

## National Grid's response to Ofgem's RIIO-2 sector-specific methodology consultation - Cross-Sector

### Overview

This response to Ofgem's RIIO-2 sector specific methodology cross-sector document is on behalf of National Grid Gas plc and National Grid Electricity Transmission plc. In this overview, we provide our key comments on the cross-sector document. We answer the 102 cross-sector questions in the appendix below.

### Overall package

We have two main concerns on your current direction of travel in relation to the cross-sector questions:

1. Your proposed RIIO-2 **incentive package is narrower in scope, weaker and more downside-skewed** than in RIIO-1. The weaker incentives mean there will be less incentive for network companies to improve their cost and service performance for customers, which will lead to worse outcomes for consumers. The emphasis on penalties over rewards will drive the sector towards a risk-averse, compliance culture with network companies focussed on doing just enough to avoid penalties.
2. The proposed package is **focused on inputs rather than the outputs that matter to consumers**. The input focus will reduce the ability of network companies to deliver innovative solutions for the benefit of consumers. This is because network companies will risk incurring penalties if they do not implement the activities they planned in their business plans, even if they have found better ways of delivering the outputs that matter to consumers.

### Totex incentive mechanism (TIM)

You need to provide a **strong TIM** for network companies in the RIIO-2 period to encourage them to innovate and find new cost efficiencies. You state that you expect totex sharing factors to be lower in RIIO-2 than in RIIO-1 and you propose a TIM sharing factor range of 15% to 50%. This is not in consumers' interests because the lower TIM sharing factors, coupled with the shortening of the price control period, will significantly reduce network companies' incentive to drive cost efficiency savings for consumers. You can set higher TIM sharing factors knowing that consumers will be protected from companies earning unexpectedly high returns due to the return adjustment mechanism.

You can **preserve the incentive for companies to submit high-confidence costs** while setting higher TIM sharing factors. Your blended sharing factor approach requires there to be different sharing factors for low and high-confidence costs. You can set the different sharing factors higher than your indicative 15% and 50%. This will preserve the incentive for companies to submit high-confidence costs, while also producing higher TIM sharing factors that will encourage network companies to find more cost efficiencies in the RIIO-2 period. Other components of the RIIO-2 price control will increase your confidence that companies will not make windfall gains or losses such as well-designed uncertainty mechanisms, more price control deliverables and a robust cost assessment.

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We consider you should allow a higher sharing factor for **repeatable activities**, in addition to your three proposed categories of: predictability; ability to deal effectively with uncertainty; and quality of evidence. Consumers benefit most from high TIM sharing factors on activities that are repeatable. This is because high TIM sharing factors encourage network companies to find more cost efficiencies and any cost savings a network company makes for repeatable activities in the RIIO-2 period will be carried forward into future price control periods to benefit consumers.

You should not change the TIM sharing factor **ex post**. Your proposed ex post recalculation of the TIM sharing will:

- 1) lead network companies to discount the TIM and further reduce the incentive to find and deliver cost efficiencies for consumers;
- 2) create windfall gains or losses for network companies by retrospectively changing the reward or penalty associated with decisions that they have already taken; and
- 3) create a perverse incentive for a company that is overspending during the price control to submit poor-quality evidence for its re-openers to try to achieve a lower sharing factor, which is counter to what Ofgem is trying to achieve.

### Business plan incentive (BPI)

You need to provide a **strong BPI incentive** to encourage companies to submit high-quality and ambitious business plans for consumers in the T2 period. We calculate that the highest reward available of 2% of totex for a “Good Value” plan equates to us outperforming our totex baseline by 7%. We consider a stronger BPI incentive would encourage TOs to submit more ambitious cost and service commitments in their business plans.

We consider **an absolute BPI reward** for good-quality business plans is more appropriate for transmission companies, and more consistent with the rest of the RIIO-2 framework, than a shared reward. Your proposal for a shared reward and absolute BPI penalties will cause network companies to focus on low-risk business plans to avoid a penalty rather than taking risks and proposing ambitious business plans. In electricity transmission, there are only three companies, which have very different networks, and in gas transmission there is only one company. As a result, there is little or no scope for one company’s plan to reveal the efficient frontier for the other companies. This is a point you have recognised in your July 2018 and December 2018 RIIO-2 publications when you ruled out early settlement and anchoring for transmission companies for these reasons. We propose that, for the transmission sectors Ofgem should implement an absolute reward and penalty for the BPI to incentivise companies to propose good-quality and ambitious business plans that reveal information about their particular cost and service quality frontiers.

You should **not cap the BPI reward at 2% of totex** to ensure that the incentive does not constrain the cost ambition of network companies in their business plans. You should also avoid “**cliff edges**” between the assessment categories. For example, a company falling just into the “low value” box will incur a 1% of totex penalty, but a plan that is only slightly better could be “standard” and incur no penalty.

You should **clearly set out the assessment criteria for the BPI** as soon as possible so that network companies have time to address them in their business plans. The finalised BPI criteria should be complete, unambiguous, objective and transparent. The benefits of having clear criteria well in advance of network companies submitting their plans are that you will receive

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business plans that are closer to what you want companies to deliver for consumers. You will also receive more consistent business plans that are easier for you to assess. We suggest some ideas for assessment criteria for the BPI in our responses to the BPI questions in the appendix.

### Asset resilience

The long-term health of network assets is critical to future network reliability. You are proposing a new regime for RIIO-2 to target and measure asset risk on the network – the Network Asset Risk Metric (NARM). We agree with the concept of NARM. If implemented appropriately NARM will help us manage our network reliability in an efficient way.

Your consultation does not discuss the consequences of the NARM regime for **incentives on companies to improve and which parties should bear which risks**. The consultation focuses on the target setting and measurement part of the regime rather than the potentially more fundamental change that the regime could turn out to be.

We have the following concerns about your current proposals on the NARM regime for consumers:

1. You are proposing **a relative target** of ‘risk reduced’ rather than an absolute target of ‘residual risk on the network’. An absolute target is the simplest and most transparent way to ensure risk is allocated appropriately to consumers and network companies. We are better placed to manage risk on asset deterioration than consumers. You will require complicated mechanisms to appropriately apportion risk between network companies and consumers with a relative target.
2. Your proposed business plan data table for NARM focuses on **inputs**. An input-based approach will incentivise network companies to deliver specific capital investment projects rather than incentivising them to improve activities across the entire asset management chain. This will lead to higher costs for consumers over the long term as network companies will lack the incentive to develop innovative approaches to asset management. Your proposed business plan data templates are inconsistent with your proposal that the NARM regime should be focused on delivering **a single risk target**. We agree with a single risk target - it incentivises network companies to find alternative ways to reduce risk on the network and get more out of existing assets, which will benefit consumers in both the short and long terms.
3. Your proposal on NARM could **transfer asset management risk to consumers** who are not best placed to manage it. If assets deteriorate more quickly than expected in the T2 period consumers will bear any costs arising from lower network resilience, which could include increased asset management investment in future price control periods.
4. The proposed NARM regime involves **asymmetric incentives for under and over delivery**. You are proposing network companies incur penalties for under delivery, but no rewards for justified over delivery that benefits consumers.

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We propose that you **improve the NARM regime by:**

1. Setting absolute risk targets that correspond to the reliability that customers and consumers have asked for through enhanced engagement.
2. Allocating asset-related risks to the network companies, who are best placed to manage them.
3. Placing risks that are better managed by consumers with consumers, e.g. those relating to demand changes.
4. Incentivising improvements across the entire asset management chain, not just capital work delivery.
5. Not penalising justified under or over delivery.

We ask you to finalise your approach to NARM through the working group quickly to allow network companies to finalise their business plans in this fundamental part of the RIIO regime.

### Outputs

As we explain in our responses to the ET and GT annexes we consider that:

- by **weakening the overall package of output incentives** there will be less incentive for TOs to improve their operational performance, which will lead to worse outcomes for consumers.
- Your move towards **more penalties and fewer rewards for outputs** will reduce the incentive for TOs to stretch themselves, aim high and innovate in the services they provide for their customers and consumers.

In the cross-sector consultation document you consider the use of **relative and dynamic incentives**. These types of incentives are more difficult to consult stakeholders on and have the following additional drawbacks:

- **Relative incentives** will further weaken TOs' incentive to deliver for consumers by making any outperformance rewards less certain. Relative incentives are of limited relevance in the transmission sectors because there is only one company in gas transmission and the three electricity transmission companies are different in size and activities.
- **Dynamic incentives** that change in-period will weaken TOs' incentives to deliver for consumers because if a company delivers good performance the target will become tougher during the price control period. Dynamic incentives can be difficult to implement. For example, adjusting the target will involve a lag of two years because of the need for audited data of previous performance to base the adjustment on.

### Whole systems

We welcome that you recognise that whole system solutions could deliver benefits for consumers. We agree that RIIO-2 can incentivise network companies to implement whole system solutions.

We consider that the practical focus of the whole systems work should be on **the interfaces between different parts of the energy sector** e.g. between TOs and the SO, between TOs and DNOs and between the GTO and GDNs. These provide the most practical options to deliver whole system cost savings for consumers.

We have been developing a TO:SO optimisation proposal since September 2018 and have presented our thoughts to your ET policy working groups on several occasions. We will continue

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to work with you and stakeholders to produce a workable TO:SO optimisation approach for the RIIO-2 price control.

### Return adjustment mechanisms

We support the concept of a **symmetrical backstop mechanism** that acts to automatically adjust totex incentive mechanism (TIM) returns when their level is outside a pre-determined range of what is considered a fair return. We consider that symmetrical sculpted sharing factors will retain the incentive for companies to generate efficiencies and keep the link between company behaviour and company performance. We propose the return adjustment mechanism only applies to TIM returns because the other incentives are separately calibrated and have their own caps and collars. To be clear, this means that financial performance should be excluded from the return adjustment mechanism.

The existence of a symmetrical backstop mechanism enables you to allow network companies to have **stronger incentives for cost efficiency** knowing that consumers and network companies will be protected if they are mis-calibrated.

### Innovation

Your consultation proposes **significantly restricting the amount of innovation funding available**. The RIIO-2 period is not the right time to reduce innovation funding given the extent of change in the energy system we all expect in the 2020s.

We consider you need to **retain the Network Innovation Allowance (NIA)**. The NIA provides the certainty network companies need to drive long-term innovation that spans regulatory periods and to drive the high-risk, transformational innovation required to both improve operational efficiency and environmental impact.

We consider the **Network Innovation Competition (NIC)** has delivered many projects that have benefited consumers. We are keen to work with you on your proposed approach for a funding pot that has a sharper focus on strategic energy system transition challenges.

### Competition

**We support the principle of introducing competition in transmission**, where the model and associated arrangements can deliver value for consumers.

Our view is that the **Competitively Appointed Transmission Owner (CATO) model** is the only workable onshore competition model developed to date. We strongly prefer an “early” CATO model because this has the greatest potential to deliver benefits for consumers across the whole transmission value chain.

The Competition Proxy model is actually a project-specific price control and does not constitute a competitive process at all. As such, it does not deliver any of the benefits which would be expected to result from a competition, such as innovation or price discovery. We do not support the introduction of the Special Purpose Vehicle (SPV) model for a number of reasons, including its incompatibility with the existing licensing regime and its unclear allocation of risks and accountabilities.

We do not think there is a sufficient pipeline of projects in **gas transmission** to justify the introduction of onshore competition. We do not support the ESO's involvement in gas

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competitions because it would not be consistent with the ESO's role or capability, which relate to the electricity sector.

We are not fully clear on how your proposal about “competition as **price finder**” would apply to transmission companies when we already put out to tender the large majority of our projects.

### Appeals

You propose considering the extent to which a successful appeal has consequences, if any, on other components of the price control. We have significant concerns in relation to this proposal and expand on these in response to CSQ1. Our views at this stage based on the detail in the consultation document can be summarised as follows:

- The Authority already has the ability to explain the potential knock-on effects of a successful appeal to the CMA under the existing appeals mechanism. As recognised by the CMA such matters should be limited to interrelated issues and should not extend to unrelated aspect of the wider price control settlement. There is therefore no need for any mechanism of the sort described at paragraph 2.20;
- To the extent that any decision of the CMA requires licence modification in order to address the subject matter of the appeal and /or any directly linked issue(s) then this should be achieved and implemented via the CMA's powers on allowing an appeal set out in sections 11F and 23E of the 1989 and 1986 Acts respectively. Such powers provide for the CMA to give directions to the Authority which may extend to proceeding with necessary licence modifications through the established statutory mechanisms set out in sections 11A and 23 of the 1989 and 1986 Acts respectively. Such mechanisms ensure that licence holders are afforded statutory appeal rights to the CMA in relation to such modifications. This is critical in order to maintain the integrity of an effective appeals mechanism;
- Only licence holders that are party to the CMA appeal in question should be within the scope of the CMA decision insofar as it relates to the point that is appealed and any interrelated aspect(s) that is properly considered by the CMA; and
- It appears that the proposed “discretionary mechanism” seeks to circumvent the points above. Such a mechanism would operate to undermine the certainty and integrity of the price control package by subjecting elements that are not the subject of a CMA appeal to potential modification.

### Appendix

In the attached appendix, we set out our response to the 102 cross-sector questions in Ofgem's RIIO-2 sector-specific methodology consultation.



## Appendix – responses to the cross-sector consultation questions

This is National Grid's (NGET and NGG) response to the 102 cross-sector questions in Ofgem's RIIO-2 sector-specific methodology consultation.

### Appeals

**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?**

It is difficult to comment in detail on paragraph 2.20 as Ofgem's proposed approach for considering any consequences of a successful CMA appeal on other components of the price control is not clearly set out or reasoned. During the consultation period we have sought additional clarification from Ofgem on this issue in order to help frame our response but this has not been forthcoming.

Despite this lack of detail in respect of the proposed approach, paragraph 2.20 appears to signal that Ofgem is considering a significant change to how it might seek to address the outcome of any successful CMA appeal in respect of RIIO-2. This interpretation was endorsed by Ofgem on the investor call. Where there has been a successful CMA appeal, it appears that Ofgem is contemplating reserving to itself the ability to revisit other elements of the price control both for the successful appealing licensee and non-appealing licensees. Ofgem suggest that this might be achieved by way of a "discretionary mechanism" but there is no explanation as to how such a mechanism might work in practice.

We are therefore only able to speculate what might be envisaged by this paragraph and such a discretionary mechanism in particular, but if it is proposed that such a mechanism might seek to change other aspects of the price control settlement (that were not pleaded or considered at the successful CMA appeal) outside of the existing statutory licence modification process and therefore outside of the CMA appeals process then this would raise serious concerns for both NGET and NGGT. If this is what is proposed by paragraph 2.20 then this would signal a significant departure from the established statutory licence modification mechanism and the associated statutory rights of appeal that are afforded to licence holders and other interested parties. It is not clear to us on what legal basis Ofgem could adopt such an approach given this would be contrary to the clear statutory scheme of the appeal regime – as explained below. We would also note that contemplation of any such changes – even if Ofgem had the vires – would be unnecessary given the CMA has acknowledged in previous appeals that Ofgem is able, in its response to an appeal, to bring interrelated aspects of a price control to the CMA's attention and the CMA itself may consider whether the finding of an error has knock-on effects and requires consequential amendments to non-appealed aspects of a price control (see both the BGT and NPG appeals).

The statutory right of appeal against licence condition modifications made under section 11A Electricity Act 1989 and section 23 Gas Act 1986 is set out in section 11C and section 23(B) of the 1989 and 1986 Acts respectively. These statutory rights of appeal are supplemented by the appeal rules made by the CMA under powers conferred by Schedule 5A of the 1989 Act and Schedule 4A of the 1986 Act respectively. The appeal rules require that any notice of appeal must set out the particular decision of the Authority that is the subject of the appeal as well as the specific grounds of appeal on which the appellant relies. In the BGT appeal of the ED1 price control the CMA stated that the provisions of the 1989 Act and the CMA rules clearly envisage

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that the CMA must determine the appeal “through the “prism” of the specific errors” alleged by the appellant. The CMA further acknowledged that there could be knock on effects of a decision on a specific point on other related aspects that were not appealed. However, this would need to be considered on a case by case basis.

Given the framework of this appeals mechanism, the expectation must be that any knock-on effects of a decision on a specific point that is the subject of an appeal should rightly be highlighted by the Authority in its response to the appeal notice. In this way any relevant matters that are interrelated to the specific error that is the subject of the appeal can be properly considered by the CMA in reaching its decision. As explained in *BGT v Ofgem*, the CMA is empowered to make any such consequential adjustments as are necessary given ‘links’ in the evidence (whether identified by the Authority or on its own initiative).

Any knock-on effects on interrelated issues should therefore be highlighted in the appeals process so that they can be considered by the CMA. Such effects should not and cannot be addressed via a revisiting of the price control package through further licence modification(s) implemented outside of the statutory modification process under a form of “discretionary mechanism” that does not afford the licensee with a suitable right of appeal in respect of such modification.

Paragraph 2.20 appears to contemplate that the knock-on effects of a successful appeal might extend to addressing other aspects of the price control that are not directly linked to the decision that is the subject of the appeal where such would “maintain a coherent regulatory settlement”. Such a proposal goes far beyond the need to have due regard to interrelated elements of the price control when considering an appeal on a particular point (as recognised by the CMA) and appears to suggest that elements of a price control settlement that are neither the subject of an appeal nor directly linked to the subject matter of such an appeal could be reconsidered by the regulator. We do not see any legal basis for Ofgem making such an intervention, or any suggestion that Ofgem has the power to undertake remedial action to undermine or otherwise “rebalance” the decision of the CMA as an appeal body. We are also concerned that the advancement of this proposition unnecessarily introduces uncertainty for licence holders about the predictability of the regulatory regime.

