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# Response to Draft Determination: Section F: Totex incentive mechanism, process concerns, interlinkages and appeals

## RIIO-GD2 Business Plan

4 September 2020



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## Structure of the document

Our response to the draft determination is split over six sections for ease of reference:

**Section A:** Executive Summary and Introduction.

**Section B:** Embedding the customer voice. This covers embedding the consumer voice, the CEG, and Ofgem's three consumer facing output categories - meeting the needs of consumers, an environmentally sustainable network, and maintaining a safe and resilient network. This section also covers cross-sector, sector-specific and bespoke outputs, ODIs and the CVP.

Here you will find answers to the following consultation questions;

- Core Questions (Q1 to Q9)
- Gas Distribution Sector Questions (GDQ1 to GDQ25),
- SGN Questions (SGNQ1 to SGNQ7) and
- NARMs Questions (NARMQ1 to NARMQ4).

**Section C:** Ensuring efficient cost of service. This covers the efficiency expectations approach to cost assessment, normalisation, regressions analysis, technically assessed cost and the business plan incentive. In this section we also provide our views on how COVID should be accounted for in the GD2 plan.

Here you will find answers to the following consultation questions;

- Core Questions (Q10 to Q11) and
- Gas Distribution Sector Questions (GDQ26 to GDQ41).

**Section D:** Ensuring efficient financing. This covers allowed return to debt, return on equity, the weighted average cost of capital and other finance issues such as tax.

Here you will find answers to all of the Finance consultation questions (FQ1 to Fq38).

**Section E:** Managing uncertainty and the move to net zero. This covers both cross sector, sector specific and bespoke uncertainty mechanisms, the approach to innovation and the move to net zero.

Here you will find answers to the following consultation questions;

- Core Questions (Q12 to Q33),
- Gas Distribution Sector Questions (GDQ42 to GDQ53) and
- SGN Questions (SGNQ8).

**Section F:** Totex incentive mechanism, process concerns, interlinkages and appeals.

Here you will find answers to the following consultation questions;

- Core Questions (Q34 to Q43)
- SGN Questions (SGNQ9)

These sections incorporate our responses to the questions set out in the draft determination appendices. Responses are denoted by: 'Q' for questions from the core document; 'GDQ' for questions from the gas distribution annex; 'FQ' for questions from the Finance annex; 'NARMQ' for questions from the NARMs Annex, and 'SGNQ' for questions from the SGN Annex.

For each substantive point we have then applied the following nomenclature;

**Type 1.** Factual or computational errors.

**Type 2.** Inconsistencies in stated approach or in the application of a methodology.

**Type 3.** Disagreement as to how the methodology should be applied.

**Type 4.** New evidence presented to respond to a point.

**Type 5.** Evidence that SGN has provided but hasn't been taken into account or given sufficient weight or given sufficient weight (i.e. SQs responses etc).

**Type 6.** Broad agreement with position put forward in draft determination.

Where substantial new evidence is provided, or there is a high level of confidentiality associated with the information provided, we have included this as an appendix and referenced it.

# Contents

<b>Section F: Totex incentive mechanism, Process concerns, interlinkages and appeals .....</b>	<b>293</b>
<b>10 Approach to totex and BPI mechanisms.....</b>	<b>293</b>
10.1 Totex incentive mechanism .....	295
10.2 Business plan incentive .....	296
<b>11 Process concerns, interlinkages, post appeals review and pre-action correspondence .....</b>	<b>299</b>
11.1 Process .....	299
11.2 Approach to setting outputs – Licence Drafting. ....	301
11.3 Interlinkages in the RIIO-2 package .....	302
11.4 Post appeals review, interlinkages and pre-action correspondence .....	304

## Section F: Totex incentive mechanism, Process concerns, interlinkages and appeals

### 10 Approach to totex and BPI mechanisms

**We have significant concerns about how the TIM and BPI mechanism have worked in practice. We do not think that its application followed guidance previously provided and ask that the proposal put forward in the draft determination is reassessed.**

We have significant concerns about the way the totex incentive mechanism and the business plan incentive mechanism have worked in practice as it appears counter intuitive and places incentives on networks that we do not think are in the customers interest. It penalises the companies with the highest quality, high confidence business plans and rewards companies that have provided low confidence business plans.

#### Transparency Penalty

We are proud that as a part of our business plan we made more information available to the public than any other network. This allows all stakeholders and customers to form a view on the priorities and cost effectiveness of our plan. Just as importantly, it also provides information for companies looking to provide new services and innovations into the market. It was made clear by Ofgem on multiple occasions that a high level of transparency was important and providing Ofgem with information they did not otherwise have access to would be considered favourably<sup>706 707 708</sup>. Whilst the business plan incentive structure was radically changed in the Decision Document, this objective was restated<sup>709</sup>.

Given this direction and in the absence of more specific guidance from Ofgem, we decided that all projects or programmes with an investment value of greater than £0.5m would be submitted to Ofgem with an accompanying CBA and justification. An approach clearly signalled in our first draft business plan submission in July 2019<sup>710</sup>. It was in September 2019 when the investment threshold of £2m for assets health investment covered by the NARMS methodology or £5m for asset health investments outside of the NARMS methodology was provided<sup>711</sup>. In an earlier workshop on the topic in Sept 2019<sup>712</sup> the threshold was raised and in response to a question by SGN, Ofgem stated no clear preference between multiple EJPs disaggregated to investment levels or a higher-level CBA with greater assessment of options<sup>713</sup>. In the subsequent investment pack<sup>714</sup> this point was not expanded upon.

On the basis of information reported within each of the company annexes for technically assessed projects for the LTS, Storage or entry and other capex projects (i.e. costs that sit outside of benchmarking) the opposite appears to be evident. Companies who have submitted fewer EJPs and had lower confidence applied to their assessment have been rewarded with the higher sharing factors and avoided penalties. Whilst there appears to be a direct correlation between the level of EJPs assessed as high confidence and both the level of penalty and the level of cost reduction applied.

<sup>706</sup> Ofgem workshop, RIIO-2 Business Plan Incentive Workshop, 18<sup>th</sup> June 2019.

<sup>707</sup> Ofgem workshop, RIIO-2 outputs, totex and business plan incentives workshop, 26<sup>th</sup> September 2018.

