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3<sup>rd</sup> September 2020

Dear Akshay

### **RIIO-2 Draft Determinations for Gas Distribution, Transmission and the ESO**

Electricity North West (ENWL) appreciates the opportunity to respond to this important consultation on the RIIO-2 Draft Determinations for those sectors whose price controls are due to commence in 2021. Our interest stems from the potential consequential impact on the framework development for ED2, commencing in 2023, as well as the impact the proposals will have on the energy sector as a whole and those consumers in our operating region. In summary of this letter our key points are:

- We would welcome more clarity being provided to stakeholders that decisions made as part of this Draft Determination process are not binding for ED2.
- Fuller proposals should be developed earlier in the ED2 process, giving a more complete framework that will enable stakeholders to see the overall price control and assess whether the combined effect of the individual proposals is in consumers' best interests.
- We continue to be supportive of the RIIO framework that Ofgem has pioneered and believe it can achieve the objectives of RIIO-2 through the retention and non-erosion of the RIIO cornerstones of 'Incentives' and 'Innovation', either by design or accident. We are therefore pleased to see that some incentives remain in key areas such as the sharing rates (TIM).
- Ofgem will need to challenge itself in a period of change to make agile and flexible decisions to ensure that no barriers to Net Zero delivery are created either accidentally or by design. Furthermore, Ofgem must assess whether it has the systematic approach, simple governance structures and capabilities required to make major decisions frequently, with less than six months total evaluation, consultation and decision-making each time. Ofgem should not underestimate the impact that the lack of certainty over future spend will have on the supply chain's willingness to invest, and therefore its ability to deliver in a timely manner.
- Issues remain on finance matters where we consider Ofgem is making some fundamental errors as we have already discussed with you. We do not consider that it is helpful waiting to the end of the process for the "correct forum" to decide on the legal position of the Financeability Duty. In particular, we are keen to ensure that Financeability is assessed on a licensee basis to ensure that whole regions are not left behind in the drive to zero carbon.
- If the objective of the RAMs is to protect customers and consumers from inappropriate returns, we urge that Ofgem includes finance and tax out/underperformance within RAMs as it would appear illogical to exclude them.



- A more balanced approach should be taken by Ofgem adopting positions more credibly within the ranges of evidence rather than towards particular ends of a spectrum. Ofgem should rebalance how it weights the needs to attract long term investment for future customers with short term bill reductions.
- Policy positions in RIIO-2 need to be made mindful of the CMA views and findings but should be independent of other sectors and should consider the evidence and unique circumstances both of RIIO-2 specifically and of each company.
- It is important for legitimacy that the framework for ED2 can be consulted on without prejudice. Therefore, the RIIO-ED2 framework needs to be considered on a standalone basis and proposed policy positions are established and justified for the ED sector specifically, distinct from GD2 and T2.
- Stakeholder input should be a strong underpinning of RIIO-2. From the proposed positions in the Draft Determinations we have some concerns that the weight Ofgem places on stakeholder requirements and the views of CEG's is below that which stakeholders expect.
- Continued focus should be applied to ensure Final Determinations progress in line with the existing timetable and proper processes, ensuring that there is no adverse impact on RIIO-ED2 framework development.

We have some concerns that the Draft Determinations refer to common sector-wide measures without qualification that these do not apply to ED. We note that in the Sector Specific Methodology consultation Ofgem states it is "clear that RIIO-ED2 is a separate process, however in the design of our proposals for RIIO-ED2, we have taken into account the lessons learnt and the feedback we have received from the other sectors."<sup>1</sup> **We would welcome more clarity being provided to stakeholders that decisions made as part of this Draft Determination process are not binding for ED2.**

We note that the Draft Determinations are challenging with tough proposals being taken in all areas. The combined effect thus created could make some of the price control objectives undeliverable and risks creating adverse consequences for consumers at this crucial time in the journey to Net Zero and decarbonisation. Careful consideration should be given to this, as there is little or no margin for error for all stakeholders in facilitating and supporting national and regional Net Zero targets. We welcome novel and new policy approaches being raised, however, these are being included as part of Draft Determinations without earlier signalling leaving only limited time for all stakeholders, including companies, to examine, evaluate and understand these before Final Determinations. Therefore, we suggest a further observation relevant for ED2, **that fuller proposals are developed earlier in the ED2 process and we look forward to contributing to these. A more complete framework will enable stakeholders to see the price control overall and assess whether the combined effect of the individual draft proposal elements is in consumers best interests.**

