Registered Office:
Newington House
237 Southwark Bridge Road
London SE1 6NP

Registered in England and Wales No: 3870728

Company:
UK Power Networks
(Operations) Limited

Akshay Kaul
Director of Network Price Controls
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

14 March 2019

By email only to RIIO2@ofgem.gov.uk

Dear Akshay

RIIO-2 Sector Specific Methodology Consultation

Thank you for the opportunity to give feedback on the above consultation. Our response should be treated as consolidated on behalf of UK Power Networks' three distribution licence holding companies: Eastern Power Networks plc, London Power Networks plc, and South Eastern Power Networks plc.

The latest Committee on Climate Change's annual progress report[1] stated that 75% of emission reductions in the UK have come from the power sector since 2012. We are proud to have been a key enabler to this progress by connecting over 6GW of renewable generation to our networks in such a short time period. In addition to enabling low cost connections, our attention is also now firmly on supporting the development of well-functioning flexibility markets, as well as facilitating Electric Vehicles (EVs). EVs are connecting across our network faster than anywhere else in the UK with over 60,000 vehicles (approximately 30% of the UK total) already charging within our networks today. We agree with Ofgem that the distribution networks will be at the heart of enabling the energy transition. The evolution of RIIO must provide an environment that attracts the huge amount of investment, talent and innovation needed to enable network companies to support the UK to meet its challenging carbon reduction targets and be a world leader in low carbon technologies.

The RIIO regulatory framework represents a major step forward in the way electricity and gas networks are regulated, which is internationally recognised based on the significant performance improvements that are being realised compared to other markets. In electricity distribution, the average number of customer interruptions has fallen by 11% and the duration of interruptions has reduced by 9% in just the first three years of RIIO-ED1[2]. At the same time industry average customer satisfaction scores have improved; all whilst reducing the electricity distribution element of customer bills by 19%[3]. Underpinning this progress is the shift from input based regulation, which focussed on capital expenditure, towards strong incentive based regulation that re-focusses companies' attention on using innovation and a full suite of options to deliver outcomes that are important for customers at the lowest cost.

1 https://www.theccc.org.uk/wp-content/uploads/2018/06/CCC-2018-Progress-Report-to-Parliament.pdf
2 https://www.ofgem.gov.uk/system/files/docs/2019/03/riio-ed1_annual_report_2017-18.pdf
3 Source: UK Power Networks analysis of Annex 1 LC14 Charging Statements and Annual Review Packs

Return Address:
Newington House
237 Southwark Bridge Road
London
SE1 6NP

For example, the RIIO framework has supported UK Power Networks to be one of the first network companies in the world to open up all of our load related reinforcement requirements to the market – as business as usual, not just a pilot or trial. If a market based flexibility provider helps us to deliver the same output for less money we will procure it. We are also preparing our networks for the future by investing over £80 million in state of the art monitoring and control systems. This will target 6,000 of our 100,000 sites across our networks to be able to identify and target flexibility needs or reinforcement investment where it is needed. This is only the start. We expect to build on the learning from this programme to provide well- justified investment proposals in RIIO-2 that further smarten and modernise our networks to meet the changing needs of the communities that we serve.

RIIO has incentivised companies to innovate to deliver the outputs that customers value whilst minimising expenditure and hence the cost to them, in effect replicating the dynamics of a competitive market. For RIIO-2, Ofgem has proposed new mechanisms, such as the blended sharing factor and a Return Adjustment Mechanism (RAM). Whilst we understand Ofgem's intentions, it is vital that these proposals do not weaken the overarching incentive for companies to innovate, find efficiencies and develop new services to meet the needs of customers in a fast changing energy market. This is particularly pertinent for electricity distribution, which will be at the forefront of the significant changes facing the energy and transport sectors in the coming years.

With this in mind, we have summarised below our suggestions of how Ofgem can deliver its desired outcomes as part of an overall regulatory framework that is simpler, more transparent and continues to replicate the dynamics of a competitive market.

Giving consumers a stronger voice

- **Define what a good business plan looks like by issuing clear guidance on the assessment criteria and associated weighting similar to a competitive market tender process**
  Greater stakeholder engagement during the business plan stage will naturally create expectations about what is delivered. Our observation of Ofwat's PR19 assessment of business plans is that, in numerous cases, enhancement projects co-developed by stakeholders and their water company were ultimately rejected as part of Ofwat's assessment phase. Whilst there may be valid reasons for this, from a stakeholder perspective there is a risk that this undermines the engagement process. To avoid this happening in RIIO-2, we request that Ofgem clearly defines upfront and communicates to network companies and their stakeholders, the criteria and weightings it will use as part of its assessment process.
- **Enhance the Stakeholder Engagement and Customer Vulnerability (SECV) mechanism by introducing a penalty element alongside a financial incentive**
  One of the major strengths of the current RIIO framework has been the emphasis placed on protecting customers in vulnerable circumstances. Building on what has become embedded in RIIO-ED1, we see merit in establishing the vulnerability element as its own standalone mechanism. Rather than removing the financial element of the incentive as part of a stakeholder engagement incentive in RIIO-ED2, Ofgem should consider introducing a symmetrical incentive to appropriately sharpen this mechanism.
- **Build on the now embedded stakeholder engagement practices in RIIO-1, through the use of Customer Engagement Groups**
  Regular and high-quality stakeholder engagement is deeply embedded in our business. It enables us to continuously improve our services, ensuring that we meet the changing needs of customers and the wider communities that we serve. We are particularly encouraged by Ofgem's commitment to assess business plans based on how well they reflect stakeholders' input. We support the development of Consumer Engagement Groups as another positive development of the RIIO framework.

Reflecting what consumers want and value from networks

- **Strengthen incentives, such as for reliability and service, that meet common objectives by including annual dynamic targets based on benchmarked revealed performance**
  We are broadly supportive of introducing well designed dynamic incentive targets which ensure that targets are sufficiently challenging such that good performance is appropriately rewarded. The dynamic target resetting methodology must be clearly set out upfront and enshrined in the licence for RIIO-2. It must allow for targets to move both up and down based on revealed benchmarked performance.

- **Provide freedom for companies to co-develop bespoke incentives with their stakeholders that address their local needs**
  Wherever feasible, incentives should be developed to benefit all GB customers and provide simple comparators of performance across different companies. However, where local needs indicate a requirement for a differentiated service offering, we agree that companies should have the freedom to develop bespoke outputs and incentives.

- **Set any minimum standards at a level deemed acceptable by customers and supplement these with symmetrical rewards and penalties based on enhanced performance targets**
  In principle, we agree with Ofgem's intentions for the use of licence obligations, price control deliverables and output delivery incentives. A clearly defined licence obligation should set a minimum standard at a level deemed acceptable by customers and deliverable by companies. Ex-ante allowances must fund the efficient delivery of these minimum standards. Enhanced performance targets could be set for higher levels of performance, with a symmetrical reward and penalty mechanism.

Enabling whole system solutions

- **Set a single totex sharing factor in RIIO-2 to ensure a level playing field between different network companies that can deliver the same output**
  As the opportunity for cross-sector collaboration increases, we believe the simplest way of enabling whole system benefits is for Ofgem to apply a single, common, totex sharing factor to all network companies. The Totex Incentive Mechanism (TIM), alongside a suitable sharing factor, should focus on rewarding or penalising company performance within the price control, whereas Ofgem's proposed Business Plan incentive should be the only mechanism to determine the reward/penalty of cost efficiency. This would provide a level playing field between companies that can potentially deliver the same output for customers and would allow Ofgem to focus on designing any RAM to ensure returns are fair. It also avoids any need for further complexity through additional mechanisms such as the "Coordination and Information" incentive and a blended sharing factor, and further challenges of interaction and compatibility with other areas within the price control. We recognise that the move to a single, consistent sharing factor a cross-sectors is a significant departure from previous controls, however, we welcome the opportunity to discuss how we believe this can work in a coherent package and deliver the outcomes that Ofgem desires.

- **Support coordinated cross-sector reopeners to ensure that outputs and associated funding can be transferred to the most efficient delivery body**
  It is increasingly recognised that smarter distribution networks will be central to facilitating the energy transition and ensuring that associated benefits flow back to customers, and particularly to those that are willing to provide flexibility. For example, there will be cases where we can deploy smart solutions (such as demand side response) alongside a new cluster of EVs, which simultaneously resolves both transmission and distribution constraints. To facilitate this, we support Ofgem's proposal for the development of cross-sector reopeners in RIIO-2 that enable outputs and associated allowances to transfer to the party that is best placed to deliver them.

- **Improve the Directly Remunerated Service (DRS) funding mechanism to ensure that companies have a risk and reward profile commensurate with the benefit they are providing to consumers**
  Our experience of RIIO-1 is that the DRS mechanism works at a basic level; however, in its current form, we do not think it truly drives whole system benefits. One of its key limitations is that the allowed margin for the party delivering a solution is minimal compared to the incentive on output delivery. DRS routes should be revised to ensure companies have a risk and reward profile commensurate with the benefit they are providing to customers.

Ensuring future resilience

- **Evolve the current RIIO-ED1 methodology on network outputs to improve how companies assess longer term risks**
  We recognise Ofgem's desire to enhance its methodology of assessing network risk to reflect the life-time benefit of interventions. Before deciding to introduce a new Network Asset Risk Metric (NARM) for RIIO-2 that risks being rushed and incomplete, we believe that Ofgem should work with the industry to adapt the existing RIIO-ED1 Common Network Asset Indices Methodology (CNAIM). This provides a strong foundation to build upon and refinements could be in place for the start of RIIO-ED2.

  Furthermore, any new metric should not be the primary basis for justification of companies' investment proposals for their asset management activities; instead, this should remain with the company's asset management teams who are best placed to manage short and long term risks on behalf of their customers using all available evidence.
- **Support the development of a workforce that has the skills to deliver the energy transition, reflecting the communities they serve**
  Many utilities are facing significant challenges, both in replacing and recruiting a workforce fit for the future. This is particularly apparent in electricity distribution, where millions of new small generators and connected devices are revolutionising the way we manage our networks. Companies should therefore be supported through their allowances to ensure they have a workforce with the right skills and that they reflect the communities they serve. A series of surveys of companies' workforce strategies could then be undertaken to ultimately inform whether it is necessary to design and introduce any metrics in these areas for RIIO-2.
- **Fund cyber resilience activities via suitable ex-ante allowances with appropriate outputs. This ensures that efficient delivery is incentivised**
  As we move to a more decentralised and digital energy system, most industry observers expect the number of connected smart devices to rise exponentially. Whilst providing huge opportunities for new services for customers, they also represent new attack surfaces that could be used to disrupt electricity supplies. Electricity companies must continue to be appropriately funded to combat fast evolving threats through ex-ante allowances, ensuring security is delivered whilst costs are kept down for customers.

Managing uncertainty

- **Align all network price controls in RIIO-3 and enhance flexibility in RIIO-2 by appropriate use of volume drivers alongside uncertainty mechanisms**
  Ofgem's move to shorter price controls in RIIO-2 will significantly help with managing uncertainty and reduce the risk of forecasting errors. We recommend that Ofgem aligns all of its network price controls for RIIO-3, either by shortening RIIO-ED2 to three years or by extending the price controls starting in 2021 by two years. We believe this will facilitate whole system approaches and increase efficiency, because it will enable business plans to be coordinated a cross-sectors, avoiding stakeholder fatigue and ensuring the right delivery body for network solutions from the outset.

Alongside this we continue to support the use of new volume drivers and uncertainty mechanisms as a way of ensuring companies are able to flexibly deal with uncertainty during RIIO-2 for the benefit of their customers. For example, in RIIO-ED1, we already have separate reopeners for load related expenditure and high value projects, which protect both network companies and customers from the level of required investment being materially different from the original forecast.

Lastly, to ensure that all RIIO-ED1 data is utilised as part of Ofgem's cost assessment in RIIO-ED2, any difference between forecast and actual spend in the last two years of RIIO-ED1 should be accounted for as part of an adjustment in RIIO-ED2.

- **Include anticipatory investment as totex spend and not a standalone investment and encourage efficiency improvements by developing a utilisation metric in RIIO-ED2**
  We support network companies taking a stronger role in addressing societal issues; particularly in areas such as climate change, as we will need to ensure that our network is resilient to evolving challenges. For example, we are working closely with the Greater London Authority to ensure our network can facilitate a switch to cleaner, electric, forms of transport in London. Therefore, we agree with Ofgem that network companies should be encouraged to support these types of developments in their business plans as long as they are well justified. If, at the time of the business plan submission, a larger investment need is identified and well justified, we believe this should be considered as part of totex, within a High Value Project (HVP) mechanism. This enables simplicity, clarity and visibility for Ofgem, network companies and stakeholders to assess cost submissions. For any larger investment that is identified in-period, this should be dealt with through an HVP reopener. We do not believe there is a case for treating any well-justified 'anticipatory' investment differently from other spend, and our concern is that this will drive the wrong type of behaviour. To ensure investments are and continue to be justified, we believe there is merit in developing a new utilisation incentive in RIIO-ED2. This could sharpen the incentive on DNOs to use innovative solutions in local areas to improve network efficiency.
- **Mitigate forecasting errors through the use of indexation where suitable**
  We believe the indexation of Real Price Effects (RPEs) will help to mitigate forecasting errors, in line with what we advocated prior to the start of RIIO-ED1.

  On cost of equity indexation, we recommend further analysis of the impact on revenue volatility, both for network companies and market participants, before this is implemented. Further explanation is provided in our answer to question FQ5.

Driving innovation and efficiency through competition

- **Maintain the Totex Incentive Mechanism (TIM) with a suitable sharing factor to drive innovation and competition as business as usual**
  We recommend that Ofgem continues to use the totex approach in RIIO-ED2 to stimulate nascent local flexibility markets, whilst ensuring distribution network companies remain accountable for service delivery when contracting and deploying any market based solution. Whilst a margin or fee approach to running competitions may work in a mature market with established players, we think this approach is unsuited to stimulating new markets where there is uncertainty about deliverability and costs.

  A key benefit of the DNO to DSO transition is that it ensures that security of supply will not be compromised at the same time as facilitating the energy transition. For example, network companies have clear accountability for meeting engineering standards that deliver high service levels; this is then reflected when contracting and deploying non-network solutions.
- **Simplify innovation by removing the Network Innovation Allowance**
  We agree with Ofgem that innovation should continue to be deployed as part of network companies' business practices. The TIM, coupled with an effective sharing factor, is the best way of achieving this as opposed to providing innovation funding and then applying arbitrary "smart grid" savings with no real basis.

Whilst the NIA has provided an important stimulus for smaller companies to develop innovative products and services in RIIO-1, as the market is now more mature there is merit in considering whether the NIA could become business-as-usual. We therefore recommend that Ofgem simplifies RIIO-2 by removing the NIA and providing companies with an efficient level of totex coupled with strong incentives to innovate in order to outperform for the benefit of customers.

- **Promote competition where it can demonstrably provide the greatest benefit to customers**
  As a principle, we support Ofgem's use of competition to drive cost efficiencies wherever it can demonstrably benefit customers. Since the start of RIIO-ED1 there has been a significant increase in competition for new connections. For single, high value projects, Ofgem has understandably been looking at the role of what it defines as 'early' competition as a way of ensuring price discovery; however, until this has been shown to consistently work well we do not see a case for exploring its use for highly integrated, high volume, low cost works where the majority of the work on our networks lie. The Department of Transport's 'Strategic Vision for Rail'[4] recognises the difficulty in contracting high-volumes of works and that it can result in poor performance for the customer when "*things go wrong, energy and time which could be spent on solving the problem can be lost in contractual debate and industry dispute processes.*" We are concerned that forcing competition into areas where it is not suitable is an outdated model which will be to the detriment of customers and be guilty of not learning the lessons of the past.

  Importantly, the TIM already drives network companies towards native competition that delivers cost savings, which are then shared with customers via the sharing factor. We strongly believe that totex incentives provide the right risk and reward balance by encouraging network companies to deliver their outputs at lowest cost.

Simplifying Business Plan assessment

- **Drive the right behaviour by introducing a competed pot in the business plan assessment, and ensuring that the size of the pot provides a strong and meaningful incentive signal to companies**
  The inclusion of a strong symmetrical financial reward and penalty on network companies' business plans, has the potential to drive stakeholder engagement and early buy-in to the RIIO-2 process. The Business Plan incentive should be the sole mechanism to incentivise ambitious plans and ensure efficient costs. This negates the need for either an IQI or a blended sharing factor to adjust the TIM. To achieve this, Ofgem should use clearly defined quantitative and qualitative elements in its assessment, as this will help companies to deliver high quality business plans backed by their stakeholders. Including a competed reward pot, proportionally sized to the number of companies within that sector, provides Ofgem with the opportunity to replicate the competitive dynamic that would exist in the wider market.
- **Ensure companies are held accountable for delivering their plans by including business plan rewards and penalties within any Return Adjustment Mechanism (RAM)**
  If Ofgem continues with its plans to introduce a RAM in RIIO-2, we believe it is crucial that any reward/penalty from the Business Plan incentive is included within the RAM envelope. Failure to do so presents a danger that customers may inadvertently pay for a "good sounding plan" regardless of whether a company has the ability to deliver it because Ofgem would have no scope to claw back the reward. Whilst Ofgem may attempt to close this loophole with specific commitments from the network company, we believe a simpler and more transparent outcome would be to build all business plan outcomes into any RAM.

[4] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/663124/rail-vision-web.pdf

- **Ensure cost assessment is fair and comparable through regional adjustments that are not necessarily a zero sum game**

  It is not appropriate for all regional cost adjustments to be considered symmetrical. Whilst it can work for certain cost elements (e.g. regional wage differentials), it is not appropriate for elements that are inherent within particular networks, such as increased costs resulting from the Ultra-Low Emissions Zone in London or the need for remote location generation in parts of the Scottish Highlands. Fair and appropriate cost assessment must be considered at an individual licensee level, taking account of robust evidence cases and the regulatory precedent developed by Ofgem over successive price controls.

Fair Returns and Financeability

- **Revise the cost of equity in RIIO-ED2 to correct methodological errors to ensure it incentivises investment in a way that really drives the energy transition**

  It is important to remember that the cost of equity is the incentive to invest and if Ofgem sets a cost of equity below a fair level, it risks setting an investor perception that incremental investment destroys value. Furthermore, we do not agree with Ofgem's proposal to adjust the derived cost of equity by its view of expected outperformance. Instead, regulatory targets should be set appropriately to incentivise companies to innovate and deliver the outputs that customers want, at the lowest cost.
- **Ensure the appeals process supports the overarching regulatory framework**

  We have concerns around the wording in the consultation that seemingly presents Ofgem with the option to open up all areas of a price-control settlement following a successful challenge through the Competition and Markets Authority (CMA). As a principle, we do not believe it should be within Ofgem's powers to retrospectively alter other areas of the price control, as this could lead to adjustments that do not fulfil the intent of a CMA ruling and provide significant uncertainty to companies and their investors. Further work and detailed explanation is needed from Ofgem on this topic to ensure all parties perceive the entire process provides certainty and fairness.
- **Design any Return Adjustment Mechanism with the aim of:**
  - **Being simple to implement and transparent to stakeholders**
  - **Avoiding a situation whereby poor performers dilute the returns of better performing companies**
  - **Mimicking a competitive market by retaining an incentive to deliver frontier performance**

  We believe that Ofgem can ensure fair returns by setting appropriate targets and allowances. If a RAM is to be introduced, it should be designed with the characteristics defined above and must only operate in extreme scenarios in order to avoid blunting the incentives in RIIO-2. Of the options presented by Ofgem, our current view is that 'proportional anchoring' best meets Ofgem's desired outcomes in the distribution sectors whilst having the least distortionary impact. We do not agree with Ofgem's proposal to avoid adjusting companies relative to the base cost of equity, as this could mean that a strong performing company and its customers are subsidising another company's poor performance. Instead, all companies should be adjusted if a RAM threshold is breached.
- **Any RAM introduced should only include companies' performance that management can materially affect**

  A RAM should only operate on parameters that are controllable by a company's management team – these should include the level of totex spend and performance against incentives, e.g. bespoke incentives and the Business Plan incentive. Financial out- or under-performance should not be within scope; for example, the ability for a company to materially affect its performance against its historical debt portfolio is limited and risks arbitrarily creating winners and losers.

Achieving a reasonable balance in RIIO-2

- **The RIIO-2 package should provide certainty and fair rewards for companies to invest efficiently to deliver the necessary customer outputs and support the delivery of a low carbon economy**
  Ofgem should retain the focus on the TIM as the main driver for companies to cost efficiently deliver excellent performance. This should be enabled by setting a single sharing factor (within a range of 40-60%) and use the Business Plan incentive for cost assessment to ensure efficient business plans, rather than introducing blended sharing factors that will add significant complexity for little value. A key benefit of the totex model in RIIO was to remove any bias between capital and operating expenditure. To reduce total costs for our customers, we are incentivised to test and deploy innovative non-network options, such as demand side response, whilst ensuring we deliver excellent levels of performance for our customers.

Conclusion

We fully support Ofgem's continued use of the RIIO model in the next round of gas and electricity network price controls. The proposals that we have set out above will support the design of an overall price control package that protects customers, delivers efficiencies and enables companies to be financeable and appropriately rewarded. It will also ensure that the UK regulatory model continues to be at the forefront internationally and a leading example of how to facilitate a low carbon future.

We are committed to working with Ofgem over the coming months to ensure that the new proposals under RIIO-2 are well designed and fit together as an overall coherent price control package.

Our responses to the relevant questions from your consultation are set out in the appendices to this letter. We hope that you will find our comments helpful and if you wish to discuss any part of our response, please do not hesitate to contact us. We look forward to working with you over the coming months to develop the suggestions in this response, and to set up a clear process for RIIO-2 and subsequently RIIO-ED2.

Yours sincerely

Basil Scarsella
Chief Executive Officer
UK Power Networks

RIIO-2 Cross-Sector Questions[5]

OUTPUT CATEGORIES QUESTIONS

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

We have concerns around the wording in the consultation that seemingly presents Ofgem with the option to open up all areas of a price-control settlement following a successful challenge through the Competition and Markets Authority (CMA). As a principle, we do not believe it should be within Ofgem's powers to be able to retrospectively alter other areas of the control, as this could lead to adjustments that do not fulfil the intent of a CMA ruling and provide significant uncertainty to companies and their investors. Further work and detailed explanation is needed on this topic to ensure all parties understand what Ofgem's intentions are in this area.

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

Yes we agree.

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

We believe the new outputs capture the required outcomes.

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

In principle we agree with Ofgem's intentions for the use of licence obligations, price control deliverables and output delivery incentives. A clearly defined licence obligation should set any minimum standard at a level deemed acceptable by customers and that is deliverable by companies. Ex-ante allowances should fund the efficient delivery of these minimum standards. A tougher target could be set for higher levels of performance, with a symmetrical reward and penalty mechanism.

We understand Ofgem's intent to set a tougher price control in RIIO-2. Underpinning the RIIO-2 framework should be the overarching principle that companies are rewarded to innovate and targets are set appropriately using the wealth of data that Ofgem now has from licensees. With this in mind we are happy to work with Ofgem on this to address any concerns that licence conditions are currently not tough enough.

Licence obligations, as defined, currently set an effective 'minimum standard' that must be met by licensees. Failure to do so would result in a licence breach and a possible penalty. However, it is unclear for what elements of the price control new minimum standards will apply, and where this level of 'minimum standard' will be set, let alone how it interacts with other parts of the price control. For example, an interpretation of the current definition could suggest that a reward could be applied to any

[5] We note that following Ofgem's publication of the main consultation document on 18th December 2018 Ofgem subsequently published updated versions, which contained different question numbers. In our response we have endeavoured to list the questions as they appeared in the latest version of the consultation document. If there are any inconsistencies that make our response unclear, please do not hesitate to get in touch with us.

service beyond that minimum standard and that any service below would result in an incentive penalty and a licence breach simultaneously, as depicted in Figure 1 below.

