

Steven McMahon
Deputy Director, Electricity Distribution & Cross Sector Policy,
Ofgem,
10 South Colonnade,
Canary Wharf,
London E14 4PU

1 October 2020

Dear Steve,

SSE Distribution response to the RIIO-ED2 Sector-Specific Methodology Consultation

On behalf of Scottish Hydro Electric Power Distribution plc and Southern Electric Power Distribution plc, we welcome the opportunity to respond to the Sector-Specific Methodology Consultation (SSMC) for RIIO-ED2.

Since the publication of Ofgem's Framework Decision for RIIO-ED2 in December 2019, we have been engaging pro-actively on key issues with Ofgem, other Distribution Network Operators (DNOs), and stakeholders. Our response to the SSMC therefore reflects our extensive on-going stakeholder engagement for RIIO-ED2.

We provide a comprehensive and evidence-based response to all questions included in the SSMC in Appendix 1. In this cover letter, we highlight areas of concern and proposals for changes which we think are necessary to ensure RIIO-ED2 can deliver for consumers now and in the future, as well as wider stakeholders and our shareholders.

Learning the lessons from RIIO-T2 and GD2

There is an opportunity to learn from the experience of RIIO-T2 and GD2, where new approaches and mechanisms are being tested. The application of any of these proposals to RIIO-ED2 will require careful consideration, and Ofgem should not shy away from taking a different approach to RIIO-T2 and GD2.

Business plan assessment process and implementation of the Business Plan Incentive (BPI)

Further work is required by Ofgem to develop and implement a business plan assessment process which is robust, transparent and fair. This extends to the application of the BPI, which has proven to be heavily skewed towards the downside, with companies for example earning similar levels of penalty regardless of whether minimum requirements have been met.

Stakeholder responses to RIIO-T2 and GD2 Draft Determinations have highlighted significant errors in the cost assessment and BPI process. It is imperative that these are resolved, and that clarity is provided on a number of fronts, such as the extent to which disallowed costs are eligible for a penalty in Stage 3 of the BPI. Similarly, the application of a Confidence Dependent Incentive Rate (CDIR) requires a transparent and

objective approach, and must ensure companies remain incentivised to drive efficiencies through the Totex Incentive Mechanism (TIM).

We note the limited rewards proposed by Ofgem in RIIO-T2 and GD2 Draft Determinations. We urge Ofgem to reconsider the BPI to provide genuine opportunities for reward under stages 2 and 4 of the mechanism. This is necessary to ensure the regulatory framework continues to incentivise behaviours that are in the long-term interests of consumers.

Setting clear expectations

Ofgem must provide DNOs with as much clarity as possible on what it considers constitutes a high-quality, ambitious and robust business plan.

We welcome the additional clarifications that Ofgem has provided in the SSMC and associated updated Business Plan Guidance, for example around Consumer Value Propositions (CVPs) and Price Control Deliverables (PCDs). With regards to CVPs in particular, we would welcome early discussions with Ofgem to agree on reasonable and proportionate approaches to valuing consumer benefit.

We have significant concerns with Ofgem's proposal to reset minimum requirements following the submission of our first draft business plan. Potential late changes to minimum requirements create a moving target and the approach is at odds with the concept of stakeholder-led business plans. We have yet to see details of the process for resetting minimum requirements (including timings, consultation, treatment of additional costs, and opportunity to retest plans with our stakeholders). It is therefore difficult for us to assess the implications of Ofgem's proposals for our customers and stakeholders. We recognise the importance of ensuring minimum requirements reflect stakeholder needs. We believe that there has been ample opportunity for Ofgem to test these through the SSMC process and associated working groups.

The next few months are critical to the business plan development process, and we would reiterate the need for Ofgem to provide a clear steer in November 2020 in relation to the Access Significant Code Review (SCR). The outcomes of the SCR will have substantial implications for how we plan and manage our networks, and it is not yet known how fast and how significantly customer behaviours will change. We are keen to keep the dialogue going with Ofgem to ensure the RIIO-ED2 framework is able to adapt accordingly.

Stakeholder-led business plans

We would urge Ofgem to reconfirm its commitment to stakeholder-led business plans for RIIO-ED2. We would further welcome clarification from Ofgem on how stakeholder views and evidence will be considered in the RIIO-ED2 decision-making process.

As we enter the next phase of our extensive stakeholder engagement programme, it is important that we are able to communicate to our stakeholders how their needs and concerns and feedback will be reflected in our business plans, and taken into account by Ofgem. For example, many of our stakeholders have already participated in workshops on Local Network Plans (LNPs), with further engagements still to come. However, the SSMC is currently unclear on the role LNPs will play in determining investment needs, and there is therefore a significant risk of frustrating stakeholder expectations.

Delivering Net Zero

We firmly believe that DNOs have a central role to play in the delivery of Net Zero, and that this must be reflected in the RIIO-ED2 framework. In order to successfully deliver Net Zero, Ofgem must actively balance the interests of current and future consumers, recognising that investment today will help keep bills low in the future, delivering wider societal benefits and resulting in lower costs to consumers overall.

Recognising the importance of regional and local plans in strategic investment

Credible plans that deliver Net Zero will need to reflect local as well as national requirements, in particular devolved administrations' targets and policies, such as the legally-binding 2045 Net Zero target in Scotland. In addition, there may be a strong case for our plans to account for more localised ambitions, for example where these are supported by clear funding commitments. In these circumstances, LNP should be fully recognised as fundamental to ensuring local needs are fully reflected in investment planning and decision-making. Underpinning our approach, we propose DNOs develop their ex-ante baseline LNP starting with a baseline DFES, with well justified adjustments made based on the strength of the evidence presented by devolved and local authorities.

