

ED2 methodology response

KEY POINTS

- Ofgem must set a price control that puts electricity distribution networks at the heart of the transition to net zero, challenges companies to deliver new levels of service, efficiency and innovation and which brings forward significant levels of investment.
- Relative to its current direction of travel, that requires Ofgem to:
 - put greater emphasis on meeting clear, objectively-set targets;
 - reduce the potential for there to be subjective and/or retrospective adjustments;
 - rely less on regulatory micromanagement; and
 - set an appropriate return on investment.
- Ofgem should learn lessons from the past and seek to set realistic and challenging cost targets at the outset of the price control period.
 - The emphasis on comparative totex benchmarking should be increased.
 - The use of disaggregated benchmarking should be limited to providing a cross check – and the overly complex, badly-specified ED1 models should not be the starting point.
 - Several of the newly proposed reopeners ought to be catered to by base allowances, since a five-year price control planning horizon offers ample opportunity to predict requirements and avoid distorting boundaries in the cost base.
- Pay as you go volume drivers, based on electric car and heat pump uptake, should be used to link funding levels to the actual level of consumer usage of low carbon technologies.
- Ofgem's new incentives for connections, vulnerability and DSO activities should be streamlined into existing mechanisms (e.g. licence obligations) to reduce the scope for subjective, discretionary assessments.
- Ofgem's misguided shift to micromanaging what is – and what is not – a legitimate cost saving discourages the most effective and innovative forms of efficiency and will drive up costs to customers.
- Ofgem's allowed returns methodology is flawed and gets the balance wrong, exposing customers to the significant risks associated with setting the rate for investment too low.
 - Ofgem has exhibited a bias in handling the evidence to create a range for beta estimates that is much too low. Flawed or circular "cross checks" then lower this range further, before Ofgem makes an unjustified 25bps reduction to its own underestimate of the cost of equity.
 - The risk and costs of underinvestment in electricity distribution are higher than in any other sector given the significance of those networks to the decarbonisation agenda.
 - Ofgem's approach creates a very similar outcome to the view taken by Ofwat, which the CMA has provisionally found to have been materially wrong.
- Ofgem should set asset lives for business as usual investment at the current average (ca. 25 years) to create flexibility to fund the low carbon transition, be inter-generationally fair and avoid baking in large long-term price rises – a 45-year asset life could be applied to any significant additional investment needed to support the step change in decarbonisation.

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1. Overview: How Ofgem can solve the critical issues

1. Electricity distribution is set to be at the heart of society's transition to net zero. The ED2 price control has to create an environment where DNOs are incentivised to make the investments that are required to facilitate this transition as efficiently as possible.
2. Yet Ofgem is largely proposing to replicate many aspects of its T2 and GD2 methodology. That methodology isn't appropriate for electricity distribution.
3. As we explained in our response to the T2 and GD2 draft determination consultation:

At each turn the draft determinations replace the incentives that are meant to be a cornerstone of the RIIO regime with uncertainty mechanisms, ex post assessment, claw-backs and a reduction in the rewards that are available where a company finds a more efficient way of running its business. The harm this will do to consumers will be incremental. It will build slowly and over a long period of time. But it will be costly.

4. Although Ofgem appears poised to stick to this philosophy, we believe there is still ample opportunity for it to create a price control that better protects customers, using controlled (and now capped) incentive mechanisms to drive innovation and new levels of efficiency and service.
5. In any scenario, we would argue that customers are better served by a price control that makes more use of this approach. Even if Ofgem believed that for the next period all the DNOs have to do is to keep the networks ticking over with a blend of asset replacement and maintenance, it would still be better to place more reliance on the mechanisms that have driven the significant improvements in service and efficiency in the sector.
6. But Ofgem (and Government) expects the DNOs to begin to provide the platform for societal decarbonisation, to transition into the role of DSO and to seek out innovative solutions other than reinforcement to solve constraints on the network. In this scenario, the cost to customers of diluting incentives by increasing the scope for subjective, ex-post adjustments and regulatory micromanagement - at the same time as setting too low an allowed return on investment - are very significant.
7. The remedy for this is for Ofgem to adhere more closely to the RIIO principles that set the framework for these price controls. Ofgem should look to set a well calibrated ex ante allowance that covers most of a DNO's expenditure, coupled with meaningful incentives to drive further efficiency and improved performance.
8. As we did for T2 and GD2, we set out below the most critical issues as we see them, and how Ofgem needs to solve them.

Ofgem's approach to allowed returns is flawed and gets the balance wrong

9. The approach Ofgem proposes to allowed returns exposes customers to the significant risks associated with setting the rate for investment too low.

10. Ofgem needs to set ED2, and future ED price controls, with an investment focus. The sector is critical to the low carbon transition, and the costs to energy consumers from underinvestment will be significant. Ofgem also has a stronger starting point than in T2 and GD2, thanks to a better-established set of comparative outcome incentives and cost benchmarking approaches relative to those other sectors.
11. Consequently, Ofgem should set a higher baseline cost of equity for ED2 than those sectors, in addition to any differences in systematic risk.¹
12. The CMA's recent provisional findings in the water sector mean Ofgem will have to reconsider and revise its methodology for estimating the cost of equity.

Ofgem should shorten asset lives on business as usual investment levels to create financial headroom for the low carbon transition and ensure inter-generational fairness

13. In order to create much needed financial headroom to help fund any major increase in investment for the low carbon transition, Ofgem should:
 - a. set the asset life for business as usual levels of investment at the current average (ca. 25 years); and
 - b. retain flexibility to use the longer 45-year asset life, for any significant additional investment.
14. This is also necessary to be inter-generationally fair, by ensuring that:
 - a. future (as well as current) customers benefit from a historically small asset base, allowing these savings to offset some of the costs of the low carbon future; while
 - b. any big increase in investment can still be spread fairly over time.

A low carbon volume driver, based on the number of electric vehicles and heat pumps, should be used to ensure allowances flex with regional levels of uptake...

15. Ofgem should increase cost allowances as the number of low-carbon devices in use rises to fund the associated network rollout on as close to a "pay as you go" or "real-time" basis as is possible. This option has many good properties, since it would:
 - a. **Maintain strong incentives:** DNOs would have incentives to control their costs, since their own actions in minimising costs would not directly affect their allowances. DNOs would face the same incentives if they invest in a new asset, re-evaluate the capabilities of their existing assets, or procure flexibility services to manage network issues.

¹ As well as correcting the flaws in its assessment of the cost of equity in T2 and GD2; we covered these points in response to Ofgem's recent T2 and GD2 consultation, less than a month ago, and so do not repeat them again here.

- b. Facilitate centralised cost benchmarking:** provided DNOs are asked to forecast the level of costs associated with a range of scenarios, it would be possible to comparatively benchmark the cost.
- c. Effectively control for the uncertainty:** the number of low carbon devices in use would be the clearest indication possible over the degree of actual progress towards net zero.
- d. Be perfectly decentralised:** since funding will flow directly with the level of decarbonisation achieved by local administrations.

... which would also remove Ofgem's dilemma between decentralised and centralised forecasts – because allowances would depend on actual uptake, not forecasts

16. The mechanism we propose caters to a scenario where one region moves ahead of the rest of the country in terms of its progress towards decarbonisation, and where this places more demands on the local distribution network (in terms of more electric vehicles on the road or heat pumps in homes).
17. DNO engagement with their local stakeholders, to understand the extent and likely impact of their plans, could be factored into the baselines as Ofgem suggests – although DNOs would always have the incentive to keep expenditure efficient, since if that uptake takes longer to materialise, the DNO would have to wait longer for its funding.
18. This would not present issues in terms of inappropriately delaying funding. Almost all DNO investment decisions are taken ahead of need to some degree. Their investment funding is therefore ahead of need too. The overall settlement would just need to be calibrated to ensure the funding remained “the right degree” ahead of need.² And if one DNO chooses to progress investments even further ahead of need than the others, it can do so, safe in the knowledge that funding will catch up as long as the uptake actually occurs.
19. It would of course require Ofgem to start to gather accurate data on low carbon devices that neither Ofgem nor the DNOs are likely to hold at present. This is far from insurmountable, for example:
 - a.** public bodies may already hold the information, e.g. OLEV for electric vehicles, the RHI register for heat pumps; and
 - b.** where data is not currently collected, Ofgem could require DNOs to (collectively) commission survey based evidence.

And, even if Ofgem doesn't adopt the low carbon volume driver we have suggested, it is difficult to envisage a future where Ofgem doesn't need this data to make informed decisions.

² We cannot rule out the possibility that, if the uptake trajectory rose suddenly, funding might fall behind investment. However, with a volume driver already wired into price control settlement, DNOs would have certainty that this uptake would be followed by funding.

Ofgem must stop looking for inspiration for how to regulate DSO from the flawed TSO system

20. Ofgem appears to look to the TSO system for inspiration in how to regulate DSO functions.
21. This would fail to draw on the very different circumstances in electricity distribution that mean completely different, and more effective, approaches to economic regulation are possible.
22. Ofgem's DSO incentive is one example.
 - a. It will distort activity towards visible DSO outcomes, even if these are not cost effective, and away from more subtle approaches that deliver bigger consumer benefits.
 - b. It will reward the best submissions, not the most effective DSOs.
 - c. It is unnecessary; Ofgem could instead rely on its cost and outcome incentives, along with comparative competition between DNOs.
23. Ofgem has started to consider the last of these, proposing greater coverage for low carbon interactions in some of its outcome incentives. But it can and should aim to go further. This would be a far better use of Ofgem's (and DNOs') resources, instead of trying to put in place and then operate a series of discretionary incentives. And insofar as Ofgem does still want to be able to reward sector-leading developments to DSO standards, it will be operating the ED3 business plan incentive in 2025-26, at around the same time as its first proposed discretionary award, so it can rely on that instead and avoid duplication.

Instead, the established RIIO system has aligned DNO interests with the same outcomes that consumers will value from the DSO role

24. As we highlighted in our ED2 framework response, *"at its heart, the distribution system operator role is about ensuring cost and reliability are being effectively managed in face of requirements being placed the network, including to facilitate decarbonisation. These are all outcomes that the existing system incentivises, through a single price control that includes:*
 - a. *a single totex cost incentive rate, so DNOs earn higher profits if they can minimise costs (including by replacing traditional reinforcement with flexibility solutions);*
 - b. *a single regulatory capitalisation rate, applied to all types of costs, so DNOs have no incentive to favour particular costs which cause higher RAV; and*
 - c. *a suite of incentives so DNOs earn higher profits if they deliver good outcomes on reliability, customer service and connections, regardless of the approach they use to deliver those good outcomes (e.g. flexibility vs network investment)."*
25. By combining enhancements to the existing ED1 incentives with targeted licence obligations (e.g. if new services are needed) Ofgem can develop a highly effective proposition for a regulatory framework to support distribution system operation.

The ED1 suite of incentives provides an excellent starting point for ED2, but will need to be specified so they are fit for ED2

26. The established suite of ED1 incentives for reliability, for customer satisfaction across interruptions, connections and other enquiries, and for faster connection times, means Ofgem has a significant amount of established practice and data on which to build.
27. The value of this alignment between company and consumer interest should not be overlooked.
28. As we highlighted in our response to the open letter, these incentives can be *“used to ensure DNOs take pro-active steps to support decarbonisation outcomes, by “mainstreaming” activities that will support decarbonisation into their measurement. For example:*
 - a. *DNO incentives to quote and then complete new connections quickly can be extended to new or modified connections which involve disruptive loads, like heat pumps.*
 - b. *Customer satisfaction survey incentives could be extended to all activities that can support decarbonisation (like third party data usage, installation of heat pumps, or witness testing of generation installations);...”*
29. These changes will require specific and targeted work to identify the additional circumstances to which the incentive should be applied, undertake the necessary work to ensure this happens, and develop data that gives confidence that the targets are challenging but realistically achievable.
30. This should be the main focus of Ofgem’s ED2 work programme for incentives.

Performance has increased significantly across the board during ED1, and more care must now be taken to avoid setting unachievable targets

31. Benchmarking is a means to an end. To the extent Ofgem uses benchmarking to calibrate incentive mechanisms, it cannot simply rely on the fact that it has used the same model in the past. Ofgem must always satisfy itself that the outcome that flows from the benchmarking isn’t wrong.
32. As performance has improved across the ED1 period, the risk of Ofgem setting unachievable targets has heightened.
 - a. Differences between companies that could previously be overlooked in benchmarking will now be more important.
 - b. Imperfections in the benchmarking that happened to offset themselves in the past may not do so this time round.
 - c. Where incentives are being extended to new customer interactions, it might not be realistic to set targets based on the old basket of services.
33. Ofgem also needs to place more emphasis, on an ongoing basis, on how it gathers and uses data within the price control period to understand better what is being measured. For instance, the general enquiries element of the customer satisfaction survey currently shows wide variation

between DNOs in the make-up of the survey sample. Yet right now, Ofgem gathers no data that would give it visibility of this, even though we have provided Ofgem with a way forward.

Ofgem must fulfil its promise to ensure that WPD's high level of funding during the ED1 period doesn't create an uneven playing field at ED2

34. At the ED1 slow track final determinations, Ofgem recognised that it had over-funded WPD's licensees significantly. The cost allowance element alone amounted to £614m, with the single largest source of this coming from higher generalised funding for real-terms increases in input prices (of over £300m), followed by additional funded asset investment.

35. At the slow track final determinations, Ofgem said:

While we judge it would have been more efficient for WPD to deliver less over the RIIO-ED1 period it will not particularly profit from this additional work. It is committed to secondary deliverables that reflect these volumes. If it materially reduced its overall workload in RIIO-ED1 without justification it would be penalised....

The additional volumes we've described mean that WPD would be doing work that other DNOs should delay until RIIO-ED2.... We can ensure that WPD does not benefit from this additional expenditure in our RIIO-ED2 assessment.³

36. Ofgem should not attempt to "unpick" the ED1 settlement for WPD through the ED2 settlement; this would undermine the investor certainty that Ofgem worked so hard to maintain by refusing to revisit its fast-track settlement for WPD.
37. But it is essential that Ofgem ensures the higher level of funding provided to WPD does not lead to unachievable targets being set for ED2, either because:
- a. WPD's performance on ED1 outcome incentives, such as for interruptions or the customer satisfaction survey, leads to tougher targets being set at ED2.
 - b. WPD's relatively high level of asset investment in the ED1 period, compared to other DNOs, allows it to forecast a relatively low level of asset investment in the ED2 period.

Bespoke outputs should not be necessary

38. A fragmented set of bespoke price controls will also be more difficult for Ofgem to monitor and manage, distracting it from issues like enforcing licence obligations and developing sector-wide outcome measures that will help support the low carbon transition.
39. It is also difficult in electricity distribution to imagine a scenario where a financial outcome delivery incentive would be in the interests of energy consumers in one distribution services area but not in the rest of the country. If a new outcome is identified that justifies incentivisation, it should probably be rolled out nationally.

³ Ofgem, 2014, RIIO-ED1: Final determinations for the slow-track electricity distribution companies, paragraphs 2.12-2.17

Ofgem should optimise the business plan incentive to ensure companies bring forward challenging plans

40. We think it would be better if Ofgem was to introduce:
- a. clearer prospects of material rewards for companies that submit plans based on challenging cost levels;
 - b. less focus on “discretionary” assessment by Ofgem of what constitutes a good plan, or the need to submit “value propositions” before seeing Ofgem’s assessment of the plans;
 - c. less emphasis on the distinction between high- or low-confidence costs, since this will distort incentives for companies to challenge themselves on costs across all of totex; and
 - d. sharing factors set based on the efficiency of company costs, rather than the proportions of the plan that fall in different pots.
41. Ofgem would need to revise its proposals promptly, in time for the ED2 methodology decision, if the incentive is to have the desired effect on company business plans.

We strongly support Ofgem’s proposal to remove three incentives based on discretionary assessment

42. Discretionary assessment incentives are resource intensive for Ofgem and DNOs alike. They always carry the significant risk that they will reward the quality of the submissions more than the underlying activity; drawing material resource away from activities that could improve outcomes for consumers and towards an essay writing competition.
43. They are also becoming a weaker incentive over time, as Ofgem becomes less willing to make awards.
44. So, although these incentives may have served a purpose in driving a step change in approach in specific targeted areas, which were difficult to measure or incentivise, it is now appropriate to move to a more mature regulatory framework of licence obligations and base funding. We therefore strongly support Ofgem’s proposals to remove them.

Ofgem should streamline its new incentives so it can focus more of its resources on developing the regulatory framework, not assessing large numbers of DNO performance submissions

45. Ofgem is proposing three new incentives where Ofgem will:
- a. require DNOs to report annually; and
 - b. undertake ex post discretionary assessment at two and five years.
46. We think Ofgem has a significant opportunity to streamline its proposals through potential synergies with existing mechanisms, and that doing so would allow Ofgem (and DNOs) to spend more time focussing on consumer outcomes.

47. The streamlining we propose is:
- a. developing licence requirements for baseline standards – with the associated risk of penalties if DNOs fail to comply;
 - b. using the reputational incentives created by the annual business plan reporting requirements, for areas where a DNO's plan goes beyond the licence standard; and
 - c. using the ED3 business plan incentive to reward DNOs that develop new propositions that are valuable to all energy consumers.
48. This would remove the need for six discretionary reward submissions, and all the associated assessment by Ofgem, freeing up resources at the mid-point and the end of the period. The value of this should not be overlooked. That time could be spent:
- a. developing and refining strong incentives based on quantitatively measured consumer outcomes, even if this means an extended process; and
 - b. establishing clear licence requirements, with enforcement against failures.
- The use of disaggregated benchmarking should be limited to providing a cross check - and the overly complex, badly-specified ED1 models should not be the starting point.***
49. Ofgem's ED1 disaggregated models cost energy consumers £1 billion pounds. They should be consigned to history, not used as the basis for Ofgem's consultation on ED2 disaggregated modelling.
50. Their biggest weakness was that they granted higher allowances to companies that proposed bloated volumes of an activity at lower (or just average) unit costs. This is costly to consumers regardless of whether companies deliver those volumes.
- a. Models covering 16% of the cost base had no scrutiny of volumes whatsoever.
 - b. Models covering 40% of the cost base separated unit costs from volume scrutiny; with volume scrutiny that was varied and ineffective in many places.
 - c. Even in some models where Ofgem assessed the cost of an activity, it used "workload" as a cost driver, giving higher allowances to companies with higher volume forecasts.
51. This was exacerbated by Ofgem providing a "draft" copy of the models ahead of the ED1 slow track submission, even though Ofgem has long understood the risk that this would allow companies to "optimise" their submissions to perform well against the model.⁴

⁴ Ofgem had previously stated that its RIIO cost assessment would mean that companies "will not know the precise form that scrutiny might take. As such, companies will not have an incentive to adjust their plans to perform well in one assessment (e.g. an operating cost benchmarking study)." Ofgem, 2010, RIIO handbook, page 62

Ofgem should instead borrow from the 100% totex approach at GD2

52. Ofgem is now consulting on whether to remake its ED1 mistakes, by using the ED1 disaggregated models as its starting point for ED2, and consulting area by area on the models.
53. Ofgem should not. It should instead decide in its methodology to scrap them entirely, and to use totex models, supplemented by brand new “cost pool” models if necessary, as its predominant form of assessment.
54. A 100% weight in totex is well supported by precedent, which proves there are no practical obstacles to it, including:
 - a. Ofgem’s proposed GD2 approach, which relies on totex assessment for the large majority of the cost base; and
 - b. Ofwat’s PR19 approach, which benchmarked each individual part of the water sector value chain, such as water distribution, with essentially totex regression models.
55. And to the extent Ofgem wants comfort that the proposed allowances are achievable by the companies in question, it can always maintain some form of disaggregated analysis, limiting its role to that of a cross check.

Ofgem should not index energy network allowances for real price effects to the wider economy

56. The COVID-19 pandemic has illustrated very well why Ofgem shouldn’t index energy network cost allowances to things like pay in the wider economy. Ofgem’s proposal would have cut energy network allowances on account of non-essential sectors using the government’s furlough scheme.
57. This is ridiculous – and creates a demonstrable risk that will raise the cost of capital for the sector. Fixed allowances should be set for real price effects instead, using long term averages.

Ongoing efficiency assumptions should be based on a balanced assessment of the evidence

58. Ofgem’s proposals for ED2 amount to applying the approach it set out in the T2 and GD2 draft determinations. These chose the higher of the two ranges Ofgem’s consultants (CEPA) proposed, went straight to the top of that range, and added some more for good measure, explicitly disregarding CEPA’s advice on good regulatory practice, even though Ofgem is under a duty to have regard to such practice.

The suggestions for ED reopeners are generally appropriate – although Ofgem could go further and improve some of the existing mechanisms

59. The new electricity distribution specific reopeners Ofgem has suggested, for environmental legislation and new government guidance on black start standards, are good additions provided that:
 - a. the trigger is specified as a clear external change; and

- b. the reopener is held as soon as practicable after that change (to set ex ante allowances, rather than setting allowances after the expenditure has happened).

60. However, we think Ofgem could go further in improving some of the existing ED1 uncertainty mechanisms, where costs are now well understood:

- a. **Streetworks:** this could be moved to an automatic allowance driver based on the timing of the introduction of any: (i) remaining permit schemes; and (ii) lane rental schemes.
- b. **Smart meter intervention costs:** Ofgem should remove the current distorting smart/non-smart boundary by introducing either a: (i) volume driver based on all supplier meter operative driven work; or (ii) a fixed cost allowance per percentage point of rollout undertaken by suppliers in a DNO's region, based on a benchmarked cost seen to date.

Ofgem's newly proposed cross sector reopeners will damage investor certainty and incentives

- 61. Several of the newly proposed reopeners ought to be catered to by base allowances, since a five-year price control planning horizon offers ample opportunity to predict requirements and avoid distorting boundaries in the cost base.
- 62. But it is worse than that. Ofgem's proposed "wide definition" net zero reopener would entitle it to re-base allowances, at any time, with limited process, if it thinks allowances should be adjusted because of something it judges to be related to net zero.
- 63. This broad catch all reopener, coming as it does with no recourse for licensees to their full price control appeal rights (limiting them to the weaker protections afforded by judicial review) has obviously damaging implications for investor certainty, and raises the level of regulatory risk.
- 64. The broad nature of this reopener, and reopeners for things like "changes in cyber threat profile", undermines incentives for companies to manage business risks, and to identify and reveal cost efficiencies. The end result will be consumers having to pay more. Ofgem should not apply these reopeners to ED2, regardless of what it does at T2 and GD2.

The use of deliverables and NARMs as uncertainty mechanisms, where the uncertainty is whether companies will find volume efficiencies, will cause obvious damage to incentives

- 65. In common with its T2 and GD2 proposals, Ofgem is seeking to use:
 - a. price control deliverables as an uncertainty mechanism, where the uncertainty trigger is whether companies will amend their plan; and
 - b. the NARMs mechanism to claw back almost all of any cost savings from more efficient asset management (and focussing incentives on procurement and unit costs only).
- 66. The loss of incentives for companies to find ways to avoid costs altogether will therefore be damaging to long term productivity in the sector and thus costly to energy consumers.

Ofgem's proposed pre- and post-appeals framework is an obvious attempt to place a thumb on the scales which will undermine investor confidence

67. As we highlighted in our response to Ofgem's T2 and GD2 consultation, it is proposing to:
- a. require companies to provide it with details of any potential appeal outside the statutory process, and, in fact, before it takes the decision which is actually subject to appeal; and
 - b. introduce a post appeals review policy which is either unnecessary (in its narrow formulation) or undermines the appeal regime (in the wider versions Ofgem reserves the right to adopt).
68. These proposals are either unnecessary or ultra vires and proposing them damages investor confidence.

2. Ofgem's Overview questions

70. We provide our responses to the questions in the overview document to Ofgem's *RIIO-ED2 methodology consultation* (the Consultation) below.

Interlinkages and CMA Appeals in RIIO-2

OVQ1 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

71. We provided our response to this specific question in Ofgem's recent consultation on the T2 and GD2 draft determinations. We reproduce this response below.
72. We remain of the view that the proposed statement of policy would be unnecessary and risks undermining the statutory role of the CMA and the integrity and transparency of the appeal process.
73. Ofgem now cites a non-exhaustive list of two scenarios where it considers such a review may be appropriate. Where:
- a. the CMA quashes the decision(s) appealed and remits to Ofgem for reconsideration with a direction that Ofgem reconsider the decision and consider interlinkages; or
 - b. the CMA quashes the decision(s) appealed, retakes the decision itself but directs Ofgem to consider interlinkages.
74. In both these examples Ofgem would have no choice but to consider the interlinkages and what to do about them. Having a policy that confirms this doesn't do any harm, but it would remain the case whether Ofgem adopts the statement of policy or not.
75. If Ofgem expands the instances where it would enact such a review beyond these then this will undermine the statutory role of the CMA and the integrity and transparency of the appeal process.

OVQ2 Do you have any views on the proposed pre-action correspondence, including on the proposed timing for sending such to Ofgem?

76. We provided our response to this specific question in Ofgem's recent consultation on the T2 and GD2 draft determinations. We reproduce this response below.
77. In its Open Letter the CMA explains that:

We wish to encourage this pre-appeal conduct as good practice. Where it appears that appellants have acted in a way which, without good reason, makes case management more difficult, for example appellants who fail to engage with the appropriate regulators and notify us and update us about their potential intentions to appeal, this could be reflected in our assessment of their conduct when allocating costs at the end of the appeal, even when such appeals are successful. Ideally, we would prefer such prenotification to include the

potential scope of any appeal, rather than be limited to notification of the potential existence of an appeal.⁵

78. This clearly represents good practice. If appellants are obstructive then the CMA will take this into account in its cost order. However Ofgem's construction of what this means for pre-appeal conduct is lopsided and stretches the CMA's statement well past the credible.

79. Ofgem's position is that it expects potential appellants to:

[c]ome forward to clearly explain their intention to appeal, the element(s) of the RIIO-2 price control that they intend to appeal, the scope of that appeal including, in sufficient detail, the alleged errors, and why that particular component(s) of the price control is wrong having regard to interlinked aspects of the decision.

And

send pre-action correspondence at a sufficiently early stage, between the publication of Final Determinations and ahead of the appeals window opening. We would expect to receive this correspondence in the period from early December 2020 to early February 2021 - after the publication of Final Determinations and before we are due to publish a decision on the corresponding RIIO-2 licence conditions.

80. Ofgem's position is unreasonable and it ignores the following:

- a. Given the various consultations (including this one) that lead up to a price control decision, it is virtually certain that any appellant will already have engaged with Ofgem in detail before Ofgem takes its decision.
- b. A price control decision is complex and multifaceted. It takes a long time to digest. After which a prospective appellant has to determine if any elements of it are wrong. Following those two steps, it has to decide whether or not it is in its interests to appeal. This can be a finely balanced decision. A prospective appellant is – for good reason – highly unlikely to be able to provide the information Ofgem thinks it is entitled to in the timeframe Ofgem expects.
- c. Ofgem is asking for this information *before* it has actually taken the decision which is subject to appeal – the decision to modify a licence. This is absurd.

81. Ofgem also provides that

[i]n line with the approach set out the CMA in its open letter to the Authority we would expect that any interlinkages that exist between [Ofgem's three] pillars ... are in the first instance raised by an appellant (and wider parties) in the context of any CMA appeal so that each element of our proposed price control determinations is viewed in its proper context.

In fact the Open Letter provides that:

⁵ Paragraph 12 of the Open Letter.

[t]o the extent that such interlinkages form part of the response to an appeal, in stating that an error on one part of the price control is linked to another part of the price control, we encourage regulators to explain these interlinkages, and the reasons for them, in their decision documentation⁶

82. Before going on to add that:

[w]here there are such interlinkages described clearly by the regulator, we would encourage appellants to explain why the component under challenge is wrong having regard to the interlinked aspects of the decision [emphasis added]⁷

83. It follows, then, that the first instance at which interlinkages would be addressed are in Ofgem's determinations, to the extent there are any links. Provided those links are set out sufficiently clearly, an appellant would be wise to address them when lodging an appeal.
84. The efficacy and legitimacy of the appeal process is one of the cornerstones of the regulatory regime; it represents the only backstop investors have. Ofgem's positions on interlinkages, post-appeal reviews and pre-appeal correspondence all seek to skew this process in Ofgem's favour. They represent a reluctance to accept that appellants have focussed appeal rights and, when they exercise them, Ofgem shifts from being a decision maker to a defendant, on an equal footing with the claimant.
85. On the one hand, as the appeal process is set out in statute and the CMA's rules, it shouldn't really matter what Ofgem's position is. The CMA is the arbiter. But on the other hand, Ofgem's attempts to put a thumb on the scales and its reluctance to be properly held to account necessarily damage investor confidence.