<sup>708</sup> RIIO-2 Sector Specific methodology 18 Dec 2018. 9.10 *"We want companies to provide us with high quality information in their Business Plan. We may reward companies if they provide us with information that is not available to us, that helps us set a more accurate control that delivers greater benefits than would otherwise be the case. If companies do not provide us with the information that we ask for, or provide us unambitious, poor quality information, then financial penalties may be appropriate."*

<sup>709</sup> RIIO-2 Sector Specific methodology – Core Document 24th May 2019.11.9. *"The incentive would make rewards available to companies if their plan represented genuine value for money and provided information that helps us to set better price controls. Inefficient, low quality plans would be subject to a financial penalty."*

<sup>710</sup> SGN Draft Business plan, 1<sup>st</sup> July 2019, pg 13

<sup>711</sup> RIIO-GD2 Investment Decision Pack Guidance, 20th September 2019, pg 7

<sup>712</sup> CBA and EJP Workshop – RIIO GD2 Price Control, 6<sup>th</sup> Sept 2019, presentation to working group

<sup>713</sup> Ofgem working group, GD2 Asset Management WG2 (previously CBA/NARM/Repex WG), 7th August 2019

<sup>714</sup> RIIO-GD2 Investment Decision Pack Guidance, 20th September 2019

Given the regulatory principles that have been set, we think these conclusions would suggest the fifth principle that “Regulators should ensure clear information, guidance and advice is available to help those they regulate meet their responsibilities to comply”<sup>715</sup> has not been appropriately fulfilled and that a full assessment of the application of the business plan incentive is completed to ensure that it is consistent with the methodology as set out in the sector specific methodology decision<sup>716</sup>.

Confidence in business plans.

GDN		Technically assessed costs	
<b><u>Wales and West Utilities</u></b> <sup>717</sup>			
Number of EJPs submitted:	1		
% of total submitted costs:	1.1%		
Cost reduction applied:	0%		
Proposed Sharing Factor:	49.6%		
BPI Penalty:	£0m		
<b><u>Northern Gas Networks</u></b> <sup>718</sup>			
Number of EJPs submitted:	2		
% of total submitted costs:	2.4%		
Cost reduction applied:	6.1%		
Proposed Sharing Factor:	50%		
BPI Penalty:	£0m		
<b><u>Cadent</u></b> <sup>719</sup>			
Number of EJPs submitted:	20		
% of total submitted costs:	2.4%		
Cost reduction applied:	11.5%		
Proposed Sharing Factor:	49.5%- 49.8%		
BPI Penalty:	£0.1m		
<b><u>SGN</u></b> <sup>720</sup>		All EJPs	EJPs > £2m threshold
Number of EJPs submitted:	53		
% of total submitted costs:	5.7%		
Cost reduction applied:	25%		
Proposed Sharing Factor:	49.0% - 49.6%		
BPI Penalty:	£1.1m		

Based on the analysis above it is our view that rather than supporting openness and availability of information and data as stated within the guidance document produced, Ofgem have actually demonstrated the opposite in how they have

<sup>715</sup> Regulators' Code, Better Regulation Delivery Office, BEIS, April 2014

<sup>716</sup> RIIIO-2 Sector Specific Methodology – Core Document, 24<sup>th</sup> May 2019, appendix 4 examples 1 & 2

<sup>717</sup> RIIIO-2 Draft determinations – Wales and West Utilities, Table 6 & 7, Table 21, Table 41,

<sup>718</sup> RIIIO-2 Draft determinations – Northern Gas Networks, Table 6 & 7, Table 21, Table 43 & 44

<sup>719</sup> RIIIO-2 Draft determinations – Cadent, Table 6 & 7, Table 21, Table 49 & 50,

<sup>720</sup> RIIIO-2 Draft determinations – SGN, Table 6 & 7, Table 21, Table 48 & 49,

assessed the plans, and networks who have put more generic, lower confidence information into the public domain have experienced a lower penalty and lower associated cost reduction

We strongly urge Ofgem to check whether this structure has been applied in the way that it was set out in the sector specific methodology decision and to confirm that the incentive properties that it generates are those that Ofgem intend.

## 10.1 Totex incentive mechanism

Based on the assessment of each of the Gas distribution networks set out above we do not understand how the totex incentive figures has been determined. On the basis of the figures above then you would expect the following

- |          |  |
|----------|--|
| • SGN    | 0.96% of cost considered low confidence (assessing only projects above the £2m threshold as set out in the investment decision pack) |
| • Cadent | 1.34% of costs considered low confidence   |
| • WWU    | 1.1% of costs considered low confidence  |
| • NGN    | 1.68% of costs considered low confidence   |

On this basis SGN should have secured the highest sharing factor of all the GDNs rather than the lowest.

### 10.1.1 Approach to high and low cost confidence assessments

#### Clarity around the categorisation of high and low confidence costs

For all our submitted projects we provide similar detailed information, 154 EJPs were submitted for any value greater than £0.5m with a detailed breakdown of the costs and we responded to over 500 SQs on these to provide greater clarity and confirming any points of confusion (such as the treatment of overheads or the treatment of operating costs) with the vast majority responded to within Ofgem's five day turnaround rule. We demonstrated that our EJPs were underpinned by a robust and coherent body of evidence and therefore do not understand what the distinguishing factor was that determined a project as high or low confidence.

We have responded to each of the 'low confidence' projects disallowed in section 5.7.3 and they either fall into a low confidence because the consultants thought there was an overlap that does not exist, or that the consultants considered need under a narrow definition of being specific to network operation.

This second category we need to be mindful of, as many activities that our customers and stakeholders could be considered in this category (environment measures, actions to support the vulnerable etc) and could in principle come under this narrow definition.

#### Impact of high and low confidence costs on cost assessment process.

The second point of clarification is the impact of high and low confidence costs on the cost assessment process. Our understanding<sup>721</sup> is that if a cost is determined as low confidence it is either exposed to a 10% fine or not, but no assessment of the costs is undertaken. Whilst if a cost is assessed as high confidence and there is a point of comparison, it becomes subject to greater scrutiny.

If we put to one side the fact that a large proportion of cost reductions applied to the SGN technically assessed projects reduced overheads (which should be out of scope), then this could create the perverse scenario that a network has to game or weigh the possibility of achieving a 10% fine on a low confidence project with the risk of identifying it as high confidence but exposing the project to the technical cost assessment process.

On this basis, the rational approach would be to submit a single EJP with poorly justified costs so that the needs case is certain (to ensure that it does not get rejected) but avoiding altogether any evaluation of the cost.

We do not have the full understanding of Ofgem's process to confirm whether or not this is the case; however, the fact that this is the logical inference based on the observable data suggests that there needs to be greater clarity and transparency regarding the assessment process. More generally, as set out separately above, we continue to believe that the costs identified for our projects were appropriate.

<sup>721</sup> Verbal explanation in an Engineering Bilateral, 11<sup>th</sup> Aug 2020.

## 10.2 Business plan incentive

On the basis of the assessment set out above we have no confidence that the business plan incentive has delivered the objectives that were set out to achieve.