It is also essential that the regulatory framework for RIIO-ED2 remains flexible. It needs to facilitate timely and efficient investment, meet the needs of consumers, and deliver on Net Zero obligations and ambitions for a green recovery. In our response, we highlight issues with Ofgem's proposals for funding strategic investment included in the SSMC. We propose an alternative approach which we think provides sufficient flexibility, while addressing Ofgem's concerns in this space.

Managing uncertainty

The introduction of a fair and robust framework for managing uncertainty that provides clarity to stakeholders and confidence in regulatory decision-making will be central to the successful delivery of Net Zero. This will allow companies to continue providing high-quality services to their customers, and work with their supply chain to plan ahead and deliver efficiencies.

Further discussions are required to develop an appropriate framework for managing uncertainty for RIIO-ED2, which protects customers without creating unnecessary complexity or causing undue delays to investment. In the case of re-openers, this should include enabling companies to trigger key mechanisms such as the Net Zero re-opener, and allowing sufficient time to prepare and submit any requests for additional funding. Ofgem should further set out, and commit to, a fair, transparent and timely process for decision-making.

Driving innovation, whole systems and transition to DSO

We are broadly supportive of Ofgem's approach to innovation. We agree that, where appropriate, innovation should become business as usual. This must be underpinned by proportionate baseline funding and a strong TIM. With regards to the proposed RIIO-2 Strategic Innovation Fund (SIF), while we are supportive of the overall approach, further details are required on how the mechanism will operate in practice. We also welcome the retention of the Network Innovation Allowance (NIA), which we believe would be well suited to funding innovative consumer vulnerability initiatives.

We are building on the learning achieved in RIIO-ED1 through innovation projects, such as SSEN's Local Energy Oxfordshire (LEO). As the functions of a DSO are more clearly articulated, we believe it is evident

that they naturally fit with the DNOs current permitted purpose and this creates maximum potential to deliver efficient and coordinated outcomes. However, the regulatory framework must give legitimacy to new functions, be transparent, and provide appropriate funding to deliver efficient outcomes.

We have already taken significant steps in RIIO-ED1 to implement whole-system solutions, for example through our Shetland project. Our view is that a strong BPI should reward companies for bringing forward whole system solutions, and there should be a clear link between innovation funding and whole system solutions. We provide detailed feedback on the proposed Coordinated Adjustment Mechanism (CAM) in our response.

A strong incentive package that delivers for consumers

A strong package of incentives is required in order to deliver for consumers, including the TIM sharing factor and Output Delivery Incentives (ODIs). Based on the information provided in the SSMC, we are unable to carry out a full assessment of the proposed incentive properties of the RIIO-ED2 framework. While we recognise the concerns with the perceived outperformance in RIIO-ED1, we would urge Ofgem not to overcorrect, for example by applying a Return Adjustment Mechanism (RAM), in addition to weakening the TIM and limiting rewards on ODIs in a way that does not reflect benefits delivered to consumers. This approach will have a distortionary effect on incentives, leading to adverse impacts on consumers.

We provide detailed feedback on all proposed ODIs in our response. We welcome the strong focus on vulnerability through the introduction of a new vulnerability strategy ODI, and the introduction of a new DSO ODI. Ofgem are proposing a number of incentives based on this same model and need to provide clarity on how these will work in practice.

We are disappointed by the lack of specific ODIs designed to encourage improvements in our natural environment and wider sustainability and would welcome further discussion in this space. We would also ask Ofgem to keep the door open for CVPs and bespoke ODIs where supported by robust evidence of stakeholder support and benefits to consumers.

Finance

The overall financial framework for RIIO-2 has been in development for several years since the RIIO-2 Framework Consultation in 2018. The industry has responded to the Sector Specific Methodology Consultation (SSMC) for GD2 and T2, the Sector Specific Methodology Decision (SSMD) for GD2 and T2 and now the Draft Determinations for GD2 and T2. The ENA Finance Working Group has presented significant evidence over this period. This includes submitting evidence to, and attending, third party hearings at the CMA for NERL's appeal of RP3 and the four water company appeals of PR19. As we have seen in the Provisional Findings published by the CMA on PR19, the cost of capital has been increased significantly for the four appealing water companies. As Ofwat has relied on a similar approach and evidence to Ofgem, we see this as a key development for RIIO-2. The CMA has corrected a number of errors made by Ofwat which will have implications for how Ofgem sets the cost of equity. Ofgem must ensure these errors, as well as other errors identified throughout RIIO-ED2, are corrected in advance of the Sector Specific Methodology Decision for RIIO-ED2 (SSMD). We have provided evidence in support of our position to Ofgem and to the CMA (as part of RP3 and PR19 appeals). Please see our response to the questions in the finance annex for further information.

Impact Assessment

We urge Ofgem to give due consideration to the issues flagged in our response to SSMC. While we have not provided detailed comments on the draft Impact Assessment (IA) included in the SSMC, we are concerned that Ofgem has not fully articulated all impacts, in particular the risk of under-investment or delayed investment. The proposals set out in the SSMC could also overall result in a significant change in approach compared to RIIO-ED1. As highlighted above, it is important to ensure that RIIO-ED2 does not accidentally over-correct for perceived issues in RIIO-ED1. We would also ask Ofgem not to underestimate the implementation risks associated with the introduction of significant changes to the regulatory framework across a number of different areas, including RIIO-ED2 and the Access SCR. As noted by Ofgem in the IA, this could result in the sub-optimal implementation of policy decisions, and material errors affecting network companies and the benefits delivered to consumers.