Net Zero and Innovation

OVQ3 Do you agree with our proposed approach to a Net Zero re-opener?

86. No, we don't agree with the proposed approach.
- a. Ofgem should use a tight definition, based on specific external events (like revised government legislation) to maintain incentives and the integrity of the price control.
 - b. It should not allow itself to re-open the price control settlement, at any time, with limited process, on the basis that "something to do with net-zero has changed".
87. Ofgem's proposed "wide definition" net zero reopener would entitle it to re-base allowances, at any time, with limited process, if it thinks allowances should be adjusted because of something it judges to be related to net zero.

⁶ Paragraph 14 of the Open Letter.

⁷ Paragraph 15 of the Open Letter.

88. This broad catch all reopener, coming as it does with no recourse for licensees to their full price control appeal rights (limiting them to the weaker protections afforded by judicial review) has obviously damaging implications for investor certainty, and raises the level of regulatory risk.
89. The broad nature of this reopener, and reopeners for things like “changes in cyber threat profile” or for telecoms systems, undermines incentives for companies to manage business risks, and to identify and reveal cost efficiencies. The end result will be consumers having to pay more. Ofgem should not apply these reopeners to ED2, regardless of what it does at T2 and GD2.

OVQ4 In what circumstances, would a centralised approach to setting forecasted outputs be appropriate? What form should this take?

90. If there is now sufficient certainty that new capacity is necessary to meet a “full electric” scenario by 2050, or alternatively a “full electric light transport” scenario, then Ofgem could require distributors to plan and invest on this basis under the existing framework.

OVQ5 What would be the factors we should take into account that would give us high certainty in a centralised approach to setting outputs?

91. The over-riding factor has to be the degree of certainty over the pathway to net-zero.
92. We doubt this pathway is yet clear enough, and, therefore, some combination of decentralisation or use of uncertainty mechanisms is necessary. We provide our views on the specific combination below.

OVQ6 Alternatively, in what circumstances would it be more appropriate to take a decentralised approach to determining forecasts?

93. We think a decentralised approach has many advantages in terms of involving stakeholders, but it has to be done in a way to avoid the potential pitfalls of the approach (which we comment on in response to OVQ7 below).
94. Ofgem would **have** to take a decentralised approach where powers have been devolved to local administrations that allow them to impose obligations on electricity distributors, resulting in additional costs in these areas for those companies. If this were the case, Ofgem would have a duty to finance the cost of those obligations.
- a. If local administrations have already imposed differential obligations, this should be taken into account in forecasts and base allowances.
 - b. If they may impose different requirements, it would be appropriate to use an uncertainty mechanism, triggered by the imposition of these new obligations.

OVQ7 What would be the factors that we should take into account that would give us high certainty in forecasted outputs derived through a decentralised approach?

95. We think a decentralised approach has some significant issues that are difficult to address – but we also think that the uncertainty mechanism we propose would solve this problem.

96. The problem is that there is always a reasonably likely possibility that such a decentralised forecast may suffer from optimism bias over the rate of progress, even if all the factors mentioned in paragraphs 4.45 and 4.46 of the Consultation overview are fulfilled. This bias could be driven by local stakeholders that recognise their own interests but have no duty towards energy consumers (as Ofgem recognises at paragraph 4.45).
97. However, we think a decentralised approach can work very well if Ofgem does not fix a forecast, and requires investments at the level that would facilitate this, but instead links allowances to the level of uptake of low carbon devices that each region actually achieves. This would:
- a. let allowances match pace with the achievements of particular regions, or nations, in delivering net zero;
 - b. remove any conflict of interest for DNOs in developing their decentralised forecasts; and
 - c. still provide DNOs with strong incentives to understand the needs and actions of their local stakeholders, since this would allow them to invest more efficiently to meet those needs (even as they change during the price control period).

OVQ8 Do you consider that the LAEP Best Practice guidance produced by the Centre for Sustainable Energy and the Energy Systems Catapult provides adequate checks and balances to ensure that local or regional energy plans are robust, unbiased and have broad support?

98. No, we don't.
99. In saying this, we strongly support the concept of a Local Area Energy Plan (LAEP) and we are exploring this and other planning approaches with our stakeholders, because:
- a. collaborative alignment of our plans with our stakeholders' can improve the data used in modelling and assumptions on which we base our plan;
 - b. more robust, better, and comprehensive evidence to support our network planning is welcomed;
 - c. engagement with a wide range of stakeholders can help us identify opportunities for working with others to do more for less; and
 - d. we recognise that local areas are heterogenous, and spatially aware solutions will be instrumental to facilitate decarbonisation and meeting the legally binding net zero target.
100. However, this does not mean they are a silver bullet for setting allowed revenue, because:
- a. Ofgem will still need to apply a rigorous process of its own to check that the business plans proposed by electricity distributors are in the interests of energy;

- b. it will not be possible for any best practice guidance to fully address the issues Ofgem has set out in the Consultation, or the issues we reflect on in response to OVQ7, regardless of its quality;
- c. the practical limits on progress that local stakeholders can make in applying the concept in the coming year, up to final business plan submission, presents a further obstacle; and
- d. some of the investments a LAEP may involve can, and should, be charged for directly by DNOs⁸, giving price signals to encourage optimisation when compared with other “whole system” solutions, and aligning costs with local democratic accountability.

101. These issues further support our view set out in response to OVQ7 above that Ofgem should implement a volume driver, based on the number of low carbon devices (heat pumps or electric vehicles) in each region.

OVQ9 Which of the uncertainty mechanisms and incentives in Appendix 3 will be most effective in enabling efficient strategic investment?

102. Ofgem should increase cost allowances as the number of low-carbon devices in use rises to fund the associated network rollout on as close to a “pay as you go” or “real-time” basis as is possible. This means we favour option 2A.

Below we evaluate each of the options set out in appendix 3 below; focussing more on our preferred option but still touching on the others.

Option 2A – a volume driver based on low carbon device volumes

103. Option 2 A has many good properties, since it would:

- a. **Maintain strong incentives:** DNOs would have incentives to control their costs, since their own actions in minimising costs would not directly affect their allowances. DNOs would face the same incentives if they invest in a new asset, re-evaluate the capabilities of their existing assets, or procure flexibility services to manage network issues.
- b. **Facilitate centralised cost benchmarking:** provided DNOs are asked to forecast the level of costs associated with a range of scenarios, it would be possible to comparatively benchmark the cost.
- c. **Effectively control for the uncertainty:** the number of low carbon devices in use would be the clearest indication possible over the degree of actual progress towards net zero.
- d. **Be perfectly decentralised:** since funding will flow directly with the level of decarbonisation achieved by local administrations.

⁸ As directly remunerated services, in the same or a similar way that the cost of a connection is charged to the connectee.

104. The mechanism we propose would also remove Ofgem’s dilemma between decentralised and centralised forecasts – because allowances would depend on actual uptake, not forecasts. It caters to a scenario where one region moves ahead of the rest of the country in terms of its progress towards decarbonisation, and where this places more demands on the local distribution network (in terms of more electric vehicles on the road or heat pumps in homes).
105. DNO engagement with their local stakeholders, to understand the extent and likely impact of their plans, could be factored into the baselines as Ofgem suggests – although DNOs would always have the incentive to keep expenditure efficient, since if that uptake takes longer to materialise, the DNO would have to wait longer for its funding.
106. This would not present issues in terms of inappropriately delaying funding. Almost all DNO investment decisions are taken ahead of need to some degree. Their investment funding is therefore ahead of need too. The overall settlement would just need to be calibrated to ensure the funding remained “the right degree” ahead of need.⁹ And if one DNO chooses to progress investments even further ahead of need than the others, it can do so, safe in the knowledge that funding will catch up as long as the uptake actually occurs.
107. It would of course require Ofgem to start to gather accurate data on low carbon devices that neither Ofgem nor the DNOs are likely to hold at present. This is far from insurmountable, for example:
- a. Public bodies may already hold the information, e.g. OLEV for electric vehicles, the RHI register for heat pumps; and
 - b. Where data is not currently collected, Ofgem could require DNOs to (collectively) commission survey based evidence.

And, even if Ofgem doesn’t adopt the low carbon volume driver we have suggested, it is difficult to envisage a future where Ofgem doesn’t need this data to make informed decisions.

108. Ofgem has also made two additional proposals (for an incentive and a deadband). These would not undermine the good properties of the mechanism that we highlight above but we do not think they are necessary:
- a. **LCT incentive:** we do not oppose this, but nor do we think it is necessary. The reliability incentive (and the customer service incentive), acting together with the access rights of consumers, already provide strong incentives for DNOs to invest efficiently ahead of need.
 - b. **A deadband on the volume adjustments:** if calibrated carefully (e.g. so the deadband is not wider if DNOs forecast higher) then it should not affect the DNOs’ incentive to forecast accurately.

⁹ We cannot rule out the possibility that, if the uptake trajectory rose suddenly, funding might fall behind investment. However, with a volume driver already wired into price control settlement, DNOs would have certainty that this uptake would be followed by funding.

Option 2B – a volume driver based on capacity

109. Option 2B performs poorly on incentives because it would depend so heavily on how DNOs monitored capacity, and the actions they took, rather than on a direct measure of the uncertainty.
110. Proposals such as a potential penalty for excessive capacity would depend heavily on the system of measurement. A granular set of capacity measurement rules would:
- a. incentivise DNOs to optimise their business against the mechanism, rather than against achieving net zero at least cost; and
 - b. create a likelihood that Ofgem would move into micro-management of DNO investment decisions, and judgements over what counts as a “genuine” cost saving, as Ofgem is proposing with its network asset resilience metrics.

Option 1 – PCD with funding triggers linked to regional plans

111. Ofgem’s proposal has the advantage that the deliverable (and associated funding) would only be triggered by clear external triggers, such as penetration of electric vehicles, or changes in planning permission. This would provide some form of “gateway” to reduce the risk of unnecessary investment.
112. However, it would:
- a. **Remove incentives:** we understand that funding would still be linked to the delivery of the investment, therefore this would remove incentives to identify different solutions to the same issue, that might reduce the cost.
 - b. **Require micro-management:** regional plans set on this bespoke basis would require extensive micro-management by Ofgem.
 - c. **Be difficult to benchmark:** comparative cost benchmarking of totex costs would be impossible for the “regional” element of each plan; creating a distorting boundary in the cost base.

113. It may also be relatively difficult to build a 5 year plan on this basis, as specific triggers like changes in planning permission may be difficult to anticipate if a local area is not already considering them; and areas that were not initially considering such changes might implement them within the period.

Option 3A: a generic reopener

114. Ofgem mentions both the ED1 load related expenditure reopener and the ED2 net zero reopener.
115. Expenditure based reopeners such as the ED1 load related reopener have the disadvantage of reducing or removing incentives to control costs. They act only to provide a backstop limit on how far expenditure can stray from allowances.
- a. This may not be necessary now that Ofgem is putting in place a return adjustment mechanism.

- b. Alternatively, a load related reopener could be combined with a volume driver (with the “band” for the reopener floating up or down with load related allowances, as these are amended via the volume driver, providing a further backstop protection for Ofgem and DNOs).

116. We comment separately on the proposed net zero reopener.

Option 3B: a scheme specific funding process

117. Ofgem’s final option is a scheme specific process, that we understand may be similar to the transmission process for bringing forward new schemes during T1 and T2.

118. This type of highly granular process would:

- a. **Have high administrative costs:** schemes are likely to be relatively high volume and low value in distribution (when compared to transmission). The administrative costs of this approach would be relatively high.
- b. **Be difficult to benchmark:** if different companies propose different sets of schemes at different times in the price control, this would be more difficult to benchmark comparatively than total expenditure at a price review.
- c. **Undermine the business plan incentive:** the business plan incentive would be undermined to the extent alternative routes are created for companies to request funding, that sit outside the reward/penalty framework of the price review.

Option 4: a heat pump “utilisation” incentive

119. Ofgem’s suggested potential incentive in this area appears to have some significant issues, and therefore we oppose it.

120. Most fundamentally, it is an incentive towards a particular network management strategy, rather than an incentive towards a consumer outcome (such as low costs or good reliability). As specified the incentive is likely, in certain circumstances, to encourage companies to incur higher costs in order to meet Ofgem’s expectations of the “right” approach to network management.

121. This type of micro-management incentive should be avoided. Instead Ofgem should rely on its totex cost incentives to encourage cost minimisation; and ensure that outcome incentives, such as the reliability incentive and the customer satisfaction survey incentive, include customer experiences related to net zero (such as heat pump uptake).

OVQ10 Do you agree with our proposals to increase levels of BAU innovation?

122. We agree with low risk innovation being funded from BAU totex, and indeed have done so for many years. While this has been our practice, we have not perhaps reported such innovation as diligently as NIA funded innovation. These proposals will ensure that we do so and we support them, in this light.

OVQ11 Do you agree with our proposed methodology in relation to the RIIO-2 Strategic Innovation Fund?

123. We support a consistent framework across the various energy network sectors.

OVQ12 Do you agree we should adopt a consistent NIA framework for DNOs, and other network companies and the ESO?

124. Yes, we consider it reasonable to adopt a consistent NIA framework.

OVQ13 What are your thoughts on our proposals to strengthen the RIIO-ED2 NIA framework?

125. We support most of the proposals to strengthen the NIA framework.

126. However, Ofgem should not restrict projects to those which deliver net benefits for electricity sector customers. It should also take into account benefits for gas sector customers. Otherwise Ofgem will create silos that may exclude projects that have net benefits when both gas and electricity customers are taken into account, but would not meet this hurdle for either sector independently.

OVQ14 Do you have any additional suggestions for quality assurance measures that we could introduce to ensure the robustness of RIIO-2 NIA projects?

127. We support peer review of project quality. However:

- a. Where a project proceeds to BAU implementation its quality should be assumed, reducing assurance overhead and cost.
- b. Flexibility in terms of who undertakes peer review should be maintained, in line with paragraph A4.32 of the Consultation. For example, academics may tend to be more familiar with early stage projects, and less familiar with later stage projects that are closer to deployment.

OVQ15 Do you agree with our proposed approach for setting individual levels of NIA funding?

128. Yes, we are generally supportive of these arrangements.

Modernising Energy Data

OVQ16 Do you agree with our approach to regulating digitalisation and better use of data through the introduction of cross-sector licence obligations?

129. Yes - but we have the following specific comments on the approach, which we also provided in response to the consultation on the T2 and GD2 draft determinations (Q5-Q7):

- a. **Do not let this slip into micromanagement:** for example, the requirements for updates on the action plan should not be so prescriptive as to rule out ongoing updates or a variety of formats (e.g. website updates, user emails etc.).

- b. **Build reporting into existing requirements where possible:** this will help to avoid stakeholder fatigue.
- c. **Avoid unnecessary duplication:** for example, allow alignment between the requirements of the DSO and Digitalisation strategies.
- d. **Use a focussed definition for the data to which the obligation applies:** this will be in consumer interests as too wide a definition:
 - i) is likely to result in information overload, reducing the consumer benefits; and
 - ii) will drive additional and unnecessary costs. Ofgem also has a duty to finance these costs which energy consumers will ultimately bear.

DSO Transition and a Whole System Approach

OVQ17 Do you agree with the proposals we have set out to support optionality for wider institutional change should we later decide to separate DSO functions from DNOs? How else could the methodology support optionality?

130. We do not think that creating this optionality is in the interests of energy consumers.

131. To the extent that it requires a departure from current arrangements, it is likely to:

- a. involve additional costs, such as administrative costs, that will be borne by energy consumers; and
- b. risk creating boundaries between DSO and non-DSO functions, either through output incentives or cost assessment treatment, that would undermine the RIIO approach to regulation.

132. As we highlighted in our response to the ED2 framework consultation:

Ofgem built the RIIO-ED framework to meet the challenges of the transition to a low-carbon future, including through the use of flexibility solutions and innovation to minimise constraint management costs. Ofgem now needs to let the system it already built work. DNOs are the right parties to continue holding the DSO role.

Separating DSO functions would be a damaging and retrograde step for energy consumers that would lead to higher costs over the longer term and a loss of clear accountability for network stability. Likewise, a separate price control for DSO activity would lead to all the same regulatory headaches that Ofgem has faced in respect of the transmission system. Ofgem must avoid these pitfalls.

133. The Consultation does not fully recognise the interconnectedness of certain DSO functions with the DNO role, even though it mentions some of the relevant issues at paragraph 6.35. For instance:

- a. Decisions on relatively small reinforcement projects (to increase network interconnection) or investments in technology at lower voltages can have a significant bearing on interruptions performance, including restoration time.
- b. The example model that Ofgem sets out at paragraph 6.10 (where DNOs only retain responsibility for owning and maintaining network assets) would fundamentally make something like the current interruptions incentive unworkable, due to the meshed and interconnected nature of the distribution system, undermining one of the engines of consumer benefit over the last two decades.

OVQ18 Do you agree with our proposal to use the Business Plan Incentive to encourage companies to reveal standards of performance higher than our baseline expectations in their DSO strategies? Do you agree we should require, where appropriate, all DNOs adopt these revealed standards?

134. Yes, we think this is an appropriate strategy but also think it should be used sparingly.
135. Revealing best practice in these areas is one of the purposes of a business plan incentive (and the fast track incentive at ED1). Therefore we agree with the idea that Ofgem could require all DNOs to adopt standards set in the most compelling DSO strategies, in certain circumstances.
136. It should be used sparingly because:
- a. Ofgem must take care to balance the cost of the higher standards with the benefits; and
 - b. Ofgem doesn't need to mandate strategies where there are strong incentives in the price control for all DNOs to adopt it, such as strategies that will reduce costs or improve network preparedness for the low carbon transition at no additional cost. In these areas Ofgem should avoid micro-management.

OVQ19 Do you agree with our proposal to invite companies to provide metrics and performance benchmarks in their DSO strategies?

137. We agree that DSO strategies represent a vehicle for the companies to suggest metrics against which they will monitor their progress against.
138. This type of metric is likely to be well suited to a reputational incentive such as the current requirement to report on progress against business plan commitments.
139. We are much more cautious about the prospect that DSO metrics that would warrant potential rewards.
- a. DSO activity should carry rewards in its own right under the cost incentive and outcome delivery incentives (such as reliability).
 - b. Where it doesn't, it should be developed as a licence obligation with potential penalties for non-compliance.

- c. Separately incentivising DSO activities for their own sake would distort incentives, be costly to energy consumers, and isn't necessary.

140. In response to question OVQ21 below we describe how Ofgem can develop its existing suite of arrangements – the business plan incentive at ED2 and ED3, licence obligations, and existing financial outcome incentives such as customer satisfaction and reliability.

OVQ20 Do you agree with our proposal to introduce a DSO ODI in which we would, via an ex post incentive, penalise or reward companies based on their delivery against baseline expectations and performance benchmarks? If so, what criteria and other considerations should we take into account in determining whether we should apply a reward or penalty?

141. No, we do not think a separate DSO incentive of this type would be in the interests of energy consumers. Instead we propose an alternative approach, which we detail in response to OVQ21.

142. Ofgem appears to look to the TSO system for inspiration in how to regulate DSO functions.

143. This would fail to draw on the very different circumstances in electricity distribution that mean completely different, and more effective, approaches to economic regulation are possible.

144. Ofgem's DSO incentive is one example.

- a. It will distort activity towards visible DSO outcomes, even if these are not cost effective, and away from more subtle approaches that deliver bigger consumer benefits.
- b. It will reward the best submissions, not the most effective DSOs.
- c. It is unnecessary; Ofgem could instead rely on its cost and outcome incentives, along with comparative competition between DNOs.

145. Ofgem has started to consider the last of these, proposing greater coverage for low carbon interactions in some of its outcome incentives. But it can and should aim to go further. This would be a far better use of Ofgem's (and DNOs') resources, instead of trying to put in place and then operate a series of discretionary incentives. And insofar as Ofgem does still want to be able to reward sector-leading developments to DSO standards, it will be operating the ED3 business plan incentive in 2025-26, at around the same time as its first proposed discretionary award, so it can rely on that instead and avoid duplication.

146. Instead, the established RIIO system has aligned DNO interests with the same outcomes that consumers will value from the DSO role.

147. As we highlighted in our ED2 framework response, *"at its heart, the distribution system operator role is about ensuring cost and reliability are being effectively managed in face of requirements being placed the network, including to facilitate decarbonisation. These are all outcomes that the existing system incentivises, through a single price control that includes:*

- a. *a single totex cost incentive rate, so DNOs earn higher profits if they can minimise costs (including by replacing traditional reinforcement with flexibility solutions);*

- b. *a single regulatory capitalisation rate, applied to all types of costs, so DNOs have no incentive to favour particular costs which cause higher RAV; and*
- c. *a suite of incentives so DNOs earn higher profits if they deliver good outcomes on reliability, customer service and connections, regardless of the approach they use to deliver those good outcomes (e.g. flexibility vs network investment)."*

148. By combining enhancements to the existing ED1 incentives with targeted licence obligations (e.g. if new services are needed) Ofgem can develop a highly effective proposition for a regulatory framework to support distribution system operation.

OVQ21 Do you agree with our proposal to undertake that ex post incentive performance assessment in the middle and at the end of the price control? Do you think the assessment should be more or less regular?

149. We think Ofgem has a significant opportunity to streamline its proposals through potential synergies with existing mechanisms, and that doing so would allow Ofgem (and DNOs) to spend more time focussing on consumer outcomes.

150. The streamlining we propose is:

- a. developing licence requirements for baseline standards – with the associated risk of penalties if DNOs fail to comply;
- b. using the reputational incentives created by the annual business plan reporting requirements, for areas where a DNO's plan goes beyond the licence standard; and
- c. using the ED3 business plan incentive to reward DNOs that develop new propositions that are valuable to all energy consumers.

151. This would remove the need for six discretionary reward submissions, and all the associated assessment by Ofgem, freeing up resources at the mid-point and the end of the period. The value of this should not be overlooked. That time could be spent:

- a. developing and refining strong incentives based on quantitatively measured consumer outcomes, even if this means an extended process; and
- b. establishing clear licence requirements, with enforcement against failures.

OVQ22 Do you have views on how we might set appropriate values for rewards and penalties associated with the DSO ODI?

152. As set out above, we do not support the specific set of DSO ODI arrangements Ofgem proposes to introduce.

153. Instead, the ED1 suite of incentives provides an excellent starting point for ED2, but will need to be specified so they are fit for ED2 – and in doing so Ofgem can directly incentivise good DSO outcomes.

154. The established suite of ED1 incentives for reliability, for customer satisfaction across interruptions, connections and other enquiries, and for faster connection times, means Ofgem has a significant amount of established practice and data on which to build.
155. The value of this alignment between company and consumer interest should not be overlooked.
156. As we highlighted in our response to the open letter, these incentives can be *“used to ensure DNOs take pro-active steps to support decarbonisation outcomes, by “mainstreaming” activities that will support decarbonisation into their measurement. For example:*
- a. *DNO incentives to quote and then complete new connections quickly can be extended to new or modified connections which involve disruptive loads, like heat pumps.*
 - b. *Customer satisfaction survey incentives could be extended to all activities that can support decarbonisation (like third party data usage, installation of heat pumps, or witness testing of generation installations);...*
157. These changes will require specific and targeted work to identify the additional circumstances to which the incentive should be applied, undertake the necessary work to ensure this happens, and develop data that gives confidence that the targets are challenging but realistically achievable.
158. This should be the main focus of Ofgem’s ED2 work programme for incentives.
159. If a within period DSO incentive is introduced:
- a. it should be of limited value to encourage the development and sharing of best practice;
 - b. it should be reward only, to reflect the positive nature of the ongoing development activity – with the penalty element taken ahead through requirements to comply with licence obligations; and
 - c. if any scope for penalty is introduced, there should be multiple “gateways” to ensure Ofgem has gathered the full facts, and allowed DNOs to respond.

OVQ23 Do you agree with the DSO roles, principles and associated baseline expectations in Appendix 5? Does it provide sufficient clarity about the role of DNOs in RIIO-ED2? Do you think amendments or additional baseline expectations are required?

160. The guidance and requirements set out by Ofgem provides sufficient clarity to enable high quality plans to be brought forward by DNOs.
161. Ofgem must only consider applying business plan penalties in respect of the clear requirements in the guidance. Although we think the guidance reflects the DNOs’ ambitious programmes for DSO activity, and is very useful as an aid to this, in many places the baseline standards are not sufficiently clear to warrant a penalty should Ofgem subsequently determine that it would have liked a DNO to do something differently in its plan. Further, Ofgem needs to be conscious that its baseline standards, where they are clear, are firm requirements placed on DNOs. Ofgem needs to avoid over-

specifying the baseline requirements otherwise it will impose unnecessary costs on energy consumers.

OVQ24 Are there any electricity distribution specific barriers to whole system solutions, and if so, are there any sector specific price control mechanisms to address these?

162. As previously stated, we continue to consider that there are no electricity distribution specific barriers to whole system solutions in general.

- a. Where DNOs require services from a third party to meet their obligations, they can contract to do so and the costs are treated equally to all others (as totex), providing strong incentives to choose flexibility over capital solutions.
- b. Where other networks or third parties require services from DNOs to address whole system issues, we can (and will) provide them any service which is ancillary to the activity of distributing electricity as a directly remunerated service.

163. However, to the extent Ofgem creates uncertainty that DNOs will be allowed to continue to offer these services in the ED2 period, as it did earlier this year when it consulted on options including banning DNO provision of certain balancing services, Ofgem itself creates a barrier. Why would a DNO invest in services when its own regulator is contemplating preventing it from recovering the cost? Ofgem should remove any remaining uncertainty for ED2 and allow DNOs to continue to offer the whole system services that the licence currently allows, within the scope of the Distribution Business and under prices that are regulated as directly remunerated services. The licence already prevents DNOs from pursuing the wider activities that Ofgem wants to develop in a competitive environment; and Ofgem can rely on this while letting DNOs get on with delivering consumer benefits in their core area of business.

164. If Ofgem does receive any other suggestions in the course of the Consultation, it would be worthwhile adopting a review process, through a working group, or via the ENA, to discuss these.

OVQ25 Are there any electricity distribution specific issues you think should be accounted for in the Business Plan Incentive?

165. We have not identified any additional whole system issues that should be accounted for in the business plan incentive.

166. If Ofgem does receive any suggestions in the course of the Consultation, it would be worthwhile adopting a review process, through a working group, or via the ENA, to evaluate these.

OVQ26 Do you agree that whole system solutions are relevant to the innovation stimulus?

167. Yes; it is inevitable that whole system solutions are relevant to the innovation stimulus.

OVQ27 Do you agree with our key proposals for the CAM?

168. As we highlight in our response to OVQ29 below, we can see little or no requirement for the CAM.

169. But we do not think it can do any harm (provided the key proposal is maintained that both affected licensees must be in agreement for it to be triggered). And there may be circumstances when it could be beneficial in addressing regulatory barriers that we have not anticipated.

OVQ28 Do you consider that two application windows, or annual application windows, are more appropriate, and should these be in January or May?

170. We provided our views on this question in response to Ofgem's consultation on the T2 and GD2 draft determinations. This response is reproduced below for convenience.

We do not have strong views on this point.

On the one hand, an annual process would appear to deliver greater fluidity than bi-annual. On the other hand, the excluded services framework and commercial contracting between licensees already allows for a fluid, any time of year, process for achieving similar outcomes.¹⁰

OVQ29 Do you consider that the current electricity distribution licences should be amended to include the CAM, or wait until in 2023 at the start of their next price control?

171. We provided our views on this question in response to Ofgem's consultation on the T2 and GD2 draft determinations. This response is reproduced below for convenience.

We are neutral on this issue.

On the one hand, provided that licensee agreement to any adjustments is necessary for the co-ordinated adjustment mechanism to operate (as we understand it will be), applying it earlier to ED1 does not seem to be detrimental to the integrity of the ED1 price control or the rights of licensees.

On the other hand, we can see little or no requirement for the CAM, since electricity distributors can already provide any services (or assets) that other network operators might require as an excluded service; and would also expect to be able to procure any services they require from other network operators.¹¹

Access SCR

OVQ30 Do you agree with the impacts of our potential Access SCR proposals that are identified in this Chapter? Are there additional impacts that are not identified?

172. Ofgem has correctly identified the three main distribution charging areas being considered as part of the Access SCR, namely:

- a. review of the electricity distribution connection charging boundary;
- b. review of the definition and choice of access rights for distribution users; and

¹⁰ Northern Powergrid, 2020, response to the T2 and GD2 draft determinations, page 17, paragraphs 80-81

¹¹ ¹¹ Northern Powergrid, 2020, response to the T2 and GD2 draft determinations, page 17, paragraphs 82-84

- c. a wide-ranging review of distribution network charges.

