SGN Sector Specific Methodology Consultation

14th March 2019

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1 Sector Methodology Consultation

1.1 Executive Summary

SGN welcomes the opportunity to respond to Ofgem's Sector Specific Methodology Consultation. SGN is the UK's leading gas distribution network company, operating some 74,000km of gas mains and services across Scotland and Southern England. With connections to nearly six million-meter points we deliver gas to more than 14 million people. Our two distinct network areas include the most densely populated areas of south London and the remotest parts of Scotland and the Hebrides. We manage the risks of gas transportation every day through appropriate interventions and investments.

Our charges account for around 20% of the average household gas bill, estimated at £136 a year. For this we deliver to our customers;

- A highly reliable gas supply – our customers currently experience an interruption on average once every 40 years. Our full emergency service responds to gas escapes 24/7, responding within an hour to uncontrolled gas escapes over 98% of the time.
- Award winning customer service standards. We are recognised as the best network for customer service and we are continually improving. We have reduced complaints by 65% so far during RIIO-1, we have increased our support services to our vulnerable customers, we are ranked first for customer satisfaction in Scotland, and we have consistently been a leading network in stakeholder engagement.
- Deploying innovation. We lead the way on innovation and helped other networks adopt new technologies for delivering more efficiently and with less disruption. Our innovations in RIIO-1 include robotics, management of gas risers in high rise buildings and the reduction of our impact through core-and-vac excavation technology. We were the first network to add the green gas biomethane to our network and we are on track to meet our target of supplying the equivalent of 250,000 homes with biomethane by 2021.
- Over RIIO-1 we forecast a reduction in customer bills of 8% in real terms. We expect to replace 8,300 kms of our metallic mains, renew over half a million steel service pipes, and connect 27,500 fuel poor customers.

As in all business planning, assumptions were made in RIIO-1. These were uncertain at the time but, with the exception of increasing labour costs, these assumptions have played out largely to the benefit of networks. For this reason, we are fully supportive of reducing the length of the price control to five years; of improving the appropriate indexation of costs; the simplification of output categories and the introduction of the enhanced consumer engagement process to provide valuable challenge. We think that this goes a long way towards addressing the concerns over RIIO-1.

We benefit from the long-term commitment, vision and investment of our shareholders and recognise that our role in the community requires social legitimacy. We have listened closely to our customers and broader stakeholders, undertaking a substantial research and engagement programme and acting on what we have learned. Recognising the need for legitimacy, we were the only gas distribution network to make a substantial voluntary contribution to customers. Our £145m contribution supported the roll out of further fuel poor network extensions, improved the security of our network, and reduced bills for our customers.

It is our view that RIIO-1 has worked, and has delivered strong consumer benefits - improved safety, improved customer service, improved efficiency and clarity of outputs. We are keen to ensure in RIIO-2 that the issues of RIIO-1 are appropriately addressed through an evolutionary approach consistent with the regulatory principles of proportionality, accountability, consistency, and transparency[1] and that we continue to deliver our shared ambitions for all our customers and stakeholders.

In RIIO-2 we will look to reduce our bills and deliver greater value to our customers. To achieve this, it is important RIIO-2 incentivises actions that are in customers' interests, whether that is through improved service, improved efficiency, or the effective targeting of innovation through a transparent and consistent regulatory structure.

This potential could be hindered by the number of regulatory structures that have departed from established regulatory principles that have been presented – cashflow floor, revenue adjustment mechanisms, expected return adjustments, dynamic incentives, innovation support and the business plan incentives. These need to be fully assessed both in isolation and as a broader package. Networks need clarity on how the package as a whole will operate in a transparent and timely

[1] http://www.legislation.gov.uk/ukpga/2006/51/pdfs/ukpga_20060051_en.pdf

manner prior to plan submission. Where timelines do not allow this to happen we would like to work with Ofgem to enable a fuller range of policies to be introduced for the following regulatory period.

In RIIO-2, we encourage Ofgem to recognise the mutual benefit delivered and to support strong incentives that drive efficiency and innovation to continue to improve customer outcomes. There is a risk that the regulatory structure proposed in the Sector Specific Methodology will not deliver this; rather the proposed structure risks stifling ambition by focusing on penalties rather than incentivising better consumer outcomes. These risks are set out below along with proposed solutions.