Paragraph 2.20 also appears to suggest that the outcome of a successful appeal to the CMA may have implications for the licences of licence holders that were not appealing to the CMA on the point in question and that changes to such licences might also be implemented through the discretionary mechanism. This is deeply concerning. A CMA decision will relate only to the Authority decision that is appealed and will so only apply to the price control of the successfully appealing licensee or the controls of relevant licensees in the case of a successfully appealing non- licensee. It is therefore not clear under what vires the Authority might seek to revisit the provisions of a price control of a non-appealing licence holder. Such a proposition would also seem to fundamentally undermine the certainty of the price control package that such a licensee has, by virtue of not appealing, accepted into its licence.

By way of summary, our views on paragraph 2.20 are that:

- The Authority already has the ability to explain the potential knock-on effects of a successful appeal to the CMA under the existing appeals mechanism. As recognised by the CMA such matters should be limited to interrelated issues and should not extend to



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unrelated aspect of the wider price control settlement. There is therefore no need for any mechanism of the sort described at paragraph 2.20;

- To the extent that any decision of the CMA requires licence modification in order to address the subject matter of the appeal and /or any directly linked issue(s) then this should be achieved and implemented via the CMA's powers on allowing an appeal set out in sections 11F and 23E of the 1989 and 1986 Acts respectively. Such powers provide for the CMA to give directions to the Authority which may extend to proceeding with necessary licence modifications through the established statutory mechanisms set out in sections 11A and 23 of the 1989 and 1986 Acts respectively. Such mechanisms ensure that licence holders are afforded statutory appeal rights to the CMA in relation to such modifications. This is critical in order to maintain the integrity of an effective appeals mechanism;
- Only licence holders that are party to the CMA appeal in question should be within the scope of the CMA decision insofar as it relates to the point that is appealed and any interrelated aspect(s) that is properly considered by the CMA.
- It appears that the proposed “discretionary mechanism” seeks to circumvent the points above. Such a mechanism would operate to undermine the certainty and integrity of the price control package by subjecting elements that are not the subject of a CMA appeal to potential modification.

Given the concerns that are presented by paragraph 2.20 in its current form we would welcome further engagement and clarification from Ofgem as to what is being proposed. In the absence of such we are only able to speculate on the proposal and, as we have done, raise significant concerns in relation to any departure from the existing statutory licence modification and CMA appeals process. Such a departure is unacceptable to NGET and NGGT.

### Output categories questions

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

We agree with your proposed three new output categories.

Following your requirement for network companies to engage with their stakeholders to develop their business plans we have identified eight key stakeholder priorities for electricity and gas transmission that we are building our business plans around. We can broadly map our eight key stakeholder priorities to your three new output categories, but we are notifying you that we are not explicitly building our business plans around your three new output categories.

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

We consider that the three output categories are sufficiently broad to cover the outcomes we will propose in our T2 business plan.

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

We consider the three categories of licence obligations, price control deliverables (PCDs) and output delivery incentives are not as clear as they could be.

First, the distinction between licence obligations and PCDs is not very clear. We understand that the main difference between a licence obligation and a PCD is that the default action for a network company not achieving a licence obligation is enforcement action, but for a PCD it is an automatic financial penalty (similar to a penalty-only ODI). We are therefore confused by paragraph 4.19 when you state “We will consider linking certain PCDs to licence obligations”. This suggests we could incur both an automatic PCD penalty and enforcement action for not achieving an output in such cases, which would amount to penalising us twice for the same action. This feels disproportionate.

Second, “output delivery incentives” is the wrong name for the third category. These should be called “outputs” or “incentivised outputs” because “output delivery incentives” refers to the incentives to deliver them.

#### **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?**

We are disappointed that we attended many ET and GT policy working groups on outputs and that none of them discussed dynamic and relative incentives, even though we enquired about when they would be discussed. As a result, we consider your assessment of the dynamic and relative incentives misses some important considerations.

First, we find it confusing that you talk about both targets and incentives being relative and dynamic. This suggests that both the target and the potential rewards and penalties could change. This would give network companies no certainty over how the incentive will operate and therefore a weak incentive to deliver improvements for consumers.

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Second, we consider you have missed out some important disadvantages of dynamic targets as follows:

1. A dynamic target is affected by a company's performance. This creates a disincentive for a company to improve its performance for consumers because it will make its target harder to achieve in subsequent years. This was a point Ofwat acknowledged in its [PR19 methodology consultation in July 2017](#) (page 50): "However, this is not [Ofwat's] preferred approach because dynamic adjustments could dampen incentives for the best performing companies to improve. This is because, companies will know that any improvement will lead to a tightening of the commitment and a reduction in rewards for outperformance. This approach would discourage companies from shifting the frontier of performance..."
2. There are practical issues with adjusting targets within the price control period. It takes time to collect the performance data and assure it. TOs submit RRP data to Ofgem in July, which is 4 months into the following year. This either means: (i) the target for the next year is updated during the year so that TOs do not know what their target is in advance; or (ii) there is a 2-year lag in adjusting the target, which is a significant delay in a 5-year price control period.
3. Dynamic targets are less transparent for consumers and stakeholders because they do not know in advance what the targets will be. This makes it harder to engage meaningfully with consumers and stakeholders as part of our business plan engagement process.
4. Dynamic targets could become easier as well as tougher if a company under-performs relative to its target. You seem to acknowledge this point on page 28 when you state: "This design implicitly assumes that year-on-year incremental performance improvement is achievable."

Third, we agree with your view that "Our initial view is that comparison may be more achievable in sectors with a higher number of licensees (gas and electricity distribution)" (paragraph 4.34). It will be difficult to use dynamic-relative incentives in electricity transmission because we (NGET) account for 70% of the sector's RAV and our network is not directly comparable to the two other TOs. It will be impossible to use dynamic-relative incentives in gas transmission because there are no other comparators. In addition, to apply dynamic-relative incentives you will need very high levels of comparability between companies. In the water sector, Ofwat and the water industry worked hard over several years to develop comparable data on, for example leakage, supply interruptions and sewer flooding, and still did not apply relative incentives to those metrics.

Fourth, we agree with your view that "Where performance is less comparable, we are less likely to take a dynamic relative approach to setting rewards and penalties" (paragraph 4.35). We have the following points in relation to dynamic rewards and penalties:

1. We are confused by what you meant by static and dynamic-absolute penalties, especially because the description of both is identical in the table on page 28. We presume that "dynamic" penalties could change from year-to-year which would give TOs less certainty about the penalties they might face and could encourage them to overspend relative to the efficient level just in case the penalties are larger than the current year.

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2. We are similarly confused about dynamic-absolute rewards and on what basis they would change from year to year. Uncertainty over the rewards we might earn for outperforming our target would reduce our incentive to outperform and deliver better service quality for customers.
3. You mention some drawbacks of dynamic-relative rewards and penalties: (i) the need to achieve high-levels of comparability; (ii) the risk of disincentivising collaboration; and (iii) the risk of rewarding poor absolute performance or penalising good absolute performance. A further drawback is that it is hard to see how dynamic-relative rewards and penalties can work for gas transmission where there is only one company and in electricity transmission where the companies are of very different sizes and have different types of networks. In addition, it is difficult for us to engage with our stakeholders on the appropriate size of our rewards and penalties if they are dynamic and relative and we do not know what they will be in advance. A further drawback is that the lack of ex ante clarity about the size of penalties or rewards a network company might earn will reduce the incentive to invest to deliver service improvements for consumers.

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

We strongly support allowing network operators to propose their own bespoke outputs in collaboration with their stakeholders and User Groups. We agree that our proposed bespoke outputs should be underpinned by evidence of consumer benefit and stakeholder support. We are developing some bespoke outputs and will engage with Ofgem and our stakeholders as we progress them.

We are concerned that the criteria for bespoke outputs you set out in paragraphs 4.39 and 4.40 might rule out some bespoke outputs that would benefit consumers. For example, we could develop a bespoke output around investing in local communities. This might not meet your criteria that the output should be “a service that consumers expect to receive from a network company”, that an output is “best dealt with through the price control” and “only proposed for key areas of high importance to consumers”. However, investing in communities is something that our stakeholders support and can provide measurable value to consumers. It would be helpful if you could clarify that you will apply your criteria flexibly to allow for bespoke outputs that stakeholders support and can deliver measurable value to consumers.

We understand from some of the working groups that you might want to focus bespoke outputs on lower consumer bills. We want to emphasise that bespoke outputs can drive value for consumers by encouraging network owners to deliver higher-quality services at a cost that is lower than the value consumers attach to the service improvement.

We also understand from the working groups that you might want to include any proposals for bespoke outputs in your May framework decision. We consider you should leave open for network companies to continue to develop bespoke outputs during 2019 in consultation with their stakeholders and you. We want to avoid a situation where if a bespoke output is not in your May 2019 framework decision, nearly two years before the next price control period starts, it will be ruled out for RII0-2.

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

Financial ODIs are important for driving changes in network companies' behaviour to benefit consumers. As the water regulator says in its [PR19 final methodology](#):

“Outperformance and underperformance payments, where supported by customer engagement, align customer, management and shareholder interests by increasing the focus on improving the services that customers care about. They also give shareholders a return for the additional effort and risk-taking needed to deliver stretching performance improvements.” (Page 57).

Bespoke financial ODIs can involve consumers paying more in-period for services they value. These bespoke financial ODIs are beneficial for consumers when they value the service improvement more than the cost. You will need to make sure you give yourselves enough time in the assessment process to be comfortable with the bespoke financial incentives, given their potential bill impact, to avoid rejecting ones that are beneficial to consumers.

You should take into account that transmission companies do not have direct relationships with end consumers, apart from with a small number of directly-connected customers. For transmission companies Ofgem should be open to proposals where we can show stakeholder support and provide qualitative or indirect evidence of consumer benefit.

### Enabling whole system solutions questions

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

We agree with your view that whole system solutions could deliver benefits for consumers. We agree that RIIO-2 can incentivise network companies to implement whole system solutions. Some of the solutions will involve changes both within and outside the price control. Overall, for RIIO2 it is about ensuring the right flexible framework is put in place to enable cross-sector working and collaboration and implementation of solutions that will benefit consumers.

We consider that the practical focus of the whole systems work should be on the interfaces between different parts of the energy sector e.g. between ETOs and the SO and between ETOs and DNOs and the Gas TO and GDN's. The interfaces provide the most practical options to deliver whole system cost savings for consumers.

We have been developing a TO:SO optimisation proposal since September 2018 and have presented our thoughts to your ET policy working groups on several occasions. We will continue to work with you and stakeholders to produce a workable TO:SO optimisation approach for the RIIO-2 price control.

We will also continue to look at how we improve the coordination, collaboration and interaction between gas transmission and the gas distributions networks in delivering whole system solutions because we see this as being key to help drive decarbonisation during RIIO-2 and beyond.

#### **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?**

We consider your narrow definition of whole systems for detailed policy development is pragmatic. We recognise the challenge of adopting a wide focus for whole systems. However, we consider there might be an opportunity for widening your definition of whole systems to include the heat and transport sectors as key policy decisions are made during the RIIO-2 period.

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

There might be benefits in adopting a broader scope for whole systems in:

- Heat – government decisions on heat policy are due mid-way through the RIIO-2 period. This might mean network companies should start implementing new solutions towards the end of the RIIO-2 period to benefit the environment and consumers. Having a flexible RIIO-2 framework would enable network companies to start implementing these policy changes more quickly if they arise.
- Transport – the policy and technology in relation to electric, gas and hydrogen vehicles are constantly evolving. It would be helpful for the RIIO-2 framework to be flexible enough to enable such developments if they arise during the price control period.



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

We support your direction of travel in developing a policy framework to support and enable whole system solutions. We set out our view on the six mechanisms you propose below:

No.	Proposed mechanism	National Grid's view
1	Business Planning Incentive (BPI)	<p>We do not think the BPI is well suited to incentivising whole system solutions for the following reasons:</p> <ol style="list-style-type: none"> <li>1. The BPI relates to the overall quality of the business plan, of which whole systems is only one element. Therefore, the BPI is not a strong enough incentive to encourage whole system solutions.</li> <li>2. You are proposing the BPI is a competitive incentive with competed rewards. However, whole system solutions are by their nature collaborative. Therefore, the BPI is not well suited to whole system solutions unless you remove its competitive element.</li> <li>3. You have not provided clear criteria for the BPI yet, including for whole systems. Without clear criteria the BPI will have a limited impact on encouraging network companies to propose whole system solutions.</li> </ol>
2	Ensuring network innovation has a whole system focus	We strongly agree there should be an innovation stimulus to help network companies develop whole system solutions.
3	Coordination and information sharing incentive	<p>We welcome the principle of a coordination and information sharing incentive. However, there are some barriers to information sharing. For example, we would need to consider how we could address the commercial sensitivity and competition rules affecting information exchanges between network companies. There may be a need for some code changes.</p> <p>The incentive would need to cover the additional costs of coordination plus a reward for the effort and risk taking involved.</p>
4	Balancing financial incentives between traditional and whole systems behaviours	<p>Ensuring the optimum consumer outcome will require the party delivering the solution to be appropriately remunerated and this to be recovered in a cost reflective manner.</p> <p>Our main points are:</p> <ul style="list-style-type: none"> <li>• Individual companies' revenue allowances can be linked to changes in volumes (volume drivers) for which we can define unit cost allowances in advance.</li> <li>• An independent party should have responsibility for the decision on the optimal solution to whole system issues.</li> <li>• Outputs needs to be defined to cover whole system solutions rather than being identified at the local level or across existing system boundaries.</li> </ul>

## NATIONAL GRID RESPONSE TO OFGEM CONSULTATION – CROSS-SECTOR

5	Ensuring the framework is able to flex to meet whole system needs	<p>We agree with the principle of ensuring the RIIO-2 framework is able to flex to meet whole system needs, especially given the uncertainty about these needs in the 2020s as the energy system transitions.</p> <p>As for row 4 above we suggest individual companies' revenue allowances can be linked to changes in volumes (volume drivers) for which we can define unit cost allowances in advance. These would be preferable to re-openers, which may disincentivise innovation due to network companies being uncertain over the outcome of re-openers. If you do decide on re-openers for the RIIO-2 period they would need to be carefully and clearly defined.</p>
6	Whole system discretionary funding mechanism	<p>This funding mechanism might involve a lower administrative burden than a re-opener.</p> <p>For the funding mechanism to encourage network companies to develop and implement whole system solutions you would need to provide clear upfront rules about how you would make the decision to award funding.</p>

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

Please see our answer to CSQ11 above.

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

We have identified the following key areas across electricity licensees that act as a barrier to the optimum consumer outcome:

- **Absence of initial allowance** - If an initial allowance for an identified solution is not included in an ex-ante allowance for any of the licensees there is no revenue to transfer between networks.
- **Cost reflectivity** - Current fund transfers do not maintain cost-reflectivity on users of different networks. For example: a solution deployed by a DNO for system reasons might be predominately recovered from regional consumers rather than via national network charges. Similar tension can exist if we consider existing versus future consumers.

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

We believe that volume drivers could ensure the appropriate networks receive the funding to deliver whole system solutions (see our answers to CSQ11, row 4 above). We consider volume drivers will be more effective in encouraging whole system solutions because they provide network companies with more certainty about changes in their revenues than re-openers.

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

We consider that the focus of the whole systems work should be on the interfaces between different parts of the energy sector e.g. between ETOs and the SO, between ETOs and DNOs and between GTO and the GDNs.

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Recognising some of the solutions will involve changes both within and outside the price control, and in line with your 'narrow' definition of whole system, we have focused our efforts on interfaces where the RIIO-2 framework can unlock consumer benefits. These interfaces provide the most practical option to deliver whole system cost savings for consumers.

We have been developing a TO:SO optimisation proposal since September 2018 and have presented our thoughts to your ET policy working groups on several occasions. We will continue to work with you and stakeholders to produce a workable TO:SO optimisation approach for the RIIO-2 price control.

We will also continue to look at how we can improve the coordination, collaboration and interaction between the gas transmission and gas distributions networks in delivering whole system solutions because we see this as being key to help drive decarbonisation during RIIO-2 and beyond. We propose that Ofgem keep this area open for the development of new incentives across sector boundaries where they can support delivery of consumer value.

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

Network companies' licence conditions restrict the sharing of certain information. To enable a more coordinated sharing of information, the regulator and network companies should work together to identify and remove the barriers to sharing information, where that benefits consumers.

Compliance with obligations is a potential issue. For example, an ETO needs to be sure that a reactive compensation solution implemented by a DNO will support delivery of its Security and Quality of Supply Standard (SQSS), but the compliance obligation is on the TO rather than the DNO. This introduces additional risk for the party sub-contracting to deliver against its compliance obligations.

An innovation stimulus will enable networks to develop whole system solutions to help inform policymakers ahead of the key policy decisions needed during the RIIO-2 period, particularly around the decarbonisation of heat. For Example, various projects on the feasibility of hydrogen usage that the Gas TO and GDN's are looking at will provide valuable information to policymakers and industry.

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

Given the amount of industry change that will continue to happen during RIIO-2, an innovation stimulus should continue, as this provides the incentive for networks to look at projects that will deliver benefits to consumers.

A continued collaborative approach to joint projects will help deliver benefits for consumers. For example, a joint approach to decarbonisation of heat projects, such as hydrogen projects.

There is a big potential benefit for consumers at the interface between the SO and the TOs (see our answer to CSQ8).

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

We consider the following three of your proposed mechanisms would deliver more benefit to consumers if you broadened the definition of whole systems:

- the innovation stimulus;
- the coordination and information sharing incentive; and
- the whole system discretionary funding mechanism.