173. The first of these three could have relatively significant implications for the distribution price control, since it would directly shift costs from connectees and into the main revenue restriction.

174. The effects of the others are less likely to have a significant impact, although they could have some impact. The effects may also interact with one another. For example:

- a. we already offer flexible connections on a case by case basis, especially for the largest connections, which will realise cost savings even absent the SCR outcome; while
- b. if Ofgem moves the connection charging boundary, connectees will be less likely to choose these flexible connections (because they will no longer face the full price signal from their decision).

OVQ31 Do you agree with the proposed Access SCR baselines for the RIIO-ED2 business plan submissions (ie that Draft RIIO-ED2 Business Plan submissions should use Access SCR Minded to Consultation as a baseline, and that Final Business Plan submissions should use Access SCR Final Decision as a baseline?)

175. Ofgem should set aspirational guidance in this area, but not impose the risk of a business plan “minimum requirements” penalty if a DNO cannot fully meet the requirement.

176. The timing of the Ofgem publications will be critical in determining whether they can be fully reflected in the draft or final business plan submissions.

OVQ32 How do DNOs propose to demonstrate the impact of our Access SCR reforms on RIIO-ED2 Business Plans?

177. We would expect DNOs to explain how their cost forecasts have been developed in their plan narrative and cost justification; including where they have factored in the SCR outcome.

178. Any financial quantification of the impact on business plans would however depend entirely on a counterfactual “without SCR” cost forecast. If clear historical data is available (e.g. historical connections data, if the connection boundary is moved) a reasonable estimate of this counterfactual might be possible. In other areas there may be no counterfactual that Ofgem could reliably place any weight on.

179. Because of this, Ofgem should ensure it puts in place strong incentives for:

- a. DNOs to reveal efficient forecasts of costs through business plans; and
- b. ongoing efficiencies to be identified during the period.

OVQ33 What further guidance might be required from us to allow DNOs to identify the parts of their draft Business Plan submissions that could be impacted by our Final Decision of the Access SCR?

180. Ofgem's documents, both the minded-to and final decisions, should be as clear as possible on the policy position being proposed (e.g. on the connection boundary and non-firm/firm access choice price differentials) and exactly how it expects the decision to be implemented.
181. To the extent Ofgem must necessarily consult on options, it will be easier for DNOs to predict the potential impact of the final decision where these are binary and discrete (e.g. a specific change to the connection boundary vs no change).

COVID-19

OVQ34 Do you think we need specific mechanisms in RIIO-ED2 to manage the potential longer-term impacts of COVID-19? If yes, what might these mechanisms be?

182. COVID-19 may have longer term impacts on productivity, and therefore could have implications for any ongoing efficiency assumption (or indeed for real price effects). With two years left before allowances are due to be set, we think there is adequate time to consider any evidence that emerges in the remaining stages of the price review.

3. Annex 1 - Delivering value for money services for consumers

Approach to setting outputs and incentives

OUTQ1 Do you agree with our proposal for setting upper and lower limits on the value of bespoke ODIs?

183. We do not support bespoke outputs. They should not be necessary.
184. We set out our reasoning in our response to Ofgem's T2 and GD2 sector methodology consultation cross sector questions, CSQ6 and CSQ7. This response is reproduced below.
185. "There should be no need for company specific bespoke outputs. Ofgem's existing framework already incentivises delivery across key areas. If a new candidate output incentive is discovered in the course of consultation on RIIO-2, and judged to be beneficial to energy consumers in one part of the country, it should be introduced across the whole country as part of a consistent incentive package, through a rigorous Ofgem led process of national consultation and evidence evaluation.
186. "If Ofgem follows this approach, then almost by definition any candidates for bespoke outputs are likely to bring at best limited incremental value for consumers, as all material items will already be captured by the common, core outputs framework. Bespoke outputs will therefore most likely bring unnecessary complexity and administrative burden to the price control and dilute the relative incentive strength of core output delivery incentives ("ODIs") that carry the greatest value to consumers. The more complexity Ofgem introduces in terms of bespoke outputs, the more likely its settlement will "leak value" to specific companies or stakeholder groups, to the detriment of energy consumers.
187. "If Ofgem wishes to retain the option for companies to propose bespoke outputs, it must set a high bar when appraising them."

OUTQ2 Do you agree with our proposal for a minimum value for bespoke PCDs?

188. As set out in response to OUTQ1, we do not support bespoke outputs.
189. Ofgem should be sceptical of bespoke price control deliverables as these may reflect attempts to take costs outside of the:
- a. cost assessment framework; and
 - b. business plan incentive arrangements.
190. Requiring companies to go on to deliver them or risk a PCD clawback will remove incentives for companies to avoid the investment. This will ultimately raise costs for energy consumers.

Customer satisfaction

OUTQ3 Do you agree with the proposed scope and associated customer category weightings for the satisfaction survey?

191. We set out our views on the issues this question spans below:

- a. **Scope – low carbon technologies:** we support the broadening of the survey sample to capture a greater proportion of interactions supporting low carbon technologies.
- b. **Scope – additional connection segments:** we do not support this proposal, which is badly targeted as currently defined. We explain this view in response to question OUTQ7 below.
- c. **Weightings:** we think that the overall weight in the price control on connections should be reduced, for four reasons.
 - i) This was boosted at ED1 to encourage more focus here – and has served its purpose.
 - ii) Reported scores are likely to be lower as customers making a large payment for the service are likely to have higher expectations; this does not mean service is poor.
 - iii) The high connections weighting squeezes the weight on other survey categories, and is detrimental to vulnerable customers or people installing low carbon technologies that do not require a new or modified connection.
 - iv) The financial value riding on new and modified connections may be disproportionate; Ofgem should explicitly evaluate the value of the incentive per incentivised connection and consider if this is appropriate. It can be calculated using:
 - (1) the likelihood of any given customer ending up being surveyed; and
 - (2) the change in the DNO's overall rewards if it receives a low score, rather than a high score, reflecting the weight of each surveyed customer in the sample.

192. Ofgem also needs to place more emphasis, on an ongoing basis, on how it gathers and uses data within the price control period to understand better what is being measured. For instance, the general enquiries element of the customer satisfaction survey currently shows wide variation between DNOs in the make-up of the survey sample. Yet right now, Ofgem gathers no data that would give it visibility of this, even though we have provided Ofgem with a way forward.

OUTQ4 Do you agree with our proposed approach to target setting and calculating rewards and penalties in RIIO-ED2?

193. Benchmarking is a means to an end. To the extent Ofgem uses benchmarking to calibrate incentive mechanisms, it cannot simply rely on the fact that it has used the same model in the past. Ofgem must always satisfy itself that the outcome that flows from the benchmarking isn't wrong.

194. As performance has improved across the ED1 period, the risk of Ofgem setting unachievable targets has heightened.

- a. Differences between companies that could previously be overlooked in benchmarking will now be more important.
- b. Imperfections in the benchmarking that happened to offset themselves in the past may not do so this time round.
- c. Where incentives are being extended to new customer interactions, it might not be realistic to set targets based on the old basket of services.

195. Ofgem must also pay particular attention to ensure it does not set targets at an unachievable level based on WPD's past performance. At the ED1 slow track final determinations, Ofgem recognised that it had over-funded WPD's licensees significantly. The cost allowance element alone amounted to £614m, with the single largest source of this coming from higher generalised funding for real-terms increases in input prices (of over £300m), followed by additional funded asset investment. It is essential that Ofgem ensures the higher level of funding provided to WPD does not lead to unachievable targets being set for ED2, in any area of the settlement, including customer satisfaction.

196. We set out our views on the range of other issues that this question spans below:

- a. **Fixed vs dynamic targets:** we support Ofgem's proposal, of targets fixed at the outset.
 - i) We agree that evolving customer expectations mean fixed targets can be dynamic.
 - ii) Fixed targets also help support collaboration across DNOs to share best practice.
- b. **Target setting timing:** Ofgem should set targets or a methodology in the methodology decision, in line with the RIIO approach. Otherwise, DNOs would not be able to price the cost of meeting a particular level of service in their business plans.¹²
- c. **Application of a deadband:** Ofgem should not apply a deadband before rewards start to be earned.

197. Our reasoning on the last of these three points was set out in our response to the T2 and GD2 draft determinations consultation, gas distribution appendix question GDQ11, and is reproduced below.

198. "We can see no reason that a deadband should apply to a financial incentive.

- a. "The whole point of the arrangement is to create an incentive to optimise performance.
- b. "A deadband switches off the incentive across a range of performance and thus distorts and weakens the arrangement.

¹² Where the scope of the survey is broadened, we would support establishment of a pilot survey to establish the relative volume of interactions in the new categories, and identify whether any adjustment to the target is warranted.

- c. “If the rationale for a deadband is exposure to external factors (i.e. measurement “noise”), then this noise presumably still exists outside of the deadband. A better response to such uncertainty might be to lower the incentive rate and apply the incentive across a larger range (so the incentive still has the same financial “size”, but so the effect of any “noise” is less pronounced).

199. “For similar reasons, we also disagree with Ofgem’s proposal for a deadband in respect of the GD2 customer satisfaction survey incentive (although there is no consultation question on this). It is distorting and against the interests of energy consumers to give average-performing companies no marginal incentive to improve, but to give a relatively strong incentive to better-performing companies.”

OUTQ5 Do you agree with our proposed approach to setting complaints metric targets in RIIO-ED2?

200. We support Ofgem’s proposed approach. We would also support a de minimis floor on the target where sector performance tends towards very low levels.

201. We set out our views on the issues this question spans below:

- a. **Fixed vs dynamic targets:** we support Ofgem’s proposal, of targets fixed at the outset. By its nature the incentive is a backstop against poor service and it does not warrant repeated re-setting.
- b. **Target setting timing:** we support Ofgem’s proposal to establish a target setting methodology in its methodology decision. This will allow DNOs to align their business plan forecast costs with the level of service expected.

OUTQ6 Do you agree with our proposal to remove the Stakeholder Engagement and Consumer Vulnerability Incentive in RIIO-ED2?

202. We strongly support this proposal.

203. Discretionary assessment incentives are resource intensive for Ofgem and DNOs alike. They always carry the significant risk that they will reward the quality of the submissions more than the underlying activity; drawing material resource away from activities that could improve outcomes for consumers and towards an essay writing competition.

204. They are also becoming a weaker incentive over time, as Ofgem becomes less willing to make awards.

205. So, although these incentives may have served a purpose in driving a step change in approach in specific targeted areas, which were difficult to measure or incentivise, it is now appropriate to move to a more mature regulatory framework of licence obligations and base funding. We therefore strongly support Ofgem’s proposals to remove them.

Connections

OUTQ7 Do you agree with our proposal to expand the connections element of the customer satisfaction survey?

206. We support one aspect of the proposal (to include LCT interactions) but we do not support the wider and less well targeted proposal to include the segments set out in table 11.

207. We think that the LCT interaction aspect of the proposal could be important in supporting the low carbon transition, and ensuring DNOs are incentivised in respect of this and their DSO activities. This view was set out in our response to Ofgem's ED2 open letter consultation, when we said that:

- a. *"Ofgem should "mainstream" net zero into its existing suite of incentives (like reliability, connections, and customer service), rather than introducing an entirely new incentive", as stated on the front page; and*
- b. *Ofgem may wish to "broaden the connection quotation, speed and satisfaction incentives to a wider range of connections, such as existing household's installing disruptive loads (which are likely to include low carbon technologies like heat pumps)", as stated in response to Q22.*

208. We do not support the wider broadening, as set out in table 11 to annex 1 of the Consultation. We set out our reasoning in response to the next question.

OUTQ8 Do you consider that we have identified the relevant considerations to determine which customers should be captured in its scope?

209. We think Ofgem has identified the primary considerations, which are whether:

- a. the customers are "small" i.e. share characteristics with current minor connectees¹³; and
- b. they sit in a market which is not competitive or potentially competitive¹⁴.

210. However, many of the connections in the three segments Ofgem suggests will not meet these tests.

- a. **The existing segments are not well tailored to the issue:** since they are based predominantly on the voltage of work being undertaken, with no regard to size of the connection or any characteristics of the customer.
- b. **The proposed segments include work which is competitive, or potentially competitive:** any activity which is competitive in one region must be potentially competitive in the other regions, since there is no intrinsic difference in the activities:

¹³ Paragraph 5.7 of annex 1 to the Consultation.

¹⁴ Ofgem states in paragraph 2.26 of annex 1 to the Consultation that incentives will not apply where DNOs are operating in competitive or potentially competitive markets.

- i) **LV demand:** ENW and SPD both passed the test in this segment¹⁵, while Northern Powergrid Northeast had a market share of only 29% for connections in this segment involving more than 20 premises at the date of its DPCR5 competition notice.¹⁶
- ii) **HV demand:** Northern Powergrid, ENW and SPD all passed the competition test in this segment.¹⁷
- iii) **LV DG:** although no DNOs passed the competition test in this area, the segment includes some relatively large connections, e.g. 20+ houses fitted with solar PV.

211. Some specific customers that fall within the above segments may warrant inclusion – indeed we proposed alternative segmentation when we submitted our competition notices in 2013 under the DPCR5 arrangements. But this is unlikely to apply to the bulk of the connections in the identified segments.

212. Therefore, if Ofgem extends the incentive as it proposes, it should use an alternative and much more limited definition of the relevant customers than the existing market segments.

OUTQ9 Do you agree with our proposal to retain the TTC incentive as a financial ODI in RIIO-ED2?

213. We think Ofgem could remove the time to quote and time to connect incentive without causing consumer detriment.

214. The rationale for incentive is questionable, since the consumer “outcome” is reflected in the customer satisfaction survey results. For example:

- a. some connectees actively want slower connections (e.g. to be able to put their connection on hold if a building site is running behind schedule); and
- b. an incentive driven by the time to connect can push DNOs to offer worse service.

215. If Ofgem did remove the time to quote and time to connect incentive, it could focus more of its regulatory attention on improving the customer satisfaction survey, and potentially place more weight on all elements of this incentive.¹⁸

216. Ofgem does not ask a question about whether time to quote / connect should be expanded to other market segments. Our response on this aspect of the Consultation is, however, the same as set out in response to question OUTQ8 above.

¹⁵ Figure 13 on page 167 of annex 1 to the Consultation

¹⁶ Northern Powergrid, 2013, Competition Notices submitted under special condition CRC12 of the electricity distribution licence, page 6, figures by estimated value.

¹⁷ Figure 13 on page 167 of annex 1 to the Consultation

¹⁸ As suggested in our response to OUTQ3, Ofgem should consciously evaluate the size of the incentive being placed on individual interactions and consider whether it is proportionate and reflects consumer value.

OUTQ10 Do you agree with our proposal to include a reopener which allows us to revisit targets, and potentially introduce penalties, in the period?

217. No, we do not support the proposal for a reopener to introduce penalties.
218. A reopener like this would weaken the incentive – and when Ofgem says that “*the option to reset targets in the period would enable us to tighten targets if they are easily outperformed*”¹⁹ it explicitly ensures this, because DNOs can anticipate that any value from improvements is likely to be clawed back, thus weakening any investment case.
219. ED2 will only be 5 years long, and there is now much more data on which to base targets when compared to ED1. There is far less reason now to have a reopener after 2.5 years than in ED1, when a reopener after 4 years was put in place.
220. Ofgem should therefore take a decision up front:
- a. if it has enough confidence in the data, the incentive it drives, and Ofgem’s ability to set targets it should impose a reward and penalty incentive from the start of ED2; while
 - b. if it lacks this level of confidence, it should discontinue the incentive.

OUTQ11 Do you agree with the methodology we propose to use to set the new TTC targets?

221. No, we do not support the methodology.
222. The very limited quantitative data that Ofgem currently gathers is insufficient for Ofgem (or the DNOs) to even begin to understand whether DNOs are taking different approaches to things like discontinuing quotations (and starting a new one), or limiting the options customers have in terms of timing of their connection. This issue is not quickly or easily resolved.
223. Where Ofgem lacks comparable data on performance, it should implement company specific rolling targets, rather than benchmarked targets.
224. Ofgem should not unduly complicate its reward schedule for the incentive. It should instead set the marginal incentive (per day) at whatever level of consumer value Ofgem estimates will arise from a faster quote or connection. It seems unlikely this will increase as connections get faster.

OUTQ12 Do you have views on our proposed Connection Principles and associated standards (in Appendix 4) for RIIO-ED2? Do you disagree with any of the standards we have proposed? If so, why?

225. We think Ofgem needs to make some specific adjustments to the baseline standards to avoid including broad requirements that could potentially be very difficult or costly to implement effectively, going well beyond the existing statutory and licence based connection requirements, or which might not be beneficial to connectees.

¹⁹ The Consultation, annex 1, page 43, paragraph 5.24

226. We list the potential issues we have identified below.

- a. *"Where appropriate, the likely implications for the connection offer if any changes arise...[in the customer's requirements or in other connections]"*. This is not appropriate as a baseline standard as it is not clear:
 - i) how we could factor into connection offers the implications of changes outside of our control such as these without potentially incurring significant cost; or
 - ii) what use the information about the requests of other customers would be to the customer, since that customer would not be able to affect these, and since it would have a firm connection offer with a set validity period anyway.

We understand the importance that customers place on engagement throughout the connections process and this engagement is useful in unpacking any potential scenarios. However, at the point that the connection offer is produced and issued certainty is required.

- b. *"Where consortium connections are available, provide clear and detailed information about where, how and under what conditions"*. Our experience throughout ED1 is that many factors come into play when determining if a consortium approach is likely to be beneficial for customers. We have not yet found these factors to align for a consortium in the ED1 period. We therefore think we should maintain flexibility on a case by case basis, rather than trying to spell out a specific set of circumstances (and risk discouraging potential consortia).
- c. *"...should include processes to manage customer accounts"*. It is not clear what the words *"customer accounts"* mean. All our connections customers have a nominated single point of contact for each of their active connections projects; however we do not call these individuals account managers and they do not oversee the customer's portfolio of active schemes held with Northern Powergrid at an aggregate level. We do not think that Ofgem is intending to mandate a particular approach to customer management, yet its wording as a baseline standard may do this.
- d. *"...ensure the availability of flexible connections for all customers, including storage"*. We do not expect any demand from certain customer groups for flexible connections, for example unmetered connections, therefore Ofgem should write a list of the customers this applies to, or limit the requirement to *"all customers the DNO considers likely to require flexible connections"*.
- e. *"...have processes in place for releasing capacity that is not being used"*. This should not be included as a connection baseline standard, since existing customers may have a contractual right to that capacity, and since Ofgem's Access SCR is considering this and related issues.

- f. Ofgem suggests DNOs "*show consideration of innovative connection solutions for customers which may include, amongst other things, improved coordination with other utility connection providers and between connection customers*". This is an aspirational requirement to try and be innovative that is more appropriate for stage 2 of the business plan incentive (customer value propositions) than stage 1 (potential penalties for failing to meet baseline standards).
- g. Before Ofgem hard codes a requirement for the inclusion of processes that promote certain types of customers (such as storage) in the connection queue in its baseline standards, the Open Networks project needs to complete its work considering the implementation solutions required for such a proposal. The practicality of the principle needs further development to take account of the commercial and electrical hurdles that must be overcome before it is set as a baseline standard. Ofgem would then also need to consider whether or not any consequential changes were required to the electricity distribution licences to allow for this discrimination in favour of a particular type of connectee.

OUTQ13 Do you have views on our proposal to use the Business Plan Incentive to encourage companies to reveal higher baseline standards of performance and to apply this, where appropriate, to all DNOs?

227. Yes, we think this is an appropriate strategy but also think it should be used sparingly.

228. Revealing best practice in these areas is one of the purposes of a business plan incentive (and the fast track incentive at ED1). Therefore we agree with the idea that Ofgem could require all DNOs to adopt standards set in the most compelling DSO strategies, in certain circumstances.

229. It should be used sparingly because:

- a. Ofgem must take care to balance the cost of the higher standards with the benefits; and
- b. Ofgem doesn't need to mandate strategies where there are strong incentives in the price control for all DNOs to adopt it, such as strategies that will reduce costs or improve customer satisfaction. In these areas Ofgem should avoid micro-management.

230. Turning to rolling out best practice to requirements for all DNOs, this seems sensible since Ofgem is proposing to standardise a set of requirements, where possible. In doing so, we agree that Ofgem should evaluate whether the higher standards have an associated cost, and ensure it makes allowance for it. It could achieve this by applying the following two tests.

- a. First: Ofgem should check if the DNO proposing the higher standards in its business plan included an additional cost for it, or is already likely to be incurring additional costs (e.g. because they already have the service standard, but other companies do not).
- b. Second: It should check whether this cost flowed through Ofgem's cost benchmarking to all DNOs (e.g. because the relevant DNO set the cost benchmark).

231. If the first test is met, but the second test is not, Ofgem should ensure it makes allowance for the cost of the requirement for all DNOs.

OUTQ14 Do you agree with our proposal to use an ex post assessment to penalise/reward companies who fail to deliver their strategies in line with our guidance/exceed performance targets?

232. We think Ofgem has a significant opportunity to streamline its proposals through potential synergies with existing mechanisms, and that doing so would allow Ofgem (and DNOs) to spend more time focussing on consumer outcomes.

233. The streamlining we propose is:

- a. developing licence requirements for baseline standards – with the associated risk of penalties if DNOs fail to comply;
- b. using the reputational incentives created by the annual business plan reporting requirements, for areas where a DNO's plan goes beyond the licence standard; and
- c. using the ED3 business plan incentive to reward DNOs that develop new propositions that are valuable to all energy consumers.

234. This would remove the need for six discretionary reward submissions, and all the associated assessment by Ofgem, freeing up resources at the mid-point and the end of the period. The value of this should not be overlooked. That time could be spent:

- a. developing and refining strong incentives based on quantitatively measured consumer outcomes, even if this means an extended process; and
- b. establishing clear licence requirements, with enforcement against failures.

OUTQ15 Do you consider that an assessment of performance in the middle and at the end of the price control is a proportionate approach?

235. As set out above, we think Ofgem should streamline the discretionary assessment element of the package into other existing incentive arrangements.

236. The mid-period assessment may clash with the RIIO-3 review, and could be eliminated by relying on the ED3 business plan incentive instead. The end of period assessment would come too late to inform ED3 and thus be of relatively limited value.

237. If a within period discretionary incentive is introduced:

- a. it should be of limited value to encourage the development and sharing of best practice;
- b. it should be reward only, to reflect the positive nature of the ongoing development activity - with the penalty element taken ahead through requirements to comply with licence obligations; and

- c. if any scope for penalty is introduced, there should be multiple "gateways" to ensure Ofgem has gathered the full facts, and allowed DNOs to respond.

OUTQ16 Do you agree with our proposal to retain the Connections GSoPs for all connection customers in RIIO-ED2?

238. Yes, we agree with Ofgem's proposal to retain the Connections GSOPs.

OUTQ17 Do you agree with our proposed approach to uplifting the Connections GSoP payment values in line with inflation, indexing payment levels to inflation, and rounding to the nearest £5?

239. No, we don't agree with this proposal, which adds unnecessary complexity to the arrangements. Ofgem should just fix a value for the price control period, since:

- a. this will set clear expectations for stakeholders;
- b. the exact payment values are fairly arbitrary anyway;
- c. forecast inflation across a 5 year period can be taken into account from the outset; and
- d. Ofgem updating the statutory instrument once every five years is more administratively efficient than 6 DNO groups monitoring the inflation linked values annually and potentially having to update all their relevant customer paperwork on an annual basis.

OUTQ18 Do you agree with our proposal to remove the Incentive on Connections Engagement for RIIO-ED2?

240. We strongly support this proposal.

241. Ex post discretionary assessments like this are administratively burdensome for Ofgem and network licensees, and can reward the perceived quality of the submission more than the underlying activity.

242. So, although the incentive may have served a purpose in driving a step change in approach in a specific targeted area, which was difficult to measure or incentivise, it is now appropriate to move to a more mature regulatory framework of licence obligations and base funding (and penalties for non-compliance).

Consumer Vulnerability

OUTQ19 Do you agree with our proposed approach to ensuring consumers in vulnerable situations receive an appropriate range and level of support in RIIO-ED2? If not, what alternative approach should we consider?

243. Yes, we support the proposed approach and think it will be effective, although we think one aspect of it should be streamlined to make full use of existing arrangements, as described in response to OUTQ21 below.

OUTQ20 Do you have views on our proposed Vulnerability Principles and associated standards (in Appendix 5) for RIIO-ED2? Do you disagree with any of the standards we have proposed? If so, why?

244. We support the standards but have one specific comment.

245. On data cleansing activity, paragraph A5.4 bullet 2, Ofgem should delete “effective”. Effectiveness would be a subjective judgement that would in any case be difficult for Ofgem to assess. If Ofgem wants to further define the activity of PSR database maintenance we would support a consistent methodology across all DNOs.

OUTQ21 Do you agree with our proposal to use an ex post assessment to penalise/reward companies who fail to deliver their strategies in line with our guidance/exceed performance targets?

246. We think Ofgem has a significant opportunity to streamline its proposals through potential synergies with existing mechanisms, and that doing so would allow Ofgem (and DNOs) to spend more time focussing on consumer outcomes.

247. The streamlining we propose is:

- a. developing licence requirements for baseline standards – with the associated risk of penalties if DNOs fail to comply;
- b. using the reputational incentives created by the annual business plan reporting requirements, for areas where a DNO’s plan goes beyond the licence standard; and
- c. using the ED3 business plan incentive to reward DNOs that develop new propositions that are valuable to all energy consumers.

248. This would remove the need for six discretionary reward submissions, and all the associated assessment by Ofgem, freeing up resources at the mid-point and the end of the period. The value of this should not be overlooked. That time could be spent:

- a. developing and refining strong incentives based on quantitatively measured consumer outcomes, even if this means an extended process; and
- b. establishing clear licence requirements, with enforcement against failures.

OUTQ22 Do you consider that an assessment of performance in the middle and at the end of the price control is a proportionate approach?

249. As set out above, we think Ofgem should streamline the discretionary assessment element of the package into other existing incentive arrangements.

250. The mid-period assessment may clash with the RIIO-3 review, and could be eliminated by relying on the ED3 business plan incentive instead. The end of period assessment would come too late to inform ED3 and thus be of relatively limited value.

251. If a within period discretionary incentive is introduced:

- a. it should be of limited value to encourage the development and sharing of best practice;
- b. it should be reward only, to reflect the positive nature of the ongoing development activity - with the penalty element taken ahead through requirements to comply with licence obligations; and
- c. if any scope for penalty is introduced, there should be multiple "gateways" to ensure Ofgem has gathered the full facts, and allowed DNOs to respond.

Network reliability

OUTQ23 Do you agree with our proposed approach to retain the RIIO-ED1 methodology for setting unplanned interruptions targets?

252. We support the interruptions incentive but do not think the ED1 target setting methodology remains fit for purpose at ED2.

253. The interruptions incentive is one of the most effective incentives that Ofgem has, across any of the regulated network sectors. It relates to the aspect of service that consumers most value and is directly financially quantified, allowing energy networks to optimise their investment decisions and operational costs based on the consumer value derived.

254. Maintaining this incentive is as important as ever, or perhaps even more important, in the transition to net zero and DSO capabilities. It ensures DNOs will optimise their decisions in respect of reliability as the number of low carbon devices increases; and it also gives DNOs an incentive to use network management techniques like flexibility services where this offers value for money.

255. Benchmarking is a means to an end. To the extent Ofgem uses benchmarking to calibrate incentive mechanisms, it cannot simply rely on the fact that it has used the same model in the past. Ofgem must always satisfy itself that the outcome that flows from the benchmarking isn't wrong.

256. As performance has improved across the ED1 period, the risk of Ofgem setting unachievable targets has heightened.

- a. Differences between companies that could previously be overlooked in benchmarking will now be more important.
- b. Imperfections in the benchmarking that happened to offset themselves in the past may not do so this time round.
- c. Where incentives are being extended to different situations (or if exclusions are adjusted), it might not be realistic to set targets based on the old basket of circumstances.
- d. Performance improvement factors that may have been achievable at ED1 may no longer be achievable.

- e. It has become more difficult to just assume that any reliability performance benchmarks will be funded through the cost benchmarks.
- f. The higher level of funding given to WPD at ED1 must not be allowed to cascade into tougher targets for other DNOs that weren't given this funding.

257. Ofgem also proposes to impose a ratchet, down to "current" company performance if it is below target. Ofgem does not define "current", but if it means the latest reported CI and CML when it is making its determinations, then this:

- a. is against regulatory good practice because it damages the incentive for companies to improve towards the end of a price control period; and
- b. would impose weather related volatility on the targets.

