that party to meet its obligations by buying services from third

³ All users take decisions at the point of installation between electricity and gas for various activities, e.g. space and water heating, and some choose a mixed system that allows ongoing decisions across energy vectors. Some industrial processes allow for real time optimisation, and this could involve real-time optimisation across gas and electricity usage.

parties, and Ofgem could also establish obligations for other energy networks to share information and offer solutions at cost plus a reasonable margin.

60. We reject the second set of proposals due to the damage they would cause, the complexity they would introduce and the loss of clear accountability that would follow. A discretionary incentive on cross-sector collaboration is exactly the type of incentive that Ofgem has identified drives administrative burden and leads to subjective outcomes. A mechanism to transfer obligations and allowances within period would create perverse incentives, whether managed through reopener windows or via a discretionary mechanism. This is unnecessary because:
- a. The existing system allows networks to provide and pay for services from other network companies; and
 - b. Staggered five yearly price controls can accommodate any major reallocations of responsibility with a 2-3 year transition period.

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

61. Mechanisms 3, 5 and 6 all involve ongoing decisions by Ofgem on who should be accountable for a particular issue, whether funding should be allocated (or clawed back) or whether there should be discretionary penalties or rewards for network company actions.
62. Mechanisms like these would create strong incentives for parties to attempt to transfer away 'out of the money' obligations, and to focus excessive resources on ongoing regulatory lobbying. The incentives might depend on who was the decision taker in respect of output transfer.
- a. If Ofgem were the decision taker, there would be a strong incentive for the affected parties to bring forward self-interested (and flawed) evidence cases, for example arguing their costs are high in order to avoid needing to deliver the output, and Ofgem would not be well-placed to mitigate the inevitable information asymmetry.
 - b. If the ESO was the decision taker, it would have a strong commercial incentive to favour National Grid's TO's interests over those of other network companies. The very different treatment of costs incurred by the SO, the TO and other network companies mean this conflict of interest persists even with organisational separation, and it will be difficult for Ofgem to balance the incentives that this additional role for the ESO would create.
63. This system would also be administratively burdensome, both for Ofgem and the network companies. It is instead appropriate that decisions on accountability for an issue should be revisited once every five years, at the price review.
64. Rewards should be based on whether long-term costs for consumers are kept as low as practicable, not on whether a particular company made a convincing regulatory submission.

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)?

65. There are no obstacles to a network company contracting with another network company for a service. All networks make extensive use of outsourcing. None can claim that there are any barriers to making a payment to a third party, including another network company, in exchange for a service.
66. It is also possible, through commercial contracts, to ensure that the relevant parties carry the risk for delivery or non-delivery of whatever is contracted for. Again, since all network companies already use sub-contractors extensively, they cannot claim that there are barriers to appropriate risk-sharing through contracting approaches. This is also the approach being used in the RIIO-1 period, where the ESO has requested services from DNOs in respect of interactions with generators over issues with their settings that could lead to system instability, proving the concept.
67. The only potential issue we can see is the fact the ESO and transmission price controls do not have the equalised incentives that are central to the RIIO model, across major classes of expenditure. For example, if the ESO is unable to treat solutions that involve a DNO providing it with a service equivalently to the costs of a connected end user providing it with a service, this is likely to distort decision making (since the ESO knows it will be allowed the costs for one, but not the other).
68. This is not a regulatory barrier to contracting between one entity and another. It is a problem of misaligned incentives in the price control of the ESO.

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

69. Ofgem must maintain a system of strong financial incentives for the relevant parties to find the least cost solution. This can be achieved by allocating clear accountability for outcomes at the price control review, and coupling this with strong incentives.
70. The status quo arrangements are well suited to this. This system allows licensees that are accountable for an output to contract with a third party for its delivery, including other networks (as excluded services in their price control). This creates a clear delineation between:
 - a. The price review process by which accountability is established, funding is granted and incentives to minimise cost are established.
 - b. Delivery of the activity at the least cost during the price control period, where the accountable party has strong incentives to identify and use the cheapest option.
71. Where the cheapest option is another network company, that network can provide the service as an 'excluded service'. Its charges would be regulated to its costs, plus a reasonable margin, while the revenues are excluded from its main revenue restriction. This is all established in the existing framework; it doesn't require anything new.

72. The fact a margin is allowed gives a commercial incentive for other networks to offer these services, although if some networks suffer a behavioural aversion, Ofgem could also supplement this with a clear duty to provide 'whole system' excluded services.⁴
73. Ofgem could also adjust the ESO price control to give it balanced financial incentives in respect of the different options it can choose from, to reduce the chances that its decisions are distorted by a conflict of interest (between its role in evaluating whole-system solutions across the transmission and distribution system, and its commercial payoff in different scenarios).

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

74. We have not identified any mechanisms that Ofgem has not listed. If this Consultation identifies mechanisms that Ofgem thinks may have merit, they should be the subject of a further consultation.

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

75. We have not identified any additional framework-level whole system barriers that Ofgem has not listed, and in fact think the existing barriers are less significant than the Consultation indicates. If the Consultation identifies issues Ofgem thinks may be a concern, they should be the subject of a further consultation.

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

76. We have not identified any additional sector-specific whole system barriers that Ofgem has not listed, and in fact think the existing barriers are less significant than the Consultation indicates.
77. There is a general issue that the proposals set out in the Consultation would encourage networks to co-operate less, be more risk averse, and incur higher costs over time. This applies to whole system issues as well as many other aspects of the regulatory framework.
78. If the Consultation identifies other issues Ofgem thinks may be a concern, they should be the subject of a further consultation.

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?

79. We do not at present think a broader definition of whole system is warranted, and cannot offer informed comment on the appropriate mechanism based on the limited details in the Consultation.

⁴ For the avoidance of doubt, Northern Powergrid will already provide these services. For example, since National Grid first raised 'whole system' voltage issues in 2015, we have consistently maintained that we would provide any services National Grid requires to help it meet its obligations regarding transmission system voltage under a commercial contract.

If Ofgem wished to take this ahead, and consults with specific examples of what this would mean, we will be able to provide comment on the appropriate mechanisms.

3. 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?

80. No, we don't agree with the proposals.
81. In respect of asset resilience, Ofgem must pull back from secondary deliverable arrangements that will lead it into micro-management (and potentially close to cost pass through).
- a. Ofgem's secondary deliverable arrangements (especially network asset resilience measures) are turning into a requirement for companies to:
 - i) deliver their original plan; or
 - ii) pursue investments which "optimise" against Ofgem's framework rather than seeking those which they judge their network actually needs.
 - b. Ofgem needs to make sure its framework encourages, and appropriately rewards management teams that engage in a process of discovery and innovation, rather than directly regulating the replacement cycles according to a model that is not fit for the purpose.

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

82. No, we don't agree with the proposals expressed in this broad brush fashion.
83. From our understanding of the transmission arrangements, the T1 asset renewal secondary deliverable targets were described as 'absolute' but, due to how the data is measured, are better understood as 'relative'. In this context, it would be appropriate for the T2 target to be 'relative'.
84. However, we do not agree with proposals to 'define outputs for all sectors using a relative measure of risk'. There can be circumstances where absolute NARMs are appropriate, and this should remain part of Ofgem's RIIO toolkit. At DPCR5, for example:
- a. Ofgem set absolute targets for load indices at primary substation sites, which ensured that network companies would have to take steps to keep utilisation at those sites below the target risk levels in the face of rising demand.

- b. The metrics worked in tandem with the load related expenditure reopener, which would provide additional funding if demand was rising, and would also act to reduce funding if efficient expenditure was significantly below allowance.
- c. Unlike relative targets, the absolute targets did not require electricity distributors to pursue investments if increases in loading did not materialise, and the sharing factor and load related reopener were together effective in saving energy consumers money.

85. ED2 should not be included in the scope of any decision taken at this stage because there is more experience using NARMS in electricity distribution.⁵ Although the Consultation explicitly indicates at paragraphs 1.14 to 1.17 of its Executive Summary, the Consultation goes on to say at paragraphs 6.6 and 6.23 that the general NARMS proposals will apply to ‘*all four sectors*’. The earlier statements should prevail. No decision should be taken in respect of electricity distribution at this stage, even if some of the proposals are capable, in principle, of application in ED2.
86. Ofgem must also take care in how it describes these metrics and their role in the price control settlement. In this section of the Consultation it describes NARMS using terms such as outcomes or outputs, when in fact NARMS are neither. They are an asset management tool, which can be used as a price control deliverable, and are relatively close to inputs. This is why Ofgem called them ‘Network Asset Secondary Deliverables’ in the ED1 settlement. They are a long way from any outcome or RIIO output.

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

87. No, we don’t agree with the proposals.
88. Ofgem’s proposals to base “risk removed” at RIIO-2 on a long-term net present value measure will worsen the distortions the framework can cause, because it will make it more heavily dependent on highly speculative risk curves far into the future. Over long planning horizons those curves increasingly become guesswork and are unlikely to be reliable in all cases, yet Ofgem seems intent to make a uniform set of assumptions on this the corner stone of asset management practice.

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

89. No, we don’t agree with the proposals.
90. Ofgem should not rely on NARMS in its cost assessment of asset renewal, or to calibrate penalties, especially in sectors where it can use comparative competition. This would lead to windfall gains and losses and, because companies can heavily influence whether they have a “high” or “low” monetised risk, it could allow companies to bias Ofgem’s results.