This is because these are the mechanisms we support for whole system solutions more generally (see our answer to CSQ11) but also because these are likely to be the best approaches to support possible future changes in heat and transport policy (see our answer to CSQ10).

### Asset resilience questions

We set out our overall views on NARM in the overview at the beginning of this document. We propose that you improve the NARM regime by:

- 1) Setting absolute risk targets that correspond to the reliability that customers and consumers have asked for through enhanced engagement.
- 2) Allocating asset-related risks to the network companies, who are best placed to manage them.
- 3) Placing risks that are better managed by consumers with consumers, e.g. those relating to demand changes.
- 4) Incentivising improvements across the entire asset management chain, not just capital work delivery.
- 5) Not penalising justified under or over delivery.

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

Yes, we agree with your proposals to use monetised risk to support and justify our investment plans. There will be the need to replace assets for purposes not driven by monetised risk, for example: where the methodology does not accurately reflect the assets' criticality; if assets are not compliant with legislation; or where our plans need changing to address deliverability concerns. Monetised risk is a new methodology for Transmission, hence there may be the need to develop the methodology further as our knowledge improves over time.

It is important that monetised risk is seen as an input to our asset investment process, with a number of subsequent processes and our asset management expertise used to ensure our T2 plans are stakeholder led and focused on long-term consumer benefit.

We support the use of a single risk target for NARM because this incentivises network companies to deliver reliability in the most efficient way, benefitting consumers in the long-term. Your proposed business plan data template for NARM focuses on inputs and is inconsistent with the single risk target. An input-based approach will incentivise network companies to deliver specific capital investment projects rather than incentivising them to improve activities across the entire asset management chain. This will lead to higher costs for consumers over the long term as network companies will lack the incentive to develop innovative approaches to asset management. We propose that the NARM data table and Non-Load related data tables are co-ordinated and simplified to remove duplication, increase transparency, and incentivise companies to deliver to a single risk target.

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

No, we do not agree with your proposal to define a relative output measure of risk the same as in ED1. This allocates the risk of asset health deterioration inappropriately with consumers. It is important to ensure that risk is placed with the party best able to manage it. For this reason, Ofgem established an absolute target for RIIO-T1. We have not seen Ofgem's justification to move away from this position. Therefore, our preference is to retain an absolute target, which is the simplest and most transparent way to ensure risk is allocated appropriately to consumers and network companies.

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If you decide on a relative target a suitable uncertainty mechanism needs to form part of the package to respond to changing circumstances. For example, if a company identified an increased deterioration or a type fault on a specific asset type, and it would be in consumers' interests to intervene, the relative measure of risk and associated allowances should be able to adjust to accommodate the increased work load. This approach would retain the benefits of the relative and absolute measures, whilst providing appropriate protection for consumers and network companies.

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

Yes, we agree that defining outputs using a long-term measure of risk benefit is appropriate because this should better value interventions on different assets and optimise the long-term network costs for both today's and future consumers. Further work is needed to define the long-term measure including how this is reflected in the output. Our plans will reflect long-term deliverability and, through Cost Benefit Analysis, will show that the options we selected were the best long-term solutions for consumers.

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

Yes, we agree with the principle of using monetised risk as a fundamental part of justifying our asset health expenditure. We agree that monetised risk enables more meaningful engagement with stakeholders.

We have engaged with our stakeholders and will deliver a level of network risk that is supported by them. We will carry out further stakeholder engagement in 2019 to explore this further, so that our proposed network risk target is fully informed by the needs of our stakeholders (including consumers). Ofgem should be aware that there might be changes to our business plans between July, October and December based on the results of our stakeholder engagement programme.

We agree that it is not possible to include any further lead assets into NARM at this time, although this should be reviewed throughout the RIIO-2 period.

In terms of the three specific applications you propose for monetised risk (i.e. benchmarking, ensuring allowances are efficient and setting outputs) we believe monetised risk is most suited to setting outputs and cost benefit analysis. Only a limited amount of work has been done on benchmarking across sectors and we are unclear exactly how you would use monetised risk to assess efficiency. Therefore, we do not think monetised risk should be used for benchmarking or assessing efficiency for RIIO-2 and would expect Ofgem to use conventional approaches instead.

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

Yes, Option 2 clearly provides the best outcome for consumers for the funding of work spanning across price control periods. Option 2 would serve consumers better, providing an allowance for the work to be delivered in T2. A true-up at the end of the period can ensure the amount of allowance is aligned with the volume of work delivered.

Option 1 does not serve the interests of consumers because it could disincentivise network companies from carrying out essential work if it does not deliver an output in the current period.



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This could create additional risk for consumers if network companies defer investment to the following price control period.

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

Yes, we strongly consider that the penalty or reward for dealing with deviations from output targets should not be asymmetric. In the cross-sector working groups on NARM you presented two options for dealing with deviation from output targets. The group, and we, prefer Option 1: maintaining cost neutrality, which includes making the licensee whole for what it has spent to over-deliver. Option 1 also provides the best solution for consumers.

We agree that where a company has failed to deliver its output target the associated cost allowance should be removed. However, we do not think that where a company has failed to deliver, and cannot justify its failure, the network should be exposed to the monetised risk benefit. The monetised risk benefit is intended to be the long-term value - this will not be the cost the consumer will be exposed to if the network undertakes the work in the following year. It is likely that the monetised risk benefit would be excessively penal in addition to the inherent uncertainties within this value. We would recommend where under delivery cannot be justified a penalty consistent with the existing RIIO-1 arrangements would be more appropriate.

We do not think you should penalise under or over delivery that network companies can justify as being in consumers' interests. In terms of over delivery, we are supportive of an approach that maintains cost neutrality where the over delivery is in consumers' interests.

For both over and under delivery we believe it is also important to include a suitable materiality threshold, similar to that used within the RIIO-1 reopener processes.

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

Assets that are funded through other mechanisms (e.g. load related) but also deliver a monetised risk benefit should count towards the overall risk target, with the funding held elsewhere (e.g. in load-related).

There should be an uncertainty mechanism triggered where work is required to be done for asset health reasons that was intended to be funded by another mechanism but that driver has fallen away.

### **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?**

We understand ring-fencing to mean projects that are not available for risk-trading using monetised risk as the common currency. Where it can be shown that this protects consumers from additional costs if the driver changes then these projects should be ring-fenced. Ring-fenced projects will continue to be asset health driven, and PCDs should be agreed as an output to be delivered.

We do not expect many projects to be 'ring-fenced'. Our initial views on which types of project these could be are:

- High-value projects spanning price control periods (e.g. London Power Tunnels).

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- Other non-load projects, but not asset health drivers (e.g. driven by ESO).
  - Legislative requirements due to safety or resilience.
  - Site-specific campaigns e.g. at major entry terminals such as St Fergus and Hatton.
- However, the more separation you introduce into NARM the more you will reduce the potential for networks to flex work programmes to respond to emerging issues in an efficient way. Therefore the use of ring-fencing should be constrained.

### 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?**

We support Ofgem’s proposal to require companies to explicitly include their workforce resilience strategy within their RIIO2 business plan submissions and the proposed elements of the strategy set out within the consultation document, including the time period of RIIO-2 plus an additional 10 years.

We propose that the definition of “critical roles” should be extended to include roles involved in the operation of assets. Ofgem should also widen the scope to include non-field based roles that are involved in the monitoring, protection and control of network assets, to reflect the increasing shift away from field-based monitoring to a more automated, but no less critical, “cyber” monitoring. The skillset required to manage this monitoring faces its own recruitment and retention challenges and network companies will need to devise strategies to manage resilience in this part of the workforce also.

Ofgem should be clearer on what areas or issues it is seeking network companies to collaborate on common approaches to workforce capability and how this would link to regulatory funding in the RIIO-2 period and beyond. National Grid has a dedicated Academy site where we deliver Ofsted Grade 1 training to our own workforce and for other network companies. Through our membership of EU Skills and the National Skills Academy for Power Energy and Utilities, we collaborate with other companies in the energy sector to consider skills forecasting, qualifications/competency and the resilience of the supply chain. We see these as key activities that support the energy industry in managing the challenges of workforce resilience.

We believe that a well-designed RIIO-2 framework should hold network companies accountable for delivering the outcomes they set out in their business plans, with clear consequences for when they do not deliver. We also support the principle that the framework should clearly distinguish what is within the control of network companies and what is outside of their control, and that network companies are strongly incentivised to outperform those activities that are within their control, preventing windfall gains or losses.

We support the use of appropriate metrics to track network company performance against their workforce resilience strategy, as this enhances the accountability of network companies to deliver a resilient workforce for consumers.

Any agreed milestones or measures should have the following characteristics:

- They are aligned to the outcome that the network company is seeking, as opposed to measuring inputs to the process. An outcomes approach will maintain the incentive of network companies to manage the risks within their control and innovate to deliver in different ways where this enhances consumer benefits.
- Be targeted towards outcomes within the control of the network company, most likely measures associated with its own workforce. For example, whilst attraction of school leavers into the industry supports network company recruitment activities, it is not solely within the control of network companies to manage this risk.
- Be simple to report on, transparently defined and easily understood by stakeholders.
- May be a mixture of targets and metrics, depending on how much control networks have over the outcome. For example, a network may report their progress in improving

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diversity in critical roles using metrics, but not set out a specific target given the external factors that are not wholly within their control.

### Physical security questions

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

Yes, we agree that the existing scope of costs that fall under Physical Security (associated with the PSUP works) should be maintained for both electricity transmission and gas transmission. These are essential works to enhance and maintain the physical security of Critical National Infrastructure, coordinated at a sector level to safeguard our networks.

Specifically, on gas transmission, NGGT and the Gas Distribution Networks (GDNs) established a joint working group to review arrangements for delivery of PSUP works at shared gas sites. For further information please refer to the joint working group's separate response to this consultation question.

**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.**

Yes, we agree with the proposed approach of ex ante allowances for PSUP works mandated by government. We propose that these ex ante allowances should be accompanied by an uncertainty mechanism to take account of changes to CNI sites or requirements as mandated by Government under the PSUP.

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

Yes, we agree that an uncertainty mechanism included within the RIIO-2 framework would be appropriate to take account of the changing threat landscape and any changes to investment required due to government-mandated changes to PSUP.

We consider that any mechanism could work similarly to the approach proposed for cyber-security outlined in our response to CSQ34, but covering costs for PSUP works mandated by government.

We are currently assessing the need for uncertainty mechanisms in other areas and consider that in general, threats against our network, or requirements for responding to threats are likely to change in the future. This includes the threat of damage or disruption caused by cyber-attack, or extreme weather. There is uncertainty around the type of threat the networks face and new threats may emerge within RIIO T2. We consider that it would be appropriate to include an uncertainty mechanism which covers 'protection from external threats as a whole'.

**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?**

We propose that the frequency of any uncertainty mechanism that takes account of physical security costs should, as a minimum, match the timescales proposed by CPNI and BEIS in reviewing the list of CNI ISS sites and their security requirements. This review is currently planned on a 2-3 year basis.

### Cyber resilience questions

**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.**

We do not agree that the scope of costs should be limited to costs incurred as a “direct” result of implementation of the NIS Regulations, or “above business-as-usual activities” as both terms are very ambiguous. For example, it is unclear if “direct” costs would include the cost of cyber security upgrades to the most sensitive CNI where there is good justification to exceed the minimum NIS requirements, or if “above BAU” would include upgrading of an existing system.

Our view is that costs that National Grid have economically and efficiently incurred to maintain and continually improve cyber resilience (within an agreed risk appetite) should be recoverable, recognising that not all future risks to our systems can be fully anticipated. We consider a clear cost recovery mechanism is required that enables National Grid to make the necessary investment with confidence.

We recognise that a pragmatic balance needs to be struck between ensuring that costs are efficiently incurred and that there is the appropriate level of investment in cyber security. We therefore propose developing a cost recovery mechanism with you based on:

- (1) a baseline level of ex ante allowance for projects where known and measurable outputs can be delivered; together with
- (2) an uncertainty mechanism to address emerging and future risks and resulting requirements that cannot be fully anticipated.

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

Yes, we agree with the proposal for ex ante funding in this area for investments known to be required as a result of NIS Regulations, and any other necessary cyber investment that is outside the scope of the NIS Regulations. However, we do not believe that this should be applied on an annual spend basis to allow for changing priorities and delivery efficiencies. Any new investments required because of changes in circumstances should be covered by an uncertainty mechanism.

Whilst there is a degree of uncertainty within the RIIO-2 period, we will be proposing ex ante allowances for projects where there are known and measurable outputs.

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

Yes, we agree with the proposal to include an uncertainty mechanism for cyber resilience costs because the threats which drive us to enhance our cyber and data security are continually evolving and future risks and resulting requirements cannot be fully anticipated. For this reason,



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there is a need for an uncertainty mechanism to recover costs for investments required in response to a change in threat or requirement within the RIIO-2 period.

We would expect that the scope of any uncertainty mechanism should include investments required as a result of;

- Policy changes – e.g. changes in Government requirements (CPNI, NIS Regulations etc.)
- Cyber-attacks – e.g. investments required reflecting the lessons learned from cyber-attacks.
- Changes in threat / risk – e.g. required response to changes in threats or changes in the risk or criticality of affected assets.
- Market changes – e.g. significant changes in the supply chain and/or technology change.

Whilst a re-opener is a logical solution to managing uncertainty around both volume and cost, we consider that the change in cyber-threat that has been seen in recent years, and is expected in the future, may warrant a different approach. In line with our RIIO principles, we will only seek to pass on risk to consumers where we cannot reasonably manage it.

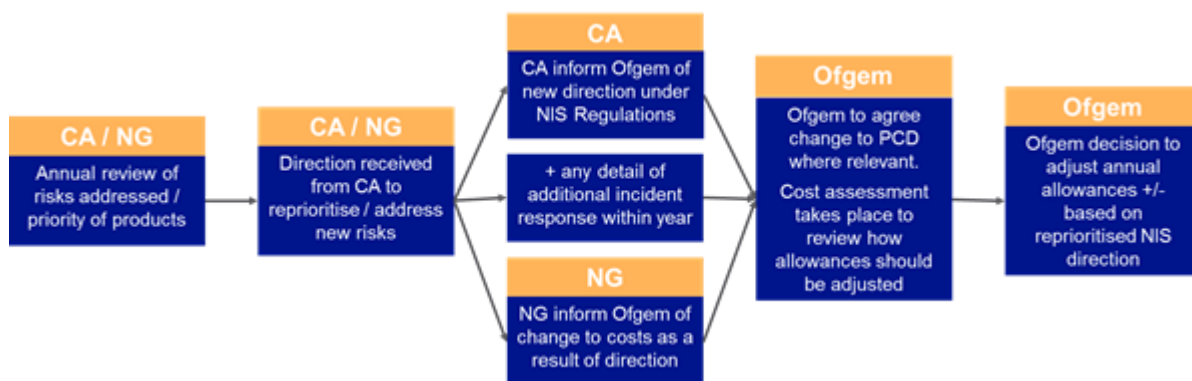
The design principles of the uncertainty mechanism approach we are proposing are as follows:

- The ability to address (as yet) unknown threat vectors.
- The ability to provide and maintain a coordinated, consistent and proportionate response across the energy sector.
- Agility to respond quickly and repeatedly (if required) in response to changing circumstances.
- Linkage to clearly defined and agreed outputs.
- An appropriate and proportionate process, monitoring and reporting arrangements, potentially using NIS periodic reporting.

We would like to work with Ofgem to develop an uncertainty mechanism which reflects the principles outlined above and could work in conjunction with the monitor and review process under the NIS Regulations yet to be implemented by the Competent Authority.

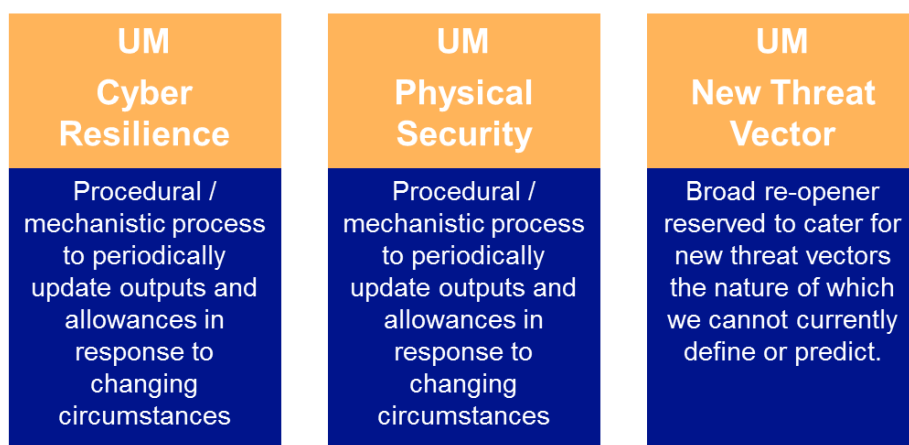
We outline an initial proposed approach for cyber security below. We request that cyber security be managed by a process which periodically updates outputs and allowances in response to changing circumstances. This could involve submitting a formal request to Ofgem to adjust allowances and/or PCDs as a result of changes in threats, requirements or priority of investments as agreed with the Competent Authority as outlined below:

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As recognised by Ofgem, we agree that the areas of cyber resilience and physical security each now has sufficient materiality, associated regulation, due process or established custom and practice to warrant having its own prescribed price control deliverable and uncertainty mechanism. We have set out in this response our view that the RIIO-2 uncertainty mechanisms for cyber resilience and physical security should become more procedural, routine and enduring processes that more seamlessly bring together the roles of the network company, Competent Authority, and the economic regulator.