We are keen to continue working closely with Ofgem in the run-up to the Sector-Specific Methodology Decision to help ensure RIIO-ED2 delivers for consumers now and in the future. In the meantime, please do not hesitate to get in touch with any questions on our response.

Yours sincerely,

Clothilde Cantegreil

Head of Regulatory Strategy, RIIO-ED2

Appendix 1 – Responses to consultation questions

SSMC Overview document

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?

Please see our response to OVQ2 below.

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

We disagree with Ofgem’s proposals relating to the introduction of a post-appeals review and pre-action correspondence on the same grounds as those articulated in our responses to Q41 and Q42 of the RIIO-T2 and GD2 Draft Determinations (core document). For ease of reference, these are included in Appendix 2 of this letter.

We also note Ofgem’s proposal in paragraph 3.22 of the RIIO-ED2 overarching document to carry out an exercise to identify “interlinked components that come together to create an integrated price control,” in line with the approach taken in the other sectors. As highlighted in our response to Q39 and Q40 of the RIIO-T2 and GD2 Draft Determinations (core document), we do not consider that it is a useful or appropriate exercise to attempt to enumerate or categorise the relationships in the abstract, particularly in advance of the Final Determination. We understand the term “interlinkages” in this context is referring to a legal concept developed in the decisional practice of the Competition and Markets Authority (CMA). In that context, the question of whether any interlinkage arises can only properly be assessed on a case-by-case basis in light of the specific flaws identified in grounds of appeal raised in respect of Ofgem’s final price control decision. Moreover, it is clear that in certain cases an imbalance in the price control caused by a specific flaw in Ofgem’s decision can properly be corrected by a change to only one of a number of related aspects thereof. Whether any relevant interlinkages exist (in the sense used by the CMA in its decisional practice) and, if so, the consequences for any remedy that the CMA orders to correct Ofgem’s decision is a matter for the CMA, and not Ofgem, to determine.

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

We welcome Ofgem’s recognition that achieving the most effective transition to Net Zero requires an adaptive regulatory regime. To be truly adaptive, any cross-sector mechanism must be able to respond to an identified need, regardless of the source, in a timely manner and in a way that however require clearer guidance on the parameters of use to avoid unintended interactions with other mechanisms. We urge Ofgem to recognise that the mechanism should be capable of adjusting upwards as well as downwards. Further we urge Ofgem to provide enough flexibility to allow the mechanism to be triggered as and when required; and allow network licensees, not just Ofgem, to trigger the mechanism. Network companies are at the heart of designing and delivering these investments and have a close relationship with customers and understanding of their specific technical needs; allowing us to bring forward proposals in a

collaborative approach with Ofgem, and other stakeholders, will ensure proposals leverage our unique insights on network capability and customer needs, which will enable more efficient and cost effective solutions to be developed.

We support the introduction of a Net Zero Advisory Group (NZAG) to provide increased strategic coordination between Ofgem, Government and key stakeholders. However, we believe that informed and effective development and implementation of Net Zero policies can only happen if network licensees, and their stakeholders, also have a role in the process, including a route to present, inform and influence the debate. We would like to explore with Ofgem ways in which we can ensure transparency, for example through ENA engagement. The group composition must also be suitably diverse with the right expertise to understand local issue. We urge Ofgem to reflect on the membership to ensure it represents the needs of consumers in remote and island communities, who are often near to some of the biggest infrastructure developments. This should go beyond just including devolved authorities within the group membership.

We would welcome clarity on the role Ofgem anticipates NZAG will play in the Net Zero Re-opener decision-making process. We note the importance of ensuring the process remains transparent and enables timely decisions so that projects can go ahead without unnecessary delays.

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

Please see our response to OVQ7.

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

Please see our response to OVQ7.

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

Please see our response to OVQ7.

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?

We have chosen to respond to questions OVQ4-OVQ7 with a single response given their significant overlap. We welcome Ofgem's continued focus on Strategic Investment for RII0-ED2. This is a vital component in enabling investment to support Net Zero.

Whilst we are encouraged by the continued thinking and debate on Strategic Investment, we are concerned that there remain areas within the SSMC which require clarification and more detailed consideration. We believe that these should be urgently addressed by Ofgem to avoid confusion and to enable a robust and credible business plan:

1. We note the four models for Strategic Investment outlined in figure 6 of the SSMC overview document; however, we also note Ofgem has published four alternative options for forecasting in figure 5 of annex 2 for cost assessment. Furthermore, Ofgem has stated a preference to use option 3 within figure 5 of annex 2 "a common set of scenarios from which DNOs would select their own "best view"."

We note the comment in paragraph 7.22 of annex 2 “Option 3, is to fulfil a specific function (benchmarking). This does not necessarily mean that this approach should form the basis of the investment plan.” We think this could give rise to an inconsistency between the model used for cost benchmarking and that used for volumes relevant to investment planning, and that this will likely lead to confusion and inconsistency in business plan development assessments. Also, it is not clear what information and data Ofgem expects to receive from network companies to fulfil the functions of benchmarking and plan development if they are to be derived from different models or sources.

We ask Ofgem to provide clarification on the relationship between these models, and how information should be provided in the business plans? Our preference is that we should strive for consistency between models of assessment.