### 10.2.1 BPI Stage 1 assessment process

- **Q34. Do you agree with our view that SHET, SPT, SGN and WWU passed all of the Minimum Requirements, and as such are considered to have passed Stage 1 of the BPI?**

We are confident that SGN passed all of the minimum requirements and we provide a matrix correlating each point of business plan guidance to where it was delivered in the plan.

- **Q35. Do you agree with our rationale for why NGET and NGGT should be considered to have failed Stage 1 of the BPI?**

We are not in a position to comment.

- **Q36. Do you agree with our rationale for why Cadent and NGN are considered to have passed Stage 1 of the BPI?**

We are not in a position to comment.

### 10.2.2 BPI Stage 2 assessment process

As we set out in section 4.7 having seen the assessment of the CVPs, we are unable to explain what we would do differently to secure customer value proposition. Furthermore, where CVPs have been awarded, as set out in section 4.7, we struggle to see the differentiating factor that made those proposals eligible.

The two characteristics appears to be that CVPs must be simple and be easily quantifiable. Given the focus of the business plan guidance on major themes such as decarbonisation, open data, and LEAPs it is a disappointment that the CVP did not recognise where network companies had challenged themselves in these areas, particularly as issues such as the environment are the areas which have been identified through our customer engagement as adding genuine consumer value.

### 10.2.3 Customer value proposition

- **Q37. Do you agree with our overall approach regarding treatment of CVP proposals?**

**There appears to be a lack of consistency in how the CVP was determined both within and across sectors and the reasoning applied in the draft determination appears to be contrary to the guidance provided in the sector specific methodology decision document.**

We do not agree with Ofgem's approach regarding the treatment of CVPs. There appears to be a lack of consistency across networks and there does not appear to be a clear rationale as to why a CVP was considered successful in one area and not in a second. This would appear to make the CVP assessment process somewhat arbitrary, with insufficient transparency and justification for Ofgem's position.



- Three CVPs were awarded for ‘caring for the natural environment’<sup>722</sup>; ‘no net biodiversity’<sup>723</sup> and ‘natural environmental improvements’<sup>724</sup>. We agree that these are important areas of consumer value. Our own CVP proposed a similar measure around delivering environmental benefits which was not accepted<sup>725</sup>.
- A further CVP was awarded for community initiative<sup>726</sup>. Again, we agree this is an important area of consumer value. Our own CVP proposed similar initiatives, ‘Community action projects’ and ‘new services for vulnerable households’<sup>727</sup>, which were rejected on the basis that CSR should be business as usual for GDNs.
- Finally, the only CVP awarded to GDNs was for gas escapes to reduce leakage within seven and 28 days<sup>728</sup>. Given that our Scotland network currently achieve a significantly higher performance on the existing 12hr standard and our 28-day performance in GD1 already nearly delivers the proposed final year of GD2 target we are surprised that this is considered to provide customer value<sup>729</sup>.

From a policy perspective we think that it should be a concern that when evaluating the CVP assessment we are unable to identify what we could have done differently to generate a positive outcome. Our CEG in its report expressed that they “do not feel that we have a clear understanding of what Ofgem is expecting” and that there was a “lack of comparators against which to judge what good looks like.”<sup>730</sup> Given the outcome of the draft determination, we do not feel that we could give our CEG any further guidance on either of these two issues.

Secondly when considering the list of potential proposals set out in the Business Plan Guidance that could be considered<sup>731</sup> there appears to be a surprising and unsatisfactory lack of consistency between the guidance provide and the outcome of the assessment.

Given this lack of clarity we think that it is important that Ofgem provide a detailed methodology note that sets out the process through which they evaluated the CVPs across the different sectors and the detailed criteria against which they were assessed, This important for consumer and stakeholder confidence that the assessment has taken place within the boundaries of a rigorous assessment, for consumer confidence in the upcoming RIIO-ED2 price control. Secondly, we would encourage Ofgem to engage customer and stakeholder groups on this assessment to ensure that it actually reflects true customer value rather than assumed customer value.

### **Q38. Do you agree with our proposed clawback mechanism to treat received CVP rewards?**

We are concerned that the requirement for a clawback mechanism has led to a narrowing of the concept of the customer value proposition only to those points where a specific clawback can be clearly defined. The business plan guidance suggests that claw-back was a consideration<sup>732</sup> rather than requirement, and when considering the list suggested as potential areas for CVP there are several suggestions such as data sharing, innovation strategy, raising Ofgem’s awareness to uncertainty mechanisms that would not appear to be an easily definable clawback mechanism.

### **SGNQ9. Do you agree with our proposals on CVPs? If not, please outline why.**

**We disagree with the assessment of the CVP and the narrow definition of consumer value that has been applied. We have chosen not to reply on all the points, but rather to focus on particular points of value.**

<sup>722</sup> RIIO-2 Draft Determinations – NGET SHET Annex table 13, Row 1, pg 33

<sup>723</sup> RIIO-2 Draft Determinations – SHET Annex table 12, Row 1, pg 18

<sup>724</sup> RIIO-2 Draft Determinations – NGGT Annex table 11, Row 1, pg 54

<sup>725</sup> SGN Business Plan, Dec 2019, pag 49, and Appendix 005a – SGN – CVP – Dec 19, section 1.4, pg 5

<sup>726</sup> RIIO-2 Draft Determinations – NGGT Annex table 11, Row 2, pg 54

<sup>727</sup> SGN Business Plan, Dec 2019, pag 49, and Appendix 005a – SGN – CVP – Dec 19, section 1.4, pg 5

<sup>728</sup> RIIO-2 Draft Determinations – NGN Annex table 20, Row 1, pg 28

<sup>729</sup> IN GD1 Scotland had the highest 12 hr standard of replacing 70% within 12 hrs, compared to the next nearest network which average 64.4% whilst Southern average 63.3%. For the 28 standard the average achieved in Scotland was 97.6% with a variation between 99.0% and 96.7%

<sup>730</sup> SGN’s Customer Engagement Group – Final report December 2019, Chapter 5, pg 17

<sup>731</sup> RIIO-2 Business plan Guidance, Sept 2019, para 5.18, pg 35

<sup>732</sup> RIIO-2 Business plan Guidance, Sept 2019, para 5.20, pg 36

## Absorbing weather risk

We are disappointed that our Consumer Value Proposition of absorbing weather risk has been rejected on the basis that there is insufficient evidence of additional value to customers to justify a CVP reward and that they expect GDNs to actively manage this risk<sup>733</sup>. We think that this is based on a misunderstanding of the proposal that has been put forward.

Weather risk is defined as a return to seasonal normal winters (i.e. colder than recently experienced) while retaining the existing summers (i.e. not accounting for any increase in temperatures, despite record high temperatures typically occurring each year).