We are conscious that the threat landscape is ever changing and it is possible that new, as yet unknown, threat vectors could emerge in future that are not catered for in the remit of the established processes for cyber resilience or physical security. We propose that Ofgem should consider introducing a third form of re-opener that could be reserved for such new threat vectors. This would operate in parallel with the other mechanisms, but would only be called upon in the event of a new threat vector presenting itself. The concept is summarised in the illustration below:



### 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?**

For transmission companies input prices vary differently to those in the basket of goods that make up the CPIH index. This means there are Real Price Effects (RPEs) that the regulatory framework needs to take account of.

The market prices of the inputs we require to build and maintain our transmission networks were affected during the RIIO-T1 period by external factors such as the global supply and demand for commodities and the UK supply and demand for skilled engineering and construction labour.

We have evidence of real price effects affecting our businesses in the following areas:

- Labour – NGET and NGGT pay has tracked above both CPIH and RPI over the T1 period. The reasons for this include: the increasing challenge for network companies to access the specialist technical and engineering skills they need (as you discuss in paragraph 6.50 to 6.52 of the consultation document); the long-term nature of employment within the sector; and unionised workforces.
- Materials and Plant – our procurement experience is that input price changes are incorporated into our contracts by our contracting partners. We act to mitigate the volatility of commodity prices where possible through approaches such as fixed price contracts. However, this only creates a lag in RPE effects and does not protect us from input price changes over time.

In our business plans we will submit a proposal as to which elements of the cost base should have a real price effect included in ex-ante allowances to best allocate the input price risks between networks and consumers. We support indexation on components of the cost base where we genuinely have limited control or difficulty forecasting our input prices.

Our initial views on appropriate indices for RPEs are that three key criteria are important when assessing the suitability of an index:

- non-controllability;
- longevity;
- correlation with the underlying cost.

We propose to work closely with you to derive appropriate indices for our cost base where appropriate.

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

Yes, we agree with your view that notional cost structures are not an option for NGET or NGGT because of the absence of comparators.

**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?**

Where allowances are agreed to be indexed for real price effects, we agree with your proposal to update allowances for RPEs annually and to include a forecast of RPEs as an upfront allowance. This should reduce volatility in charges for customers, avoids the need for a true-up at the beginning of RIIO-3 and will be simpler to implement.

Our other main comments about the implementation of RPE indexation related are:

- Volatility - A pure indexation approach may result in volatile charges to our customers and therefore consumer bills. Although network companies are materially impacted by real price effects they can take actions which potentially mitigate volatility in the short term, such as fixed price contracts. Some forms of indexation can take this into account, such as the use of deadbands or a moving average.
- Interaction with TIM – the consultation is unclear on precisely how the allowances will be updated each year. We need to ensure that no rewards or penalties for genuine performance are lost through RPE adjustments.
- Interaction with RPI and CPIH – The allowances for RPEs need to reflect that the transition from RPI to CPIH needs to be value neutral from an investor perspective. Re-basing inflation to CPIH gives rise to risk in this area that needs to be adequately dealt with through allowances and mechanisms.
- Changing mix of inputs – we would welcome clarification about how our allowances will be updated if the mix of inputs (e.g. of materials and labour) changes over time. For simplicity, it would be best to assume the mix stays constant within a price control and to reflect changes at the start of the next control.
- Baseline or uncertainty mechanism – we would welcome clarification about whether the RPE allowance would be included in baseline allowances and adjusted by uncertainty mechanisms or fully funded through an uncertainty mechanism. For simplicity, we would propose that a baseline allowance should apply and any indexation would then adjust this through an uncertainty mechanism line.

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

Yes, we agree with you that the EU KLEMS dataset is a key reference for assessing productivity trends. Alongside this, it would be worth considering alternative productivity data such as the Bank of England and OBR forecasts for productivity growth.

Since the financial crisis there has been a slow-down in productivity across industries which has continued post-recession where productivity has failed to return to pre-crisis levels. It is important to consider what a reasonable estimate of productivity is to be expected over the RIIO-2 period given the shorter duration and the uncertainty around possible economic factors that may be leading to the push down of productivity levels.

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We consider there is a tested relationship between productivity and wage growth. We are concerned by Ofwat's PR19 initial proposals which suggest a departure from this relationship by embedding productivity efficiency overlays without a corresponding real price effect allowance on wages.

### 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?**

We agree with your view that an asset utilisation incentive is not merited for either the gas or electricity transmission sector (paragraph 7.22).

Asset utilisation is a risk that networks have little control over because it is most strongly influenced by the supply and demand patterns that evolve in the relevant wholesale market. Furthermore, there are challenges in defining a utilisation incentive that rewards and penalises companies appropriately, given the dynamic nature of system utilisation on any given day as the specific network and market conditions are managed. For example, under normal operating conditions some circuits may be relatively lightly loaded but, under more extreme or fault conditions, these circuits may avoid significant transmission constraint costs and thus reduce costs for end-consumers.

We believe a framework that incentivises the delivery of outputs at the lowest cost will encourage network companies to make best use of their existing network. Indeed, in the most recent Network Options Assessment (NOA) round, NGET put forward several low and no investment options to provide additional boundary capacity using existing assets.

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

We welcome you including anticipatory investment in your consultation. It is essential the RIIO-2 framework enables network companies to undertake anticipatory investment given the rapid pace that new technologies can evolve at and several future energy scenarios pointing to the need to decarbonise transport and heat. It is essential the RIIO-2 framework facilitate these changes in a way that is in consumers' interest.

We agree there may be certain investments that are linked to Government policy objectives that are broader than Ofgem's own remit. A forum such as the Electricity Networks Strategy Group (ENSG) could provide the means to support such decision making. There are strong grounds to establish such a group ahead of RIIO-2 given some of the areas where anticipatory investment might be justified. To provide confidence in such a forum it is important that the process leading to a decision is well defined and not open-ended.

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

For our views on the risk-sharing approach, please see our answer to CSQ42.

There are two current areas where we consider a risk-sharing approach to anticipatory investment might be justified, these are:

- Supporting the decarbonisation of transport. Considerable investment is needed to address drivers' range anxiety, which is a considerable barrier to the widespread uptake of electric vehicles. We believe targeted investment will future-proof a network of charging facilities along the motorway network.
- Helping to meet regional low carbon generation targets. For example, the Welsh Government has stated its policy is to generate 70% of its electricity consumption from

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renewable energy by 2030. Anticipatory investment could be undertaken to support this ambition.

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

The consultation identifies the availability of higher or lower returns as one way of facilitating risk-sharing for anticipatory investments. There are various ways that this could be formulated depending on the circumstances and drivers for that investment. For example, a cap and collar arrangement could be agreed; or volumetric targets above or below different returns could be earned. We can explore a variety of options with you.

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

The new working group, similar to the ENSG, could challenge network companies' proposals. As you mention in paragraph 7.40 as an independent regulator you will only approve a project after undertaking your own assessment of it.



### Innovation questions

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

We agree that low-risk, high Technology Readiness Level (TRL) innovation that drives outperformance within the regulatory period in which the investment is made can be funded as business as usual (BAU) through the totex incentive mechanism (TIM). However, elsewhere in the consultation you state that you expect totex sharing factors to be lower in RIIO-2 than in RIIO-1 and suggest a range of 15% to 50%. A low TIM sharing factor will significantly reduce the incentive for network companies to innovate within period because they will not earn the return necessary to justify their investment. In addition, by moving from an eight-year to a five-year price review period you are reducing the potential payback period for innovation as BAU.

BAU is not suitable for the transformative innovation required in the RIIO-2 period. Strong innovation incentives are needed for the RIIO-2 period when the energy system will be changing extensively. For example, lower TRL projects, such as early-stage research in the Gas System Operator, is difficult to justify as BAU investment because the risk of failure is high and there would be no immediate financial value realised, however the benefits for the wider system could be substantial. The projects could help better understand and mitigate future challenges which the system could face, helping ensure a secure, reliable and lower carbon energy system into the future. This form of research and development is not suitable to include in Business Plans or fund through the TIM. This research provides an agile way to develop our understanding of the future Energy System Transformation challenges as they become apparent (e.g. whole system, gas/electricity system interactions, decarbonisation of heat).

We have some other points about innovation funding in the RIIO-2 period that do not fall under the specific questions you ask:

- **Uncertainty about innovation funding between regulatory periods** – we need to know well in advance the innovation funding mechanisms for the RIIO-2 period to develop our draft business plan for 1 July 2019. One of the major barriers to continuous, improved management of innovation in the energy sector has been the uncertainty between regulatory periods which has led utilities to slowly run-down their innovation teams in the anticipation that innovation funding might be removed. This has a negative impact on network companies' innovation and the benefits it can deliver for customers. At present, you have not provided clarity around what risk profile of innovation you want to see in the RIIO-2 period. This risk is that without this clarity network companies are more risk averse around innovation in their business plans.
- **Third parties** – we support third parties being involved in innovation as they bring new ideas and approaches. However, third party access to relevant information might present a barrier to participation in some cases. As our networks are critical national infrastructure, it is important that we remain closely involved in innovation related to our assets even if it is carried out by third parties. Therefore, we are concerned about precisely how direct third-party access to innovation funding will work in practice and the governance associated with it. Direct third party access to funding raises issues in terms of giving third parties direct access to live energy networks and the practicalities of knowledge sharing, dissemination and commercialisation of technologies developed with the funding.

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

We agree that network companies have not used the current IRM much. The main issue with this mechanism is that it is a re-opener and was only available twice within the regulatory period. This meant that when a network company needed access to a rollout funds quickly, it was often not available.

However, there is a need for a rollout mechanism of some form due to the cost of rolling out some technologies and the long payback time for earning a return. A rollout mechanism is even more important with the move to a five-year price review period, which reduces the payback period for rolling out innovations. An alternative would be ex ante funding for an investment programme to allow for the rollout of innovations to benefit consumers. This funding could be associated with price control deliverables to ensure consumers were refunded if companies did not spend their rollout funding.

### **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?**

We agree with your proposals for a new network innovation funding pot to focus on strategic energy system transition challenges. This should coordinate with other government initiatives.

NIC has a proven track record of delivering innovations that meet big strategic innovation challenges. Therefore, we suggest your new network innovation funding pot builds on the NIC.

There are some issues with the current NIC you could address with your new network innovation funding pot:

- The current NIC governance structure requires network companies to demonstrate significant value to consumers within the period. This drives the NIC to focus on high-TRL innovation projects. The new funding pot could be more open to low-TRL innovation projects.
- The rules for the new funding pot need to address who would cover the liabilities on projects where: (i) we install equipment on our network from companies who go out of business; or (ii) we install equipment that causes significant reputational and operational damage to our network because the innovation fails in the medium-long term. Addressing these issues should increase confidence in third party involvement in the funding pot.

The process for establishing the relevant “system transition innovation challenges” for the new funding pot (paragraph 8.26) need to be independent and transparent. In addition, we need the process to set out the challenges clearly and well in advance so that network companies and third parties have time to develop bids for the funding pot.

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

We note that you will be consulting in the future on “whether RIIO-2 electricity innovation funds need to be raised via BSUoS Charges” (paragraph 8.35) rather than TNUoS charges, as they are at present. We wonder whether you meant to say that the ESO’s innovation funds would be raised via BSUoS for RIIO-2 rather than all electricity innovation funds.

### **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,**

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### **why these could not be funded through totex allowances and what the benefits of these projects would be**

We strongly consider there is a continued need for the NIA within RIIO-2. RIIO-2 is not the right time to remove or heavily restrict innovation funding such as the Network Innovation Allowance (NIA), given the energy system transition that will be taking place in the 2020s.

As we explained in our response to CSQ44 you are proposing a lower TIM sharing factor for the RIIO-2 period and reducing the length of the price control to five years. This will significantly reduce the payback for investment in the RIIO-2 period and mean there is a much greater need for dedicated innovation funding.

We need to retain NIA to drive long-term innovation that spans regulatory periods and drives the high-risk, transformational innovation required to improve both operational efficiency (e.g. digitisation) and environmental impact (e.g. new materials and revolutionary substation / transmission designs). With our new infrastructure projects taking an average of 4 years to develop and deliver and lasting for over 50 years, we need to carry out innovation that addresses the needs of future consumers; this can only be done through an innovation allowance.

NIA has helped us to deliver many successful projects and benefits to consumers as we explain in our annual innovation reports:

- National Grid Gas Transmission's "Network Innovation Allowance Annual Summary 2017/18" (<https://www.nationalgridgas.com/document/119831/download>); and
- National Grid Electricity Transmission's "Network Innovation Annual Summary 2017/18" ([https://www.nationalgridet.com/sites/et/files/documents/National-Grid-Electricity-Transmission-NIA-Annual-Summary-2017-18\\_0.pdf](https://www.nationalgridet.com/sites/et/files/documents/National-Grid-Electricity-Transmission-NIA-Annual-Summary-2017-18_0.pdf)).

For RIIO-2 you should review the governance of the NIA to allow the true embedding of innovation, including commercialising the intellectual property and supporting the cost of implementing new technologies and processes. This would help address the well-known "valley-of-death" where good ideas going through the innovation process fail to progress to full implementation.

We have heard strongly through our stakeholder engagement about the importance of NIA funding for the small and medium-sized enterprises (SMEs) community. The NIA governance allows for higher-risk projects with procurement strategies that enable SMEs to get involved as well as big Original Equipment Manufacturers (OEMs) and other global organisations.

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

We recognise that significant customer funding has been invested in innovation and our stakeholders are keen to see how effectively we have used their money. Through the Energy Innovation Centre (EIC), energy networks have developed an innovation measurement framework. Working collaboratively with other networks, we have developed a measurement framework to assess the behaviours associated with successful innovation.

One of the points our stakeholders have made is around how to ensure independence in reporting network company performance. One solution we suggest is that any Innovation

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Governance document which applies during RIIO-2 could include reporting requirements. We would be keen to discuss this option further with you following the close of the consultation.

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

We support your view that despite the different price control period for electricity distribution companies they should continue to collaborate in innovation projects with other network companies in 2021-22 and 2022-23.

### Competition questions

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

We support the principle of introducing competition in transmission, where the model and associated arrangements can deliver value for consumers.

The Competitively Appointed Transmission Owner (CATO) model is the only workable onshore competition model developed to date. The existence of a licence would allow for the asset owner and operator to be directly regulated by Ofgem, enable risk to be clearly allocated, and provide statutory powers to the party building the assets. The CATO model would also allow for the competition to be run earlier in the process, maximising the opportunity for consumer value. We support Ofgem's intention to seek legislation to facilitate this model.

The Competition Proxy model does not constitute a competitive process, it is purely a project-specific price control. As such, it does not deliver any of the benefits which would be expected to result from a competition, such as innovation or price discovery. Further, the current proposals do not represent an outcome which would realistically result from a competition, and as such the consumer benefit assessment is not credible. Therefore, we do not support this model.

We do not support the introduction of the Special Purpose Vehicle (SPV) model. Firstly, it is not clear how the SPV would be able to participate in transmission or gas transportation activity without holding the relevant licence. Secondly, it suggests a reduction of Ofgem's regulatory powers, and unclear accountabilities and risk allocation. The lack of licence would bring additional risk for the TO, for which it is not proposed that the TO is compensated. In addition, there are multiple aspects of the model which are not sufficiently well developed. As such, we do not find Ofgem's assessment of consumer benefit to be credible.

Our views on the Competition Proxy and SPV models are discussed further in our consultation responses of 9<sup>th</sup> November 2018, 20<sup>th</sup> March 2018, and 11<sup>th</sup> October 2017.

Ofgem should explore the early CATO model further. The early model, although potentially more complex to implement, has the potential to deliver a greater consumer benefit than the Late model, and is consistent with international experience. It will be important to distinguish between "very early" and "early" models: the stage of the process where the competition is run will impact on the potential for innovation, certainty for bidders, and ease of comparing bids. The ENA Early Model Report <sup>1</sup> in 2017 defined a "very early" model as the competition being run after the need is identified, where bidders can propose options. The "early" model is where a competition is run after the solution is identified, and bidders can propose initial solution designs which are refined during the consenting process. The report found that an "early" model would be more workable.

We comment on native competition in our responses to CSQ61-63.

#### **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?**

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<sup>1</sup> [https://www.ofgem.gov.uk/system/files/docs/2017/04/ena\\_working\\_group\\_report\\_16\\_feb\\_2017.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/04/ena_working_group_report_16_feb_2017.pdf)

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The only workable late competition model proposed to date is the CATO model: as such, our comments below relate to this model. As stated above, we do not support the Competition Proxy or SPV models. Further, we note that a late model, where bidders compete only for delivery and financing, may not deliver a significant consumer benefit, as it allows little scope for innovation and introduces a handover between consenting and construction. An early model would maximise potential consumer benefit across the whole value chain, giving scope for innovation.

The “new, high value and separable” criteria for assessing whether a project is suitable for late competition are useful criteria to give a shortlist of projects to be considered. Fixing these criteria gives certainty to stakeholders, and using the same criteria across different sectors is consistent with facilitating whole system solutions (for example, where a distribution issue can be resolved by a transmission solution). However, we agree that some adaptation to wording may be required before applying the criteria to the gas transmission or electricity distribution sectors. The competition criteria should form part of the licence, in order to ensure that they are subject to suitable governance and any changes are subject to rights of appeal.

If £100m is the project cost where Ofgem expects the benefits of competition to outweigh the costs, it would not seem logical to run the same type of competition for projects with capital costs beneath this threshold, regardless of which sector they are in. There is no justification for lowering this threshold at present, as to date no CATO competitions have taken place, and therefore it is not possible to prove that the available savings outweigh the additional costs of competition. Similarly, it would not be appropriate to split assets within projects such that a competition is run for a sub-project which has a value below £100m.