⁵ ED2 will be the third electricity distribution price control to use NARMS, giving greater experience in setting and closing out these arrangements, while they have also been used in wider circumstances in ED (including at DPCR5)

91. NARMs have a legitimate role in the regulatory settlement on asset renewal⁶, as a check to ensure companies deliver the value they promised as part of that settlement. But Ofgem is now proposing a bigger role for the monetised risk measure from NARMs:
- a. As a cost driver in cost assessment; and
 - b. To calibrate penalties where companies have not delivered.
92. In electricity distribution at least (and possibly other sectors) monetised risk values are simply not fit for these purposes, because:
- a. The margin for error on these values may be very wide;
 - b. Asset management decision making cannot use them in this way (as monetised risk may not be well-correlated with asset renewal needs);
 - c. Poor asset stewardship in past periods would boost performance on the assessment, introducing perverse incentives; and
 - d. At their core NARMs rely on company led assessments of asset condition which introduces subjectivity that can make comparisons between companies misleading.
93. The reality is, if NARMs are used in the way proposed, they will distort company decisions between different classes of cost and will undermine the totex approach to cost assessment. In any sectors where Ofgem has a credible alternative (and this is certainly the case for ED2 and probably for GD2) it should not use NARMs in cost assessment or in determining claw-back penalties.

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

94. Ofgem should provide allowances for costs at the time it expects companies to incur them. This may require holding companies to account for completion of the associated price control deliverables in future price control periods.
95. If Ofgem does follow Option 1, logging up, it must make sure that it provides the cost of capital on any deferred funding. The net present value (NPV) of option 1 and 2, discounted at the cost of capital, should be no different.
96. With lengthy projects, changes can and do happen within the lifetime of the project. Ofgem must ensure that it funds efficiently incurred costs, even where subsequent changes mean that it makes no sense for the network company to go on and complete the original deliverable.

⁶ We use this term to incorporate asset replacement and refurbishment.

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

97. Ofgem should not use the ‘pounds worth of risk removed’ from the NARM risk metrics to calibrate penalties.
98. The metrics may not be well correlated with asset renewal needs. The pound values may have little or nothing to do with the allowance that Ofgem provided companies, or the cost of delivering the un-delivered metrics. At their core they rely on subjective judgements by companies, and they may be exposed to bias as a consequence. They are simply not fit for this purpose.
99. Ofgem’s proposals at paragraph 6.40 of the Consultation would have many perverse incentives. For example:
 - a. If companies would have to hand back allowances if they find ‘justified’ ways of not delivering, Ofgem will have removed the incentive for good asset management and innovation to reduce costs to consumers; costs would rise over time.
 - b. If companies are exposed to the pound value of a risk metrics, they will have an incentive to manage this down, or, if they cannot, they would be exposed to a random penalty (adding risk to the settlement and raising the associated cost of capital).
100. Instead Ofgem should maintain strong incentives for companies to effectively manage their asset base, and deploy innovation. It should achieve this through a more straightforward and better informed evaluation of the issues at stake:
 - a. Where the under-delivery is justified and based on sound asset management, including but not limited to the deployment of innovative techniques, and where the investment will no longer be required or can be deferred for a significant length of time, there should be no claw back of the associated allowances. Companies should retain a share, at the level set by the cost sharing mechanism.
 - b. Where the under-delivery is unjustified, or where it will simply increase costs in the next price control period, Ofgem should hold companies to account by clawing back either the allowances, or the forecast cost of delivery, whichever is higher⁷; or holding companies to delivery in the next period, with no additional funding.⁸ Ofgem should not take the approach it took to under-delivery at GD1, where a programme facing engineering challenges was scaled back and only the allowances were returned.⁹

⁷ The DPCR5 approach. Ofgem, 2009, *DPCR5 Final proposals, Incentives and Obligations document*, paragraph 9.30

⁸ The ED1 approach. Ofgem, 2013, *RIIO-ED1 Strategy Decision, Reliability and Safety annex*, paragraph 6.7.

⁹ The GD1 mid-period approach in respect of medium pressure mains, on the assumption that work which involves “engineering and stakeholder challenges” is likely to be more expensive than the benchmarks on which allowances were set. We note that Ofgem’s decision did however appear to be appropriate in the relevant context, where there were no clear consequences for non-delivery. Ofgem, 2017, *MPR parallel work decision*, paragraph 3.56.

101. We do however agree that Ofgem should not provide additional funding where companies over-deliver on their metrics, except through the sharing factor. This was the approach taken at DPCR5, and reduces the extent to which the metrics are an uncertainty mechanism through the back door.

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

102. Ofgem must recognise that there can be significant interactions between different types of expenditure.
103. It will be easy enough to implement the proposals at paragraph 6.43 of the Consultation, namely to avoid double funding of the same investment project through two different mechanisms (by allocating the project to one or the other).
104. However, companies managing their asset management plans effectively can see significant changes occur in the course of a price control period, that push costs from one category to another. The RIIO totex approach to the cost sharing factor and capitalisation rate was designed to remove distortions across cost boundaries. However, individual sub-mechanisms for adjusting allowances can re-introduce distortions. Ofgem must be cognisant of this, and its proposals must not create incentives for companies to deliver their original plan where an alternative approach (for example reinforcement) would be better.

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?

105. There are additional administrative and regulatory costs associated with ring-fencing specific costs or activities for a price control deliverable. These include the costs associated with monitoring the arrangements, and any resulting distortions in price control incentives to reduce costs that will result in higher costs to energy consumers over the long term.
106. For these reasons, ring fencing should be used sparingly.
107. Where certain projects or activities have a ring-fenced price control deliverable mechanism, as was the case with high value projects at DPCR5, there seems little value in including their delivery in the main NARMs mechanism. This would only lead to the need to introduce a complex mechanism to avoid double counting of claw-back, if the company failed to deliver on both mechanisms.
108. Any assessment of ring fenced deliverables should also minimise, as far as possible, distortions that could reduce company incentives to reduce costs (for example through innovation) and any distortions across price control boundaries (by recognising related costs in different price control categories or periods).¹⁰

¹⁰ For example, at DPCR5, one of Northern Powergrid's high value projects had a significant interaction between costs that would be reported as transmission exit charges over the longer term and costs that Northern Powergrid expected to incur

4. Workforce resilience question

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?

109. Ofgem should drop plans to micromanage workforce planning.

- a. Responsibility for delivering a sustainable workforce should sit squarely with the companies. Accountability should not become blurred.
- b. Ofgem's role is to benchmark labour costs as part of the overall costs of running the business. It should then leave companies to bear the consequences if they perform worse than their peers.
- c. Measures to 'hold companies to account' for a specific strategy may distort optimal resourcing decisions.
- d. They would increase regulatory risk and make the price control more complex than is necessary.
- e. The only regulatory intervention that Ofgem should consider, if it is concerned expenditure in this area might be unsustainably reduced, is a set of "use it or lose it" allowances, like those used at DPCR5.

110. Ofgem (indeed, any regulatory office) lacks the expertise and resources to micromanage the businesses. If it did staff up sufficiently to take this on, it would result in a destructive blurring of responsibilities.

5. Physical security and cyber resilience questions

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

111. Yes, we agree with maintaining the existing scope of costs that fall under any PSUP mechanism, although any relevant sites where allowances can reasonably be set at the time of the price control review should be excluded from any reopener (as is the case at ED1).

in the price control period. Compared to the original proposal underlying the price control cost submission, the cheapest solution involved less investment on the transmission system and more investment on the distribution system.

112. This scope creates the clearest boundary possible for the costs imposed by this government policy, and any changes in its requirements, while setting ex ante allowances for sites where this is possible ensures the strongest possible incentives.

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.

113. We support ex ante allowances for costs associated with the physical security upgrade programme (“PSUP”) mandated by the government.
114. This programme is now well advanced and requirements are clear. Even by the time the ED1 price control was set, Ofgem had transitioned the more certain part of the programme to ex ante allowances. This has allowed reduced expenditure on administrative requirements, since companies have incentives to minimise costs (while a “pass through” approach might necessitate additional value for money audits, which consumers would have to fund).
115. Ofgem should now move the whole programme to ex ante allowances, like the costs associated with the many other obligations placed on companies by Government.
116. Ofgem should also step back from micromanagement. It should not set price control deliverables for what is likely to be a relatively small part of the cost base, as this will drive unnecessary complexity in the settlement, raise administrative costs both for Ofgem and the companies, and distort company decisions (pushing them towards the solutions initially developed and agree with Ofgem, rather than seeking lower cost alternatives). All of this would lead to higher costs for consumers over the longer term.
117. If there is material uncertainty in Government requirements, Ofgem should of course put in place an uncertainty mechanism. But the trigger should be a change in government requirements, not a change in how companies meet those requirements, to maintain strong incentives on companies to minimise costs.
118. ***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?***
119. Ofgem is moving to a 5 year price control period. It should not be necessary to maintain reopeners for categories of expenditure where there is limited uncertainty over the level of costs, or where the cost exposure is not large.
120. We doubt a reopener mechanism is still required for this category of expenditure. Even at ED1, we received about half of the total cost of the programme as ex ante allowances; we set ourselves challenging cost targets; and consumers have enjoyed benefits from the fact we faced strong incentives to minimise over-expenditure relative to these targets.
121. A reopener should only be contemplated if some companies or sectors request large allowances for the cost of highly uncertain Government requirements.

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?

122. We do not think a reopener is likely to be required.

123. If one is included, then under five year prices controls it should only operate at the mid-point.

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.

124. Cyber resilience is not just about IT systems. For example, it involves ensuring that day to day processes are resilient, and making sure every employee is conscious of cyber risks. Even looking at IT systems, it will be very difficult to differentiate "new" from "business as usual" costs, since systems that meet both types of requirement are often built in tandem, or are substitutable.

125. Ofgem should design its mechanism in a way that is fully cognisant of this. We comment on this further in our response to CSQ34, below.

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.

126. Given the profile of the cyber expenditure threat, we can see why Ofgem would want to ensure a certain level of attention and expenditure on the issue through a "use it or lose it" allowance. This would involve limited regulatory burden, little or no regulatory risk, and would leave companies responsible for the activities they chose to undertake.