2. The guidance document for Business Plan Data Tables contains no mention of Strategic Investment with relation to tables CV1- CV6. We remain somewhat unclear as to whether Strategic Investment is a new load-related activity or a methodology for determining expenditure to be reported against existing categories. Further clarity is also required on the interaction with load related investment which is not Strategic Investment by definition, this might include some fault level reinforcement and new transmission capacity charges. How these are justified, including use of scenarios, and how they are funded within the baseline and through uncertainty mechanisms needs clarity. **We ask Ofgem to provide clarification on how Strategic Investments fit within the cost and volume reporting framework; and to provide guidance for non-Strategic Load Related Investment.**
3. There is no reference to the scenarios frameworks which could be used if a fully or partially centralised approach were to be taken. We note the existence of several alternatives, within the DFES framework; however, each have different set of guiding assumptions to reaching Net Zero which can vastly alter investment trajectories. There is likely to be significant divergence of opinion across stakeholders on the choice of scenario framework. **We ask Ofgem to urgently outline which DFES scenarios are available for consideration on which to base plans, the level of consistency they wish to drive across network licensees and invite stakeholder views.**

Notwithstanding the points raised above we believe the Business Plans should be based on the following methodology:

- A DFES scenario which achieves Net Zero by 2050 is agreed between the network companies and Ofgem; informed by stakeholder views. This sets a baseline scenario for all network companies;
- An adjustment to the baseline DFES scenario to account for the different target dates; for Scotland, and other devolved administrations which have a legally binding target set different to the UK target. Such as Net Zero by 2045 target in Scotland, and where the devolved administrations also have associated enhanced fiscal and policy powers, as is the case in Scotland;
- Where supported by well justified locally/ community driven evidence, DNOs are permitted to adjust the baseline DFES scenario. This could be informed by local authorities within a DNO licence area as input to the Local Network Plan (LNP);

- Using the above input definition approach, DNOs would then develop a LNP informed by Cost Benefit Analysis to set out the ex-ante baseline investments required for the RIIO-ED2 period. Uncertainty Mechanisms would be used to adjust allowances in period as the scenario landscape evolves. Our response to question OVQ9 provides further details on our proposals for Uncertainty Mechanisms

Mapping this to Ofgem's four models in figure 6 of the SSMC Overview document the methodology we outline would sit between model B and D. We believe in all cases there is a strong case for an ex-ante baseline plan supported by uncertainty mechanisms to fund Strategic Investment. Therefore, we would not support models A or C as presented.

In our proposed methodology DNOs would only to make regional (i.e. for devolved administrations) and local (i.e. for local authorities) adjustments, when this is supported by carefully assessed evidence which necessitates proportionate divergence from the agreed GB DFES baseline. It should be the responsibility of DNOs to make these adjustments using stakeholder evidence, though we would welcome Ofgem publishing in the SSMD a framework on what constitutes a clear evidence threshold, so consistency can be maintained across DNOs and divergence is grounded.

We believe evidence thresholds should be categorised around devolved and local government: (i) targets and associated policy ambition; (ii) financial support put forward; and (iii) commitment and engagement on delivery. All three elements are critical when making adjustments to the DFES baseline. Evidence thresholds are also critical because they separate aspiration from firm commitment and ensure timely delivery of investments to avoid potential issues of stranding. The Local Area Energy Plans (LAEP) Best Practise guidance produced by the Centre for Sustainable Energy and the Energy Systems Catapult has a role to play here, but as we reference in our response to question OVQ8 LNPs informed by stakeholders are likely to be more influential for baseline plans whilst LAEPs continue to mature.

We believe that the methodology proposed here is sensible and credible. Having an agreed baseline, applied across DNOs set through DFES would ensure growth trajectories for technologies which are heavily influenced by national policy, such as offshore wind farm connections and flows from the transmission grid onto distribution are set consistently. It would also set a starting point for EV, heat, battery storage and onshore wind connection trajectories, but gives sufficient latitude for well justified deviations when supported by evidence from DNO stakeholder engagement. Further, by aligning with a DFES scenario at a high-level, Ofgem can ensure the sum of the DNO plans generally align with national trajectory of the scenario for Net-Zero, providing a vital reality check.

Finally think DFES is a useful starting point because it is already established with our stakeholders; is aligned with the National Grid ESO FES framework; shares key socio and economic framing; sets GB level trends; and has consistent technology assumptions; but critically includes more detailed DNO data which we have about our network into the scenarios, and has already been identified as a future NDP requirement.

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?

LAEPs have a strong role in signalling the ambition of communities to achieve Net Zero within their areas; and DNOs have an important role to support the development of these.

There is not however a consistent set of developed LAEPs across the country and many of these will only mature within the RIIO-ED2 period. Therefore, when setting ex-ante baseline plans for submission in 2021, these may be unsuitable in some areas. As referenced in our response to question OVQ4-OVQ7, we propose DNOs develop their ex-ante baseline LNP using a methodology starting with a baseline DFES and well justified adjustments are made to this based on the strength of the evidence presented by devolved and local authorities. LAEPs if they are sufficiently developed can feed into the process of evidencing adjustments.