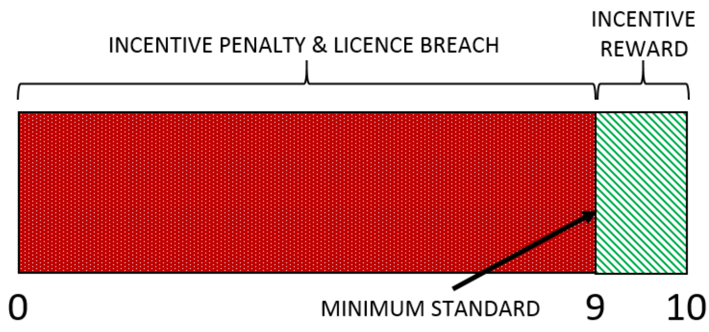

Figure 1 – Interpretation of RIIO-2 interaction of Licence Obligation and Output Delivery Incentive, which we do not believe is appropriate

If we have shown the correct interpretation, this scenario is a significant departure from what licence conditions are today. With RIIO-2 promising to deliver 'tougher' targets, there is a real risk that licensees could find themselves in a licence breach scenario. A licence breach is a serious label to apply to not hitting a target that is not a minimum standard, and would undoubtedly bring with it severe ramifications, both financial and reputational.

We do not believe Figure 1 is representative of Ofgem's position. Instead, we consider Figure 2 to be a more appropriate interpretation of what is intended, but we welcome clarification on this point. That is, where deemed necessary to introduce a minimum standard it should be set at a level deemed acceptable, and a tougher target set at a higher level of performance with a reward and penalty mechanism symmetrically applied around this target. Any performance difference between the maximum penalty and the defined minimum standard would sit in a dead band area, as depicted below in Figure 2.

This will guard against unnecessary licence breaches and ensure targets can be set at suitably challenging levels.

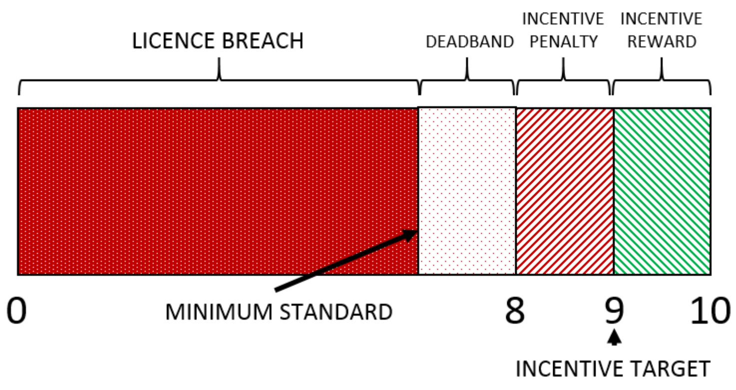

Figure 2 – UK Power Networks' view of how the interaction of Licence Obligation and Output Delivery Incentive should work in RIIO-2

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 supportive of introducing dynamic incentive targets, where appropriate, as this ensures that good performance is appropriately rewarded. However, there are two points to note with regard to dynamic targets:

1. The dynamic target resetting methodology must be clearly set out and defined upfront and enshrined in the licence for RIIO-2. This will ensure there is visibility of how the targets may update across the period and allow companies to take appropriate business decisions ahead of time, promoting efficiency and ensuring companies to deliver this for their customers.
2. The methodology needs to allow for targets to move both up and down based on revealed performance. In a fast-changing energy sector with increasing challenges and pressures such as the continued rise of distributed generation and the electrification of transport and heat, it is not appropriate for targets to only get tighter in a one-way ratchet. This will need to be clearly articulated to stakeholders in advance to ensure there is transparency over the range of potential outcomes. If Ofgem only intends dynamic targets to operate as a one way ratchet, this must be clearly articulated so that licensees can factor in the implications of this and reflect it in their business plans and totex forecasts.

Implementing these two points will ensure dynamic targets are both stretching and realistic, reflecting the circumstances network operators are operating in.

We understand that Ofgem is trying to sharpen companies' performance, at the same time, as mitigating sector-wide outperformance through new relative targets and a competed pot. However, there are drawbacks around this and evidence that these types of incentives do not deliver outcomes in the interests of customers. Introducing a competed pot around incentives would also significantly weaken any need for a new RAM and vice versa. Furthermore, if both these mechanisms were to operate together in RIIO-2 they are likely to cancel each other out in terms of their outcomes. As an alternative solution we believe that tighter targets should be set following engagement with companies' stakeholders.

Network companies have a strong track record of collaborating together. For example, the co-development of the benchmarking system now allows company performance to be compared, which has led to customer benefits by driving competition. We have concern that the use of relative incentives will reduce this appetite to collaborate, as companies are likely to work more independently to try and maintain an advantage over others and therefore reduce the benefits to customers.

Furthermore, how the relative incentive reward mechanism works is also cause for concern, Ofgem have continued to suggest the use of either a 'zero sum' or 'fixed' pot. Both have issues that would not encourage behaviours in the interests of customers:

- **Zero Sum Incentive Pot:** This would be a fundamental departure from how Ofgem have traditionally employed incentive regulation. In this scenario, poor performing companies' customers would effectively pay strong performing companies, breaking the direct and fundamental linkage between a network operator and its own customers. If the sector is poorly performing, the "least bad" companies may still earn rewards, which may question the appropriateness of such mechanisms. Conversely, in a strong performing sector, this could penalise a company even though it is delivery a good service to its customers.
- **Fixed Incentive Pot:** This will distort the underlying incentive rate as companies will not have sight of what the incentive is as it is based on peers' performance. Again, a poor performing companies' customers would effectively pay strong performing companies, breaking the direct and fundamental linkage between a network operator and its own customers.

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 agree with the concept of allowing network operators to develop their own outputs, helping to ensure companies reflect the needs and willingness to pay for additional performance or outputs beyond that set out in the standard price control. There are two important aspects that need to be considered in the creation and implementation of bespoke outputs:

1. Should a network company and its Customer Engagement Group or User Group agree a bespoke output, Ofgem's RIIO-2 Challenge Group and Open Hearings need to be mindful of not undoing or changing the bespoke output so much so that it no longer reflects those views that the original output and stakeholder's willingness to pay was based upon. We are concerned that this could serve to undermine the stakeholder engagement process and risk damaging the reputation between network companies and its stakeholders. Therefore, there needs to be clear rules and guidance upfront as to the grounds on which the RIIO-2 Challenge Group and/or Open Hearings could challenge or amend bespoke output proposals to ensure they are justified.
2. Whilst we do not support the introduction of a new Return Adjustment Mechanism (RAM), if Ofgem include one within any price control framework (see response to question CSQ82), then we believe that bespoke incentives should sit inside the RAM. This is consistent with our view that the Business Plan incentive should also sit inside a RAM so that it meets Ofgem's desired outcome without unintended consequences. For example, if bespoke outputs are outside of any RAM, one could argue that there is a stronger incentive for companies to devise and deliver these, rather than meeting their core objectives, which have less guarantee of financial reward. Rather than making performance more comparable this would make a cross-sector assessment of performance more challenging.

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

Please see response for CSQ6 above.

ENABLING WHOLE SYSTEM SOLUTIONS QUESTIONS

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

We support Ofgem's recognition around the importance of enabling whole system solutions to deliver benefits to customers. However, to achieve this it is imperative that Ofgem works with others such as BEIS, Department for Transport, the National Infrastructure Commission etc. to develop a joined up approach on whole systems. Importantly, whole systems is not only about meeting climate targets, but must consider opportunities around economic growth, productivity, health and employment.

Regarding Ofgem's definition, we are unclear how electricity and gas issues will interact and form part of licence conditions if heat and transport are not included within the remit. As Ofgem develops it's thinking in this area we recommend it adopts a consistent cross-sector approach in licence conditions. Initially we believe Ofgem's focus should be on resolving existing barriers to unlocking customer benefits by considering what tangible actions they can take to addressing these in the RIIO-2 timescale.

As per our response to CSQ11 we can see a potential conflict between the definition Ofgem is now consulting on, what was included in the recently published draft licence condition on whole systems[6], and any wider definition that may be applied for cross vector innovation projects. However, network companies have collectively been undertaking whole systems scenarios for RIIO-2, as well as working together through the Network Innovation Competition to investigate cross-vector issues e.g. the Freedom Project[7]. This highlights that it is not necessary to have in place an agreed definition to enable collaboration. Therefore, whilst a single definition of whole systems is a desirable aim, we recognise this may be difficult to achieve now.

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?

Aside from innovation projects, at the moment we are unaware of examples where there is a benefit to customers of defining whole systems across electricity and gas in licence conditions. However, we see the Business Plan incentive as a driver for companies to collaborate with each other on whole system issues within RIIO-2. For example, if there is a strong case for a gas and electricity company to work together this could be developed as part of a bespoke output, subject to discussion with stakeholders.

We believe that licence conditions defining whole systems should be in place for electricity transmission and distribution for the start of the 2021 controls, but that these should be revisited at the start of RIIO-ED2 when Ofgem can re-evaluate circumstances e.g. on low carbon heat. This would be in line with the draft licence condition Ofgem recently published[6]. Nevertheless, we should be aiming to build processes, and share data, that allows cross-sector projects to be assessed when required. We recommend that such projects meet certain criteria and materiality thresholds, to avoid network companies incurring escalating costs through unnecessary cross-sector Cost Benefit Analysis.

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

Whilst there may be merit in not accurately defining whole systems for innovation projects and wider issues, we would caution against a broad scope being defined in licence conditions. Instead, we believe it is Ofgem's intention to start RIIO-2 with a narrow definition that focuses on electricity transmission and distribution as this is reflected in their recent whole systems draft guidance published[6]. We agree with this approach; nevertheless we welcome Ofgem revisiting this question as part of their consultation of RIIO-ED2 to capture any industry changes.

---

[6] https://www.ofgem.gov.uk/ofgem-publications/144990

[7] https://www.wwutilities.co.uk/media/2717/the-freedom-project-outline-april-2018.pdf

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?

In principle we support the Business Plan incentive being used to identify whole system solutions and foster co-operation between network companies. However, under Ofgem's wider proposals whole system activities could be given a low sharing factor due to their uncertain cost, but conversely be rewarded as part of the Business Plan incentive; this potential contradiction could lead to companies focusing on traditional solutions initially, effectively negating the incentive Ofgem is trying to foster.

We also have concerns with the Coordination and Information Sharing Incentive, which we believe may not be required if the Totex Incentive Mechanism and Business Plan incentive are specified and calibrated correctly. Adding new mechanisms increases complexity, working against Ofgem's desire to simplify the control and therefore any additional mechanism should be targeted only where there is a clear and compelling need. If existing mechanisms are already in place or planned to be introduced, we would recommend that wherever possible they be calibrated to deliver the full range of benefits that could be feasible from them, rather than bolting on add-ons such as the Co-ordination and Information Sharing Incentive.

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

We have a concern that the proposed Coordination and Information Incentive could create a distortion that restricts the delivery of whole system solutions that are in the best interest of customers. We think there is potential risk that it disincentivises companies to share and engage at the business plan stage in order to increase any reward within period. Due to the misalignment of price control periods for RIIO-2 this is of particular concern for electricity distribution companies. Firstly, there will be a stronger incentive for companies going first through RIIO-2 to find solutions, regardless of whether they are best placed to do so; secondly, there is a risk that the ESO and TOs duplicate work that will subsequently be part of DNOs' plans.

Nevertheless, we recognise that licensees must meet obligations that could lead them to include work DNOs may be better placed to define and/or deliver. As well as encouraging this in the business plan stage, we think this can be facilitated via cross-sector reopeners in RIIO-2 that enable outputs and associated allowances to transfer to the party that is best placed to deliver them. This should ensure that customers do not double-fund investment and allowances are ultimately placed with those best placed to deliver the most efficient outcomes for customers.

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

Yes, there are obstacles with transferring revenues between network companies. Many of these have been identified and discussed within the ENA's Open Networks Project, which Ofgem has been actively involved in. Our experience of RIIO-1 (e.g. through the Vector Shift Project), is that the Directly Remunerated Service (DRS) mechanism may work at a basic level, however, in its current form it does not truly drive whole system benefits. One of its key limitations is that the allowed margin for the party delivering a solution is likely to be minimal compared to the incentive on output delivery.

Broadly, we believe there are four ways Ofgem can improve the RIIO framework to encourage whole system solutions that deliver benefits to GB customers:

1. Outputs should be transferable between companies to ensure that the party best placed to deliver them can do so. To facilitate this we support coordinated cross-sector reopeners that enable the transfer of outputs and associated allowances;
2. DRS routes should be revised to ensure companies have a risk and reward profile commensurate with the benefit they are providing to customers;
3. The Totex Incentive Mechanism alongside a common, and suitable, sharing factor for all network companies will be a simple and effective way of enabling outputs to be transferred between parties fairly. Whereas Ofgem's proposed Business Plan incentive should be the only mechanism to determine the reward / penalty of cost efficiency; and
4. A Whole System Discretionary Fund, if designed appropriately, could be a flexible way for companies to receive an allowance to deliver bespoke outputs within the price control period. This could be similar to the Environmental Discretionary Reward in RIIO-ET1, which encouraged companies to find innovative ways of improving their environmental performance.

We believe the combination of the above proposals alongside a continuation of the totex model will encourage whole system solutions in RIIO-2 by allowing the transfer of outputs whilst helping to avoid any double funding or conflicts.

It should be noted that whilst considerable benefit was accrued by customers, projects such as Vector Shift, have come with an additional cost to network companies, over and above that considered within the RIIO-1 regulatory allowance. In addition, the way in which funding and benefits have been realised to date for these one off projects is not conducive to an enduring requirement to deliver on whole system solutions as the current funding arrangements are not commensurate with project risk. As such we would expect consideration of appropriate funding mechanisms and incentives be given in the upcoming RIIO-2 price control and revisited ahead of starting RIIO-ED2.

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

As early as possible outputs should be given to the party best able to deliver them, and the Totex Incentive Mechanism should be seen as the primary financial driver for delivering whole system benefits. Alongside this the Directly Remunerated Service (DRS) mechanism should give network companies an opportunity to work together flexibly to deliver outputs. Under the totex arrangements this should enable a network company to lower their customers' costs by using another network company's available resource, whereas the latter should be able to earn an appropriate margin for proving the service.

Our view is that the proposed Information and Coordination Incentive, as well as Ofgem's suggestion of the Electricity System Operator (ESO) running competitions on behalf of DNOs, will not be in customers' best interests. We believe this will disrupt the progress being made through flexibility tenders, and, reduces accountability for output delivery by splitting responsibility across more parties. Our view is that all network companies should be encouraged to investigate how they can support whole system needs and we caution against Ofgem focussing on a top-down approach, whereby the ESO is more strongly incentivised than others. For example, as a DNO we have local expertise that is helping us to identify bottom-up solutions to meet whole system requirements, which we believe will lead to significant customer benefit. It is crucial that Ofgem supports this type of behaviour, rather than discouraging it by removing or diluting our responsibilities.

For many of the forthcoming strategic whole system issues we support the use of innovation funding, which could have a separate and broader definition that includes issues around heat and transport. Such a definition should be consistent across networks and should not hinder the ability for companies to manage their own licence obligations cost efficiently.

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

We support Ofgem's objective to clarify whole system responsibilities through new licence conditions and we recently responded to a separate consultation on a draft version of these. To facilitate the energy transition in a cost efficient way, it will be critical to have a common framework for developing whole system solutions. To this end, we believe that the proposed new whole system licence conditions and guidance should apply to the Electricity System Operator (ESO) in the same way as it does to electricity distribution licence holders. Without this, there is a real risk of misalignment between the expectations key parties have when working together to deliver whole system benefits. For example, currently Ofgem is suggesting that DNOs have licence obligations to ensure that they share appropriate information with other licensees, whereas the ESO will have a financial reward for the equivalent task as part its framework.

The Power Potential project is a whole systems case study whereby UK Power Networks and the ESO have been working collaboratively to address technical and commercial issues that cut across electricity distribution and transmission. This joint project has involved UK Power Networks, and the ESO, both exhibiting many of the behaviours Ofgem describe in the draft licence conditions and guidance. Through Power Potential we are demonstrating how apportioning roles and responsibilities in the right way can optimise the final solution i.e. the DSO controlling network and assets to dispatch the correct volume at an appropriate price. Therefore, ensuring equivalent requirements on these parties will further encourage this type of work going forward.

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

At this stage we believe the greatest customer benefit can come from ensuring that outputs relating to electricity network companies can be better transferred between one another. The energy transition has significantly redefined network flows between transmission and distribution and will continue to do so. To cost efficiently manage the electricity system, it is crucial that outputs rest with those best able to deliver them. For this reason we support Ofgem's intention for co-ordinated cross-sector reopeners which could be used to transfer outputs between TOs and DNOs and vice versa. This would have the benefit of encouraging TOs to ensure they have outputs at the start of RIIO-2 to deal with issues emanating from the distribution network, but would equally ensure that if a DNO is better placed to resolve the issue it has the opportunity to do so, without any cost to the TO. Rather than precluding the DRS route, we believe this would work alongside it.

As the arrangements for the first round of RIIO-2 price controls becomes clearer we will revisit this question and make clear to Ofgem if we uncover such problems and propose remedies to deal with them.

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

We do not believe that there should be any special treatment given to specific sectors in terms of additional mechanisms, particularly as an increasing number of solutions will be deliverable on different networks.

We are already concerned that the misalignment in the timing of the price controls between RIIO-ET2 and RIIO-ED2 may create distortions when considering whole system solutions; for example, the proposed Information and Coordination Incentive is likely to give a sharper financial reward to TOs for identifying solutions in comparison to DNOs as their regulatory period is two-years ahead. This is because there will be no such incentive for DNOs to similarly coordinate and share information until 2023 at the earliest. Our primary concern is that as many of the changes taking place in the energy sector are within electricity distribution networks, this new incentive will encourage TOs to duplicate the work of DNOs, yet they will not be best positioned to undertake a full cost benefit analyses of the options in the distribution network. Therefore our preference is for Ofgem to focus on the Business Plan incentive and DRS mechanism as ways of achieving cooperation between network companies.

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

We think that Ofgem's proposals to 'ensure network innovation has a whole system focus' and the inclusion of a Whole System Discretionary Fund will help achieve greater collaboration a cross-sectors. However, we recommend that a single definition of whole systems that focusses on electricity transmission and distribution is most appropriate within licence conditions for the start of RIIO-2; nevertheless, this could be revisited at the start of RIIO-ED2.

To manage expectations around cross-sector deliverables and benefits, there would need to be clear demarcation between Ofgem's expectations for any innovation spend that includes both electricity and gas networks.

ASSET RESILIENCE QUESTIONS

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

We do not agree with Ofgem's proposal to use monetised risk as the primary basis for network companies to justify their investment proposals. The primary basis for network investment, i.e. asset replacement and asset refurbishment should lie with the company's asset management teams. Monetised risk, through the Common Network Asset Indices Methodology (CNAIM), considers many aspects of an asset, and is derived from factors contributing to the health and criticality of an asset. It does not, however, consider other elements such as engineering experience, guidance from manufactures or the consequential replacement/refurbishment of assets, i.e. when replacing poles along a route. An asset manager's decision when to replace or refurbish an asset is based on using all the available information available to them and therefore, whilst monetised risk is a useful metric, it should not be the only factor considered as to why a particular network intervention was chosen.

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

We agree. The electricity distribution sector has used a relative measure of risk or 'delta' target throughout both DPCR5 and RIIO-ED1 and this has worked well. A delta based target ensures that irrespective of changes up or down in the wider system risk, the licensee is always required to deliver the output it was funded to deliver at the start of the price control. A fixed point target risks windfall gains or losses to licensees and we question the benefits it would bring to customers compared with the delta-based target.

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

We do not believe there is enough time before the start of RIIO-2 to consider moving the sectors within this consultation to a long-term monetised risk measure. It took the electricity distribution sector two years to develop the CNAIM methodology and reporting under it is still undergoing refinement. It is therefore highly optimistic to consider developing a new metric before the start of the gas and transmission price controls. Ofgem should instead use the learning from RIIO-ED1 and implement monetised risk across the electricity and gas transmission, and gas distribution sectors who have spent considerable time and resource rebasing their RIIO-1 Health Index targets to fall into line with the current RIIO-ED1 approach.

A long-term measure of risk could however be explored for the electricity distribution sector given the price control is not due to start until 2023 and we are happy to work with Ofgem to progress this further and re-evaluate its suitability for RIIO-ED2.

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

As in our response to question CSQ21, we do not believe that long term measure of risk is appropriate given the timescales involved.

Ofgem have suggested setting an agreed monetised risk level or target objective through consultation with stakeholders including appropriate understanding of willingness to pay. Whilst we agree that stakeholders should be involved, along with an understanding of how different intervention strategies could affect customer bills, we believe this should be at a relatively high-level. Monetised risk, whether through the use of CNAIM or any new longer-term metric, is a very complex methodology and we question the ability of stakeholders to truly understand the intricacies of its operation to be able to give an informed view at a detailed level of what level of risk should be on the network. Network operators have the licence conditions to maintain a safe, reliable and efficient network and thus it is they that are best placed to ultimately decide what level of risk is appropriate, taking into consideration stakeholders feedback at a high level e.g. "maintain network risk, reduce network risk, allow network risk to rise".

We also have fundamental concerns about Ofgem's suggestion of the use of monetised risk benchmarking to determine allowances because, as it stands, the definition within the consultation is very high-level. One meaning of this could be for the use of data from RIIO-1, the amount of monetised risk delivered and the cost associated with that delivery to determine a benchmarked £ per point type volume driver. We have three major concerns with this type of approach:

1. **The level of risk on companies' networks are not the same.** For example if Network A is inherently riskier than Network B, then for the same interventions and spend Network A would deliver more monetised risk reduction points than the other for the same cost. This could make Company A seem more efficient than Company B. If Ofgem were then to set its efficient £ per point allowance at close to the rate of Company A, then Company B could find itself with insufficient funding simply because its

network has less inherent risk, regardless of whether it was to act in an efficient way when implementing its intervention strategy.

2. **Companies work programmes are not the same.** Interventions, whether replacement or refurbishment, asset to asset, cost different amounts of money. Setting an arbitrary £ per point allowance would not take into account the different make-up of company investment strategies and it would effectively incentivise companies to search out 'cheaper' interventions aiming to outperform the £ per point allowance. This may not drive the right behaviours and ultimately not be in the best interests of customers.
3. **Monetised risk coverage differs.** Certainly within RIIO-ED1, not all assets that fall within CNAIM are included by each DNO in their targets for RIIO-ED1. As can be observe in Table 1 below, there are significant differences in the level of HI Asset Categories that contribute to each DNOs RIIO-ED1 target.

HI ASSET CATEGORY	ENW	NPG	WPD*	UKPN**	SPEN***	SSE***
LV	3/3	1/3	3/5*	3/3	1/3	2/3
HV	4/5	4/5	4/5	4/5**	4/5	4/5
EHV	8/9	9/9	8/10*	8/9**	3/9	6/9
132	7/8	8/8	8/9*	7/8	7/8***	4/8***
OTHER	0/1	0/1	0/1	0/1	0/1	1/1
TOTAL	**22/26**	**22/26**	**23/30**	**22/26**	**15/26**	**17/26**
	85%	**85%**	**77%**	**85%**	**58%**	**65%**

Table 1 - CNAIM Reported HI Asset Category DNO Comparison

* WPD have additional categories at LV, EHV and 132KV voltage levels due to being fast-tracked

** UKPN has two less reporting categories in their LPN license as we do not have any assets to report against at the '*OHL Support – Poles*' HI Asset Category at HV and EHV voltage levels

*** Both SPEN and SSE do not report any categories at the 132KV voltage level in their respective Scottish licence areas as they do not own this part of the network

Instead, we believe for RIIO-ED2, Ofgem should retain and update the cost setting allowance methodology it used for RIIO-ED1 whereby interventions were benchmarked on a cost and volume basis. This will ensure that companies will not be penalised for the inherent makeup of their networks, leading to incentivising the right behaviours of efficient interventions.

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

- **Option 1 –** We do not support this option. This would lead to a work programmes becoming start-stop as the framework would not apportion risk appropriately. If it is Ofgem's intention to drive companies to take a longer-term view of asset management – then this option should be avoided.
- **Option 2 –** We can understand Ofgem's intention with this option, implemented so that customers only fund work that is generating an output, but the terminology around the use of the word 'true-

up' needs to be more clearly defined. One reading of the definition could be that at the end of the period, Ofgem will 'true-up' the allowances associated with work spanning price-controls. This could mean that there is no incentive for efficient delivery as Ofgem will true up the costs at the end of the control, in other words efficient delivery would not be rewarded, or inefficient delivery not penalised. Instead the intention of the true-up should ensure that only work that is delivered in the period is funded, the remaining allowance should then be available in RIIO-3, but the original allowance should not have changed from that granted at the start of RIIO-2. This would also require some form of separation of such work from wider works purely associated within one price control. This has implications for how output targets are set, performance is reported on and licence conditions and close-out methodologies are drafted.