258. Ofgem should, at a minimum, use a four year average for its measure of current performance.

OUTQ24 Do you have views on the alternative approaches to setting unplanned interruptions targets set out? Are there any other approaches that we have not considered?

259. We agree with Ofgem that the existing approach will develop challenging targets.

260. Ofgem needs to confirm the general approach to target setting before DNOs submit their business plans, since the costs submitted in the plans need to be consistent with the targets being proposed; even if those targets have not been finalised.

261. Lastly, the data Ofgem uses to set the ED2 targets needs to be consistent with how Ofgem will measure performance during the ED2 period. If Ofgem makes changes to the exceptional event definitions, or removes the "other exceptional event" category of exemption, the historical data used in the model needs to reflect this change too.

OUTQ25 What are your views on revisiting unplanned interruptions targets within the price control period?

262. Ofgem should set fixed targets from the outset of the period in order to maintain the strongest possible incentive.

263. The alternatives would be damaging:

- a. **Discretionary changes:** if Ofgem were to revisit the targets on a discretionary basis, this would fundamentally undermine the incentive since companies would expect incentive gains to be clawed back.
- b. **Annual re-running of the target model:** we agree with Ofgem that the administrative burden would be significant. Furthermore, this process would:
 - i) weaken the incentive for companies to improve on the company specific elements;
 - ii) introduce uncertainty (and so raise the cost of capital);

- iii) create a risk that case new data would causes issues that had not previously been anticipated; and
- iv) create a disincentive for collaborative innovation.

OUTQ26 Do you agree with our proposed position not to introduce further convergence of DNOs' targets over time?

264. Yes, we agree, further convergence of targets would not be appropriate.
265. One of the strengths of the IIS is that it forces DNOs to recognise the economic cost of interruptions, and balance this against the costs of improving performance.
266. Some networks will inherently have different reliability properties that will affect this cost benefit trade off (e.g. if a high balance of underground network has been historically installed). In this context, it is entirely appropriate that different outcomes could result in different parts of the country.
267. As set out in response to OUTQ25 above, we think the ED1 models now present a risk of setting unachievable targets (for a number of reasons).

OUTQ27 What are your views on retaining an incentive for planned interruptions performance, and the associated targets?

268. We support a continued incentive. At the present stage a continuation of the ED1 approach (rolling targets) appears appropriate.
269. However, Ofgem should not rule out changes to this, for example if particular external requirements or the low carbon roll out mean that higher volumes of interruptions are inevitable, and beyond DNO control.
270. The only reason for Ofgem to “expect DNOs to justify any sustained worsening of performance” is if Ofgem is planning to set targets by a different methodology. However, if a DNO is proposing to keep the rolling target in place, then Ofgem should not impose additional requirements for DNOs to justify particular levels of performance.

OUTQ28 What are your views on the potential amendments that could be made to the mechanism, including (but not limited to) the options presented in Tables 23 and 24?

271. We do not support any of these potential amendments at present – but note that this does depend on whether external factors beyond DNO control mean that the number of planned interruptions will increase.
272. In terms of the “weighting” of planned interruptions:
- a. **50% weighting:** it is logical that the incentive rate on planned interruptions should lower than unplanned, because an interruption is less disruptive when customers know when it is going to happen, and how long it is likely to be. Any change to the 50% weighting would need to be based on some evidence.

- b. **Company specific weights:** willingness to pay research results can be heavily affected by the methodology, and differences in the estimates individual companies develop will be affected by differences in methodology.

273. In terms of target setting:

- a. **Fixed targets:** these provide strong incentives so do bring advantages; whether this is worthwhile will depend on if Ofgem needs to move away from rolling targets.
- b. **Benchmarked targets:** these would require a large amount of development work; which is not worthwhile if DNOs are not forecasting increased volumes of interruptions.
- c. **DNO proposed targets:** a process would be needed to evaluate the DNO proposed targets on a consistent basis across companies. This would require a large amount of development work; which is not worthwhile if DNOs are not forecasting increased volumes of interruptions.

OUTQ29 What are your views on how VoLL should be updated for RIIO-ED2?

274. Ofgem's starting point, updating the ED1 (and T1) figure for inflation, is sensible, and light-touch, which may be appropriate given the extensive work undertaken previously to calibrate this value.
275. Different VoLL methodologies will, by definition, give different answers. Each methodology is also applied under uncertainty, and therefore is only indicative.
276. If compelling evidence existed from a broad range of sources that VoLL is now materially different, then this would warrant a closer look to update it. One particular estimate, from one study, would not meet this hurdle.
277. Lastly, Ofgem should be wary of changes to VoLL which in themselves become drivers of regional disparity, as this will further undermine the ability to compare performance between licensees.

OUTQ30 What are your views on the different methodologies for updating VoLL?

278. We haven't reviewed the various methodologies in detail.
279. However, we would note that adopting one specific methodology, in order to infer region-specific values, may make Ofgem's estimate less robust than using a single value estimated nationally using a range of approaches.
280. If Ofgem wishes to assess the merits of a specific approach in greater depth it could commission a review by an independent consultant.
281. An alternative approach would be to commission a "meta-study" of the various approaches available, which might yield more relevant outputs. It is, however, not clear to us that this will yield meaningfully more representative results than the ED1 value (updated for inflation).

OUTQ31 Do you have a view on retaining alignment with VoLL figures used in other RIIO price controls and/or parts of the energy sector?

282. Ofgem should use the best available view of VoLL in all its calculations.
283. This promotes alignment, although Ofgem should consult on whether the value remains appropriate at each relevant decision. And since Ofgem has not yet confirmed its proposal for VoLL in the T2 price control, we are unable at this stage to offer specific comment on this value.
284. Lastly, we continue to support application of the cost sharing factor to the incentive rate, as was the case in both T1 and ED1. This is likely to mean that the “raw” reliability incentive rate differs in each price control; but these differences would be justified by the fact that the different share of costs incurred by companies in improving reliability.

OUTQ32 Do you agree with our proposed approach to retain the RIIO-ED1 revenue cap for the IIS at 250 RoRE basis points?

285. Ofgem should retain a symmetrical cap and collar on the IIS incentive. We presently have no analysis to support a different approach to the ED1 250 RoRE basis point assumption.

OUTQ33 Do you agree with our proposal not to introduce an incentive on short interruptions in RIIO-ED2? If not, how should such an incentive be structured and developed?

286. Yes, we support Ofgem’s proposal to not introduce an incentive on short interruptions.
- a. These interruptions are already very brief. They were excluded from the IIS for a good reason: they are less disruptive to consumers.
 - b. The potential consumer benefits are likely to be relatively low, since the value of lost load is low (relative to the number of such interruptions), and therefore the changes in DNO practice in response to any incentive are likely to be relatively small as well.
 - c. Our stakeholder engagement ahead of ED2 tells us these are not a material issue for our end users.

287. This area may therefore not warrant the added complexity and administrative costs of developing an incentive – although developing better data, as Ofgem proposes, would be the first step in undertaking a proper evaluation.

OUTQ34 What are your views on a minimum standard for short interruptions for RIIO-ED2?

288. We do not support this.
289. The customer benefits of such a standard should be evaluated in tandem with the development of better data, rather than a guaranteed standard being put in place ahead of this understanding.

290. The Electricity Act (1989) allows only for guaranteed standards that “in the Authority’s opinion, ought to be achieved in all cases”. If a standard were set at levels that DNOs cannot reasonably be expected to achieve, then putting in place a minimum or guaranteed standard could have implications for price control funding requirements, depending on the level it is set at. Ofgem therefore needs to take its decision at the methodology stage so that DNOs can factor this into their business plans.

OUTQ35 What information should we be capturing in RIIO-ED1 and RIIO-ED2 to better understand short interruptions and how DNOs are performing?

291. Our own customer engagement ahead of ED2 continues to tell us that this is not a material issue for our end users.

292. We are, however, supportive of collecting data on an industry basis to facilitate a data led discussion with stakeholders during the course of ED2. This will allow further customer centric decisions to be made about short interruptions ahead of ED3.

293. Therefore, if Ofgem does want to think about this area, it should:

- a. start with high level estimates of the value of lost load; and
- b. place this in context relative to the main IIS.

294. Only once this has been considered would it make sense to consider whether additional data capture might be warranted.

- a. There is significant variation in how short interruption data is collected across the sector.
- b. To accurately appraise the impact of short interruptions we expect that licensees would need to develop their telemetry at lower voltages.

OUTQ36 Do you agree with our proposal to retain the RIIO-ED1 SWEE mechanism?

295. The severe weather exceptional event (SWEE) exemption helps to reduce the volatility of the incentive to extreme weather, and, therefore, on balance, we support its retention. However, we would support work to evaluate a potential sliding scale for the mechanism. The present binary cut-off point means that having more exceptional events can actually be a good thing, compared to falling just short of the threshold. This distortion can create volatility in results and also reduces (at the margin) the incentive created by the IIS for resilient networks.

296. In the event Ofgem reconsidered this and removed the exemption for ED2, it would be critical that historical data is re-stated on a consistent basis before it is used in calculating targets.

OUTQ37 Do you agree with our proposal to remove the OEE mechanism? If not, what evidence is there to support its retention, and what changes should be made to the existing approach to improve it?

297. No, we do not support the proposal to remove the other exceptional event mechanism (OEE).

- a. This mechanism serves the same purpose as the weather related exemption, to avoid the incentive imposing “tail end” risk on DNOs from major and potentially rare events, which could otherwise raise the cost of capital.
- b. The SWEE was designed for the abrupt impact of weather on the overhead line network. Climate change will lead to periods of more intense and prolonged rain fall, which has a gradual severe effect on the underground network, that isn’t captured by the 24-hour window of the SWEE. The OEE is necessary to address all forms of weather volatility.
- c. Ofgem claims at paragraph 7.94 that the type of events falling in the category have changed in recent years. If Ofgem is going to rely on this to support a decision, it should present evidence showing how the proportions of different types of claims have changed.

298. If the exemption is removed:

- a. Ofgem would have to ensure it includes the customer interruptions and minutes lost during previous “other” exceptional events in the dataset it uses for setting ED2 IIS targets.
- b. The SWEE mechanism would need to be revised so that it would capture the impact of extreme rainfall on the underground network, where the effects are not instantaneous (such as high wind and ice bringing down wood poles).

OUTQ38 What are your views on the threshold that should apply to either exceptional event mechanism?

299. We believe that the current thresholds are broadly right, bearing in mind our comment in response to OUTQ36 that Ofgem could consider a sliding scale (i.e. less binary), approach.

300. If Ofgem amends the thresholds for ED2, it must ensure that the dataset it uses to set ED2 IIS targets is consistent with these new thresholds. So:

- a. if fewer events would be excluded under the new thresholds; then
- b. the interruptions and minutes lost associated with such events would need to be included in the target-setting dataset.

OUTQ39 What performance do you think should be excluded under each mechanism?

301. We provide our views on the threshold levels of performance to exclude under each mechanism in response to OUTQ38, and on potential changes to the SWEE that would be required to allow it to capture rain related events (if the OEE was removed) in response to OUTQ37.

302. If the question means what “type” of performance should be excluded under each mechanism we have the following comments.

- a. The mechanisms were designed with threshold tests that can be objectively evaluated. This is appropriate.

- b. Subjective judgements on the “type” of impact on performance would be difficult to apply and would lack the clarity necessary for financially material calculations.

OUTQ40 Do you agree with our proposal to retain the existing GSoPs? If not, what changes do you think are necessary and what are the reasons for them?

303. Yes, the existing guaranteed standards of performance are well understood and should be retained. We propose no amendments.

OUTQ41 Do you agree with our proposal to uplift payment values in line with inflation, indexing payment levels to inflation, and rounding to the nearest £5 for clarity for stakeholders?

304. Our view on this proposal is the same as in respect of connections standards, set out at outQ17 and reproduced for convenience below.

305. No, we don't agree with this proposal, which adds unnecessary complexity to the arrangements. Ofgem should just fix a value for the price control period, since:

- a. this will set clear expectations for stakeholders;
- b. the exact payment values are fairly arbitrary anyway;
- c. forecast inflation across a 5 year period can be taken into account from the outset; and
- d. Ofgem updating the statutory instrument once every five years is more administratively efficient than 6 DNO groups monitoring the inflation linked values annually and potentially having to update all their relevant customer paperwork on an annual basis.

OUTQ42 Do you agree with our proposal to retain some form of mechanism for WSC in RIIO-ED2?

306. Ofgem should remove the existing worst served customer mechanism.
307. Its complex qualification rules mean that it only provides funding for improvements that are lowest cost; which are the very improvements that are most likely to go ahead without a mechanism.
308. Ofgem does have another mechanism to encourage improvements for these customers, in the form of the standard interruptions incentive. Improvements are incentivised up to the value of lost load. If it proposes to fund improvements above this level, Ofgem should have regard to the cost (which is borne by all customers). Whole system solutions, such as backup batteries, might also offer increasingly better value alternatives to expensive distribution system improvements, in addition to those circumstances where customers have always maintained their own backup generation (such as to support critical systems in hospitals).

OUTQ43 What are your views on the options presented for WSC? Are there other options that we should consider?

309. We do not favour any of these options.

310. Ofgem should rely on the existing IIS which already creates an incentive for improvements (where they are cost benefit justified).
311. The IIS does not lead to DNOs “focusing on an average level of performance across their region” as Ofgem implies in paragraph 7.122. It incentivises them to focus on the performance of every one of their circuits, in respect of each and every one of their customers, recognising the economic cost of the performance of that circuit on its connected customers.
312. If it does think a mechanism is warranted, in spite of the inherent cross subsidy from one group of consumers to another, the criteria for qualification should be far simpler, so the economic effect of the mechanism can be more easily understood.

Network Resilience and Environmental Sustainability

OUTQ44 Do you have any views on our proposed NARM framework?

313. We support NARMs themselves as a valid regulatory tool but we oppose Ofgem’s increasing use of them to micro-manage DNO decisions, and Ofgem’s proposal to virtually remove any incentive towards good asset management where this can help reduce volumes of activity.
314. The use of deliverables and NARMs as uncertainty mechanisms, where the uncertainty is whether companies will find volume efficiencies, will cause obvious damage to incentives.
315. In common with its T2 and GD2 proposals, Ofgem is seeking to use:
- a. price control deliverables as an uncertainty mechanism, where the uncertainty trigger is whether companies will amend their plan; and
 - b. the NARMs mechanism to claw back almost all of any cost savings from more efficient asset management (and focussing incentives on procurement and unit costs only).
316. The loss of incentives for companies to find ways to avoid costs altogether will therefore be damaging to long term productivity in the sector and thus costly to energy consumers.
317. We commented extensively on issues surrounding micro-management and removal of incentives in our response to Ofgem’s T2 and GD2 methodology consultation, questions NARM Q1 to NARM Q4, and do not reproduce this here given it was a response to an entire Ofgem document.
318. Turning back to Ofgem’s ED2 proposals, it now proposes options that appear to include, as option 3, extending a volume driven framework to non-NARM asset classes. If we have understood correctly, this is astonishing, as it implies that Ofgem may be proposing to remove incentives for good asset management from virtually the whole price control settlement (since companies would be in effect held to the volumes in their plan). Option 2, an attempt at a framework that allows trading off assets in a NARMs category with a non-NARMs category appears to have the same property. Option 3, fault

rates, at least focusses on a measure of an outcome²⁰; although it is captured in the IIS incentive (to the extent it impacts customers) and was removed from ED1 for good reasons.

319. Ofgem correctly recognises the disadvantages of these options. However, it then goes on to say it may need to use uncertainty mechanisms – without providing further details. If the uncertainty Ofgem is referring to is the volume of activity the DNOs will actually undertake, this exemplifies everything that is wrong with Ofgem’s approach to RIIO-2; at every turn seeking to prevent any risk of outperformance, and in doing so removing the very incentives that Ofgem’s original RIIO framework intended to keep the cost of the low carbon transition low.
320. Instead, Ofgem should use its cost benchmarking, and, in particular, totex benchmarking, to establish appropriate baseline allowances, and then let its cost efficiency incentive act on volumes and not just unit costs. In effect, this is the current framework, or the “do nothing” option. To do otherwise will cause a gradual creeping inefficiency, that will cost energy consumers significant amounts in the longer term.
321. Beyond this, and turning specifically to the development of NARMs, we have the following comments.
- a. We support the continuing use of NARMs in ED2 and, in particular, the proposed developments including:
 - i) the expansion of reporting against 61 asset categories;
 - ii) the development of the long term risk measure; and
 - iii) the creation of the engineering good practice guide.
 - b. We support the future development of NARM assessment methods for non-NARM assets where they can be reasonably developed during the ED2 period for their later application.
 - c. We think Ofgem has identified the appropriate role for NARMs as part of the business plan investment justification framework at paragraphs 8.78 to 8.80. This:
 - i) includes, quite rightly, recognition that CBAs and EJPs will also be needed as justification for expenditure; and
 - ii) appears to recognise that cost assessment will be a distinct process based on its own tools.

²⁰ Ofgem states that fault rates are “not a direct output measure of the outcomes of condition-based expenditure”. However, it is actually an outcome that comes close to something consumers might care about; unlike a count of volumes.

OUTQ45 Do you agree with our proposal not to introduce outputs or incentives related to workforce resilience?

322. Yes, we strongly support Ofgem's proposal in this area.
323. DNOs have strong incentives to manage their workforce resilience, through Ofgem's cost and outcome incentives. This area does not need specific measures.

OUTQ46 Do you agree with our proposal that DNOs should submit a Cyber Resilience IT Plan and a Cyber Resilience OT plan?

324. We can see that two separate plans would be needed due to the difference in Ofgem's proposed funding position, although both plans are likely to have some level of overlap.
325. We think Ofgem should ensure there are opportunities to merge these plans with the requirement to produce digitalisation strategies and action plans so as to reduce the need for multiple publications, potentially each with separate timings.
326. For example, IT cyber resilience is just one aspect of overall risk profile of any IT system, therefore should be demonstrated in our digitalisation action plan alongside other resilience perspectives.

OUTQ47 Are there further requirements of expectations that we should be considering for the DNOs?

327. No, we do not believe so at this stage.
328. However Ofgem has not asked any consultation questions on several important aspects of its ED2 methodology. It states as its reason for its proposed approach that "*We believe that this approach has been carefully developed through the transmission and gas distribution RIIO-2 price controls and is equally appropriate for RIIO-ED2.*" But Ofgem does still need to check that the approach is appropriate in the context of a different price control and a different sector.
329. Given the profile of the cyber expenditure threat, we can see why Ofgem would want to ensure a certain level of attention and expenditure on the issue through a "use it or lose it" allowance, and why it might allow a reopener for any step change in requirements. Having said this, we do not think a reopener is specifically necessary, as cyber threats are just another business risk that we manage, and Ofgem should always be conscious that companies calling for reopeners may be seeking a one way bet for additional allowances in the future.
330. Assuming that Ofgem adopts its proposed change relative to ED1, Ofgem should pay additional attention in ED2 (compared to other sectors) to the potential distortion of incentives that is the drawback of these approaches, across and within price control periods, which could be detrimental to consumers over the longer term.
- a. Across price control periods, Ofgem's assessment of company requirements must check whether other energy networks already spent the necessary money. To maintain the strongest possible incentives, those companies that did shouldn't be disadvantaged, while those that didn't shouldn't be advantaged by their slowness to act.

- b. Ofgem proposes to monitor delivery of plans and apply “outcome-based PCDs”. If this means that Ofgem intends to apply ex post assessment of delivery, and clawback of allowances if DNOs deliver a different plan, it should not do so, as this micro-management would remove the incentive for DNOs to find many types of cost efficiency. Instead Ofgem should rely on comparative cost assessment at successive price reviews which provides an adequate safeguard in an ED2 context, particularly where Ofgem uses totex level assessments and/ or avoids granular “plan specific” expert assessments (as it should in an ED2 context).

331. On both of these points, the issues in ED2 might differ from T2 and GD2, for instance because Ofgem has different data or cost assessment tools available to it in an ED context, or if there is greater variation between company approaches to cyber expenditure in the RIIO-1 period than was evident in T2 or GD2. Ofgem therefore does actually need to consider this further.

OUTQ48 Do you agree with our proposal for the establishment of a ‘climate resilience’ taskforce or working group, to help DNOs develop strategies for managing the risks of climate change?

332. As referred to in the Consultation we already work collaboratively within the sector to assess climate risk to our networks and develop collective actions for our climate change adaptation reports. The intent seems fine but developing a national approach is not necessarily going to move our adaption plans forward in a way that addresses all the issues of our respective plans.

333. The electricity sector has some of the most mature adaptation plans in the country, however the Committee on Climate Change have identified weaknesses with respect to interdependencies between the DNOs and other infrastructure operators. The solutions may not always rest with DNOs, since resilience can be built in multiple ways, and it may be appropriate for the costs of enhanced distribution grid resilience to be borne by the infrastructure that requires it (to ensure they internalise the cost and seek the most efficient solution).

334. Some of that could be addressed via national level working groups, but other elements are regional issues where we need to work more closely with regional infrastructure providers to address areas of interdependence to mitigate the risks that became a reality during the flooding in December 2015.

OUTQ49 How should DNO strategies inform best practice that is used across the industry? How can these be used to help DNOs develop longer term investment proposals to manage the risks of climate change?

335. We think the existing framework is effective.

336. DNOs have demonstrated over time that they can and do work collaboratively to establish best practice (for example, flood resilience standards and vegetation management).

337. The effects of climate change already appear to be manifesting themselves in more frequent extreme weather. DNOs are responsible for their assets in perpetuity and thus have every incentive

to make longer term investments to protect their network from climate change, incentives which are supplemented by the reliability incentive and guaranteed standards. They also have every incentive to ensure this is done in a cost efficient manner. This includes through learning from best practice and working collaboratively to develop standards.

338. The present system is working effectively in a balanced manner, and no additional regulatory intervention (or micro-management) by Ofgem is necessary.

OUTQ50 Do you agree with our proposal to retain the RIIO-ED1 approach to flood resilience?

339. Yes, we do, the ED1 approach is effective.

OUTQ51 What are your views on how we/industry reports on progress against flood resilience plans?

340. We do not think Ofgem needs to try and develop a resilience metric to track DNO progress in this area. This would significantly overcomplicate the issue. We also don't think an abstract resilience metric would help stakeholders understand how DNOs are managing current and emerging risks, as Ofgem discusses in paragraph 8.121 of Annex 1 to the Consultation. This is better done through a narrative in DNO annual stakeholder reporting on business plan commitments.

341. Beyond this, it is straightforward for Ofgem to monitor the number of sites that have been defended to particular levels, although Ofgem and DNOs should take care in how progress is reported externally, so that appropriate narrative descriptions are always in place. Not having a defence for all "at risk sites" is not necessarily a failure of the DNO's ability to deliver; it may simply be that it is not cost effective to deliver a defence or that the impact to customers can be mitigated via the use of interconnection.

OUTQ52 Do you agree with our proposal to retain the RIIO-ED1 approach to ensuring networks are resilient to trees?

342. Yes, we do, the ED1 approach is effective.

OUTQ53 Do you agree with our proposal to develop a wider resilience measure over the course of RIIO-ED2? If so, what should it cover?

343. We do not see the purpose of this proposal, and we do not think an additional metric is needed, during ED2 or beyond.

344. Our reasoning is that:

- a. All of Ofgem's assessment, with which we agree, points to the ED1 arrangements working, and highlights the need for DNOs to have flexibility in, and be responsible for, their decision taking. We agree with this.
- b. Developing a metric would duplicate work already undertaken to develop national good practice standards, and would be inefficient. It would risk being viewed as a replacement for DNO responsibility or a tool for management of investment decisions. If it were used

in this way, it would distort incentive towards pursuit of that metric rather than focussing on consumer outcomes.

- c. Given the costs and risks of developing such a metric, it would be against the interests of energy consumers, who would ultimately bear these costs. Ofgem should instead ensure that DNOs face appropriate financial outcome incentives to manage the risk of factors that threaten resilience, and that customers enjoy appropriate standards.

OUTQ54 Do you agree with our proposed approach of retaining the existing arrangements for Black Start, physical security, and telecommunications resilience?

345. We agree with Ofgem's proposals in this area.

346. We note that Ofgem is in fact proposing a change to arrangements for black start, to introduce a reopener if anticipated changes to the black start guidance are not made soon enough to be included in business plan costs. We support this proposed change.

OUTQ55 Do you agree with our proposal to include a reopener for physical site security, with a window during the price control and a window at the end of the price control?

347. We agree with Ofgem's proposal.

348. In its T2 and GD2 framework, Ofgem proposed to apply the materiality threshold to this area, even though it didn't plan to apply it to certain other costs (like telecoms). This was illogical and is not appropriate at ED2, as the standard materiality threshold could easily rule out entire distribution programmes of site security enhancement. Where the government considers enhancements to site security important enough for national security, Ofgem should be willing to fund it. If it does not, it is failing to meet its duty to allow companies to finance the cost of requirements imposed upon them.

OUTQ56 Do you agree with our proposal to continue monitoring the development of telecommunications resilience and reviewing the arrangements as necessary?

349. We support Ofgem's proposal that it should not, at this stage, put in place the telecoms reopener that it has used at GD2 and T2. It should be possible for DNOs to forecast these costs for the five year ED2 period, and for Ofgem to assess them as part of its totex cost assessment (or any other tools of comparative assessment it chooses to use, and provide totex allowances).

350. The proposition to *"review whether the current arrangements for telecoms are appropriate when further clarity has been provided, and whether changes to DNOs' allowances are needed"* is therefore sensible. As with cyber costs, Ofgem should always be conscious that any companies calling for reopeners may be seeking a one way bet for additional allowances in the future.

OUTQ57 Do you think our proposed environmental framework will drive DNOs to deliver an environmentally sustainable network?

351. DNOs have long been working to achieve this aim. Ofgem's proposals will support that ambition, rather than drive it.²¹

OUTQ58 Do you consider that the proposed areas in scope of the Environmental Action Plan, and associated baseline standards, are appropriate? We particularly welcome views on any areas that should be omitted/included and if new areas should be included, what the baseline standard should be?

352. We broadly agree with the areas of scope and as an organisation we are strongly committed towards environmental respect – it is one of our core principles.

353. We offer the following high-level observations in respect of the proposals.

- a. The baseline standards need to be clear, otherwise Ofgem could not reasonably apply a potentially significant penalty under the business plan incentive if companies fail to meet them. While some are clear, others are not. For example, terms such as “science-based target” and “Circular Economy principles” are used, but they are likely to mean different things to different people.
- b. Ofgem needs to be conscious of the cost of these proposals since its principal objective is to promote the interests of energy consumers.
 - i) In places this is assured by Ofgem's adoption of an “efficient and economic” hurdle in its standards, and for network investments it is reasonable to expect DNOs to judge efficiency on a case by case.
 - ii) For many standards, this hurdle is lacking, and it would be difficult in any case for DNOs to apply an efficiency judgement to things like imposing requirements on their supply chain. These baseline standards might require DNOs to incur far higher costs than could be justified.
- c. Some of the standards overlap extensively with national environmental legislation and regulations. Since these standards are in place for all businesses, and have been set at a national level, Ofgem does not need to undertake its own micro-management.
- d. Ofgem says at paragraph 9.19 it expects DNOs to take into account stakeholder engagement and to focus on the most material impacts arising from their network. But they cannot do this in respect of the baseline standards – these are the requirements Ofgem is imposing that stakeholders literally cannot influence. If Ofgem expects

²¹ Less driving would also help to address some of the environmental issues that Ofgem highlights, such as NOx emissions.

stakeholder engagement to influence any of the factors listed in the baseline standards, it must remove the relevant factor from the list of baseline standards.

OUTQ59 Do you agree that the annual reporting through the Environmental Impact Report will increase transparency of the DNOs' activities and the resulting impacts on the environment?

354. Yes, we agree.

355. We offer the following comments:

- a. Ofgem should exploit synergies in stakeholder reporting wherever possible, to ensure the widest possible audience, and minimise stakeholder fatigue.
- b. Not all areas in the EAP should carry equal weighting, and Ofgem should consider a proportionate approach to reporting requirements. For example:
 - i) Improving business carbon footprint and exploring opportunities for SF6 alternatives are key proactive activities of global importance. They are not reflected in any of the financial outcome incentives and thus should be prominent.
 - ii) Noise abatement is a reactive activity in response to a customer enquiry, of very local importance. We carry out very little activity in this area (around 30 interventions in the last 10 years) and the costs associated are not significant. As long as the interactions are included in Ofgem's scope for the customer satisfaction survey, good customer outcomes are incentivised and no further action is needed.