Consumer outcomes

We are fully aligned with Ofgem's objective of improving the consumer experience through RIIO-GD2. As proposed in the Sector Specific Methodology we do not believe that the RIIO-GD2 package will deliver its full potential for improving customer outcomes. To ensure that RIIO-GD2 delivers a better consumer outcome we believe that the Sector Specific Methodology requires:

- **A greater focus on incentive-based regulation.** We believe that incentive-based regulation creates a strong signal to drive better customer outcomes in a transparent manner. The success of RIIO (revenue, incentives, innovation and outputs) is that it has incentivised companies to deliver better outcomes, transforming our approach to customer service and delivery. In the Sector Specific Methodology Consultation, the proposed output delivery incentives (ODIs) have been significantly reduced in scope and positive incentives have often been replaced with penalty structures. We believe that penalty-based regulation encourages network companies to seek compliance with minimum standards rather than pursue better consumer outcomes. We encourage Ofgem to incentivise true ambition, with clear incentives based on clearly defined targets that are driven by customer engagement and where best practice is shared.
- **A broader definition of regulation.** It is our broader role in the community that is regularly brought to the fore by our customers and stakeholders – whether this is our impact on the roadway, the environment or the communities that we serve. The Sector Specific Methodology Consultation proposes to adopt a narrow remit that we consider to be at odds with its objective of improving the consumer and network user experience. Our customers and stakeholders regularly tell us that we should be looking to minimise the disruption that we cause as we go about our work, and we think that higher standards in this regard could be appropriately incentivised under the price control. A broader remit is consistent with the feedback from our stakeholders.
- **Customer centric ODIs**. Following extensive engagement with our customers, we have identified areas where company specific ODIs may be appropriate to progress. However, under the Sector Specific Methodology Consultation we note the apparent high bar for company specific ODIs, the limited enthusiasm for sector level incentives and the lack of clarity on success criteria. Our customers and stakeholders tell us that reducing disruption, reducing our environmental impact and increasing our support for local communities are important to them and we would like to reflect those priorities in our plan. There is however a very compressed programme and we encourage Ofgem to provide clarity regarding its ambition for company specific ODIs and clarity on the definition of what would make a company specific ODI attractive. There is however a very compressed time available to develop customer-centric outputs and we encourage Ofgem to provide clarity regarding its ambition for company specific ODIs along with clarity on the definition of what would make a company specific ODI attractive.
- **Recognising the importance of collaboration.** Collaboration has delivered excellent customer outcomes - sharing best practice to promote safety, deploying innovation, and working with vulnerable customers[2]. At SGN we have regularly visited, and hosted visits from, other networks to share best practice. Over RIIO-GD1, the performance of all networks for customer satisfaction scores now exceed the best performer at the start of RIIO-GD1 due in part to sharing best practice and a clear incentive structure and there is a culture of shared innovation. Whilst we recognise Ofgem's duty to promote competition, we encourage Ofgem to recognise that it will discourage collaboration between network companies and the consumer benefits that arise from that collaboration.
- **Promoting innovation.** We believe that RIIO-1 has been a positive 'win-win'. We have improved efficiency through process improvements and innovation and these improvements have benefited both the company and the customer. For every process innovation or efficiency improvement achieved at the start of RIIO-GD1, the net benefit to the consumer exceeds the net benefit to the company before the end of RIIO-GD2. If the improvement is introduced in year

[2] Examples include the deployment of robotics to reduce leakage, processes surrounding risers in multi-occupancy buildings, deployment of innovative techniques such as core-and-vac, responding to large scale incidents such as Silsden, call handling and complaint processes, and vulnerable customer identification and support.

4 of RIIO-GD1 then this customer benefits exceeds the company benefit by year 2 of RIIO-GD2. The customer carries on benefiting from that efficiency improvement for its lifetime. We think that the strong focus on improving efficiency has benefited all stakeholders and should be replicated in RIIO-2.

Balance of risk and returns

For SGN to continue to be even more ambitious in delivering customer benefits and driving innovation throughout the company we believe that Ofgem needs to reflect the broader economic risks and regulatory uncertainties raised by the sector methodology. As it stands, and as we have previously brought to Ofgem's attention, we do not consider the Sector Specific Methodology consultation to provide an appropriate balance of risk and return. We consider the package to be very low powered, to have low returns and to have relatively high risk for those returns. This is due to the introduction of new operating risks, new regulatory risks, and the continued existence of energy, political and macro-economic risks which we do not believe have been taken into account.