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

The only concern we have with the proposals is how Ofgem propose to deal with the unjustified under-delivery. Putting aside our earlier comments on long-term monetised risk – the proposal for unjustified under-delivery is to penalise companies by the amount equivalent to the monetised risk benefit that customers have lost (i.e. the life time benefit). Depending on the intervention and the asset involved, the size of the penalty has the scope to be disproportionally large. For example, an unjustified under-delivery of a £1million asset replacement, but that would have provided £10million worth of customer benefit, would see the company being penalised by £10million. This is disproportionate and creates an inappropriate asymmetric incentive mechanism. Furthermore, the company may deliver that asset replacement in the next period, restoring that customer benefit, and thus making the previous penalty inappropriate.

Instead a pragmatic solution for and an unjustified under-delivery would be to maintain and refine an approach similar to the RIIO-ED1 mechanism, whereby the licensee losses the allowance and associated financing benefit associated with that allowance, alongside a 2.5% penalty of the value of that under-delivery.

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

We broadly agree with Ofgem's proposal. However, there is merit in exploring whether an assumed level of risk from other areas could and should be included in both RIIO-2 targets and reported delivery. One such area may be faults, particularly where faulted assets are replaced. Given the different network characteristics across gas, transmission and electricity distribution, we believe this should be taken forwards as part of the RIIO-ED2 sector specific development.

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?

If the intention of these ring-fenced projects and activities is similar in nature to how High-Value Projects (HVPs) operated in RIIO-ED1 then we agree with Ofgem's intention. We note that in RIIO-ED1, HVPs are included in licensee's overall output targets. We believe there is merit, from a simplicity and transparency perspective of reverting to a similar approach used for DPCR5 whereby HVP outputs were separately identified and assessed.

WORKFORCE RESILIENCE

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

We note Ofgem point to perhaps developing a similar metric for workforce resilience as constructed under the NARMs mechanism but that it may not be practical. We believe for the sectors whose price-control start in 2021 it may be challenging for them to develop a coherent framework in the timescales available. Companies should however be supported through their allowances to ensure they have a workforce with the right skills that reflect the communities they serve. A series of surveys of companies' workforce strategies could then be undertaken to ultimately inform whether it is necessary to design and introduce any metrics in these areas for RIIO-2.

PHYSICAL SECURITY

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

We support Ofgem's intention subject to the definition of 'Physical Security' remaining as all works that fall under the Physical Security Upgrade Programme (PSUP).

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

We agree with Ofgem's proposed approach of ex ante allowances for PSUP works mandated by government.

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?

We agree with Ofgem's proposal to include a reopener mechanism to deal with changes to the PSUP. This should operate like the re-opener in RIIO-ED1, i.e. by having a £0 reopener materiality threshold.

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?

As with the reopener in RIIO-ED1, the opportunity to reopen the price control for physical security should be at the mid-point of the control, i.e. Year 3 (summer 2025) taking account of changes since the setting of the price control in late 2022. There should also be a review as part of the close-out process. This will ensure that any outcome and recommendations from physical security reviews of Critical National Infrastructure by BEIS can be accommodated and taken forward appropriately.

CYBER RESILIENCE

CSQ32. Do you agree with the scope of costs that are proposed to fall under cyber resilience, ie 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.

In February 2019 we submitted out NIS Directive self-assessment to Ofgem. 2019 is a formative year to understanding the implications and requirements of the NIS Regulations for both ourselves and Ofgem. As we further develop our understanding in this area it will become more apparent as to the most appropriate way to treat the scope of costs that are as a result of this and other cyber resilience investments.

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.

We question why Ofgem feel the use of an ex ante 'use-it or lose-it' type arrangement for funding is appropriate. A set allowance provides companies with the incentive to search-out the most efficient delivery model for any scope of works, an incentive that benefits both customers and shareholders through the Totex Incentive Mechanism and Sharing Factor. With cyber resilience becoming such an important defence, particularly within the energy sector, the scope for investments in this area could grow considerably. Sticking with a 'use-it or lose-it' type arrangement provides no incentive for companies to deliver efficiently and could inadvertently encourage licensees to undertake unnecessary investment decisions, which grow their RAV rather than deliver savings to customers. This approach would not be in the best interests of customers. Greater clarity is required on how efficient allowances will be established and any ongoing efficiency and output assessments will be undertaken. Given our responsibility for key locations in GB, we believe this will be an area of ever increasing importance in future price controls.

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. As with answers to questions CSQ30 and CSQ31 a re-opener should be included within the price-control to cover any scope of works or changes in government policy that were not included within the original allowance. Aligned with the re-opener with physical security, this should have a £0 materiality threshold, with a trigger point at the mid-point of the control.

REAL PRICE EFFECTS 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?

The range of indices proposed by Ofgem in Table 11 of Appendix 1 look broadly sensible, with the exception of RPI. As part of moving to a CPIH based price control framework, RPEs will need to be calculated on a CPIH stripped basis. However, as DNOs are in the process of changing their business models to become DSOs they will be procuring services that they have not historically procured e.g. flexibility services. Dependent on how the latter develops, over the short term it may be necessary to review the list of indices included in RPE indexation.

With respect as to whether RPEs are required, Figure 3 below shows the rise since 1991 of RPI against civil engineering labour, supervision, copper pipes and accessories prices. This figure clearly demonstrates that input prices can be volatile and many input prices have historically risen at a rate much greater than RPI growth. If RPEs are not considered in the RIIO-2 methodology there is a significant risk that movements in input prices are not fairly reflected.

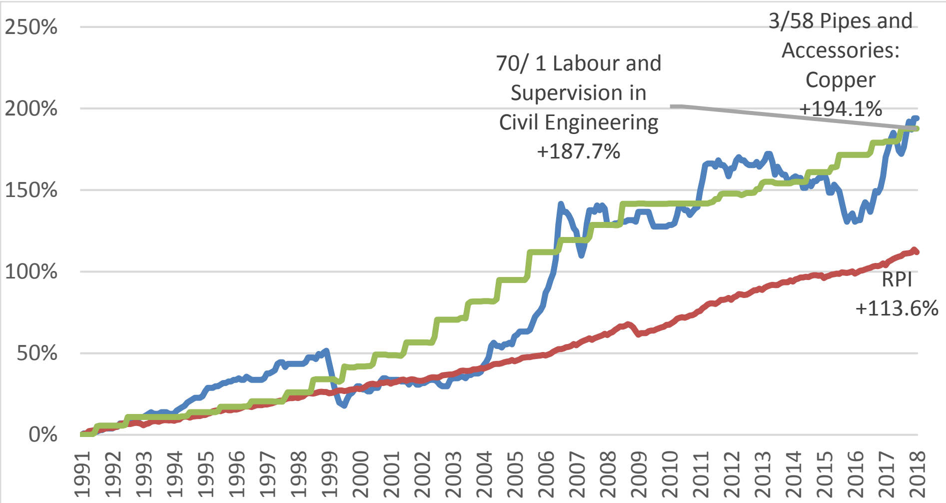

Figure 3 - RPEs Vs RPIs Comparison

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

Notional cost structures are only valid in companies are utilising similar business models. For example, dependent on the relative speed of transition to the DSO model across DNOs there may be different opex/capex splits across companies. This would need to be assessed at the business plan submission stage.

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

Yes, we agree with Ofgem's proposal to include a forecast of RPEs in the base allowances and then to update these annually as part of the annual iteration process.

ONGOING EFFICIENCY QUESTIONS

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

Our preferred approach to assessing ongoing efficiency is for Ofgem to require companies to set out their evidence for the scope of such efficiency improvements as part of the business plan submission. Ofgem can then use datasets such as the EU KLEMS data to cross check the company assumptions.

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 believe there is merit in considering an utilisation incentive in electricity distribution. However, we welcome clarity from Ofgem on what they define as a utilisation incentive, as we think it may not be consistent with our definition. Our understanding of the utilisation metric used in Sweden, which Ofgem references in its consultation document, is that it was crudely based around reducing total peak network demand (MWh). Instead, we believe a utilisation metric should be the ratio of peak demand observed on a particular feeder versus the (MVA) capacity of that feeder, and that any incentive should focus on maintaining capacity headroom.

For example, alongside increased monitoring of network flows this could sharpen the incentive on DNOs to transition to DSOs in areas where DER uptake is forecast to create constraints and drive network upgrades. This could work particularly well when trialled alongside more cost reflective charging signals and time of use tariffs, as being discussed as part of Ofgem's wider work. In this regard an utilisation incentive could reward or penalise DSOs for staying within or going beyond a network capacity threshold, which should help decrease the risk of supply outages and therefore cost or disruption to customers.

If designed correctly this would have the significant benefit of reducing demand peaks further up the network, therefore Ofgem must consider that a successful utilisation factor for distribution networks could mean transmission networks could be consequently less utilised in the future, if current DER forecasts prevail. This demonstrates the importance of taking a whole systems approach that looks at the cost benefit of different options across systems boundaries. For example, incentivising greater utilisation at lower voltages, can help offset need for reinforcement at higher voltages. To the contrary increasing network utilisation at high voltages will not lead to any obvious benefit at lower voltages where the vast majority of electricity demand is located.

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

We broadly support Ofgem's rationale that any investment ahead of need must be in customers' interests and it is network companies' responsibility to demonstrate this by working with their stakeholders. As at RIIO-ED1, we believe that where a licensee has a well-justified case for investment which will deliver benefits into the future, the RIIO-2 framework should encourage companies to bring such cases forward as part of their business plan submissions. Where there is significant uncertainty about the needs and merits of proposals at the time of business plan submission, the framework should facilitate review of such proposals during the period via an appropriate uncertainty mechanism.

Under RIIO network companies are already starting to take a stronger role in addressing societal issues. For example, we are working closely with the Greater London Authority (GLA) to ensure our network can facilitate a switch to cleaner, electric, forms of transport in London. This will help us work together to tackle where poor air quality is having the greatest impact on citizens. Poor air quality can disproportionately affect the most vulnerable sections of society. For RIIO-ED2 we are open to dialogue with Ofgem and government as to achieving an appropriate balance between using the price control and other funding sources to deliver significant benefits to wider society. This is particularly pertinent in areas such as climate change, given the need to ensure that network are resilient to evolving challenges.

Elsewhere in the consultation document Ofgem has highlighted the work that UK Power Networks is doing to open up network requirements to competition, which is summarised in our Flexibility Roadmap.[8] Essentially, this rewards customers who can provide flexibility as an alternative to traditional network solutions. As we seek to deliver cost efficient solutions (e.g. through the use of flexibility), we would welcome further engagement with Ofgem and government on how best to make effective use of all funding being directed at network issues.

We are concerned that treating anticipatory investment differently from other spend will have unintended consequences by creating a grey area between what is deemed to be in this category versus business-as-usual (BaU) spend. As an alternative, we would support the extension of a mechanism such as the RIIO-ED1 HVP arrangements. With clearly defined outputs and end of period assessment, the RIIO-2 framework should be able to accommodate new 'anticipatory investments' whilst affording protection for customers from asset stranding or non-delivery.

Ofgem's proposal on anticipatory investment also has an interplay with their other proposals on RAMs and the blended sharing factor, and therefore must be considered carefully to avoid unintended consequences in RIIO-2. We are concerned there is a risk that Ofgem's currently proposed RIIO-2 package could drive the wrong type of behaviour. For example, the implementation of a RAM will act to limit underperformance e.g. overspend exposure and will also limit outperformance e.g. share of underspend. However, if Ofgem creates different arrangements for certain types of investment, compared to those within the totex framework, which are subject to a RAM, there is a risk that this sends distortionary investment signals.

As an alternative we believe that Ofgem should treat all projects equally when assessing a company's business plan. Consequently the onus should be on network companies to work with their stakeholders to justify that their plans are in the best interests of customers. This should be backed up by common assessment tools, such as CBAs, to ensure that customers are protected from speculative investments that ultimately may become stranded. At the same time it should enable companies to propose investments for which they have a strong degree of confidence will yield significant benefits to customers if acted on early.

We are concerned with Ofgem's proposal that via the blended sharing factor they will assign a higher sharing factor to a project defined as 'anticipatory' to reflect a higher risk reward profile. If, for example, this project fails to materialise due to unforeseen circumstances, it is unclear what would then happen to the blended sharing factor within the price control. Any readjustment would not only have a significant impact on the network company's cash flows and performance, but would also affect other licensees' if a sector-wide RAM is applied. The complexity and uncertainty of making ex-post adjustments to sharing factors undermines regulatory certainty and creates a lack of clarity for customers and investors. As a result we do not recommend Ofgem progresses this in RIIO-2.

[8] https://www.ukpowernetworks.co.uk/internet/en/have-your-say/listening-to-our-connections-customers/flexibility-services.HTML

Ofgem proposes to tighten their evaluation of a project's need as part of a "higher hurdles" test. This will require network companies to present evidence to justify project spend, which will cover how it addresses customers' needs and a CBA that demonstrates why the option chosen is the best of those available. We believe the same process should apply to projects regardless of whether they are viewed as anticipatory or not. We are unclear of Ofgem's point on encouraging *"circumstances where expenditure is justified on the basis of policy objectives beyond our remit or whole economy",* and seek clarity of whether this represents a major policy change.

We welcome Ofgem's proposal to create an Electricity Networks Strategy Group to encourage a joined up approach towards anticipatory investment from a whole systems perspective, and would welcome the opportunity to further discuss how this could operate. Nevertheless, we are mindful that there is now a wide range of engagement groups being created and there is a risk of duplication, cost and confusion over decision-making. Therefore we strongly encourage Ofgem to consider how these groups fit together as part of the overall governance structure in RIIO-2.

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

The totex regulatory framework already includes a risk-sharing mechanism, which encourages network companies to deliver their outputs and licence obligations at the lowest cost. Importantly any cost saving or cost overrun compared to set allowances is shared between companies and customers, which means there is an equivalent risk and reward profile. We believe all projects should be considered under this approach in the same way, and we see no rationale for introducing a new approach for certain types of investment. Ofgem has moved away from differential sharing factors over successive price controls and has ultimately arrived at a single sharing factor covering all totex in RIIO1. We are concerned that Ofgem's proposals, such as the blended sharing factor, represent a step backwards from where RIIO-1 has got to by treating cost types differently. However, we see no clear or compelling evidence that this will deliver benefits to customers.

We are particularly concerned that any new risk-sharing approach by Ofgem will set a precedent that is misaligned to the objectives of the Smart Systems & Flexibility Plan jointly issued by Ofgem & BEIS. For example, UK Power Networks in its transition from a DNO to DSO has developed a Flexibility Roadmap that aims to stimulate new local flexibility markets. However, this is on the basis that we can use native competition to pass on value to flexibility providers that would otherwise be used for capex investment. This market testing approach can and should apply both at the transmission and distribution level. Furthermore, through a whole systems approach it is possible to simultaneously resolve transmission constraints by deploying flexibility at the distribution level i.e. demand peaks are prevented from manifesting up voltage levels. Yet, there is a risk that anticipatory investment at the transmission level dilutes the value of local flexibility by removing the opportunity to compete on a level playing field. It is also potentially at odds with the Network Access & Forward Looking Charges Review, which aims to make charge signals both fair and cost reflective, in that it creates a potential distortion between opex or capex solutions.

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

We acknowledge there could be circumstances whereby government can help meet their policy objectives either through strategic infrastructure investments under their direct control, with network companies acting as delivery bodies, or by encompassing such funding within the price control itself. A good example of the former is the Infrastructure Planning Authority's new £400m fund for EV-charge-point infrastructure[9], which could be partly used to deliver anticipatory investment that is in citizens' interests. We believe Ofgem should continue to work with government and network companies to ensure that business plans set prior to RIIO-2 can deliver key strategic policy goals, whether these are local or national.

Network companies have agreed engineering standards that they work to ensure security of supply. These standards are continuously being reviewed and updated, for example, Ofgem is currently signing off P2/7, which goes further than P2/6 in terms of its treatment of system flexibility. If there is a proposal to work to a different standard, either as a collective or by individual licensees, we think this must be clearly justified in terms of a CBA for customers. We recommend that these decisions are not conflated to cover wider policy decisions on anticipatory investment. Once standards are agreed licensees should be free to decide how they will meet these and the Totex Incentive Mechanism ensures that this is done cost efficiently.

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

We believe that there needs to clear demarcation between what are a licensee's duties i.e. meeting a certain standard of security of supply and what is part of delivering a wider policy outcome.

Through our engagement with internationally based network companies we are aware of arrangements, for example, in California where there is a perceived market failure in the availability of public EV charge points in urban areas. To address this network companies have taken a stronger role in providing strategic infrastructure and have developed novel cost recovery mechanisms as part of this. We are continuing to monitor these arrangements to understand the potential read across for RIIO-ED2.

INNOVATION QUESTIONS

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

We agree that innovation should continue to be deployed as part of our business-as-usual activity. Our view is that the Totex Incentive Mechanism coupled with a suitable sharing factor is the best way of driving this. We caution against introducing the blended sharing factor, which we believe will make doing innovation as BaU more challenging.

Throughout RIIO-ED1 we have continued to roll out innovative solutions into our BAU practices and have reported on savings in our E6 tables. We have a total of twenty seven E6 solutions transitioned to BAU.

However, the risk associated with innovative investments makes it less attractive to be the chosen solution unless there is a strong incentive to do so, or the innovation is at high technology readiness level to reduce the risk. It is important to consider how best to allow high risk, high benefit innovation to happen. Due to this, we agree that companies should fund lower-risk operational and capital innovation projects as BAU. We have proven that innovation can return a positive return on investment and is essential to outperform challenging price control categories.

We would welcome further clarity to understand how '*any funding for BAU innovation which is not rolled out will be recovered as part of close-out for RIIO-2'.* From our experience, innovation projects carry a high

[9] https://www.gov.uk/government/news/management-of-400-million-electric-vehicles-charge-fund-opens-to-bidders

degree of uncertainty and can take longer than originally envisioned. Therefore, we welcome more clarity around the criteria Ofgem is considering to put in place for returning funds already spent.

We support Ofgem's proposal for network companies to demonstrate in their business plans how they will apply innovation as part of business-as-usual activity. We continually revise our innovation strategy to ensure we remain focussed on meeting the challenges that matter to our customers most. As part of our governance process, all projects include a Gate D 'Deploy and Track', through which we ensure that there is accountability to deliver the re-baselined benefits case, along with the correct tools to track the benefits of the particular solution.

We are strong advocates of third party involvement in our innovation programmes and have worked extensively with many industry players across our innovation portfolio. We are also keen to continue to set bold and ambitious targets in our innovation strategy commensurate to the potential benefits these provide our customers. To achieve this it will be important for us to understand how Ofgem will assess rewarding or penalising the 'ambition' of our innovation strategy using feedback from engagement groups. We believe there are different approaches to collecting feedback from stakeholders as part of this and Ofgem should further consult with industry to identify and adopt the best approach. For example, it may be appropriate to use established local stakeholder groups rather than an independent group looking across the whole sector, which will find it more difficult to assess and compare local challenges.

Finally, we believe that an innovation stimulus package in RIIO-2 similar to the NIC will provide benefits to customers. For example, we have spent £35m as part of an innovation stimulus in RIIO-1 and have delivered £149m in customer benefits.

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

Yes, as RIIO-ED2 will be five years instead of eight, we do not see the requirement of having a mechanism for securing additional funds for rolling out innovation solutions. Also, we see the uptake and award of this mechanism has been limited in part due to the management and criteria of the initiative.

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

We agree. Networks have made marked progress to align strategic priorities through the sector specific innovation strategies. We agree that it is important to focus funding on the most important and transformational challenges the industry faces.

Whilst we identify with the need to utilise the funding to channel strategic energy initiatives, it is important that the funding available can be applied flexibly, so that the sector can respond appropriately to a fast-changing energy landscape and does not ignore upcoming challenge areas and unintentional loss of associated opportunities. We recommend that to support this Ofgem does not make using any innovation funding pot in RIIO-2 onerous in terms of the regulatory and governance requirements.

In the past, NIC funding has enabled simultaneous projects looking at different and equally important challenges. We would be keen to participate in problem definition and call for ideas and welcome engagement with Ofgem on how often this process would take place in RIIO-ED2

We agree that it is important to continue to demonstrate collaboration between network companies; therefore we want to build on our partnerships in RIIO-2. In RIIO-1 we have made great strides in network innovation by working with other licensees such as National Grid, for our Power Potential project, SPEN, for our Active Response project, and more recently SSEN with our Optimise Prime project. Collaboration also continues outside of the regulated stimulus package as evidenced in our various partnerships with NPG and SSEN on the Innovate UK V2G portfolio.

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

The proposal to raise funding from use of system charges as they are during NIC is a reasonable way to socialise the costs of investments that will deliver customer benefits. We are also initially supportive of ESO innovation funding being recovered from BSUoS.

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

We agree with Ofgem that innovation should continue to be deployed as part of network companies' business practices and we think the Totex Incentive Mechanism, coupled with a suitable sharing factor, is the best way of achieving this.

Whilst the Network Innovation Allowance (NIA) has provided an important stimulus for smaller companies to develop innovative products and services in RIIO-1, as the market is now more mature there is merit in considering whether NIA could become business-as-usual. We therefore recommend that Ofgem simplifies RIIO-2 by removing the NIA and the reporting burden associated with it.

Our view is that Ofgem should avoid introducing innovation allowances in RIIO-2 that may be subject to arbitrary reductions, which we do not believe are in customers' interests. We believe that long term trajectories with iterative improvements would deliver best value to customers as it allows all parties (network companies, suppliers, SMEs and others) to respond to those changes over time.

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

If the current NIA is to be retained reporting requirements should be more visible and consistent in RIIO-2. To demonstrate that we are serious about this, we have been part of a collaborative initiative with other network companies that has looked at how to improve the way we measure the value that any innovation stimulus provides in RIIO-2; the findings of which have been shared with Ofgem's innovation team.

We would welcome a collaborative approach between Ofgem and the network companies to develop a best in class benefits reporting framework for any RIIO-2 innovation stimulus. This would ensure it is efficient to complete, consistent across network companies and can be used to demonstrate the value innovation brings to network customers.

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

Yes we agree with Ofgem's proposals that will enable us to continue to collaborate on innovation projects between 2021 and 2023.

COMPETITION QUESTIONS

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

As a principle, we support Ofgem's use of competition wherever it can demonstrably benefit customers by driving cost efficiencies without reducing service delivery. Since the start of RIIO-ED1 there has been a significant increase in competition for new connections, with both Independent Distribution Network Operators and Independent Connection Providers undertaking a large share of contestable works. For single, high value projects, Ofgem has understandably been looking at the role of what it defines as 'early' competition as a way of ensuring price discovery; however, until this has been shown to consistently deliver benefit, we do not see a case for exploring its use for lower value projects. Importantly, the Totex Incentive Mechanism already drives network companies towards native competition that can deliver cost savings, which are then shared with customers via the sharing factor. We strongly believe that totex incentives provide the right risk and reward balance by encouraging network companies to deliver their outputs at lowest cost.

Whilst we acknowledge Ofgem's project timeline process differentiating between 'early', 'late' and 'very late' competition within the electricity transmission sector, we do not think this is appropriate for electricity distribution. Firstly, as mentioned above, competition is already benefitting customers in RIIO-ED1. Secondly, the materiality threshold demonstrates that Ofgem's approach is designed for larger schemes of work, which are uncommon in electricity distribution. Thirdly, through what Ofgem calls native competition, we are now opening up our network requirements to the market, more detail of which is discussed below.

To help support local flexibility on distribution networks and facilitate market liquidity, UK Power Networks has developed the concept of flexibility zones, in which market providers can replace the need for network reinforcement up to 18 months ahead. We currently have 27 active flexibility zones on the Piclo flex platform[10] which anyone can bid into. Importantly, this has been a collaborative effort that has involved listening to and adapting to our stakeholders' requirements. The totex model in RIIO-ED1 underpins our progress, therefore we do not see merit in Ofgem exploring other models of competition in RIIO-2 to address distribution led issues such as reinforcement.

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?