As we set out in our business plan<sup>734</sup> based on seasonal norms, we would expect that winters may return closer to historical average temperatures. However, during GD1, we have seen warmer and wetter winters on average with an increase in extraordinary winter weather events, a trend that we expect will continue into GD2<sup>735</sup>. A return to average winter temperatures and intense periods of cold weather increase public reported escapes and increase the costs associated with them. Similarly, a continuation of the exceptionally hot summer periods which we have recently experienced can also increase our workloads and similarly impact our costs.

For our GD2 business plan, rather than assume a return to cold winters in our forecast we have instead based our expected costs on the warmer winters observed through GD1 and the expected seasonal normal summers. Similarly, we have not factored in any additional costs in relation to an exceptional event, and therefore both factors represent a cost which we are currently proposing to absorb.

This creates a direct consumer saving as they do not have to fund the repair activities, it sits outside of the regression modelling (as both volumes and costs are adjusted) and presents an increased risk to us that actual weather may return to long-term historical trends.

We proposed to absorb the financial risk associated with deterioration in weather during GD2 with an associated customer benefit of £7m across GD2. This was proposed as a Customer Value Proposition as we consider it beneficial that SGN, rather than the customer, carries this risk.

We were therefore disappointed that Ofgem's assessment considers this to be business as usual when other networks appear to have included increased workloads associated with returning to seasonal normal<sup>736 737</sup> and these forecasts appear to have been accepted. We believe that this presents a true customer value proposition as we have accepted a higher level of risk ourselves rather than expecting customers to pay for it. We would encourage consistent treatment across GDN business plans in respect of weather risk.

## GSMR standards

We are disappointed that our Consumer Value Proposition of promoting GSMR standards has been rejected on the basis that the outcome is not fully within SGN's control, the benefits cannot be solely attributed to SGN's work and the lack of a clear timeframe<sup>738</sup>. These reasons would appear to be at odds with some of the examples given in the business plan guidance<sup>739</sup> which includes proposals for innovation strategy likely to drive forward energy system thinking and whole system approaches likely to drive forward the industry. By definition any measures proposed by any network within these categories would have been unable to deliver the assessment criteria suggested by the draft determination assessment for GSMR standards.

## Environmental action plan

We consider our environmental action plan delivers the expectations as set out in the business plan guidance which refers to "well justified initiative in the environmental action plan to reduce the environmental impacts that will result in measurable outcomes that are valued by consumers." The SGN CVP assessed the customer value of environmental

<sup>733</sup> RIIO-2 Draft Determination – SGN, table 22 pg 32

<sup>734</sup> Appendix 013 – SGN – Emergency Service – Dec 19, pg40.

<sup>735</sup> <https://www.metoffice.gov.uk/binaries/content/assets/metofficegovuk/pdf/research/ukcp/ukcp18-infographic-headline-findings-land.pdf>

<sup>736</sup> NGN Business plan, Dec 2019, section 6.6.1. Controllable Opex, pg 173

<sup>737</sup> WWU Business plan, Dec 2019, Chapter 9. Cost efficiency pg 77

<sup>738</sup> RIIO-2 Draft Determination – SGN, table 22, row 34, pg 34

<sup>739</sup> RIIO-2 Business plan Guidance, Sept 2019, para 5.18, pg 35

benefits compared to the costs of delivery as evidence of consumer value delivered<sup>740</sup>. This was not accepted in the draft determination, the reason given being it was due to the uncertainty mechanism being rejected<sup>741</sup>. This would appear to be a peculiar reasoning given it was an uncertainty mechanism designed to protect consumers by returning unspent allowances to them and introducing a stakeholder led governance structure to assess delivery and trade-offs.

### Fuel poor network extensions

It is notable that we have taken on a level of ambition that significantly exceeds that proposed by other networks, something that should be recognised within our CVP

#### 10.2.4 BPI Stage 3 assessment process

As we have set out in section 5.3.7, the projects that have been put into this category all have assessment errors associated with them - either in identification of an overlap which is not accurate, or by being excluded on the basis that it is not core to the operation of the network (even if it is justified by a very short pay-back period).

On this basis it is important to have greater clarity on the processes and checks that are in place prior to a project being subject to the penalty.

#### 10.2.5 BPI Stage 4 assessment process

We have identified that the application of this appears to differ from the manner in which it was explained to us shortly after publication of the sector specific methodology decision document, and as set out in the appendix2. Here it was explained that if a network exceeded the benchmark value then they would receive the value that they asked for within the business plan, and would secure the differential between their cost and the benchmark value multiplied by TIM as the incentive.

When we questioned this logic, it was explained that the value was the same if the network had outperformed by an equivalent amount, but the network would receive the value up front rather than across the price control. We therefore confirmed that the value from being ahead of the benchmark was only the time value of money, which was confirmed in the meeting.

This does not appear to have been applied in practice.

## 11 Process concerns, interlinkages, post appeals review and pre-action correspondence

In this section we set out various concerns regarding recent developments in the RIIO-2 process, the effect that these have had and the risks that they pose, noting that they have cumulatively both affected our ability to meaningfully engage with the draft determination and led us to question whether Ofgem can have confidence that its decisions are robust and supported by evidence.

We also respond to the questions in the consultation in relation to interlinkages, post appeals review and pre-action correspondence. In our responses, we express concern that Ofgem's proposals, among other things, appear to frustrate licence holders' legitimate statutory appeal rights.

### 11.1 Process

**The material errors in the published data, the delay in receiving data and model formats and the errors in that model data have disrupted our ability to respond to this consultation in an appropriate manner. The extent of errors are such that we need the draft determination to be republished and an opportunity for comments to be fed back and reflected prior to final determination.**

<sup>740</sup> SGN Business Plan, Dec 2019, pag 49, and Appendix 005a – SGN – CVP – Dec 19, section 1.4, pg 5

<sup>741</sup> RIIO-2 Draft Determination – SGN, table 22 pg 32

We fully recognise the disruption that has been brought about by COVID-19, and that regulators have, like us, experienced difficulties since the beginning of lockdown on 23 March. Accordingly, while we were disappointed that the open hearings were postponed<sup>742</sup>, we understand why this decision was taken and look forward to a more limited, but hopefully nonetheless productive, event on 22 October<sup>743</sup>. We similarly appreciate the impact COVID-19 has had on Ofgem's draft determination timelines. For our part, we would encourage Ofgem to take as much time as necessary to ensure the final decisions for long running price controls are correct, appropriate and based on a robust analysis of the information available<sup>744</sup>.