- **Operating risks:** New operating risks include the introduction of relative and dynamic targets, cashflow floors, a disproportionate level of penalties and the tightening of licence obligations. These create less predictable and transparent cashflow forecasts and, as set out below, have created new asymmetric risks that will reduce the appetite for new innovation and deploying new customer focused services.
- **Regulatory risks:** The new regulatory risks are directly related to the new and untested regulatory structures and methodologies. These include very low sharing factors, the gradation of sharing factors according to 'confidence', the revenue adjustment mechanism, the differentiation between allowed and expected returns, the business plan incentive, the calibration of the competitive incentives, the unprecedented low returns and resulting concerns of financeability.
- **Energy sector risks**: These risks include the decarbonisation pathway and the potential that by 2050 significant areas of the gas network could be decommissioned to allow for electrification of heat or repurposed to enable hydrogen roll-out.
- **Political risks**: There are risks associated with Brexit and associated legislative changes, independence movements, political parties entering the next election on an agenda of nationalisation, along with the new obligations being placed on network companies from non-energy departments.
- **Macro-economic risks:** These include the risk of contractor market, supply chain or skilled labour market contraction, after Brexit, a rapid change in exchange rates driving a changing cost base and broader economic shocks.

We believe that risks should be appropriately calibrated, provide networks with the incentives to drive further innovation and customer standards while commensurate with the expected equity returns. To achieve this, these risks need to be either mitigated or accounted for within the cost of capital.

Asymmetric risks

In addition to the broader level of risk identified above, the Sector Specific Methodology consultation proposes a number of regulatory structures that create a significant asymmetry in the risk borne by network companies. This risks disincentivising ambitious business plans and should be reflected in the cost of equity. These risks include:

- **Output Delivery Incentives (ODIs).** We would like the current incentive regimes to continue with an evolution in output targets to reflect the change in ambition and standards achieved by networks. As proposed, the current ODIs, are either downside penalties or dynamic incentives. Downside only penalties are clearly asymmetric in their risk profile. For dynamic incentive mechanisms the changing reward structure increases the risk that investments will not be recovered. This introduces a significant risk asymmetry that was not there in RIIO-GD1.
- **Increasing licence obligations.** Our research shows that consumers are not asking for an increase in licence obligations. By increasing licence obligations, the burden of compliance increases as does the risk of breaching the licence obligation. This increases the risk of direct fines, but potentially more importantly could lead to a breach of financing arrangements. In order to mitigate this risk, network companies will need to continue to deliver above the higher standard and this will incur a higher marginal cost. We are not aware of a strong body of stakeholder or consumer evidence that supports increasing licence obligations or that consumers are willing to pay for an increase in costs or an increase in risk exposure.

- **Business Plan Incentive – competitive upside.** Within the business plan incentive there is a downside risk of 2% and an upside potential that is a share of 2%. Whilst this is asymmetric in design it is particularly detrimental to SGN where SGN Southern and SGN Scotland are separate licence entities therefore SGN as whole has a maximum incentive of 1% and, in some scenarios could be as low as 0.13%. We believe that the upside potential should be fixed to remove this asymmetry and the specific detriment to SGN. There is a direct contrast with Cadent, which covers four of the eight network areas under a single licence which could allow a full 2% of totex as an incentive. Wales & West Utilities and Northern Gas Networks who operate under separate licences and brands but have common shareholders also maintain a full 2% totex incentive.
- **Business Plan Incentive - efficiency.** We would welcome a more flexible efficiency incentive. Currently, the boundary for the definition of an efficient plan at 4% is very low and does not reflect actual experience in RIIO-GD1 or RIIO-ED1. In RIIO-GD1 the average efficiency score for the networks has been between 6% and 18%. This assessment was based on four Ofgem models; SGN Scotland had a variance in its efficiency of between 1% and 12% across those four Ofgem models. An efficiency test of 4% is within the error margin of Ofgem's modelling and risks penalising companies on the basis of modelling assumptions. It is important for Ofgem to set out the error margin within its own models and how this error margin relates to the efficiency test boundaries prior to the submission of the business plan. In addition to the range we encourage Ofgem to consider the scale of the impact and introduce a higher level of gradation in performance.
- **Output measures.** We encourage Ofgem to return to the symmetrical risk approach for output measures. Currently output measures, such as NARMs and PCDs, are proposed to be downside risk only. For NARMs the non-delivery penalty is based on the monetised benefit rather than the cost of the measure. As the monetised benefit can be several times greater than the cost of the measure, and there is no equivalent reward for justified over delivery this presents a significant asymmetric risk. This contrasts to the current structure where 2.5% of cost is an incentive/penalty according to whether the over/under delivery is justified or not.
- **Cash flow floor.** We do not believe the cashflow floor is either appropriate or desirable and places an unwarranted additional risk on the equity providers. The equity provider takes the risk of Ofgem mis-calibrating the price control and the baselines or mis-calibrating financeability by setting the cost of capital too low. S&P have recently commented that "*'We therefore struggle to recognize the value of the cash flow floor mechanism and question whether the introduction of the mechanism signals the regulator's willingness to allow credit quality in the industry to decline."*[3] On this basis, it is important that all financeability downside tests should be carried out without the cash flow distorting normal market behaviour.