We cannot see a rationale for Ofgem including their 'late' model of competition in the electricity distribution sector. As Ofgem acknowledges in the consultation document, the criteria developed around late competition has been defined around the electricity transmission sector. As a result this would be inappropriate to apply to electricity distribution, where projects are of a different nature and scale. Furthermore, Ofgem is yet to demonstrate that their late competition model can work at the electricity transmission level and therefore we would question why it should be extended elsewhere.

[10] https://piclo.energy/flex

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

We have concerns that Ofgem has not yet fully considered the wider impacts on customers from adopting their approaches to competition. In particular we are unconvinced that enough attention has been given to the allocation of risk with regards to the construction phase, as well as the operation of assets post construction. For example, the network company will be expected to deliver a project on time in the same way that it is now, although it is unclear whether they will have the same risk reward balance; and if this is not the same, whether this will translate into greater delivery risks to customers.

We have reservations with regard to the strength of evidence Ofgem has provided on the benefits case for both the Special Purpose Vehicle (SPV) model and Competition Proxy model. We believe more work is required to justify moving towards any implementation phase. Due to the additional risks and complexity associated with the SPV Model, it is uncertain whether these will be justified by any lower project costs borne by customers. Whilst there are legitimate reasons for driving competition to reveal potential cost savings, Ofgem should ensure they review whether the SPV model has worked as intended at pre-agreed checkpoints e.g. every three-years from policy commencement. This review should conclude whether continuing competition under this model is appropriate for both existing and future customers. We believe Ofgem's proposed Competition Proxy model is fraught with difficulty and represents a poor alternative to achieving genuine competitive dynamics in network price controls. If this is applied in electricity distribution, where competition is already taking place in connections and natively through flexibility tenders, it is likely to increase the barrier for new entrants. In addition to the practical challenges of how any proxy would be implemented, we would expect this to weaken the price signal sent to flexibility providers.

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

When looking at electricity distribution, Ofgem should consider the existing role of Independent Distribution Network Operators (IDNOs). It is particularly concerning that in its draft Impact Assessment, Ofgem mentions its intention to extend the role of competition into other sectors such as electricity distribution, yet there is no recognition for the arrangements already in place. We therefore recommend Ofgem combines its analysis on the CATO and SPV models, with the progress that IDNOs have made. This should also include a review into the customer benefits and sustainability of IDNO arrangements within electricity distribution. For example, as IDNOs take on a greater share of new connections, Ofgem must address differences in the regulatory arrangements between IDNOs and DNOs to ensure there is a level playing field.

Given the benefits that the RIIO framework provides customers we believe Ofgem should consider extending RIIO to IDNOs, subject to a de-minimis size threshold. When considering extending RIIO to include IDNOs, Ofgem would need to consider factors such as the more disparate nature of IDNOs' network area, the age of their networks and the composition of their customer base.

There are many areas where IDNOs currently do not have to comply with a number of performance and reporting obligations in their licence including:

- The Incentive on Connections Engagement and Average Time to Quote/Connect – protecting future electricity distribution connectees;

- The Broad Measure of Customer Service, comprising of three components (complaint handling, telephony performance and an independent customer service survey) – protecting ongoing levels of customer service for electricity customers; and
- Interruptions Incentive Scheme – protecting electricity customers from a poor level of quality of supply.

With this in mind we seek clarity that Ofgem's work plan will address these differences, as requiring an IDNO to comply with the above obligations will ensure that customers connected to its network are afforded the same protection as those connected to a DNO network.

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 agree with Ofgem's concerns that deliverability could be an issue in early competition if it is not the party who comes up with the proposal that is given the output to deliver. This supports our view that native competition where the outputs are given to the party best able to deliver is the best option for customers.

As we transition from a DNO to a DSO we will look to work with Ofgem, the ESO, TOs and DNOs to develop a system wide Network Options Assessment (NOA) based on common principles; this will help avoid any risk of conflict or duplication when considering early options. Alongside greater transparency of network companies' CBAs, we believe this will also help mitigate any perceived concerns around companies' having conflict of interest.

CSQ56. Are there other potential drawbacks of early competition?

Through our flexibility tenders we are able to ensure that early competition is in the interests of our customers by conducting a full cost-benefit-analysis (CBA) of the different options, which ensures both cost efficiency and deliverability. The RIIO regulatory framework is enabling us to develop a CBA that evaluates all available options across both short and long timescales. Therefore, we strongly recommend Ofgem continue to use the totex approach in RIIO-ED2 to stimulate nascent local flexibility markets, whilst ensuring distribution network companies remain accountable for service delivery when contracting and deploying any market based solution.

At electricity transmission, where projects are typically linked to a particular development e.g. a new large generator connecting, there is a greater risk that projects fail to materialise due to the longer timeframes involved. This creates different risks around early competition than we would see at electricity distribution. For example, we can be confident that the procurement of local flexibility will provide optionality value across a number of different scenarios. However, if electricity transmission related expenditure is directly linked to a single market-based development that does not materialise, it is likely that the optionality value of any third party solution will be low.

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?

We regularly engage with network companies from across the world in order to knowledge share, develop our thinking and help identify best practice. To the best of our knowledge we are globally one of the first network companies to open up our load related reinforcement requirements to the market. Therefore in the vast majority of our engagements we have found that other network companies have been very keen to understand the RIIO framework in more detail. This is because RIIO is internationally recognised as a major step forward in network regulation, which has led to greater innovation and competitive dynamics.

As further detailed in our response to question CSQ51, we are actively demonstrating 'early' competition by enabling market players to defer or avoid traditional capex via the Piclo flex platform. As soon as we forecast a network constraint we aim to make this transparent to the market to enable them to bid into our flexibility tenders; this means in most cases we are signalling our need 18 months ahead of delivery. Importantly, this is providing our customers benefits, because if we are able to reduce the costs associated with managing network constraints, this translates into bill savings via the Totex Incentive Mechanism.

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?

We have made great strides in developing early competition within our distribution networks and we are committed to opening up many of our network requirements to the market as detailed in our Flexibility Roadmap[11]. The RIIO regulatory framework is enabling us to develop a cost-benefit-analysis that evaluates all available options across both short and long timescales. Therefore, we strongly recommend Ofgem continue to use the totex approach in RIIO-ED2 to stimulate nascent local flexibility markets, whilst ensuring distribution network companies remain accountable for service delivery when contracting and deploying any market based solution.

A key disadvantage of moving away from the totex model and/or changing who is responsible for running tenders is that it would both disrupt the progress being made through flexibility tenders, and, reduce accountability for output delivery by splitting responsibility across more parties. To mitigate against this, Ofgem should work with DNOs to ensure that they retain accountability for service delivery, whilst facilitating competition in a way that meets their stakeholders' needs.

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?

We do not believe Ofgem's proposed criteria for early competition is appropriate for electricity distribution. In RIIO-ED1 we are already setting out where the market can help deliver our outputs at the lowest cost for customers. For example, by signalling areas where flexibility can help defer and/or avoid network constraints 18 months ahead of need, market players have an opportunity to engage with us on their proposals. Due to the immaturity of the market in the areas we are seeking to procure flexibility solutions, we are closely working with providers who often have highly innovative proposals. We believe at this stage this is the best approach to stimulating local flexibility markets.

[11] http://futuresmart.ukpowernetworks.co.uk/wp-content/themes/ukpnfuturesmart/assets/pdf/futuresmart-flexibility-roadmap.pdf

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

We agree with the criteria set out by Ofgem, but believe further analysis is needed on the transaction and coordination costs of who run the competitions. For example, it is very likely that an Impact Assessment would show there is a significant saving to customers by keeping native competition with DNOs versus handing this role over to the ESO.

We recommend the following criteria is used for early and late competitions:

- ESO: Project > £100m across electricity industry
- DNO: Projects < £100m within service area as DNOs understand their assets and can carry the risk of solutions selected through competition

Ofgem must also consider the appropriateness of different funding routes as part of its assessment of who and how tenders are run in the future. For example, DUoS and TNUoS related costs from DNOs and TOs respectively, are recovered over a long time-frame. This reflects the fact that these are asset heavy companies and helps to balance the cost impact on current and future customers. In contrast the ESO recovers its costs using BSUoS, which is recovered under a much shorter time-frame due to the asset light nature of the ESO's investments. Consequently, we question whether it is appropriate for the ESO to be funding network based assets that have long lifetimes through BSUoS. Nevertheless, we recognise that there will be strong synergies between the challenges both the ESO and other network companies' face in facilitating the energy transition, hence close collaboration is required to facilitate competition.

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

Yes, we agree that native competition describes a licensee using the Totex Incentive Mechanism to meet agreed outputs cost efficiently e.g. UK Power Network's tenders.

We agree that market testing will help to reveal prices, hence we have committed to doing this on all Load Related Reinforcement in RIIO-ED1. However we believe the totex model alongside a stable and fair sharing factor at the outset is the best way for DNOs to open up competition.

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?

In RIIO-ED1 the Totex Incentive Mechanism has demonstrably proved a powerful way of encouraging network companies to deliver their outputs at lowest cost. The removal of any capex bias through totex has enabled UK Power Networks to develop one of the first DSO-led flexibility markets in the world and there is no evidence of a distortion between network and non-network solutions. However, to avoid any perceived bias we have committed to undertaking independent assurance of our procurement process in 2019.

In paragraph 8.88 of the main consultation document Ofgem states that regarding the use of flexibility *"it is not obvious that companies should keep a significant proportion of the 'saving' in the control period as* *profit".* We are concerned that based on this Ofgem has misinterpreted how totex allowances are set from one price control to another. Any saving is shared with customers via the totex sharing factor and, importantly, if we do not need to reinforce in later price controls, this will result in the greatest customer cost saving. As flexibility markets mature we expect to see the blended unit cost to form part of the relevant cost assessment modelling that will ultimately inform future totex allowances. It is critical that Ofgem does not lose sight of how powerful the totex model is; therefore focus should be on using this as a way of continuing to incentivise competition.

Currently we are incentivised to procure any non-network solution that helps us meet our outputs as long as it is more cost efficient than the traditional solution, which has been benchmarked. This means that if network reinforcement is the only benchmark, we are incentivised to utilise flexibility that is cheaper on a Net Present Value (NPV) basis. As we, for example, start to procure greater volumes of flexibility instead of reinforcing, our costs may decrease as local markets mature; this would then lead to a lower unit cost that is factored into future benchmarking processes.

Further to the above, we believe that Ofgem's assessment as part of the proposed Business Plan incentive should include network companies' level of commitment and ambition with regards to using native competition. Naturally, Ofgem's confidence around the delivery of this will be based on the network companies' work to date, as well as the detail within their business plan.

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 believe that a cost plus margin approach will distort investment decisions between choosing opex and capex and could therefore lead to the wrong type of behaviour with respect to Ofgem's objectives. This approach would be particularly fraught in distribution areas that are expected to experience a high number of network constraints in the RIIO-2 period.

Therefore, we do not agree with Ofgem's proposed approach and believe it could delay the progress being made to develop local flexibility markets. Through native competition and the totex model, network companies can assess network and non-network options on a level playing field. This means that if a market based solution is more cost efficient than the solution previously used to deliver the same output, there is an incentive to adopt it. By pre-emptively forecasting the costs that will be revealed through competition and setting an ex-ante allowance based on these, Ofgem is undermining the core benefit of the totex approach. Nevertheless, once costs have demonstrably reduced as a result of competition and there is evidence to support lower unit costs in the next price control, we see a rationale for including these.

Given the experience of the smart grids adjustments applied to cost allowances as part of the RIIO-ED1 settlement and their subsequent challenge and quashing at the CMA, we are wary of similar "ex-ante" approximations being used to set allowances for RIIO-2. We believe revealed performance, with competition occurring during price controls driving costs down which is subsequently captured and baked in going forwards, is a far more robust and defensible approach for the regulator to take.

Whist a margin or fee approach to running competitions may work in a mature market, we think this approach is unsuited to developing new markets where there is uncertainty about deliverability and costs. A key benefit of the DNO to DSO transition is that it ensures that security of supply will not be compromised at the same time as facilitating the energy transition. For example, network companies have clear accountability for meeting engineering standards that deliver high service levels; this is then reflected when contracting and deploying non-network solutions. In contrast, it is unclear how non-network options could be adequately benchmarked to conventional options by moving to a cost plus margin approach.

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

As per our response on the definition of whole systems (CSQ8), this option would need to be consistent with definitions, roles and responsibilities used elsewhere. Clarity would be required on the ongoing role of the existing ESO responsibilities if ultimately Ofgem is looking to have a single transmission system operator.

BUSINESS PLAN AND TOTEX INCENTIVES QUESTIONS

CSQ66. What are your views on our proposed approach to establishing a Business Plan incentive?

We support Ofgem's proposal around a Business Plan incentive. This should drive the right behaviour in RIIO-2 by introducing a competed pot in the business plan assessment and ensuring that the size of the pot provides a strong and meaningful incentive signal to companies.

The inclusion of a strong symmetrical financial reward and penalty on network companies' business plans, has the potential to drive stakeholder engagement and early buy-in to the RIIO-2 process. The Business Plan incentive should be the sole mechanism to incentivise ambitious plans and ensure efficient costs. This negates the need for either an IQI or a blended sharing factor to adjust the TIM. To achieve this, Ofgem should use clearly defined quantitative and qualitative elements in its assessment, as this will help companies to deliver high quality business plans backed by their stakeholders. Including a competed reward pot, proportionally sized to the number of companies within that sector, provides Ofgem with the opportunity to replicate the competitive dynamic that would exist in the wider market.

We believe the Business Plan incentive will benefit customers by:

- Sharpening the reward/penalty associated with meaningful stakeholder engagement from the very start of RIIO-2, which will help to shape level of ambition;
- Encouraging network companies to set and deliver high standards, which can be benchmarked to past performance as well as other company plans; and
- Driving companies to submit cost efficient plans by separating out any decision on the sharing factor, avoiding any double reward.

To work as intended it is important for Ofgem to quantify and articulate the benefits of their proposed Business Plan incentive, and describe how these align with their other proposals e.g. on RAMs. In our response to question CSQ70 we flag where we think the interaction between Ofgem's new proposals create unnecessary complexity and thereby risks unintended consequences.

At a high-level, we agree with the proposed four-stage assessment as part of the Business Plan incentive. Whilst we support the new scoring matrix as part of this assessment process, we believe far more clarity is required on the criteria that Ofgem that will use to assess business plans. For example, it would be helpful for companies if Ofgem indicated what weight they are minded to give to different parts of the assessment. Currently there is a significant lack of detail on this, which is concerning given the introduction of new qualitative elements that could be more subjective in their nature. To encourage ambitious plans in a way that is conducive with Ofgem's objectives, we think it is important that network companies and wider stakeholders have a common understanding of the criteria companies will be assessed on.

CSQ67. 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?

As a principle, we believe that the entire totex allowance should be considered during the cost assessment phase. Nevertheless, we recognise that this is dependent on having a suite of cost assessment models available. To address this issue in RIIO-ED1 some costs that did not fit into regression models, were instead solely assessed through disaggregated models and analysis. Due to the greater availability of data in RIIO-ED2, we encourage Ofgem to use this data to compare and contrast network companies to help assess costs. Our concern with any complete separation in the treatment of cost items from the assessment of overall efficiency is that it could lead to an inconsistent approach to cost benchmarking. This potentially exposes customers to rewarding a network company upfront which in reality is less efficient, i.e. by excluding certain costs in the assessment, an incorrect view is arrived at.

It is not appropriate for all regional cost adjustments to be considered symmetrical. Whilst it can work for certain cost elements (e.g. regional wage differentials), it is not appropriate for elements that are inherent within particular networks, such as increased costs resulting from the Ultra Low Emission Zone in London or the need for remote location generation in parts of the Scottish Highlands. Fair and appropriate cost assessment must be considered at an individual licensee level, taking account of robust evidence cases and the regulatory precedent developed by Ofgem over successive price controls.

To ensure that all RIIO-ED1 data is utilised as part of Ofgem's cost assessment in RIIO-ED2, any difference between forecast and actual spend in the last two years of RIIO-ED1 should be accounted for as part of an adjustment in RIIO-ED2.

CSQ68. 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?

In RIIO-ED1 costs were assessed by Ofgem using interpolation; this meant the reward or penalty a network company received for their business plan was based on a sliding scale commensurate with how close they were to Ofgem's view of efficient costs. Whichever option is adopted in RIIO-2 it is important that network companies understand the mechanics of the cost assessment process if they are to succeed in delivering customer benefits that meet both Ofgem's expectations and those of wider stakeholders'. Based on the information Ofgem has published to date, there is a lack of clarity on how the cost assessment process will work in practice. Therefore, it is difficult at this stage to definitively comment on the method for categorising cost forecasts and their boundaries.

Our initial feedback on Ofgem's high-level proposals is that there is no justification of why Ofgem has chosen 4% as its threshold for separating what is defined as 'Good' and 'Value'. For example, this is a very different range to previous network controls, as well as what Ofwat recently used in PR19. If Ofwat had of used 4% as part of their PR19 cost assessment methodology only one out of seventeen water companies would have been considered as 'Good', whereas thirteen would have been 'Poor'. Due to the increased risk and penalty of being regarded as poor, this may have the unintended consequence of driving companies to be conservative in their business plans. We do not believe this is in line with Ofgem's desire for companies to show ambition and innovation with regards to facilitating the energy transition.

We are particularly concerned with the low margin of error in the cost category boundaries and our view is that the narrow intervals between what is classified as, high, medium and low is a relatively crude approach. It is also unclear how Ofgem's proposed scoring system would lead to a final decision on whether business plan costs are deemed to be 'Good', 'Average' or 'Poor' e.g. whether this would involve a blend of bottom-up and top-down analysis, similar to the approach in RIIO-ED1.

In Figure 4 below we have indicated a potential unintended outcome of the proposed scoring approach in RIIO-2 when compared to the interpolation used in RIIO-1. Whereas the latter proportionately rewarded or penalised companies on the overall efficiency of their plans, the proposed RIIO-2 approach would lead to scenarios where two companies (A and B) are very close to one another in terms of efficiency score in cost assessment, yet their reward or penalty level would significantly differ. This issue is potentially exaggerated if companies expect Ofgem to only reward a single company 'Good Value' on quality/costs, as suggested in the consultation document. This is because the reward pot for being in the 'Value' category is likely to be further diluted i.e. by being shared with the company that is 'Good Value' as well as any other companies deemed 'Value'.

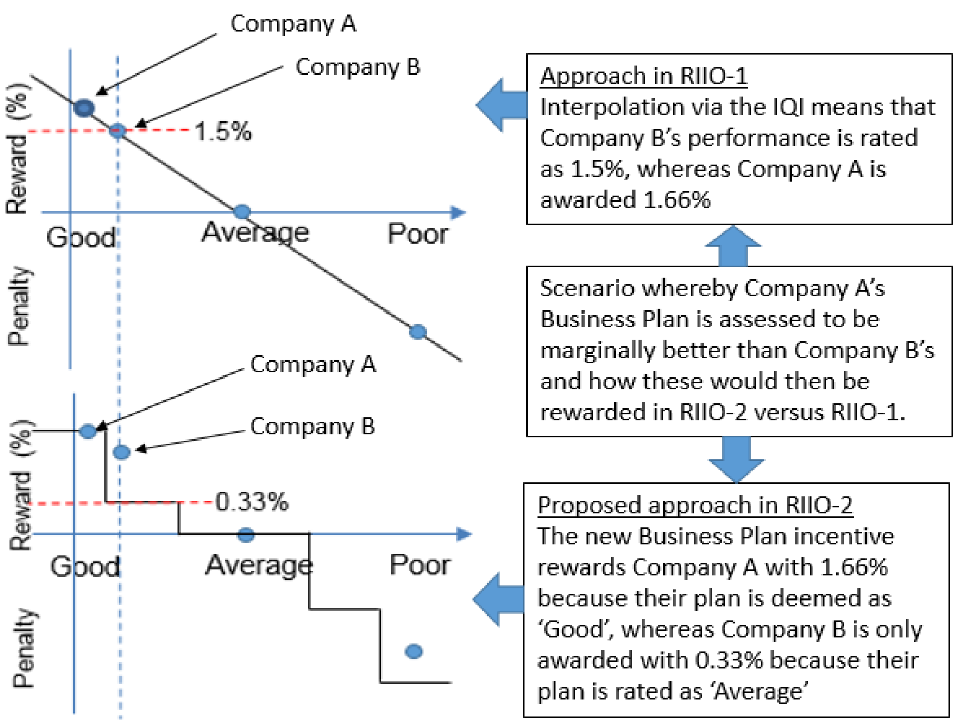

Figure 4: Comparison of how the business plan was rewarded in RIIO-1 (top) versus Ofgem's proposal for RIIO-2 (bottom)

To summarise, Ofgem must ensure that the objective to simplify the cost assessment in RIIO-2 does not lead to a weakening of incentives, which is not in the interest of customers. Equally, Ofgem must avoid over-engineering the RIIO-2 package as to make it unclear to network companies and their stakeholders what companies need to deliver to be rewarded as good performers. We recommend Ofgem reassess their scoring and reward system on the Business Plan incentive with this in mind.

CSQ69. What should be the range for the Business Plan reward/penalty? Is the range of ±2% of totex equivalent appropriate for incentivising high quality and ambitious Business Plan submissions (e.g. Value or Good Value)?

The proposed range is lower than included in RIIO-1 despite Ofgem signalling that they want companies to be more ambitious. For example, network companies in RIIO-ED1 were guaranteed a minimum reward of 2.5% of totex for being fast-tracked. A key difference and potential issue with Ofgem's proposal is that the strength of reward incentive i.e. 2%, is diluted depending on the number of companies that are either classified as 'Good Value' or 'Value'. As the reward is regardless of the number of companies in a sector, the distribution sectors (both gas distribution and electricity distribution), will potentially be disadvantaged compared to transmission sectors. Our analysis of a scenario in which one company is ranked Good Value with two in Value demonstrates that the companies in the latter category will receive only a 0.33% totex reward, in contrast to the former that will receive 1.33%. This represents a four-fold difference in reward, yet as explained in our response to question CSQ68 the difference between being ranked in a different category could be marginal.

To ensure there is a sharp incentive on network companies to be ambitious Ofgem should re-evaluate its proposals to ensure that they are mimicking a normal competitive market and any associated rewards or penalties are not unduly disproportionate. For example, we believe a good principle of economic regulation is having symmetry across any rewards and penalties; therefore we question why the penalty side of Ofgem's Business Plan incentive is fixed unlike the reward side.

We welcome clarity that the reward or penalty levied on network companies will be on Ofgem's allowed totex, as currently this is unclear from reading Ofgem's publications. To clarify, we recommend that Ofgem bases any reward or penalty on the lower of allowed totex or the company's forecast totex, so as not to act as a double penalty or reward.

CSQ70. 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?

Whilst we understand Ofgem is keen to dispense with the IQI, any replacement must be built on principles of incentive compatibility and proportionate treatment. There is a danger that by oversimplifying cost assessment outcomes and not being transparent on how qualitative areas will be combined with quantitative areas, that Ofgem unduly rewards or penalises business plans. It is unclear whether there is meant to be alignment with the outcome of cost assessment and the blended sharing factor. If they are completely independent, it could be feasible that the least efficient company has the highest sharing factor. This is perverse. Conversely, if cost assessment outcomes and sharing factor strengths are intended to align, we question the need for the blended sharing factor exercise.

Based on our experience of the IQI in RIIO-ED1 we recommend that Ofgem prioritises issuing clear guidance on the cost assessment process, as this acted as a barrier when DNOs were developing their business plans.

Further to the above, we have concerns that the step change nature of the proposed Business Plan incentive increases the sensitivity to any errors, which could result in a significant difference in a company's reward or penalty. By increasing transparency of the cost assessment process, Ofgem will enable companies to flag any discrepancies in data as early as possible, and we are aware of instances where this happened in RIIO-1.

CSQ71. 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?

We do not see compelling evidence to support the introduction of a blended sharing factor. In contrast, we think this proposal adds complexity without providing clear benefits. A key success of RIIO is its focus on totex, which does not create a bias towards capex and opex solutions. However, we are concerned that Ofgem's suite of proposals moves us away from this approach. For Ofgem to meet its stated objectives we believe it is important that they assess costs and incentives in a holistic way in RIIO-2. A particular risk with the blended sharing factor is that it creates an inconsistent approach to incentivising network companies, which may dampen benefits to customers.