Although the “new, high value and separable” criteria are a useful starting point, they are not the only characteristics which should be considered when determining whether the project is a good candidate for competition. Other important aspects are time-criticality (running a competitive process will necessarily take longer than the status quo of incumbent delivery), scope for consumer savings, and the certainty of the project need case (to avoid wasted competition costs for a project which does not ultimately go ahead). Ofgem should consult on the case for competition on a project-specific basis, taking into account stakeholder views and the level of interest from potential bidders.

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

Ofgem’s draft impact assessment appears to overstate the benefits of late competition, and understate some of the costs. We do not believe that the introduction of the SPV or Competition Proxy models would benefit consumers.

Within the draft impact assessment, we observe that the range of costs (4.2-10.8% of the value of projects involved) has a significant overlap with the range of savings of 4-19% for the SPV model, and 10-12% for the CPM. If these numbers are correct, there appears to be a real risk that the costs of introducing these models would outweigh the benefits. However, there are areas where we believe that Ofgem has understated the costs of introducing these models, and overstated the benefits (for example, in assuming that projects could be financed at the low cost of capital proposed). If these additional costs were to be correctly reflected in the cost-benefit analysis, there would be an even greater risk that these models would not deliver genuine savings for consumers. We also note that no assessment is made of the costs and benefits



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associated with a CATO model, which is the only workable model of onshore competition developed so far.

### Financing benefits

We recognise that CATOs may be able to access new sources of finance, or innovative finance arrangements not available to existing TOs. However, it is not clear that Ofgem's reasons for assuming that CATOs can deliver savings in financing costs are robust. The low operational cost of capital observed in OFTO bids represents a model where no construction activities are required, and the assets exist at the periphery of the network with no expectation that the assets may need to be continually modified to accommodate changes on the network. It cannot be assumed that this low cost of capital would be achievable onshore, where the bidder would be competing to undertake a set of activities that would include both construction and operation, and would undertake a role more comparable to that of an existing onshore TO.

We do not agree that changing the level of gearing would result in a lower cost of capital. It is an established economic principle that, in the absence of tax, capital structure should not affect the overall cost of capital. Although debt is generally cheaper than equity, the cost of debt and cost of equity would both increase as gearing is increased. We also note that any differences in the weighted average cost of capital (WACC) due to tax do not represent a true consumer benefit, as consumers are generally also taxpayers, and any reduction in tax income would need to be offset by a corresponding increase elsewhere. Ofgem should also consider the implications of high gearing on companies' financial resilience.

Further, it is not clear that consumer value would result from locking in a particular cost of debt. This source of value would rely on Ofgem's ability to predict future market movements over a 25-year period.

### Capital and operational costs

A CATO model, particularly an early model, would have the potential to deliver a consumer benefit by way of revealing efficient costs, driving innovation, and providing new benchmarks. The introduction of competition may also place downward pressure on other capital and operational expenditure.

However, it is important to note that incumbent licensees already tender a large proportion of their construction activities, use a holistic approach that considers the entire project lifecycle, and benefit from economies of scale. Further, the Impact Assessment does not recognise that where risk is transferred away from the project to facilitate a low cost of capital, additional capital costs may be incurred.

It is also important to consider the design life of CATO assets, as assets designed to last only 25 years may result in consumers paying higher costs in the long term if they need to be replaced shortly after the end of the regulatory depreciation period.

### Other considerations

Ofgem's assessment of costs associated with competitive bidding does not consider the fact that, although costs to unsuccessful bidders will remain with them in the short term, all bidders will price in the chance of not being successful. It is also worth accounting for the costs which are incurred in relation to projects which are not ultimately progressed: the introduction of



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competitive bidding would result in more costs being incurred earlier, when the need for the project is less certain.

We would expect additional interface costs to result from onshore competition, particularly in the operational phase, and would like to see this given more prominence in the Impact Assessment. Although delays to transmission projects may not result from the actions of competitively appointed parties, it is worth considering whether such parties would be well placed to accommodate the requirement to adjust construction timescales in line with the Network Options Assessment recommendations.

It is worth noting that the consumer benefit assumed to result from the introduction of onshore competition is dependent on the existence of a pipeline of eligible projects, to offset Ofgem's development costs and make it worthwhile for bidders to participate in the process. For some sectors, such as gas transmission, this does not seem to be the case. Even in electricity transmission, the perceived uncertainty around project need (for example in relation to the connection of nuclear generation) may deter potential bidders.

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

Ofgem has taken its assumptions in relation to consumer benefit for competition in electricity transmission and assumed that they are equally applicable to gas transmission and distribution. Before extending competition to these sectors, Ofgem should take account of the likely pipeline of projects, how interfaces and operational processes would work, and whether there are companies willing to bid for these projects who would be able to construct, operate and finance these assets at a lower total cost than the incumbent.

We do not foresee any gas transmission projects which are expected to be needed that would meet the “new, high value and separable” competition criteria. As such, it is not likely to be worth developing a set of competition arrangements for gas transmission, as the process costs of developing the regime would not be offset by consumer savings for eligible projects. Also, bidders may not be willing to engage in the market and set up bidding teams if there is not a large number of projects for which to bid.

If Ofgem intends to roll out competition to these other sectors, it would need to ensure that the legislative changes it originally proposed for CATO are fit for purpose for all sectors. Additionally, it would need to consider the interaction with the upcoming RIIO-ED2 price control, which is not yet subject to consultation.

We have previously stated, in relation to the SPV model, that the Electricity Act requires anyone participating in electricity transmission to hold a licence. The Gas Act contains an equivalent rule for those who convey gas through pipes, and additionally holders of a gas transporter licence are required by the Gas Safety (Management) Regulations to submit a Safety Case to the Health and Safety Executive, which would need to be accepted. This means that a model whereby a party without a transmission licence participates in transmission, or a party without a transportation licence conveys gas through pipes, would not be workable in either electricity or gas transmission, because it would circumvent the legal structure that must be applied to critical national infrastructure assets. It is not clear that any exemption from this requirement would be in the consumer interest.

**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?**

We support Ofgem's intention to develop an early CATO model of competition, as an early model would have greater potential for consumer benefit by way of innovation and would give the successful CATO clear accountability for the project. We recognise that there are some potential challenges associated with developing an early model, however we believe that these are worth addressing to maximise the potential consumer benefit available from the introduction of competition.

We believe that it would be helpful to distinguish between a "very early" and "early" competition. A "very early" competition could be defined as one where the ESO defines a system issue and bidders propose solutions to resolve it, and an "early" competition would be one where the ESO proposes a high-level reference solution and bidders put forward more specific project proposals. The earlier the competition is run, the greater the potential for innovation, but the greater the extent of implementation challenges. An "early" model would therefore be a more realistic starting point, with a "very early" model being a potential future evolution of this.

We recognise some of the challenges identified by Ofgem, in particular the change of circumstances between running the competition and the project being delivered. We addressed this issue in our work with the ENA on the early Model in 2017<sup>2</sup>. Under the early model proposed by this report, the ESO would provide a reference design for potential CATOs to bid against (with scope for bidders to propose alternatives). Bidders would then put forward a range of costs for both capex and opex to accommodate the uncertainty associated with the extended time period between bidding and project delivery. Bidders would also propose sharing factors, showing the extent to which any changes in cost would be shared with consumers. This would reveal the bidders' risk appetite, and their confidence in their cost estimates. Ofgem would then assess the range of costs, in combination with the proposed sharing factors, to appoint a CATO. The successful CATO would then obtain planning consent and construct the project. In order to promote financeability, the successful CATO would be reimbursed for the costs it incurred during preliminary works. In the event of the project no longer being required, CATOs would also be compensated for the costs committed to date.

Ofgem points to the challenge of deliverability. The party that proposes a solution should deliver it, as this would ensure that solutions are priced on a realistic basis and would remove the scope for any misunderstandings that could result in technical issues or miscommunications with stakeholders. We discuss Ofgem's two proposed high-level approaches further in our response to CSQ58.

The challenge of accessing land is, in our view, a less significant challenge. We would not expect bidders to conduct more than a desktop exercise while preparing their bids, noting that the ability to bid a range of costs would allow CATOs to accommodate changes in land conditions from their original assumptions. Once the CATO had been appointed and obtained a licence, we assume it would benefit from the same statutory powers that are available to existing onshore transmission licensees. This further reinforces the fact that it is appropriate and necessary for anyone participating in onshore transmission to hold a licence.

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<sup>2</sup>[https://www.ofgem.gov.uk/system/files/docs/2017/04/ena\\_working\\_group\\_report\\_16\\_feb\\_2017.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/04/ena_working_group_report_16_feb_2017.pdf).

### **CSQ56. Are there other potential drawbacks of early competition?**

Depending on the variant of early model used, there are a number of issues which may need to be addressed in order to unlock its potential for consumer benefit.

One potential drawback of early competition is the difficulty in comparing bids, given that the final solution and therefore project costs can be highly uncertain before planning consent is obtained. However, the ENA early model described in our response to CSQ55 could be developed to address this issue, by allowing bidders to submit a range of costs with an appropriate sharing factor.

A “very early” model would have additional drawbacks, such as the requirement for a network model. If bidders are to propose solutions, the impact of these solutions on the rest of the network would need to be assessed. Either a public network model (which would need to be continuously maintained) would need to be available to bidders, or the SO would have to assess the impact of all proposals on network security and operability.

A “very early” model would also experience significantly more uncertainty regarding the project need, scope and timing, which may deter potential bidders. Bidders may also be concerned that the regulatory environment may change over the time period in question.

However, despite the potential drawbacks, we believe that an early model has much greater potential for consumer benefit than the late model, given the scope for innovation, clearer accountabilities, and reduced handover costs between consenting and construction. The ENA early Model workshops in 2016 demonstrated significant industry support for developing an early Model.

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

The ENA early model report referred to above provides a number of examples of competition in other sectors and internationally. However, it is important to note that many of these projects are still under construction, so it is not possible to assess the true extent of consumer savings realised, or whether the framework is workable during the operational phase.

However, a number of lessons can still be learnt from the case studies in the early model report. The examples showed that “early” variants were more workable than “very early”. Earlier models promoted more innovation in design, whereas later models led to innovation in finance. However, innovation in the design phase was possible even after a baseline solution was chosen.

### **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?**

In our view, the one-stage process (single competition for idea and delivery of solution) would be the most straightforward solution. We would also expect it to be more attractive to bidders because the successful bidder would be guaranteed to deliver the project and receive the associated revenue stream.

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We agree with Ofgem's view that the one-stage process should result in more deliverable ideas. It should also result in a more realistic assessment of costs and risks, as the successful bidder would be obliged to deliver the project. It would give clear accountabilities, result in fewer handovers, and reduce process costs associated with running a competition (giving more scope for consumer benefit). A process involving two stages of competition would take longer, particularly given the requirement for bidders in the second competition to verify the technical feasibility of the solution which results from the first competition.

A one-stage process need not result in a sub-optimal solution if the competition is run at an appropriate stage in the process, where there is more certainty over the requirements for the project. We recognise that running a single early competition could be complex, but we would not expect that splitting this into two separate competitions would remove the underlying complexity associated with evaluating a range of different solutions. The ENA early model report proposes ways of addressing this complexity.

The two-stage process would introduce additional cost and timing impacts, and an additional handover. It would also place less responsibility on bidders participating in the first competition to produce a realistically-priced and deliverable idea, and the lack of a guaranteed operational revenue stream may deter potential bidders. It is also not clear how you would deal with the issue of intellectual property if one party's idea can be developed by others. Ofgem proposes that the ESO could obtain planning consent or develop transmission designs. However, we do not believe that these activities are compatible with the ESO's role and expertise. It would be preferable to develop an early model where a CATO can carry out these activities, which are closely linked to project delivery.

### **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?**

The existing competition criteria (new, high value and separable) should be retained as a minimum for all competition models, so that stakeholders have visibility of the upcoming pipeline of competeable projects, and incumbent licensees know which projects to include in their baseline. However, there are certain project characteristics which may make an early model more suitable.

Time-criticality is a relevant consideration for all competition models because running a competitive process, beyond that already undertaken as part of native competition, will always take additional time. When the impact of late project delivery to consumers (by way of electricity transmission constraints) is considered, we would not expect it to be in the consumer interest to use competition for projects where timescales are short.

We agree that the early model would be most beneficial where a wider range of possible technical solutions is envisaged. However, additional technical solutions may be revealed as part of the competition process, which may not have been foreseen ahead of running a competition.

Certainty of need is important for an early model, as bidders may be deterred from participating in a competition if they believe that there is a chance that the project will not go ahead. It also would not be desirable for consumers to incur the costs associated with running a competition if the project may eventually not be required.

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Where an early competition could result in a non-build solution, it may be difficult to apply the existing competition criteria. However, under the ENA early model, where incumbent TOs propose solutions and the SO identifies a reference solution for prospective CATOs to bid against, the criteria could be applied to the reference solution. Where non-build solutions are put forward, the principles of avoiding unnecessary operational complexity and not transferring existing assets should be maintained.

### **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?**

It is our view that Ofgem should run as much of the competition process as possible. Ofgem carrying out these activities would reassure bidders that the process is impartial, which should increase the pool of competitors. A consistent process across all sectors would also be more attractive to bidders. Ofgem running the process would also offer an economy of scale compared to a different party carrying out these activities for each sector. Where the activity is not a particular area of expertise for Ofgem, Ofgem could either develop its capability in preparation for future competition processes, or buy in expertise as needed.

The roles of defining the system need and conducting options appraisal for load-related projects are currently carried out by the ESO for electricity transmission, and GSO and GTO (as part of an iterative process) for gas transmission. This is part of a detailed process involving the production of the Future Energy Scenarios, which feed into the Electricity and Gas Ten Year Statements. It is logical for these roles to remain with the parties which are currently responsible for them, who have the relevant capability and access to the required information. Note that these activities also cover projects which are not eligible for competition.

Tender design, running tenders and evaluating bids is a role that would naturally sit with Ofgem, who would also be responsible for awarding a licence to the successful bidder. This is consistent with the CATO work Ofgem has done to date, and its role in the OFTO regime.

Preparatory work, such as obtaining consents and planning permission, needs to be carried out by a transmission licensee with the relevant powers. Under an early model, this would be carried out by the competitively appointed licensee: this would be the same party which carries out construction work. Under a late model, this is not an activity which sits well with the SO's role and expertise, and therefore would be logically carried out by the relevant TO.

### **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?**

We are not clear about your description of native competition. Our understanding of the consultation is that you propose three tiers of competition as follows:

- “Native competition” refers to the use of our existing procurement processes for projects where an ex-ante allowance is set as part of the RIIO-T2 baseline.
- “Competition as price finder” is an enhanced form of native competition that would be used for larger projects that do not meet the competition criteria but are funded through re-openers during the price control.
- Early and late CATO models could then be used for projects meeting the competition criteria, where it is appropriate to do so.



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We would like further clarification from Ofgem as to the situations in which the different models would be applied, given that the examples given in the consultation document relate to DNOs. However, we agree that the extent of competition, and Ofgem's scrutiny of it, should be proportionate to the scale of the project.

We are not fully clear on how your proposal about “competition as price finder” would apply to transmission companies when we already put out to tender the large majority of our projects.

Competition As price finder is similar to the approach which TOs already take for large re-opener projects such as Strategic Wider Works. However, it is not clear how this would work with the blended sharing factor: would the project costs be classified as certain or uncertain? At what stage during the process would this distinction be made: in the business plan submission, or when a funding submission is made for this specific project? The consultation refers to the blended sharing factor being updated to account for project costs becoming more certain after a tender. However, this emphasises the fundamental issue with the blended sharing factor, namely that it is an ex-post adjustment which fundamentally undermines the purpose of an incentive. Our views on the blended sharing factor are set out in our responses to questions CSQ70 to CSQ80.

We would be concerned by an approach where licensees would run a tender exercise to obtain a price and then not eventually contract with any of these providers. This would lead to reduced confidence from bidders, and eventually reduced participation, in future procurement exercises run by licensees.

Given the number of aspects of Ofgem's native competition proposals which are unclear, it would be difficult for licensees to accurately reflect these proposals in their business plan submissions for 1 July 2019, without further information. It also not clear how network companies' approaches to native competition could contribute towards the business plan incentive without further clarification of Ofgem's assessment criteria.

### **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?**

Ofgem needs to provide a strong totex incentive mechanism (TIM) in the RIIO-2 period because it is the best approach to encourage network companies to innovate and find new cost efficiencies. We already put out to tender the large majority of our projects, which the strong RIIO-1 TIM sharing factor encourages us to do. Ofgem states that it expects TIM sharing factors to be lower in the RIIO-2 period and proposes a sharing factor range of 15% to 50%. We do not think this is in consumers' interests because the lower TIM sharing factors, coupled with the shortening of the price control period, will reduce network companies' incentive to undertake their own competitive processes and drive cost efficiency savings for consumers. We set out our views on the blended sharing factor in our responses to CSQ70-80.

The TIM should be applied to native competition (where the ex-ante cost is set in the baseline) and could be applied to competition as price finder projects where it could encourage networks to incentivise their contractors to seek out further cost savings beyond their original estimate of price.

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We have doubts about how suitable an incentive, other than TIM, around native competition would be for transmission companies when we already put out to tender the large majority of our projects. If Ofgem goes ahead with such an incentive, there are several ideas which could be considered. One example is a business plan incentive could reward an effective procurement framework which tests a good proportion of the market, is clearly understood, and is appropriate and proportionate for the task in hand. For each significant procurement exercise (competition as price finder), a Finder's Fee could be awarded for a high-quality procurement process, based on aspects such as the provision of timely information to bidders, the number of tenders received, and bidder satisfaction with the overall procurement process. The performance of this competitive approach could be evidenced through metrics such as the average number of bidders per sourcing event, average percentage saving from tender price to award price, and the introduction of a supplier net promoter score.