127. The proposals Ofgem describes at paragraph 6.87, to monitor delivery and inform funding adjustments, and allowance claw back, are symptomatic of Ofgem's move towards micromanagement and an ex post regulatory framework. This is not present in Ofgem's ED1 framework, which was the RIIO-1 control that came closest to the original RIIO ambition.

128. Ofgem should of course undertake any role required of a competent authority under the Network and Information Systems Regulations 2018. But it should still maintain an incentive based framework that sets clear allowances and leaves companies responsible for minimising the costs of discharging their obligations.

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 reopener mechanism.

129. There has been a step change in the cyber threat profile and this area is now as sensitive as physical site security. We can see why Ofgem might want to remove the incentive for companies to reduce

expenditure (through use it or lose it allowances), and also to provide a reopener in case there is a further step change.

130. This type of mechanism inevitably distorts incentives, across and within price control periods, which is detrimental to consumers over the longer term. Ofgem should therefore try to minimise this detriment.
- a. Across price control periods, Ofgem's assessment of company requirements must check whether other energy networks already spent the necessary money. To maintain the strongest possible incentives, those companies that did shouldn't be disadvantaged, while those that didn't shouldn't be advantaged by their slowness to act.
 - b. Within price control periods there will be strong substitutability between costs for "new" cyber requirements and "business as usual" requirements. This could lead to inefficient substitution if "use it or lose it" is applied to one but not the other. This damage may be reduced if the approach is applied to all related costs.

6. Real price effects and ongoing efficiency questions

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?

131. Ofgem is mistaken on RPE indexation: this mechanism won't reduce the risk that allowances don't match the cost pressures faced by companies; it will in fact add to the risks faced by companies in the price control period.
132. Ofgem must admit that, in the ED1 slow track, it showed itself capable of correctly predicting the path of its chosen real price effect indices. In fact, as at the latest full regulatory year, our estimates show that it under-forecast for slow track companies. This shows that that the over-forecasting in earlier RIIO-1 settlements was not a necessary consequence of the fixed RPE allowance approach, undermining the case for RPE indexation.
133. RPE indexation also has significant drawbacks; companies would be exposed to fluctuations in prices that have little or nothing to do with the costs they face in the price control period, since available indices (that Ofgem is willing to use) are nothing more than long-term proxies.
134. This is not good news for consumers: there is as much possibility that allowances might rise faster than they need to as there is that they will be set too low; while the attendant pro-cyclical risk exposure to companies will directly raise the cost of capital.
135. RPE indexation is also impractical; some of the available indices may stop being published during the price control period, or see significant changes in the underlying data, and the resulting need for Ofgem intervention would cause additional regulatory risk.

136. We have not been able to identify in the Consultation the factors that Ofgem proposes to consider in deciding appropriate input price indices for RIIO-2.¹¹ We can however say that Ofgem will not be able to decide “appropriate” price indices for RIIO-2. For example, the constraint it has imposed on itself of not using the companies pay settlement data means it will have to use benchmarks from other companies or sectors. These will be imperfect and, at any one point in time, or over the course of the whole price control period, they may diverge materially from the cost pressure the network companies are actually exposed to. As we highlight above, this is unnecessary, will raise risk, and will ultimately be detrimental to energy consumers.
137. On a point of relative detail, on Ofgem’s comment that it will consider whether to retain an input price index in its calculations at T2 and GD2, we continue to think that Ofgem should not use an input producer price index in any sector’s calculations (and note that Ofgem removed the input price index from its approach at ED1 following consultation).

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

138. We agree with using notional cost structures for setting RPE allowances.
139. Using company specific cost structures would undermine the totex approach to regulation and distort incentives, encouraging companies to favour cost structures that are likely to maximise RPE allowances rather than minimise overall costs.
140. We do not agree that notional cost structures are not an option in respect of the transmission sectors. Ofgem can still form a view on an efficient notional structure in respect of these sectors, as it does for example on notional gearing in its cost of capital calculations, or when it determines cost benchmarks for these companies.

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?

141. If Ofgem takes the flawed approach of RPE indexation, then the proposal to include an initial forecast allowance and update these allowances annually is better than the alternatives.
142. It must also recognise the risk additive nature of RPE indexation, especially given that it is likely to make the allowances of companies more pro-cyclical, removing a natural hedge that fixed allowances previously gave companies. The removal of this risk reducing natural hedge will increase systematic risk and increase equity beta and the cost of equity.

¹¹ Appendix 1 to the Consultation contains a description of the approach used at RIIO-1, followed by details of how Ofgem intends to use to implement indexation once indices are selected, but we have not been able to identify content on how Ofgem proposes to identify appropriate indices at RIIO-2.

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?

143. The EU KLEMS dataset is the most frequently cited source of relevant evidence that we are aware of. We agree that Ofgem should make use of it but Ofgem should also put in place strong incentives for companies to set themselves challenging productivity assumptions in their business plans, something which Ofgem achieved at ED1 but which the current business plan incentive proposals would fail to do.
144. In respect of completeness, we would also highlight that at ED1 Ofgem did not accept the productivity assumptions of *individual* slow track DNOs as reasonable, as might be inferred from the Consultation. Productivity assumptions were inspected directly but once Ofgem found them to be within a reasonable range, they were included in costs used in the cost benchmarking process.¹² This meant that the productivity assumptions applied to slow track DNOs were calculated through Ofgem's benchmarking models, including an upper quartile efficiency target.
145. The productivity assumptions that were imposed through this process may well have been at or even above the top of the productivity range cited in the Consultation. This is yet another example of the success of Ofgem's ED1 approach to encouraging companies to reveal information on the costs they expected to incur in the ED1 period.

7. Managing the risk of asset stranding questions

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?

146. A utilisation incentive would be worse-targeted than the tools Ofgem already uses, and would have many drawbacks. We agree with Ofgem that it should be discounted, and agree with its reasons as listed in the Consultation.¹³ All of this reasoning, and more, will apply when Ofgem considers this question in respect of ED2.
147. The fact is, big changes in utilisation may be entirely beyond the control of network companies, and so exposing companies to this would significantly increase risk and require major increases in the cost of capital. At the same time, Ofgem already has many incentives that encourage companies to raise utilisation where they can. This includes its totex cost incentive and totex benchmarking approaches, that encourage companies to minimise cost, including through higher utilisation.

¹² . A number of DNOs also included additional "bottom up" productivity assumptions that were not included in the headline productivity figures, although WPD omitted productivity improvements between the 2012-13 base year and 2015-16, at least on the face of its 2013 plan submission, and received cost allowances on this basis as it was fast-tracked.

¹³ With the exception of the second sub-bullet in paragraph 7.23 which relates to asset health and is irrelevant to utilisation.

148. There is also no genuine economic reason to think high(er) utilisation is always a good thing, at the margins. For ED2, it is important to consider that:

- a. DNOs can use demand side response to encourage less network usage, and lower utilisation, to reduce total costs; and
- b. In the future consumers might get good value from a robust “backup” network with occasional power flows (and low utilisation).

149. Instead of a utilisation incentive, we continue to advocate that Ofgem should focus on incremental improvements to its existing suite of incentives. We have set out our proposals for this in other parts of this response.

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

150. From an electricity distribution perspective, we see no need at all for this direction of travel in relation to anticipatory investment.

- a. In relation to reinforcement, covered by the price control arrangements, there is already a significant element of risk sharing, because companies face a totex efficiency assessment at the price control review and are then exposed to a cost sharing factors.
- b. In relation to new connections, new connectees pay only for their share of the connection, and having covered this cost they take the commercial risk of whether the investment will pay off. New connections are also exposed to competition.

151. We can see more reasons for this type of framework in relation transmission investments, especially where they are major and lumpy, or if distortions in the existing framework mean new transmission connectees do not pay an appropriate share of the cost of that connection. But we would still caution against the direction of travel. Neither network companies, nor BEIS, nor Ofgem will be better placed than the market to decide whether highly anticipatory investments will be worthwhile. ‘Picking winners’ amongst speculative investment projects is likely to lead to white elephants and wasted money.

152. Ofgem’s framework decision stated it would require networks to meet a high evidentiary hurdle in relation to the need for new investments. We think this should remain the case. Ofgem should ensure its arrangements mean that new connectees pay an appropriate share of the cost of a connection. Those connectees should then be left to decide whether it really is worth connecting, and to bear the risk of that decision, while the cost of any necessary and efficient investment beyond the size they require should be funded through the normal price control arrangements (with the relevant network companies sharing risk through the cost assessment and the efficiency incentive).

153. We recognise however that Ofgem has said in the Consultation that this proposal is “*based on policy objectives beyond our remit*”. We presume that this means Ofgem anticipates the possibility of additional requirements being placed on network companies (or Ofgem) due to future Government

priorities and policies. Once it becomes clearer what these priorities and policies might relate to, we will be able to offer better informed comment on them, and on the appropriate delivery model and regulatory framework. Once government policy decisions make clear that investments will be used and useful, asset stranding will become less likely in any case. At this point they are likely to go ahead under the current arrangements. Any decision to allow for their funding through price control allowances, where this would not currently happen, and socialise their costs instead, would raise costs to energy consumers and would require a further government policy decision, rather than a regulatory one.

154. Turning to Ofgem's proposals for a cross-sectoral common base scenario, this may be helpful for presentational purposes, especially if the base case is aligned towards the lowest reasonable view of uptake of new network technologies, with alternative cases flexing upwards above that to show the potential impact of higher update.
155. It must not become a vehicle for "setting" the level of network investment to cover a particular scenario, and to lock in a particular approach to investment, with no thought to what would happen when a different scenario materialises. It must also not undermine the incentive for companies to present a lower-cost plan than their peers, by accepting more risk than others, by giving an Ofgem-led green light for higher levels of investment.
156. The really important question is instead how the regulatory arrangements should flex upwards (or downwards) from the base case, as actual levels and patterns of uptake of new technologies become clear.