The regulatory environment and framework should facilitate, support and deliver decarbonisation and the transition to a low carbon economy. **We have been supportive and continue to be supportive of the RIIO framework that Ofgem has pioneered and believe it can achieve these objectives. To achieve this the cornerstones of RIIO, 'Incentives' and 'Innovation' should be retained and not eroded either by design or accident.**

**We are pleased to see that incentives remain in key areas such as the sharing rates (TIM)** for Gas Distribution companies, although the combined proposed positions in the Draft Determinations do represent a notable shift in the RIIO framework toward less incentivisation. We believe that in ED1, Ofgem has been very successful in both aligning benefits for customers and incentive mechanisms. We are concerned to understand why reducing incentives and therefore customer benefits appear to be such an important policy direction, when our research indicates that customers value the improvements seen. Companies and Ofgem should always be looking to improve performance and efficiency for consumers and as improvements become harder to identify, strong incentives that can justify the costs of improvement investment must be maintained.

We recognise that the ESO is unique and therefore we support the creation of an alternative form of regulation for this entity. For GD/T, given the uncertainty faced by these sectors as a consequence of the

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<sup>1</sup> RIIO-ED2 Methodology Consultation: Overview, para 2.4, Ofgem  
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timing of their price control cycle, uncertainty of heat policy and their individual investment characteristics, we understand the extensive use of uncertainty mechanisms, reopeners and Price Control Deliverables (PCDs). This does create a more gated regulatory regime and will require Ofgem to take a more hands-on and central role in enabling and administering Net Zero, signing-off investments/company decisions and providing any funding in a timely manner thus increasing regulatory burden on both Ofgem and companies. **Ofgem will need to challenge itself in a period of change to make agile and flexible decisions to ensure no barriers to Net Zero delivery are created accidentally or by design.**

This approach has impacts on the numerous supply chains supporting the sector. Tariffs will need to be reset post any decisions from Ofgem. Current charge setting restrictions will create a timing delay of c.15 months before these reset tariffs affect cashflow reducing the ability for companies to pay supply chains until this takes effect. This is especially true in RIIO-2 where financial headroom could be limited. **Ofgem in its decision making should consider whether sufficient time and clarity are given so resource levels can be mobilised in the supply chains due to the use of uncertainty mechanisms and reopeners.** Also, **Ofgem must assess whether it has the systematic approach, simple governance structures and capabilities required to make such decisions at least twice a year, with less than six months total evaluation, consultation and decision-making each time.** This may also include bold decision making where evidence and certainty might not be at historical thresholds expected by Ofgem.

**Whilst we understand the reasons for this approach for GD/T this model may not be the optimal approach in sectors where frequent and incremental investment is required, such as ED.** Such a model will reduce flexibility as well as companies' abilities to react to unforeseen changes in a highly dynamic environment such as that expected for ED2.

**Issues remain on Finance where we consider Ofgem is making some fundamental errors. The Financing duty of Ofgem is to ensure that an efficient individual licensee can secure both debt and equity funding.** In RIIO-2 Ofgem is wrongly interpreting this duty as being to a notionally geared, artificially identified group of companies, creating circumstances of windfalls to some companies at the expense of financeability and/or reduced equity returns (and therefore investment incentives) for others. We continue to disagree with the proposed approach to debt allowances which fails to fund efficiently incurred debt costs and urge Ofgem ensures that licensees can secure both debt and equity finance consistent with its financing duty.

RIIO-2 provides almost no opportunity for individual companies to absorb these financing issues in the round and this problem is compounded by Return Adjustment Mechanisms (RAMs) being proposed to operate without considering financing and tax performance. The consequence is that companies like ourselves that perform strongly for our customers, set industry efficiency benchmarks at ED1, but have efficient debt taken out in the market ahead of the financial crisis, are less able to achieve fair returns by offsetting debt underfunding by incentivised strong performance for customers, as reflected in our RIIO-ED1 performance. **We would urge that Ofgem includes finance and tax within RAMs as this would better protect customers and consumers from inappropriate returns in RIIO-2.** Further, Ofgem's proposal not to take derivatives into account in assessing the cost of debt is illogical. Derivatives are an important way to manage risks for our customers as well as shareholders. Our views should be familiar to Ofgem through our ongoing dialogue and we have shared our views with the CMA as part of our submissions on PR19<sup>2</sup>.