Lower credit quality

SGN are very concerned about the unforeseen consequences of Ofgem's proposal on credit quality and its longer-term impact on investment in regulated assets across the UK and beyond. Investment is required in the UK energy sector - a requirement that will increase as we decarbonise. A stable regulatory regime able to support investors with a long-term investment horizon is a pre-requisite to delivering that investment at least cost. The UK has a good reputation for stable, transparent and predictable regulation in energy infrastructure, that risks being lost. If this reputation is lost, then it will be hard to re-establish confidence in the UK as an attractive investment destination.

In the Sector Specific Methodology Consultation Ofgem appear to be allowing a downgrade in the sector as a whole. If the regulator is willing to let credit quality decline, then this will be a concern for all investors. For current debt holders this will increase the risk debt holders attribute to their existing bonds and for new debt holders it will increase the returns they will require to invest.

We need to ensure that the package is demonstrably financeable for the industry as a whole both in RIIO-GD2 and the longer-term with sufficient headroom to absorb plausible shocks without a cashflow floor. Among the gas distribution networks Cadent, (who comprise of approximately half of the sector) have recently entered a new financial structure following a corporate sale. This enabled them to secure a historically low cost of debt, but to do so they incurred significant associated transaction costs. We need to ensure that the low cost of debt secured in their new financing structure does not distort the financeability tests. This low cost of debt and associated transaction costs should be accounted for in the finance test or the sector concept should be adjusted to reflect individual company circumstances.

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[3] p6, S&Ps Report 'Ofgem's Proposed RIIO-2 Regulatory Framework Will Test U.K. Energy Networks' (Feb 19)

This is particularly important as there appears to be limited confidence in the cashflow floor. The expectation, based on Ofgem's duties, is that the package should be financeable without the need to revert to novel mechanisms in the event its cost of capital assumptions prove to be too low.

Cost of debt

In our response to the RIIO-2 Framework Consultation we identified a 15 to 20 year trailing average for the cost of debt as the conceptually correct approach based on the tenor of issuance of energy networks and that GDNs have issued debt since network sales in 2005. This is consistent with the determination made in RIIO-ED1.

Through the ENA we have also conducted an analysis of actual costs by an independent consultant, this provides strong evidence to support transaction and liquidity costs that are significantly higher than the historical levels allowed for by the regulator. Using appropriate industry benchmarks that take this into account broadly aligns with the 15-20 years conceptual approach set out above.

This report also presents strong evidence that the halo effect that Ofgem have assumed in previous price controls should be removed as an assumption.

With one company comprising of approximately half of the sector, it is important that the transaction costs incurred to secure their low cost of debt is taken into account when determining the debt benchmark or the sector concept should be replaced with an individual company assessment being undertaken, as we set out in the response to the framework consultation.

Low cost of equity

We consider that the cost of equity is too low in comparison to other sectors and international benchmarks and does not adequately reflect the risks of the sector.