OUTQ60 Do you agree with our proposal to introduce a re-opener to accommodate environmental legislative change within the RIIO-ED2 period?

356. Yes, we support the proposal.

357. We have the following comments.

- a. There should be a clear external trigger – environmental legislation changing the standards that DNOs must meet.
- b. The materiality threshold should be applied so that impacts of peripheral legislation continue to be managed by DNOs.
- c. Where possible Ofgem should reopen before the expenditure, so that ex ante allowances can be set and strong incentives to minimise costs can be maintained, but where this is not possible Ofgem should use an end of period window for the adjustment.

358. As we highlight in response to OVQ3, we do not support Ofgem's wide definition for the net zero reopener. Instead we think a narrow definition is appropriate. This being the case, we think the net zero reopener could be subsumed as part of the environmental reopener.

OUTQ61 Do you agree with our proposed removal of the Losses Discretionary Reward?

359. Yes, we strongly support this proposal.
360. Discretionary assessment incentives are resource intensive for Ofgem and DNOs alike. They always carry the significant risk that they will reward the quality of the submissions more than the underlying activity; drawing material resource away from activities that could improve outcomes for consumers and towards an essay writing competition.
361. It has also been rendered ineffective by Ofgem's demonstrated unwillingness to make awards.
362. So, although the incentive may have served a purpose in driving a step change in approach, which was difficult to measure or incentivise, it is now appropriate to move to a more mature regulatory framework of licence obligations and base funding.

OUTQ62 Do you agree with our proposal to retain the visual impact allowance for RIIO-ED2?

363. Yes, we support this proposal.
364. We received an excellent response from our stakeholders on our visual amenity programmes. The national park authorities are highly engaged with the process of scheme identification, prioritisation through to delivery.
365. The use it or lose it allowances, within the bounds of the mechanism, allow for minimal administrative requirements on Ofgem or DNOs, as long as the relevant stakeholders are effectively engaged. The scheme is working well in this regard.

OUTQ63 Do you agree with our proposed approach to setting a funding pot for the visual impact allowance for RIIO-ED2?

366. Yes, Ofgem's proposal for willingness to pay checks is appropriate, although Ofgem should also be willing to reflect the results of DNO willingness to pay research with bill paying consumers as an additional source of evidence. Depending on the nature of the evidence, this could apply nationally or regionally.

4. Annex 2: Keeping bills low for consumers

Aggregated Econometric Analysis and Model Specification

COQ1: Do you agree with our proposal to include totex benchmarking in our toolbox for cost assessment in RIIO-ED2?

367. Yes, we support Ofgem's proposal to include totex modelling in its toolkit for ED2 cost assessment.

368. This is because totex modelling:

- a. provides strong incentives for companies to minimise the total cost of running a distribution network;
- b. avoids the distortions of more granular modelling that can incentivise DNOs to favour a higher cost business model over another; and
- c. would ultimately lead to lower costs for energy consumers.

369. This final point is well illustrated by ED1. Had Ofgem placed 100% weight on it from the outset of the ED1 process, it would have saved energy consumers more than £1billion.²²

COQ2: What cost drivers do you consider appropriate for our proposed totex benchmarking? Why?

370. We strongly support exogenous cost drivers that reflect the demands being placed on a network, like customer numbers for example.

371. We strongly oppose endogenous cost drivers like workload, company determined volumes, and headcount. Such drivers are within relatively direct control of companies, and so using them severely damages efficiency incentives. This will ultimately be costly to energy consumers.

COQ3: What are your views on the use of both historical and forecast data in our modelling?

372. Ofgem should hold open the option of using either or both, because in different circumstances they can be valuable.

373. At ED2 Ofgem will inevitably have to make some use of forecast data if it is to accommodate potential increases in cost due to low carbon technology uptake. For example, under our proposal for a low carbon technology volume driver, Ofgem would need to benchmark company forecasts for

²² Ofgem's decision to fast-track WPD hinged on its initial ED1 disaggregated model results. It cost energy consumers at least £800m compared to a slow-track settlement for WPD. The slow track settlement would have been reduced by a further £450m, including the "notional" WPD values, if Ofgem had placed no weight on its disaggregated models, taking the actual cost to energy consumers of ED1's disaggregated models, compared to a 100% weight on totex, to £1.25bn. Looking at the question through a different lens, and excluding the costs exclusively associated with fast-tracking, the "swing" in Ofgem's final ED1 models, from a notional settlement that used 100% disaggregated modelling to one that used 100% totex, was just over £1billion. Source: calculations based on Ofgem's ED1 "scores and allowances" spreadsheet.

- a. the amount of uptake they could accommodate within “business as usual” investment levels; and
- b. the cost per heat pump or electric vehicle beyond this.

374. However, this is not to say that forecast data should be used without caution. Relying on forecast data can exacerbate the problems with disaggregated models.

- a. Companies can relatively easily forecast a high volume of activity in order to outperform on unit costs; and then go on to deliver a lower volume at a higher unit cost later.
- b. There are therefore particularly acute risks from using forecast data in models with workload based cost drivers, or volumes of assets being installed.

375. At the ED1 review, we proposed that Ofgem should place weight on a balanced assessment of both historical and forecast efficiency. This approach would have the advantage of strengthening long term incentives towards efficiency, and also smoothing over capital cycles.

376. We took this proposal further in 2018 when we proposed that some weight be placed on a benchmarking assessment of long term “value for money”, i.e. costs charged to energy consumers, to enhance incentives for companies to forecast low costs at each successive price review. Details are set out in our response to Ofgem’s RIIO-2 framework consultation.²³

COQ4: At what level should we set the efficiency benchmark?

377. The 75th percentile is an approach supported by extensive regulatory precedent.

378. Ofgem highlights that the GD2 draft determination approach of the 85th percentile was justified by sector-wide outperformance in GD1.²⁴ We disagreed that this was appropriate in our GD2 consultation response. In any case, outperformance in ED1 has not been sector wide. If anything, it may tell Ofgem something about the poor predictive fit of its disaggregated models.

379. To the extent Ofgem wants to improve the predictive fit of its cost benchmarks, it should improve its cost benchmarking tools, rather than changing the benchmarking quartile.

380. Ofgem must also fulfil its promise to ensure that WPD’s high level of funding during the ED1 period doesn’t create an uneven playing field at ED2.

381. At the ED1 slow track final determinations, Ofgem recognised that it had over-funded WPD’s licensees significantly. The cost allowance element alone amounted to £614m, with the single largest source of this coming from higher generalised funding for real-terms increases in input prices (of over £300m), followed by additional funded asset investment.

382. At the slow track final determinations, Ofgem said:

²³ Full details can be found in our April 2018 response to Ofgem’s RIIO-2 framework consultation, page 14, paragraphs 66-68

²⁴ Annex 2, page 22, paragraph 3.46.

While we judge it would have been more efficient for WPD to deliver less over the RIIO-ED1 period it will not particularly profit from this additional work. It is committed to secondary deliverables that reflect these volumes. If it materially reduced its overall workload in RIIO-ED1 without justification it would be penalised....

The additional volumes we've described mean that WPD would be doing work that other DNOs should delay until RIIO-ED2.... We can ensure that WPD does not benefit from this additional expenditure in our RIIO-ED2 assessment.²⁵

383. Ofgem should not attempt to “unpick” the ED1 settlement for WPD through the ED2 settlement; this would undermine the investor certainty that Ofgem worked so hard to maintain by refusing to revisit its fast-track settlement for WPD.

384. But it is essential that Ofgem ensures the higher level of funding provided to WPD does not lead to unachievable targets being set for ED2, either because:

- a. WPD's performance on ED1 outcome incentives, such as for interruptions or the customer satisfaction survey, leads to tougher targets being set at ED2; or
- b. WPD's relatively high level of asset investment in the ED1 period, compared to other DNOs, allows it to forecast a relatively low level of asset investment in the ED2 period.

COQ5: Do you agree with the proposed criteria for developing cost pools for a middle-up approach?

385. We agree with all of Ofgem's criteria, but think there should also be one other – **efficiency incentives**.

386. We also support cost pool models as an alternative to highly granular disaggregated analysis, since they overcome many of the disadvantages of that type of modelling.

387. Our comments on specific criteria are as follows.

- a. We agree that complementary costs, and costs that can be traded off against one another, should ideally be grouped in the same pool.
- b. The criterion on cost-boundary complexity is appropriate; although we would note that using cost pools will by definition reduce the effect of cost boundaries, and thus:
 - i) mid-level models will always beat highly granular models on this criterion; while
 - ii) totex models will outperform mid-level models.

²⁵ Paragraphs 2.12-2.17 RIIO-ED1: Final determinations for the slow-track electricity distribution companies

- c. There should be an additional criterion, efficiency incentives, to capture the effect on incentives towards efficiency. A cost pool model that aggregates total costs, rather than just unit costs, will perform far better on this criterion.

388. Lastly, Ofgem should also be clear that it did not use a middle-up model at ED1, instead placing 50% weight on totex models (using two different cost drivers) and a 50% weight on granular disaggregated models.²⁶

COQ6: What cost drivers would be appropriate in a middle-up approach?

389. In all models we would support strongly exogenous cost drivers, in line with our response to COQ2 above.

390. We do recognise that an advantage of the middle up approach is that different drivers could potentially be used for different parts of the cost base, and transparently assessed and tested. But Ofgem must avoid any temptation to use endogenous or workload driven cost drivers. Using such drivers would have a catastrophic effect on the efficiency incentive properties of the model.

COQ7: What are your views on the CEPA developed totex and opex plus approach? What opex activities are there trade-offs that support the rationale for testing ‘totex and opex plus’ modelling?

391. We do not support an “opex plus” approach; a regression based cost pool approach appears a far stronger alternative.

392. The opex plus approach was not especially clearly described by CEPA but we think it amounts to applying:

- a. regression analysis to operating costs plus a subset of capex; and
- b. granular engineering analysis to the rest

393. This amounts to totex with lots of exclusions. The problem with this is that, every time Ofgem excludes something from totex, and adopts a granular or engineering based analysis, it creates a cost boundary that will make it hard to apply equal challenge to different types of costs. This will create distortions, and companies will expect to be able to secure higher cost allowances if they push more of their cost forecast into the excluded categories.

394. Moreover, as we noted in our response to the 2019 GD2 cost benchmarking consultation, there are trade-offs between operating and capital costs.

- a. “For business support costs and capital costs, contractors used in the delivery of capital investment will include a business support overhead recovery rate. An efficient company

²⁶ The Consultation erroneously claims at paragraph 3.28 that the ED1 modelling suite placed a 25% weight on mid-level models. This is not true. Describing the ED1 modelling suite in this way may falsely lead stakeholders to think that maintaining the ED1 slow-track weight on totex models would require only a 25% weight to be placed on them, when in fact it would require a 50% weight.

making greater use of contractors is likely to have lower business support costs and higher capital costs when compared to another efficient company using a business model that involves less use of contractors.

- b. “In electricity distribution, greater time spent on engineering analysis (and targeted asset inspection) can significantly reduce the volume of activity that is required, by targeting intervention only at those assets that genuinely require it. This can reduce capital costs while leading to higher indirect costs.”

COQ8: Do you believe it is appropriate to use bottom-up, activity-level, disaggregated modelling in RIIO-ED2?

395. The use of disaggregated benchmarking should be limited to providing a cross check - and the overly complex, badly-specified ED1 models should not be the starting point.
396. Ofgem’s ED1 disaggregated models cost energy consumers £1 billion pounds. They should be consigned to history, not used as the basis for Ofgem’s consultation on ED2 disaggregated modelling.
397. Their biggest weakness was that they granted higher allowances to companies that proposed bloated volumes of an activity at lower (or just average) unit costs. This is costly to consumers regardless of whether companies deliver those volumes.
- a. Models covering 16% of the cost base had no scrutiny of volumes whatsoever.
 - b. Models covering 40% of the cost base separated unit costs from volume scrutiny; with volume scrutiny that was varied and ineffective in many places.
 - c. Even in some models where Ofgem assessed the cost of an activity, it used “workload” as a cost driver, giving higher allowances to companies with higher volume forecasts.
398. This was exacerbated by Ofgem providing a “draft” copy of the models ahead of the ED1 slow track submission, even though Ofgem has long understood the risk that this would allow companies to “optimise” their submissions to perform well against the model.²⁷
399. At the ED1 slow-track final determinations, Ofgem placed a 50% weight on totex modelling. Ofgem’s GD2 draft determinations show that a 100% weight can be placed on totex benchmarking results.
400. The move towards totex modelling is part of Ofgem’s equalisation of incentives across cost categories, which involved a single totex incentive rate, and a single capitalisation rate.
- a. When combined with equalised scrutiny of totex costs, companies will have strong incentives to reduce their costs through all means, including innovation.

²⁷ Ofgem had previously stated that its RIIO cost assessment would mean that companies “will not know the precise form that scrutiny might take. As such, companies will not have an incentive to adjust their plans to perform well in one assessment (e.g. an operating cost benchmarking study).” Ofgem, 2010, RIIO handbook, page 62

- b. Where Ofgem uses bottom-up activity level modelling, it introduces distortions between different cost categories, because some face stronger or weaker assessment, undermining the totex approach to regulation through the back door.

401. We set out the associated issues further in our response to Ofgem's RIIO-2 Framework consultation, which is directly relevant to Ofgem's methodology to ED2:

A unified approach to cost incentive rates and capitalisation treatment, on all costs, is one of the fundamental reforms brought in by the RIIO approach to regulation. This is necessary to ensure that incentives are not distorted between competing solutions to network issues, such as when taking decisions between innovative asset light solutions or more traditional asset investment.

Unified incentive rates are widely recognised as being a success but, in order to work as intended, they must be supported by an approach to setting cost allowances that prevents differential incentives from creeping in through the back door. This will happen wherever Ofgem sets cost allowances for different categories of expenditure through separate, disaggregated, cost benchmarking approaches.

But this is not the only reason to avoid this type of disaggregated benchmarking model. At RIIO- ED1, Ofgem's disaggregated models proved to be susceptible to undue influence by company plans. This exacerbated the information asymmetry problem Ofgem faced because their use:

- a. allowed some companies to benefit from submitting high costs in the first instance, so they could wait until Ofgem had revealed its hand on individual cost categories and then align their plan to this; and*
- b. allowed some companies to improve their scores significantly at the second stage of a plan submission, without cutting overall costs, by reallocating costs between categories of expenditure.*

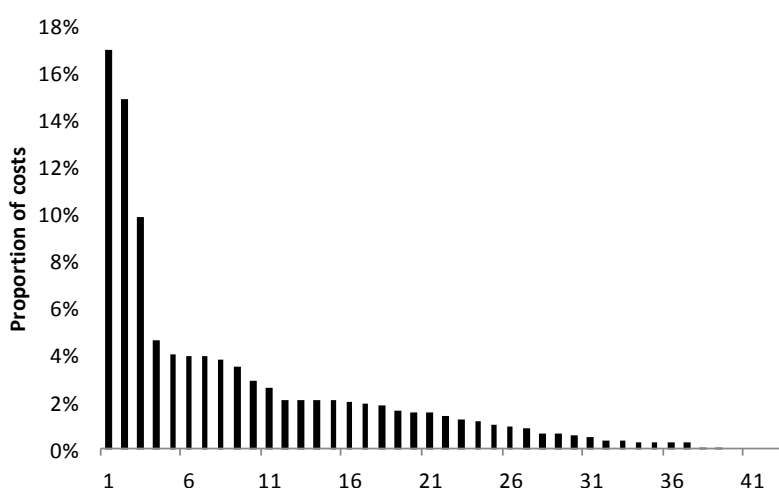
Instead, Ofgem should continue to develop and place more reliance on total cost (totex) benchmarking. This captures decisions on volumes as well as unit costs, and avoids distorting incentives between different approaches to asset stewardship, which is becoming more important in distribution thanks to the move to a distribution services operator (DSO model). There are increasing options to substitute asset light approaches for asset heavy approaches, and disaggregated approaches to benchmarking fail to capture the trade-offs between very different parts of the cost base. Totex benchmarking, on the other hand, caters to these trade-offs and does not suffer from the same flaws.²⁸

²⁸ Northern Powergrid, April 2018, Response to Ofgem's RIIO-2 framework consultation, page 52, paragraphs 255-258

402. To the extent that Ofgem chooses to undertake activity level modelling in ED2, Ofgem should not follow its proposed approach of using the ED1 models as a starting point²⁹.

- a. There were far too many models, often applied to very small cost pots.
- b. The complex suite of models was difficult to run, or to scrutinise for mistakes.
- c. A high proportion of the cost models involved little or no volume scrutiny.

403. The chart below shows how many of the ED1 disaggregated models covered a small fraction of the cost base.



404. The table below illustrates how the models broke down across different types. Of these, 15% lacked any volume scrutiny. A further 64% either started from the company volumes in their scrutiny or used a “workload” measure as their cost driver (and thus reflected inefficiency in workload directly into cost allowances).

	No of models	Proportion of cost base
Regression models: business scale driver	1	1%
Regression models: workload driver	2	18%
Ratio models	10	19%
Unit cost models – separate volume scrutiny	10	40%
Unit cost models – no volume scrutiny	12	15%
Expert or qualitative review	7	6%

405. To the extent Ofgem does wish to use disaggregated models, it should therefore:

- a. merge large areas of the cost base, to form cost pools; and

²⁹ Annex 2, page 22, paragraph 3.42

- b. benchmark the total cost of the activity against an exogenous cost driver, rather than trying to scrutinise unit costs and volumes separately (which will introduce distortions and make it difficult to “see the wood for the trees”),³⁰ and / or
- c. limit their use to that of a cross check, allowing the totex models send the strong incentives they are designed to give.

COQ9: If we use a combination of aggregated and disaggregated modelling approaches, how should we determine the weight we apply to each, in combining our analysis?

406. A high weight should be placed on totex, equal to or higher than the 50% weight placed on totex models at ED1, and recognising that GD2’s draft determinations show that a 100% weight is possible.
407. If Ofgem introduces mid-level models it should not “squeeze” the weight on totex modelling, which is an important component of the overall scheme of totex regulation.
408. A 100% weight in totex is well supported by precedent, which proves there are no practical obstacles to it, including:
- a. Ofgem’s proposed GD2 approach, which relies on totex assessment for the large majority of the cost base; and
 - b. Ofwat’s PR19 approach, which benchmarked each individual part of the water sector value chain, such as water distribution, with essentially totex regression models.
409. And to the extent Ofgem wants comfort that the proposed allowances are achievable by the companies in question, it can always maintain some form of disaggregated analysis, limiting its role to that of a cross check.

COQ10: If we did not use disaggregated modelling approaches, what approach should we consider for disaggregating totex allowances for the setting of PCDs?

410. Ofgem should use the same approach or similar approach to that it used in the GD2 draft determinations, disaggregating the totex allowance based on the proportions of each plan that fell into each cost category.

COQ11: What model estimation options should be considered for our cost assessment and why?

411. Ofgem has identified an appropriate set of model estimation options for considering in relation to cost assessment.
412. Pooled OLS models are likely to be prime candidates, given they were used at ED1 and GD2.

³⁰ Granular activity level cost assessment will of course be necessary for any costs that cannot be included within totex. As was the case at ED1, a high bar should be applied to determine whether it is necessary to exclude costs from totex, since any exclusions necessarily create distortions in the cost base and weaken the overall totex scheme of regulation.

413. However, Ofgem should undertake further analysis before making any decisions on estimation techniques. It should not simply adopt OLS from the outset (as it proposes³¹).

COQ12: Do you agree with our proposal to continue using Cobb-Douglas functional form? Why?

414. The Cobb-Douglas functional form is a standard approach to considering cost relationships and we see no reason not to continue using it.

415. Ofgem should however consider any potential alternative approaches based on their merits. Where the data supports different functional forms, these may be appropriate.

COQ13: Do you have any views on our proposed model selection criteria?

416. We agree with the criteria for selecting regression models that Ofgem has listed, but Ofgem should also add three other (and more critical) criteria to the list.

417. We offer the following comments on each of the criteria Ofgem mentions.

- a. **Economic/technical rationale:** we agree that a regression model should always have a strong economic theory as its foundation.
- b. **Transparency:** it is useful for any benchmarking model to be easy to interpret, and easy to use to test sensitivities.
- c. **Robustness:** we agree that a regression model must be robust to statistical tests, changes in the sample and model specification, with a robust ability to explain existing costs and future forecasts data.

418. The above three model criteria were included in CEPA's work for Ofgem. However, Frontier Economics have also identified further criteria that Ofgem should include³².

- a. **Promoting efficiency:** it is important that the chosen econometric modelling promotes efficiency and creates the right incentives. The model needs to estimate a clear relationship between cost driver and costs with clear economic rationale, and the cost driver must be strong and be exogenous to encourage DNO's to reduce costs in an efficient way.
- b. **Proportionate resource costs:** it is important that the chosen modelling has a proportionate resource cost.

419. We also think some ordering of priority is important, since there are likely to be trade-offs across criteria. Efficiency incentives should be given priority. For example, models that use workload or volume forecasts as a cost driver might appear to have a robust fit and also an engineering based technical rationale, but will be highly damaging to volume efficiency incentives.

³¹ The Consultation, Annex 2, page 25, paragraph 4.5

³² 'A review of Ofgem's benchmarking at RIIO-ED1', Frontier Economics, February 2018

420. Lastly, Ofgem should be careful to apply the robustness test equally across different approaches. This is because it is easy to test the robustness of a totex or regression based model. But the results of a granular model are built up from many small decisions, which have a cumulative impact; a like-for-like robustness test requires the cumulative impact of all of these decisions to be understood.

Regional and Company Specific Factors

COQ14: Do you agree with the proposed criteria for assessing regional and company specific cost factors that we have outlined?

421. Ofgem is missing one criterion and also an important process point.

- a. **Correlations with cost drivers should be evaluated:** it is this criterion that led Ofwat to conclude that no regional labour adjustment was necessary at PR19. Ofgem must be open to this possibility at ED2; and should explicitly include a lack of demonstrable correlation in its criteria.
- b. **Regional adjustments should not be a one way bet:** at present there is a strong incentive towards unnecessary or exaggerated requests, including because there is no incentive for companies to identify counter-veiling factors. Ofgem should therefore:
 - i) require companies to request and quantify any regional cost adjustment they think is necessary in their business plans, based on the additional costs that they actually experience, and including all counter-veiling factors (including evaluating potential correlations with common cost drivers); and
 - ii) include these requests in the business plan incentive, e.g. by treating them as low-confidence costs; so that if Ofgem finds the adjustment to be unnecessary, or excessive, a low confidence cost disallowance penalty would be applied.³³

COQ15: What are your views on our approaches to account for regional and company specific cost factors in our modelling?

422. Ofgem should start from the theory but also let the data speak for itself, and include regional factors including regional labour in the regression analysis.

423. Like Ofwat, Ofgem should be willing to make no adjustment at all where the data does not demonstrate an economically and statistically significant relationship – particularly if there is reason to expect that the regional factor is correlated with the cost drivers.

424. Pre-modelling adjustments, like those Ofgem made at RIIO-1, have one serious shortcoming: if the data used to specify the adjustment is flawed, these flaws will be directly translated into the modelling outcomes. At least where flawed data is incorporated in a regression, the modelling results and diagnostic tests can control for this.

³³ There are limited circumstances where it would not be appropriate to apply a penalty, e.g. if a licensee could not have anticipated a disallowance because it is due to correlation of the factor with a cost driver Ofgem has not previously used.

Real Price Effects and Ongoing Efficiency

COQ16: Do you agree with our proposed approach to index RPEs, rather than setting an ex-ante allowance based on forecasts?

425. No, we don't agree. An ex-ante allowance based on forecasts should be used.
426. Our objections were set out in our response to Ofgem's T2 and GD2 methodology consultation.³⁴ In short, real price effects must be allowed for, but indexing allowances to other sectors or the wider economy on a year-to-year basis will add to the risks facing energy networks, when compared to fixed allowances.
427. The COVID-19 pandemic has illustrated very well why Ofgem shouldn't index energy network cost allowances to things like pay in the wider economy. Ofgem's proposal would have cut energy network allowances on account of non-essential sectors using the government's furlough scheme.
428. This is ridiculous – and creates a demonstrable risk that will raise the cost of capital for the sector. Fixed allowances should be set for real price effects instead, using long term averages.
429. We also highlight that Ofgem ran a specific consultation on RPE indexation during the ED1 price control review. It was right to conclude that it should not introduce the approach Ofgem is now once again consulting on.

COQ17: Do you agree with our proposal to have a high materiality threshold for RPEs? What are your views on the materiality level for RPE submissions, and the criteria we use to select input price indices?

430. No, we don't.
431. Using a default CPI assumption for any cost categories where RPI would have been used at ED1 forecast would break Ofgem's promise, in the 2018 RIIO-2 framework decision, to make the switch from RPI to CPIH "value neutral". Value neutrality in this area would imply a CPI + 1 percentage point assumption as the default for any cost categories where an RPE cannot be reliably estimated.
432. A zero RPE relative to CPI is also flawed in economic theory terms. Our reasoning on this specific point was set out in our response to Ofgem's consultation on the T2 and GD2 draft determination, in the bullet point that is reproduced immediately below:
- a. "If the evidence supports an RPE on or close to zero, this would seem reasonable. But if Ofgem assumes zero RPEs simply because the category of costs is small, or there is an absence of evidence on the level of RPEs for that cost, this is not reasonable. This is because:

³⁴ Northern Powergrid, March 2019, response to RIIO-T2 and GD2 sector methodology response, cross sector questions document, pages 22-23, paragraphs 131-137

- i) the price of inputs, on average across the economy, will rise faster than measures of inflation; and³⁵
- ii) Ofgem cannot just ignore this positive relationship, which supports a positive starting assumption for RPEs (for any “immaterial” categories of cost).”

433. CEPA’s twin materiality tests, as described at paragraph 6.9 of Annex 2 to the Consultation, also make no sense. This is easily illustrated with the simple worked example below; such badly flawed tests should be disregarded.

- a. First, if Ofgem carved the cost base into small cost categories, the entire cost base would fail the first test.
- b. Second, if the entire cost base faced moderate RPEs, the cost categories would all also fail the second test.
- c. The entire cost base, which faces RPEs that are in highly material in aggregate, would fail the requirement that one test must be passed, and Ofgem would give no RPE allowance.

434. Ofgem should not apply a materiality threshold to any category of costs that it assesses at a price review. It instead needs to:

- a. make an allowance based on the evidence for the expected level of cost; or
- b. apply an uncertainty mechanism.

COQ18: Do you agree with the suggested common input and expenditure categories for structuring RPEs in ED2?

435. We support Ofgem’s proposal to use a notional cost structure for determining RPE allowances, rather than company cost structures.

436. We support Ofgem using a common set of input and expenditure categories that are aligned to cost monitoring and reporting in electricity distribution. The input and expenditure categories used in gas distribution would be impractical, although we cannot rule out the possibility that some forms of evidence on RPEs might not be neatly aligned to the cost categories Ofgem highlights.

COQ19: Do you agree with our proposed approach, and its scope, to set an ongoing efficiency assumption for RIIO-ED2?

437. Ofgem’s proposals appear to boil down to using the same approach as at T2 and GD2 draft determinations.

438. We therefore offer the same comments as for those draft determinations, and reproduce these below. Ofgem will also have to consider what the CMA’s recent provisional findings in the water sector mean for its methodology at ED2.

³⁵ Measures of inflation will be lower than the increase in input prices due to offsetting improvements in productivity.

439. “We do not agree with Ofgem’s proposed approach.

440. “In common with other parts of the settlement, such as Ofgem’s assessment of the cost of capital, the proposed approach has every appearance of a regulatory goal seek to choose the least advantageous parameter for the regulated companies even in the face of strong opposing evidence.

441. “This is a material parameter; some evidence must be needed to support a regulator’s view on it. Yet Ofgem’s apparent gerrymandering of the evidence continues:

- a. Ofgem goes straight to the top of the range CEPA estimates based on value added (VA) data, relying solely on “regulatory judgement” to justify this stance.
- b. Ofgem places no weight on CEPA’s gross output (GO) measures, again, citing “regulatory judgement”; even though:
 - i) these are internally consistent with the totex costs that productivity is applied to; and
 - ii) CEPA stated in its advice to Ofgem that *“it is typically seen as good regulatory practice to consider the information provided by both methods [GO and VA] when developing a range for ongoing efficiency estimates.”*
- c. The additional 0.2% “innovation bump” assumption lacks any supporting evidence.
 - i) CEPA *“identified no robust evidence for establishing a firm quantitative relationship”*; it only identified a causal relationship from innovation to productivity.
 - ii) Ofgem must be assuming energy networks have out-innovated the rest of the economy (but it hasn’t said this or tested it).
 - iii) Ofgem’s other argument is that energy network management can focus on productivity gains because they lack competition. To put it mildly, this is a speculative and unorthodox assessment of the consequences of monopoly power and would certainly need some corroboration before anyone could sensibly rely on it.
 - iv) It introduces an “innovation penalty”, and this creates a direct disincentive for network companies to access innovation funding in future.
- d. There is a double count, as Ofgem appears to have not properly stripped productivity assumptions out of GDN business plans.
- e. Lastly, the productivity gains seen by networks over the last 20 years have been driven by operators taking measured risks, driven by strong incentives to improve performance. These incentives are being both significantly weakened and capped; and Ofgem cannot expect the same levels of productivity gains in this new environment.