We have worked to provide a substantial body of independent expert evidence to Ofgem's finance work stream through the ENA's RIIO-2 Finance Working Group. It is disappointing that Ofgem appears to have dismissed almost all the expert insight from these leading consultancies, and often based solely on Ofgem's own judgements justified with what appears to be weaker evidence. We are concerned that Ofgem's approach to financial matters is skewed and represents an unbalanced settlement where extreme positions are selected in all components. Applying the extreme-end of a plausible scale in all areas risks driving unintended consequences and behaviours and lead to inadequate investor appetite to drive forward decarbonisation in line with government policy worsening outcomes for consumers. **We urge Ofgem to take a more balanced approach, adopting positions more credibly within the ranges of**

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<sup>2</sup> Appendix 6: ENWL third-party representation letter to CMA review of PR19 appeals  
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**evidence rather than towards particular ends of a spectrum and to rebalance how Ofgem weights the need to attract long term investment for future customers with short term bill reductions.**

The ongoing PR19 referrals to the CMA should be a point of reference for Final Determinations and considered as part of the development of RIIO-ED2. Central proposed policy positions in Draft Determinations such as; issues of financing, ongoing productivity/efficiency assumptions, and the use of more stringent than upper quartile efficiency benchmarks are being reviewed as part of these appeals. **It is important that policy positions in RIIO-2 are made mindful of the CMA views and findings, but independent of other sectors and consider the evidence and unique circumstances of RIIO-2 specifically and of each company.** The decarbonisation challenges, as well as the transformative changes required are not inherently part of the water sector as they are in energy.

**We strongly believe the RIIO-ED2 framework needs to be considered on a standalone basis where proposed policy positions are established and justified for the ED sector specifically, distinct from GD2 and T2.** This will ensure that the framework is fit to enable a smarter more flexible energy system responsive to the drivers of decarbonisation, digitisation and decentralisation. Our stakeholders are asking us to take a leading role in delivering the Government's policy and the RIIO-ED2 framework and its application must therefore facilitate this.

For ED2 there is a real opportunity to reflect on the learnings of process and development of the T2/GD2/ESO Draft Determinations, and to ensure that these are enacted supporting the business planning process, including the role of stakeholder input. **Stakeholder input should be a strong underpinning of RIIO-2. From the proposed positions in the Draft Determinations we are concerned the weight Ofgem places on stakeholder requirements and the views of CEG's is below that which stakeholders expect.**

**We support continued focus to ensure Final Determinations progress in line with the existing timetable and proper processes, ensuring that there is no adverse impact on RIIO-ED2 framework development.** It is important that stakeholders, customers and companies can assess all the relevant information including the impact of the changes in a timely manner so that DNOs can engage, assimilate and reflect stakeholder responses to these policy changes in their business plans.

Process and appropriate engagement is important for all stakeholders and we note that Draft Determinations coming out just before the ED2 SSMC is a challenge especially where both have relatively short consultation periods and overlap in their timing. **It is important for legitimacy that the framework for ED can be consulted on without prejudice.**

We welcome the engagement we have had with Ofgem to date and look forward to this continuing at pace for ED2, working with Ofgem and other stakeholders. We remain confident that an overall framework including financing aspects for RIIO-ED2 that enables the delivery of key objectives, whilst ensuring fairness for all customers and shareholders could be achieved by Ofgem.

We have responded to the Draft Determinations by exception through six appendices to this letter. This response should also be read in light of our previous correspondence on RIIO-2. If you have any questions relating to our response, please don't hesitate to contact me or Paul Bircham ([paul.bircham@enwl.co.uk](mailto:paul.bircham@enwl.co.uk)).

Yours sincerely,



**Peter Emery**  
**Chief Executive Officer**

Encs: Appendix 1: response to RIIO-2 Draft Determination Core document questions; Appendix 2: Finance; Appendix 3: ESO; Appendix 4: Gas Distribution; Appendix 5: NARMS; Appendix 6: ENWL third-party representation letter to CMA review of PR19 appeals