Notwithstanding this, we unfortunately consider that the price control process has not been managed as effectively over the course of the last six months as it might have been; there have been a number of shortcomings in Ofgem's approach from a procedural perspective, and it appears that Ofgem has made various material errors.

This is all the more important given Ofgem's duty to have regard to the principle under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, as well as any other principles that represent best regulatory practice.<sup>745</sup> Given the scale in terms of changes in approach by Ofgem on key areas of this price control, Ofgem will be particularly mindful of the importance of ensuring that its changes are "well justified" given the benefits of a "stable and well understood regulatory framework."<sup>746</sup>

At this stage, we are particularly concerned by the following matters:

- **Substantive policy changes:** We are disappointed that Ofgem has chosen to adopt substantive policy changes in respect of NARMs and Repex without prior discussion via the working groups. We have set out various specific concerns in relation to these changes where relevant in this response. More generally, however, Ofgem's approach has generated confusion that could have been avoided by engaging in dialogue prior to publication of the draft determination. Further, important information and documentation relating to the areas affected by these policy changes has not been forthcoming. For example, we identified at an early stage that an important appendix to the QEM report was not provided. Despite requesting it on 10 July and making multiple subsequent requests for it to be provided, we only received the QEM appendix on 21 July. Follow up details regarding the cost breakdown that were requested shortly afterwards on 23 July, meanwhile, were only provided on 14 August. This, combined with the lack of meaningful dialogue, has hampered our ability to fully engage with and respond to the draft determination. In some respects, we note, the already very tight 8-week consultation period (in comparison to the typical 12-week period prescribed in Ofgem's Consultation Policy for consultations on "major issues of wide interest") has effectively been compressed into the equivalent of a <4 week consultation period<sup>747</sup>.
- **Publication of the financial models:** Whilst the draft determination was published on 9 July, the cost assessment models were published on 17 July<sup>748</sup> and the NARMs models were published on 20 July, the necessary codes to enable us to run the cost assessment models were not released until 5 August. These models included errors, moreover, meaning they subsequently had to be corrected such that we were not able to fully run the cost assessment models until 10 August. Other important data files were still being released on 14 August and 20 August, a couple of weeks before the deadline for responding. As an example, the two excel files<sup>749</sup> that were released on 20 August and each file contained 59 detailed sheets. Many of these sheets contained between 1,000 to 4,000 data points with some sheets containing up to 20,000 data points. This late publication of important information has often introduced fresh and material inconsistencies<sup>750</sup>. It has also led to significant duplication of work and placed us in a position where we have not been able to communicate with confidence to our leadership team and board and respond to the consultation accordingly.
- **Errors within Ofgem's modelling:** We are concerned by the extent of the errors contained in the draft determination (including double counts and omissions). Such errors are not immaterial – on our analysis they could result in Ofgem's calculations being out by more than £80m over the RIIO-2 period +/- 3% in total allowances. A significant error in Ofgem's calculations was determined on the 14 August, and the impacts were

<sup>742</sup> Email from Ofgem 17<sup>th</sup> March 2020

<sup>743</sup> Email from Ofgem 28<sup>th</sup> July 2020

<sup>744</sup> 20-08-12 SGN response to open letter timing contingency, 12 August, 2020

<sup>745</sup> Section 4AA,(5)(A), Gas Act 1986

<sup>746</sup> Bristol Water final determination, Competition Commission [2010], para 9.21

<sup>747</sup> A letter was sent to OFGEM from the ENA on the 23<sup>rd</sup> July 2020 which explicitly asked for a two-week extension, this was rejected by Ofgem in their response on the 6<sup>th</sup> August 2020.

<sup>748</sup> Whilst we appreciate that there were important issues of commercial confidentiality to be addressed, it would have been helpful to address these prior to publication on the 9<sup>th</sup> of July by providing unpopulated templates for networks to review.

<sup>749</sup> Capex\_Synthetic\_Unit\_Cost\_Model\_Aug20.xls and Repex\_Synthetic\_Unit\_Cost\_Model\_Aug20.xls

<sup>750</sup> As an example the file release on the 20<sup>th</sup> August contained inconsistencies between the two files released.

confirmed mid-week of the 17 August. As a result, rather than Southern being 3<sup>rd</sup> in the regression, Southern is instead 7<sup>th</sup> in the regression analysis. **This error has fundamentally changed the nature of the response that we were to be submitting and has fundamentally changed the scale of the challenge that we were looking to address three weeks before the due date.**

- **Response to questions.** Given the lack of clarity in the draft determination SGN has posted 111 supplementary questions asking for clarifications and data. Of these we posted 77 questions in July. **Of these 77 questions 41 were received in the last week (on or after the 26 August).** In comparison we were asked 541 supplementary questions by Ofgem and returned the vast majority within 5 working days. During a single 2-week period Ofgem raised 325 supplementary questions and we responded to 96% within 5 working days and the 12 outstanding were returned within 8 working days. The lack of clarity and the subsequent lack of responsiveness to questions has undermined our ability to respond effectively to this consultation.
- **Timing and content of impact assessment publication:** The publication of the impact assessment took place on 31 July, a number of weeks after the Draft Determination was published. Given the complexity of the document and the challenges set out above, we think it is important that we have sufficient time to conduct a full analysis of the impact assessment. **In order to do this, we will need to return our assessment to you after 4 September, however we would request that it is nonetheless taken into consideration as a part of this consultation response.** More fundamentally, we are further concerned that the timing of the impact assessment suggests that it was not carried out prior to the DD and therefore did not inform the proposals contained in it. It is hard to see how Ofgem could have indeed taken this impact assessment into account in its assessment.
- **Failure to calibrate different aspects of the price control:** Linked to each of the above, we are concerned by Ofgem's apparent failure to calibrate its proposals as a whole so as to provide adequate returns to licensees for the risks they face in the price control. Presently, notwithstanding the process concerns and errors we have identified above, Ofgem has proceeded to set out proposals across multiple different metrics that are at the extreme end of challenging and which combine to form a DD that is unrealistic and would, if implemented, lead to detrimental impacts for consumers and a severe worsening in the financial resilience of our company.

While we are mindful of the challenges that Ofgem has faced as a result of COVID and the associated changes to working practices, the reality is that the draft determination is now not as developed and clear as might otherwise have been expected and contains material errors that risk being replicated at final determination. This is very troubling, and it would be an error for Ofgem to ignore these issues. We will, of course, continue to work with Ofgem in the most constructive manner possible to help minimise the risk of the errors remaining at final determination. In order to ensure meaningful engagement, Ofgem will need to ensure that there is greater openness in working groups to discussing policy and Ofgem publishing an updated set of models prior to final determination such that companies can review them to identify any further material errors. We would also strongly recommend early publication of an embargoed FD for review and checking to help identify any errors, as used to happen with the annual report.