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

157. Additional risk sharing, beyond the efficiency incentives built into normal price control arrangements, will raise the cost of capital above the level that can be achieved via the price control, and therefore the total cost of the project.
158. It should only be considered where Ofgem is convinced the case for investment is not made out, and thinks network companies are likely to be well placed to judge whether the investment will be successful and carry the risk of this decision.

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

159. The best way to ensure risk is managed appropriately, where possible, is for the parties driving the expenditure to face their fair share of the cost, as is the case for new electricity distribution connections (including through rules that apportion part of the cost to the main price control, where appropriate, and second comer rules which provide additional protection). This means they internalise that cost, and the anticipatory nature of the investment, only taking ahead projects where they can see net benefits.

160. If this is not possible for any reason, Ofgem's framework for interconnectors provides a model which exposes operators to downside risk while allowing them to enjoy higher returns (up to a limit) based on the outcomes of the commercial market in which they operate. A similar model could be used.
161. Ofgem should not try to set higher or lower returns on the project based on its own view of whether the project is likely to deliver a net-benefit to energy consumers. This would be subjective and likely to lead to bad outcomes.
162. Lastly, Ofgem should ensure it takes full advantage of all competition. The types of projects Ofgem seems to be describing in its proposals are likely to meet the criteria for competition.

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

163. Provided that Ofgem maintains appropriate levels of risk sharing in its business as usual framework (for instance through a cost sharing factor that is high enough, and connection arrangements that place the risk associated with appropriate levels of cost on the connectee) there is less likely to be a need to put projects into an alternative framework. Minimising the use of any alternative framework would help guard against distortions.
164. Ofgem could also eliminate the risk of double-funding by taking decisions on projects that might be eligible for the 'risk sharing' mechanism every five years, aligned with the price control for the relevant sector.

8. Innovation questions

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

165. Delivering better or cheaper services for customers through changes to business as usual (BAU) practices is rightly the core objective of innovation for companies.
166. However, Ofgem's proposals appear to be designed to discourage innovation as BAU. At paragraph 8.16 the Consultation states that *"any allowed funding for BAU innovation which is not subsequently rolled out will be recovered as part of close-out for RIIO-2"*.
167. We are concerned by Ofgem's proposal to claw back funding for any projects that aren't rolled out into business as usual. This will be a strong disincentive to any innovation, where (by definition) it is uncertain whether the research will prove or disprove a hypothesis. Even when a project proves a method shouldn't be rolled out, it represents valuable learning (by telling others not to try this).
168. Such a mechanism would also increase the regulatory risk that innovation carries, and thus discourage it even further. In addition, once projects have gone ahead, the mechanism would distort decisions about roll-out, pushing companies towards the innovative solution, even if other options would in fact be better. This would raise costs to consumers.

169. Ofgem would also be required to make a subjective evaluation on the extent to which innovation has or has not been rolled out into BAU. From a practical perspective, it is difficult to choose a counterfactual and to understand how changes made to BAU processes relate to specific innovation projects. Our experience in the ED1 period is that changes to business processes are usually the result of the synthesis of learning from a number of innovation projects as opposed to a 1:1 relationship.
170. If Ofgem does move to ex ante allowances for innovation expenditure, set as part of an assessment of business plan cost proposals, it should not then discourage innovation through the threat of a close-out claw-back mechanism.

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

171. Yes, the IRM should be discontinued. We say this for four reasons.
- a. The mechanism adds complexity.
 - b. It can only be triggered in a very limited “sweet spot” that is so narrow as to be unlikely.
 - c. Where it can be triggered it creates a distortion between innovative and non-innovative ways to solve the same problem.
 - d. A five-year price control period reduces the need compared to the previous longer period.

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?

172. We agree Ofgem should refresh the Network Innovation Competition (“NIC”). It would however be short sighted for Ofgem to exclusively limit the focus of innovation funding to energy system transition (EST) issues, even though such matters will play a key part in many future innovation projects.
173. We are concerned that the focus on energy system transition (“EST”) projects is:
- a. Too limited, as non-EST projects can deliver savings to consumers;
 - b. Poorly defined, leading to boundary issues in trying to establish whether projects address EST issues; and
 - c. Guaranteed to lead to less innovation in non-EST areas that can still be valuable.
174. If Ofgem does limit the future network innovation competition to EST issues, this makes it even more important that it retain a flexible Network Innovation Allowance (NIA).

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

175. If legislation is made to give innovation funding directly to third parties, there is no reason for this to be funded via energy networks
176. We are not the sole source of knowledge on what could benefit our consumers – we welcome collaboration and ideas from our partners; we would encourage other parties seeking to develop products and new services to innovate, whether or not we are involved.
177. We are however accountable for the safe and reliable operation of our network such that granting others direct access to live networks to test innovations, without our direct involvement and oversight, is unrealistic. We are also responsible for passing on the cost for the innovation funding we receive and therefore have an incentive to only use innovation funding in ways that we expect to reduce long term bills; this incentive is further underpinned by Ofgem’s role in the governance arrangements, requirements for DNOs to provide their own commercial contribution.
178. Giving direct access to that funding to others, removing network companies from the governance, creates additional risks to consumers. There would therefore need to be alternative governance arrangements in place to manage the expenditure, and reduce these risks to consumers. There is no reason that the innovation would need to be limited to energy network activity; it could be off-network. And there is also no reason it should be funded through energy networks, since, for example, it could be raised with greater administrative efficiency through a single party, such as the ESO.

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.

179. We agree with Ofgem’s reasons for considering continuation of the Network Innovation Allowance (“NIA”).
- a. We have found the mechanism effective in helping us leverage larger amounts of innovation funding from other sources which gives good value to energy consumers.
 - b. It has provided SME’s significant support and the lack of an application window has been commented on positively.
 - c. It has helped ensure that projects like the UKPN / Northern Powergrid collaboration on “Development of Oil-filled Cable Additive”, set to make a multi-million pound contribution to efficiency in oil cable management, proceed.
180. The NIA provides allowances on a ‘use it or lose it’ basis. If Ofgem wishes to protect a certain level of network-led innovation expenditure, then it should continue to provide the funding on a use it or lose it basis rather than as part of the main totex allowances.

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

181. Retention of the NIA should not hinge on “tracking benefits” from the NIA, as it is always difficult to draw robust conclusions from the reporting of non-costs. But to the extent Ofgem is concerned it may encourage an inefficiently high level of innovation by protecting expenditure from cost-cutting via the NIA and then it can account for this in how it calibrates the level of the allowance.

CSQ50. Do you agree with our proposals for electricity distribution companies prior to the commencement of RIIO-ED2?

182. We agree that electricity distributors should be able to act as project partners for transmission and gas distribution companies under their RIIO-2 innovation arrangements, and vice versa. If Ofgem did not allow this, cross-sectoral or whole system projects would lose valuable expertise, and deliver lower benefits.

9. Competition questions

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

183. The models Ofgem has set out in Figure 4 of the Consultation are all valid, but we think Ofgem should consider a further model.
184. There are many existing electricity network operators with the expertise to construct, maintain and operate extra high voltage lines. Distribution licences allow their holders to operate high voltage lines, with no voltage limits, as part of their distribution network. And even where it would not form part of their distribution network, and where the activity would be transmission, the Secretary of State can grant a derogation from the requirement for a transmission licence under the Act. DNOs are therefore a ready-made source of potential competition on transmission projects, especially projects involving new connections (like any prospective move to build a new network to serve motorway car charging infrastructure).
185. The only regulatory barrier we can see to distribution operators competing for transmission projects (on an early or late basis) are distortions between the charging framework for the transmission sector and the distribution sector. These distortions should be addressed, to ensure distribution companies can offer connections at very high voltages on the same basis as a transmission company.
186. Even at lower voltages, distribution systems can also offer early-stage solutions to transmission issues, in the correct circumstances. For example, at Harrogate, Northern Powergrid has built 132kV extensions of its own network to avoid expensive transmission connection charges. This demonstrates that the higher distribution voltages can offer cheaper solutions than transmission assets.

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?

187. Ofgem's existing criteria for late-competition in transmission should be extended to other sectors. The criteria will ensure that this type of arrangement is focussed on high value projects that justify the administrative costs, while avoiding problems such as a lack of clarity over the ownership boundary. The criteria are sufficiently generic that they must, by definition, be suitable for all of the sectors.
188. Maintaining these criteria at the levels set will also help mitigate some of the additional costs of a more fragmented system that competition can introduce. Ofgem's impact assessment is right to recognise the existence of these costs.
189. In terms of detailed wording of the 'separable' criteria for electricity distribution (covered in table 13 of the Consultation), it would not be appropriate for a late competition model to be applied to owning and operating components that are integral to a distribution network. The criteria should not be phrased in a way that could require this. To achieve this, Ofgem should:
- a. retain the existing statement on a clear ownership boundary;
 - b. remove the statements that contiguity and electrical separability are not required (or should be determined on a case by case basis); and instead
 - c. require that the assets represent discrete sections of network rather than potentially including the replacement of integrated component parts.¹⁴
190. The replacement set out in points b. and c. is necessary because, without it, the current criteria might allow for competition to replace and then own distribution network component parts, where programmes of replacement hit a high enough value. This splintering of accountability could see third parties taking risks with high volume and low-value components that threatens the stability of an entire network.

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

191. As we note at paragraph 188 above, Ofgem's impact assessment is right to recognise that competition will lead to costs associated with a more fragmented system.
192. It is appropriate that Ofgem should not place any weight in its calculations on purported benefits from using information on operational or finance costs as a benchmark for the onshore RIIO-

¹⁴ If a third party was allowed to compete for a project to replace a large number of distribution substations, for example, it would lead to an entirely fragmented yet entirely inter-dependent system, heightening network management risk.

framework. The risks and costs associated with running a new, discrete, asset for a fixed period of 25 years are very different to those associated with running an onshore network.