We agree with Ofgem's assessment in paragraph 9.32 of the main document that companies could *"result in a duplication of rewards and penalties"* within the IQI methodology in RIIO-1, because it was determining both the sharing factor and ex-ante award/penalty associated with cost efficiency. Rather than resolving this through the Blended Sharing factor, which we believe will lead to the same risks, Ofgem should have confidence in the effectiveness of its Business Plan incentive to drive ambition and efficiency. Separately Ofgem should consider a single, common, and suitable sharing factor to ensure network companies are incentivised to deliver good performance for customers within the RIIO-2 price control. We believe a suitable range is between 40% and 60%.

In Ofgem's comparative assessment of the blended sharing factor versus Ofwat's cost sharing mechanism, it is noted that the former option incentivises network companies to provide Ofgem with more rigorous information that could increase confidence of costs. However, the latter option is seen as weaker by Ofgem, because of the perceived reliance on network companies' information. We think these assessments are contradictory as in both approaches the regulator is requesting company information to inform its decision on cost efficiency. Therefore, in practice, it will be the strength of the incentive rather than the different mechanics of the two approaches that will drive improvements in the quality of information submitted.

The onus appears to be on companies' to justify their proposals e.g. on how they will manage uncertainty in order to receive a higher sharing factor. However, if Ofgem propose to reward a higher sharing factor based on qualitative elements, such as a commitment in the business plan to include new uncertainty mechanisms, then this will lead to distortions that will make it difficult to compare different companies' performance and efficiency. For example, it is unclear how Ofgem would compare the effectiveness, and therefore appropriately reward or penalise, individual companies' uncertainty mechanisms.

CSQ72. 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.

On balance, presented with arguments put forward by Ofgem and noting Ofgem's strong desire to move away from using the IQI in RIIO-2, our current preference is for a single fixed sharing factor to be applied to network companies. This would mean that the Business Plan incentive would focus on rewarding and penalising companies for the quality of their submissions, whereas within the price control each company has the same totex incentive rate. A key advantage of this approach is that it harmonises the cost benefit analyses between companies thereby facilitating whole system solutions i.e. different solutions can be assessed on a level playing field. It would also make it easier to compare the performance of different companies, which will be an important feature due to the increased role of customer engagement in RIIO-2. Moreover, in the event that Ofgem introduces a Return Adjustment Mechanism, a single sharing factor will make the mechanics of any readjustment simpler and will provide companies and stakeholders with a clearer understanding of how they will be rewarded if they improve their performance.

As reflected in our response to question CSQ71 we do not believe Ofgem have made a strong case for their preference of using blended sharing factors. We agree with the assessment that blended sharing factors will be difficult to implement as they will add significant complexity. However, we do not follow Ofgem's rationale that the blended sharing factor will sharpen the incentive on companies to provide robust cost justifications, when compared to RIIO-1 or Ofwat's cost sharing mechanism. The only reason this would be the case is if Ofgem plan to pull down the sector's average sharing factor, as suggested by the lower range in RIIO-2 (15-50%); however, a similar outcome could be achieved regardless of the mechanism used.

On the ability to mitigate behavioural biases, Ofgem has correctly flagged the issue with blended sharing factors in cases where a company overspends with a low sharing factor. We think this issue could be made worse without clarity on the cost evaluation process e.g. clearly defined cost categories. This is because there is a greater risk that a company's' forecast of costs will be different to Ofgem's. By skewing the sharing factor in the way proposed, Ofgem is essentially assuming that companies will underspend, however, should this assumption be wrong there is a high risk that customers will bear most of the penalty of any overspend. We therefore recommend that Ofgem sets a single, common, sharing factor around 50% (i.e. within a range of 40-60%), which aligns the risk and reward between network companies and customers.

Below is a consolidated list of issues we have with the proposed blended sharing factor:

- Looks particularly poor at helping to deal with uncertainty i.e. increases customers' exposure to risk for low confidence cost items. This represents a step backwards when compared to RIIO-1. Due to the increased focus on facilitating the energy transition in RIIO-ED2 this is concerning;
- Recalculations of the sharing factor within the price control make forecasting costs and performance difficult. Rather than aiding transparency and accountability, this serves only to add significant complexity and make the ability for stakeholders to understand performance more challenging; and
- Introduces a barrier for DNOs looking to procure greater volumes of non-network solutions such as flexibility. Rather than enabling DNOs to benchmark conventional network solutions and use the Totex Incentive Mechanism to market test requirements, Ofgem's suggestion of not defining a sharing factor until competition has delivered would completely undermine the use of totex.

Instead, to manage uncertainty, we recommend Ofgem build on RIIO-1 by including volume drivers, as well as separate reopeners for load related expenditure and high value projects, which protect both network companies and customers from the level of required investment being materially different from the original forecast.

CSQ73. 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?

If Ofgem choose to proceed with blended sharing factors, our strong preference would be for an approach to be used that sets a common confidence level for specific cost categories i.e. companies understand how Ofgem will treat a cost category prior to submitting their business plan. This will ensure a consistent approach is taken to evaluating costs and will enable performance to be benchmarked during RIIO-2, e.g. if asset replacement were deemed “’high confidence” and attracted a 50 per cent sharing factor, then all companies would have this applied to the proportion of their allowed totex falling under this category. Even were this to be the case, we note that by applying differing sharing factors based on projected/allowed costs in specific categories, the blended sharing factor proposal risks unwinding the benefits derived from taking a totex approach to delivering cost savings and performance improvements for customers.

One of the reasons we believe the proposed blended sharing factor is fraught with challenges is that it moves RIIO-2 towards subjective evaluations, as opposed to using transparent and quantifiable metrics that are central to successful regulation. Importantly, we think this will increase the risk for distortions and unintended consequences. For example, two companies may separately forecast the same total cost to deliver an equivalent output in their respective business plans, however, the way they split the costs across different categories may mean that they are rewarded and/or penalised differently, despite the outcome for customers being the same. This also results in one set of customers paying more relative to another’s for exactly the same level of service/output. Table 2 below illustrates the above example.

		High confidence			Low confidence			
	Total expenditure	Expenditure	Sharing factor	Contribution to blended sharing factor	Expenditure	Sharing factor	Contribution to blended sharing factor	Blended sharing factor
Company A	100	60	50%	30	40	15%	6	36%
Company B	100	40	50%	20	60	15%	9	29%

Table 2 - Blended Sharing Factor Example

CSQ74. 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)?

If Ofgem decides to proceed with blended sharing factors, as a starting point we recommend data from RIGs is used to initially inform cost evaluations. Nevertheless, we believe more work is required between Ofgem and network companies before a particular methodology can be fully endorsed. As noted above, if sharing factors were to be updated during the period then there would also need to be alignment of the reopener categorisations with blended sharing factor categories.

CSQ75. Do you have any views on whether the proposed Business Plan incentive coupled with the blended sharing factor will drive the right behaviours?

Ofgem must be clearer on what the “right” behaviour is in RIIO-2 as in RIIO-1 our interpretation of the right behaviour was delivering outputs for our customers at the lowest cost. We would welcome clarity from Ofgem that this remains the case.

The RIIO-2 package should provide certainty and fair rewards for companies to invest efficiently to deliver the necessary customer outputs and support the delivery of a low carbon economy. We strongly recommend Ofgem retain the focus on the Totex Incentive Mechanism as the main driver for companies to cost efficiently deliver excellent performance. This should be enabled by setting a single sharing factor (within a range 40-60%) and instead use the Business Plan incentive for cost assessment to ensure efficient business plans, rather than introducing blended sharing factors that will add significant complexity for little value. A key benefit of the totex model in RIIO was to remove any bias between capital and operating expenditure. To reduce total costs for our customers we are incentivised to test and deploy innovative non-network options such as demand side response, whilst ensuring we deliver excellent levels of performance for our customers.

Insufficient detail has been provided in Ofgem's publications for a definitive view to be formed at this stage. However, as mentioned in our above responses it is unclear how the mechanics of the blended sharing factor will work efficiently alongside the Business Plan incentive, as well as any Return Adjustment Mechanism. As such our current view is that Ofgem's proposals may not drive the right behaviours. Whilst we support separate incentives and penalties across the RIIO-2 timeframe to ensure that customers' interests are protected, the complex interaction between Ofgem's proposals may undermine this broader objective. For example, we think there is a risk that under the current proposals, companies are incentivised to focus on qualitative arguments in the business plan stage, which may not be deliverable or comparable to other business plans. Rather than placing undue weight on a qualitative assessment at the start of the price control, we believe information revelation through the period, with appropriate caps and collars on incentives and out/under performance will drive the right behaviours and deliver value to customers.

CSQ76. What views do you have on our assessment of the sharing factor ranges?

We disagree with the proposed use of a blended sharing factor in RIIO-2. Our view is that Ofgem's proposal of low confidence items being applied with a 15% sharing factor and high confidence cost items being applied with a 50% sharing factor, is that this represents a crude way of splitting the risk and reward between customers and network companies. If Ofgem does proceed with the blended sharing factor, they should as a minimum, define more intervals as opposed to applying either 15% or 50% only. We are particularly concerned that Ofgem's proposals will increase customers' exposure to any risk for low confidence cost items i.e. a 15% sharing factor would lead to customers paying for 85% of any overspend. This forms part of our rationale for the sharing factor being closer to 50% (i.e. within a range of 40-60%) to strike a balance between risk and reward for both underspend and overspend.

Ofgem's analysis of sharing factors in RIIO-2 has not been made public and it is therefore not possible for us to comment in an informed manner on Ofgem's assessment. However, we do note that over successive price controls Ofgem has increased the strength of sharing factors whilst tightening the IQI break-even point. From a process perspective, for future consultations it would be beneficial to all stakeholders for supporting analysis to be made available.

CSQ77. Are there any other factors that you think we should take into account in the design of sharing factors?

Yes – please refer to our response on question CSQ73.

To summarise, we believe Ofgem should consider the following when designing the sharing factor mechanism:

- Whether this will hinder rather than facilitate whole system solutions and innovation. For example, sharing factors must create a level playing field between network companies who can deliver the same whole systems output;
- Whether any additional complexity will make company performance less transparent and harder to measure;
- Whether it will help customer representatives to engage with price controls;

- Whether it can be used consistently across different companies and across the whole RIIO-2 timeline; and
- Its interaction and compatibility with other key mechanisms such as the Business Plan incentive and any Return Adjustment Mechanism.

We see particular merit in further considering the last point. For example, we do not see a rationale for putting the Business Plan incentive outside the scope of a Return Adjustment Mechanism. If Ofgem's intention is to set a threshold that limits out/under performance in a way that continues to drive the right behaviours, we recommend the Business Plan incentive reward and/or penalty is within the Return Adjustment Mechanism's true up. Otherwise there is a risk that reported performance during the period is both hiding and failing to deal with true outperformance or underperformance associated with the price control in its entirety. This could also lead to distortions in a company's decision-making before and during the price control.

By baking in an upfront reward with no scope to claw it back if promises at Business Plan submission turn out to not materialise, there is a danger that customers may inadvertently pay for a "good sounding plan" which over the course of the price control they do not receive. This would be at the same time as using such promises to ratchet targets and allowances for other companies beyond where may be feasible. Whilst Ofgem may require price control deliverables / commitments from a company it rewards under the Business Plan incentive, it is unclear from Ofgem's proposals how any required unwinding of "false" targets would occur during, or at the end of the control to rebalance arrangements for the remaining companies.

CSQ78. Do you have any evidence on the scope for productivity improvements in the different sectors?

We do not see any rationale for setting sharing factors on forecasts of a sectors' forecasted productivity. Ofgem assert in paragraph 9.64 that where a sector has scope for future productivity improvements this could justify a higher sharing factor. However, we see a counter argument, whereby a sector which has yet to pick all the "low hanging fruit" should find it easier to deliver outperformance, than a sector which has made significant strides already and further savings require additional effort to deliver. Given the gaps and inconsistencies in datasets used to conduct the productivity assessments that accompanied the consultation, we would caution against making potentially subjective and possibly misguided adjustments to sector sharing factors.

CSQ79. Do you have views on whether adjustments to sharing factor levels after the price control is set are desirable or necessary?

As set out in earlier responses, we do not believe sharing factors should be adjusted once they have been set for the period. If Ofgem proceeds with a blended sharing factor approach we recommend that these are not adjusted after the price control is set. As highlighted in our response to question CSQ77, Ofgem's suite of proposals have introduced multiple moving parts that have interdependencies. For companies to manage their costs and performance there will need to be a degree of predictability on any adjustments; the combination of proposals does not currently provide this.

CSQ80. Under which circumstance do you consider such adjustments should take place?

As stated in CSQ79 as a general principle we do not agree that there should be any adjustments to a company's sharing factor within price control except for business mergers. Historically where two companies with different sharing factors have merged during a price control period Ofgem has equalised across the combined company, we continue to believe this is appropriate.

CSQ81. When do you consider an adjusted sharing factor should be calculated?

See response to question CSQ80 – in summary, adjustments should not happen at all, but if required then there should be clear triggers.

ENSURING FAIR RETURNS QUESTIONS

CSQ82. Do you agree with our comparative assessment of RAMs set out in Table 18 in Appendix 4?

Ofgem should design any RAM with the aim of:

- Being simple to implement and transparent to stakeholders;
- Avoiding a situation whereby poor performers dilute the returns of better performing companies; and
- Mimicking a competitive market by retaining an incentive to deliver frontier performance.

We believe that Ofgem can ensure fair returns by setting appropriate targets and allowances. If a RAM is to be introduced, it should be designed with the characteristics defined above and must only operate in extreme scenarios to avoid blunting the incentives in RIIO-2. Of the options presented by Ofgem, our current view is that 'proportional anchoring' best meets Ofgem's desired outcomes in the distribution sectors whilst having the least distortionary impact. We do not agree with Ofgem's proposal to avoid adjusting companies relative to the base cost of equity, as this could mean that a good performing company and its customers are subsidising another company's poor performance. Instead, all companies should be adjusted if a RAM threshold is breached.

If Ofgem continues with its plans to introduce a RAM in RIIO-2, we believe it is crucial that any reward / penalty from the Business Plan incentive is included within the RAM envelope. Failure to do so presents a danger that customers may inadvertently pay for a "good sounding plan" regardless of whether a company has the ability to deliver it because Ofgem would have no scope to claw back the reward. Whilst Ofgem may attempt to close this loophole with specific commitments from the network company we believe a simpler, and more transparent outcome would be to build all business plan outcomes into any RAM. We also believe that this demonstrates the need for Ofgem to set out criteria of how a network companies' track record will be factored into the assessment.

We broadly agree with the conclusion from Ofgem's comparative assessment that Proportional Anchoring is the 'better' of the options presented. Below, in table 2, we have set out recommendations that would help Ofgem meet the criteria it has set out.

Criteria	***Our recommendations***
Effectiveness	• Applying Proportional Anchoring to RoRE will guarantee effectiveness and a consistent approach.

	• The RAM should include parameters that are controllable by a company's management team, including the level of totex spend and performance against incentives e.g. bespoke incentives and the Business Plan incentive.
Impact on Incentives	• Avoid Proportional Anchoring working alongside a blended sharing factor by instead defining a single, common, suitable sharing factor (within a range of 40-60%) for all network companies, which retains a strong performance incentive. • Focus on greater use of volume drivers and setting appropriate incentive targets that drive good performance and ensure that Proportional Anchoring is only a failsafe.
Effect on companies' risk profile	• Design Proportional Anchoring so that its use is minimal and is predictable i.e. network companies know the risk/reward of investments • Avoid adjusting companies relative to the base cost of equity, as this could mean that a good performing company and its customers are subsidising another company's poor performance.
Impact on collaboration	• For larger projects retention of the Network Innovation Competition funding pot will continue to encourage collaboration • To facilitate the energy transition network companies should be encouraged to continue to engage in industry working groups e.g. via the ENA on common scenarios
Level of complexity and challenges in implementation	• Complexity will be minimised by setting a fixed totex sharing factor upfront and designing a true up with the RAM in the annual iteration process • If incentive targets are set appropriately and any threshold around the cost of equity is equity is avoided, Proportional Anchoring should only have an impact in rare cases

Table 3: Our recommendations for how Ofgem can ensure that their proposal on proportional anchoring meets their set criteria

CSQ83. Do you agree with our proposal not to give further consideration to using discretionary adjustments?

We agree with Ofgem's proposal not to further consider using discretionary adjustments in RIIO-2. Discretionary adjustments would entail considerable regulatory burden to define appropriately, and failing to do this would only serve to provide greater uncertainty to companies and stakeholders about their potential operation. Ofgem is rightly proud of the stable predictable regulatory framework that has evolved over successive price controls. Discretionary adjustments are the anti-thesis of this.

CSQ84. Do you agree with our proposal to introduce an individual performance-based adjustment approach (Class 1) for the transmission sectors?

We can understand the logic of using an individual performance-based RAM where there is a low number of comparators. However, we believe that the other options (Class 2) better mimics the dynamics of a competitive market and also enables stakeholders to more easily compare company performance.

CSQ85. Do you agree with our proposal to introduce a sector average-based adjustment approach (Class 2) for the GD sector?

Having reviewed Ofgem's proposals we think if an adjustment mechanism is to be introduced in the Gas Distribution sector it should be a Class-2 type as these more accurately mimic the dynamics seen in a comparative market.

CSQ86. 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?

No, we do not agree that Ofgem should use the cost of equity as a threshold for deciding whether to adjust company revenue. We believe it is crucial that Ofgem avoids this as it could mean that a good performing company and its customers are subsidising another company's poor performance.

Whilst we disagree with having any minimum threshold, if Ofgem is to include one, a simpler and more palatable approach would be to use the cost of debt. This would have the advantage of replicating a competitive market and would avoid blunting performance incentives such that companies are clustered together. Placing too many restrictions on what may or may not be adjusted both builds in additional complexity and also runs counter to Ofgem's stated desire of enabling strong performers to earn higher rewards.

CSQ87. Would a return adjustment threshold of ±300bps RoRE achieve a good balance between providing scope for companies to outperform and ensuring return levels are fair?

We believe Ofgem must revise the cost of equity in RIIO-ED2 to correct methodological errors to ensure it incentivises investment in a way that really drives the energy transition. Without having sight of the RIIO-ED2 package we are unable to comment on what an appropriate RAM threshold is. When setting out proposals on this we recommend Ofgem ensures that any threshold is proportional to the potential customer benefits that a sector can deliver by innovating and delivering excellent performance.

The cost of equity is the incentive to invest and if Ofgem sets a cost of equity below a fair level it risks setting an investor perception that incremental investment destroys value. Furthermore, we do not agree with Ofgem's proposal to adjust the derived cost of equity by its view of expected outperformance. Instead regulatory targets should be set appropriately to incentivise companies to innovate and deliver the outputs customers want at lowest cost.

This question must be considered alongside Ofgem's proposal to include a 50bps outperformance wedge in RIIO-2. Whilst we reject Ofgem's rationale for including this expected outperformance in their decisions, if this is to be included it must be factored into the return adjustment threshold to avoid a double penalty.

Without further clarity on Ofgem's cost evaluation process and suite of incentives (e.g. sharing factor design, Business Plan incentive, price control deliverables etc.), it is difficult at this stage to comment definitively on whether 300bps is the correct threshold for meeting Ofgem's objectives. It would be helpful to understand from Ofgem whether this proposed 300bps range is independent of the cost of equity, i.e. does Ofgem accept fixed incentive range on top of cost of equity irrespective of the final cost of equity, or is its intention to trade off any increase in cost of equity with a reduced incentive range?

By taking on board our recommendations on greater use of volume drivers, having a single, common, sharing factor and including the Business Plan incentive and any bespoke incentives within a RAM, Ofgem can set a RAM threshold with the confidence that it will work as intended. However, failure to do this will result in a very complicated regulatory framework, in which neither Ofgem, network companies nor their stakeholders, will be able to confidently determine if returns are fair and proportionate against performance.

CSQ88. 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?

RoRE provides a comprehensive metric that puts cost performance and incentive performance on the same footing in order to compare network companies. Therefore, we see merit in Ofgem keeping a consistent approach by using RoRE, if they decide to introduce a RAM. However, as noted in our response to question CSQ82, the Business Plan incentive should be included in the RoRE calculation over the entire period to give a complete view of performance. By including the full range of rewards and penalties network companies are exposed to, Ofgem can focus on setting a RAM threshold using RoRE that meets the desired outcome i.e. being a failsafe to guard against sector wide outperformance.

CSQ89. Should we include financial performance within the scope of return adjustments? If not, what is the rationale for excluding financial performance?

Any RAM introduced should only operate on parameters that are controllable by a company's management team, which should include the level of totex spend and performance against incentives e.g. bespoke incentives and the Business Plan incentive. Financial out or under performance should not be within scope, for example the ability for a company to materially affect its performance against its historical debt portfolio is limited and risks arbitrarily creating winners and losers.

At this time we believe financial performance should be out of scope, on the basis that past management decisions on finance should not affect other companies' performance. Nevertheless, we welcome Ofgem's continued regulation of financial performance in a way that drives the right behaviour by companies. For example, the transition to more reflective indexation metrics on debt are helping to address concerns around forecasting errors.

CSQ90. 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?

If a Return Adjustment Mechanism is to be introduced the full scale of performance will only be available at the end of the price control during close-out. However, we see merit in an annual iteration process being adopted to avoid any significant cash flow shocks at the close-out. As network companies already submit forecast data to Ofgem an annual iteration process for adjusting returns would be feasible. Our current thinking is that this annual iteration process would operate in conjunction with a final true-up at the end of the period, to account for final outturns as delivered through the close-out process. Nevertheless, this could be significantly complicated if Ofgem propose to also adjust sharing factors. This is one of our reasons for not supporting to changes to a company's sharing factor during the price control.

RIIO-2 ACHIEVING A REASONABLE BALANCE QUESTIONS

CSQ91. Do you agree with our assessment of the measures we have identified to make the price control more accurate?

Measure	*Agree / Disagree*
Uncertainty mechanisms	**Agree:** We continue to support the use of new volume drivers and uncertainty mechanisms as a way of ensuring companies are able to flexibly deal with uncertainty during RIIO-2, protecting both network companies and customers from the level of required investment being materially different from the original forecast.
Indexation	**Agree in part:** Ofgem have proposed indexation in three areas: RPEs, cost of equity and the cost of debt. • RPEs: We fully support the indexation of RPEs as it will help to mitigate forecasting errors, in line with what we advocated prior to the start of RIIO-ED1 • Cost of equity: We recommend further analysis of the impact on revenue volatility, both for network companies and market participants, before this is implemented. • Cost of debt: Retaining the full indexation methodology will only be appropriate if the resultant allowances remunerate efficiently incurred debt. The current full indexation approach can create arbitrary winners and losers based on each company's issuance profile. We believe Ofgem should publish its analysis to show how its full indexation approach would impact each company and if a company's debt cost is not being remunerated then Ofgem should explain why this is appropriate. If a company's debt costs are not being funded the implication is that Ofgem believes that these costs are inefficient. We believe that Ofgem must demonstrate that the costs are inefficient before disallowing them. If full indexation is shown not to remunerate a company's efficiently incurred debt costs then Ofgem should consider alternative mechanisms such as company specific partial indexation with new debt being subject to an index.
Cashflow floor	**Disagree:** We do not agree with the principle of a cashflow floor. We have noted that all of the main credit rating agencies have also raised concerns over the proposed mechanism – please see our response to questions FQ24 & FQ25.
Price control deliverables	**Agree:** Providing these are set at a relatively high-level and not on an individual line by line basis we agree with the inclusion of Price Control Deliverables – as they will in effect operate in a similar way to other uncertainty mechanisms

Dynamic targets	**Agree:** We support the use of dynamic targets, but they must be able to move both up and down rather than only become tighter. This will ensure targets always remain stretching whilst also being reflective of the environment networks are operating in.
Network resilience metric	**Agree:** We are supportive of the development of a resilience metric that captures the longer term benefit of company interventions – but this should be developed over time – we do not believe there is sufficient time to develop an appropriate, well-functioning metric for the electricity and gas transmission and gas distribution sectors. Instead, these sectors should focus on reporting akin to how the electricity distribution sector has reported in RIIO-ED1.
Return Adjustment Mechanism (RAMs)	**Disagree:** A RAM does not serve to improve the accuracy of a price control – it is simply a failsafe mechanism should other areas of the control turn out to be deemed inaccurate. We believe mechanisms such as volume drivers and uncertainty mechanisms, coupled with a shorter price control mean that the accuracy of the price control is such that a RAM is unlikely to be required. However, if one is employed, it should be used as a temporary measure to help regain Ofgem and wider stakeholders' confidence and support in a sectors performance.
Competition	**Agree:** As a principle, we support Ofgem's use of competition to drive cost efficiencies wherever it can demonstrably benefit customers. For single, high value projects, Ofgem has understandably been looking at the role of what it defines as 'early' competition as a way of ensuring price discovery; however, until this has been shown to consistently work well we do not see a case for exploring its use for lower value projects. We strongly believe that the Totex Incentive Mechanism provides the right risk and reward balance by encouraging network companies to deliver their outputs at lowest cost.
Business plan incentive and a sharing factor	**Disagree:** We agree with Ofgem's intention on driving ambitious business plans and ensuring efficient costs however we do not agree with all of Ofgem's proposals to achieve this. The Business Plan incentive, if designed correctly, has the ability to deliver both ambitious plans with efficient costs, but this requires both a suitable reward (i.e. a symmetrical incentive pot that is proportional to the number of companies within the sector) and clear assessment criteria so companies can target it effectively. Defining the sharing factor through an additional cost assessment process such as IQI, blended sharing factor or an Ofwat type approach risks rewarding / penalising companies twice for their cost assessment – something that Ofgem is keen to guard against. Instead a single sharing factor should be applied across all companies and sectors (within a range of 40-60%) to maintain a strong incentive to find cost efficiencies within period through TIM and provide a level playing field for whole system solutions.