- **Investor concerns.** We believe that this is reflected in the market sentiment that has been expressed in the share price of listed companies since the Sector Specific Methodology Consultation was published and in the negative watch assessment of credit ratings that have been subsequently published. We note the concern of international investors about the attractiveness of the UK regulatory space as reported in the Financial Times[4] that '*concerns grow about 'negative' and 'hostile' political and regulatory environment'*.
- **Adjustment for expected returns.** We disagree that the application of an adjustment for expected returns is appropriate. The evidence is based on recent price controls and overlooks earlier price controls that showed significant under-performance and it is a primarily subjective adjustment. The adjustment carries performance between price control periods, and any strong performance risks being double counted in the setting of the baseline and a corresponding adjustment to the allowed returns. This will disincentivise efficiency and dampen incentives to maximise efficiencies.
- **Methodological concerns.** We have methodological concerns with key elements of the cost of equity calculation. We disagree with the deflation and averaging of historical and long-term average returns and the approach to the calculation of the equity beta. We believe that Ofgem have miscalculated the long-term historical Total Market Return as a result of the methodology used.
- **Transfer of risk to Equity.** In addition to the risks set out above, the cashflow floor is a direct transfer of risk from debt to equity holders that has not been taken into consideration when calculating the return on equity. We believe the cashflow floor should be removed; however, if it remains, then the cost of equity should take into account this transfer of risk.
- **Comparability of returns.** Ofgem argue that the difference between the RIIO-2 and PR19 cost of equity (3% vs 4%) is made up of 50bps as an allowance for expected returns, and 50bps due to the choice of indexed RfR compared to a forward curve. Of this last component we think that less than half is due to the RfR indexation and the remainder is due to a different equity beta methodology. As a result, Ofgem's COE is more than 75Bps lower than Ofwat's due to adverse methodological choices.

[4] Financial Times, 23rd January 2019, 'Infrastructure investors put 'blanket ban' on UK assets.

Investors have a choice about where they invest. There have already been public statements from key institutional investors that the UK regulatory space is looking less attractive for new investment as a result of Ofgem's proposals. There is a risk that a poorly calibrated price control will have a long-term detrimental impact on the industry and consumers. We believe that this is an increased risk under the proposed regulatory structure and we encourage Ofgem to reassess the balance of risk that network companies are exposed to.

Analysis put forward in the framework consultation supported a cost of equity significantly higher than the current Ofgem range. We still consider the arguments presented remain robust, and do not support the working assumptions that places the cost of equity at the bottom of the range.

Appropriate incentives

We believe that the incentive properties of RIIO support better customer outcomes and that it is in customer interests for them to be sharpened rather than dulled. It is in customer interests that efficiency and improved service are unlocked rather than overlooked.

- **Level of ambition.** For the revenue adjustment mechanism Ofgem considers that 300bps on RORE is an appropriate level for an extreme failsafe mechanism. We consider this to suggest a lack of ambition on behalf of the customer. As set out in RIIO-1 and PR19, we consider a 10% totex incentive an appropriate aspiration for a good performing company, equivalent to nearly 225bps on RORE. In RIIO-1 incentives allowed a further 120bps. Ofgem's expected calibration of RIIO-1, and Ofwat's calibration of PR19 would be either close to or exceed the extreme failsafe mechanism calibration of 300bps on RORE, as such we feel it represents a reduction in ambition for the price control.
- **Dynamic and relative incentives.** We disagree that competition through dynamic and relative incentives and outputs drives better customer outcomes. If Ofgem is going to pursue its implementation, then it is important to have clarity on the competitive entities. The gas distribution networks can be divided according to shareholder group (3 entities), brands (4 entities), licences (5 entities) or network regions (8 entities). The choice of entity will either benefit or disadvantage specific companies and will define the appropriate calibration of the incentive. We think that competition should be applied where it is appropriate, but the points raised in our response to CSQ5 and the high market concentration of the sector[5] suggests that this is not an appropriate point of competition.
- **Sharing factors.** The proposed sharing factors are very low and will blunt the incentive properties of the ODIs, we therefore encourage clear ODIs based on clearly defined company specific targets that are outside the sharing mechanism giving clear transparency between the service delivered and the 'reward'.
- **Increasing the business plan incentive.** At a maximum of 2% of Totex, before being reduced through competition with other companies, we consider the business plan incentive too low to encourage companies to take on more risk in their cost efficiency. We believe that an improved business plan incentive would be more appropriate to drive ambitious cost plans that benefit the consumer by committing companies to efficiency improvements and broader benefits of reducing sector level benchmarks.

We encourage Ofgem to allow a stronger incentive regime as improved efficiency and standards are in the interests of all stakeholders. This can be achieved through the strengthening of the business plan incentive, sharpening the incentive structure and increasing the failsafe threshold on the revenue adjustment mechanism.