193. Ofgem's calculations of any change in finance costs must recognise that Ofgem would expect to set a lower cost of debt in the RIIO-2 price controls if companies take forward large projects and have higher RAV growth, because Ofgem would forecast more new debt issuance at current low rates.

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

194. No. Once the generic criteria are met, the relevant considerations will be similar. Different circumstances in different sectors are likely to be reflected in how frequently the criteria are met.
195. Of course, electricity distribution projects are less likely to qualify under the criteria. They are typically smaller and less likely to justify the administrative expense of a bespoke Ofgem led late-competition process. The systems are also significantly more meshed and overlapping, making it more difficult to identify assets that are sufficiently separable that clear ownership and operational boundaries could be established.
196. But while Ofgem should recognise that these practical issues will limit the number of projects that are likely to justify bespoke competitions in distribution, it should also be clear that distribution consumers will still benefit from extensive early and late competition:
- a. There is extensive competition through design and procurement of network solutions.¹⁵
 - b. Asset financing makes extensive use of third party debt, issued on competitive markets.
 - c. Ofgem's benchmarking of asset and finance costs imposes competition between networks.
197. There is also already extensive competition in distribution, in construction of network extensions to serve new connections and in ongoing ownership and operation of these. Ofgem has not yet harnessed the benefits of the latter type of competition, as the benefits currently flow either to landowners or to the relevant network operators. In parallel to RIIO-2, it has the opportunity to address this shortcoming through suitable reform to this system.

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?

198. The Consultation lists as potential drawbacks issues such as deliverability, land access, and changes in circumstances. These also affect traditional models of network delivery. If new assets must be constructed, they aren't an obvious advantage or disadvantage for early competition.

¹⁵ 80% of Northern Powergrid's direct operational work load consists of bought in goods, services and materials; the majority of which is tendered. This means that a large majority of the works that we deliver are already exposed to market forces.

199. If new assets are required, we do not think rights to access land would pose a problem in practice. If the bidder wishes to own and operate assets under a competitive framework, they will need a licence, and would gain the relevant rights. They could alternatively partner with a licence holder. There are many licence holders they could partner with, as long as Ofgem's framework permits this.

CSQ56. Are there other potential drawbacks of early competition?

200. The only genuine drawback we can see is the additional administrative cost. It is always worth being aware of potential options.

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?

201. We mentioned at paragraph 186 an example where Northern Powergrid used a distribution system solution, using 132kV assets, to substitute for our initially preferred transmission solution, within the existing price-control arrangements.

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?

202. A two stage process with a separate 'competition for ideas', then opening of the winning idea to bids, would have a number of significant drawbacks. For example:

- a. it would not act to reveal information on costs, because the bidders would have an incentive to over-sell their ideas, to try and win a success fee; and
- b. entrants who wanted to own and operate assets would face weaker incentives to develop ideas, if these ideas could then be taken ahead by third parties at the next stage.

203. A single bid process would discourage bidders with innovative solutions because of the high costs of preparing a full and final bid without any certainty that it would be eligible.

204. To mitigate the disadvantages of both options, a hybrid option should be taken ahead.

- a. A 'competition for ideas' could be taken ahead as a pre-bidding stage, for potential entrants to signal their interest in providing a solution, and provide an outline.
- b. These initial ideas would then be assessed against whether they would meet the network need; provided they do, confirmation would be given to the interested parties.
- c. Full and binding bids would follow from bidders at the next stage.¹⁶

¹⁶ This hybrid option is consistent with a possibility mentioned on page 149 of the Consultation, of a first stage which leads to shortlisting into the second stage. We propose that shortlisted bids would fully develop and cost their own proposal.

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?

205. Value and certainty of system need are likely to be key criteria.
206. Time criticality is unlikely to be an issue. It takes time to undertake early design of a transmission solution, gain relevant consents, undertake detailed design, and then tender for any construction contracts. There will always be time to undertake an early stage competition, in parallel to standard design processes, where the value at stake makes the associated administrative costs worthwhile.
207. As a distribution system operator, we also expect to use early-stage competition relatively routinely, through native competition, even where the value at stake would not warrant the administrative cost of an Ofgem-led competition. We as distribution system operator would remain accountable for success of the solutions, unlike under a system where a third party designed and operated it.

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?

208. An additional criterion is required: **in-depth knowledge of the relevant network topography**, which is necessary for the proper understanding of how potential solutions will interact with the existing network and usage patterns of connected customers. This is distinct from (and complementary to) technical proficiency. In the electricity transmission sector the ESO carries this knowledge. In the electricity distribution sector the local distribution networks carry the relevant knowledge.
209. Electricity distributors are the right parties to take on the DSO role and minimise costs to consumers.
210. The efficient co-ordination of increasing volumes of energy resources connected to distribution networks is one of the key issues for the R110-2 price controls. The scope of the distribution system operator role needs refinement but it is already clear that electricity distributors have a key role to play as the DSO itself.
211. As set out above, distributors are ideally placed to facilitate native combination. No other party can be given the same blend of a genuine commercial incentive to minimise total cost, equalised incentives between different solutions, and money on the line based on the “real” results (rather than based on a presentational exercise, like the ESO’s incentive).
212. Integrated ownership and operation also ensures clear accountability, with money on the line if there is a failure.
213. And lastly, separation of ownership and operation (or even ring-fencing of operation) are more technically challenging in electricity distribution than transmission.
- a. Distribution networks are more complex. They have many more nodes and much greater levels of interconnection, and have far less automation at lower voltages.
 - b. As such operation, maintenance and asset management are much more closely linked than for transmission networks.

214. This inevitably makes the case for the separation of operation from ownership, or even for ring-fencing of operation within the same organisation, much more difficult to justify for distribution when compared to transmission.
215. The Consultation repeatedly mentions “perceived bias” alongside actual bias.
216. While it is no doubt important to help address the concerns of key stakeholders, the tail shouldn’t wag the dog and lead to bad regulatory design.
217. Commercial entities bidding for contracts understand the difference between perceptions and reality, and would not be put-off from entering a market by such perceptions. Of course, that isn’t to say they wouldn’t still lobby for changes if, for example, they thought they could encourage Ofgem to introduce of bias in their favour (to the detriment of energy consumers). So Ofgem should assess the position for itself. DNOs manifestly have a very strong incentive under the ED1 arrangements to seek out, and utilise, alternatives that help them to defer or even avoid altogether expensive network investment.
218. Ofgem must not let misperceptions of conflicts of interest or ill-founded allegations lead it to fragment the existing “unified” R110 framework for electricity distribution, or to reallocate responsibilities to parties that may have actual conflicts of interest, or simply lack the expertise or deep knowledge of the local network to take the relevant decisions.

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?

219. Ofgem designed significant aspects of the R110 framework to encourage native competition, such as equalisation of incentives across capital and operating solutions. Ofgem must ensure it does not undo this work.
220. Instead it should allow native competition to continue developing. And once it observes that distribution companies are able, in practice, to achieve lower costs through the use of native competition, Ofgem needs to pass these benefits on to consumers through the sharing factor and the five-yearly price control reset. The potential savings to consumers are significant.
221. In electricity distribution at ED1 Ofgem was able to apply the “full” R110 framework on a unified basis to ownership and operation activities.
222. This creates a major advantage over the electricity transmission model, where practical reasons (at T1 and prospectively T2) mean that system operation and system investment costs are subject to very different incentives, and this fragmentation creates conflicts of interest and boundary issues between price controls that are challenging to manage.
223. The ED1 framework regulates away these conflicts of interest, and creates all the right incentives for network companies to use native competition to identify cases (and only those cases) where alternative solutions will reduce long-term network costs. These savings will be passed on to energy consumers, first through the totex sharing factor, and over the longer term through comparative

benchmarking of company costs which ensures distribution companies have a long term incentive to secure benefits from native competition. Ofgem must build on these positive arrangements, not undo them, at ED2.

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?

224. Yes, the totex approach is the best approach.

225. At paragraph 8.88 of the Consultation, Ofgem draws attention to the risk that companies might propose a replacement project, defer it through an innovative solution, and then request the allowances again. But this is not a problem under the current system. Ofgem can simply refuse to provide further funding for a project that has already been funded under the price control allowances, as long as it has provided the necessary funding for the company to fulfil its obligations, and as long as it takes care not to undermine incentives for companies to achieve efficient cost reductions.

226. This is the baby that must not be thrown out with the bathwater: if a company can defer a project for long enough by using innovative approaches, then consumers will enjoy a share of this, and will also benefit from lower long term costs as those innovative approaches gain more widespread application.

227. Of course, where there is uncertainty at the outset over system needs, Ofgem can put in place an uncertainty mechanism. To maintain strong incentives, these should depend on external circumstances, rather than network company actions.

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?

228. Trying to apply different incentives to cost savings, based on a granular distinction between the 'type' of cost saving, would inevitably introduce distortions between different categories of cost.

229. If this were applied to parts of the system where the RIIO totex approach has been applied in full, like in electricity distribution (and potentially the gas sectors), it would create conflicts of interest and un-balanced incentives where this is presently not an issue. Such a retrograde step should be avoided.

230. This includes Ofgem's proposal to use competition as a 'price finder', as described at paragraphs 8.93 to 8.95 of the Consultation. What Ofgem describes is, in effect, a granular re-opener that would revisit cost allowances on a line by line basis within the price control, with the licensee's share of any cost saving limited to a tenderers award. This would remove the incentive for licensees to

find the lowest cost approach, as they may prefer an approach that only just beats the reference benchmark and therefore still qualifies for a tenderers award.

231. Ofgem has not detailed what would happen if the results of the ‘price finding’ competition came back above the reference benchmark. If Ofgem would allow these costs, then this amounts to pass through, and costs can be expected to rise over time. If Ofgem would instead try to judge on a case by case basis whether the costs should be allowed, this creates additional regulatory risk, which would raise the cost of capital. In either case, this approach would raise costs to energy consumers over the longer term.
232. Allowing network companies to pick and choose which costs they take outside of the totex framework, as suggested at paragraph 8.96 of the Consultation, would exacerbate these problems and further undermine the objectives of RIIO and the totex incentive.