The LAEP Best Practice guidance produced by the Centre for Sustainable Energy and the Energy Systems Catapult has a role to play here regardless. In our response to question OVQ4-7 we ask Ofgem to publish in the SSMD a framework on what constitutes a clear evidence threshold, so consistency can be maintained across DNOs and divergence is grounded. We believe evidence thresholds should be categorised around devolved and local government: (i) target's and associated policy ambition; (ii) financial support put forward; and (iii) commitment and engagement on delivery. All three elements are critical when making adjustments to the DFES baseline. We believe the LAEP Best Practice guidance can inform this framework and help Ofgem define what constitutes a clear evidence threshold for adjustments.

Finally, many local authorities are not sufficiently resourced with the appropriate capabilities to undertake LAEP development. We request that Ofgem considers additional allowances to DNOs to enable them to support local authorities in plan development. The level of resource should be proportionate to the anticipated level of funding through uncertainty mechanisms DNOs expect to request based on developing LAEPs.

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

Funding Strategic Investment requires a balance between ex-ante baseline funding and uncertainty mechanisms. An approach is also required to provide checks and balances on investment decisions to ensure they are efficiently incurred. In our response to questions OVQ4-OVQ7, we outline our proposed methodology to allow DNOs develop their ex-ante baseline LNP using a methodology starting with a baseline DFES and well justified adjustments are made to this based on the strength of the evidence presented by devolved and local authorities. We also articulate the strong role Uncertainty Mechanisms have for adjusting allowances in period as the scenario landscape evolves.

The uncertainty mechanisms presented in appendix 3 of the overview document are comprehensive but not exhaustive. Significant technical detail on the mechanics is presented but there is limited consideration of the benefits to consumers and the relative advantages and disadvantages of different mechanisms. It is important that these are first considered so that mechanisms can be assessed. Below we outline an assessment criteria before considering each of the presented mechanisms against each

criteria and finally we conclude with our recommendations on the most effective mechanism to enable strategic investment and next steps, including our recommendation.

In presenting the SSMD we expect Ofgem to adopt a similar approach to justifying its decision.

Assessment criteria

There are four criteria against which any mechanisms must be assessed. These are outlined below alongside the supporting sub-criteria:

1. Does the mechanism provide efficient funding to cover the outputs that network companies may need to deliver in a way which protects consumers from windfalls and is resilient to change?
 - Does the mechanism support all the output types we may need to deliver, including allowing for new innovative and flexibility (non-wire) solutions which may not be known today?
 - Does the mechanism protect consumers from windfall profits and losses?
2. Does the mechanism encourage network companies to make prudent and efficient investment decisions which first consider utilisation of assets currently existing on the network before investing in new outputs?
 - Does the mechanism protect consumers from stranding or partial stranding of assets?
3. Does the mechanism allow network companies to facilitate wider policy objectives on Net Zero in a way which minimises the delivery disruption and inconvenience to consumers?
 - Does the mechanism allow network companies to invest in a proactive and timely, yet efficient way to enable society to realise Net Zero ambitions?
 - Does the mechanism promote a 'touch once' principle to network intervention as far as possible in order to minimise disruption to consumers?
4. Can the critical parameters of the mechanism be built with existing data and can the mechanisms be implemented in a straightforward way?
 - Can the parameters for the mechanism be validate using rich and robust data?
 - Does the mechanism minimise regulatory burden, and can performance be measure in an easy, transparent way which minimises additional cost to do this?

Review of mechanisms

Four uncertainty mechanisms and three output incentives are presented in the SSMC.

The approach of using Price Control Deliverables (PCD) we do not believe works because it relies on knowing with certainty what needs to be delivered, but not when. This does not to give enough scope for innovation nor is it flexible to change in the energy and economic landscape.

The approach of using a re-opener, whilst consistent with the approach to managing uncertainty elsewhere in the price control is more than likely to become excessively onerous to Ofgem and network companies if implemented to cover all Strategic Investment. We think a re-opener mechanism is suited to the highly anticipatory investments with significant deviation of costs from the baseline for single investments. We think this could operate alongside a mechanistic volume driver mechanism, but with clear delineation on its use, for example only applicable to investment above £25m triggered by the network company. Further work though would be required to clearly distinguish the re-opener from proposals outlined by Ofgem for a Net Zero re-opener.

For the volume driver mechanisms and their associated output incentives presented in the SSMC the figure below summarizes our assessment of these relative to the assessment criteria we set out above.

Assessment of Strategic Investment Uncertainty Mechanisms and Utilisation Incentives in the SSMC			
Assessment criterion	Sub-criteria	LCT Volume Driver	Capacity Volume Driver
Consumer protection and efficient funding	Does the mechanism support all the output types we may need to deliver, including allowing for new innovative and flexibility (non-wire) solutions which may not be known today?	No – the mechanism is limited to the technologies for which the unit cost is designed for. Potentially causing limitations for innovations within period	Yes – the mechanism is output based. It uses a measure independent of the underlying technology thus allowing flexibility for innovation within period
	Does the mechanism protect consumers from windfall profits and losses?	Yes – if unit costs designed appropriately using econometric analysis and a rich data set	Yes – if unit costs designed appropriately using econometric analysis and a rich data set
Network utilisation efficiency	Does the mechanism protect consumers from stranding or partial stranding of assets?	No – there is no measure of efficient utilisation of the capacity developed	Yes – there is a measure of efficient utilisation of the capacity developed
Achievement of Net Zero	Does the mechanism allow network companies to invest in a proactive and timely, yet efficient way to enable society to realize Net Zero ambitions?	Yes – the LCT incentive and dead band encourages an element of investment ahead of need	No – network companies can invest to meet capacity needs but are constrained by efficiency incentive
	Does the mechanism promote a ‘touch once’ principle to network intervention as far as possible in order to minimize disruption to consumers?	Yes – some investment ahead of need encouraged, but doesn’t guarantee no subsequent reintervention	Yes – some investment ahead of need encouraged, but doesn’t guarantee no subsequent reintervention
Straightforward to implement	Can the parameters for the mechanism be validate using rich and robust data?	No – the mechanism is limited to the technologies for which the unit cost is designed for. Potential causing limitations for innovations within period	Yes – the mechanism is output based and unit rates can be built from known investment types
	Does the mechanism minimize regulatory burden and can performance be measure in an easy, transparent way which minimizes additional cost to do this?	Yes – the mechanism is straightforward to run in practise and can easily measure its performance	No – measuring the efficiency of network utilisation will require significant investment in network monitoring, and approach to metric may mask true performance