Table 4 - Reasonable Balance Measures

CSQ92. Are there other measures we should take to improve the accuracy of the price control?

Due to the inevitable timings when constructing a price control, assessments on costs will likely take place on historical data up to and including six years of actuals and two years of forecasts for the RIIO-1 price control. This means that any marked difference in a company's actual final two years in comparison to its forecasts will not be factored into Ofgem's assessment and resultant allowance – this could create the possibility for companies to 'game' the assessment process by forecasting high, thereby gaining a more generous RIIO-2 allowance. To guard against this, to ensure that all RIIO-ED1 data is utilised as part of Ofgem's cost assessment in RIIO-ED2, any difference between forecast and actual spend in the last two years of RIIO-ED1 should be accounted for as part of an adjustment in RIIO-ED2.

CSQ93. Are there other steps we could take to simplify the price controls, without significantly affecting the accuracy of the control?

As highlighted earlier in the response, the intention for using Ofgem's blended sharing factor can be delivered via strengthening the Business Plan incentive through the use of a symmetrical incentive pot that is proportional to the number of companies within the sector and clear assessment criteria. This would enable Ofgem to set a fixed and consistent sharing factor (within a range of 40-60%) across all sectors, promoting a level playing field for whole system solutions but also serve to reduce the complexity of the price control considerably.

Furthermore, our view is that all regulatory investment should be considered as part of totex, as this enables simplicity, clarity and visibility for Ofgem, network companies and stakeholders to assess cost submissions. We do not believe there is a case for treating any 'anticipatory' investment differently from other spend and our concern is that this will drive the wrong type of behaviour. Please see our response to question CSQ 40-43 for further detail.

CSQ94. Do you agree with our consideration of the risks facing these companies? Do you think the measures we are proposing will mitigate these risks? Does the expected level of return indicated by our proposals reflect these risks?

We believe the terms 'risk' and 'accuracy' can be considered together as in essence the less accurate something is, the more exposure to risk for both customers and companies. Thus the table provided in response to question CSQ91 provides our view point into how well the proposed mechanisms deal with risk uncertainty.

One risk not covered by the table is that of asset stranding. In the consultation, Ofgem seek to guard against this through both the policy on RAV depreciation and future charging reform. We believe that there is potentially merit in developing a further mechanism through an Asset Utilisation Incentive. This could sharpen the incentive on DNOs to guard against asset stranding whilst also promoting the use of innovative solutions in local areas to deal with network constraints particularly in areas of high DER uptake. Please see our response to CSQ39 for more detail.

Furthermore, we have significant concerns with regard to the expected level of return adequately reflecting these risks – please see our responses contained within the financial annex.

CSQ95. Have we achieved a reasonable balance with our proposals in seeking to achieve an accurate price control with return adjustment mechanisms only being used as a failsafe? Should we instead have a simpler price control and put more reliance on return adjustment mechanisms?

We believe that it is right to try to increase the accuracy and reduce the risk of forecasting error within the control with clearly defined upfront and transparent mechanisms. This ensure companies are clear on how their investment decisions will be reflected within the mechanics of the control. It is for this reason that with the various proposals put forward by Ofgem, (such as volume drivers, uncertainty mechanism) that we believe a RAM is unlikely to be required. However, given it is Ofgem's intention that the RAM only operates in extreme scenarios, this will limit the risk it poses to investors of distorting the link between investment and the intended outcome.

CSQ96. 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 do not believe any of the mechanisms are required, however if one is to be employed only a RAM should be used in extremis. We do not agree with Ofgem's proposal to adjust the derived cost of equity by its view of expected outperformance. The principle of RIIO was that Ofgem incentivised companies to innovate to deliver the outputs customers wanted at lowest cost. The impact of this framework is that companies have a strong incentive to continually review all aspects of their cost and performance to identify ways to push forward the efficiency frontier. This is obviously in all customers' interests as they will receive the benefits of this in future price controls. From this perspective it is wrong to automatically view outperformance as negative. As part of every price control process Ofgem resets and recalibrates its view on the appropriate cost and performance targets. If the assembled evidence shows that the sector can reduce expenditure or improve outputs then Ofgem should adjust its totex allowances and/or its performance targets, not the cost of equity. Any unsubstantiated adjustment to the cost of equity will increase investor's perception of risk in the sector which must ultimately result in an increase in the cost of equity. Please see our response to question FQ19 for more detail.

CSQ97. Have we got the right focus on the areas that are of most value to consumers?

We agree.

CSQ98. 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 agree the proposed methodology achieves a reasonable balance between the interests of different customer groups.

CSQ99. Are we proposing a methodology that allows us to achieve a reasonable balance between the interests of existing and future consumers?

We agree that Ofgem's methodology should achieve a reasonable balance between the interests of existing and future customers.

PRELIMINARY IMPACT ASSESSMENT QUESTIONS

CSQ100. What are your views on the approach we are proposing for assessing impact of our RIIO-2 proposals?

We agree that it is sensible to look at each of the key components of the price control and to try and evaluate the benefits, costs and the net impact of the proposed changes. However, the current impact assessment is very light on quantification of both the potential costs and benefits. Having looked at individual components the impact assessment should also evaluate whether the sum of the respective parts provides a coherent package which is net positive for customers.

CSQ101. What are your views on the assumptions we have made in our assessment to date

We believe there is not enough quantification evidence within the impact assessment, with many unsubstantiated statements such as "our analysis indicates that the long term benefit of introducing improved resilience measures is likely to exceed the potential costs". In the impact assessment to accompany its decision document in May 2019, Ofgem must make visible the cost and benefit values it has used to support its positions. Ofgem should also make clear how the provisional £30 per annum reduction on customer bills is distributed across the respective network sectors. We note that Ofgem's current impact assessment includes a view of benefits accruing from RIIO-ED2 and we believe clearer visibility should be provided of the breakdown to the final value Ofgem determines in its May decision.

CSQ102. What are your views on the uncertainties we have identified for the purpose of this assessment?

As Ofgem commenced its review of RIIO-1, the electricity distribution price control was only in its early stages and we welcome Ofgem's recognition of the risk of making early decisions on price controls which have still to conclude. We welcome Ofgem's commitment to using "the best information available" and to update the impact assessment in response to the consultation and further developments. One proposal that we have put forward is that Ofgem looks to build a mechanism into its RIIO-ED2 framework which accounts for material differences in company forecasts in the "hidden" final years of the RIIO-ED1 price control.

CSQ103. What additional evidence should we consider as part of our ongoing assessment?

Consistent with our views in RIIO-ED1 and a request for greater clarity on Ofgem's RIIO-2 business plan assessment criteria we believe Ofgem's impact assessment should clearly set out what good performance looks like. This should enable Ofgem, companies and stakeholders to clearly see how RIIO-2 is delivering against the set criteria and enable impartial evaluation to take place, not just at the time of setting the price control, but as an enduring reference point to assess how well the overall framework is delivering against the goals.

Finance Annex

COST OF DEBT

FQ1. Do you support our proposal to retain full indexation as the methodology for setting cost of debt allowances?

Retaining the full indexation methodology will only be appropriate if the resultant allowances remunerate efficiently incurred debt. As we have previously highlighted the current full indexation approach can create arbitrary winners and losers based on each company's issuance profile. We believe that Ofgem should publish its analysis to show how its full indexation approach would impact each company and if a company's debt costs are not being remunerated then Ofgem should explain why this is appropriate. If a company's debt costs are not being funded the implication is that Ofgem believes that these costs are inefficient. We believe that Ofgem must demonstrate that the costs are inefficient before disallowing them. If full indexation is shown not to remunerate a company's efficiently incurred debt costs then Ofgem should consider alternative mechanisms such as company specific partial indexation with new debt being subject to an index.

We are also concerned that Ofgem appear to be taking the position that its financing duty relates to the sector and not the individual companies within that sector. Our view is that Ofgem's duty, to ensure that an efficient company can finance its functions, relates to the individual company not the sector.

FQ2. Do you agree with our proposal to not share debt out-or-under performance within each year?

If Ofgem's approach to setting the cost of debt ensures that each company's efficient debt costs are funded then we would agree that in-period debt under-or-out performance does not need to be shared within each year. We also believe that financing costs should be excluded from any Returns Adjustment Mechanism. Unlike operational performance, management have little ability to materially affect financing performance, due to the fact that such performance will depend on long-term embedded debt costs which cannot be easily changed by management.

FQ3. Do you have any views on the next steps outlined in Finance annex paragraphs 2.22 to 2.25 for assessing the appropriateness of expected cost of debt allowances for full indexation?

We agree that it is appropriate for Ofgem to consider both the HALO effect and issuance costs. With respect to the latter, Ofgem has previously not specifically allowed issuance costs and instead has assumed that the HALO effect has exactly offset them. We believe this is inappropriate and in common with a number of other regulators Ofgem should explicitly allow such costs. Our view is that at least 20bps should be added to the cost of debt allowance for issuance costs.

In its February 2018 paper CEPA had recommended to Ofgem that the iBoxx index should be reduced by between 10-25 bps to account for the HALO effect. Based on NERA's analysis[12] we believe that this is materially overstated because:

- CEPA uses coupon as its measure of the cost of debt which understates companies' cost of debt because many of the bonds were issued below par; and
- CEPA fails to correctly control for bonds' rating at issue. Pre 2010 energy networks' bonds were predominantly A rated at issuance so it is unsurprising that they outperformed the average of A and BBB bonds.

[12] Cost of Debt at RIIO-2, NERA, 2018

As Table 5 below shows NERA's recreation of the CEPA analysis would imply that the HALO effect is marginally negative and hence Ofgem should make no adjustment.

ITEM	NERA ANALYSIS
CEPA HALO EFFECT	38 bps
NERA REPLICATION OF CEPA ANALYSIS (WIDER SAMPLE)	20 bps
CORRECTING FOR YIELD AT ISSUE	-8bps
CORRECTING FOR RATING AT ISSUE	-15bps
REVISED HALO EFFECT	-3bps

Table 5[13] - NERA HALO effect analysis

FQ4. Do you have a preference, or any relevant evidence, regarding the options for deflating the nominal iBoxx as discussed in Finance annex paragraph 2.14? Are there other options that you think we should consider?

It is widely recognised that the current approach of deflating the nominal iBoxx by breakeven inflation to derive the real cost of debt and then reflating the derived allowed return by outturn inflation, introduces basis risk. We think that the option of deflating by a forecast of CPI would be the most appropriate approach, as this would ensure that the value is consistent with that used to index the revenue. However, we also believe that this forecast should be subject to a true up process where the original CPI forecast is trued up to the actual CPIH outturn. The principle of trueing up for actual inflation is already embedded with the current price control framework where revenue is trued up for actual inflation. In our opinion this approach would also contribute to ensuring NPV neutrality.

RISK FREE RATE QUESTIONS

FQ5. Do you agree with our proposal to index the cost of equity to the risk-free rate only (the first option presented in the March consultation)?

We believe that further analysis of the impact of equity indexation is required before it is implemented. Our concern is that introducing indexation of the risk free rate into the price control process will result in greater volatility in returns and hence allowed revenue. We believe this raises three issues which must be considered and addressed before equity indexation is implemented:

- **Investor perception**: Increased volatility in returns is likely to increase investor's perception of risk in the sector which may lead to a higher required cost of equity;
- **Impact on credit metrics**: The increased revenue volatility may put pressure on credit metrics. Consequently, if Ofgem decides to pursue equity indexation we would expect it to include plausible downside scenarios in its financeability analysis with respect to equity indexation; and
- **Impact on energy retailers**: The implementation of equity indexation may cause significant year on year fluctuations in revenue which would then be passed onto energy retailers. Previously, energy retailers have indicated a preference for price predictability so we would expect Ofgem to seek views from across the spectrum of energy retailers on this proposed change.

[13] Cost of debt at RIIO-2, NERA, 2019, page 18

FQ6. Do you agree with using the 20-year real zero coupon gilt rate (Bank of England database series IUDLRZC) for the risk-free rate?

If indexation is implemented we believe that the nominal 20 year coupon deflated by CPI would be the most appropriate approach to derive the real risk free rate. We do not believe it is appropriate to use the 20 year real zero coupon gilt as it is widely recognised that yields on these instruments have been suppressed due to the supply demand imbalance, as a result of the demand for index-linked instruments from pension funds.

In common with our proposed approach for the cost of debt we believe that this methodology should be subject to a trueing up process for the actual level of CPIH inflation. Again, we believe that this would contribute to NPV neutrality.

FQ7. Do you agree with using the October month average of the Bank of England database series IUDLRZC to set the risk-free rate ahead of each financial year?

If Ofgem adopt the proposal to true up for actual CPIH inflation then the assumption on the risk free rate is effectively a placeholder until the true up occurs. However, to avoid unnecessary volatility we would recommend averaging the derived risk free rate over a 12 month period.

FQ8. Do you agree with our proposal to derive CPIH real from RPI-linked gilts by adding an expected RPI-CPIH wedge?

Please see our answer to Question FQ6.

TOTAL MARKET RETURN QUESTIONS

FQ9. Do you have any views on our assessment of the issues stakeholders raised with us regarding outturn inflation, expected inflation, and the calculation of arithmetic uplift (from geometric returns)?

Answered as part of our response to question FQ11.

FQ10. Do you have any views on our interpretation of the UKRN Study regarding the TMR of 6-7% in CPI terms and our 6.25% to 6.75% CPIH real working assumption range based on the range of evidence?

Answered as part of our response to question FQ11.

FQ11. Do you have any views on our reconciliation of the UKRN Study to previous advice received on TMR as outlined at Finance annex appendix 2?

Ofgem’s approach to the Total Market Return is principally based on the recommendations from the UK Regulator’s Network (UKRN) report on the Cost of Capital. In that report there are two recommendations with which we disagree. They are that:

- Historical real total market returns should be analysed with reference to historical CPI inflation published by the Bank of England (BoE) in the Millennium dataset (“Millennium dataset”), as it is more consistent over time and therefore superior to RPI over the historical period since 1900; and
- Rather than calculate arithmetic averages directly, it is more reasonable to start with the compound or geometric average returns and add an adjustment depending on the extent to which regulators wish to take account of serial correlation of returns.

The outcome of the above is that the UKRN report recommends a real (CPI-deflated) TMR of 6 to 7 per cent.

With respect to the former, NERA[14] demonstrates that the Millennium dataset is both unreliable and inconsistent for the period before 1989, which covers the majority of the time period over which the TMR is being measured. The reasons for this are:

- For **1950-1988**, the "CPI" data is based on ONS (2013) back-estimates of "CPI" derived from the official published RPI index and the ONS has raised significant concerns regarding the reliability of this data;
- For **1915-1949**, the Millennium dataset for "CPI" and "RPI" is identical, based on a single series of inflation data published by O'Donoghue et. al. (2004)[15]. NERA analysed this source and found that this series includes *RPI inflation* data after 1947 and estimates of the *RPI index* before 1947 based on data from Feinstein (1972)[16]. There is therefore no CPI data available for this period and instead the BoE CPI series uses RPI inflation data; and
- For **1900-1914**, the "CPI" data is based on Feinstein (1991)[17], which estimates a cost of living index for working class households only and not CPI inflation. The Feinstein (1991) cost of living index is narrowly defined to focus on spending of *working class households*, whereas the CPI index has a much wider definition and covers *all private and institutional households*. Consequently, NERA conclude the Feinstein (1991) data is not a reliable measure of CPI inflation over this period.

We agree with NERA's conclusion that "*RPI represents the most reliable measure of UK inflation historically and therefore should be used to determine the historical real TMR for the period since 1900, instead of the unreliable Millennium "CPI" series".*

On the second point, as highlighted by Oxera[18], there is considerable academic evidence that greater weight should be placed on the arithmetic mean rather than the geometric mean to derive market returns. In addition, NERA has highlighted that the evidence supporting return predictability is extremely contentious[19] and that, in their 2013 report for Ofgem, Wright and Smithers also pointed out that the evidence of return predictability is contentious and the evidence to support it is extremely limited. NERA also point out that the UKRN report and Ofgem have ignored established approaches e.g. Blume to calculate unbiased estimates of the TMR over long horizons, an approach which has been used by the CMA in its NIE price determination.

As a matter of due process, in its sector specific determination we would expect Ofgem to set out fully its response to the points raised in the NERA and Oxera reports as part of finalising its range for the TMR which we believe is currently understated.

[14] Review of UKRN Report Recommendations on TMR, NERA, 2018

[15] O'Donoghue, Goulding, Allen (March 2004), Consumer price inflation since 1750.

[16] Feinstein (1972), National income, expenditure and output of the United Kingdom, 1855-1965

[17] Feinstein (1991), A new look at the cost of living 1870-1914; in Foreman-Peck (1991), New perspectives on the late Victorian economy: essays in quantitative economic history 1860-1914, Cambridge University Press, chapter 6.

[18] The cost of equity for RIIO-2. A review of the evidence, OXERA, 2018

[19] Review of UKRN Report Recommendations on TMR, NERA, 2018

EQUITY BETA QUESTIONS

FQ12. Do you have any views on our assessment of the issues that stakeholders raised regarding beta estimation, including the consideration of: all UK outturn data, different data frequencies, long-run sample periods, advanced econometric techniques, de-gearing and re-gearing, and the focus on UK companies?

Answered as part of our response to question FQ15.

FQ13. What is your view on Dr Robertson's report?

Answered as part of our response to question FQ15.

FQ14. What is your view on Indepen's report?

Answered as part of our response to question FQ15.

FQ15. What is your view of the proposed Ofgem approach with respect to beta?

We believe that there are six main issues with Ofgem's approach to the estimation of beta. They are:

1. The approach to delevering and relevering of beta;
2. The choice of beta estimation model;
3. The lack of comparator data;
4. The use of low frequency data;
5. The choice of time period for beta estimation; and
6. The calculation of debt beta

<u>1. The approach to delevering and relevering of beta</u>

We are believe that the approach that Ofgem has taken to the delevering and relevering of the observed equity beta is flawed. It is not reasonable to de-gear market observations of equity betas with anything other than the associated observations of capital structure. The principle of delevering is to control for differences in capital structure, or financial risk, between comparator companies to obtain a like for like comparison. To maintain internal consistency, equity betas should be delevered in line with the market based estimate of the capital structure that actually underpins the observed share price movements. Additionally, we believe it is inappropriate for Ofgem to delever equity betas as batch which it has done to derive it view of the appropriate asset beta. As Oxera have shown there is a spread in raw equity betas, as well as gearing ratios for UK utilities. The correct approach is to delever each company's equity beta using its own market gearing that reflects the average gearing over the period.

We also disagree with Ofgem's position that consideration of raw equity betas has merit. Financial theory states that as gearing increases the required equity return also increases (Modigliani Miller Proposition II). If Ofgem were not to adjust its beta calculation for differences between the actual gearing and the notional gearing it must explain why current financial theory does not apply in this case.

<u>2. The choice of beta estimation model</u>

The proposed move to the GARCH class models is a significant change in regulatory approach. We note that Indepen highlight that various GARCH specifications exist and using such an approach would lead to introducing company specific solutions which in turn may result in both regulatory subjectivity and unpredictability. Given the latter Ofgem must demonstrate that moving to a new beta estimation model produces materially superior answers than the existing models. If the latter cannot be done then Ofgem should continue to use the Ordinary Least Squares (OLS) approach.

3. The lack of comparator data

In our view, to produce robust estimates of beta Ofgem should assemble as large a dataset as is practicable. Notwithstanding the differences in jurisdictions and regulatory regimes, as highlighted by Indepen, we believe it is appropriate to examine the evidence on European energy networks, as this provides more data points for the beta analysis. As Oxera[20] note the equity betas of these networks closely track the equity beta of National Grid, the most relevant observation for energy networks, which is consistent with investors viewing these businesses as having similar risk profiles.

4. The use of low frequency data

We note that Ofgem are proposing to consider both high and low frequency observations in determining equity betas. The use of the latter is a significant departure from regulatory precedent and we note that the in its 2015 Bristol Water determination the CMA explicitly ruled out the use of quarterly data due to its unreliability. We also note that the UKRN report acknowledges that the use of quarterly data is unusual in academic studies and is not used by any commercial provider. Therefore, if Ofgem is to use low frequency e.g. quarterly data it must set out clearly the rationale which supports it use.

5. The choice of time period for beta estimation

The choice of time period for beta estimation needs to balance ensuring that there is sufficient data to facilitate robust estimation and the time period used reflects the risk profile of the companies in question. However, as both Indepen and Oxera highlight there have been significant structural breaks in the market data used to determine betas over the 2000-2018 time period, particularly in relation to the impacts of the Dotcom and Global Financial Crisis. This casts doubt on the reliability of the data for beta estimation pre 2008. In this area the CMA have typically used periods of up to five years as striking the best balance between data coverage and relevance. If Ofgem propose to use a period longer than five years then it should set out the rationale and evidence that supports this choice.

6. The calculation of debt beta

We also disagree with Ofgem's assumed debt beta range of 0.1 to 0.15. The analysis presented by Oxera illustrates that the debt betas across the listed energy and water regulated network companies support a debt beta of 0.05 which is significantly lower than Ofgem's current range.

CROSS CHECKING THE CAPM

FQ16. Do you agree with our proposal to cross-check CAPM in this way?

Answered as part of our response to question FQ18.

FQ17. Do you agree that the cross-checks support the CAPM-implied range and lend support that the range can be narrowed to 4-5% on a CPIH basis?

Answered as part of our response to question FQ18.

FQ18. Are there other cross-checks that we should consider? If so, do you have a proposed approach?

We believe that it is appropriate to cross check the CAPM estimates. However, we disagree with a number of Ofgem's proposed cross checks. In our response to the RIIO-2 framework consultation we highlighted a

[20] Review of RIIO-2 finance issues, the estimation of beta and gearing, Oxera, 2018, Pages 6,7

number of issues with Ofgem's use of Market to Asset Ratios (MARs), acquisition premia and comparison to offshore transmission rates of return. We also note that CEPA has updated its Dividend Growth Model (DGM) modelling. We still believe that the modelling is flawed in two respects, namely:

- The short term dividend growth assumptions are based on UK GDP forecasts rather than analyst forecasts which the Bank of England use in their DGM model; and
- The long term dividend growth assumptions in the central case are based on an average of real UK GDP growth plus assumed inflation with a sensitivity which adds the difference between the IMF's short term advanced economies GDP growth and the OBR's short term GDP forecasts to the long run UK GDP growth figure of 4.5%. The latter sensitivity does not properly address the original criticism of the CEPA DGM model that the long run dividend assumption should be a properly-weighted estimate of the growth rate based on long-term GDP forecasts for each of the different world regions from which FTSE listed companies derive their earnings. The latter is also the approach used by the Bank of England in its DGM.

Consequently, we still believe that the CEPA DGM model is downwardly biased.

In addition to those listed previously, Ofgem has compared its CAPM derived Total Market Return to the returns listed by investment managers and that of the Financial Conduct Authority (FCA). However, it is important to note that the objective of the FCA is to minimise the risk that customers are miss-sold investment products, a very different objective to Ofgem's. Figure 5 below details the range of evidence that the FCA considers in coming to its view. This illustrates that the FCA has selected a value towards the bottom of the evidence which is not unexpected considering its main objective. In our view the body of evidence considered by the FCA would support a TMR significantly above the current Ofgem range.