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

233. We do not see how the ESO could identify better outcomes than the relevant network operators deploying native competition, incentivised under the totex incentive.
234. If Ofgem did make the ESO responsible for facilitating competition in the gas sectors, and move away from the RIIO-approach based on equalised incentives, this could introduce un-balanced incentives and genuine conflicts of interest where none presently exist.

10. Business Plan and totex incentives questions

CSQ65. What are your views on our proposed approach to establishing a Business Plan incentive?

235. Under the new “business plan incentive”, Ofgem is encouraging cost base growth and bad value for energy consumers.
236. The RIIO framework places the business plan at the heart of the price control process. If companies have weak incentives to submit good plans, then Ofgem has poor information to work with from the beginning. Asymmetries of information are exacerbated, not mitigated.
237. The business plan incentive is then at the heart of the battle against asymmetric information, a concern that Ofgem has emphasised in its December document.
238. In the name of simplicity Ofgem has decided, for GD2 and T2 at least, not to use the IQL. However its proposed replacement mechanism appears to us to be equally complex and, based on our review, doomed to failure.
239. In terms of complexity, Ofgem has not yet been able to write an algorithm that describes what will happen in all the possible scenarios, in sectors with multiple companies. Instead it has created a dilution rule that relies on a non-standard way to add up percentages, and compensated for this

with a couple of worked examples that do not provide a set of rules for what will happen in all the other potential scenarios.

240. We set out the reasons that it will fail in greater detail below, but in short:

- a. There would be no penalty for submitting a heavily inflated plan;
- b. The rewards for submitting a lean plan would be diluted not once, but twice, first through Ofgem's relative cost benchmarking process, then through inter-twining of the results

241. Ofgem's proposals for the IQI's replacement are so weak over the critical ranges that whether Ofgem wants to admit it or not, it is in effect encouraging cost base growth to the detriment of consumers. Over time, coupled with little or no prospective reward for outperformance, cost bases would balloon.

242. Given the importance to price control outcomes of stimulating the submission of lean business plans, Ofgem needs to fundamentally change its proposal.

- a. Ofgem must split the business plan incentive into its two component parts, with a standalone cost incentive that is not diluted by the value of the plan quality incentive.
- b. If the quality dimension is to be retained, the sums in play must be turned down substantially.
- c. The cost incentive should also be much finer-grained than Ofgem's proposal to make companies at all points in the efficiency spectrum think harder about where to locate their plans.
- d. Ofgem should abandon plans to dilute rewards on the cost dimension. The dilution it seeks is, in the distribution sector, guaranteed by upper quartile benchmarking.
- e. Penalties and rewards should rise gradually to significant levels.

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?

243. Ofgem should also base its assessment on totex as a whole, with as little as possible by way of exclusions. Any other approach would damage the incentives for companies to provide robust, well evidenced, cost forecasts.

244. Where costs are subject to uncertainty (e.g. over the need for the project), then an uncertainty mechanism would of course be required, and should insofar as possible be based on measurable external factors rather than company decisions. But uncertainty mechanisms should be put in place as well as the incentive for companies to provide robust cost forecasts, not instead of that incentive.

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?

245. Under these proposals, companies would face weak incentives to submit a plan containing a lean cost forecast, and would likely regret it if they did.

- a. In effect, there is no penalty for submitting a heavily inflated plan. Ofgem's mechanism would split companies into three buckets, good, average and poor according to their overall benchmarking efficiency score. But by setting the threshold for poor at >104% of Ofgem's view of efficient cost, the cost incentive is all but "switched off" for most companies, because Ofgem's proposal to apply the same penalty whether companies are 5% or 30% inefficient.
- b. Any reward for submitting a lean plan would be diluted not once, but twice.
 - i) Since Ofgem uses the upper quartile to determine what 100 is in its benchmark, rewards for low cost business plans in the distribution sector will inevitably be shared, diluting any upside; and
 - ii) Any outperformance will be further diluted due to Ofgem's proposal to intertwine the outcome of its cost appraisal with its assessment of plan quality.

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

246. As noted in our answer to CSQ67, companies would face weak incentives to submit a plan containing a lean cost forecast, and would likely regret it if they did. In effect, there is no penalty for submitting a heavily inflated plan.

247. On top of this, companies would be able to earn material rewards by getting good scores in a subjective appraisal of plan "quality". There are several problems with this.

- a. Consumers will rightly focus on value rather than some woolly conception of "quality". If Ofgem is doing its benchmarking right, value should be captured under the cost element of the incentive. Adding a quality dimension adds little.
- b. Yet Ofgem's plans would put vast sums in play on quality. To illustrate, National Grid's transmission operator alone (excluding its other interests), at annual expenditure levels like those seen in 2016-17 (of £1.1 billion), would see up to £110 million on the line as part of an essay writing competition. There is simply no justification for this.
- c. Ofgem's past track record on gauging plan quality does not inspire confidence that it will be able to award prizes to the right parties.

- d. The potential for this quality dimension to dilute the cost element of the business plan incentive – the part that really matters – makes this part of Ofgem’s mechanism

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?

248. We do not agree with the conclusion from the assessment, as it appears to use the wrong counterfactual. The fact is that, every time the IQI has been applied, it has led to better outcomes than if no incentive had been in place.

249. The IQI and before that the SSM have worked well in the right circumstances and always resulted in better outcomes than would have occurred without them. Looking ahead to ED2, Ofgem must keep a “simplified and intensified” IQI on the table, as it signalled it intended to in its RIIO-2 Framework Decision.

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?

250. Ofgem should not view a high sharing factor as an incentive to submit a lean business plan cost forecast. It serves a distinct role and the two should not be conflated.

251. The blended sharing factor approach, in isolation of a strong incentives applied to the efficiency of the cost proposals companies submit, could lead companies to:

- a. submit very rigorous justification for very high cost forecasts, to obtain an allowance the company can outperform, and a sharing factor that allows them to keep a high proportion of this outperformance; or
- b. submit wilfully poor justifications for cost forecasts, as this would allow them to self-select into a regime that has weak incentives and is close to pass-through.

252. They could also lead to the worst of both worlds, when combined with excessive use of the uncertainty mechanisms proposed at paragraph 9.44 (sub bullet two) of the Consultation, especially companies propose bespoke mechanisms that are based on cost or volume outturns (rather than factors that are not within company control). A company would be incentivised to:

- a. seek high allowances on “baselineable” activities, to gain outperformance opportunities; and
- b. self-select into pass-through arrangements on activities that are subject to greater delivery risk.

253. To avoid these perverse outcomes, Ofgem needs to couple the blended sharing factor approach with a strong disincentive for badly justified or high cost forecasts, and a strong incentive for low and

robustly-justified cost forecasts. As we set out in our responses to the questions above, the business plan incentive that Ofgem has proposed provides no comfort in this regard.

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.

254. We do not agree with a number of aspects of Ofgem's assessment of the blended sharing factor. In particular, we think that in isolation of an effective incentive on plan cost levels it could drive perverse incentives. We set out our reasons in our response to CSQ70 above.
255. However, we agree with other aspects of the assessment, for instance that it scores 'low' on ease of implementation.
256. In relation to Ofgem's appraisal of Ofwat's proposals, Ofgem incorrectly suggests in line four of its assessment that Ofwat's approach could counteract behavioural biases; instead it could make these worse.
257. The Ofwat framework, simply put, should not be adopted. We have analysed carefully the effects of Ofwat's proposals in depth already.¹⁷ They create distorted incentives and would lead to poor outcomes for consumers. They may well encourage the majority of companies in a sector to overstate their cost requirements. But while the Consultation gives the wrong reasons for the proposal to not use Ofwat's approach, it has at least arrived at the right answer in disregarding it.

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?

258. Ofgem has proposed two ways in which it might set the strength of totex incentives following its decision to abandon the IQI for GD2 and T2. Neither will work well.
259. The thinking behind Ofgem's blended sharing factor proposal is muddled.
- a. Ofgem's sole focus is on the degree of confidence it can have in setting a forecast. If confidence is low, then Ofgem argues that a low incentive rate is called for.
 - b. Ofgem makes no mention of the principal motivation for having an incentive in the first place, i.e. the belief that there is uncertainty around outcomes for some given activity and that the company, appropriately incentivised, is able to manage that risk to achieve better outcomes on behalf of the consumer. This is a glaring omission.
 - c. The cost heads around which there is lowest confidence will (almost by definition) be related to areas where outcomes are particularly uncertain.

¹⁷ Frontier Economics, November 2018, *Development of the IQI, A report prepared for Northern Powergrid*

- d. These are likely to include areas where management focus may therefore offer the greatest reward in terms of lower cost and better outcomes.
- e. Yet under Ofgem's proposal, such cost heads would receive a low incentive rate, not a high rate.
- f. As a result, sectors where there is much that the company could do to manage cost would be most likely to have the lowest blended incentive rates, whereas sectors where there is least to play for would receive higher incentive rates.

260. The effect of Ofgem's proposal would seem calculated to weaken incentives in the exact areas where they should be strongest, and to transfer to consumers risks that should be properly borne and managed by the networks.

261. When coupled with Ofgem's misguided proposals for business planning, it becomes clear that under Ofgem's proposals companies would face no incentive to submit lean forecasts, and then weak at best incentives to outperform the resulting allowances. Ofgem needs to go back to the drawing board.

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)?

262. We do not have any views in respect of the sectors which the Consultation relates to, other than those expressed in the answer to CSQ70 and 72 above.

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

263. As will be clear from our answers to other questions, we have a number of material concerns with Ofgem's broad set of proposals. Ofgem must significantly reform these proposals if it is to create appropriate incentives for companies. Under the proposals as they stand, the wrong behaviours will be incentivised.