442. “In other words, it is deeply flawed, in terms of the logic and empirics that Ofgem uses to support its position, includes “double counts”, goes against what Ofgem’s own advisers, CEPA, describe as regulatory good practice (to which Ofgem has a duty to have regard), and will dis-incentivise

network companies from using innovation funding in future. On every count, it is a regulatory catastrophe.

443. “Ofgem should remove the 0.2 percentage point innovation adjustment, place weight on the GO measures (as well as VA), select the mid-point of the range to take a balanced view, and move on.”

COQ20: Do you agree with our proposal to use a growth accounting approach as our primary source of evidence to set an ongoing efficiency assumption? What parameters would best support this approach?

444. A growth accounting approach is reasonable.
445. The efficiency assumption will be applied to a totex measure of costs, and so a GO estimate would be consistent with it. However it is also consistent with regulatory practice to place some weight on a VA estimate as well.
446. Our views on how the T2 and GD2 parameters would need to be adjusted, in order for these to be consistent with the evidence, are set out at paragraph 443 above.

Disaggregated Cost Assessment

COQ21: Do you agree with our proposed approach on forecasting options for RIIO-ED2

447. We support Ofgem’s proposed option (option 3) because it allows us to choose our own “best” scenario using our own network planning tools and utilising stakeholder feedback.
448. We are also engaged in joint work with other DNOs (for Network Development Plan (2022)) to agree a standard approach to a set of scenarios.
449. We also note that, under our proposal for a low carbon volume driver based on the number of heat pumps and electric vehicles in use, Ofgem would only need from DNOs:
- a. the company’s best view of uptake in its region;
 - b. a “£ per MW” value for each low carbon technology covered by the mechanism; and
 - c. (potentially) how much uptake could be accommodated under business as usual investment levels.
450. Option 3’s range of scenarios would provide a set of specific realisations of the above parameters. But the specific parameters could be requested as well, for completeness.

COQ22: What are your views on our proposal for establishing network impacts and assessing LRE requirements for RIIO-ED2?

451. We recognise the need for more monitoring of data and sharing digitised data in an open manner, and will take this step to help us run an efficient network.
452. We do not agree with Ofgem’s apparent desire to:
- a. base its allowances on a DNO by DNO assessment of whether capacity is lacking; and

- b. understand, at a granular level, whether “any investment was made efficiently and achieved the intended outcome”.³⁶

453. The capacity a DNO has on its network is a product of its past investment decisions, along with how it “rates” its equipment, as well as the demands placed on it by consumers. Any lack of capacity today might reflect past decisions to not invest in the network (or an ongoing decision to under-rate its equipment); if Ofgem rewards this with higher investment allowances it will be sending the wrong incentives.

454. All DNOs are responsible for networks which involve a portfolio of network circumstances; and they all face the same strong incentives to deliver low costs and good reliability outcomes. Ofgem can use this information, on revealed efficiency, to set appropriate cost allowances at a relatively high level. DNOs should, of course, invest in more monitoring of LV networks if this is efficient – but this may only be a small part of the answer to the balance Ofgem must strike in setting cost allowances.

COQ23: Do you agree with our proposal to compare flexibility solutions and network based solutions evenly in our cost assessment?

455. Our response covers two points.

- a. The first is an important change Ofgem must make in its financial proposals in order to ensure even incentives relating to flexibility solutions, where Ofgem has failed to understand the inter-linkage between a finance decision (capitalisation rates) and incentives towards flexibility vs RAV solutions.
- b. The second relates to how an even assessment is undertaken, where we favour a totex approach instead of a more granular one.

456. On the first of these points, and as set out in our responses to the finance questions (FQ19), Ofgem should apply a benchmarked totex capitalisation rate, so companies won’t stand to grow their RAV faster if they favour investment solutions in their business plan.

457. On the second point, we agree wholeheartedly with the aspiration, but think it will be difficult or impossible to achieve in a bottom up assessment.

458. The informational requirement Ofgem suggests for business plans justifying flexibility vs reinforcement on a line by line basis³⁷ could be massive; and Ofgem would then need the equivalent capacity to scrutinise line by line investment planning decisions. This is not where an economic regulator can add the most value.

459. Ofgem can instead rise above this detail for the following reasons.

³⁶ Implied by the Consultation, Annex 2, page 58, paragraph 7.33

³⁷ At paragraph 7.46 of Annex 2 to the Consultation, Ofgem states “we propose requiring a strong justification for why a particular solution, flexibility or asset based, is submitted in the Business Plan, and how this compares with alternatives”

- a. Flexibility should reduce costs overall, so a DNO making effective use of flexibility in its plan will perform better in an aggregated cost assessment than other DNOs.
- b. Ofgem sets equalised incentives for companies to minimise their ongoing costs, ensuring all trade-offs in actual cost are taken into account.
- c. Flexibility tenders are a factor in the most recent historical cost data; and even before that many other innovative techniques have been used to reduce costs; and Ofgem can also create incentives for companies to forecast a challenging level of cost.

460. A benchmark set based on totex can therefore encapsulate an efficient level of flexibility solutions as part of the mix. Ofgem does not need to be like the mechanic who gets under the bonnet.

COQ24: How should we treat the fixed costs of procuring flexibility when considering flexibility solutions as an alternative to reinforcement?

461. These costs would ideally be included within the totex benchmark that we propose above, in order to capture trade-offs between different parts of the cost base.

462. Under a disaggregated model, they should be included with the fixed costs of other forms of procurement, within the indirect cost category. An efficient level of this expenditure would then be catered to by Ofgem's assessment of that category.

463. Ofgem should not attempt to single out flexibility procurement as requiring a special specific assessment. This would create a boundary between one procurement activity and another, be difficult to report against accurately (and to police), and by likely to distort incentives. This is not warranted for something which is just another form of procurement.

COQ25: What are your views on the use of LIs as outputs in RIIO-ED2?

464. We support load indices as a useful measure of how licensees are performing against the assumptions made in setting their allowances.

465. However we also urge Ofgem to avoid a creep into micro-management, and to not develop them in the direction of its NARMS framework (for all the reasons set out in our response to OUTQ44 above).

466. We set out further details below:

- a. **Expanded bandings/widths, fault level, flexibility, and distributed generation:** we recognise the value of these items and think that a sub-working group should be set up to define them in further detail.
- b. **Consistency:** we are doubtful that genuine consistency can be achieved, or whether it is desirable. For example assessment of firm capacity is a key area of asset management expertise, assessing the appropriate level of risk to take in light of all relevant circumstances – and if Ofgem defines how firm capacity must be measured, then the incentive to reduce costs through careful assessment of capacity will be destroyed, raising costs to energy consumers over the longer term.

- c. **Timescales for business planning:** the timescales to business plan submission present a further reason why commonality may be difficult to achieve in practical terms.
- d. **Forecast fault level:** we would support a form of fault level index being developed, but would highlight the development work required to provide such a forecast, and the additional resource required to do this on a regulatory reporting basis. These costs, which would ultimately be paid for by energy consumers, should be considered.
- e. **Extending LIs to all voltage levels:** we are supportive of the development of load indices at lower voltages, but note that the timetable for development needs to be considered in light of ongoing projects to develop LV monitoring by DNOs – this is a much longer term project. Otherwise information would need to be estimated; and it is unlikely that mandating DNOs to estimate this in a consistent way would be beneficial to energy consumers.

COQ26: What are your views on the treatment of incremental costs in RIIO-ED2?

467. We support option 3 – do not attempt to measure this.

- a. Incremental costs could apply to almost any decision to “touch” an asset, whether asset replacement, reinforcement or indeed other activities.
- b. Trying to measure the “incremental” part consistently across DNOs would depend on all DNOs adopting the same counterfactual for what they would have put in place. This would be impossible to do consistently, and the lack of consistency in the data would render the exercise valueless.
- c. Set against this, Ofgem would be imposing additional costs on companies through its regulatory reporting; which will ultimately fall on energy consumers.

468. As with flexibility costs (and our response to COQ23), Ofgem should rise above this detail and use a benchmark of the total cost of the activity. Ofgem is aided in this because:

- a. ED1 data will include within it incremental costs, wherever DNOs have identified cost effective opportunities to invest incrementally to avoid future costs, since they have incentives to take these opportunities (created by ED2 cost benchmarking).
- b. Ofgem can also create incentives for companies to forecast a challenging level of cost, and place some weight on benchmarks of forecasts.
- c. Ofgem’s ongoing incentives for efficiency, e.g. through comparative cost benchmarks at future price reviews, will incentivise companies to invest efficiently in incremental costs during the ED2 period.

469. Ofgem should also bear in mind that, if it uses a totex cost assessment, DNOs will have an incentive to invest efficiently in incremental costs during the ED2 period, in order to be able to propose lower costs in the next period, and thus perform better in the ED3 totex assessment. The possibility of an

efficient level of incremental costs therefore gives yet another reason to favour totex cost assessment.

COQ27: Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing Non-op capex costs in RIIO-ED2?

470. As a general rule, we do not support the continued use of the ED1 disaggregated models.
471. However, we think that the disaggregated models for non-operational capex were amongst the better models, as they were simple, transparent and should not have been overly distorting. The ratio models were simple and used a business scale variable (MEAV) as the driver, sometimes grouped with certain CAIs and sometimes weighted with expert review.
472. Expert review always suffers from the weakness that it is likely to start from the company plan, and that the expert is unlikely to be able to spot cases where the company has just deferred costs from the previous price review (resulting in double funding). However, the relevant part of the cost base is relatively small.
473. For completeness, we summarise in the table below the models in this part of the cost base, according to their type.

	No of models	Proportion of cost base
Regression models: business scale driver	0	0%
Regression models: workload driver	0	0%
Ratio models	3	2%
Unit cost models – separate volume scrutiny	0	0%
Unit cost models – no volume scrutiny	0	0%
Expert or qualitative review	2	2%

COQ28: Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing NLRE in RIIO-ED2?

474. No, we do not; and given the significance of asset replacement costs we would specifically highlight that the ED1 model (and even less so the NARMS submissions) will not offer adequate tools for scrutiny of this cost base at ED2.
475. The two approaches both have significant weaknesses:
- a. **Age based replacement modelling:** this approach gives higher allowances to DNOs that have an older asset base. This in turn will create a strong incentive for short term deferrals from the ED1 period; which would be rewarded twice – once through the cost incentive in ED1, and again through an additional allowance at ED2.

- b. Using NARMs in the cost assessment:** this approach suffers the same issues as age based replacement; with the further problem that the company's assessment of the condition of the assets would also influence cost allowances (and we highlight that it is more difficult to consistently and objectively measure asset condition than it is to measure asset age).

476. Ofgem should therefore consider other approaches that would not have these weaknesses as it develops its tool kit for ED2 cost assessment, for example through using higher level benchmarks of the total cost of maintaining the asset base.

477. To look beyond asset replacement, we summarise in the table below the models in this part of the cost base, according to their type.

	No of models	Proportion of cost base
Regression models: business scale driver	0	0%
Regression models: workload driver	0	0%
Ratio models	1	<0.5%
Unit cost models – separate volume scrutiny	4	20%
Unit cost models – no volume scrutiny	7	7%
Expert or qualitative review	2	1%

478. As can be seen from the table, this category of expenditure saw repeated use of the fragmented unit cost benchmarking approach, which in many cases comprised more than a hundred line by line cost benchmarks (each paired with a separate volume benchmark).

479. We offer the following high level comments, in no particular order.

- a.** The distinction between unit costs and volumes in many calculations did not allow Ofgem to assess whether the total cost of the activity was being minimised (bearing in mind trade-offs between volumes and unit costs).
- b.** The assessment of systematic patterns in the results that might allow robustness to be tested was virtually impossible, resulting in an extreme lack of transparency.
 - i)** Each convoluted model could comprise hundreds of individual benchmarks nested within and overall model.
 - ii)** This was compounded by the use of multiple models, such that the total count of individual benchmarks probably exceeded 1000.
- c.** Although the highly granular unit cost benchmarking presupposes similar units, in many cases they simply are not – for instance refurbishment might involve a new coat of paint or extensive replacement of existing parts (plus a new coat of paint); the lack of

comparability of costs at this granular level then necessitates many small qualitative adjustments, which come nowhere near to Ofgem's threshold for a regional adjustment.

- d. In some cases, the cost of an activity (asset replacement) was further split from the essential supporting works (civil works) and separated from categories with obvious cost trade-offs (refurbishment).
- e. Many of the cost categories received no volume scrutiny at all, totalling a substantial part of the ED1 cost base; although this is perhaps not surprising in an approach where Ofgem splits the cost based into thousands of small parts and tries to decide what to do in respect of each of them. In all these cases, the DNO can and does influence the workload; this is even the case for diversions, which are externally driven, since the volume can be affected by a DNO's relationship with key stakeholders.
- f. The flooding resilience model was based on "cost per risk point", which presumably introduces the DNOs subjective assessment of "risk removed" into the calculation, and therefore providing additional scope for the calculations to be distorted.
- g. It seems likely that Ofgem should focus its attention much more on the total cost of maintaining the asset base than putting its component parts under a poor-resolution microscope.

COQ29: Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing NOCs in RIIO-ED2?

480. No, we do not support Ofgem's analysis of network operating costs.

481. We summarise in the table below the models in this part of the cost base, according to their type.

	No of models	Proportion of cost base
Regression models: business scale driver	1	1%
Regression models: workload driver	1	3%
Ratio models	1	4%
Unit cost models – separate volume scrutiny	3	12%
Unit cost models – no volume scrutiny	2	2%
Expert or qualitative review	1	0%

482. We offer the following comments, in no particular order:

- a. The faults analysis was highly complex. It subdivided the area by voltage and asset type; applied regression analysis to some categories, and unit cost / volume analysis to many others, and then made extensive use of "qualitative" adjustments to fudge the poor quality results.

- b. The assessment of systematic patterns in the results that might allow robustness to be tested was virtually impossible, resulting in an extreme lack of transparency, since each individual model could comprise a very large number of benchmarks, and the results depended on multiple models like this – making it virtually impossible for Ofgem to “see the wood for the trees”.
- c. The distinction between unit costs and volumes in many calculations did not allow Ofgem to assess whether the cost of the activity was being minimised (bearing in mind trade-offs between volumes and unit costs).
- d. For tree cutting, the use of spans cut as a workload driver is directly under company control, and thus undermines incentives towards cost minimisation.

COQ30: Do you agree with our proposal to maintain the RIIO-ED1 approach for assessing CAIs in RIIO-ED2?

483. As a general rule, we do not support the continued use of the ED1 disaggregated models.

484. However, there were significant plus-points in this aspect of Ofgem’s analysis. In particular, the top down regression analysis approach, applied to reasonably large cost pools, had the advantages of simplicity and transparency. We would generally be more in favour of disaggregated models that take this approach than highly granular assessments. The table below summarises the type of models in this area.

	No of models	Proportion of cost base
Regression models: business scale driver	0	0%
Regression models: workload driver	1	15%
Ratio models	3	6%
Unit cost models – separate volume scrutiny	0	0%
Unit cost models – no volume scrutiny	0	0%
Expert or qualitative review	0	0%

485. Although we think the assessment was one of the better parts of the ED1 disaggregated suite, we do still think it could be improved:

- a. The use of workload drivers in some cases means that inefficiency in the workload is directly factored into inefficiency in allowances; a business scale driver would be preferable.
- b. The substantial and arbitrary adjustment in favour of one DNO to the results of the main regression model could have been avoided if Ofgem had selected a better cost driver in the first place. We say this because the adjustment:

- i) was in effect designed to undo the choice of the cost driver, by introducing a business scale variable as a comparison across licensees;
- ii) relied on “bootstrapping” that DNO up to WPD’s level of cost benchmark based on its workload driver; and
- iii) was selectively applied even though the calculation indicated adjustments for other licensees.

COQ31: What are your views on the different approaches presented for the treatment of BSCs in RIIO-ED2?

486. Ofgem should benchmark business support costs through regression analysis, using exogenous cost drivers that should influence the scale of the business (such as customer numbers).
487. Ideally it should do this as part of its totex benchmarking or as part of any “opex plus” benchmarking. But failing this it should assess business support costs at the cost category level, in any disaggregated analysis.
488. Ofgem suggests in the Consultation comparing certain components of business support costs with other network companies, such as GDNs.³⁸ It should not try to do this as there is no rationale to support using data on business support costs from different sectors. The relationship between the explanatory variable and the efficient level of business support costs will vary depending on the type of business in question. Gas distributors and electricity distributors are undertaking different activities from one another, and the efficient level of business support costs will differ, even if their number of customers, MEAV, or any other cost driver, happen to be equal.
489. Beyond this point, we summarise in the table below the models in this part of the cost base, according to their type.

	No of models	Proportion of cost base
Regression models: business scale driver	0	0%
Regression models: workload driver	0	0%
Ratio models	2	7%
Unit cost models – separate volume scrutiny	0	0%
Unit cost models – no volume scrutiny	0	0%
Expert or qualitative review	1	2%

490. Beyond this relative simplicity of the modelling suite, the models themselves were relatively simple, making then transparent, which we support.

³⁸ The consultation, Annex 2, page 70, paragraph 7.91

491. This is a striking contrast to some of the convoluted models used in non-load expenditure or network operating costs, which actually comprised hundreds or even thousands of individual benchmarks, sometimes with differing structures, nested within the overall model, making assessment of any systematic patterns in the results virtually impossible, and resulting in an extreme lack of transparency.

Cost Benefit Analysis, Engineering Justification and Data Assurance

COQ32: Do you agree with our proposed application of CBA in the appraisal of investment options for RIIO-ED2?

492. We are supportive of the approach of using CBAs as a supporting cost justification tool.

493. We offer the following further comments:

- a. **DNOs should retain discretion on when to use them:** we restate our belief that this is appropriate, in line with Ofgem’s proposal.
- b. **They should supplement cost assessment, not offer a “route out”:** CBAs have a valid role as part of the cost assessment tool kit. However, if they offer a route out of other forms of cost assessment, this could “distort” the base costs which are used to set benchmarks, and would also provide an incentive for excessive provision of CBAs. This would not be a good outcome.
- c. **Early sight will be useful for net zero scenarios:** we note with interest that the net zero section on future pathways requires further sensitivity analysis to be performed, and we would therefore request sight of any new CBA template at the earliest opportunity.
- d. **A common cost of capital (WACC) assumption should be used:** Ofgem should determine this as a cross-sector input, unless it considers it is likely to set different DNOs a different WACC. Using plan values could result in arbitrary differences in assessment by different DNOs of otherwise identical options. This wouldn’t make sense.

COQ33: Do agree with our proposals to retain the requirement for DNOs to produce Engineering Justification Papers?

494. Yes, we are supportive of the retention and use of EJPs for our high materiality programmes.

495. We would value an early indication of whether Ofgem is going to define “high materiality” and early visibility of any other updates to the EJP guidance.

COQ34: Do agree with our proposal retain the assessment framework for EJPS developed as part of the RIIO2 process?

496. Yes, we do.

497. Feedback from Ofgem to DNOs on the effectiveness of the EJP process for T2 and GD2 would further help to guide the ED2 process.

COQ35: Do you agree with our proposal to adopt the principles outlined above to guide the production of EJP and focus the engineering submission?

498. Yes we support the principles to guide production of the EJPs.
499. We agree in principle that engineering justification should be essential where investments and volumes are significantly higher than at ED1.
500. Otherwise they should be at the DNOs discretion (recognising our query in response to COQ33 on any definition of “high materiality”).
501. As a point of detail, at paragraph 9.3 (bullet 3) Ofgem suggests EJPs would be essential for investments that are significantly different to ED1. However we do not think EJPs should be required for investments or volumes that are significantly lower than at ED1.

COQ36: What specific activities and methods should be adopted to ensure the Data, Data Assurance and Compliance processes of the RIIO-ED2 price control are run as effectively as possible?

502. In the first instance the focus should be on using the non-technology related principles of the data best practice so as to encourage the right ways of thinking before we start trying to improve with technology only.
503. To this end, creating robust metadata to ensure data is well described and understandable and using better data management practices stand out as key focal points initially, after which we can consider shared data models and more automated data exchanges based on APIs to further improve processes. We would not seek to rush to implement technology solutions without understanding if and how these capabilities could improve consumer services for ED2, particularly as they may be costly and are unlikely to be justified for regulatory data exchange alone.

Uncertainty Mechanisms

COQ37: Do you agree with our proposed uncertainty mechanisms and their design?

504. Ofgem is proposing too many uncertainty mechanisms as part of its approach of removing or reducing incentives for companies to control their costs, so as to avoid the risk of outperformance.
505. The loss of these incentives will be detrimental to energy consumers over the longer term, as costs inexorably rise. Every reopener also introduces further boundaries in the totex cost base, and takes costs out of the business plan incentives.
506. In terms of the newly proposed mechanisms³⁹:
- a. **Net zero:** a reopener might be warranted, but Ofgem’s proposed definition is far too wide. It should be focussed only on legislation changes. See our response to OVQ13.

³⁹ We have not included the financial uncertainty mechanisms here; these are addressed in our responses to the finance questions.

- b. **Cyber resilience:** we disagree with the proposals as the cost boundaries will cause distortions, and because this is just another business risk. If there is a reopener it should be limited to extra requirements imposed on energy networks by legislation or Ofgem in its role as competent authority. See our response to OUTQ47.
- c. **IT and telecoms reopener:** we agree with Ofgem's proposal to not have a reopener. There is no need, whatsoever.
- d. **Co-ordinated adjustment mechanism:** this reopener appears unnecessary to us, but also appears fairly harmless to incentives, so we do not oppose it.
- e. **Black start:** we agree with Ofgem that:
 - i) ideally the business plans would include the costs, with no reopener, if possible; and
 - ii) a reopener is warranted if the new guidance comes too late.
- f. **Environmental legislation:** we think a reopener is warranted, provided the trigger is new environmental legislation that is targeted at distribution networks. Other more generic environmental legislation should be treated like any business risk.
- g. **Any "strategic investment" mechanism:** we support a volume driver based on the number of heat pumps and electric vehicles in each region. See our response to OVQ9
- h. **Real price effect indexation:** we disagree with the proposals as they will add risk to the settlement and raise the cost of capital. See our response to COQ16.

507. We generally agree with Ofgem in terms of the existing uncertainty mechanisms it is proposing to retain or amend.⁴⁰ The two most significant exceptions are:

- a. **Streetworks:** we think Ofgem should reform the mechanism because the schemes and their costs are now relatively well understood. Instead it should maintain stronger incentives and remove cost boundary issues by either:
 - i) using an automatic allowance driver based on timing of introduction of any: (i) remaining permit schemes; and (ii) lane rental schemes; or
 - ii) setting a probability adjusted ex ante allowance for the costs.
- b. **Smart meter intervention costs:** there is still uncertainty over the pace and extent of the rollout but we think Ofgem should reform the cut-out intervention funding mechanism since there is now much more data on the efficient cost, and since the protracted smart

⁴⁰ Ofgem includes pension deficit repair in its list of mechanisms that will be retained in line with ED1, at paragraph 11.29 of Annex 2. The summary, table 7 of Annex 2, states the mechanism would be revised for RIIO-2. If the summary is not a typographical error then Ofgem should clarify this and consult further.

meter rollout is blurring the lines between “business as usual” cut out interventions and smart meter related interventions. We can see two potential models.

- i) Ofgem could set a fixed cost allowance per percentage point of rollout undertaken by suppliers in a DNO’s region, based on a benchmarked cost seen to date.
- ii) Ofgem could broaden the volume driver mechanism so that it applies to all meter operative generated call outs, thus removing the distorting and uncertain revenue boundary between smart meter related call outs and other call outs.⁴¹

COQ38: Are there any other uncertainty mechanisms that we should consider? If so, how should these be designed?

508. We have not identified any. We think Ofgem is already proposing too many, although some of its additions (if tightly enough targeted at new government legislation) are appropriate.

COQ39: Do you agree with our proposed removal of the above uncertainty mechanisms for RIIO-ED2?

509. We disagree with Ofgem’s position on the following re-openers.

- a. **High value projects:** the threshold (£20m+ inflation, per licensee) is sufficiently large to have a reopener, while still remaining below the £100m threshold at which bespoke competition may be triggered. Although a high bar should be applied, it offers a backstop that helps avoid an increase in the risk licensees face (and the cost of capital).
- b. **Load related reopener:** we agree this reopener “interacts” with funding for low carbon technology uptake, but we think it could potentially be retained alongside some of these.
 - i) We are proposing an allowance volume driver so that base allowances flex automatically based on the number of low carbon devices (e.g. electric vehicles).
 - ii) A load related re-opener could potentially still be applied, as a backstop if expenditure strays a long way from revised allowance.

COQ40: Do you agree with our proposed common approach for re-openers being applied to RIIO-ED2?

510. No, we do not agree with it.

511. We provided our views in response to Ofgem’s consultation on the T2 and GD2 draft determinations. These views are reproduced below, for convenience.

512. “We disagree with two aspects of Ogem’s proposals and have a suggestion on a further aspect:

⁴¹ The pass through of Data Communication Company (DCC) fixed costs is completely appropriate, since these are non-controllable.

- a. we oppose Ofgem allowing itself to trigger reopeners at any time during a price control period;
- b. Ofgem should not give itself the ability to reject re-opener application simply because it did not contain all the information that Ofgem subsequently decides that it needs to take an informed decision; and
- c. we suggest that Ofgem introduces an “updated submission” window to its process.

513. “If Ofgem gives itself the right to trigger reopeners at any time, it will make itself more exposed to any political pressure that can from time to time arise. This reduced insulation against political pressure will in turn expose investors to additional risks, raising the cost of capital to the detriment of energy users. Furthermore, the process Ofgem proposes at paragraph 7.26 of the consultation, which appears limited to publishing a direction and consulting for 28 days, appears far too limited to provide network companies and their investors any real protection from this regulatory risk. A longer process, with multiple stages (including informal consultation on Ofgem’s analysis) should be introduced.

514. “Ofgem should not give itself the discretionary ability to reject reopener requests out of hand because it considers the application to have not contained the information necessary to take an informed decision. Ofgem has the ability to ask for further information throughout the reopener process, along with its already extensive information gathering powers. It would be unreasonable and disproportionate for Ofgem to reject a reopener application because it subsequently decided the initial application did not contain all the information it wished. Ofgem should not contemplate this as to do so would lead it to fail in its duty to fund the efficient costs of licensees in undertaking their regulated business.

515. “We do not oppose Ofgem bringing forward the reopener window by four months, from May until the last week of January, but there are pros and cons to this and we have one suggestion. The change to timetable means that:

- a. Ofgem will afford itself additional time for assessment, and also more time to obtain any additional information this it thinks it may require to take a decisions, which is positive and has our support; but
- b. submissions will need to use additional forecast information (since the then current regulatory year will not yet be completed), which will reduce the amount of information available to the process.

516. “In light of these pros and cons, Ofgem should consider introducing an “updated submission” window, for revised submissions later in the process, perhaps around May. This would allow for the latest information to be introduced, along with any revisions to submissions that Ofgem’s question and evaluation process has revealed is necessary, e.g. to aid comparability.

517. “Continuing to use the RIIO-1 materiality thresholds, and the proposed new thresholds that would allow for the aggregated effect of multiple re-openers, seems reasonable.”

Increasing Competition

COQ41: Do you agree that our flexibility proposals are sufficient to incentivise DNOs' native competition?