It is important that in the lead up to final determination we and others have the opportunity to review and give detailed feedback on a draft determination that more accurately reflects what a final determination may actually deliver. This is important both to improve confidence in the models and to ensure that we and others have clarity in advance of final determination on the scale of the potential financial impact.

**We think that Ofgem would be wrong, and ill-advised, to proceed to final determination without a re-publication of the draft determination given the materiality of the issues identified above.**

## 11.2 Approach to setting outputs – Licence Drafting.

In addition to the matters outlined at [11.1] above, during the licence drafting working group discussions held to date, certain important topics have arisen that we believe need to be considered and addressed<sup>751</sup>;

- **Governance and guidance documents:** The draft licences often refer to governance and/or guidance documents – however the latest advice from the Licence Drafting Working Group is that not all of these will be finalised before the start of the price control period<sup>752</sup>. It is important that there is clarity as regards the expectations set out in any

<sup>751</sup> Many of these were raised in a letter from the ENA to Ofgem on 29<sup>th</sup> June 2020, Ofgem responded on the 7<sup>th</sup> August 2020, in the response some of these points were not fully addressed.

<sup>752</sup> RIIO-2 Licence drafting working group, 6<sup>th</sup> May 2020; Draft Vulnerability and Carbon Monoxide Allowance and the draft Fuel Poor Network Extension licence conditions are both examples where associated Governance Document are referred to.



governance or guidance document in advance of the licence entering into force. Furthermore, clarity is required in relation to the design of these documents. At present, a variety of approaches have been described in the working groups, ranging from specific PCD-focussed guidance to a single over-arching generic document.

- **Change control on procedures:** It is very important that there is a clear and ongoing linkage between any change in the governance documents and the associated output(s). An example of an unfortunate lack of linkage in RIIO-1 was fuel poor network extensions where an initial relaxation of the eligibility criteria encouraged networks to take on more ambitious targets<sup>753</sup> which then remained in place when eligibility criteria were tightened later on in the price control<sup>754</sup>, potentially (unfairly) exposing networks to associated penalties for under-delivery.
- **Difference between guidance and governance documents:** In some instances, Ofgem has made references to guidance documents and governance documents<sup>755</sup>. It is important that there is clarity around the intent and standing of each of these documents and that the implications of a change in either are fully understood by all stakeholders. Our understanding is that rules set out in governance documents are mandatory, whilst guidance is not; however we would suggest that the implications need to be expressly set out, and the principles that determine whether guidance or governance documents are applied should be clearly established.
- **PCD modular approach**<sup>756</sup>: Whilst we recognise the desirability of a consistent and modular approach to the design and structure of PCDs, we have reservations that such structures may become a hinderance rather than a support if they are applied inflexibly and do not fully recognise the differences between projects and their unique characteristics.
- **Best endeavours:** As set out in the ENA letter to Ofgem<sup>757</sup>, it is important to recognise the distinction between 'reasonable' and 'best' endeavours in terms of any output expectations, with 'best' endeavours implying an obligation to take all steps in a party's power to produce a desired result while 'reasonable' endeavours provides flexibility to take into account commercial, social or environmental considerations. We consider it is important that outputs are defined on a 'reasonable' endeavours basis to take into account the broad range of licensees' interests.
- **Best practice:** In some instances, such as in relation to data, there are specific references to delivering 'best practice' as a part of the licence requirement without determining what 'best practice' constitutes. We are concerned by this, noting that defining what constitutes 'best practice' and then assessing (in an impartial manner) whether the obligation has or has not been complied with in any given case is likely to be fraught with difficulty.

**Licence Consultation:** It was envisaged that there would originally be a consultation in March and a second consultation in September prior to FD. Ofgem have subsequently indicated that there will now only be one consultation and that the period allowed for consultation will be four weeks. At this stage we have not received any visibility of which licences will be included in this consultation and as highlighted above nor have we received all the governance and guidance documentation. Whilst we appreciate the impact to the timescales as a result of COVID, we have significant concerns that the absence of vital documentation, compressed timescales and changes to the consultation structure will result in the licensees not being able to respond fully.

## 11.3 Interlinkages in the RIIO-2 package

### Q39. Do you have any views on the interlinkages explained throughout this chapter?

As an initial comment, we note that the CMA, in its open letter of 30 October 2019, stated that where *"one part of the price control is linked to another part of the price control"* it would *"encourage regulators to explain these interlinkages, and the reasons for them, in their decision documentation"*. We share the CMA's view that it is primarily Ofgem's responsibility to identify those price control decisions that it considers are *"not in practice a separable decision"* and *"can only be considered alongside other linked decisions"*, and that the identification of interlinkages should not at this stage primarily be incumbent on us or other licensees. Accordingly, while we are willing to share initial observations, our

<sup>753</sup> Fuel Poor Network Extension Scheme Review Final Decision document, 30<sup>th</sup> September 2015

<sup>754</sup> Decision to change the criteria for the fuel poor network extension scheme, 18<sup>th</sup> December 2017

<sup>755</sup> RIIO-2 Licence drafting working group, 6<sup>th</sup> May 2020; PCD Update on licence drafting. As an example for Fuel Poor Network Extensions refers to governance documents, similar example for compressor refers to guidance documents. An explanation was provided in the meeting, but this needs to be set out clearly for all stakeholders to understand.

<sup>756</sup> RIIO-2 Licence drafting working group, 6<sup>th</sup> May 2020; PCD Update on licence drafting.

<sup>757</sup> Letter from ENA to Ofgem (Min Zhu) 2<sup>nd</sup> June 2020; RIIO-T2 Licence drafting -changes to best endeavours

position as to the interlinkages referred to in Chapter 11 and generally, including as to their existence, extent, relevance and materiality, is expressly reserved.

In terms of Ofgem's general proposition in Chapter 11 of the core document, we broadly agree with the high-level summary set out in Figure 9 as to how the three pillars of outputs, expenditure allowances and uncertainty and risk mitigating mechanisms come together to provide the basis for the RIIO-2 package. We have a number of observations, however, in respect of the broader approach Ofgem appears to be taking (or implying that it might seek to take in due course) regarding interlinkages (which, as the CMA has identified, is a term used to identify those decisions that are not in practice separable from other aspects of the price control).