The Network Options Assessment process run by ESO is the right place to create a level playing field to assess whether a system issue should be resolved by a network or non-network solution. Once the preferred solution has been selected, where it is a network solution it can follow the relevant process depending on the scale of the project and be subject to the totex incentive. Where it is a non-network solution, for example the provision of balancing services, it would be the responsibility of the system operator to contract for this service.

### **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?**

We understand this to refer to the Competition as Price Finder approach. We are not clear how the Competition As Price Finder proposal would apply to transmission companies when we already put out to tender the large majority of our projects.

We do not think the Competition as Price Finder approach is workable, apart from projects funded as part of a re-opener. It would represent a move towards ex-post regulation, and would not incentivise networks to run a good procurement process. A robust cost assessment to set ex-ante funding levels, coupled with a strong totex incentive (with a high sharing factor), is sufficient to drive network companies to search out the most efficient way of delivering solutions. Ex-post adjustments undermine the strength of incentives, by introducing uncertainty in decision making when investments are made.

For projects where a funding allowance is set as part of the baseline at the start of the price control, it may be premature to run a tender exercise if the project is not due to be delivered for several years. Suppliers may not be willing to prepare realistic bids if they consider the bid process to be speculative. In these cases, it would not be possible to use costs revealed through competition to set an ex-ante allowance. We therefore suggest that competition as price finder would only really work for projects funded as part of a re-opener.

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

It would not be logical for the ESO to play a role in facilitating competition in the gas sectors. Facilitating gas competition would not be consistent with the ESO's role or capability, which relate to the electricity sector. The gas and electricity transmission networks are fundamentally different, with different operational challenges and physical characteristics. It would not be in the



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consumer interest for activities to be undertaken by a party which does not have the relevant expertise.

### Business Plan and totex incentives questions

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

We support a strong incentive on network companies to produce good-quality business plans that reflect a robust stakeholder engagement process and contain well evidenced costs to enable Ofgem to perform a rigorous price review. The proposal represents an evolution from the Information Quality Incentive (IQI) that incentivised cost efficiency but neglected other equally important criteria.

We consider Ofgem can improve the Business Plan Incentive (BPI) as put forward in its consultation in the following ways:

- Ofgem should perform the BPI assessment separately for each sector with Ofgem assessing NGET and NGGT individually. NGGT is the sole operator within the gas transmission sector and so has no comparators. NGET represents over 70% of the RAV for the electricity transmission sector and comparison with other TOs would be distorted by its significant size and the different nature of its network. A separate assessment of NGGT and NGET is consistent with the principles that Ofgem set out when it removed fast tracking in the GT and ET sectors, and in its approach to the implementation of RAMs.
- Both the BPI penalty and reward should be absolute. An absolute reward for good-quality business plans is more appropriate for transmission companies and consistent with the rest of the RIIO-2 framework. Ofgem's proposal for a shared reward and absolute BPI penalties will cause network companies to focus on low-risk business plans to avoid a penalty rather than taking risks and proposing ambitious business plans. In electricity transmission, there are only three companies which have very different networks and in gas transmission there is only one company. As a result, there is little or no scope for one company's plan to reveal the efficient frontier for the other companies. This is a point you have recognised in your July 2018 and December 2018 RIIO-2 publications when you ruled out early settlement and anchoring for transmission companies. We propose for the transmission sectors that Ofgem should implement an absolute reward and penalty for the BPI to incentivise companies to propose good-quality and ambitious business plans that reveal information about their particular cost and service quality frontiers.
- Ofgem should not cap the BPI reward at 2% of totex to ensure that the incentive does not constrain the cost ambition of network companies in their business plans. Ofgem should also avoid "cliff edges" between the assessment categories. For example, a company just falling into the "low value" box will incur a 1% of totex penalty, but a plan that is only slightly better could be "standard" and incur no penalty.
- Ofgem's assessment of the quality of network company plans should take account of the views of network companies' User Groups and the Ofgem Challenge Group on those plans. These groups will have had multiple opportunities to review the business plans by the time of submission, including how the plans reflect the challenges they have raised with the network companies. Ofgem will still be responsible for the final assessment of quality.

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- Ofgem should clearly set out the assessment criteria for the BPI soon so that network companies have time to address them in their business plans. The finalised BPI criteria should be complete, unambiguous, objective and transparent. The benefits of having clear criteria well in advance of network companies submitting their plans are that Ofgem will receive business plans that are closer to what Ofgem wants companies to deliver for consumers. Ofgem will also receive more consistent business plans that are easier for it to assess. We suggest some ideas for business plan quality test questions for the BPI below that we shared with you and other network companies at a workshop on 7 March.

### Illustrative business plan quality test questions

Quality of plan - test area	Illustrative questions to address
<b>1. Enhanced engagement</b>	How well has the company:
	1.1 Provided evidence of robust and high quality engagement with stakeholders by the company in designing the plan?
	1.2 Provided evidence that its business plan reflects its stakeholders' feedback?
	1.3 Provided evidence of effective engagement with User Groups, Customer Engagement Groups and the RIIO-2 Challenge Group?
<b>2. Business plan commitment</b>	How well has the company:
	2.1 Provided assurance that the plan and associated costs have been tested for accuracy?
	2.2 Provided assurance from sufficiently independent directors that the plan and associated costs have been tested for ambition and efficiency?
<b>3. Enabling whole system solutions</b>	How well has the company:
	3.1 Justified its plans and processes for joint planning with other network companies / the ESO?
	3.2 Given effective consideration of whole system solutions to network planning and constraints in their cost benefit analyses?
	3.3 Demonstrated long-term whole system thinking and value for money, including developing new approaches to deliver benefits for consumers?
<b>4. Meet the needs of consumers and network users</b>	How well has the company:
	4.1 Demonstrated ambitious proposals to improve service quality for its consumers?
	4.2 Provided evidence to support its proposed service improvements?
	4.3 Justified its approach to the network asset risk metric (NARM)?
<b>5. Maintain a safe and resilient network</b>	How well has the company:
	5.1 Developed a sustainable workforce strategy?
	5.2 Justified its approach to cyber security, including its strategic investment plans for cyber resilience?
	5.3 Justified its approach to physical security?
<b>6. Deliver an environmentally sustainable network</b>	How well has the company:
	6.1 Demonstrated ambition in its proposals for enabling the transition to a low carbon network?
	6.2 Demonstrated its commitment to improve the environment in areas other than low carbon?
	6.3 Provided evidence that justifies its environmental proposals, including evidence of stakeholder and/or consumer support?
<b>7. Efficient financing</b>	How well has the company:

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	7.1 Demonstrated its approach to financing takes account of the management of risk and uncertainty?
	7.2 Provided a clear statement that its plan is financeable?
	7.3 Evidenced its approach to fast / slow money and depreciation rates are beneficial for consumers, both now and in the longer term?
<b>8. Innovation</b>	How well has the company:
	8.1 Ensured that previously proven innovation is rolled out into BAU?
	8.2 Explained what innovation activities it is planning for RIIO-2 using its totex allowance?
	8.3 Described what arrangements it will take to secure third party involvement and collaborate with other network companies as part of its innovation activities?
<b>9. Competition</b>	How well has the company:
	9.1 Justified its overall approach to competition in RIIO-2 and how it will benefit consumers?
	9.2 Identified projects that might be eligible for competition processes?
	9.3 Provided information about its governance processes for native competition processes?

**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?**

We propose that Ofgem should base its stage 2 cost assessment on “high confidence” costs only. This is because the Business Plan Incentive reward has an upfront reward calibrated to an expected level of cost outperformance though the price control (7%) and Ofgem will need to be able to confidently set its own expectation of cost.

We expect a relatively low proportion of our plan to contain uncertain costs, after putting in place uncertainty mechanisms such as real price effect (RPE) indexation. Ofgem’s cost assessment should include costs covered by uncertainty mechanisms that are agreed ex ante, such as unit costs for volume-driven uncertainty mechanisms. This is because Ofgem should be able to make a confident assessment of unit costs independently of the expected volume of activity in the price control.

**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?**

Ofgem should avoid “cliff edges” between the cost assessment categories. Ofgem’s use of two boundaries at 1.0 and 1.04 creates cliff edges. For example, a company whose cost forecast is 1.04 times Ofgem’s forecast will be assessed as “average” but a company whose forecast costs are 1.05 times Ofgem’s forecast will be assessed as “poor”. This could result in significant differences in the BPI incentive for these two companies based on a relatively small difference in their cost forecasts. In addition, a company whose forecast costs are 1.05 times Ofgem’s and a company whose forecast costs are 1.40 times Ofgem’s would both be assessed as “poor” even though the first company is much closer to Ofgem’s cost forecast than the other.

If you retain cost boundaries, we propose Ofgem retains a cost boundary of 1.05 for the assessment of gas transmission and NGET based on the approach Ofgem used with IQI in RIIO-1. The proposed boundary of 1.04 represents a reduction in Ofgem’s level of expected errors in its forecast from T1 for transmission businesses (which assumed up to a 5% forecast

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error). Ofgem has not presented any evidence with its proposal as to why it believes the inaccuracy of its cost forecasts for transmission businesses has increased since the T1 period.

Assessing the BPI on a sector-by-sector basis means that Ofgem can set different cost boundaries according to the risk of forecast error for each sector. In electricity transmission differences between some of the network activities the network companies undertake limits the information available to Ofgem to form an accurate cost forecast; NGGT has no comparators for its gas transmission activities.

**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)?**

### Size of reward

We do not agree that a 2% totex equivalent reward is an appropriate value for the BPI reward. Ofgem should not constrain the cost ambition of network companies in their business plans. The proposed 2% reward/penalty is a reduction from the +2.5% to -2.6% range used in the RIIO-T1 IQI. A lower level of incentivisation than in RIIO-1 is unlikely to encourage network companies to submit high-quality business plans.

Under the Ofgem proposal network companies are only incentivised to submit a business plan with efficiencies up to, but no greater than, a 7% totex allowance outperformance (assuming a “good” quality score). For network companies that are confident of securing a higher sharing factor, the incentive to submit cost efficiencies is further reduced (because a company can achieve a saving equivalent to 2% of totex with a lower level of outperformance if it has a higher sharing factor). We do not think it is in consumers’ interests to limit the cost ambition of network companies’ business plan submissions. Ofgem needs to take care both to ensure the correct calibration of incentive strength relative to the benefits it targets, and to understand the potential interactions between Business Plan Incentive and sharing factor calibration.

### Totex or RAV-based BPI incentives

We support the use of a totex-based BPI reward/penalty. Basing the BPI reward or penalty on the size of totex in a business plan retains a clear link between the value to consumers of a good value business plan and the size of the reward/penalty.

However, the return on regulated equity (RORE) impact of a totex-based reward will vary depending on the relative size of RAV; for instance, a 2% totex reward for NGET will have a lower RORE impact for NGET than that for the Scottish TOs because NGET has a significantly larger regulatory asset value (RAV).

We propose that Ofgem assesses NGET separately from the Scottish TOs for the reasons we set out in our response to CSQ65, and to minimise the distortion of the RORE impact of the BPI reward/penalty between NGET and the smaller Scottish TOs.

**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?**

We support Ofgem’s move to a broader measure of business plan quality, rather than a single dimension assessment of cost efficiency on which the IQI was based.

However, the IQI was effective as an incentive for high quality submissions to the extent that it clearly set out the expected rewards or penalties, allowances and sharing factor, in advance of business plan submission, incentivising network companies to deliver ambitious plans. We consider the IQI would have been more effective at influencing network companies' business plans in RIIO-1 if Ofgem had set out the IQI design well in advance of companies submitting their plans.

We recognise that replacing the single combined IQI assessment of business plans that set allowances, a reward/penalty and calibrated sharing factor with two separate assessments (the BPI and blended sharing factors for TIM) requires careful design. Ofgem needs to take care both to ensure the correct calibration of incentive strength relative to the benefits it targets, and to understand the potential interactions between the two mechanisms.

We have identified some problems with the BPI that we address in our answers to CSQ65 to CSQ68 above.

**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?**

Ofgem needs to provide a strong TIM for network companies in the RIIO-2 period to encourage them to innovate and find new cost efficiencies for current and future consumers.

Ofgem can preserve the incentive for companies to submit high-confidence costs while setting higher TIM sharing factors. The blended sharing factor approach requires there to be different sharing factors for low and high-confidence costs. Ofgem can set the different sharing factors higher than the indicative 15% and 50% in its consultation. This will preserve the incentive for companies to submit high-confidence costs, while also producing higher TIM sharing factors that will encourage network companies to find more cost efficiencies in the RIIO-2 period.

A possible perverse effect of the blended sharing factor methodology is that it could lead to a lower sharing factor in sectors with higher uncertainty, reducing the incentive to find new cost efficiencies and passing a higher share of any overspend to consumers. Efficiency incentivisation might be particularly important where there is high uncertainty, as management need a stronger incentive to identify efficiencies.

Other components of the RIIO-2 price control will increase your confidence that companies will not make windfall gains or losses such as well-designed uncertainty mechanisms, more price control deliverables and a robust cost assessment. An additional tool for Ofgem to incentivise the rigour of totex submissions would be adding the quality cost evidence to the BPI assessment criteria.

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

We agree with Ofgem's assessment of the Ofwat cost sharing mechanism chiefly because the competitive dynamic that underpins the Ofwat mechanism does not exist in the transmission sector where there is little or no comparability between transmission companies.

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The blended sharing factor assessment criteria are weighted towards the incentivisation of network companies to submit robust totex plans. Ofgem does not place enough weight on the need to provide strong TIM sharing factors for network companies in the RIIO-2 period to encourage them to innovate and find new cost efficiencies.

In our response to CSQ70 we have highlighted that Ofgem can preserve the incentive for companies to submit high-confidence costs while setting higher TIM sharing factors. Ofgem should place greater weight on criteria that consider cost efficiency incentives and the avoidance of unintended consequences.

Ofgem's assessment of the ease of implementation does not consider the ex post adjustment it proposes alongside the blended sharing factor methodology. In addition to undermining the strength of the totex incentive the ex post adjustment would result in additional complexity and administration through the price control period. We consider this a significant disadvantage of the ex post adjustment element of the blended sharing factor.

Ofgem's assessment should consider how each methodology interacts with other elements of the framework, in particular with the BPI. In our response to CSQ68 we highlight how separating the assessment of the sharing factor from the BPI may constrain the cost efficiency ambition network companies put forward in their business plans. Ofgem needs to carry out careful analysis to ensure the incentives are appropriately calibrated to avoid any unintended consequences; a risk raised by CEPA in their assessment of possible replacements to IQL in their review of RIIO-1 framework.

### **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?**

We consider that Ofgem should classify areas of expenditure where network companies have proposed well-justified uncertainty mechanisms to be “high confidence”. Ofgem should set out clearly the process by how proposing an uncertainty mechanism results in a higher sharing factor than would otherwise have been obtained because this is not clear from the consultation document.

Ofgem should clarify what it means by “higher than the sharing factor for ‘low-confidence baselines’” (paragraph 9.44, third bullet point). We would expect that, where appropriate to do so, providing cost evidence through comparison to other companies or international comparisons (i.e. benchmarking evidence) should result in Ofgem assessing the costs as high confidence.

One criteria you could add is “repeatability”. Consumers benefit most from high TIM sharing factors on activities that are repeatable. This is because high TIM sharing factors encourage network companies to find more cost efficiencies and any cost savings a network company makes for repeatable activities in the RIIO-2 period will be carried forward into future price control periods to benefit consumers.

### **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)?**



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Ofgem's cost assessment should be aligned to the Business Plan Data Table structure to prevent submission of two different sets of data. Ofgem's assessment of cost certainty should be performed at as high a level as is meaningful to avoid complexity and additional work.

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

We support the use of a **Business Plan Incentive** to incentivise high quality plans. To ensure the right behaviours are delivered Ofgem should:

1. Make the reward absolute (consistent with the absolute penalty), to ensure the incentive is sufficiently strong.
2. Strengthen the value of the reward, so as not to constrain cost efficiency ambition.
3. Ensure the incentive is well calibrated and does not result in unintended consequences e.g. to avoid "cliff edges" between the assessment categories.
4. Clearly set out the assessment criteria for the BPI soon so that network companies have time to address them in their business plans. The finalised BPI criteria should be complete, unambiguous, objective and transparent.

The current proposal for **the blended sharing factor** will not result in network companies being sufficiently incentivised to identify and deliver cost efficiencies. Ofgem should:

1. Provide a strong TIM sharing factor for network companies in the RIIO-2 period to encourage them to innovate and find new cost efficiencies. This is consistent with preserving the incentive for companies to submit high-confidence costs (as we explain in our response to CSQ 70).
2. Incentivise robust cost evidencing through cost assessment, uncertainty mechanism design, price control deliverables and use of the Business Plan Incentive. This will enable Ofgem to avoid using the blended sharing factor solely as a means of incentivising companies to submit high-confidence costs and allow Ofgem to focus on using the TIM sharing factor to incentivise cost efficiencies.
3. Set the sharing factor at the price control review and not make adjustments throughout the price control.

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

We do not support the proposed TIM sharing factor range of 15-50% because it is too low.

Ofgem needs to provide a strong TIM for network companies in the RIIO-2 period to encourage them to innovate and find new cost efficiencies. A TIM sharing factor range of 15% to 50% is not in consumers' interests because the lower TIM sharing factors, coupled with the shortening of the price control period, and taking account of tax, will significantly reduce network companies' incentive to drive cost efficiency savings for consumers. Ofgem can set higher TIM sharing factors knowing that consumers will be protected from companies earning unexpectedly high returns through the return adjustment mechanism.