518. Ofgem's proposals are extremely strong in this area, and it is correct to assess that it does not need to require or incentivise competition plans through the business plan process.
519. The flexibility proposals overlay a degree of process consistency across DNOs and act as an additional safeguard for consumers to the existing system.
520. This is in addition to Ofgem's ED1 approach to regulation which provides extremely strong foundations for native competition that were not present as precursors to T2 and GD2:
- a. The ED1 approach to totex regulation, with minimal exclusions of cost, does not separate the price control for system operation from maintaining the network, unlike:
 - i) transmission where a true totex approach has never been implemented (because that price control has always been split into several parts); and
 - ii) gas distribution, where repex receives a different treatment to other costs.
 - b. ED1's well-developed consumer outcome incentives promote native competition being used to enhance service, not just minimise cost.
521. We think Ofgem can develop ED1's approach to totex regulation it further.
- a. As set out in our responses on cost assessment, Ofgem should rely less on granular volume driven models at ED2 (compared to ED1) and more on higher level cost assessment to reduce the possibility that incentives towards particular business models creep back in through the cost assessment.
 - b. As set out in our responses to the finance questions, Ofgem should apply a benchmarked totex capitalisation rate, so companies won't stand to grow their RAV faster if they favour investment solutions in their business plan.

COQ42: Do you believe there are similarities between DNOs running early competitions and the roles and activities that may be related to electricity DSO functions?

522. Yes, native competition encompasses all forms of competition, including early competition, and all potential options. It includes trading off early stage solutions (e.g. operation vs investment) as well as later stage solutions (though procurement processes). It is therefore fundamentally inter-related with electricity DSO functions, which extend the option set at all stages of the process.
523. The framework is completely flexible and incentive driven. This means that it applies to all procurement decisions, including relatively small ones so long as the DNO expects the benefits will justify the administrative costs. It also avoids the need for process codification that is the disadvantage of formal early or late competition.

COQ43: Do you agree with our proposed approach on early competition?

524. Yes, we agree with it, insofar as it has been outlined, including the suggested threshold of £50m along with the criteria. It is difficult to see a justification for different criteria in electricity distribution compared to other sectors, since the criteria are generic, not sector specific.
525. Ofgem should also consult on the proposed early competition plan once this has been developed (in addition to the consultation on an impact assessment mentioned in paragraph 12.21 of Annex 2 to the Consultation).

COQ44: Do you have any views on our draft RIIO-ED2 Late Competition Impact Assessment?

526. The impact assessment (IA) needs to be significantly improved if it is to be a basis for what is a significant policy change, including a quantification of expected benefits and further consultation.
527. As it stands it has been gerrymandered to give the desired assessment, because it:
- a. **engages in a lengthy and speculative search for qualitative benefits:** the one sided nature of which is painfully apparent from the fact Ofgem rarely considers even the possibility that a potential benefit would also be present in the status quo option – even though, in many cases, it is obvious that it would be – a point we demonstrate below;
 - b. **applies a different and higher hurdle to costs:** where Ofgem very specifically states it will only consider differences between the two models, and carefully finds reasons to discount all potential costs other than the narrow transactional costs - even though it admitted that system fragmentation would cause difficult to quantify costs in its draft IA for application in transmission⁴²; and
 - c. **specifically avoids providing any quantification of the benefits:** even those which can be estimated, by reference to the fact *some* benefits are complex to quantify, saying "*It is complex to quantify and monetise the efficiency and dynamic benefits of opening markets to competition, such as the scope of increased innovation and the introduction of new products, services and technologies. We draw on quantitative assessments of comparable competitive regimes as an illustration, but do not make our own quantitative assessment.*"

528. We in fact think it would be straightforward to begin to quantify the potential benefits. Ofgem has developed a range for the cost of equity at 60% gearing in its T2 and GD2 draft determinations. Since this range represents it's assessment of the likely uncertainty over the cost of equity for comparable businesses, the difference between the proposed cost of equity and the lower bound of this range could be used to calculate an upper bound estimate of the potential savings from using a

⁴² As a minor point on the quantified assessment of costs, it omits the bid costs of failed bidders, which should nevertheless be considered as they are a cost to society of the proposal (and under competitive markets would be expected to flow through to consumers, e.g. because bidders would factor in recovery of their expected loss on bid costs). If we assume five bidders, the bid costs Ofgem assumes should be multiplied by five.

competitive approach to tendering, and apply this value to the total tendered assets that the IA assumes. The savings could of course be smaller, or even negative, because of the aforementioned uncertainty. But at least it would give some a readily calculated number to start to compare with the costs.

529. Lastly, to illustrate point a above, we have below provided a detailed assessment of the benefits aspect of the impact assessment. Many of the potential wider benefits claimed in the IA should be discounted.

- a. That qualitative assessment is summed up in two paragraphs, 5.7 and 5.8, where Ofgem says:
 - i) *“The OFTO regime has been estimated to have brought consumers net savings of 19-23% of the value of OFTO projects, when compared to regulated counterfactuals”;*
 - ii) admits that this is not directly relevant; and
 - iii) asserts that *“the evidence suggests that the potential savings from introducing competition are likely to be above the costs we have modelled in this IA” ...*
 - iv) ...while giving no basis for this statement, because the benefits have not been quantified.
- b. In terms of the reference to a comparison of OFTO vs a counterfactual:
 - i) It is not clear that the counterfactual is regulation of electricity distribution under RIIO. The counterfactual should be electricity distribution i.e. ED2 (and future) settlements. It seems more likely that a different counterfactual has been used.
 - ii) The consultation provides no specific information on how this figure has been calculated. Ofgem must set out its calculations so that consultees can engage with them on an informed basis.
- c. Turning to the four pages of qualitative assessment:
 - i) In terms of the general benefits:
 - (1) Paragraphs 3.3-3.4: Ofgem fails to recognise the comparative competitive aspects of its ED framework in any way, including native competition, or that its RIIO framework is designed to encourage innovation;
 - (2) Paragraph 3.5: Competitively appointed operators would not reveal useful information on operating costs that could be used in setting DNO price controls; their costs would relate to operating new and separable assets, and would not be reflective of the cost of operating the basket of assets, some of which may be 100 years old, that DNOs are responsible for, and where Ofgem already has ample evidence from its comparative regulation of DNOs; and

- (3) Paragraph 3.5: Competitively appointed operators would not reveal additional information on network investment costs that could be used in setting DNO price controls generally. The reasons are the same as paragraph 3.4.

ii) In terms of the financing benefits:

- (1) Paragraph 3.6 and 3.8: Ofgem states that bidders may seek efficient financing structures, and many OFTO bidders have very high gearing. Yet in its main price control, Ofgem applies claw back for higher gearing, seeks to discourage it, and has specifically chosen to reduce notional gearing in its T2 and GD2 controls, presumably because it sees consumer benefits from doing so. The benefit the IA claims from “efficient finance” structures is therefore at odds with Ofgem’s revealed beliefs over appropriate financing structures;
- (2) Paragraph 3.7: There are no additional benefits from CADO's locking in debt finance for 25 years, since DNOs also issue long term debt under the status quo, meaning that the RIIO-ED price controls (which use a benchmarked DNO cost of debt) also lock in long term rates; and
- (3) Paragraph 3.8 and 3.12: The OFTO model does not provide evidence on the cost of financing the onshore late competition model. This is because the OFTO does not take on any design or construction risk, and faces low risks on a wide range of other issues.⁴³

d. In terms of non-financial cost savings:

- i) Paragraphs 3.10 and 3.11: Ofgem’s assertion that DNOs may exclude credible suppliers from their procurement processes is speculative and unfounded.
- (1) This would cause DNOs to incur higher costs - but they have strong incentives to reduce their costs.
- (2) Ofgem presumably applies some pre-qualification criteria for late competitions.
- ii) Paragraph 3.11: Ofgem’s claimed benefit for the late competition model, that “The competitively appointed party can also design and construct the project with the full lifecycle in mind,” does not support late competition, and in fact cuts against it because:
- (1) in terms of the ability to procure for design and build, this applies equally to the RIIO-ED counterfactual, since DNOs can and do procure turnkey solutions to large

⁵ See Northern Powergrid’s response to Ofgem’s T2 and GD2 draft determinations, pages 38-39, paragraphs 210 to 212 and the associated table

projects, especially at higher voltages, and will decide on a case-by-case basis whether turnkey or in-house design options are more efficient; and

(2) in terms of bearing the full lifecycle in mind, a DNO is responsible for an asset it constructs in perpetuity, and is fully incentivised to consider its full life cycle, unlike an OFTO-type approach to late competition where the asset owner is only responsible for the first 25 years of the lifecycle.

- e. In terms of international evidence (paragraph 3.13), Ofgem sets out no details of its examples beyond the continent they come from and its view that they were successful. Ofgem could equally point to many examples where a regulated framework has been successfully implemented, with a longer list of continents. Yet of course it does not.
- f. The evidence on contacts for difference is irrelevant, as it compares an auction process with a bilateral negotiation – and ED price controls are not a bilateral negotiation thanks to Ofgem’s use of comparative competition, and thanks to information revealed through cost incentives within the period.
- g. The evidence from Ofwat’s Thames Tideway procurement process (paragraph 3.15) is based on an inflated assessment of the counterfactual and, even if there were benefits, shows a pyrrhic victory for late competition, since the 2.5% real RPI linked WACC (fixed until 2030) is well above the 2.47% real CPI linked WACC that Ofgem has just proposed for Scottish Hydro Electricity Transmission in RIIO-2.

COQ45: What are your initial views on the three models of late competition (CATO/CADO, SPV and CPM) in the context of electricity distribution? If there would need to be differences from the other sectors, can you please explain what these should be, and why.

530. We think the different context of electricity distribution renders the Competition Proxy Model (CPM) and Special Purpose Vehicle (SPV) model effectively redundant. Our reasoning is as follows.

- a. **Competition proxy model (CPM):** Ofgem already has many tools to proxy competition within the distribution sector, therefore its main price control settlement should realise all the benefits of CPM.
- b. **SPV model:** If this would allow a DNO to reduce its costs, it could already implement an SPV. While a transmission company in a bilateral regulatory negotiation with Ofgem may not want to reveal these cost reductions to Ofgem, the comparative system of regulation in place in distribution means DNOs would have strong incentives to do so, if (and only if) it would reduce its costs.

COQ46: Do you agree that the late competition models proposed could deliver benefits in RIIO-ED2?

531. We agree the late competition models could deliver benefits. The criteria for competition are generic and benefits are possible whether they are in transmission or distribution.

532. However, we do expect those benefits to be lower in distribution in absolute terms. For example, competition is already present in electricity distribution to an extent that is not the case in electricity transmission, including through a much stronger ED framework for native competition, along with the competition between IDNOs and DNOs that Ofgem highlights.

COQ47: Do you agree that our proposed criteria for identifying projects suitable for late model competition are applicable in the context of electricity distribution?

533. We agree with the broad criteria, but not the detailed wording, which is inappropriate for distribution. We addressed this issue in our response to the T2 and GD2 methodology consultation, which we reproduce below.

534. “The criteria will ensure that this type of arrangement is focussed on high value projects that justify the administrative costs, while avoiding problems such as a lack of clarity over the ownership boundary. The criteria are sufficiently generic that they must, by definition, be suitable for all of the sectors.

535. “Maintaining these criteria at the levels set will also help mitigate some of the additional costs of a more fragmented system that competition can introduce. Ofgem’s impact assessment is right to recognise the existence of these costs.

536. “In terms of detailed wording of the ‘separable’ criteria for electricity distribution (covered in table 13 of the Consultation), it would not be appropriate for a late competition model to be applied to owning and operating components that are integral to a distribution network. The criteria should not be phrased in a way that could require this. To achieve this, Ofgem should:

- a. retain the existing statement on a clear ownership boundary;
- b. remove the statements that contiguity and electrical separability are not required (or should be determined on a case by case basis); and instead
- c. require that the assets represent discrete sections of network rather than potentially including the replacement of integrated component parts.⁴⁴

537. “The replacement set out in points b. and c. is necessary because, without it, the current criteria might allow for competition to replace and then own distribution network component parts, where programmes of replacement hit a high enough value. This splintering of accountability could see third parties taking risks with high volume and low-value components that threatens the stability of an entire network.”

⁴⁴ If a third party was allowed to compete for a project to replace a large number of distribution substations, for example, it would lead to an entirely fragmented yet entirely inter-dependent system, heightening network management risk.

COQ48: What are your views on the best ways to identify a suitable project pipeline for late competition in electricity distribution (eg our proposal to require flagging of projects that meet the high-value, new, and separable criteria)?

538. We support Ofgem’s proposal to require flagging of relevant projects in ED2 business plans.

539. We also highlight that the model can only be applied to new assets. Otherwise ownership rests with the existing operator, and their property rights must be respected.

COQ49: Do you agree with the proposed range of options available for repackaging projects in RIIO-ED2 in order to maximise consumer benefit?

540. We agree with the proposed options (as stated in paragraph 12.36 of Annex 2). The considerations are generic across transmission and distribution.

541. We comment in response to the next question on Ofgem’s suggestion (at paragraph 12.38) of applying them differently compared to transmission. This in effect creates an additional option compared to transmission that is deeply flawed.

COQ50: What relevant factors do you think we should consider in deciding how these repackaging proposals are specifically applied in electricity distribution?

542. Ofgem should not introduce additional options for repackaging projects in distribution through the back door. The specific additional option proposed suffers severe flaws.

543. The relevant considerations in competition are generic across transmission and distribution, and the options should be generic too. As Ofgem says in the Consultation “*we can see no basis for concluding that any of the approaches identified would not be relevant to electricity distribution, or that additional options specific to electricity distribution are required*”. Yet proposing to apply the options in a completely different way is in fact creating another option.

544. We provide a detailed critique of this additional option below.

- a. **The proposal to differentiate from transmission is illogical:** on a logical level, there will also be programmes of similar relatively small projects in transmission that could be bundled. Yet Ofgem has not suggested trying to stretch its criteria for competition to these. This should highlight to Ofgem that it is wrong to do so.
- b. **Badly fragmented projects will be less attractive to bidders:** bundled programmes of significant volumes of works are likely to carry much higher risks and administrative costs for potential bidders; they are far less likely to be attractive and thus gain competitive bids, undermining the whole premise of competition (and potentially leading to higher costs to consumers than the status quo).
- c. **Fragmented assets are much less likely to be separable:** distribution systems are significantly more meshed and overlapping than transmission, making it more difficult to identify assets that are sufficiently separable that clear ownership and operational

boundaries could be established. These issues are even more significant in respect of component parts of the system.

- d. **A fragmented distribution system is against consumer interests:** bundled programmes of significant volumes of works would quickly fragment the distribution system. This would be against consumer interests because it would remove the clear responsibility of a DNO for the reliability of its system – and Ofgem did recognise the costs of fragmentation of the system in its transmission impact assessment.
- e. **Competition already exists where separability is clearest:** competition is already in place for each and every system extension to facilitate a new connection, between DNOs and IDNOs (as Ofgem recognises in the Consultation) which further limits the potential benefits for the proposed additional option.

545. We also note that Ofgem has excluded from its impact assessment its proposed additional option of applying the late competition model to programmes of large numbers of smaller projects. Indeed Ofgem states that IDNO type projects would not meet the criteria for late competition *“We are aware that in ED there is the possibility of competition via iDNOs or flexibility markets; however, we are not aware of any projects that would meet the new, separable and high-value criteria outlined above that would be subject to iDNO competition or flexibility markets. We have therefore assumed that the status quo in this instance is incumbent DNO delivery through RIIO-ED2.”* Yet bundles of such IDNO projects would in fact fall within the additional option Ofgem suggests in the Consultation.

Incentivising Business Plans and their Delivery

COQ51: Do you agree with our proposed approach to implementing the CDIR method in setting the TIM efficiency incentive rate?

546. No, we don't.

547. We set out our views on the business plan incentive in general in response to COQ52 below. As part of this we think that sharing factors should be set based on the efficiency of company costs, rather than the proportions of the plan that fall in different pots and may be set on a discretionary basis (and which will dampen incentives).

COQ52: Do you agree with our proposed design of the BPI for RIIO-ED2?

548. We think it would be better if Ofgem was to introduce:

- a. clearer prospects of material rewards for companies that submit plans based on challenging cost levels;
- b. less focus on “discretionary” assessment by Ofgem of what constitutes a good plan, or the need to submit “value propositions” before seeing Ofgem’s assessment of the plans;

- c. less emphasis on the distinction between high- or low-confidence costs, since this will distort incentives for companies to challenge themselves on costs across all of totex; and
- d. sharing factors set based on the efficiency of company costs, rather than the proportions of the plan that fall in different pots.

549. Ofgem would need to revise its proposals promptly, in time for the ED2 methodology decision, if the incentive is to have the desired effect on company business plans.

COQ53 What are your views on our suggestion to use proposals contained in draft business plans in the setting of baseline standards in a number of areas (as discussed in paragraphs 13.28 and 13.29)?

550. We can see why Ofgem is considering this proposal – but it raises further issues that need to be addressed before it can be applied.

551. On the positive side, if Ofgem wishes to set additional baseline standards, beyond those set in the methodology decision, it is appropriate to allow companies to identify the additional cost associated with those proposals, so Ofgem can include them in its cost benchmarking process. The proposal is a way of achieving this.

552. However, we think the proposal raises issues that would need to be addressed:

- a. **The timing of Ofgem’s decision will be critical:** if additional baseline standards are to be imposed companies will need adequate time to cost these in their final business plans.
- b. **The proposal interacts with Ofgem’s CVP mechanism:** Ofgem will need to make sure there is no disincentive in its package to revealing CVPs at the draft plan stage.

COQ54 Do you agree with our proposal to cap the number and value of CVP proposals that can be included within business plans.

553. Yes, we do.

554. We think Ofgem could limit them even more tightly, to perhaps half the proposed level, so that companies focus on their best candidates.

COQ55: Is there any further detail on the proposed content of the Business Plans that you think should be set out in the Business Plan Guidance?

555. Our suggestions for further detail or clarifications are below.

- a. We would value confirmation as to whether the draft business plan must be published on our website at draft submission stage.
 - i) Ofgem has said it should be sent to Challenge Group with Ofgem in carbon copy.
 - ii) If plans are also published, this may undermine the competitive nature of the CVP (although this would not be an issue if Ofgem is judging CVPs at draft plan stage).

- b. The guidance should clarify whether CVPs that were accepted at GD&T are acceptable for inclusion as CVP proposals at ED2.
- c. Clarification would be helpful around the level of detail Ofgem requires for areas not covered by the Business Plan Guidance, for example reliability, which is a high priority for our stakeholders.

556. We have also provided feedback in response to the various questions on the baseline standards that the business plan guidance sets out. We do not reproduce that feedback here.

COQ56: Is there other information that we should be requesting in the Business Plan Guidance in order to assess a network company's Business Plan?

557. Ofgem may need to update the guidance to specify further information that it would require to assess plans depending on its decisions regarding how to address net zero uncertainty.

COQ57: Do you agree with the proposed set of minimum requirements for Stage 1 of the BPI that are set out in the draft Business Plan Guidance?

558. There is a conflict between the extent of the minimum requirements and the proposed page limit.

559. The Business Plan Guidance mandates a significant volume of content for inclusion on business plans and the guidance states:

7.2 Where the company needs to provide further, more detailed information, it should use annexes. Though annexes will not count towards the 200-page limit, companies should where possible ensure that the core Business Plan text contains all information relevant to Ofgem's assessment of the plan. Annexes should be clearly signposted and referenced within the core Business Plan text.

560. The GD2 and T2 guidance contained fewer minimum requirements but used the same page limit.

561. Ofgem should therefore allow DNOs include the detail for mandatory elements of the plan e.g. strategies (for example DSO, vulnerability, connection etc.) as annexes to the main plan submission with only a summary in the main document. Otherwise Ofgem's requirements will force content that other stakeholders would expect to see into annexes, which would be a poor outcome.

COQ58: Do you agree with the approach for assessing companies CVP proposals that is set out in the draft Business Plan Guidance?

562. We think Ofgem should explicitly give itself the option to assess the merit and value delivered by the CVPs through its consultation on Draft Determinations.

- a. It is doing this in practice at T2 and GD2 – and seeking to establish a different methodology to value one of the proposals.

- b. This would allow Ofgem to reward valuable CVPs where that value may be difficult for the company to estimate up front, but where Ofgem can establish it through consultation.⁴⁵

COQ59: We anticipate that DNOs are investing in improving / creating data dictionaries and business information models that describe the data-driven aspects of DNOs overall business architecture. We anticipate there may be opportunities to take advantage of these investments to support the process of cross-referencing data used within RIIO-ED2 Business Plans. What are your views on this?

563. As part of our developing Digitalisation Strategy and Action Plan we have identified initiatives that look to build on our pilot projects to catalogue our data and trace these to both the internal and external stakeholder data requirements.

564. We are receptive to:

- a. the concept of making our catalogues “open”;
- b. identifying which of the catalogued data we will/can make “open”; and
- c. providing easy access to that “open data” to avoid lengthy request processes.

565. Where possible, depending on ED2 business planning timescales and process, we may be able to allow external stakeholders to cross reference those data areas and initiatives to our ED2 proposals.

566. Our key considerations at this point are:

- a. prioritisation of data cataloguing;
- b. putting in place a triage process to respond to stakeholder data requirements, including provision of data that is not “open” but that we could provide on case by case basis;
- c. planning for implementation of our data investment initiatives; and
- d. further alignment with the wider industry on key priorities and actions.

⁴⁵ Ofgem should ensure that valuable propositions never go unrewarded, even if companies have not been able to evaluate the value before plan submission; if Ofgem did leave them unrewarded, it would weaken the effectiveness of the incentive in respect of “hard to value” propositions.

5. Finance

Allowed Return on Debt

FQ1 Do you agree with our proposal to use the iBoxx Utilities 10yr+ index rather than the indices used in RIIO-1?

567. Yes, we do, as long as the calculation Ofgem uses based on it reflects the full expected cost of debt of the electricity distribution sector.

568. We reproduce our response to the same question in Ofgem's T2 and GD2 draft determinations below.

569. "Using an index of utilities bonds to estimate the cost of debt for utilities seems reasonable.

570. "We also do not think it is especially financially material. Ofgem is setting its trailing average to mirror the expected cost of debt of the sector, therefore the fact the utilities index averaged at a lower level than the iBoxx corporates index during the financial crisis will "come out in the wash"."

FQ2 With reference to paragraph 2.8, do you have a view on what debt allowance calibration should be used for business plan working assumption purposes, and why?

571. We think Ofgem should ask electricity distributors to develop a working assumption during the course of late 2020.

FQ3 Do you have any evidence to suggest ED networks should or should not have a debt allowance that has a different calibration to GD&T networks?

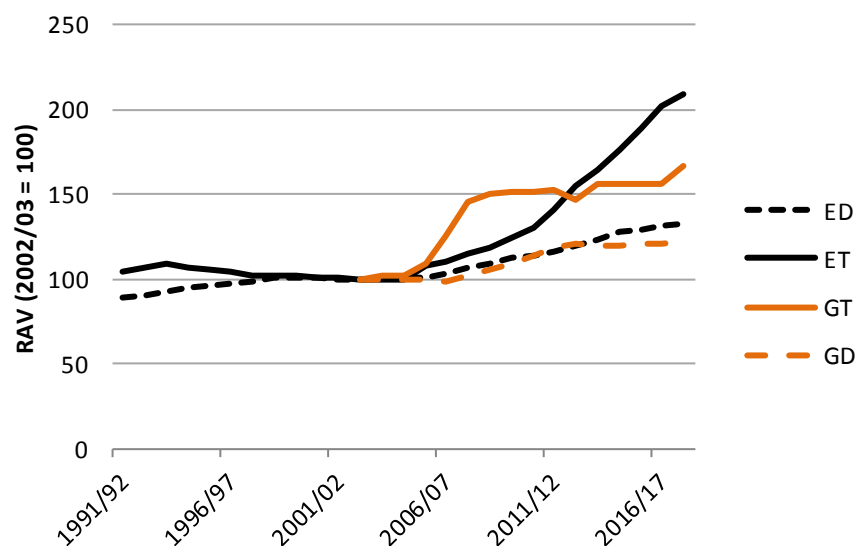
572. Yes, we do.

573. At the start of ED2, the a priori evidence supports a higher ED cost of debt than transmission or gas distribution networks.

574. This is to be expected because:

- a. The cost of issuing the long term fixed rate debt that networks predominantly use to finance their activities that has declined repeatedly and significantly since the 1990s.
- b. All else held constant, electricity distribution networks will have a higher weight on older, and higher rate, debt than their counterparts in transmission or gas distribution because:
 - i) recent RAV growth in transmission has been significantly higher than electricity distribution, meaning a larger proportion of RAV has been financed recently; and
 - ii) none of the gas distribution companies existed before the mid-2000s, or have any debt pre-dating their creation (we understand), so they lack expensive embedded debt issuances from the 1990s or early 2000s.

575. The RAV growth profiles of the various sectors are shown in the chart below, which we reproduce from our ED2 framework consultation response, while the timing of the creation of the current gas distribution companies is a matter of historical fact.



576. The electricity transmission companies have seen RAV growth of 109%, compared to electricity distribution at 33%, between 2002/03 and present. Given how much the cost of debt has declined over that period, it is virtually inconceivable that electricity distribution would not have a higher cost of debt at present. For gas distributors, the entirety of the current RAV has been newly financed since the mid-2000s, while for electricity distributors this figure could be as low as 25% (based on RAV growth since the early 2002/03).

577. Ofgem will also have to consider what the CMA's recent provisional findings in the water sector mean for its methodology at ED2.

FQ4 Do you have any views on our analysis of additional costs of borrowing that may not be captured by an index of bond yields?

578. Our response to Ofgem's T2 and GD2 draft determinations on the additional cost of borrowing is reproduced below. This response contained a descriptive imperfection which is corrected in parenthesis.

579. "Whatever index is used, it is important that Ofgem ensures the cost of debt from the index calculation mirrors the full expected cost of debt of the relevant networks, including issuance.

580. "We therefore also agree with Ofgem's proposal to make separate allowance for issuance costs. It is however not clear to us whether Ofgem's calculations include two factors that, in our experience, would be relevant to the evaluation of issuance costs on *historically issued* debt:

- a. the coupon on our historically issued debt has almost always been "snapped" to [the nearest] 1/8 of a percentage point [that is] below the true cost of the debt (the bonds have been, in effect, sold at a small discount to the face value). On average, the true cost of the debt has been about 6 basis points above the coupon; and

- b. many bonds issued in the early to mid-2000s will have benefitted from a credit wrap, and so would have been AAA rated (at the time of issue) with the commensurate reduction in the coupon. These credit wraps did not come free. Ofgem should account for the full cost of this debt, including the wrap, where it has been issued. In our experience wrap fees have been in the region of 25bps; Ofgem would need to obtain data from other licensees in the relevant sectors as to which of their bonds were wrapped at issue.”

FQ5 Do you agree with our proposal to use the longest term OBR forecast for CPI to deflate nominal index yields to a real CPIH allowance and to switch to using OBR CPIH forecasts if these become available?

581. Yes, we support using a reputable economic forecast for this purpose, and the OBR forecast is reputable.
582. In terms of the proposal to potentially switch forecasts during the price control period, the inflation forecast is used in two different ways:
- a. at the price control review, to deflate actual company debt and iBoxx history, which can affect the entire calibration of a trailing average; and
 - b. on a year to year basis, to deflate each new year’s iBoxx data.
583. We would agree with a proposal to make a forward looking switch for b. only. Other changes could represent a significant re-basing of the price control and should be avoided.

Allowed Return on Equity

FQ6 In light of the equity methodology we set out in Draft Determinations for GD&T, do you have a view on how implementation could best be applied to the ED sector?

584. Electricity distribution is set to be at the heart of society’s transition to net zero. The ED2 price control has to create an environment where DNOs are incentivised to make the investments that are required to facilitate this transition as efficiently as possible.
585. Ofgem’s approach to allowed returns is flawed and gets the balance wrong. The approach Ofgem proposes to allowed returns exposes customers to the significant risks associated with setting the rate for investment too low.
586. Ofgem needs to set ED2, and future ED price controls, with an investment focus. The sector is critical to the low carbon transition, and the costs to energy consumers from underinvestment will be significant. Ofgem also has a stronger starting point than in T2 and GD2, thanks to a better-established set of comparative outcome incentives and cost benchmarking approaches relative to those other sectors.

587. Consequently, Ofgem should set a higher baseline cost of equity for ED2 than those sectors, in addition to any differences in systematic risk.⁴⁶

588. The CMA's recent provisional findings in the water sector mean Ofgem will have to reconsider and revise its methodology for estimating the cost of equity.

FQ7 Do you have suggestions on how we could estimate systematic risk for ED2 or any evidence to support a difference between ED and the other RIIO sectors, GD&T?

589. Ofgem is right to ask about differences in systematic risk. But it must not focus only on these, as it also must consider the costs to energy consumers of any underinvestment, and it should also consider sources of specific risk since, beyond a narrow CAPM, this does contribute to the cost of capital in practical terms.