264. With suitable reform to the proposed business plan incentive, as described in our response to CSQ65 above, we think it could drive the right behaviours. To achieve this, Ofgem would need to separate the two components of its business plan incentive, and place much more emphasis on the cost incentive/blended sharing factor approach. If this is done with care, Ofgem will have replicated the virtues of the IQI.

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

265. Ofgem's assessment appears to be based on analysis that has not been described fully, and results which have not been disclosed. It is difficult to comment on assumptions underpinning analysis that

has not been published. The results of this type of analysis will depend critically on those assumptions.¹⁸

266. Instead we think that Ofgem should make more use of the evidence it holds from the sharing factors used in previous price controls. These should be stated on a comparable (post-tax) basis, and on a blended and non-blended basis. We think Ofgem will find that it has not previously set sharing factors as low as 15% (or at least not in distribution price controls). The bottom end of Ofgem's range would therefore represent uncharted territory making it difficult to support a prediction that companies would have an adequate incentive to reduce costs within the price control period.
267. Ofgem should also consider the warning it gave previously that *'It is important that the lower bound is set appropriately as if the incentive rate is set too low, a company may not face exposure to the costs that result from overspend and could spend money unnecessarily to increase its regulatory asset value (RAV).'*¹⁹ This is a far more relevant consideration than the incentives to capitalise expenditure which Ofgem mentions, since Ofgem removed those incentives from its framework some time ago.

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

268. In each of its RIIO-1 price reviews, Ofgem set the same sharing factor for all totex costs, with minimal exclusions, and imposed a uniform capitalisation rate. This equalised incentives across the relevant costs, which is one of the cornerstones of the RIIO framework, and removed capitalisation bias. The only exceptions were carefully considered, like entirely non-controllable costs where pass-through treatment is appropriate.
269. Ofgem must not reverse this decision by setting lower sharing factors for categories of costs where Ofgem lacks confidence in company forecasts. Differentiation like this would lead to higher cost and RAV growth over time and be costly to energy consumers.

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

270. No, we do not have any evidence which is not already in the public domain.
271. Ofgem has of course just published a study of the most comprehensive historical data source available, the EU KLEMS dataset.

¹⁸ At paragraph 9.58, Ofgem states that *"if we set sharing factors too high, then companies may... choose to capitalise expenditure when it is not in consumers' benefit"*. This is not a relevant consideration given that, under RIIO, Ofgem sets a single capitalisation rate for all types of expenditure.

¹⁹ Ofgem, 2010, RIIO Handbook, page 84, paragraph 10.9

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

272. This would be an unnecessary complication in the arrangements.

273. It could also drive perverse incentives, for instance allowing companies to 'optimise' their sharing factor within the price control period, when they know whether they are under- or out-performing.

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

274. This would be an unnecessary complication in the arrangements and should not be pursued.

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

275. This would be an unnecessary complication in the arrangements and should not be pursued.

11. Ensuring fair returns questions

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

276. We agree with the relative positioning of the options, when comparing across the columns in the table, but in absolute terms several aspects of the assessment are incorrect. Ofgem has:

- a. understated the negative effect of sculpting (including sector average sculpting) on incentives;
- b. failed to recognise the obviously risk additive nature of anchoring (when compared to the status quo) due to the greater exposure to competitive pressure and direct exposures to errors in the price control settlements of other companies; and
- c. failed to recognise the current extent of collaboration on incentives²⁰, and thus failed to recognise the negative impact of anchoring on collaboration.

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

277. Yes.

278. Discretionary adjustments raise regulatory risk and damage incentives. They would result in the cost base being higher, and performance worse, than necessary. They also raise the cost of capital.

²⁰ For example, in the earlier parts of the ED1 period, other DNOs provided Northern Powergrid with guided tours of their call centres, and an overview of their processes in relation to customer service and the customer satisfaction incentive, but under the competitive pressure of dynamic-relative targets or anchoring this is unlikely to occur.

279. Since ex post and discretionary adjustments are detrimental to energy consumers Ofgem should rule them out in general, not just in relation to RAMs.

CSQ83. Do you agree with our proposal to introduce an individual performance based adjustment approach (Class 1) for the transmission sectors?

280. In terms of the specific proposal to introduce a class 1 RAM in transmission:

- a. We stated in our Framework Consultation response that this was the least damaging form of return adjustment mechanism (RAM).
- b. The lack of viable comparators for individual transmission companies means there is no other option in this context.

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

281. A return adjustment mechanism is Ofgem's key to setting strong incentives elsewhere.

282. Ofgem is clearly under wider political pressure as a result of the returns being earned in the sector. These returns vary considerably across the sector, with those in electricity distribution being the lowest of all. Although the recent past has seen strong outperformance across the sector, this has not been consistently observed over time. At DPCR4, for example, the core cost and output targets were set at levels that many companies could not meet. At the gas distribution price control period ending in March 2007, companies overspent their allowances by £864m, with companies bearing 31% of the value of that overspend.

283. The outperformance (which has gone hand-in-hand with improved service) is due to three factors, with the second and third of these growing in significance over the past two review cycles:

- a. Unanticipated efficiency savings that were driven by the strength of the incentive arrangements;
- b. Understandable forecasting errors, which were most in evidence in the regulatory reviews after the Great Financial Crash; and
- c. Target setting misjudgements.

284. A RAM – in combination with the reintroduction of the five year price control period - may be needed as a backstop to reassure stakeholders. But it is not a substitute for a properly calibrated price control. Ofgem's duties and the focussed nature of the appeal regime mean it remains incumbent on Ofgem to get each of the constituent elements of the price control right.

285. Despite the significant departure that it represents from one of the key features of the UK network regulatory arrangements and the risks that come with it, we can come to terms with a well-designed RAM if it has the following features:

- a. The terms of the RAM are set out clearly and in full at the outset, such that it cannot collapse into ex post regulation.
- b. The calibration of the RAM:
 - i) Permits an upside that has sufficient headroom over the WACC to reward well run companies who drive benefits for consumers; and
 - ii) Ensures it is not activated if one or two companies happen to enjoy mis-calibrated settlements (as is the case at ED1).
- c. There are no adjustments for companies earning less than the equity return expected by Ofgem.
- d. Financing performance is not included. This would amount to a sharing factor on the cost of debt through the back door and require robust measurement of the cost of debt on an annual basis.²¹

286. Lastly, in the context of differences between sectors, Ofgem should also recognise the additional competitive pressure that a sector average RAM would place GDNs under, compared to transmission companies, and allow a higher cost of capital in recognition of the additional risk a comparative settlement entails. This is additional risk should be recognised even in the absence of a RAM, but the RAM will accentuate it.

287. With a RAM in place and the risk of runaway returns constrained, Ofgem can encourage investment, information revelation and productivity gains.

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?

288. Yes, this is a necessary condition for a well-designed RAM.

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

289. Yes. It is essential that the calibration of the RAM:

- a. Permits an upside that has sufficient headroom over the WACC to reward well run companies who drive benefits for consumers; and
- b. Ensures it is not activated if one or two companies happen to enjoy mis-calibrated settlements (as is the case at ED1).

²¹ Ofgem has ruled out a sharing factor because it would not be able to measure what is to be shared. We assume Ofgem therefore does not intend to take the steps necessary to measure the cost of debt robustly on an annual basis.

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?

290. RORE is an appropriate metric for all sectors, that would be suitable for use in a RAM provided that it is defined precisely on an ex ante basis through the price review process.

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

291. It is essential that financing performance is not included. This would amount to a sharing factor on the cost of debt through the back door and require robust measurement of the cost of debt on an annual basis.

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?

292. However this is done, it is essential that the terms of the RAM are set out clearly and in full at the outset, such that it cannot collapse into ex post regulation.

293. We do not see the merit of annual true-ups. To avoid unnecessary volatility, the annual true-up would have to depend on forecasts for the whole period. Only the companies would be able to provide these forecasts with any accuracy. But by using these forecasts, Ofgem would in effect allow companies to choose when the adjustments are made. It would be better to avoid this altogether and process the adjustments through the close out, when performance levels are known with certainty, but it is also essential that the precise close out rules are specified at the time the RAM is put in place.

12. RIIO-2 Achieving a reasonable balance questions

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

294. No, we don't. The assessment is fundamentally flawed because important factors have been omitted from the framework used for the assessment.

295. Critically, Ofgem has omitted the effect on incentives from the assessment considerations it lists at paragraph 11.3. The impact of weak incentives over time, and the consequential increase in costs to consumers (including through worse performance) compared to a regime with strong incentives, should be explicitly recognised in the framework for the assessment, in line with Ofgem's principal objective.

296. Under Ofgem's assessment framework an entirely ex post, cost pass through, settlement would perform even better than the low-powered package Ofgem is proposing. This highlights how badly wrong the assessment framework is. It appears to be designed to justify Ofgem's proposals.

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

297. Yes. As we highlighted in our response to the Framework Consultation, at Ofgem's first workshop on ensuring fair returns, British Gas proposed an option involving 'enhanced scenario analysis', where Ofgem would subject each part of the price control settlement to detailed scrutiny to ensure it is calibrated effectively, and understand the potential range of outcomes.²²

298. This option has been conspicuously absent from Ofgem's consultations on RIIO-2. Yet it would allow Ofgem to achieve the twin objectives of ensuring an accurate settlement while still putting in place strong incentives. Ofgem's current proposals would involve a more complex settlement, due to their over-reliance on ex post adjustment mechanisms, and would create an environment with weak incentives, leading to higher costs to consumers.

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

299. Ofgem is putting in place a return adjustment mechanism. In light of this, and the scope for detailed ex ante scrutiny of the settlement to ensure the relevant targets are challenging, many of Ofgem's complex proposals for ex post adjustment are simply unnecessary. Ofgem should not be proposing to make such liberal use of uncertainty mechanisms and price control deliverables; and where it does use them it should base the trigger on external factors rather than company decisions, to maintain incentives. It should avoid ex post clawback mechanisms and micromanagement of company decisions through resilience metrics altogether.

