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Dear Julie,

Call for Evidence on the Electricity Transmission, Gas Transmission, Gas Distribution and Electricity System Operator Business Plans for RIIO-2 – Incentives – Managing Uncertainty

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

This aspect of our response focuses on some uncertainty mechanisms proposed by companies across the three network sectors. We present our findings in the attached appendices.

In summary, whilst we support the use of uncertainty incentives in general, we have assessed the companies' proposals and identified some mechanisms that:

- target areas where there is not a genuine and material uncertainty,
- inappropriately transfer risk to consumers,
- disproportionately de-risk companies by protecting them from managing their business risk.

For others, the form of the mechanism is not most appropriate.

We also make the following general points:

- Reallocation of risk from companies to customers should be reflected in cost of capital
- The operation of materiality thresholds should be reviewed.
- A methodology to encourage companies to submit proposals that are well-justified, efficient and represent value for money from the consumer perspective should be developed.

Reallocation of risk from companies to customers should be reflected in cost of capital: The greater use of UMs in RIIO-2 changes the balance of risk between companies and consumers by reallocating some risk from companies to consumers, compared to the RIIO-1 counterfactual. The greater use of UMs is not meant to disproportionately de-risk companies by protecting them from managing their business risk. Ofgem commented on business risk in the context of the RIIO price controls:

RIIO does not insulate companies from the risk of higher costs than provided. Rather, we designed RIIO so that it encourages companies to 'play a full role.' This means, in part, taking responsibility for managing the uncertainty that their businesses face. Under RIIO, we expect network companies to bear their own business risk.[1]

UMs should be targeted only at those areas where genuine and material uncertainty exists. Also, UMs should be designed so that risk linked to a given uncertainty is appropriately transferred to consumers – e.g. both upside and downside risk instead of just downside risk. Companies may seek ways of transferring risks they would typically bear to consumers. If those proposals are accepted, it is necessary to reduce consumer funding for risk remuneration accordingly e.g. through a downward adjustment to the cost of capital.

The operation of materiality thresholds should be reviewed:
We have not identified any underlying factors which would explain why companies have proposed different thresholds for different UMs e.g. whether there should be no threshold or whether it should be defined as a specified proportion of baseline allowances or revenues. It is possible that thresholds create the risk that companies could make inefficient expenditure decisions to prevent UMs being triggered:

- companies may stop incurring costs, despite continuing to invest being the efficient decision, to avoid breaching the over-spend materiality threshold, or
- companies may continue to incur costs, despite it being efficient to stop investing, to avoid breaching an under-spend materiality threshold.

We believe it is necessary to review the operation of materiality thresholds and to provide clarity on when they are appropriate, which parameter(s) they should be linked to and whether the thresholds should take account of sharing factors. Further, clarity should reduce the risk that, when an item of expenditure could fall in scope of multiple UMs, companies select the UM with lower triggers.

It is necessary to review whether adjustments should be the entire amount of expenditure incurred/not incurred or just the difference between the threshold and the entire amount of expenditure incurred/not incurred. It is also necessary to review whether 'clustering' multiple UMs with a single threshold protects consumers' interests. For example, WWU proposes an 'aggregate cap on network re-openers'[2]. This requires careful consideration.

[1] "MPR parallel work decision"; paragraph 3.107: https://www.ofgem.gov.uk/system/files/docs/2017/07/mpr_parallel_work_decision-v3.pdf.
[2] WWU's Business Plan; page 108.

A methodology to encourage companies to submit proposals that are well-justified, efficient and represent value for money from the consumer perspective should be developed:
The RIIO-1 price control review framework included the Information Quality Incentive (IQI), to encourage companies to provide accurate and ambitious investment forecasts in their business plans. Companies would have been financially penalised for seeking expenditure allowances above levels deemed efficient. It continues to be the expectation that price control arrangements will aim to ensure efficient, justified business plan are submitted.

Reopener mechanisms were included in the RIIO-1 price control settlements. Companies were permitted to propose funding adjustments during the price controls once the need for and the scale of investment required was more certain, and Ofgem would assess whether the proposed adjustments were efficient. However, unlike at the price control review, the reopeners did not any mechanism equivalent to the IQI - companies are no worse for proposing funding adjustments during reopener windows that are not efficient nor well-justified. This means reopeners could be perceived as a ‘free hit’ and represent a low-risk option to companies to seek additional funding.

We have observed examples of submissions for funding adjustments falling below the required standard:

NGGT’s Compressor Emissions submission in 2015: was rejected because NGGT limited stakeholders’ ability to engage effectively by omitting relevant information from the stakeholder engagement processes and did not include all the information required in its submission[3].