In terms of general observations:

- First, we note, while it may be appropriate for parts of the price control settlement that cannot be decided separately to be considered alongside other linked decisions in certain circumstances, in other cases this will not be necessary.
- Second, to the extent parts of the price control are to be considered in parallel, this does not entitle Ofgem to do away with robust and reasoned decision-making in respect of the individual components concerned in favour of decisions made "*in the round*". Ofgem is still, rather, required to correctly calibrate each individual component of the price control as best it can – to the extent Ofgem identifies issues posed by one component, it should not, as its first port of call, be seeking to address these by modifying decisions in respect of others (not least given the potential for further knock-on effects).
- Third, in any event, it is important that Ofgem does not allow its decision making to become overly driven by the pursuit of policy objectives, or seek to impose pre-determined outcomes, under the guise of "*in the round*" decision making.

As matters stand, Chapter 11 appears to imply that Ofgem might seek to "*bake in*" its conclusions "*in the round*" by making trade-off adjustments which effectively neutralise any concessions made at Final Determination. If this is indeed Ofgem's intention, then it is concerning.

In terms of more targeted observations regarding Ofgem's discussion of interlinkages in Chapter 11, meanwhile:

- Insofar as expenditure allowances are concerned, we consider there to be a clear distinction between Totex allowances and the other components which Ofgem describes as forming part of this pillar (e.g. WACC, ODI rewards and penalties and uncertainty mechanism revenues), noting that ODI rewards and penalties (for example) are designed to incentivise the delivery of outputs rather than form a component part of their efficient baseline funding. This, however, does not appear to be recognised in Ofgem's description.
- We disagree that it is appropriate to link "*levels of expected performance*" to the "*cost of equity*" by way of an embedded outperformance wedge in the cost of equity calculation, for the reasons outlined previously and in Chapter 6 of this document. In particular, Ofgem should seek to calibrate each element of the price control accurately as this aids transparency and avoids perverse incentives that distort investment behaviour. We do not, in any event, consider Ofgem's assessment of the outperformance wedge to be robust as it seems to have been assessed completely separately from the design of the rest of the price control. It does not appear to take any account of the choices that Ofgem has made in its cost assessment methodology, the increased asymmetry of the ODI package, or other policy changes made since RIIO-1 such as RPEs indexation and greater use of PCDs. We therefore don't see any legitimate basis for the adjustment to be made.
- We further note Ofgem's observation that "*any change to the level of outputs to be delivered, expenditure allowances provided, or the calibration of Uncertainty Mechanisms may have an impact on the scope for outperformance in the RIIO-2 package*". We would be concerned if any such changes in licensees' favour were to result in an increased assumed outperformance wedge and associated lower cost of capital.

Once again, our position as to the interlinkages referred to in Chapter 11 and generally, including as to their existence, extent, relevance and materiality, is expressly reserved and we note that we may wish to make further observations in due course.

**Q40. Are there other interlinkages within our RIIO-2 package that you think are relevant to the three pillars identified in this chapter?**

We note Ofgem's observation in Chapter 11 that *"the examples provided are not an exhaustive list of every way in which individual aspects of our overall price control decision may be linked to every other aspect"* and the suggestion that it *"would not be proportionate"* to attempt to provide such a list at this stage. In light of this, as well as the fact that Ofgem is yet to provide full details of its proposals, we likewise do not attempt to set out every potential area of interlinkage here and reserve the right to make further observations in due course.

Notwithstanding this, as a preliminary observation, we note that there is relatively little discussion in Chapter 11 of interlinkage between risk mitigating mechanisms (including uncertainty mechanisms) and other aspects of the price control package. This is despite the fact that paragraphs 11.10 to 11.24 of the Draft Determination Core Document go into some detail regarding interlinkages in other areas. As paragraph 11.5 of the Draft Determination Core Document rightly notes, risk mitigating mechanisms are key to managing and maintaining a fair balance of risk between consumers and licensees. Our view, however, is that Ofgem's current proposals pose significant challenges across the board and appear to have been adopted with little regard for the impact on the overall settlement.

Particular consideration should be given to the proposed Net Zero Reopener and the operation of mechanisms designed to address the risks posed by the ongoing COVID-19 pandemic (as to which, see our response to question 43 below). Should these mechanisms fail to balance the risk between licensees and consumers, this could have a significant impact on investor appetite and the cost of capital. In circumstances where these mechanisms afford licensees only limited protection from the risks they face, we would expect Ofgem to compensate for this by either (i) allowing appropriate ex ante cost allowances for this purpose and/or (ii) setting higher baseline allowances in respect of cost of debt and cost of equity. Ofgem should, of course, also be mindful of the risk of these interventions failing to achieve their intended objective more generally.

## 11.4 Post appeals review, interlinkages and pre-action correspondence

**Q41. Do you have any views on our proposal to include a statement of policy in Final Determinations that in appropriate circumstances, we will carry out a post appeals review and potentially revisit wider aspects of RIIO-2 in the event of a successful appeal to the CMA that had material knock on consequences for the price control settlement?**

We are very concerned by Ofgem's proposals in this regard.

At the outset, the introduction of a mechanism pursuant to which Ofgem seeks to revisit aspects of the price control *"following the conclusion of a successful appeal to the CMA"* would ostensibly risk undermining the statutory appeals process. The existing legislative framework, which only came into force in 2011 under the EU Third Energy Package, already provides for an effective appeals regime<sup>758</sup>, and Ofgem has not presented any evidence of a regulatory gap that needs to be filled. Accordingly, it appears as though Ofgem sees itself assuming a role that is properly the function of the CMA.

We note in this regard that while paragraph 11.32 of the Draft Determination Core Document suggests that the post-appeals review mechanism might be deployed, in particular, in circumstances where the CMA directs Ofgem to consider interlinkages following the quashing of the decision(s) appealed, it is not suggested that it would be deployed only in such circumstances (i.e. that the examples given are exhaustive).

Further, it is unclear on what basis Ofgem considers itself to have the power to conduct a post appeals review in the manner suggested. While Ofgem possesses various general powers, such powers cannot be construed as giving Ofgem the right to interfere with a statutory appeals mechanism, the rules for which have (in large part) been carefully set out in primary legislation. From our perspective, absent a prior direction from the CMA, any attempt by Ofgem to conduct a post appeals review would be *ultra vires*.

Finally, the proposed post-appeals review regime raises legal certainty issues. Pursuant to GEMA's duties under Section 4AA(5A) of the Gas Act 1986, Ofgem is required to have regard to (a) the principle that regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and (b) other principles representing best regulatory practice. Based on the information provided to date, however, the proposed post

<sup>758</sup> See 2015 British Gas Trading appeal, CMA's Final Determination, paragraph 3.52 and CMA letter to Ofgem of 30 October 2019



appeals review regime risks undermining the certainty afforded to licensees. The risk appears to be particularly significant for third parties who do not themselves choose to appeal to the CMA, but who nonetheless – on our reading of Ofgem’s proposals – would face the prospect of subsequent changes to their price control settlements in the event of a successful appeal by another licensee.