Sharing factors

We are concerned that by reducing sharing factors to a range of between 15-50% from a current sharing mechanism of 64% will reduce the incentive placed on companies to identify the opportunities with the greatest potential return, as the reward for taking a risk is dampened. We believe that this will be detrimental to the interests of consumers in the long run. The reduction in the sharing factor, coupled with the reduction in the time-frame of the price control period, will significantly reduce the incentive on companies to drive an improvement in performance. The reasons for this are set out below:

[5] The Herfindahl-Hirschman Index (HHI) gives GDN's a score of 3825 based on current shareholding. CMA guidance suggests a score over 2000 as highly concentrated. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/284449/OFT1254.pdf

- **Shorter price control period.** Given the shorter price control period, any benefits to customers will be captured through the benchmarking process at the end of the price control period, after 5 years. Rather than reducing sharing factors in principle they should be increased to allow for the shorter price control period.
- **Pass through equivalence.** A lower sharing factor protects companies from delivery risk on mandatory investments. By lowering sharing factors there is a risk that investment proposals effectively become a pass-through item with limited incentive to implement innovative technologies or process improvements that improve efficiency to the benefit of both customer and investors.
- **Reduced materiality.** A lower sharing factor reduces the incentive on companies to take on discretionary risk associated with innovation projects or establishing new ways of working. It is in customers' interests that a company should be incentivised to invest in projects with a greater upside potential; the materiality of this upside is reduced under a lower sharing factor, as is the incentive to invest in those projects.
- **Disincentivising investment at the end of price control periods.** Whilst the reduction in sharing factors is neutral on a purely NPV basis in a constant regulatory environment, when there is a significant departure from previous regulatory practice, such as between RIIO-GD1 and RIIO-GD2, then this structure significantly disincentivises investment towards the end of RIIO-GD1, as the company would incur 65% of the costs and receive only 15% of any benefits accrued.

For these reasons we would recommend that Ofgem reconsiders its approach to sharing factors, to ensure that a strong incentive remains on companies to drive efficiency improvements in this price control that can be fully credited to consumers in the next price control.

Multiple layers of control

As we set out in our response to RIIO Framework Consultation we remain concerned with the complexity introduced by the introduction of multiple layers of control. There are currently five layers of control proposed which serve to blunt the incentive properties of the price control. These are;

1. Shorter price control and indexation
2. Resetting the price control based on RIIO-1 actual costs
3. Price control deliverables and reduced sharing factors
4. Dynamic and relative incentive structures
5. Expected return and revenue adjustment mechanisms

We believe that there are enough existing tools and structures to appropriately calibrate the price control without resorting to further layers of control; 'dynamic and relative incentive structures' and 'expected return and revenue adjustment mechanisms'.

If Ofgem proceed to introduce a revenue adjustment mechanism, then an individual company sculpted sharing mechanism as we proposed in the framework consultation will be significantly less damaging than an anchoring mechanism. The reason for this is that an individual company sculpting mechanism maintains a marginal incentive to continue improving, a transparent and predictable basis on which to invest, and has significantly less complexity compared to an anchoring mechanism.

We have previously proposed that any 'additional' sharing as a result of the sculpted sharing factor should be used to create a partnership fund to build social value and community resilience, with positive economic health, safety and environmental outcomes. We would encourage Ofgem to consider the customer and social benefits of such an approach.

Such a structure needs to be calibrated appropriately, to ensure that there is not a double count of sharing – ie that additional sharing would only take effect once returns exceed an agreed dead-band range, and secondly that it acts as a true failsafe mechanism. Relevant market and regulatory evidence shows a wider range of 500 bps would be more appropriate as an extreme failsafe considering RIIO-1 and PR19 incentive structures.

Counter-acting incentives

There are a number of points through the Sector Specific Methodology Consultation where there appear to be incentive structures which either counteract each other or duplicate the intended impact of other structures. There is a risk that these could drive inconsistent behaviours or perverse outcomes. Some of these are:

- **Ambitious plans vs cost efficiency.** We support the notion that ambitious plans that promote decarbonisation, whole system approaches, improved customer service and embed innovation should be considered components of a 'good quality' business plan. There is normally a cost associated with these ambitions and as a result a business plan that promotes 'good quality' outcomes risks being penalised on the 'cost efficiency' component of the business plan assessment. It is therefore important that ambitious projects are ring-fenced and separated out from the core plan when assessing the cost efficiency of the plan.
- **Ambitious plans vs sharing factors.** It is likely that an ambitious plan will have a lower sharing factor. A plan which aims to deliver more ambitious outputs, better customer outcomes or to embed greater innovation, will have less supporting evidence and as a result is more likely to be considered a 'low-confidence' cost. Under the current proposal 'low confidence' costs will result in a lower sharing factor being applied. This structure risks discouraging companies from putting forward ambitious plans in order to avoid depressing the sharing factor. If a different sharing factor is going to be determined by cost category then it is important that it distinguishes between uncertainty associated with ambition and uncertainty in the evidence base of core plan cost components.
- **Performance vs dynamic targets.** Where targets are dynamically based on the company's performance, any investment in improving performance will risk introducing higher targets in the following years. This risks undermining the incentive to drive higher standards as a company will be making investment decisions in the knowledge that their investment outcome will influence future targets. The incentive therefore needs to be calibrated to allow substantial investments to recover their benefits in the year of delivery otherwise they will be disincentivised; i.e. a 5-year return needs to be recovered in a single year.
- **Anchoring mechanism vs marginal improvements.** As network companies approach a sector cap and there is an expectation of an adjustment taking place, there is a perverse forward incentive to reduce performance to mitigate the risk of such an adjustment taking place.
- **Expected returns adjustment vs longer term performance.** The introduction of an expected return adjustment mechanism that is based on historical precedent introduces a penalty associated with higher performance levels between regulatory periods. High performance in one period will be double counted with the resetting of baselines and increased expected return wedge applied in the following regulatory period.
- **Expected return adjustment vs efficiency test.** We believe that the efficiency test under the business plan incentive is intended to encourage companies to come forward with more financially ambitious plans (i.e. lower costs for the same outputs). This must result in a lower potential for totex efficiency gains, however under the proposed structure the same expected return adjustment would be applied. This creates conflicting drivers since an ambitious cost plan has higher risk of not delivering and still has a lower cost of equity due to the return adjustment.

Proposed adjustments

We understand the appetite for improvements within Ofgem, however we believe that the regulatory structure proposed in the Sector Specific Methodology Consultation is too great a step[6]. There are new regulatory structures that we do not think are appropriate. There are changes which we think can be implemented that target delivery of greater customer benefits, provide a more transparent and predictable regulatory environment. These are explained in detail in the consultation response, but can be summarised as;

- **Confirmation of incentives that deliver consumer aspirations**. We think that it is very important that Ofgem clearly sets out its aspirations for an appropriate range for returns, including expectations for incentives and totex incentive mechanisms. We think this range should be focused on aspirational outcomes in line with stakeholder insight and should not adversely impact collaboration that benefits all customers.
- **Strengthening ambition to drive new behaviours and outcomes for customers**. Many of the structures that have been put in place could have an adverse impact on ambition by penalising it through the efficiency test in the business plan incentive or the sharing factor structure. We would like ambition to remain at the heart of the price control, and therefore think it is important to remove 'ambitious' expenditure from the economic assessment and the sharing factor calculation. Where incentives are driving new behaviours and stronger outcomes then we would like further discussion on the appropriateness of applying sharing factors.

[6] As recognised by the Competition Commission, "consistency with regulatory precedent is a relevant consideration [and] significant changes should be satisfactorily explained and well justified." Bristol Water, Competition Commission 2010 Report, 4 August 2010, para 9.21.