SPD’s Accelerated Electric Vehicle Investment submission in 2018: was rejected because the proposed investment was outside of the scope of the reopener, the submission did not comply with all the requirements, the need for the investment had not been established and the proposed adjustment was not considered efficient.

SPMW’s High Speed 2 submission in 2018: was rejected because the proposed adjustment fell below the materiality threshold and the submission did not comply with all requirements[4].

SPD’s and SPMW’s 33kV Cable Systems submission in 2018: was rejected because the need for the investment was not established and the proposed adjustment was not considered efficient[5].

For RIIO-2, we recommend a methodology for encouraging companies to propose only adjustments that genuinely meet the qualifying criteria and intent of the respective reopeners and to provide only accurate and ambitious cost forecasts in submissions, especially since a greater number of reopeners may be included in the RIIO-2 settlements.

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[3] “RIIO-T1: Our decision on National Grid Gas Transmission’s application under the RIIO-T1 Compressor Emissions uncertainty mechanism”; page 3: https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/150928_ied_decision_letter_rev._c_2.pdf.
[4] “RIIO-ED1 Reopener Decision – High Value Projects”; paragraph 3.29: https://www.ofgem.gov.uk/system/files/docs/2019/10/riio-ed1_reopener_decision_-_high_value_projects.pdf.
[5] “RIIO-ED1 Reopener Decision – High Value Projects”; paragraph 4.45.

We hope you find these comments helpful. Please contact me if you have any questions.

Yours sincerely,

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Centrica's assessment of uncertainty mechanisms proposed by the companies

We have identified mechanisms that are not demonstrated to be in the interests of customers – they target areas without genuine and material uncertainty, they disproportionately de-risk companies by protecting them from managing their business risk and/or do not appropriately transfer risk to consumers. We discuss below.

Company:	SSEN	Title:	High Value Transmission Projects
Purpose:	To address uncertainty in the timing, location and scale of capital investments greater than £25m		
Mechanism:	Reopener		
Scope:	• Investments that are within scope of volume drivers but are expected to cost more than £100m based on allowances that would be provided if the volume drivers were applied. • Investments that are within scope of volume drivers but exceed the volume driver unit cost allowances by 33% • Projects within scope of the Strategic Wider Works Mechanism are excluded		

We do not support the element of the proposal relating to investments that are within scope of volume drivers but exceed the volume driver unit cost allowances by 33%. The mechanism would transfer the risk of out-turn costs being higher than allowed unit costs from the company to consumers without a complementary measure for returning funding to consumers if out-turn costs are lower than allowed unit costs.

At the RIIO-T1 Mid-Period Review, SPT proposed new asset solutions should be added to the shared-use connections volume driver mechanism, to provide allowances for deploying assets not included in the licence menu. Ofgem rejected the proposal, highlighting the asymmetric transfer of unit cost risk to consumers:

Amending the revenue driver would provide additional funding beyond what was set out and agreed in the price control settlement. It would also insulate SP Transmission from the risk of higher than forecast costs (where costs exceed allowances) while leaving consumers exposed to the risk that they pay above efficient costs (where allowances exceed costs).[6]

The proposed mechanism would also transfer timing and location risks, factors that can influence allowed unit costs, from SSEN to consumers. We consider these to be risks which companies typically face and have been remunerated for.

[6] "MPR parallel work decision"; paragraph 3.102.

Company:	SSEN	Title:	Brexit import tariffs
Purpose:	To address uncertainty there may be changes to import charges and other cost drivers due to Brexit		
Mechanism:	Reopener		
Scope:			

At this stage, we do not support this proposal. We accept the UK's BREXIT negotiations have not yet concluded and there may or may not be relevant factors that arise from those proposals. However, the impacts of the negotiations may be no different in type or magnitude, compared to risks companies already face such interest rates risk, foreign exchange risk and the risk of import tariffs being changed. Companies already face these risks and adopt appropriate mitigation strategies. We consider these to be risks which companies typically face and have been remunerated for. Further, SSEN has not explained how it will seek to mitigate these typical risks or how the proposal benefits consumers.

Company:	SSEN	Title:	HVDC Centre
Purpose:	To cater for the potential for the HVDC Centre to grow during the RIIO-T2 period.		
Mechanism:	Reopener		
Scope:	Expenditure associated with the HVDC Centre		

We do not support this proposal. SSEN explains the Centre was developed using innovation funding to enable the planning, development and testing of high voltage direct current transmission solutions. SSEN states "…*considering net zero targets, there is the potential for the HVDC Centre to grow during the RIIO-T2 period*…"[7]. If SSEN is suggesting there may be increased activity at the Centre to test innovative solutions to support meeting net zero targets, we agree. However, we do not agree that the increased activity should be funded via an uncertainty mechanism. If the increased activity at the Centre is due to innovative solutions being tested, we would expect the relevant expenditure to be funded by innovation funding. An uncertainty mechanism for this purpose is not necessary and funding should be sought from a more appropriate mechanism if it is needed.