Including an asset utilisation incentive for heat pump penetration we do not believe would be prudent alongside either the LCT or the Capacity Volume driver because the addition of the mechanism presents a risk of double funding for investments. Additionally, there would be excessive cost to implement the necessary LV network monitoring on the system to monitor peaks and trough points as set out in the SSMC.

Recommendations and next steps

Given the assessment criteria set out above we are in favour of a form of Capacity Volume driver mechanism. However, the approach set out by Ofgem we see as unimplementable especially the network utilisation strategy incentive. Indeed, Ofgem have acknowledged challenges with utilisation incentives previously and re-play this rational in paragraph 7.49 of annex 2 in the SSMC “given the number of factors that contribute to level of network utilisation, setting outputs for LIs in RIIO-ED1 would not provide a robust way to measure DNOs performance over the price control.”

We believe this continues to hold true and we go further by noting there are five fundamental flaws with the use of utilisation incentives in this context:

1. Utilisation incentives could encourage an overly cautious approach to investment ahead of need, especially as network companies look to optimise their overall utilisation level to avoid penalty. We see this as being prohibitive to achieving Net Zero;
2. There is no clear and agreed view on the optimal level of network utilisation across the network and whether an annual average number is credible to measure this. Clearly the extremes of 0% and 100% are undesirable but the true optimum is debatable. It is likely to vary based on voltage level, network legacy design, losses strategy adopted, and is heavily influenced by local weather conditions;
3. A utilisation check at the end of a price control might mask efficient longer-term decisions in the interest of consumers. In many cases it will be prudent to invest ahead of need, as Ofgem have acknowledged. Some investing ahead of certainty of need might be in the long-term interests of customers. Where the societal cost of failing to meet Net Zero and the customer cost of failing to meet LCT demand (e.g. customers can not charge cars) is greater than the investment costs today. In some cases, this could mean that assets remain below an optimal level until subsequent price controls. It is not clear how Ofgem intends to account for this in the current proposals;
4. We are also unclear how Ofgem intends to define utilisation levels within each band. This is important because peak or annual average utilisation could be used and monitoring one will mask the other, possibly leading to penalties being erroneously applied;
5. Monitoring of network utilisation across the network is not widespread given the prohibitive cost associated, especially at the LV level. It is therefore difficult to accurately determine utilisation rates for assets and allocate them to bands. Further, even if this was to be modelled rather than measured the for the current network the cost benefit of installing the monitoring equipment through the RIIO-ED2 period, especially at LV level, we believe has not been established

Rather than the Capacity Volume driver presented by Ofgem in the SSMC, we recommend a Capacity Volume driver is used without a utilisation incentive. We recognise that a mechanistic volume driver alone may not satisfy all the assessment criteria outlined above, especially a requirement to demonstrate efficient utilisation of existing capacity. To overcome this, we recommend Ofgem introduce a requirement for network companies to publish a Capacity Strategy document annually. We believe this could supplement and enhance the requirements currently in place to publish the Long Term Development Statement (LTDS) and the Network Development Plan (NDP). For this to work we foresee the following process being enacted by each DNO:

- NDP would give a regular update on the most constrained parts of our network across all voltages according to our latest scenario data and network modelling
- Following the production of the NDP an annual Capacity Strategy document would be produced and shared publicly giving the output of a Cost Benefit Analysis decision on the most constrained parts of the network indicating:

1. Investment decisions taken for the next year, including wire and non-wire flexibility alternatives;
 2. A pathway of investment decisions for future years across different scenarios, including where the DNO may need to invest and the opportunities for greater use of flexibility services;
 3. DNO capacity utilisation strategy update related to DNO decisions; supported where appropriate with output from Load Indices and additional HV and LV monitoring localised on the most constrained parts of the network
 4. Relative change in our baseline plans year-on-year (i.e. how much of the baseline plan is adjusted by the £/MW volume driver and why)
- Finally, we recommend the ongoing role of our Customer Engagement Group in the RIIO-ED2 period to provide a formal and independent level of challenge and review of the Capacity Strategy prior to submission to Ofgem
 - The volume driver unit cost will be applied to investments for the next year justified through the Capacity Strategy document

We envisage that this process will be akin to the process used by the ESO in their production of the Electricity Ten Year Statement (ETYS) and the Network Options Assessment (NOA). Through DNO's licence we envisage a set of requirements on the level of analysis which is undertaken and reported by each DNO, including timing.

We believe that introducing this process meets the assessment criteria we laid out above and importantly provides a deeper level of transparency and consistency across network companies to develop capacity in an economic and efficient way. Further it adopts a process consistent with that applied in other sectors and previously accepted by Ofgem in RIIO-T1.