**Q42. Do you have any views on the proposed pre-action correspondence, including on the proposed timing for sending such to Ofgem?**

We note that Ofgem has stated that it expects licensees to engage in pre-action correspondence. As a preliminary note, we believe this should be framed as a request from Ofgem, rather than a requirement, given the limits on its ability to impose obligations on potential appellants beyond the legislative framework.

More broadly, while we welcome in principle the implementation of measures intended to promote active engagement and transparency with the CMA in any appeal, we have significant concerns regarding how Ofgem’s proposed pre-action correspondence regime would operate in practice (in particular from a timing perspective). We set out our initial concerns in further detail below.

- **Timing:** As Ofgem notes, the RIIIO-2 framework is complex and the timetable to which licensees intending to submit appeals must work is already relatively constrained. Before deciding whether or not to appeal, licensees must conduct an in-depth assessment of the impacts of the Final Determination and proposed licence modification, based on the information released by the regulator at that point in time, necessitating engagement at board level, and begin preparing the relevant appeal documentation. Therefore, while it may be appropriate for licensees to indicate to the CMA whether they are potentially minded to appeal and the potential areas of concern in high level terms at the appropriate juncture, we do not consider the pre-action steps which Ofgem proposes to be at all reasonable. The suggestion that the correspondence in question should be sent to Ofgem before the appealable decision has even been published compounds our concern in this regard.

It is unclear, moreover, how the timing of any request to engage in pre-action correspondence might be impacted by Ofgem’s COVID-19 contingency plan for RIIIO-2, as described in Ofgem’s open letter of 14 July 2020.

- **Necessity of additional information;** While some level of engagement with the regulator may of course be good regulatory practice, it is unclear why appellants should be required to submit letters containing the level of detail suggested by Ofgem, in particular before the appeal window has even opened. While, as we recognise above, it may ultimately be helpful for licensees to indicate to the CMA whether they are minded to appeal and their concerns in high level terms, Ofgem’s proposals seem designed to simply afford it more time to prepare its arguments at the expense of the time afforded to would-be appellants (thereby constraining their rights to appeal).

In our view, detailed information is more appropriately included in licensees’ applications for permission to appeal to the CMA, rather than at any earlier stage before appellants have fully determined whether or not they intend to seek permission to appeal and on what grounds.

Finally, unless Ofgem’s Final Determination differs significantly from its Draft Determination and the measures adopted therein represent a significant departure from the measures on which it has previously consulted, both Ofgem (and in due course the CMA) are likely to already be familiar with the points raised on appeal ahead of time in any event.

- **Potential penalties for non-compliance:** The Draft Determination outlines Ofgem’s view that appellants who fail to engage with the proposed pre-action correspondence regime may be penalised by the CMA when it comes to costs, even in the event that they succeed on appeal. While we understand the desire of Ofgem to promote engagement with the proposed regime, we are concerned by the idea of appealing licensees being subject to arbitrary penalties at its behest. More generally, we note that considerations around costs are a matter for the CMA to determine in due course (subject to appropriate representations from all parties).

From a procedural fairness perspective, it is clear that parties should not be bound by any pre-action correspondence in the event of a subsequent appeal and that their ability to raise new or different points in an actual appeal should not be prejudiced by anything said in pre-action correspondence.

- **Broader implications for CMA appeal process:** As noted above, maintaining the stability and accessibility of the statutory CMA appeal process is paramount. To the extent that pre-action engagement were to have the effect of curtailing the effectiveness of the CMA appeal process in any way (including by imposing unrealistic time constraints on appealing licensees, constraining the points on which they might mount an appeal and/or penalising

them for doing so), then that would call into question the rationale (and potentially the legality) of these proposals.

**Q43. Do you think we need specific mechanisms in RIIO-2 to manage the potential longer-term impacts of COVID-19? If yes, what might these mechanisms be?**

**Yes, baseline allowances should be amended to accommodate the ongoing cost drivers, with a clear re-opener to capture any further unforeseen costs. Regulatory easement should be available if required, at the point of GD1 close-out, in the setting of GD2 commencement and within the GD2 price control.**

The COVID-19 pandemic required an immediate operational response in order to protect our customers and staff. Our response strategy was built upon the clear government guidance that face to face contact should be minimised, and our organisational requirement to create contingency arrangements to mitigate the risk of significant staff absence. For example, as a result, our repex programme was halted, all non-essential field work was ceased, and critical office-based functions were separated over multiple sites. Personal protective equipment was issued to all staff, as well as appropriate IT equipment to facilitate home working wherever possible.

As a result, the pandemic has created a series of unforeseen costs not captured within our December business plan. These cost drivers have had an immediate within-year impact, many of which we anticipate will also be ongoing or may become permanent influences. Detailed description of the within-year and ongoing costs are discussed in the COVID Cost Drivers Technical Assessment.

At present, we estimate an £11.9m per annum increase in expenditure due to COVID-19, Redacted

Redacted

Detailed discussion of the above cost drivers can be found in the COVID Cost Drivers Technical Assessment. Costs primarily relate to the enhanced requirements, including project re-design and increased welfare on site required to maintain social distancing and ensure staff and public safeguarding. For example, these requirements may manifest as cost drivers due to increased signage and pedestrian diversions, in addition to a reduction in productivity as a consequence of activity re-phasing to account for limited access to premises, plus staff safety measures such as staggered meal breaks.

Crucially, these cost drivers are a result of an unprecedented situation and are out of SGN's control. Regular engagement with Ofgem has already taken place throughout the pandemic, through bilaterals and also formal reporting, and we would welcome an extended period of engagement into the first year of GD2 and beyond, to ensure that the full risks and impacts of COVID-19 as we experience them continue to be understood.

It is also important that these extra costs are recognised within our baseline allowance, as it is in consumers' interests that gas distribution companies are in a position to respond effectively to the potential longer-term challenges posed by the COVID-19 pandemic. While these costs represent our best estimate of the likely drivers, it is important to recognise

that they are based on working assumptions and our experience of the pandemic so far. In the event of subsequent waves, the continued advent of localised lockdowns, or changes in the COVID regulations, our base assumptions will require review and the cost drivers identified may change. The approaching winter period will add to these risks as we experience a period of naturally increased workloads in combination with the future unknown influences of COVID. As such, it is critical that a clear reopener is accessible to accommodate such uncertainty and unpredictable changes in circumstances.

We would also highlight the need for regulatory easement, should it be required. The initial lockdown placed considerable constraints on our operational activities and while we are reviewing our opportunities to recommence this work, it is possible that this, or future lockdowns could disrupt our price control activities. As such, the opportunity to reflect this potential disruption in future targets is critical.