590. Starting with the costs to energy consumers of underinvestment:

- a. Ofgem needs to set ED2, and future ED price controls, with an investment focus. The sector is critical to the low carbon transition, and the costs to energy consumers from underinvestment will be significant; and
- b. Ofgem also has a stronger starting point than in T2 and GD2, thanks to a better-established set of comparative outcome incentives and cost benchmarking approaches relative to those other sectors.

591. Consequently, Ofgem should set a higher baseline cost of equity for ED2 than those sectors, in addition to any differences in systematic risk.

592. As we have highlighted previously, two of the biggest risks faced by investors in regulated networks are political and regulatory risk. These risks are partly systematic, since a poorly performing economy makes political and regulatory intervention more likely, but they are not likely to be entirely systematic. If they were not compensated, their expected return of an investor will fall short of the cost of equity. This applies to all energy networks, yet Ofgem has to date failed to recognise it anywhere in its calculations.

593. Looking at specific risk more closely, Frontier Economics usefully elucidated one of the reasons that Ofgem needs to be concerned with it, and not just systematic risk, in a report we commissioned from it in 2007-08: *"Investors in debt are concerned with the total risk (diversifiable and non-diversifiable) faced by a company. This is because a key driver of the debt investor's return is whether the company defaults on its debt. The risk of default cannot be diversified away by holding a portfolio."*⁴⁷ The rest of the report focussed on empirical evidence from the late 1990s to 2005 and thus is somewhat dated, but it did highlight generic factors such as the competitive nature of

⁴⁶ As well as correcting the flaws in its assessment of the cost of equity in T2 and GD2; we covered these points in response to Ofgem's recent T2 and GD2 consultation, less than a month ago, and so do not repeat them again here.

⁴⁷ Frontier Economics, 2008, an analysis of differential risk, a report prepared for CE Electric page 9

benchmarking, and the relatively high level of operational leverage, which contribute to the specific risk facing the electricity distribution sector.

594. Turning back to systematic risk, the focus of Ofgem's question, Ofgem first needs to stop using estimates of systematic risk from the water sector, or from energy networks in Belgium. Its starting point for GB energy networks should be estimates of systematic risk from those networks, on which both SSE and National Grid provide evidence. Of these:

- a. SSE includes some weight on electricity distribution and the electricity distribution regulatory framework of comparative competition; while
- b. National Grid is focussed on electricity transmission.

595. We also note that changes in SSE's activities mean that, in future, estimates of systematic risk based on it appear likely to place a materially higher weight on electricity distribution than its historical estimates. This may provide an additional source of information relevant to electricity distribution, but it will take some time for this to emerge.

Financeability, Financial Resilience and Corporation Tax

FQ8 Do you agree with our proposal to align the RIIO-ED2 financeability approach with the approach we have taken for GD&T?

596. We agree with the considerations Ofgem highlights in the ED2 methodology consultation document, including the principles listed in paragraph 4.5.

597. We also agree that same framework for assessing financeability could potentially be applicable to multiple network sectors.

598. Ofgem does however need to consult on, and take, a decision that is appropriate for each sector, in light of the information available at the time the relevant decision is taken.

599. Ofgem will also have to consider what the CMA's recent provisional findings in the water sector mean its methodology at ED2.

FQ9 Are there any reasons why this approach should differ for RIIO-ED2?

600. We highlight no such reasons in this response – but we cannot rule them out so we fully agree with Ofgem when it says financeability analysis should focus on *"a detailed review following receipt of business plans"*.

601. It is difficult to meaningfully engage with this question in the abstract from actual business plan and price control proposals.

602. Neither can we rule out other developments that might support a different approach from the one that Ofgem has just proposed in the GD2 and T2 draft determinations. This applies not just to the possibility that different proposals might be made, as Ofgem also acknowledges at paragraph 4.7, but also to the approach to assessing financeability, which is more likely to be consistent, but which may still need to be adjusted.

FQ10 Do you have a view, supported by evidence, regarding the appropriateness of different measures to address any financeability constraints?

603. Ofgem first needs to set an allowed cost of equity that is high enough. Having done so, it will have less need to consider other financeability options.

604. Beyond this we think its next steps should include:

- a. reductions to asset lives, such as that proposed for NGGT; or
- b. reductions to capitalisation rates.

605. If Ofgem assumes notional equity issuance, or a reduction in gearing, it should make allowance for the cost of these steps on a notional basis, including the cost of:

- a. “buying back” expensive embedded debt; and
- b. any notional equity issuance necessary to fund this.

606. If Ofgem failed to do so, it would fail to fund the costs of the notional company, and would also create a strong disincentive for companies to ever adopt lower levels of gearing than its notional assumptions.

FQ11 Do you have any views on the proposed scenarios to be run for stress testing?

607. We think it is sensible to have a set of common scenarios for business plan financeability testing.

608. These should be in addition to any scenarios that a company considers relevant for its plan, not instead of them.

609. Beyond this we can only offer the following generic comments.

- a. We would not necessarily expect the same scenarios to be appropriate for ED2 as for T2 and GD2, given the sectors will face different issues and since ED2 will commence two years later.
- b. Neither are we yet far enough into our ED2 business plan development to comment on whether this has any implications for common scenarios for stress testing.

610. Ofgem should therefore continue to consult on potential common scenarios with the ENA finance working group in the run up to finalisation of the rules for ED2 business plans, in case the process of plan development allows any companies to identify additional common scenarios that should be considered.

FQ12 Do you agree with our proposal to place additional requirements on licensees in RIIO-ED2 to provide Ofgem with a) published ratings reports, and b) a financial resilience report if their issuer credit rating falls below specified levels?

611. We agree with this proposal, subject to the two comments below.

612. Proposal a) represents a minor administrative burden, provided ‘published’ means in the public domain, and that the requirement is not extended to any documents which are subscription only, such as credit opinions.

613. We think that proposal b) should be contingent on at least two agencies taking the specified downgrade action, particularly in the case of a negative watch on BBB/Baa2, unless of course only one agency has a rating in place.

FQ13 Do you agree with our proposal to align the RIIO-ED2 tax approach with RIIO GD&T including; to pursue Option A; the approach to additional protections; the approach to capital allowances; and not to pursue the Fair Tax Mark certification as a requirement for RIIO-2?

614. We set out our response to Ofgem’s tax proposals in the T2 and GD2 draft determinations, in response to FQ15, FQ16 and the various elements of FQ17 (which comprised four sub questions).

615. We do not reproduce this response here for brevity and refer the reader to those responses for our full views and reasoning.

616. Instead we give a brief summary of the many issues covered.

- a. We support Ofgem’s proposal to not pursue the Fair Tax Mark certification.
- b. We support the proposal to roll forward capital allowances.
- c. We support the retention of the tax trigger for changes in corporation tax rates, including its application without a threshold.
- d. We support the proposed glidepath for the tax clawback mechanism, if there is any reduction in assumed gearing.
- e. We do not support the “additional protections”, which:
 - i) is a “regulatory solution without a problem to solve” based on Ofgem’s analysis of taxes paid versus allowances;
 - ii) will remove or reduce the incentive for licensees to identify efficient and legal approaches to managing their tax bills, and thus appears designed to promote the interests of the Exchequer ahead of Ofgem’s duty to energy consumers;
 - iii) will add to administrative burdens for licensees and Ofgem, including the costs of the “independent examiner”, and therefore the costs borne by energy consumers; and
 - iv) could be triggered by relatively minor tax timing differences.
- f. If Ofgem does implement the additional protections, it should:
 - i) apply these once per period, in a close out review;

- ii) use a cumulative materiality threshold, based on the full period's worth of annual values under the current tax trigger; and
- iii) apply the sharing factor to any clawback, so that licensees still have an incentive to manage their tax bills to the benefit of energy consumers.

FQ14 Are there any reasons why this approach should differ for RIIO-ED2?

617. We do not agree with Ofgem's approach for the reasons set out in response to the previous question.

RAV Indexation, Regulatory Depreciation and Capitalisation

FQ15 Do you agree with our proposal to implement CPIH inflation?

618. Given that Ofgem is moving away from RPI inflation, we support its approach to move immediately to a new inflation measure, to ensure a "clean break" and avoid RPI inflation from persisting through the back door.

619. We provided a view on the relative merits of CPIH vs CPI inflation in our response to Ofgem's consultation on the T2 and GD2 methodology, which we reproduce below.

620. "We have previously favoured CPI inflation over CPIH inflation, because CPI inflation has hitherto benefited stronger institutional protections, and been more likely to form the basis for any liquid market in CPI inflation linked bonds.

621. "Both of these points have weakened recently, for example the UK's exit from the EU is likely to weaken institutional protections afforded to CPI, and the advantages of CPI over CPIH are now less clear cut."

FQ16 Are there any reasons why this approach should differ for RIIO-ED2?

622. No. We think consistency across energy networks should be beneficial to energy consumers as it promotes investor familiarity with the framework and over time may help to keep the cost of capital marginally lower than it would otherwise have been.

FQ17 Do you have any specific views or evidence relating to useful economic lives of ED network assets that may impact the assessment of appropriate depreciation rates?

623. Although the question focusses on the useful economic life of ED network assets, we think Ofgem has appreciated that this should not be the only consideration in determining regulatory depreciation rates.

624. This is because its principles for ED1 include that *"The depreciation allowance... should be set, so that different generations of consumers pay for network services broadly in proportion to the value of the services they receive, whilst having regard to balancing affordability, financeability and the interaction between depreciation and capitalisation."*

625. Looking at the points in this principle in turn:

- a. The first of these points – ensuring that different generations of consumers pay for network services in proportion to the value of the services they receive – is a very different thing from simply setting the depreciation rate equal to the useful economic lives of ED network assets. We go on to demonstrate this in our response to the following question.
- b. The subsequent points, including balancing financeability, give further reasons that a regulatory asset life may depart from the useful economic life of an asset. It is hardly surprising that a regulator should consider this fact. In fact, Ofgem has at previous price controls adjusted asset lives for precisely this reason, and it is this interplay with financeability that has led Ofgem to adjust NGGT's depreciation balances, at least on our understanding of the T2 draft determinations.

626. In our response to the next question we set out evidence that is relevant to each of these points.

FQ18 During RIIO-ED1, the assumed asset life is being increased. Do you consider another change is required in RIIO-ED2 to reflect the expected economic asset life? If so, do you have supporting evidence and proposals, at this stage?

627. In order to create much needed financial headroom to help fund any major increase in investment for the low carbon transition, Ofgem should:

- a. Set the asset life for business as usual levels of investment at the current average (ca. 25 years); and
- b. Retain flexibility to use the longer 45-year asset life, for any significant additional investment.

628. This is also necessary to be inter-generationally fair, by ensuring that:

- a. Future (as well as current) customers benefit from a historically small asset base, allowing these savings to offset some of the costs of the low carbon future; while
- b. Any big increase in investment can still be spread fairly over time.

629. This policy would have many other advantages, as we highlighted in our response to Ofgem's ED2 open letter (question 45).

- a. It would help maintain company cashflows so they can respond when investment is needed, whenever that might be.
- b. It would ensure Ofgem is not trapped by the strained cashflows that uniform 45 year asset lives will create through the late 2020s and into the 2030s, if major additional investment is needed in that window.
- c. It would avoid a "price escalator" that would raise network charges above current levels, even if expenditure does not need to increase, on account of higher long-term regulatory asset value (RAV).

- d. It would reduce the inevitable upwards pressure on the cost of capital that would be caused by a significantly larger RAV in the future.

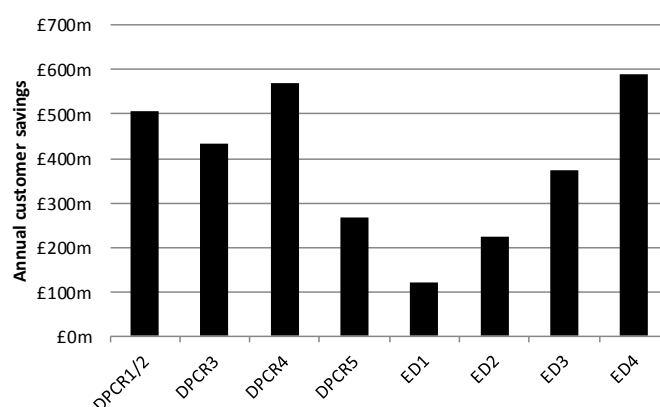
630. Below we set out evidence on three core strands of our case that:

- a. current customers have not been overpaying under 20 year asset lives;
- b. the RAV, and network charges, would increase significantly if 45 year asset were maintained; and
- c. the 45 year asset life policy could strain financeability as electricity distribution heads into the net zero transition.

Current customers have not been overpaying under 20 year asset lives

631. The chart below shows how much money electricity distribution customers have saved, and would have saved, under the pre-RIIO depreciation policies, in comparison to a 45 year policy (had this always been in place).

632. This proves the fallacy of the argument that the pre-RIIO 20 year asset lives were causing energy customers to pay too much. To the contrary, they were saving those energy customers money.



633. This can be explained by the following facts.

- a. Energy consumers were given a 'privatisation dividend', that meant annual charges for network use were below those that would have been levied if assets always been subject to 45 year asset lives.
- b. Successive policies of accelerated depreciation, at DPCR2 to DPCR5, helped maintain this privatisation dividend, and while it had narrowed as investment expenditure increased in DPCR5, it would have remained positive during ED1, and could have increased again afterwards.

634. The change to extend asset lives at ED1 is now pushing network charges further below economic cost reflective levels, because current consumers are enjoying the benefits of past accelerated

depreciation on old assets, but are gradually reducing the contribution they make to future consumers by paying less depreciation on new assets.

635. The move to 45 year asset lives is unwinding the “privatisation dividend”, to the benefit of current customers, but to the detriment of future customers. Future customers will have to pay the full cost of the services they receive. But current customers will get an even bigger discount than they would have done under the original 20 year policy.

636. This simply does not meet Ofgem’s ED2 principle that *“different generations of consumers [should] pay for network services broadly in proportion to the value of the services they receive, whilst having regard to balancing affordability”*. Under Ofgem’s 45 year policy:

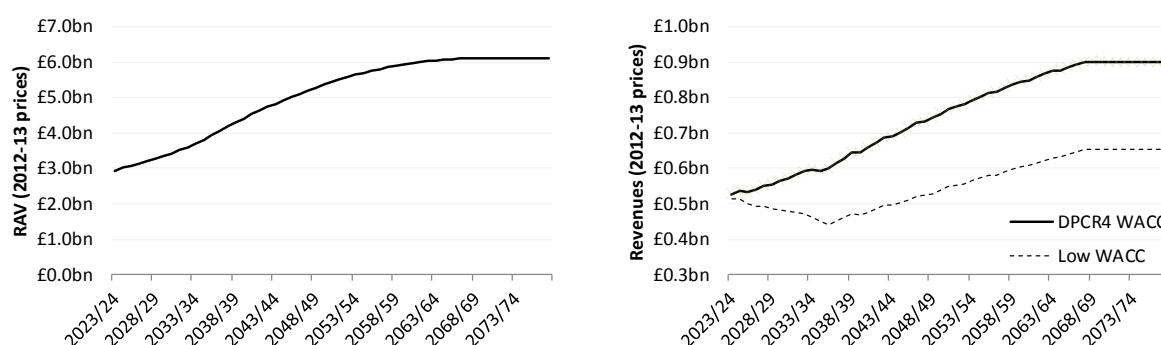
- a. current customers will pay for a lower proportion of the service they receive; while
- b. Ofgem is increasing the proportion future customers will pay to much higher levels.

637. It also means that Ofgem has significant scope to shorten asset lives at ED2 while still ensuring that current customers continue to pay less than they would have done if asset lives had always been 45 years (thanks to the benefits they already enjoy from a lower starting RAV).

638. And if the transition does require a major uplift in expenditure, 45 year asset lives could be applied to this increment, mitigating any near term bill impact and spreading the additional cost fairly over time.

RAV and charges will increase significantly under 45 year asset lives

639. Ofgem’s 45 year asset life policy could see DNO charges rise by over 70% even with no change in expenditure. The charts below illustrate both the growth in RAV, and the potential growth in charges, that would result from a 45 year asset life policy for a Northern Powergrid scale DNO at current expenditure levels.



640. The first chart shows that the RAV would approximately double from current levels – a very direct consequence of the more than doubling of asset lives.

641. The second chart shows the impact on charges, factoring in depreciation and capital payments.

- a. If the WACC stays at very low levels, there would be a temporary reduction in total distribution charges followed by a larger and permanent increase, so the costs to future consumers would greatly outweigh the benefit to current consumers.

- b. If the WACC rebounded towards DPCR4 levels, this, combined with the greatly enlarged RAV, would see total distribution charges could almost double, before the effect of inflation.

642. If Ofgem maintains its current asset life policy, it is essentially gambling that the WACC will stay at extremely low levels; anything above a small increase in the WACC will cause major costs to distribution users.

643. And this gamble will be even bigger if more money has to be spent on the distribution networks through the net zero transition.

A 45 year asset life policy could strain financeability

644. Credit ratings would also be strained during the transition. This may require Ofgem to set a higher WACC (e.g. because the cost of debt would be higher) which would be costly to energy consumers. And this risk would be even worse if the low carbon transition requires significant additional expenditure on networks.

645. Ofgem recognised this in its defence, at a CMA hearing into the appeal by British Gas of the ED1 price control modification, of its decision to allow electricity distribution companies a transition period to 45 year asset lives. This decision granted more time to consider the issue and adjust asset lives as appropriate. The CMA recounted Ofgem's argument as follows.

In response, GEMA provided a new argument which it had not included in the RIIO-ED1 process or its Response. GEMA confirmed that it did have some concerns about the end point, ie the medium-term use of 45-year indexation. Therefore, in addition to the evidence provided in the Notice of Appeal, it confirmed that it was likely to review the end point. This reflected the pictures presented above from GEMA's analysis, which demonstrated that there would be a sharp decline in revenues over ED2 and ED3. GEMA stated that it had concluded that there was a risk to financeability in the medium term, and therefore that a more substantive review would be appropriate.

As a result, GEMA stated that in coming to its decision on a transition for ED1, it was also having regard to the need for such a review of medium-term effects. It was not only looking at the appropriate transition on the assumption that the 45-year asset life would be implemented in full from ED2. For example:

*"It was becoming clearer to us that it would not be in the consumer interest to [...] dive headlong into this deep valley of depreciation and that a transitional period would provide us with a somewhat softened approach, which would allow us time to reflect before we reached RIIO-ED2 as to how to take this forward."*⁴⁸

⁴⁸ Competition and Markets Authority, 2015, British Gas Trading Limited v the Gas and Electricity Markets Authority, Final determination, paragraph 7.31 – 7.32

646. In other words, Ofgem deliberately delayed the policy in order to buy itself more time.

647. The fact that 45 year asset lives could cause financial strain beyond the ED1 period is something we explicitly highlighted in our ED1 business plan, as set out in the figure reproduced below.⁴⁹

		RIIO-ED1 period		RIIO-ED2 period	
		2015-19	2019-23	2023-27	2027-31
Moody's ratios	Adjusted interest cover				
	Net debt / RAV				
	FFO / Net debt				
	RCE / Capex				
S&P ratios	FFO interest cover				
	FFO / debt				
	Net debt / RAV				
Fitch ratios	Adjusted interest cover				
	Net debt / RAV				
Key:		A	BBB	Strained	

Figure 1: Credit metrics under the low rate scenario

648. As we are still developing our ED2 plan it is not yet possible to present comparable evidence using current financial parameters.

FQ19 Do stakeholders support licensee specific capitalisation rates for the ED sector?

649. No, we do not support licensee specific rates.

650. Instead we support a benchmarked sector average so that all companies have the same capitalisation rates.

651. We have two reasons for this.

- a. **Any differences may reflect nothing more than accounting assumptions:** the relatively small differences across licensees in the ED1 settlement are just as likely to have reflected differences in calculations of the capitalisation rate rather than differences in the underlying proportions of long lived versus short lived expenditure.⁵⁰
- b. **A benchmarked approach would further reduce any bias towards network investment solutions:** the RIIO approach to regulation imposes a fixed capitalisation rate so that licensees have less reason to favour capital over operating or innovative solutions such as flexibility services, at least in terms of RAV growth.⁵¹ Applying a benchmarked average capitalisation rate would apply this principle to the business planning process, such that a licensee that forecast it would use more of such solutions in its business plan would not receive a lower capitalisation rate.

652. Ofgem has argued in the Consultation, in response to our proposal, that a benchmarked average could cause inconsistency and inaccuracy.

⁴⁹ Northern Powergrid, March 2013, ED1 business plan, Annex 3.2: credit metrics, page 7

⁵⁰ This includes WPD's capitalisation rate, which we understood at the time was calculated using a different treatment of pensions (compared to the calculation used by other licensees).

⁵¹ This potential bias towards RAV is a concern that stakeholders have raised in respect of energy network decision taking.

653. To the contrary, it is very evident that the largest variations in capitalisation rates in ED1 are the result of inconsistency and inaccuracy in the company proposed values that Ofgem used. Indeed, we are sure that Ofgem is aware that the accounting standards on which the values it proposes are likely to allow inconsistencies to persist. A weighted average across the sector could therefore be more consistent.
654. And given that Ofgem explains, in paragraph 8.4, that “the RAV no longer precisely corresponds to physical assets” and also in its design principles at paragraph 8.12 that the capitalisation rate should reflect only “the broad balance between capital and non-capital expenditure”, we see no basis for Ofgem to reject our proposal, and even less basis for Ofgem to suggest ex post true up to actual capitalisation rates. Neither should it matter that only one licensee has suggested this, which Ofgem mentions in its reasoning at paragraph 8.15, as this is irrelevant to the substance of the issue.
655. Lastly, Ofgem states that “It is not clear to us that there would be significant incentive benefits to outweigh the potential drawbacks”. Our proposal in fact takes Ofgem’s existing RIIO policies as its inspiration, and we thought it was the logical next step in furthering Ofgem’s DPCR5 and RIIO policies, of using fixed capitalisation rates in order “to help equalise incentives” and to “avoid distorting decision making”.

FQ20 For one or more aggregations of totex, should we update rates ex-post to reflect reported outturn proportions for capex and opex?

656. No, Ofgem shouldn’t update capitalisation rates to reflect reported proportions of capex and opex.
657. A fixed capitalisation rate is simple and well understood, while an ex post true up re-introduces unnecessary complexity.
658. Ofgem has also previously stated that it thinks there are benefits from using fixed capitalisation rates and that using actual capitalisations rates results in “distorting decision making” and unequalised incentives. Given a fixed capitalisation rate was one of Ofgem’s major RIIO innovations, we are not sure why Ofgem is now considering reverting to the use of actual capitalisation rates; it would therefore help if Ofgem could set out why it is now considering a change back, in light of its previous reasoning on this topic (which we reproduce below).

In DPCR5, we modified our approach to capitalisation, with all companies having a fixed percentage of their total network costs capitalised into the RAV and the rest being expensed in year. This was intended to equalise the incentives on capex and opex and avoid distorting decision making.

Going forward we believe that to help equalise incentives we should set a fixed percentage of total expenditure to be capitalised during the price control period. We will set the percentage at the price control review, seeking to strike a fair balance between existing and future consumers in light of the nature of the expenditure expected over the

*price control period (e.g. drawing on the amount of capex like costs submitted in a company's business plans).*⁵²

Directly Remunerated Services, Disposals and Dividend Policy

FQ21 Are there any reasons why the RIIO-ED2 approach to directly remunerated services should differ from RIIO-ED1?

659. We think the ED1 approach to directly remunerated services remains fit for purpose for ED2.

FQ22 Do you support our proposal to continue the RIIO-ED1 approach to disposal of assets for RIIO-ED2?

660. Yes, we support this approach. It balances the incentive to dispose of assets against the cost of investing in new assets.

661. As an aside, the wording of this section of the Consultation gives the impression that asset disposals proceeds includes amounts recovered from third parties for damage to the network. This is not technically correct in the ED1 treatment, although the outcome is the same. Amounts recovered from third parties for network damage are included within totex (as cost recoveries) but are not classified as disposal proceeds.

FQ23 Do you agree that additional reporting on executive pay/remuneration and dividend policies will help to improve the legitimacy and transparency of a company's performance under the price control?

662. We responded to this question in Ofgem's consultation on the T2 and GD2 draft determinations and reproduce this below.

663. "No, we do not support these additional reporting requirements in respect of executive pay or dividend policies.

664. "Ofgem should not require licensees to publish details of executive remuneration.

- a. The hurdle Ofgem must get over before it requires a company to disclose (for publication) someone's personal data which – absent the request from Ofgem – the company is contractually bound to keep confidential must be very high.
- b. Ofgem is not the appropriate body to determine that this information should be disclosed. Parliament, the Financial Conduct Authority and any exchange a company's securities are listed on set the rules in respect of good corporate governance and the disclosure of directors' remuneration. These rules invariably recognise that the requirement to disclose information should vary depending on the nature of the securities that are listed.

⁵² Ofgem, 2010, RIIO handbook, page 109, paragraphs 12.20-21

665. “Ofgem’s argument that publication is required because the licensees are natural monopolies and regulated companies doesn’t stand scrutiny:

- a. To the extent that the licensees need to be treated differently to any other company, Parliament has already set out additional reporting requirements (e.g., section 42C of the Electricity Act 1989).
- b. Ofgem has put in place a price control that ensures licensees are incentivised to keep all costs as low as they can; this includes indirect costs.
- c. Directors’ remuneration is a tiny fraction of a licensee’s cost base. Ofgem should not be micro-managing certain cost sub-categories; within the envelope of its allowed costs, it is for the licensee to determine how to meet its obligations as efficiently as possible.

666. “Ofgem should also consider the risk that this will place upwards pressure on the pay of executives at companies that have managed their executive pay most efficiently, by revealing pay rates across the market.

667. “If Ofgem does wish to pursue this further, it could consider whether or not gathering the information at an aggregate level for each licensee would be more appropriate. This may just involve a cross-reference to the company accounts, which could be accompanied by a high-level explanation as to how remuneration is set.

668. “The requirement for additional reporting on dividend policies is also unnecessary. Company law and the ringfence provisions in the licence already provide adequate protection to stakeholders that licensees cannot pay dividends when they shouldn’t.

669. “Ofgem should instead focus on promoting legitimacy through how it explains the role of private sector involvement in energy networks, and how this benefits energy consumers.”

Return Adjustment Mechanism

FQ24 Do you agree with our proposal to introduce a symmetrical RAMs mechanism?

670. Yes, we do.

FQ25 Do you agree with our proposal to introduce a single RAM threshold level of 300 basis points either side of the baseline allowed return on equity?

671. Yes, we do.

FQ26 Do you have any other comments on our proposals for RAMs in RIIO-ED2?

672. Having taken the trouble to implement a RAM, Ofgem should then be willing to set strong incentives across the rest of the settlement, given how well these have served energy consumers through the lower costs and better performance they have encouraged.

673. The ED2 price control has to create an environment where DNOs are incentivised to make the investments that are required to facilitate this transition as efficiently as possible. Yet Ofgem is

largely proposing to replicate many aspects of its T2 and GD2 methodology. That methodology isn't appropriate for electricity distribution.

674. As we explained in our response to the T2 and GD2 draft determination consultation:

At each turn the draft determinations replace the incentives that are meant to be a cornerstone of the RIIO regime with uncertainty mechanisms, ex post assessment, claw-backs and a reduction in the rewards that are available where a company finds a more efficient way of running its business. The harm this will do to consumers will be incremental. It will build slowly and over a long period of time. But it will be costly.

675. Although Ofgem appears poised to stick to this philosophy, we believe there is still ample opportunity for it to create a price control that better protects customers, using controlled (and now capped) incentive mechanisms to drive innovation and new levels of efficiency and service.

676. In any scenario, we would argue that customers are better served by a price control that makes more use of this approach. Even if Ofgem believed that for the next period all the DNOs have to do is to keep the networks ticking over with a blend of asset replacement and maintenance, it would still be better to place more reliance on the mechanisms that have driven the significant improvements in service and efficiency in the sector.

677. But Ofgem (and Government) expects the DNOs to begin to provide the platform for societal decarbonisation, to transition into the role of DSO and to seek out innovative solutions other than reinforcement to solve constraints on the network. In this scenario, the cost to customers of diluting incentives by increasing the scope for subjective, ex-post adjustments and regulatory micromanagement - at the same time as setting too low an allowed return on investment - are very significant.

678. The remedy for this is for Ofgem to adhere more closely to the RIIO principles that set the framework for these price controls. Ofgem should look to set a well calibrated ex ante allowance that covers most of a DNO's expenditure, coupled with meaningful incentives to drive further efficiency and improved performance.

679. And the RAM should help give Ofgem the confidence to do so.