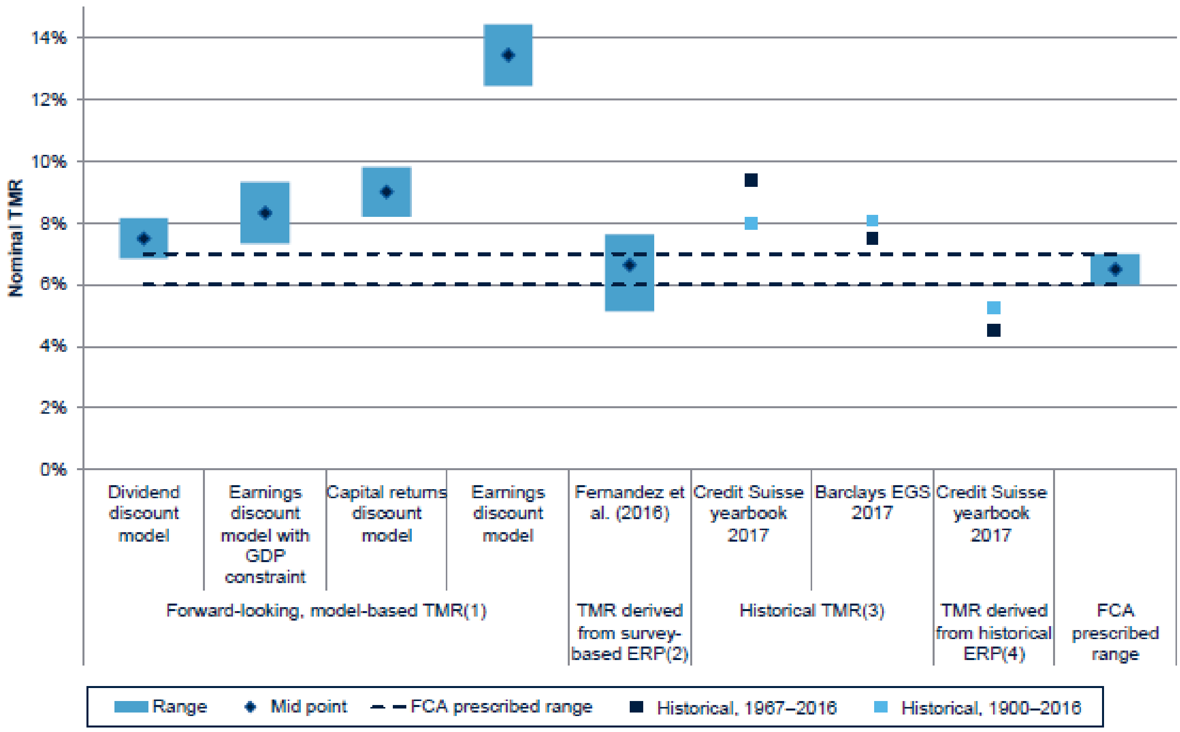

Figure 5 - FCA Total Market Return comparators

Ofgem has also compared the published target returns of a number of investment managers. As Oxera highlight in their report none of the publications quoted by Ofgem represent official product offerings and specifically state that the return projections should not be used for investment purposes[21].

One cross check that we believe Ofgem should undertake is an analysis of the difference between the debt risk premium (DRP) and the asset risk premium (ARP). For a company geared below 100% there should be an appropriate positive differential between the asset risk premium and the debt risk premium, reflecting the priority debt holders have over the funds of the company. Oxera[22] has undertaken further work for the ENA to determine what an appropriate differential should be and to compare that to the differential between the asset risk premium and the debt risk premium implied by Ofgem's current cost of capital assumptions. The analysis compares the ARP-DRP differential derived both from regulatory precedent and by analysing the bonds issued by both UK and US utilities with that implied by Ofgem's current cost of equity parameters. The outcome of this analysis is that Ofgem's ARP-DRP differential is between 50-100bps below the level derived from either regulatory precedent or an analysis of the equivalent differential of UK and US bonds. Based on the above we believe Ofgem must reconsider it CAPM parameters to ensure that they pass this test.

EXPECTED AND ALLOWED RETURNS

FQ19. Do you agree with our proposal to distinguish between allowed returns and expected returns as proposed in Step 3?

We fundamentally disagree with Ofgem's proposal to explicitly adjust the cost of equity for expected outperformance in RIIO-2. We have previously stated that if Ofgem has evidence to suggest that companies will systematically outperform its incentive and/or cost targets then it should adjust the targets not the cost of equity.

We are concerned that Ofgem is in danger of diluting the benefits of incentive regulation. The principle of RIIO was that Ofgem incentivised companies to innovate to deliver the outputs customers wanted at lowest cost. The impact of this framework is that companies have a strong incentive to continually review all aspects of their cost and performance to identify ways to push forward the efficiency frontier. This is obviously in customers' interests as they will receive the benefits of this in future price controls.

From this perspective it is wrong to automatically view outperformance as negative. We agree that regulators should strive to:

- Avoid regulatory error in setting both cost and incentive; and
- Ensure that regulatory incentives are appropriately tuned.

However, if both of these conditions are met then the revealing of additional outperformance beyond the allowed return should be viewed as good for customers.

We also cannot see how Ofgem can place a 50bps value on what this expected outperformance will be given that the incentive mechanisms have not been determined and Ofgem's approach to any Revenue Adjustment Mechanism has not been finalised.

We agree with the position stated by Phil Burns in the UKRN report where he states:

> "In our view, regulatory action on outperformance should apply to the cost and output targets not to the RAR – the RAR should be focussed on the WACC and minimising regulatory risk implies that

[21] Review of RIIO-2 finance issues, Rates of return used by investment managers, 2019, Page 7

[22] Asset Risk Premium and Debt Risk Premium, Oxera, 2019

> this should be clear and transparent. An arbitrary adjustment factor applied to the RAR would only add to regulatory discretion and risk."

In our opinion, if Ofgem arbitrarily adjusts the allowed cost of equity for its unsubstantiated view on expected outperformance this will increase the perception of risk in the sector and hence lead to a higher cost of equity. This is not in customers interests.

FQ20. Does Finance annex appendix 4 accurately capture the reported outperformance of price controls?

Answered as part of our response to question FQ21.

FQ21. Is there any other outperformance information that we should consider? We welcome information from stakeholders in light of any gaps or issues with the reported outperformance as per Finance annex appendix 4.

The analysis presented in appendix 4 represents the current forecast view of energy sector outperformance. However, these values may not be realised and will be impacted by a range of close out mechanisms which are yet to be finalised. The values also do not include the impact of either finance or tax performance which Ofgem is proposing to include as part of it new Regulatory Financial Performance Report.

We note that Ofwat's latest annual report for water companies, published in January 2019, does not show any sector-wide out-performance of Ofwat's 2017/18 totex allowances. We also note that First Economics has drawn Ofgem's attention to a very even historical mix of out- and under-performance against price controls sets by the likes of the Competition Commission, Ofwat, the CAA, ORR and the NI Utility Regulator.

FINANCEABILITY

FQ22. What is your view on our proposed approach to assessing financeability? How should Ofgem approach quantitative and qualitative aspects of the financeability assessment? In your view, what are the relevant quantitative and qualitative aspects?

The approach of looking at a range of factors is appropriate, however Ofgem also must recognise that the companies will only be financeable if they can maintain an investment grade credit rating as per licence obligation. Therefore, it would be helpful if Ofgem could set out in its financeability guidance what target credit rating it is aiming for. Our working assumption is that it is BBB+ to align with its proposals on the cost of debt. We would expect Ofgem to be assessing its proposals to ascertain if the overall package results in credit metrics that are consistent with maintaining a BBB+ rating. This must include appropriate interest rate and risk free rate stress testing scenarios.

FQ23. Do you agree with the possible measures companies could take for addressing financeability? Are there any additional measures we should consider?

We are concerned that Ofgem's proposals are only focused on what companies can do to address financeability issues. Ofgem has a duty to ensure that an efficient company can finance its functions and it would be helpful if Ofgem could set out its view on how its current proposals will fulfil this duty.

In addition, of the four company options presented the repurchase of expensive debt may not be economically viable and changes to either the capitalisation rate and/or depreciation rates may not improve interest cover credit metrics due to the rating agency treatment of such regulatory adjustments. The remaining adjustments basically require shareholders to inject equity to resolve financing issues. If this is required on a prolonged basis it will affect the attractiveness of the sector to investors. This would not be in customers' interests.

FQ24. Do you agree with the objectives and principles set out for the design of a cashflow floor?

Answered as part of our response to question FQ25.

FQ25. Do you support our inclusion of and focus on Variant 3 of the cashflow floor as most likely to meet the main objectives?

We do not agree with the principle of a cashflow floor. We have noted that all of the main credit rating agencies have also raised concerns over the proposed mechanism. Ofgem's financeability duty relates to both debt and equity investors.   We are concerned that the design of the cashflow floor is intended to reduce the returns to equity investors while at the same time increasing the risk that they bear. In order for a price control to be deemed financeable there must be sufficient financial headroom to absorb plausible downside risks. The negative impact of the current proposal is best highlighted by Moody's statement that *"If a mechanism is eventually devised that successfully removes the need for Ofgem to allow any headroom to financing costs, the credit quality of the sector is likely to be weakened."* If the credit quality of the sector is reduced this will increase the cost of capital which would not be in the long term interests of customers.

CORPORATION TAX QUESTIONS

FQ26. Do you support our proposal that companies should seek to obtain the "Fair Tax Mark" certification?

Answered as part of our response to question FQ28.

FQ27. Is there another method to secure tax legitimacy other than the "Fair Tax Mark" certification? Could we build upon the Finance Acts (2016 and 2009) with regards to the requirement for companies to publish a tax strategy and appoint a Senior Accounting Officer?

Answered as part of our response to question FQ28.

FQ28. For Option A, how should a tax re-opener mechanism be triggered? Is there a materiality threshold that we should use when considering the difference between allowances and taxes actually paid to HMRC? If so – what might this be?

In our view before Ofgem decide to place additional costs on companies, and hence ultimately on customers, it should first present evidence that it has identified an issue with the tax payments that the industry is making. We have seen no such analysis.

We are also unclear on why Ofgem has a preference for the Fair Tax Mark. In common with a number of large companies we already publish our tax strategy externally. Therefore, we recommend that Ofgem undertakes a survey to understand what actions companies are already taking before determining whether additional measures are needed.

RPI/CPIH INDEXATION

FQ29. What is your view on our proposal for an immediate switch to CPIH from the beginning of RIIO-2 for the purposes of RAV indexation and calculation of allowed return?

Answered as part of our response to question FQ30.

FQ30. Is there a better way to secure NPV-neutrality in light of the difficulties we identify with a true-up?

In principle, we agree that an immediate transition is the simplest approach. However, ensuring NPV neutrality is a key issue. In our answers to questions FQ4 and FQ6 we have proposed that for the calculation of both the real risk free rate and the cost of debt a CPI forecast is used which is then subsequently trued up the actual inflation. We believe that this approach will contribute to NPV neutrality. Furthermore, Ofgem have historically assumed that the notional company will have 25% index linked debt. Given that there is currently no material CPIH (or CPI) index linked debt market, there may be additional finance costs associated with procuring index linked debt in the short to medium term. These costs should be allowed.

In addition, for companies with RPI linked debt additional mechanisms may be required. This may include:

- Allowing the transaction costs for swapping RPI linked liabilities into CPI (CPIH) linked instruments; or
- Allowing companies to propose a phased transition to CPI, in which Ofgem provides for sufficient RPI-linked RAV to match companies RPI-linked debt liabilities, if they can demonstrate that this is an efficient mechanism to relieve RPI linked debt financeability issues,

FQ31. Do you have any specific views or evidence relating to useful economic lives of network assets that may impact the assessment of appropriate depreciation rates?

We remain of the opinion that companies should be able to propose different asset lives to improve financeability if required.

FQ32. Do you agree with our proposed approach to consider capitalisation rates following receipt of company business plans?

We remain of the opinion that companies should be able to propose different capitalisation rates to improve financeability if required.

FQ33. Do you have any comments on the working assumption for notional gearing of 60%, or on the underlying issues we identify above?

It would be helpful if Ofgem could set out its rationale for setting the notional gearing at 60%. Our working assumption is that it perceives that the reduction in the gearing will improve financeability. However, Ofgem has decided to increase gearing over a number of price controls which has reduced costs to customers. However, if a change in notional gearing is required for financeabilty reasons then it seems reasonable that the cost of facilitating that transition are shared equitably.

FQ34. Do you agree with our proposed approach to consider notional equity issuance costs in light of RIIO-2 business plans and notional gearing?

Ofgem’s approach seems reasonable.

Electricity System Operator Annex

ESO ROLES AND PRINCIPLES QUESTIONS

ESOQ1. Do you agree with our proposal to maintain the current roles and principles framework for RIIO-2?

Whilst we acknowledge Ofgem's intention of providing flexibility through a more 'principles-based' approach with regards to ESO regulation, we are keen to see the development of measureable outputs that match the ESO's responsibilities. For example, defining Key Performance Indicators (KPIs) would help provide all stakeholders with clarity of what the ESO is doing and why. These KPIs should differentiate between the ESO delivering its statutory duties and delivering additional customer benefits through innovation and efficiencies. To appropriately value any incentives and penalties greater visibility is required of the ESO's costs and how these align to delivering their forward plan.

ESOQ2. Do you agree with our proposals to keep the ESO's code administration, EMR delivery body, data administration, and revenue collection functions in place for RIIO-2? Do you believe that any of these functions (or any other functions) should be opened up to competition, either now or in future?

At the time of writing the ESO has not yet become a legally separate organisation, therefore we do not think it is appropriate to say at this point which functions it should retain in the longer term. Based on the information provided by Ofgem in their consultation document we do not currently see a strong case for committing to opening up the ESO's current functions to another third party.

ESOQ3. Do you consider the ESO is best-placed to run early and late competitions?

We support Ofgem and BEIS' ongoing review of whether the roles and responsibilities of the ESO relative to DSOs is appropriate in the context of a changing energy system. Whilst there could be a case for the ESO running competitions in the transmission sector, we do not think this is appropriate in the distribution sector, where DNOs are already transitioning to DSOs.

Our view is that as greater volumes of DERs connect in place of dispatchable transmission connected generation, the role of DSOs will naturally expand. This will help to manage the increased complexity associated with a far greater number of players and resources engaging in energy and flexibility markets. Therefore, Ofgem should focus on addressing questions on roles and responsibilities for competition within electricity distribution as part of the RIIO-ED2 process.

In RIIO-ED1 we have significantly ramped up our DSO capabilities by engaging with stakeholders and co-developing new arrangements with them and other DNOs. In 2018 we committed to market testing all of our load related reinforcement requirements prior to the start of RIIO-ED2. The Totex Incentive Mechanism has been a key enabler to this and is encouraging us to use market based flexibility as an alternative to conventional, network based, solutions. We strongly recommend Ofgem retains the Totex Incentive Mechanism and native competition in RIIO-ED2, as we believe this will allow us to continue to build on the progress we are making towards stimulating local flexibility markets.

PRICE CONTROL PROCESS QUESTIONS

ESOQ4. Do you agree with our proposal to move to a two-year business planning cycled price control process for the ESO? If not, please outline your preferred alternative, noting any key features (eg uncertainty mechanisms or re-openers) that should be included.

A key advantage of Ofgem's proposal for a two-year price control for the ESO is that the second cycle will be aligned with the start of RIIO-ED2. This will enable Ofgem to consider system operation arrangements across all levels and should therefore better facilitate a whole systems approach. Nevertheless, Ofgem should not commit itself to retaining the two-year cycle in the future, as there is currently a lack of evidence to determine what the best option is.

We have general concerns that short price controls e.g. two-years long, discourage longer-term planning, which is particularly important when decisions are being made on high-value-projects and capital intensive programmes. Whilst the ESO could be said to be 'asset light', it will have a major role in making investment decisions that are long-term in nature; therefore Ofgem must consider how to set a framework that appropriately manages risk and reward to protect current and future customers.

ESOQ5. What stakeholder engagement mechanisms should be put in place for the ESO's business planning and ongoing scrutiny of its performance? Do you agree with our proposal to maintain, and build upon, the role of the Performance Panel?

The ESO's Performance Panel was only set up several months ago, therefore it is premature for Ofgem to be talking about building on this. Nevertheless, we support Ofgem's decision to appoint a Performance Panel to assess the ESO's progress against well-defined KPIs. This should include an evaluation of the ESO's stakeholder engagement performance and the processes they are deploying more broadly. However, we were disappointed that the ESO's recently appointed Performance Panel did not have greater diversity. For example, we believe there is a risk that some groups are under-represented compared to others, which may result in the ESO not reflecting their needs adequately and will make attaining a level playing field more challenging.

In broad terms, we recognise that the ESO's stakeholder engagement will be a crucial factor in determining how successful they are at meeting customers' requirements going forward. Therefore there must be a strong incentive for the ESO to do this well. We recommend that Ofgem align the approach it has used in RIIO-ED1 when considering the ESO's regulatory arrangements in this area.

ESO OUTPUT AND INCENTIVES QUESTIONS

ESOQ6. Do you agree with our proposed approach of using evaluative, ex-ante incentives arrangements for the ESO?

We support the ESO doing its best to exceed expectations. However, we believe it is too early to respond to this question for RIIO-2 timescales and we think this should be revisited once the ESO has had a sufficient period as a legally separate organisation.

Our feedback is that Ofgem's proposals look very similar to the current incentives arrangements the SO has. We expect that as new data becomes available and the RIIO-ED2 process begins, Ofgem will be in a position to evolve the ESO's outputs and incentives.

We have concerns that Ofgem is setting financial incentives for the ESO to deliver whole system solutions, whereas for electricity distribution companies, Ofgem is proposing a separate new whole systems licence. In effect this is obliging DNOs to behave in a certain way e.g. around sharing information; in contrast if the ESO behaves in the same way it will described as good performance, which is financially rewarded. We strongly recommend that Ofgem considers arrangements more holistically and develops mechanisms that will lead to joint coordination. For example, in the consultation document Ofgem mentions the benefits to the ESO if DNOs provide information on congestion management, yet there is no mention of the benefits that we as a DNO can realise by the ESO sharing equivalent data.

ESOQ7. Do you agree that we should continue to apply a single 'pot' of incentives to the ESO, and that this should be a symmetrical positive/negative amount? If not, why not?

At this stage we agree with the use of a 'pot' of incentives, which has symmetrical reward and penalty. As a principle we believe incentive based regulation demonstrably improves performance and the value of rewards should be commensurate with the risks facing a licensee when making decisions. However, unlike in electricity distribution the ESO's performance cannot be easily benchmarked, which makes this a more difficult task for Ofgem.

A key success of the GB regulatory framework is its focus on measuring performance with respect to well-defined outputs. To meet Ofgem's definition of 'exceeding expectations' the evidence required to support achieving this should be "clear and tangible"; we therefore recommend that for each metric there is up front clarity of what qualifies as tangible evidence. For example, in RIIO-ED1 outputs and incentives on network performance, as measured by the number and length of interruptions to supply have demonstrably been a powerful way of improving service levels. We have concern that some of the ESO's proposed metrics (e.g. metric 14 on 'right first time connection offers') are difficult to both benchmark and monitor the success of independently. We would support ways of quantifying the customer benefits of different metrics, as currently it is difficult to evaluate which areas the ESO should be prioritising. Further to this, it will be appropriate for some metrics to be defined with reference to a longer timeframe, due to the nature of system changes.

Our broader view is that all of the metrics agreed for the ESO must be measurable, clearly defined, fully transparent and have independently auditable outputs. Where feasible, we believe metrics should quantify the customer benefit available and how the ESO will realise this. We would also welcome a clearer explanation in the ESO's Forward Plan as to how they have justified their new metrics. This explanation should be evidenced based and demonstrate how the ESO has tested their ideas with stakeholders as part of the decision process.

ESO COST ASSESSMENT QUESTIONS

ESOQ8. Do you agree with our proposed approach to assessing the costs of the ESO under RIIO-2? Do you think we should assess costs on an activity-by-activity basis? How would you go about defining the activity categories? Are there alternative approaches we should consider?

Ofgem should aim to develop a cost assessment process for the ESO that is consistent with the rest of RIIO-2. We are concerned that Ofgem's proposal for new activity-based benchmarking will be very complex and there are insufficient comparators to justify this. Ofgem also fails to recognise that the energy system is rapidly changing and therefore activities, alongside roles and responsibilities, are also changing. This means that benchmarking will be challenging unless a simplified and consistent approach is taken that is strongly tied to customer benefits.

As an alternative, Ofgem could develop an approach akin to their Business Plan incentive, which would encourage the ESO to engage with their stakeholders to justify any proposals. As well as being forward looking Ofgem could incorporate data on historical costs in a similar way to the rest of RIIO-2. We also question whether Ofgem should be ruling out at this stage using the Totex Incentive Mechanism for the ESO. We do not agree with the suggestion that totex will reduce spend in certain areas where investment would deliver better system activities, as we believe the ESO can and should be incentivised to include such spend when developing its business plan.

ESOQ9. Do you consider the types of cost assessment activities we outline in this chapter are the right ones? Are there additional activities you think we should consider?

We do not agree with the eight activities and services shown on pages 35 and 36 of the ESO annex; nor do we believe Ofgem should be breaking these down into further activities at this stage. It is particularly concerning that the activities listed do not translate into outputs that are meaningful for customers. For example, Ofgem has separate categories to “operate the system in real-time” and “facilitate and run markets to balance the system”, however we believe in reality these are same in terms of desired outcomes.

When comparing the proposed ESO activities with those set for DNOs as part of their outputs in RIIO-ED1, there is marked difference in terms of how measurable and independently auditable these are. Ofgem should consider ESO outputs that focus on what their primary objectives are for meeting customers’ needs. For example, DNOs are facilitating local flexibility markets because through the totex model this can reduce the cost associated with maintaining a reliable supply to customers. Similarly, the ESO should be attempting to reduce the costs associated with residual balancing across the whole system, however, this is unclear from Ofgem’s current proposals.

ESO FINANCE QUESTIONS

ESOQ10. Do you agree with our proposed remuneration model for the ESO under RIIO-2? Do you think it provides the right incentives for the ESO to deliver value for money for consumers and the energy system? Are there other models you think are better suited?

We are unconvinced that Ofgem’s proposal to utilise a cost pass-through with a margin is the best option; particularly given the complexity around setting different margins for certain activities. Ofgem recognises that it has found it difficult to efficiently assess the ESO’s costs using existing arrangements due to the lack of benchmarks, therefore we do not see how the proposed approach will lead to an improvement.

If Ofgem is minded to move away from the RAV model used elsewhere in RIIO, we believe there is merit in considering the ‘annual budget with margin’ approach, as this replicates many of the mechanics that have underpinned RIIO.

ESOQ11. Are there any risks associated with our proposed remuneration model that you do not think have been effectively captured and addressed? Do you think that we should put in place any of the mechanisms intended to provide additional security to the ESO outlined in this chapter – eg parent company guarantee, insurance premium, industry escrow or capital facility?

Based on Ofgem’s proposals we are unclear how they will protect customers from the ESO overspending. We believe that any ex-post assessment of whether spend was efficiency will be fraught with difficulty, therefore our preference is for the use of ex-ante allowances and outputs.

We do not believe that Ofgem needs to put in place any additional security for the ESO. Special administration requirements are already in place for all licensees if they experience financial difficulties and there should not be a need for anything beyond this for the ESO.

It would be helpful for Ofgem to explain why the ESO would ever face the financial difficulties they describe and whether these would be performance related.

ESOQ12. Do you agree with our proposal relating to remove the cost sharing factor? Can you foresee any unintended consequences in doing so, and how could these be mitigated?

We do not agree with this. We believe the Totex Incentive Mechanism alongside a suitable sharing factor provides a strong incentive to deliver outputs at the lowest cost. Therefore, if Ofgem correctly defines what outputs the ESO should have going forward, this approach should be used and is consistent with what is being done more widely in RIIO. We recommend that Ofgem considers a suite of outputs and incentives based on what matters to customers the most.

ESOQ13. Do you agree with our proposal to introduce a cost disallowance mechanism for demonstrably inefficient costs? What criteria should we apply in considering what constitutes 'demonstrably inefficient'?