Ofgem can preserve the incentive for companies to submit high-confidence costs while setting higher TIM sharing factors. Ofgem's blended sharing factor approach requires there to be different sharing factors for low and high-confidence costs. Ofgem can set the different sharing factors higher than its indicative 15% and 50%. This will preserve the incentive for companies to

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submit high-confidence costs, while also producing higher TIM sharing factors that will encourage network companies to find more cost efficiencies in the RIIO-2 period. Other components of the RIIO-2 price control will increase your confidence that companies will not make windfall gains or losses such as well-designed uncertainty mechanisms, more price control deliverables and a robust cost assessment.

We do not agree with Ofgem's assessment that the same level of cost incentivisation can be achieved at lower sharing factor rates. Ofgem moved from a 25% capex sharing factor in TPCR4 to around a 50% sharing factor in RIIO-T1 to increase cost performance incentives. Ofgem's current assertion that low sharing factors incentivise the same cost performance as higher sharing factors is not consistent with its previous approach.

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

See our responses to CSQ70 and CSQ74.

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

It is not clear how Ofgem's proposal to calibrate the sharing factor based on the expected productivity of a sector would fit with the blended sharing factor methodology. Higher scope for productivity would be expected in sectors experiencing higher levels growth or other change. Under the blended sharing factor methodology, the higher uncertainty associated with growth or change would lead to a lower sharing factor.

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

Ofgem should not change the TIM sharing factor after the price control is set. Ofgem's proposed ex post recalculation of the TIM sharing factor will:

- 1) lead network companies to discount the TIM and further reduce the incentive to find and deliver cost efficiencies for consumers;
- 2) create windfall gains or losses for network companies by retrospectively changing the reward or penalty associated with decisions that they have already taken; and
- 3) create a perverse incentive for a company that is overspending during the price control to submit poor-quality evidence for its re-openers to try to achieve a lower sharing factor, which is counter to what Ofgem is trying to achieve.

The ex post recalculation of the TIM sharing factor will also result in additional complexity and administration through the price control period.

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

See our response to CSQ78.

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

See our response to CSQ78.

### Ensuring fair returns questions

RIO-1 has worked well in driving a range of network behaviours which have benefitted both current and future consumers through service improvements and reduced long term costs. However, it is the level of returns which have dominated commentary around UK energy networks and while it is appropriate for Ofgem to reconsider optimal risk allocation to enhance the legitimacy of the price control, this needs to be balanced with the positive transformation that RIO regulation has driven for consumers. We are pragmatic in acknowledging the benefit the type of 'safety net' proposed would provide but are clear that it should not be used as a mechanism to claw back genuine performance driven by networks. Instead its remit should be limited to the protection of both consumers and investors from unforeseen circumstances which could not be anticipated at the time of setting the price control, creating the potential for much higher or lower than acceptable rates of return. It is key therefore that the returns adjustment mechanisms applied should be appropriately targeted and proportionate to the problems they are seeking to address.

As it stands a clear range of what a fair return is expected to be cannot be determined from Ofgem's proposals. It is vital that there is transparency and clarity upfront in the assessment of risk and its allocation and what this implies for the subsequent range of returns for different scenarios of networks performance. This will enable networks to ensure implied RoRE ranges are deliverable and consistent with the baseline cost of equity, a misalignment of risk and reward would not be in the consumer long term interests if it led to an increase in investors required rates of return in the long term.

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

We support the concept of a symmetrical backstop mechanism which acts to automatically adjust returns when their level is outside a pre-determined range of what is considered a fair return. Application of symmetrical sculpted sharing factors will retain the incentive for companies to create efficiencies whilst ensuring company behaviour influences company performance, thus ensuring certainty of outcome for investors is maintained. However, as it stands we disagree with the scope of what is being considered within the RAM and propose limiting application to totex only, please see our response to CSQ87 for further details.

By limiting to totex only, the ex-ante incentive for networks to create efficiencies is retained whilst protecting the consumer and investors from windfall profit / losses created by circumstances which are unforeseen at the time of setting the price control. This ensures the returns adjustment mechanism is appropriately targeted and proportionate to the problems Ofgem is seeking to address.

We do not agree however with Ofgem's assessment that anchoring is preferable to the other options for the Distribution sector for two fundamental reasons. Applying adjustments based on relative performance within a sector assumes that the regulatory deals are consistent and comparable and that the systematic error which is being corrected for is present and manifests itself to the same extent in all companies. The complexity of accurately calibrating an ex-ante price control is at the heart of the legitimacy challenge – yet the ability to calibrate effectively is a pre-requisite for all relative approaches.

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Whole systems solutions will need increased collaboration across network companies to bring about the energy transition and will require the sharing of information and reliance on others to deliver incentive performance. However, the application of relative measures makes it difficult to assess the benefit of any whole system solution as the return between sectors will not be on a consistent basis and difficult to predict for individual networks within a sector, creating an unnecessary challenge in an area which has the potential to create significant value for consumers.

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

We agree with the proposal not to give further consideration to using discretionary adjustments on the basis that the model would create unpredictable business cases and investment due to uncertain returns. It is also improbable that a suitably tight definition would be achievable upfront to build all relevant circumstances into the regulatory framework leading to potentially inconsistent adjustments or within period modifications to the price control.

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

Yes, as outlined in our response to CSQ81, we support the concept of a symmetrical backstop mechanism which acts to automatically adjust returns when their level is outside a pre-determined range of what is considered a fair return.

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

Our views on introducing relative mechanisms have been outlined in our response to CSQ81. Given the difficulties of calibration it is unlikely that a relative adjustment could be applied fairly across all companies without also creating a disincentive for collaboration which is key for delivering whole system outcomes successfully.

### **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?**

We do not support the application of relative mechanism therefore; we provide no further comment regarding its detailed application.

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

An investment can be considered as a 'fair deal', if at the time of investment, networks have a roughly equal chance of out and underperforming. Ensuring that this outcome can be achieved may entail earning returns above the cost of capital to compensate for the additional downside risks that were faced when the investment was made. However, the framework as proposed is unlikely to deliver a fair deal on the basis that Ofgem's focus on targeting a low return without considering risk allocation has increased the likelihood that ranges will be skewed to the downside because:

- Penalties are likely to exceed rewards for non totex incentives through the application of dynamic targets within the price control period and the potential for more downside only incentives

- More stretching price control deliverables are being proposed with asymmetrical treatment of under / over delivery. Combined with a proposal to not fund work which delivers outputs in future price controls, the downside risks borne by networks will be significantly higher
- If a distinction is made between expected and baseline allowed returns as proposed, a 50bps outperformance wedge would imply savings of between 5-15%. This is akin to setting a stretch efficiency target which in itself is extremely challenging to achieve, it is unlikely therefore that the scope would exist to create further totex outperformance opportunities.

On this basis, before even considering thresholds, the proposed package does not allow an equal opportunity for companies to outperform and therefore does not allow for a fair return. In fact, as it stands, it is likely that investors would require a higher baseline cost of equity to allow returns in line with their requirements. This principle has been recognised by other regulatory bodies, with Ofwat stating in their consultation on the outcomes framework for PR19 that: -

*‘... if investors were asked to invest in companies with a regulatory system that only allowed for penalties, or downside risk, customers would pay for this through a higher cost of capital’<sup>3</sup>*

Furthermore, while  $\pm 300$ bps of performance was deemed a fair return in RIIO-1 with Ofgem implying this is still an appropriate range, the introduction of multiple complex mechanisms, which either transfer risk or weaken incentives to the detriment of consumers, means it is unlikely that in practice this range will be achievable in RIIO-2 as the combined impact of the proposed changes has not been assessed by Ofgem.

To address this, we propose adopting a framework which will allow us to develop a true picture of the changing risk environment and its impact on returns and consumer outcomes. This will enable us to engage stakeholders as to where risk should lie such that it provides a ‘fair deal’ to consumers and investors at the start of the period and will be sustainable and legitimate through RIIO-2. Only by following a clear and transparent process in the assessment of risk and its allocation to the appropriate party can we ensure that the right balance between allowing companies to outperform and setting thresholds which ensure fair levels of return can be achieved.

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

We do not support the use of RoRE as a returns adjustment metric as, dependent on its definition, it introduces the potential for some components of performance to be inappropriately shared. For example, whilst we understand including financing and tax in a performance measure to allow stakeholders to understand the total return to the company, sharing through a RoRE adjustment would transfer risks to consumers which are not in their best interests to bear given networks are the parties best able to manage them. We set out our rationale as to why in more detail in our response to CSQ89.

Excluding these elements then allows the focus on how the business is performing operationally, the remaining components being totex and output delivery incentives performance.

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<sup>3</sup>A consultation on the outcomes framework for PR19, Ofwat (November 2016)

Under the RIIO model networks are provided with incentives to encourage output delivery and drive behaviours which benefit consumers; returns therefore vary according to performance. The extent will be linked to consumers' willingness to pay for varying levels of service and so each incentive should be calibrated such that only incremental improvements are rewarded. Applying an additional mechanism which seeks to constrain performance levels distorts incentives properties and risks consumer benefits being delayed, creating mis-alignment between outputs delivered and stakeholder priorities.

We therefore propose limiting the application of a sculpting sharing factor to totex only. By limiting to totex, the ex-ante incentive for networks to create efficiencies is retained whilst protecting the consumer and investors from windfall profit / losses created by circumstances which are unforeseen at the time of setting the price control, ensuring the returns adjustment mechanism is appropriately targeted and proportionate to the problems they seek to address.

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

We do not support including financial performance, as outlined in our responses to FQ2, within the scope of return adjustments and furthermore do not believe any such proposal would be consistent with Ofgem's own statements (para 2.12 of the Finance annex) where a sharing mechanism is specifically ruled out on the basis that there are: -

*'... a number of potential challenges, including implementation issues, increased allocation of financing risk to consumers, exposing consumers to the impacts of companies pursuing higher risk strategies and the potential for manipulation'*

The regulatory framework is about identifying an appropriate allowed return reflecting an assumed notional gearing, but companies are then responsible for determining their actual capital structure which is not required to be in line with the notional level. This approach is consistent with the principle of efficiency because actual financing is a matter for the company. Any options to share performance significantly weaken network incentives to create efficiencies and expose consumers to risks of companies moving their corporate structures away from an efficient level.

Performance is not evidence that allowances have been set incorrectly but an outcome of the funding strategies networks have chosen. Networks have full control in their choices and it is right they fully bear the consequences of their actions and manage the subsequent risks in line with the RIIO principles of allocating risk to the party best able to manage. Furthermore, introducing sharing of financing performance could have unintended consequences by changing companies' behaviours to pursue higher risk strategies than they may have done otherwise, creating the potential for higher bills for consumers.

On a practical basis, we also agree with Ofgem that understanding and defining what should be included in actual debt costs to allow pass through or performance sharing in a fair and balanced way will be hugely complex and subjective. For example, treatment of hybrid debt/equity instruments, derivatives including the use of different currencies, and costs of re-financing would all be open to interpretation and difficult to assess whether efficiently incurred.



**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?**

We recognise that the mechanistic nature of many of the uncertainty mechanisms within the framework results in significant differences between when allowances are phased in the year and when expenditure against those allowances is incurred. This makes understanding underlying performance, and therefore applying a returns adjustment with accuracy, within the price control difficult as the final position can only be determined once all outcomes are known.

In our current reporting, we address this by incorporating adjustments based on our expected outcomes of future events to ensure a more appropriate reflection of underlying performance. There is the option to incorporate these estimates and judgements to determine revenue adjustments within the period but we believe this will create additional complexity and volatility which cannot be justified, therefore we support trueing up as part of the close out process.



### RIIO-2 Achieving a reasonable balance questions

As we have stated throughout our consultation response, we strongly support the development of a regulatory framework which enables us to continue to deliver networks for consumers which accommodate their future needs and preferences at a reduced cost whilst also providing a fair return to shareholders.

In a changing energy landscape, the flexibility of companies to respond proactively to the way networks are used will become ever more important as we progress towards a low carbon environment. While uncertainty and risk are not new to the energy sector, there will be significant challenges which will require changes in how networks make decisions and the solutions they adopt. In this world, it is key that Ofgem utilise network expertise in driving the right outcomes which means providing scope within the framework to be able to address challenges as they arise. This flexibility will ensure networks do not become a blocker to energy transition causing higher costs in the long term and delays in delivery of the initiatives that people care about.

In its current form, we do not feel the proposed price control package achieves this reasonable balance. Ofgem are moving towards a form of regulation which is far more restrictive and interventionist in nature whilst constraining the ability of networks to derive value from the price control. The framework does not provide the incentivisation or funding required to compensate networks for assuming more risk for developing these new, innovative ways of working which will ultimately deliver consumer benefit in the long term.

While we recognise legitimacy of network returns has become an increasingly high-profile issue, there is too much emphasis on solving perceived short-term issues and not enough focus on how the framework interacts and long-term delivery for consumers. We are committed to developing a framework with Ofgem which provides a better way, an evolved RIIO framework which will allow us to keep bills low, drive the right investment and enable innovation to evolve the energy system that we need for the future.

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

The measures that Ofgem are introducing are clearly with the intention of setting a more accurate price control, however we do not agree that they have been appropriately balanced in the best interests of consumers and investors. Multiple complex mechanisms are being proposed leading to a much more closely monitored price control which constrains the ability for networks to innovate and create efficiencies which are key in driving down long-term costs for consumers.

In the consultation (paras 11.19 to 11.18), Ofgem have set out what they believe the impacts are of removing the mechanisms being proposed to improve the accuracy of the price control. Our views on the individual mechanisms are set out below which we have also broadly categorised as: -

Mechanisms we feel are an appropriate part of the regulatory toolkit, but could restrict networks ability to deliver efficiently the stretching outcomes stakeholders want if applied inappropriately

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*Uncertainty mechanisms:* We agree in principle that allowances should adjust to the volume of work we carry out, but it is not clear if Ofgem's current propositions are always in the best interest of the consumer as the process to allocate them has not been made transparent. Networks should bear their own business risk and as such uncertainty mechanisms should not be used to inappropriately target a low risk framework which could drive unintended consequences for the consumer.

*NARMS:* We are supportive of the introduction of clear network resilience measures which drive networks to deliver reliability in the most efficient way. However, as for uncertainty mechanisms, Ofgem need to ensure appropriate allocation of risk to the party best able to manage it. With current proposals, the risks associated with reliability of infrastructure could be transferred to consumers despite networks being best placed to manage them given their ability to influence asset management policies

*Price Control Deliverables:* We agree networks should be held to account for delivering the outcomes they have committed to with clear consequences of not delivering. However, we are concerned these benefits will be lost if used to limit network behaviours to only deliver inputs that are defined at the start of the price control. Networks need to be able to proactively respond to changing network needs and Ofgem need to ensure price control deliverables are not used to limit outcomes to a narrow range which will constrain networks abilities to innovate, develop whole system solutions and find the most cost-efficient investment strategies.

*Competition:* We support competition where it benefits consumers. In principle, we would agree that competition should bring scope for innovation and reveal the efficient costs of delivering projects. However, for these benefits to outweigh the costs of introducing competition, the right competition model needs to be used. Competition Proxy and SPV will not deliver those benefits so Ofgem should focus on introducing CATO (which is the only workable onshore competition model developed to date) when legislation can be passed, but only if a suitable pipeline of projects exists.

*RAMs:* We are supportive of the need to protect consumers and investors from windfall gains and losses which could not have been foreseen at the start of the price control. However, we need to ensure that mechanisms are appropriately targeted and proportionate to the problems they are seeking to address and not used to clawback genuine performance.

### Mechanisms which are not improving accuracy and should therefore be removed

*Cashflow floor:* This mechanism seeks to address financeability concerns in the short-term which are created by a significant lowering of cost of equity and are not a substitute for setting a sustainable financial framework. The consequences and details of application of this mechanism have not been clearly set out. However, Moody's<sup>4</sup> have expressed their concerns that if Ofgem consider there is no longer a need for headroom to financing costs as a result of the cashflow floor, the credit quality of the sector is likely to be weakened. This in itself sends a message to equity investors about a changing regulatory framework where Ofgem's proposals to transfer risk from debt to equity holders is actually being used to justify depression of equity returns, risking the likelihood of RIIO-2 providing a fair return to shareholders.

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<sup>4</sup> "Credit quality likely to weaken in RIIO-GD2 regulatory period", Moody's Investor Service, 14 February 2019

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*Dynamic targets:* Output delivery incentives are related to incremental service improvements which our stakeholders are telling us they want and are willing to pay for. Introducing dynamic targets will significantly weaken network incentives to shift performance frontier with incentives likely to be limited to a narrower range of outcomes achieving only minimum standard levels. Thus, creating the risk of outputs becoming misaligned with stakeholder priorities

### Mechanisms which need to be strengthened to drive the right network behaviours

*Business plan incentive and sharing factor:* We agree that a strong business plan incentive will incentivise networks to provide good quality information to set the price control. However, to ensure this benefit is maximised Ofgem need to clearly set out the assessment criteria so that networks are incentivised to focus on what consumers most value and set a reward which doesn't limit the efficiency ambition of company submissions. Furthermore, our view of Ofgem's proposed approach to set sharing factors is that it will actually decrease the incentive to outperform high certainty costs, whilst also increasing the risk of windfall gains or losses, clearly not in line with intended outcomes.

*Innovation stimulus:* We agree with time-limited innovation funding, however RIIO-2 is not the right time to remove and heavily restrict areas of innovation funding given the energy system transition. As it stands the package will drive the very behaviours Ofgem are seeking to avoid.