With regards to calculating the unit costs for the volume driver we believe these numbers should be proposed by DNOs and assessed through an approach aligned with the cost assessment process as part of the business plan submissions. We believe unit cost should be designed following a standardised methodology which ensures accuracy and resilience. Further work is required with Ofgem and across DNOs to establish this methodology. It should though be based on established econometric techniques and academic thinking, such as regression analysis and Monte Carlo to find values for the unit cost allowances which ensure consumers are protected. We are happy to work with Ofgem and others to develop thinking in this area.

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

We support and urge alignment with the position established for transmission and gas distributions companies that companies do more innovation BAU using TotEx allowances and the TIM. At SSEN we have worked hard through RIIO-ED1 and DPCR5 to embed a cultural shift which has placed innovation at the heart of what we do, rather than a 'nice to have'. BAU funding for innovation makes up a higher portion of our total innovation costs in RIIO-ED1 than innovation stimulus projects. We have a strong network of stakeholders who we collaborate and co-create with on innovation projects and we aim to strengthen and expand these partnerships going forward to ensure we do the right thing for customers.

To make innovation work through BAU, however a strong TIM is required. Network companies and consumers must be able to realise the benefits of cost reduction against baseline. We urge Ofgem to reflect on this when setting sharing factors to recognise the long-term benefits of innovation.

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

We are broadly supportive of Ofgem's proposals for the RIIO-2 Strategic Innovation Fund (SIF). However, our view is that more information is required if we are to fully understand the potential impact of the mechanism and the extent to which it is likely to achieve the stated policy aim. We would expect to see more detail in a number of different areas as highlighted below.

Alignment with different public funding streams

We would welcome further information on how Ofgem proposes to achieve alignment with different public funding streams, especially in circumstances where other funding streams may have a different objective. There is a risk that working across different funding streams could result in conflicts between different funders' objectives.

For example, the existing NIA IPR arrangements which aim to ensure that network customers benefit from any IPR developed through NIA projects are not necessarily compatible with the objectives of other funding agencies specifically targeting the development of products and services which can then be commercially exploited.

A clear approach to addressing potential issues would be essential to keep projects efficient and delivering maximum value. The timings of various funding initiatives need to be aligned and coordinated to allow appropriate projects to be developed.

We note the introduction of a Net Zero Innovation Board. We would welcome further detail on the role of this group and on its composition. It is important that membership is balanced appropriately across geography and disciplines.

Timings and submission process

We would like Ofgem to provide more detail on the proposed processes and timings for bid development and submissions.

As we understand it, Ofgem's proposals is for bid windows to vary yearly, with the focus of each challenge to be defined as and when required. We would welcome clarity on the likely timings for the competition: this would allow companies adequate time to identify partners, engage with stakeholders, and develop high-quality submissions.

We also note that the proposed approach to setting different challenge each year, which may be broad and less well-defined, will likely have implications in terms of companies requiring more time to develop bids.

Finally, Ofgem has yet to provide information on other elements of the assessment process, including for example eligibility and assessment criteria.

Developing bids for the RIIO-1 Network Innovation Competition (NIC) is a lengthy and resource intensive process, taking up to nine months and costing in excess of £150k. Ultimately, Ofgem's proposals for RIIO-ED2 could impact on the quality of the bids and the cost of their development. We will require further information from Ofgem in order to help maintain the quality of submissions, develop relationships with appropriate stakeholders and partners in a timely, and ensure our innovation proposals align with the new framework for RIIO-2.

Company contributions and recovery of funds

The current Network Innovation Competition (NIC) requires licensees to make a compulsory 10% contribution to the overall cost of a project. Ofgem is proposing that this contribution will vary under the SIF and will be considered on a case-by-case basis. We note the importance of providing sufficient clarity in a timely manner. This will enable us to plan in advance and ensure we are able to secure budget.

A new element of the SIF is that third parties will be able to apply directly for funding. Under current arrangements, funding is recovered through network charges, based on the concept that innovation funding will lead to an overall reduction in network charges and/ or improvement in services over the longer term. We would welcome clarity on the extent to which Ofgem envisages utilizing the same mechanism to recover funding from customers, noting that third-party funding may not ultimately contribute to a reduction in cost and/ or improvement of services for customers.

Independent administration of SIF

Further clarity is required around how the third-party responsible for administering the SIF will be appointed, managed, funded and held accountable.

We agree that the introduction of an independent third-party to administer the SIF is likely to have advantages. However, we note that it will be key to ensure that any differences in objectives between the SIF and the independent third-party, and any conflict of interests arising out of that are carefully managed. It is important that trust is created through an open, fair, and transparent appointment process, and maintained through careful management.

Bundling up of projects

Finally, we recognise that in some cases it may be more efficient to bundle different innovations projects into one larger project, to avoid unnecessary duplication. However, there will be circumstances where it is important to continue to allow different innovation projects on similar topics and issues to progress and receive funding. While, developing large single projects can assist Ofgem in their assessment of the proposal, it can add significant cost and complexity to the delivery of the projects especially if there are multiple partners and participants involved. It also places a significant additional burden on the project lead, who will be required to put in place appropriate collaboration agreements to deliver the projects, coordinate and align a wider group of participants and a larger number of work packages. This may lead to delays and generally slow the pace of innovation. There are good examples, such as the TEF projects where three projects on the same topic are being delivered individually but there is a strong collaboration to ensure that learning is shared, and unnecessary duplication avoided. Similarly, there have been several innovation projects looking at Active Network Management (ANM), each looking at different components of ANM and its application.