If this proposal adopts a similar process to that used in the RIIO-ED closeout, with assessment of efficient delivery of outputs, there may be merit in introducing a similar framework for the ESO. This relies on clearly defined outputs and well specified closeout process.

ESO INNOVATION QUESTIONS

ESOQ14. Do you agree with our proposals to retain an innovation stimulus for the ESO, but tailor aspects of this innovation stimulus to take account of the nature of the ESO business?

We support retaining an innovation stimulus for the ESO and support either options 2 or 3.

We do not agree with Ofgem's rationale for removing a limit to what the ESO can spend on innovation and we believe arrangements should remain consistent between all network companies. Furthermore, as much as possible network companies should be encouraged to co-partner with each other and third parties on innovation.

ESOQ15. What ESO-specific issues should we consider in the design of the ESO innovation stimulus package

Ofgem must consider how their current approach of measuring benefits using E6 reporting, will be split across NGET (TO) and the newly separate ESO function.

Electricity Transmission Annex

MEET THE NEEDS OF CONSUMERS AND NETWORK USERS

General output questions

ETQ1. What are your views on the overall outputs package considered for this output category?

We support Ofgem's commitment to putting stakeholder engagement at the heart of RIIO-2 and we expect that Ofgem will take a consistent approach to all network companies to achieve this.

Whilst we agree that the Business Plan incentive will be important in encouraging stakeholder engagement, we believe that a strong incentive should also exist within the price control period. Therefore, we are currently minded to support option 3, which would see a retention of a financial Output Delivery Incentive (ODI) for meaningful stakeholder engagement. The SECV incentive in RIIO-ED1 has driven DNOs to go beyond business-as-usual by replicating a competitive market whereby companies are striving to be at the top of annual rankings. We recognise that there are fewer comparators at transmission, but we nonetheless believe that Ofgem should be applying the same principle as RIIO-ED1. As with competitive markets, companies should expect a financial reward commensurate to the benefits they are providing customers by listening and responding to their needs.

ETQ2. For each potential output considered (where relevant):

a) **Is it of benefit to consumers, and why?**
b) **How, and at what level should we set targets? (eg should these be relative/absolute)**
c) **What are your views on the design of the incentive? (eg reward/penalty/size of allowance)**
d) **Where we set out options, what are your views on them and please explain whether there are further options we should consider?**

We do not have any feedback to provide on this question.

ETQ3. What other outputs should we be considering, if any?

We do not have any feedback to provide on this question.

ETQ4. What are your views on the RIIO-ET1 outputs that we propose to remove?

Our reading of Ofgem's proposals is that only the Stakeholder Engagement part of the Stakeholder Satisfaction Output (SSO) could be removed as part of the transition from RIIO-ET1 to ET2. We do not agree with the complete removal of the Stakeholder Engagement part of the SSO; as an alternative Ofgem should consider building on the learnings from RIIO-ET1 to refine and improve a stakeholder engagement related ODI in RIIO-ET2.

Supplementary output specific questions

Stakeholder Satisfaction Output: Stakeholder Engagement Incentive

ETQ5. We welcome views on whether a specific incentive for stakeholder engagement is appropriate in RIIO-ET2, and if so, whether this should reputational or financial.

Yes, we believe a specific incentive for stakeholder engagement is appropriate in RIIO-ET2 and we believe this should be financially based to replicate what is seen in competitive markets. We also think there is merit in Ofgem working with industry with the aim of developing, where appropriate, a common methodology to stakeholder engagement across the transmission and distribution sectors. We believe this would provide more comparators and would therefore help to sharpen competition between network companies.

ETQ6. Do you think individual components of the SSO should be combined into a single incentive mechanism in RIIO-ET2, should the SEI and components of the SSO be retained?

We do not have any feedback to provide on this question.

ETQ7. We invite views on types of business plan commitments that would be appropriate for stakeholder engagement.

We do not have any feedback to provide on this question.

ETQ8. We welcome views on the potential approaches to setting a financial incentive for the SSO in RIIO-ET2, if retained. Are there any other considerations we should take into account if we move to a fixed reward pot that network companies compete for?

We agree with Ofgem's intention to make performance in this area comparable across different companies. This will lead to greater transparency for stakeholders and will drive companies to find improvements in the way they engage. We think that there is merit in considering the establishment of a competed pot for the SSO in RIIO-ET2. However, if Ofgem proceeds with this, careful consideration will be required on how any competed pot interacts with any new RAM which is introduced.

Stakeholder Satisfaction Output: Satisfaction Survey, KPIs, and External Assurance components

ETQ9. Do you have any views on whether we should retain a TO User Survey, targeted at a number of key areas as identified in this document? Are there any alternative mechanisms to address potential issues in these areas we should be considering?

We do not have any feedback to provide on this question.

ETQ10. Are there any other areas, beyond those identified in this consultation document, which we should consider targeting through a potential survey?

We do not have any feedback to provide on this question.

ETQ11. Do you have any views on our proposal to retain one question on overall satisfaction from which the scores will be collated?

We do not have any feedback to provide on this question.

ETQ12. Do you agree that we should use RIIO-ET1 performance as a starting point for setting a RIIO-ET2 baseline? What alternative approach(es) should we consider?

Yes, we agree that as a principle RIIO-1 performance should be used as a starting point for setting baselines in RIIO-2. However, this does not mean that the activity, in this case stakeholder engagement, should be considered as a reputational only incentive that is business-as-usual. Instead Ofgem should be defining frontier performance using available data and quantifying what value this will provide to customers in order to set financial incentives. If Ofgem sets this value to zero then this questions the purpose of creating the ODI in the first place, as it suggests that customers will not be impacted by how network companies perform.

ETQ13. Do you agree that the User Groups could provide guidance on the stakeholders that should be included in the survey sample? Are there any specific stakeholders that you think must be surveyed to improve the validity of the scores?

Yes, it would be pragmatic for the TO's User Group to provide guidance on the stakeholders that should be included in the survey sample.

ETQ14. Do you agree with our proposals to remove the financial incentive associated with the KPI and EA components? Should the EA component be retained as a minimum requirement/ licence obligation?

We do not have any feedback to provide on this question.

<u>**Timely Connections Output**</u>

ETQ15. Do you have any views on whether we should retain the RIIO-ET1 Timely Connections Output (which applies to the connection offer stage) for RIIO-ET2, including the penalty rate, and extend it to NGET?

We do not have any feedback to provide on this question.

ETQ16. Do you have any views on options for capturing the quality of the overall connections process through our stakeholder engagement proposals, for example through the use of a survey?

We welcome Ofgem's acknowledgement of the arrangements used in RIIO-ED2 to assess the connections process via the Average Time To Quote & Connect (ATTQ&C) Incentive. ATTQ&C has significantly sharpened the focus of DNOs with regards to how they facilitate new connections on the distribution network. If Ofgem wants to deliver similar step changes in how connections are offered on transmission we suggest they do include incentives on both the quality of offers and their timeliness.

However, it is important that Ofgem recognises that each customer has different priorities and Ofgem's methodology should afford connectees the opportunity to state how well the network company met their personal expectations. This would help Ofgem weight the importance of these factors appropriately. It is also worth noting that in RIIO-ED1 the high volume, low value connections are captured in the Broad Measure of Customer Service, whilst the low volume, high value connections currently come under the ICE mechanism.

ETQ17. Are there any alternative options for capturing the quality of the overall connection process, not identified in this consultation document, which we should be considering?

We do not have any feedback to provide on this question.

ETQ18. How do you think we can ensure that transmission operators are not rewarded and/or penalised for actions actually undertaken by the System Operator?

We do not have any feedback to provide on this question.

Energy Not Supplied

ETQ19. Do you have any views on whether we should retain the ENS incentive, and whether we should retain it as a positive reward mechanism, or move towards a penalty-only scheme? What impact could the move to a penalty-only mechanism have on TO decision-making and behaviours? Please evidence.

As a principle we support the retention of an incentive similar to ENS in RIIO-ET2 as we believe that this will keep TOs focussed on ensuring network reliability. We believe the targets set as part of this should be appropriately benchmarked with existing sector performance to encourage companies to go beyond business-as-usual. However, this does not mean that Ofgem should focus on penalising companies for maintaining what is deemed by customers as a good level performance, but has become business-as-usual. Furthermore, any new targets set by Ofgem on reliability should be deliverable as well as commensurate to the customer benefits they provide.

ETQ20. Do you have any views on how Ofgem should take into account issues other than past performance when determining baseline targets? For example, processes adopted as BAU, increased TO experience and expertise on fault mitigation and management, future modernisation projects, etc. What adjustment mechanisms are appropriate?

We do not have any feedback to provide on this question.

ETQ21. Is the introduction of an improvement factor appropriate within the context of the electricity transmission system? What other mechanisms are appropriate?

We do not have any feedback to provide on this question.

ETQ22.We welcome views on additional considerations we should take into account when setting baseline targets?

We agree with Ofgem's suggestion that network companies should engage with stakeholders to determine what an acceptable baseline looks like. This would help to capture any regional differences in customers' willingness to pay for greater reliability.

ETQ23. Do you agree with our proposals to base the ENS incentive rate in RIIO-ET2 on an updated, agreed VoLL?

We support Ofgem's proposal to update VoLL. VoLL provides an important measure of customers' willingness to pay, therefore it is important that the methodology used to determine it remains accurate. Notwithstanding this we do not believe an updated ENS should be the default value for RIIO-ED2. DNOs, either collectively or independently, should be able to present well evidenced willingness to pay research at RIIO-ED2 to support the setting of appropriate incentive rates for distribution companies.

ETQ24. Do you agree with our proposals to retain the financial collar for the ENS incentive in RIIO-ET2?

We do not have any feedback to provide on this question.

ETQ25. We welcome views on approaches to estimating embedded generation at GSP points.

Significant half hourly data is already readily available on the output of large scale distributed generation, which will help TOs estimate embedded generation at GSPs. Furthermore, National Grid (SO) already forecasts the output of generation across GB in order to balance the system in real-time. If the TOs are proposing to account for embedded generation as part of a new ENS incentive then we recommend that they utilise these existing datasets.

ETQ26. What measures need to be in place to facilitate the collection of data on embedded generations and other real time information? How do you propose to approximate embedded generation data?

We are unclear of the customer benefit attached to facilitating greater volumes of data on embedded generation as part of a new incentive on the TOs. Furthermore, we have not yet been contacted by the TO on whether we have data that could be useful for them. When considering the sharing of any data on embedded generation, both Ofgem and the relevant DNOs will need to understand how this will translate into benefits for customers as part of a cost benefit analysis. Currently it is unclear based on what has been included in Ofgem's consultation document, what additional benefit customers will receive from TOs capturing accurate information on embedded generation.

ETQ27. We invite views on changing the metrics used to measure reliability on the transmission system from MWh lost to CI/CML? What measures and processes (e.g. data sharing frameworks) need to be in place to facilitate the collection of CI/CML data?

In the last three years we have had no incidents on our distribution network associated with transmission level outages. Therefore, we do not see a rationale for the TOs to move from measuring reliability in MWh lost to CIs and CMLs, which includes the customers within distribution networks. Our key question is what change of behaviour will this result in above and beyond the arrangements DNOs and TOs establish at the GSP. Unlike DNOs, the TOs supply a few large customers, and we believe there focus should be on meeting their needs by appropriately engaging with them.

We welcome the opportunity to further discuss whether arrangements between DNOs and TOs could be enhanced to ensure whole system reliability is co-optimised. For example, we already have a mechanism in place that provides a reactive signal to the TO when a transmission fault has had an impact on our customers, and we are open to exploring how this could be further improved commensurate to potential customer benefits.

ETQ28. Do you have any views on whether all loss of supply events should be incentivised? Do you have any views on amending the scope of the definition of events excluded as 'loss of supply events' and/or 'exceptional events'?

We do believe that all loss of supply events should be incentivised. Regarding the definition of 'exceptional events', we welcome Ofgem's proposal to further consult on whether this needs to be updated in RIIO-2. For example, we can see a rationale for including cyber-security criteria.

DELIVER AN ENVIRONMENTALLY SUSTAINABLE NETWORK

General output questions

ETQ29. What are your views on the overall outputs package considered for this output category?

We do not have any feedback to provide on this question.

ETQ30. For each potential output considered (where relevant):

a) **Is it of benefit to consumers, and why?**
b) **How, and at what level should we set targets? (eg should these be relative/absolute)**
c) **What are your views on the design of the incentive? (eg reward/penalty/size of allowance)**
d) **Where we set out options, what are your views on them and please explain whether there are further options we should consider?**

We do not have any feedback to provide on this question.

ETQ31. What other outputs should we be considering, if any?

We do not have any feedback to provide on this question.

ETQ32. What are your views on the RIIO-ET1 outputs that we propose to remove?

We do not have any feedback to provide on this question.

Supplementary output specific questions

Environmental framework - Business Plans and annual monitoring

ETQ33. Do you have any views on the extent to which company activities relating to environmental impacts should be embedded in Business Plans?

We do not have any feedback to provide on this question.

ETQ34. We invite views on whether the proposed environmental impact categories are appropriate areas to focus on. Are there any areas that should be excluded and/ or other areas that should be covered? We also invite views on the potential indicators and/ or metrics that are appropriate for each environmental impact category.

We welcome Ofgem's focus on network companies making a greater contribution to the low carbon transition in RIIO-ET2. We believe there is merit in Ofgem considering a package of incentives as part of a new environmental output that drives innovation in this area. As a starting point, Sustainability First published a useful thought piece[23] in this area in 2018, which can be built on. Our recommendation is that Ofgem works with network companies to define metrics that will deliver real progress in this area. For example, the Business Carbon Footprint (BCF) is an area that has seen reasonable progress in RIIO-1 but arguably could be sharpened in RIIO-2 via a stronger signal. A key benefit of the BCF is that it is measurable,

[23]https://www.sustainabilityfirst.org.uk/images/publications/other/Sustainability_First_Low_Carbon_Incentive_in_RIIO2_DIscussion_Paper_FINAL_web.pdf

comparable and relatively controllable; hence we encourage Ofgem to apply similar test on other incentives in this area.

ETQ35. We welcome views on the option of an annual reporting framework to increase transparency of the transmission networks' impact on the environment.

We do not have any feedback to provide on this question.

__Potential for bespoke ODIs around the low carbon transition__

ETQ36. We welcome views on whether we should introduce an option for the TOs to develop bespoke ODIs with stakeholders for delivering an additional contribution to the low carbon transition.

In most cases we believe that common outputs and incentives will be appropriate to TOs across the sector. Therefore we generally caution against encouraging network companies to independently develop incentives, as this risks discouraging cooperation and will make comparing performance more challenging. For example, regardless of where a customer is located they are likely to benefit in similar ways from network companies improving their environmental and reliability performance.

However, if a strong case can be made for a bespoke ODI that is unique to a network's area, we recognise that the potential benefits of these should be realised. For example, there could be opportunities to deliver environmental benefits that are very locational in their nature. We believe Ofgem should therefore encourage network companies to engage with their stakeholders to determine if there is justification for bespoke ODIs worth developing. This would require Ofgem to avoid penalising network companies in the benchmarking process because they included additional expenditure to deliver outputs beyond business as usual. Furthermore, we recognise there is merit in having flexibility within price controls for companies to be able to access funding that goes beyond business as usual action on environmental issues; similarly to how the Losses Discretionary Reward has operated in RIIO-ED1. Potentially this could form part of Ofgem's proposed Whole System Discretionary Fund.

ETQ37. We invite views on the kind of activities, not captured elsewhere, that could be captured through such ODIs.

We do not have any feedback to provide on this question.

ETQ38. We invite views on how such an ODI might operate, and any other factors we should take into account in considering bespoke ODI for the low carbon transition.

We do not have any feedback to provide on this question.

__SF6 and other insulation and interruption gases (IIG) leakage__

ETQ39. We welcome views on whether we should retain a financial reward and penalty incentive for the leakage of SF6 in RIIO-ET2, or move to a penalty only or reputational incentive.

We do not have any feedback to provide on this question.

ETQ40. We welcome views on the potential impact of a move away from a financial incentive (or move to penalty-only) on TO behaviours.

We do not have any feedback to provide on this question.

ETQ41. We invite views on whether leakage from other IIGs should also be captured in the incentive measure.

We do not have any feedback to provide on this question.

ETQ42. We welcome views on whether some leakage events should continue to be excluded from the incentive.

We do not have any feedback to provide on this question.

Electricity losses from the transmission network

ETQ43. Do you have any views on the proposed approach for integrating any losses reporting requirements into the proposed business plan and annual public reporting framework?

We do not have any feedback to provide on this question.

ETQ44. Do you have any views on the introduction of a target or measure for improving metering at and the energy efficiency of substations? How could this work in practice?

Our initial feedback is that this may be problematic to implement. Electricity consumption in substations is split between technical losses and self-consumption. The technical loss component is the electricity consumed by transformer cooling fans, pumps, battery chargers etc. The self-consumption includes substation lights and heating and should in theory be metered; therefore we already have an inherent incentive, via the Totex Incentive Mechanism, to be more energy efficient to reduce costs. It is also worth noting that most primary and grid sites are unmetered and the split between technical losses and own consumption is estimated.

As we believe there is unlikely to be much scope for improving the efficiency of the technical loss components, any benefit lies with either ensuring metering is installed and captures the true self-consumption of the substation or ensuring the accuracy of the estimate. In any event this is only a tiny fraction of total network losses and our ability to reduce technical losses is limited.

Visual amenity impacts of transmission infrastructure

ETQ45. We welcome views on incentivising the TOs' engagement with stakeholders on the development of new transmission projects through our stakeholder engagement proposals, for example through the use of a survey.

We do not have any feedback to provide on this question.

ETQ46. Do you have views on the retaining the existing scheme to mitigate the visual impact of pre-existing transmission infrastructure in designated areas? Do you agree that any decision to implement new funding arrangements should be subject to updated analysis around willingness to pay?

We do not have any feedback to provide on this question.

ETQ47. Do you agree with our proposals to modify the implementation process by which funding requests for mitigation projects are submitted and approved?

We do not have any feedback to provide on this question.

ETQ48. We welcome stakeholders' views on any other considerations they think are relevant to policy development for visual amenity issues in RIIO-ET2.

We do not have any feedback to provide on this question.

MAINTAIN A SAFE AND RESILIENT NETWORK

General output questions

ETQ49. What are your views on the overall outputs package considered for this output category?

We do not have any feedback to provide on this question.

ETQ50. For each potential output considered (where relevant):

- **a) Is it of benefit to consumers, and why?**
- **b) How, and at what level should we set targets? (eg should these be relative/absolute)**
- **c) What are your views on the design of the incentive? (eg reward/penalty/size of allowance)**
- **d) Where we set out options, what are your views on them and please explain whether there are further options we should consider?**

We do not have any feedback to provide on this question

ETQ51. What other outputs should we be considering, if any?

We do not have any feedback to provide on this question.

ETQ52. What are your views on the RIIO-ET1 outputs that we propose to remove?

We do not have any feedback to provide on this question.

Supplementary output specific questions

Network Access Policy (NAP)

ETQ53. Do you agree with our proposed approach to safety?

We do not have any feedback to provide on this question.

ETQ54. Do you agree with our proposal to retain the NAP as a licence obligation?

We do not have any feedback to provide on this question.

ETQ55. Do you have any views on the potential risks and benefits of introducing a single, consolidated NAP, and of expanding the NAP to cover interactions with third parties?

We do not have any feedback to provide on this question.

ETQ56. We welcome views on these proposals, and on any potential interactions and/ or duplications between these proposals, the NAP and the STC.

We do not have any feedback to provide on this question.

Successful delivery of large capital investment projects

ETQ57. Do you agree with our proposed approach for ensuring TOs do not benefit financially from delays in delivering large capital investment projects?

We do not have any feedback to provide on this question.

ETQ58. We invite views on the suitability of the milestone approach, the types of milestones or delivery criteria we should be considering and any potential challenges associated with implementing such an arrangement.

We do not have any feedback to provide on this question.

ETQ59. Are there any alternatives which we should also consider?

We do not have any feedback to provide on this question.

ETQ60. We invite views on the circumstances we should consider options for minimising consumer detriment and/ or sharing consumer detriment with consumers.

We do not have any feedback to provide on this question.

ETQ61. We are seeking views on these two options, including ways in which we could measure and reflect consumer detriment.

We do not have any feedback to provide on this question.

ETQ62. Are there any alternatives not identified here which you think we should be considering?

We do not have any feedback to provide on this question.

COST ASSESSMENT

ETQ63. Do you agree with our intention to evolve the RIIO-ET1 approach for RIIO-ET2?

We support this approach, which involves Ofgem adapting the cost assessment process used in RIIO-1 for RIIO-2. Our experience in RIIO-ED1 is that an appropriate blend of totex using top down benchmarking and more disaggregated modelling, allows different business models to deliver outputs for customers in the most cost efficient way.

ETQ64. Do you have any comments on appropriate cost categories, cost drivers or approaches to cost assessment?

We would welcome greater detail around how the cost assessment approach will operate as currently it is difficult to determine what exactly will be improved from the approach used in RIIO-1.

ETQ65. We invite views on the appropriateness of our proposed cost categories for RIIO-ET2.

An overarching principle should be that data collected during a price control provides the basis for a network companies' business plan. To do this it is important that cost categories are consistent from one price control to the next. Whilst we support Ofgem's intention to simplify cost categories in RIIO-ET2, we are concerned that any re-definition will make benchmarking challenging. For example, Ofgem has proposed change the definition of direct operating expenditure in RIIO-ET2, however, we would not want any drive for consistency between sectors to result in the loss of data for benchmarking by applying this to RIIO-ED2.

ETQ66. We invite views on the principles of a good cost driver and our approach to identifying suitable RIIO-ET2 cost drivers is appropriate.

We fully support Ofgem's criteria of what a good cost driver should look like. When reviewing the evidence behind cost drivers we support an approach that is reflective of the circumstances found in different sectors. We agree with Ofgem's view that in RIIO-ET2 there is likely to be more value in using bottom-up benchmarking, due to the bespoke nature of projects and small number of comparators. In contrast we believe top-down modelling using totex has greater value in RIIO-ED2 due to the greater number of comparators and historical data available.

ETQ67. We welcome any early views on how we can combine the analysis in order to ensure ex ante allowances reflect efficient costs.

We do not have any feedback to provide on this question.

UNCERTAINTY MECHANISMS

General uncertainty mechanism questions

ETQ68. We would welcome views on the design and suitability of existing uncertainty mechanisms for RIIO-ET2, and whether any of these should be removed.

We support the continued use of uncertainty mechanisms in RIIO-ET2. We also welcome Ofgem's review of individual uncertainty mechanisms in RIIO-ET1, as not all of these are likely to be needed in RIIO-ET2, and there is likely to be a case for developing new uncertainty mechanisms, which could either be initiated by Ofgem or a network company. One particular area we believe will require attention is whole systems and we encourage Ofgem to be proactive in developing an uncertainty mechanism to better facilitate whole system collaboration between TOs and DNOs. We also believe there is merit in Ofgem considering the use of new volume drivers in RIIO-2 that capture flows across the GSP, as this could help manage the uncertainty associated with load and generation connecting to the distribution network.

ETQ69. Are there any additional mechanisms that we should consider across the sector and if so, how should these be designed?

We are supportive of coordinated cross-sector reopeners to ensure that outputs and associated funding can be transferred to the most efficient delivery body. This could allow network operators to transfer ex-ante allowances and outputs to one another and could be tied to volume drivers set at the start of RIIO-ET1 e.g. a demand metric at GSPs. By including this TOs would have the assurance that they can deal with issues that affect them that emanate from the distribution network e.g. voltage issues caused by increased uptake of DER. However, it would also provide flexibility in case these issues do not materialise, or in cases where the DNO is better placed to resolve the issue in RIIO-ED2.

ETQ70. We would welcome views from respondents on the continuing relevance of these mechanisms and any changes to the way that they operate if they are to continue.

We believe uncertainty mechanisms will remain relevant in RIIO-2. However, as the price control length is being shortened, Ofgem should avoid creating overly complex and/or burdensome new mechanisms. We recommend that Ofgem aligns all network price controls for RIIO-3, by either shortening RIIO-ED2 to three years, or extending the price controls starting in 2021 by two years to facilitate whole system solutions and to address the issue of RIIO-ET price controls being out of synchronisation with RIIO-ED price controls.