Company:	SSEN	Title:	Operating cost escalator
Purpose:	To cater for increased costs due to network expansion		
Mechanism:	Driver - 1% of allowed capital funding from the year following completion		
Scope:	• Expenditure for inspection and maintenance activities, developing new processes and procedures for new technology on the network, and back office costs like buildings and fleet • For newly-installed assets funded via volume drivers, the Strategic Wider Works mechanism or the proposed High Value Transmission Projects reopener		

In principle, we accept there is a relationship between the size of the asset base and operating costs. However, we are not convinced the 1% capital cost escalator provides the best estimate of the incremental operating costs due to network additions. SSEN has not justified why newly-installed assets will cause incremental operating costs of that magnitude to be incurred during

[7] SSEN's Business Plan page 84.

RIIO-2. The proposal should be rejected is SSEN cannot robustly justify its assumptions relating to incremental costs for new assets.

Company:	SSEN	Title:	Sustainability escalator
Purpose:	To cater for additional scope 1 and 2 GHG emissions mitigation costs due to network expansion		
Mechanism:	Driver – 0.5% of allowed capital funding from the year following completion		
Scope:	• Expenditure to mitigate scope 1 and 2 GHG emissions • For newly-installed assets funded via volume drivers		

We do not think this proposal has been justified. SSEN has not explained why newly-installed assets will require mitigation costs of that magnitude to be incurred during RIIO-2. We accept some policy decisions relating to the Net Zero target are yet to be made. Those policy decisions may require additional mitigation measures to be adopted for existing assets beyond what has been included in baseline allowance requests. As such, we question whether an escalator based on the cost of newly-installed assets will provide efficient levels of additional funding. Further, the form of this mechanism is not the most appropriate.

Company:	NGET	Title:	SF6 reduction
Purpose:	To cater for the uncertainty of the level of investment required to replace assets to reduce SF6 emissions		
Mechanism:	Reopener		
Scope:			

We agree it is appropriate for outputs to be defined and efficient levels funding to be provided once the review of the asset base and the evaluation of replacement options have been completed. However, Ofgem should ensure the ability to rebase targets for the SF6 reduction and Network Asset Risk Metric (NARM) incentives once the investment programme has been confirmed is included in the price control settlement.

Company:	SPT	Title:	Net zero transition
Purpose:	To provide funding for new projects that may emerge to achieve the Net Zero target which are not currently foreseen		
Mechanism:	Reopener		
Scope:	Includes generation connection ‘outliers’: • Project unit rate is more than double the associated volume driver and the value is more than £25m • 275kV and 400kV OHL works with a value of more than £25m, or • Project involves the connection of an OFTO or generator greater than 250MW		

We accept some policy decisions relating to the Net Zero target are yet to be made and, as such, there is merit in this proposal. However, we do not support the element of the proposal relating to the project unit rate being more than double the associated volume driver. The mechanism would transfer the risk of out-turn costs being higher than allowed unit costs from the company to consumers without a complementary measure for returning funding to consumers if out-turn costs are lower than allowed unit costs. This element would also transfer other risks (such as location risk), factors that can influence allowed unit costs, from SPT to consumers. We consider these to be risks which companies typically face and have been remunerated for.

Company:	SPT	Title:	Legislative changes following Brexit
Purpose:	To address uncertainty there may be material increases in efficient costs such as increased tariffs due to Brexit		
Mechanism:	Reopener		
Scope:			

At this stage, we do not support this proposal. We accept the UK's BREXIT negotiations have not yet concluded and there may or may not be relevant factors that arise from those proposals. However, the impacts of the negotiations may be no different in type or magnitude, compared to risks companies already face such interest rates risk, foreign exchange risk and the risk of import tariffs being changed. Companies already face these risks and adopt appropriate mitigation strategies. SPT has not explained how it will seek to manage these typical risks or how the proposal benefits consumers.

SPT proposes the mechanism should apply only if there is a material increase in costs. It is possible the source of uncertainty could result in a material decrease in costs but, as proposed, the mechanism would not apply in that scenario. The asymmetry of the mechanism is not appropriate.