Setting out in the way Ofgem have done, leads us to conclude that, with a limited number of exceptions, it is difficult to disagree with the merits of individual mechanisms. However, collectively what they do is overlap and reinforce one another meaning their combined impact is likely to over-correct for the perceived high returns of RIIO-1 and create a framework which is unlikely to be sustainable into RIIO-3. To avoid this scenario, as for RIIO-1, Ofgem need to set out what the proposed package presents in terms of RoRE ranges so networks can assess whether these are deliverable and provide capacity to deal with risks that out-turn to reduce revenues whilst ensuring networks remain resilient in a changing energy landscape.

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

Incentive-based regulation is about setting constraints on what network companies are expected to deliver, providing them strong rewards / penalties for doing what is required and largely leaving them to deliver. This best mirrors the behaviours in a competitive environment. Maintaining an incentive for networks to become more efficient will ensure that costs saved will create benefits for consumers both within the period and in the longer term by improving the accuracy of the information revealed for setting the next price control. We have seen the benefits of this approach where at least £15bn of consumer value in Electricity Transmission over alone the last 25 years.

However, Ofgem's recent direction infers an end to the phase where the regulator has set the framework and allowed companies to deliver against required outcomes. We understand the concerns around legitimacy of performance which are driving Ofgem's mandate to lower returns in RIIO-2 but believe this can be addressed by fixing the underlying issues rather than introducing multiple mechanisms which when combined will create unintended consequences for consumers.

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Following a transparent process to understand, assess and allocate risk using existing regulatory tools will ensure appropriate treatment within the price control and an understanding of what risks are borne by which party. We will then test our proposals through stakeholder engagement as to where risk should lie such that it provides a ‘fair deal’ to consumers and investors at the start of the period and will be sustainable and legitimate through RII0-2. Having clarity around both process and delivery requirements will allow the package to be calibrated accurately without the need for measures which are being implemented to constrain returns.

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

The proposed framework is introducing a substantial number of new mechanisms which introduce more complexity to the price control and inevitably transfers risk to consumers creating more volatile bills. As outlined, in our response to CSQ90 we do not believe all of the mechanisms which are being proposed improve the accuracy of the price control nor do we believe the combined impact will drive the network behaviours the price control is intended to. We are also concerned that the additional complexity creates less transparency for our stakeholders who just want to understand whether they are getting value for money.

In our response to CSQ91, we have set out the process we feel Ofgem need to follow to balance risk and reward in the framework which combined with improved cost assessment and target setting can set a fair price control for both consumers and investors. These tools already exist and do not require the introduction of additional mechanisms.

In addition, we support the proposal to include a symmetrical backstop mechanism which acts to automatically adjust returns when their level is outside a pre-determined range of what is considered a fair return. This becomes the simplest and most transparent way in which both investors and consumers can be offered protection from windfall gains / losses whilst incentivising networks to drive the right behaviours.

### **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?**

Ofgem are not actively considering or making transparent the framework which will be used in the assessment of risk and the allocation of those risks to the appropriate party, which is fundamental to ensuring risk and reward is balanced for the RII0-2 deal. There is a perception amongst consumers and government that energy companies are earning excessive returns which is creating an unbalanced view of the risk/reward trade off in RII0-2, leading to proposed ranges which are inconsistent with a fair deal because of the following assumptions made by Ofgem:

- *Ofgem Hypothesis 1: Companies face a greater likelihood that risks will run in their favour rather than against them*

RII0-1 performance, and the assumption that risks are more likely to out-turn in networks favour, is being used as justification for many of Ofgem’s proposed framework changes without a robust process to identify exposure to risks and uncertainties both from external and internal influences.

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There have been key changes in business risks since RIIO-1 which Ofgem do not seem to have considered, e.g. increases in technological risk, demand / supply-side uncertainty and socio-political developments. Collectively we believe the impact of these developments means we are exposed to new risks which are not balanced by new upside opportunities.

- *Ofgem Hypothesis 2: Expected returns remain unchanged due to regulatory framework changes balancing increased uncertainty in the sector*

Whilst not made explicit, Ofgem make an inherent assumption that new risks can be balanced by changes in the regulatory framework meaning expected returns are unchanged, e.g. move from 8 to 5-year price control, increased use of indexation etc. However, the more interventionist nature of the price control means the strength of incentivisation is significantly weakened limiting the range of expected returns, but without making it clear where this is in the best interests of consumers.

- *Ofgem Hypothesis 3: The incremental impact of the proposed regulatory changes has a symmetrical impact on returns*

In our response to CSQ86, we have set out how the proposed package is skewed to the downside. There is a risk that while options appear to symmetrically truncate the distribution of returns, mechanisms reduce the upside by weakening the ex-ante incentive for networks to create efficiencies and cap the financial incentives available from ODIs without equivalent collars

Ofgem and networks should undertake a transparent risk allocation and analysis with stakeholders, this will allow us to develop a true picture of the changing risk environment and its impact on returns and consumer outcomes. This will then enable us to create an appropriately calibrated package which provides positive strong incentives to drive improved service levels and reduced long term costs for consumers whilst also providing opportunities to earn returns commensurate with the network's performance.

**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?**

As set out in our response to CSQ90 we do not agree that a reasonable balance has been achieved with the proposed framework. We support a simpler price control with fewer mechanisms but do not believe that this necessarily involves putting more reliance on RAMs. If Ofgem apply a clear and transparent process in setting the price control to set challenging allowances, appropriate risk allocation and strong incentives to drive efficiencies and service level improvements, we will still be in a position where RAMs will only be triggered when outturn is very different to any scenario which could have been anticipated at the start of RIIO-2.

**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?**

We fundamentally disagree with the concept of the expected – allowed return wedge as we have set out in our response to FQ19, so do not provide further comment to this question. However,

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we acknowledge that Ofgem has provided itself with a clean and transparent method of providing a safety net through RAMs, making additional mechanisms unnecessary.

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

We urge Ofgem to rely on the outputs of the enhanced stakeholder engagement to ensure networks focus on the areas that are of the most value to consumers. We strongly support the enhanced stakeholder engagement process, together we have identified our key stakeholder priorities and we are using these as the foundations upon which to build our business plans. We are committed to continue to engage and iterate with stakeholders to ensure feedback is updated for and our plans are genuinely stakeholder led business plans.

Our concern with Ofgem's proposals is that stakeholders want us to drive stretching outcomes which deliver the energy networks of the future but the framework in place does not provide the funding or incentivisation required to compensate networks for assuming more risk. As it stands there is a real potential for the framework to drive outcomes which are not aligned to what consumers most value as the package does not provide the required financial capacity to do so.

### **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?**

We assume this question is targeted at gas distribution companies because on page 10 of the cross-sector consultation you refer to consumer vulnerability relating to distribution companies.

Our charges are spread across all consumers in Great Britain so we are unable to target them on specific consumer groups.

We consider the framework allows us scope to develop bespoke approaches to community, environmental and social initiatives and incentives that can benefit specific groups impacted by our activities.

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

The price control framework should be set with the intention that consumers should pay for the network they use and the services they receive with no intergenerational distortions. This ensures the consumer offering is balanced from a cost benefit perspective and the risk of RAV stranding is limited. As proposed, Ofgem's mandate to drive a low return for RIIO-2 does not deliver this balance. As we have already outlined throughout our responses in this section, the framework as it stands may reduce bills for consumers now but it does not consider the requirements of future consumers or the benefit of retaining networks' incentive to continually innovate and share best practice. Thus, potentially risking the ability of networks to proactively respond to the challenge of achieving Government's 2050 Energy Strategy. In this way it does not achieve long term stability in consumer bill, or the benefits consumers should expect to see.



### Preliminary impact assessment questions

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

We support the use of impact assessment as a tool to help understand and explain the effects and impacts of the proposed framework on consumers and other stakeholders.

At this early stage of the process it is appreciated that not all the evidence needed to carry out a robust analysis is available, meaning subjective judgements have been made to allow preliminary assessments to be undertaken. On this basis, we would not expect any final conclusions to be drawn from the work carried out so far and therefore agree with Ofgem's approach to further develop assessments as more information becomes available. As part of that process, it is key that Ofgem provide a transparent view of the evidence and analysis which has been used to justify framework decisions to allow networks the opportunity to challenge and review before policies are finalised.

We also think that it is vital, that the impact assessment takes into consideration the direct feedback we will gather as part of our stakeholder engagement processes. This will ensure policy decisions do not contradict proposals we make in our business plans to drive focus in the areas of most value to our stakeholders.

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

Ofgem focus on the costs and benefits deriving from key proposals in terms of consumer bills impact, quality of service and risk allocation. Our views on the assessment are detailed below: -

#### Consumer bill impacts

Ofgem's primary duty is to protect the interests of existing and future electricity and gas consumers, this means keeping bills low while enabling networks to deliver good quality services which will facilitate evolution towards a more efficient, green and innovative energy system. The proposed package does not fulfil this duty, it focusses on the immediate pressures to reduce consumer bills through a significant reduction in returns and does not consider the requirements of future consumers or the benefit of retaining networks' incentives to continually innovate and share best practice. In this way it does not achieve long-term stability in consumer bill, or the benefits consumers should expect to see.

- Impact of financing costs

Ofgem's preliminary assessment assumes their cost of capital proposals will be net beneficial to consumers. The assumption is that reduced financing costs will outweigh any uncertainty related risks, which are limited to the impacts of the introduction of relative returns adjustment mechanisms in the distribution sector.

We fundamentally disagree with this assessment. A reduced cost of capital may deliver savings for consumers on day one, but (even if the methodology was not based on errors) the figures and framework proposed by Ofgem are not sustainable. Under the proposal's consumer bills will be higher by 2026 due to increases in the cost of long term borrowing and a failure to incentivise innovation. Ofgem's short-term focus on driving value for consumers through lower returns without considering the long-term implications will build up an increasing bill for future



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consumers. at the expense of consumer benefit in the long term. Ofgem's duty is to both existing and future consumers but this is being undermined by a misguided short-term focus

- Impact of information asymmetry

Ofgem's preliminary assessment assumes that information asymmetry is more likely to result in regulators setting a deal where allowed returns are high with a range of incentives linked to easy to achieve outcomes. They seek to mitigate this through their proposed approach to business plan incentives and the application of blended sharing factors, with only the additional administrative burden being considered as the costs.

We agree that business plan incentives are an appropriate tool to incentivise networks to provide good quality information to set the price control. However, as proposed and combined with the blended sharing factors approach, they will not reveal the better-quality information Ofgem are assuming, for reasons detailed in our response to CSQ74. Ofgem risk the incentive for networks to reveal efficient costs by imposing implausible targets, the risk of which is transferred to consumers through lower sharing factors and the increased potential for service delivery failures.

- Linking incentives closer to their cost and risk of delivery

Ofgem's preliminary assessment assumes lower sharing factors and dynamic targets in RIIO-2 will create benefits for consumer, which will exceed any limited impacts driven by network behaviour from weakened incentivisation.

Incentive-based regulation encourages networks to strive for innovations and efficiencies in the knowledge that they will benefit in the short-term from reductions in costs. Consumers will benefit both in the short-term and also in future periods as the cost reductions and improvements in services are embedded into subsequent price controls. We understand the pressures of high returns in RIIO-1 are driving Ofgem to weaken the power of incentives but we do not agree that, as proposed, the framework will not drive unintended consequences.

RIIO was a significant change to the regulatory regime which was intended to drive a range of different company behaviours to the benefit of both current and future consumers. Networks responded and have delivered a positive transformation which Ofgem should seek to build upon as opposed to fundamentally shifting. By symmetry, it may be assumed that the observed response to a strong incentives-based framework could be reversed in one which is significantly weaker. On this basis, we do not agree that benefits assumed by Ofgem outweigh the risks of reduced effort by companies to find cost efficiencies and deliver service level improvements.

- Driving down costs through extended competition

We support competition where it benefits consumers but note that no assessment is made of the costs and benefits associated with a CATO model, which is the only workable model of onshore competition developed so far. We support Ofgem's intention to develop an early CATO model of competition, as an early model would have the greatest potential for consumer benefit by way of innovation and would give the successful CATO clear accountability for the project.

It is worth noting however, that the consumer benefit assumed to result from the introduction of onshore competition is dependent on the existence of a pipeline of eligible projects, to offset Ofgem's development costs and make it worthwhile for bidders to participate in the process. For some sectors, such as Gas Transmission, this does not seem to be the case. Even in electricity

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transmission, it is worth noting that many eligible projects are dependent on the connection of nuclear generation, and the perceived uncertainty around this may deter potential bidders.

- Enabling the energy transition

We agree with Ofgem's position, in that the policy for whole system solutions should be assessed as it becomes more developed. Although, as with all policy areas, we are keen this takes place collaboratively with networks.

As for innovation, we do not agree that the proposed package facilitates activities that would not otherwise be carried out. The current innovation stimulus proposals combined with low returns reduce the networks financial capacity to respond to risks within the uncertainty of the energy transition. This comes at the very time that the flexibility of companies to respond proactively to the way networks are used will become ever more important as we drive towards a low carbon environment.

### Impact on quality of service

We accept the strong interplay between costs to consumers and quality of service and on that basis agree that incentives should be targeted where we will drive incremental improvements in line with consumer preferences and reduce long term costs. We do not agree, however, that Ofgem's current proposals balance those costs and service levels appropriately.

Ofgem are narrowing the scope and driving asymmetry into the framework through automatic adjusting targets and potential for downside only incentives. This will reduce the incentive for networks to drive performance improvements, inevitably leading to worse outcomes for consumers. During this period of change it is important the networks are able to engage with and meet their customers' expectations, maintain the reliability of the network, support the transition to a low carbon energy system and optimise across the whole energy system to benefit consumers.

- Enhanced stakeholder engagement

We agree with Ofgem's assessment that the additional costs of running an enhanced stakeholder engagement process are more than offset by the value which will be driven through increased plan scrutiny and focus on areas of consumer value.

- Asset resilience

We agree that improved asset resilience measures will drive benefit for consumers but are concerned that current proposals risk those benefits, the implications of which have not been considered by Ofgem. Asymmetric treatment of under/over delivery and the possibility of no funding for future outputs would mean that networks no longer have the capacity to support delivery of essential works without up-front funding certainty. This would create additional risks for consumers if service levels could not be maintained because networks are deferring investment into future price controls.

### Risk allocation

As we have stated throughout our consultation response, the proposed RIIO-2 framework does not achieve a better balance of risk allocation between networks and consumers. We are concerned with the emphasis that is being placed on addressing the perceived problems of RIIO-1 and the ways to limit and lower network returns in the short term rather than creating a

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framework which encourages investment and innovation. This is evident as Ofgem are not actively considering or making transparent the framework which will be used in the assessment of risk and allocation of those risks to the appropriate party, creating the potential for an expected return which does not adequately reflect our exposure. This in turn will limit our ability to respond in a way which facilitates rapidly changing consumer needs.

Please refer to our responses for the 'Achieving a reasonable balance' section which outline in more detail our concerns and the framework we propose to ensure a balanced package.

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

We agree that any evaluation of RIIO-1 would be misleading at this stage and therefore Ofgem should be mindful that they only rely on the most up to date information available to them and incorporate any further developments throughout the process. We also support Ofgem's proposal to only set methodologies for financial parameters at this stage, thus allowing any changes in market conditions and/or circumstances to be updated for before parameters are set.

In terms of the uncertainty related to company's response to the changes in incentives structure and levels, we have stated throughout our consultation response how we expect the reduced scope and strength of the incentives framework to weaken incentives for companies to innovate and discover what is possible as they strive to reach the efficiency frontier. Both will lead to higher costs and minimal improvement in services in the future. Instead of re-iterating here, we note your plans to further engage with academics and wider stakeholders in this area so we would like to draw your attention to a paper 'RIIO-2: The role of incentives' published by John Earwaker<sup>5</sup>. The paper focuses on the balance that consumers might expect to see between the strength of incentives and protection against high network returns, the key conclusions which we think are useful to draw out are: -

- *'....it is very easy to under-estimate how difficult it is to get monopolies to act like normal commercial businesses and that the prize that RIIO-1 controls has yielded should not be trivialised'*

RIIO opened three new areas for efficiency improvements which drove those benefits: an 8-year control meaning there was greater scope for efficiency improvements to be delivered, the equalisation of capex and opex exposures which doubled the incentive to find efficiencies and the innovation stimulus designed to significantly increase R&D activity. What is notable from Ofgem's proposals, how each of these areas is being weakened to create a significant adjustment in the strength of incentives in RIIO-2, thus signalling a clear over-correction of the perceived high returns of RIIO-1. As we have already said, by symmetry, it may be assumed that the observed response to a strong incentives-based framework could be reversed in one which is significantly weaker.

- *'....it is imperative that incentive rates are pitched at an appropriate level - i.e. neither too low nor too high – and stay constant and predictable within each RIIO planning horizon'*

*'...in the current economic and political climate, it may be tempting for a regulator to err towards the safety of rate of return regulation. In my view this would be a mistake'*

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<sup>5</sup> <http://www.first-economics.com/riio2incentives.pdf>

This aligns with our view that limiting the reward for pushing the efficient frontier reduces the incentive to deliver the improvements which ultimately drive reduced costs and better-quality services for all consumers by exposing best practice for the industry. RIIO has driven positive transformation which Ofgem should seek to build upon as opposed to fundamentally shifting.

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

We re-iterate the need for Ofgem to rely on the outputs of the enhanced stakeholder engagement to ensure networks focus on the areas that are of the most value to consumers. This will be key in mitigating the risk of Ofgem's decisions creating a framework which does not allow networks to deliver services and initiatives in line with what our stakeholders value and are telling us they want.