- **Setting out what a 'good' business plan looks like.** We are in constant discussion with our customers and stakeholders about elements of the business plan that are important to them and whether we are reflecting their priorities. This clarity is important to us as we set out our plan, however, it is also important to be clear on whether their expectations are consistent with Ofgem's. We have already identified some areas where there are differences, such as the scope of incentives, and as such we think it is important that we have a clear reference point of what Ofgem considers to be a good business plan.
- **Strengthening the business plan incentive**. On the basis that concerns regarding the asymmetric risk and the efficiency assessment can be resolved, we think that the business plan incentive (BPI) itself should be strengthened. Under RIIO-GD1 a Totex incentive of +/- 10% was considered an acceptable component of the identified RORE range[7]. If the objective of the BPI is to encourage network companies to take on a higher level of delivery risk and commit to a reduction in allowances for the benefit of their customers, then while we will want to take into account the overall incentive package, our current view it that a more appropriate range for the BPI would be 3-4%. An incentive at this level would be more appropriate for driving a network company to take on more risk, to lower not only its own costs to customers, but also through the benchmarking process to encourage a lowering of the benchmarking threshold.
- **Retaining only the structures that add clear consumer value**. We believe that the cashflow floor needs to be removed, the revenue adjustment mechanism should be removed or converted to a sculpted sharing factor and the expected return adjustment is unfounded and should be removed. All three increase the complexity, reduce transparency and predictability of the price control and we do not believe add value to the consumer. We note in this regard the CMA's direction in 2015 that "future price controls should seek to learn lessons from the target-setting process in RIIO-ED1 and the issues of transparency which arose in [the appeal]"[8].
- **Clarifying the cost of equity.** There is currently a substantial difference between the cost of equity proposed by Ofgem at 3%, on a real post tax RPI deflated basis, and the cost of equity of 5.5% to 6.3% on an equivalent basis proposed by Oxera in their report to the ENA for the Framework Consultation response. As a part of the ongoing dialogue with Ofgem we are submitting further independent evidence to support this discussion. Our view remains that the cost of equity should be significantly above Ofgem's proposed value.
- **Demonstrating financeability.** There is a risk that returns are so low that they drive what is ultimately an unfinanceable regulatory structure, and that this is masked by a short-term increase in prices due to the move in inflationary measures from RPI for CPI(H). There is also a concern that the proposed application of the cashflow floor may be considered as a replacement to the downside financeability test used in previous regulatory periods. It is very important that demonstrable long-term financeability remains a core requirement of any regulatory settlement and this should be independent of the introduction of CPI(h) or the cashflow floor.
- **Company and sector considerations.** Too much focus on the sector averages may distort and mask company specific considerations on both the cost of debt calibration and financeability assessments. This is a particular concern in the gas distribution sector where there are stark differences between companies given recent financing. The efficient action of any company should not be penalised, and we encourage Ofgem to maintain the company perspective alongside the sector average.
- **Calibrating the price control on a notional basis**. Ofgem have to date maintained that they consider company structures to be a choice for shareholders rather than regulators, recognising that these decisions are made at a company's own risk and this is consistent with the approach of the CMA in its assessment of previous price controls"[9]. With recent discussions there appears to a be a move away from this principle and a move to reporting structures and adjustment mechanisms based on actual rather than notional structures. We disagree with the use of actual company structures and would encourage Ofgem to undertake a full consultation and impact assessment before changing such fundamental regulatory principles. Ofgem should also be mindful of the need to provide regulatory certainty/predictability before implementing any such changes.
- **Full impact assessment**. Given the compressed timeline, and in order to reduce the risk of a mistake, we would encourage greater transparency around Ofgem's thinking for the structures themselves and their potential impacts. To this end we think that it is very important that a full impact assessment is carried out to assess the regulatory structures put forward in the Sector Specific Methodology Consultation and improve transparency. The current lack of impact

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[7] https://www.ofgem.gov.uk/ofgem-publications/48156/3riiogd1fpfinanceanduncertainty.pdf, pg 33

[8] British Gas Trading Limited v The Gas and Electricity Markets Authority, Final determination, 29 September 2015, para 5.61.

[9] Bristol Water, Competition Commission 2010 Report, 4 August 2010, para 10.10

assessment is in notable contrast to RIIO-1[10]. We would expect, in line with its Assessment Guidance[11], for a transparent assessment of policy development that would reflect the significance of the proposed changes[12].

- **Programme for development**. The timeline of the programme has been compressed substantially. The RIIO-2 Framework decision stated that the formal business plan submission would be to Ofgem in Q4 2019. One of the reasons provided for removing fast tracking that would require the business plan to be submitted by Q3 2019 was that it 'would limit the ability for stakeholders to scrutinise and challenge business plans'. As set out section '1.3 Giving Consumers a Stronger Voice' we encourage Ofgem to ensure that information requested, for example in the July data templates, is only the information needed to support decision making at that time. This will allow us to maintain our strong focus on high quality stakeholder engagement and insight which will drive the further development and iteration of our plan.

We welcome the opportunity to respond to each of the questions below. Given the absence of an effective impact assessment, the complexity of the topics being considered, and the extent of change proposed we reserve our position on this response until the methodology has been more clearly articulated.

We look forward to working with Ofgem to deliver a RIIO-2 package that responds to our customers' priorities and delivers a better outcome of improved service, lower bills and the innovation and investment needed to support the energy system transition towards decarbonisation.

For each section we have provided summary of key considerations that we think that it is important for Ofgem to take into account followed by a response to the direct questions asked.

[10] https://www.ofgem.gov.uk/ofgem-publications/51904/impactpdf, https://www.ofgem.gov.uk/sites/default/files/docs/2010/12/t1-and-gd1-ia_1.pdf

[11] https://www.ofgem.gov.uk/system/files/docs/2016/10/impact_assessment_guidance_0.pdf

[12] We note the CMA stated in 2015 that it expected Ofgem to "take steps to ensure that [..] ambiguity does not reoccur in any elements of its future price control"[12] and consider that an impact assessment would plainly serve that purpose.