Company:	Cadent	Title:	Reinforcements
Purpose:	To address uncertainty of network reinforcement required due to demand growth.		
Mechanism:	Volume drivers		
Scope:			

There is merit in this proposal. We agree it is appropriate for outputs to be defined and efficient levels funding to be provided once there is enough certainty of the need for network expansion. We question whether volumes drivers can provide efficient levels of funding. We would expect some reinforcement projects comprise assets for which separate volume drivers exist. Determining funding requirements for a project using a bottom-up approach may not capture synergies across multiple types of projects, such as project management costs. We recommend reopener mechanisms are used instead and to require Cadent to demonstrate all the funding sought is efficient.

Company:	Cadent	Title:	Pipes above safety threshold
Purpose:	To provide funding for replacing high risk pipes above a safety threshold that are not part of the Iron Main Risk Replacement Programme.		
Mechanism:	Volume drivers		
Scope:			

AND

Company:	Cadent	Title:	High pressure valves
Purpose:	To provide funding for replacing high pressure valves.		
Mechanism:	Volume drivers		
Scope:			

At this stage, it is unclear to us whether UMs are needed to provide funding for these activities. Cadent should clarify whether the asset types in scope of these mechanism fall within the scope of the NARM and can be managed within that envelope. This is an important consideration especially since the NARM mechanism allows companies to 'trade' risk across asset types.

Company:	NGN	Title:	High-speed rail and TransPennine rail Electrification
Purpose:	To provide funding projects related to high speed rail and to the electrification of the TransPennine rail line.		
Mechanism:	Reopener		
Scope:			

We agree with the element of the proposal relating to the TransPennine rail line. It is appropriate to adjust allowances once the timing of the need for expenditure is certain. However, we disagree with ex-ante allowances being provided, even if they are provided on a 'use it or lose it' basis. There is no need for ex-ante allowances to be provided as the UM permits NGN to propose adjustments for efficient levels of funding. This would mirror the approach applied to the 'slow track' RIIO-ED1 settlements which permits the relevant DNOs to propose adjustments once there was enough certainty. This process took place in 2019. Also, we highlight Western Power Distribution, which was fast-tracked, returned the ex-ante allowances it received and has been permitted to propose adjustments once there is enough certainty. There is no reason why a different approach should apply to NGN.

In our response to the Informal consultation on RIIO-ED1 price control reopeners, we highlighted differing as to whether a policy decision has been made about how diversions should be funded and whether it has been confirmed electricity consumers should fund those costs. We continue to encourage Ofgem to clarify the policy. Further, if allowances are provided via this mechanism, it should be done on the basis that they will be clawed back if it is decided these works should be funded by third parties.

We disagree with the element of the proposal relating to high speed rail. During the 2019 RIIO-ED1 reopeners, Ofgem explained that *"…that there are substantial funds set aside to cover the diversion of utilities for the purposes of HS2…"*[8]. That funding renders this UM unnecessary.

Company:	NGN	Title:	Streetworks excavation disposal
Purpose:	To provide funding efficiently incurred costs as a result of potential changes to Streetworks legislation.		
Mechanism:	Reopener		
Scope:			

In principle, we accept legislation may alter existing excavation disposal obligations. GDNs currently bears disposal costs and will continue to do so in RIIO-GD2 even if there is no change in legislation. Therefore, if this UM is included in in the price control settlement, only the

[8] "RIIO-ED1 Reopener Decision – Rail Electrification Costs"; paragraph 3.5: https://www.ofgem.gov.uk/system/files/docs/2019/10/riio-ed1_reopener_decision_-_rail_electrification.pdf.

incremental efficient costs needed to comply with the new obligations should be in scope. The UM should allow for both positive and negative adjustments to be made.

Company:	SGN	Title:	Streetworks permitting and lane rental costs
Purpose:	To provide funding efficiently incurred costs as a result of the introduction of Streetworks schemes.		
Mechanism:	Reopener		
Scope:			

We agree with the element of the proposal. The UM should allow for both positive and negative adjustments to be made to ex-ante allowances once there is enough certainty.

Company:	SGN	Title:	Legislative and regulatory change
Purpose:	To accommodate the cumulative impact of legislative or regulatory change.		
Mechanism:	Reopener		
Scope:			

In principle, we accept changes in legislation may alter existing obligations or introduce new obligations. However, the proposed UM seems indiscriminate in nature – SGN states *"…it is also very important to have a broader legislative reopener…"*[9]. We disagree. SGN (and other GDNs) have proposed UMs that cover aspects of legislative change. SGN has not explained how this UMs would operate alongside the more specific UMs. There is a risk that adopting this proposal could create the risk that SGN may not be efficient as it otherwise would be as it could claim changes in its cost base are linked to <u>any</u> legislative change. This proposal should be rejected.

[9] SGN's Business Plan page 124.