300. The cashflow floor will result in additional complexity and will be detrimental to consumers. It will reduce pressure on underperforming management (and shareholders) and will also lead to perverse incentives in particular scenarios. Given the damage it will do to incentives, and consequential detriment to energy consumers, it should be removed, which would also have the benefit of a simpler set of price control arrangements (and a simpler process of establishing those arrangements, as further consultations could be removed from the price review process).

301. Although it is absent from its assessment framework, Ofgem mentions incentives once, in its assessment of the business plan incentive. Yet this assessment fails to recognise that, on the cost side, its proposals will subject companies to far weaker incentives than under the various IQIs used at RIIO-1. This will make even worse the issue that Ofgem acknowledges: that companies can benefit from arguing for high cost allowances and influencing Ofgem's benchmarks upwards.

²² British Gas presentation to Ofgem's first fair returns workshop, October 24, 2017.

Instead it needs to place much more focus on cost levels under its business plan incentive than presently proposed. We set out how it can do this in our response to CSQ65.

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?

302. We do not think Ofgem's proposals can be justified on the basis of risk reduction because they will cause significant damage to the incentives that have delivered significant benefits to consumers since privatisation, and in some cases the proposals will actually increase risks to companies (such as where Ofgem proposes ex post assessment and clawback).

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?

303. At present Ofgem's proposals fail to take advantage of the value of having a return adjustment mechanism as a failsafe. With the risk of runaway returns constrained, Ofgem should focus on setting a price control with a set of strong incentives and challenging targets.

304. Instead, the other measures Ofgem is proposing, to dampen incentives, would fundamentally undermine the RIIO approach to incentive regulation.

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?

305. Ofgem is choosing from an incomplete option set.

306. Ofgem needs to put in place a return adjustment mechanism as a failsafe. It also needs to undertake the 'enhanced scenario analysis' that British Gas proposed at Ofgem's fair returns workshop in October 2017, in order to ensure it calibrates individual incentives and allowances accurately, without expected outperformance.

307. Ofgem is instead proposing to undertake the necessary analysis, to assess calibration of the settlement, as part of its allowed expected returns workstream. But it is then proposing to make the relevant adjustment in the wrong part of the price control settlement, and to damage the incentive that companies have to invest in the asset base, in a manner that would not have regard to the principles that regulation should be targeted, proportionate and consistent.

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

Ofgem should have regard to all of its duties and objectives, not just the subset listed in paragraphs 11.34 to 11.35. For example in relation to electricity licensees it must have regard to:

- a. *“the need to secure that licence holders are able to finance the activities which are the subject of obligations”*
- b. *“the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed”*

308. Meeting these duties will also help Ofgem fulfil its principal objective, since they will help avoid an under-investment problem, and also reduce regulatory risk, both of which will reduce costs to consumers over the long term.

309. As the inexorable consultation and decision-making process marches onwards, the options available to Ofgem to rectify these mistakes will only narrow. In other words, Ofgem risks painting itself into a corner. Ofgem needs to correct these flaws before it goes any further.

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?

310. No, in places Ofgem is having too much regard to select groups of consumers, rather than its principal objective which is to the interests of all current and future consumers taken together.

311. This can be seen in, for example:

- a. some of its proposals for vulnerable consumers, which would involve significant cross-subsidy and be contrary to its regulatory stances; and
- b. its proposals for ‘bespoke outputs’, which are likely to be proposed to benefit particular constituencies, rather than consumers in general in a particular area.

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

312. No, critical elements of the methodology will not.

313. Ofgem’s proposal to reduce the allowed return on equity below the cost of equity is badly targeted, disproportionate and inconsistent with past practice. It will undermine the incentive to invest in the asset base. This will lead to an under-investment problem. The costs of under-investment will fall on future consumers, and are acknowledged in academic literature and regulatory precedent (including from the UK’s Competition Commission) as exceeding the cost to current consumers of setting a cost of equity that is slightly too high. It will also undermine incentives to improve performance over time. This will cause further detriment to future consumers.

314. Other aspects of the proposals, such as the move away from incentive regulation that is apparent in many aspects of the proposals, would also secure potential benefits to current consumers (for instance a lower allowed return, if Ofgem was not raising regulatory risk at the same time) while

ignoring the associated costs to future consumers (for example though a cost base that gradually rises higher than it would otherwise have been).

315. Neither of these examples represents regulatory best practice.

13. Preliminary impact assessment questions

CSQ99. What are your views on the approach we are proposing for assessing impact of our RIIO-2 proposals?

316. It is appropriate that Ofgem should use an impact assessment framework for considering its T2 and GD2 methodology proposals.

CSQ100. What are your views on the assumptions we have made in our assessment to date

317. Many of the assumptions are flawed. For example the assessment:

- a. Fails to recognise in its assessment of its financing proposals the consumer detriment that can be expected to result from setting an allowed cost of equity that is below the cost of equity of the relevant network companies, due to lower than necessary levels of investment. The existence of this cost is supported by both published academic literature and good practice demonstrated by other regulators, including the CMA.
- b. Omits costs which will result from the move to CPIH indexation, due to the mis-match between existing levels of RPI linked debt and the new inflation measure. These costs will be most obvious if companies swap RPI linked debt to CPI linked debt but, even if they do not, the costs will still manifest themselves elsewhere. Ofgem will need to make allowance for these costs.
- c. Claims under “consumer bill impact” that there will be benefits from genuine cost reductions. But the proposed methodology removes incentives for companies to submit low cost plans, and to keep their costs low on an ongoing basis. They will lead to genuine cost increases. There is no basis to assume cost reductions will result.
- d. Makes the bizarre assumption that the business plan incentive proposals will encourage companies to reveal better quality information. The incentive for companies to reveal cost information, where most of the consumer value from information lies, is being significantly weakened compared to the approach it is replacing. As well as a realistic likelihood of little or no reward, the maximum potential penalties are also being reduced, with little or no incentive over the critical ranges. Whether Ofgem wants to admit it or not, it is in effect encouraging cost base growth, which is likely to progressively worsen over time, to the detriment of consumers.

- e. Fails to properly evaluate the likelihood of gradual and long term reductions in efficiency and increases in cost as a consequence of efficiency incentive rates being potentially slashed. If consumers bear proportions approaching 85% of the cost of over-spend, or even 100% in areas where Ofgem proposed moving controllable costs into pass-through, cost bases will balloon.
- f. Implies in respect of output (and cost) incentives that Ofgem sets the level of “rewards” under incentive schemes, when it does not, and goes on to erroneously claim that “reducing incentives” may yield benefits to consumers. Instead Ofgem sets incentive targets and an incentive rate. Lower rewards could be achieved by setting targets at a challenging level, such that Ofgem does not expect outperformance either at the company or sector level.²³ Yet instead Ofgem proposes to reduce incentive rates. By pushing these below the consumer valuation of changes in performance²⁴, this will lead to inefficient levels of performance, from a consumer perspective, and long term consumer detriment.
- g. Omits the cost to consumers that will result from less collaboration between companies as a consequence of within-period dynamic competitive incentives.
- h. Omits to recognise under the competition assessment that the status quo already includes:
 - i) a wide range of contractors and manufacturers being involved through competitive procurement processes; and
 - ii) competitive, market based and arms-length processes to achieve the lowest possible cost of debt, which represents the majority of the financing structure of either all or most energy networks, which have for decades faced strong incentives to minimise their cost of debt.
- i. Omits to recognise that consumers would only benefit from lower costs of innovation if companies do less innovation. Innovation activity will have to be funded irrespective of whether it is provided through totex allowance or via a separate mechanism. Instead, Ofgem seems to assume there is a source of “non-additional” funding for innovation. This “non-additional” funding source is the proverbial magic money tree. It does not exist.
- j. Fails to recognise the costs associated with micromanagement through the proposed NARMs framework. The erroneous claim that regulatory burden could fall in the long run assumes that Ofgem could somehow “fit and forget” a perfect risk based and monetised model, on which companies could base all their decisions, and justify these to Ofgem.

²³ Except where there is good reason to allow this, such as where a rolling incentive is being applied.

²⁴ Tuned down by the cost incentive rate, in line with the approach used for the ED1 interruption incentive rates.

Not only will Ofgem need to continually re-visit its assumptions, and move increasingly towards an audit approach (raising regulatory burden), but the fact its civil servants will in effect be taking on the role of asset managers for the entire sector will be highly damaging, and will result in higher costs (and more in-efficient expenditure) over the longer term.

- k. Claims mechanisms like RPE indexation might reduce the cost of capital, when in fact they will introduce additional pro-cyclicality into cost allowances, which will (by definition) raise the systematic risk carried by companies and their equity beta.
- l. Includes nothing on the myriad of ex post review, clawback and reopener mechanisms that Ofgem proposes, which will increase regulatory risk, reduce incentives for companies to reduce costs, encourage them to deliver their original plan even where alternatives are cheaper, and lead to higher costs over the long term for consumers.
- m. Ignores the fact that the cashflow floor will act to protect underperforming companies, and management teams, and lead consumers to suffer detriment as a consequence of poor performance for longer.

318. Ofgem says its assessment is qualitative, but at the same time it claims it has estimated that the benefits outweigh the costs, or that it has undertaken analysis to identify whether costs outweigh the benefits. Anywhere it has undertaken estimates or analysis it should consult on this. Anywhere it has not yet calculated estimates; it should do so and then consult on their basis.

CSQ101. What are your views on the uncertainties we have identified for the purpose of this assessment

319. These are less flawed than the assessment of costs and benefits.

CSQ102. What additional evidence should we consider as part of our ongoing assessment?

320. Ofgem should consider evidence on all of the parts of the assessment, including evidence on all of the omitted issues we list in paragraph 317 above.