There may also be different views on what the best way is to deploy innovative solutions. We firmly believe that plurality of thought should continue to be encouraged and will ultimately drive wider benefit for consumers.

Definition of innovation for the purpose of the SIF

When considering the definition of innovation to be used for the purpose of the SIF, we think it worthwhile taking into account the number of ways in which Net Zero can be supported. Delivering the network necessary to meet Net Zero will require accommodating increases in demand, resulting for example from EVs and the decarbonisation of heat, to be met through greater amounts of renewable generation. We note that the Committee on Climate Change have forecast a doubling of network demand (c.595TWh), which will need to be met by c.66% of renewable energy generation if Net Zero is to be delivered in the legislative timescales. Innovation will play a key role in accommodating this increase in renewables, through new construction methods, materials, and processes. Where the level of risk is acceptable, our view is that innovation in these areas can be delivered through BAU. However, it is important to recognise that some innovations may involve a higher level of risk and therefore may not be delivered without additional innovation funding. The definition of innovation should be flexible enough to allow for these innovations to be included. The definition should also be flexible enough to allow for projects which consider wider benefits beyond the network, or do not produce direct benefits for DNOs and their customers but may result in wider societal benefit

Introduction of a single public sector energy innovation interface

We agree that there are likely to be benefits in having one portal for a single application that covers all possible energy innovation funding. We would be keen to help develop/test any ideas for such a portal to ensure an efficient process from an applicant's point of view. There are existing industry portals such as the ENA Smarter Networks portal, which allows applicants to propose ideas to electricity licensees, which are then reviewed via the ENA Innovation Managers group. Additionally, the ENA, EIC and SSEN have all run "calls" for applicants to propose ideas, which has resulted in the development of several successful projects such as TRANSITION, LEO and RaaS.

Source of funds for administration of the SIF

We recognise that there will be costs with identifying, appointing and then maintaining a third party to administer the SIF. There are obvious impacts if the source of this funding is to be included in the overall SIF pot or a percentage allocated to individual projects. Clarity is required around the potential allocation on an individual project basis, to enable us to adequately forecast project budgets for submission. Where the third-party administrator is running a number of funding mechanisms, administration costs must be shared proportionately.

Building on the existing joint gas and electricity innovation strategies

The current joint innovation strategy has been built up through strong stakeholder engagement and provides a strong starting point for addressing future challenges. We think it would make sense for Ofgem to use this strategy as a basis for feeding into BEIS's wider Innovation Strategy.

We note the potential for conflict to arise between different needs, for example that of a supplier/market participant and that of a demand user. Any such conflicts will need to be identified early, and where they cannot be resolved, transparency around how funding is being used to deliver specific benefits will be key.

Ensuring network companies' knowledge dissemination activities build upon and link up with innovation activities funded by other bodies

Requirements could be attached to funding provisions to ensure that findings associated with overlapping funding, can be disseminated jointly to shared stakeholders. Further requirements could include accounting for previous innovation in similar areas to ensure that previous work is not being duplicated. In order to facilitate this, each funding stream involved will need to introduce clear processes for sharing information around past innovation projects, including participants and lessons learned. We note that the ENA already has a programme of shared dissemination events in place, including conferences such as LCNI, forums and webinars. These are well attended and help facilitate coordination.

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

We agree with Ofgem's proposal to adopt a consistent NIA framework and the strong focus on Net Zero and consumer vulnerability. Please see also our response to OVQ13 to OVQ15 below.

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

Funding arrangements

We agree that the NIA funding allowance should provide for the full price control period and not on an annual basis. This will help avoid peaks and troughs at the beginning and end of the price control and allow more flexibility in terms of scope of and timings of projects to deliver maximum return on NIA investments for consumers.

Scope of eligible projects

We do not fully agree with the proposed scope of eligible projects, as it is likely that certain types of innovation would not be captured and therefore are unlikely to go ahead. There may be innovation projects that do not directly tie in to the transition to Net Zero or consumer vulnerability that could nonetheless deliver significant GB-wide benefits in terms of improving the design, development, construction or operation and maintenance of the networks, ultimately reducing costs for all consumers. It is possible that these will not go ahead as BaU, where risks are too high and/ or benefits are unlikely to be achieved within the current price control

We also note that commercially available technologies would not be eligible for the NIA. We do not agree with this approach, as successful demonstration of an innovation in a particular location does not mean it will work everywhere. Industry structure, participants, legislation and commercial practices may vary in different locations, and understanding whether an innovation can work in a specific context will require careful assessment against all these parameters before BaU roll-out. This can involve a significant amount of work, and there is a risk that innovations may not be developed for GB application and value lost if NIA funding is not provided. For example, SSEN's RaaS NIC project builds on an earlier successful demonstration in Sweden of the use of renewable and energy storage to maintain network integrity. The RaaS project looks to test additional technical functionality and most importantly the business models and

commercial arrangements which will ensure that the techniques initially demonstrated in Sweden can be applied within the GB network environment.

Considering the impact of innovation on consumers in vulnerable circumstances

We welcome the new focus on innovation and customers in vulnerable circumstances. The framework in RIIO-ED2 must enable DNOs to do more to help the most vulnerable in society, ensuring no one is left behind in the transition to Net Zero and the economic recovery following COVID-19. Innovation will play a central role. Therefore, we are keen to ensure the regulatory framework leaves these options open, to be further explored following stakeholder engagement and review of the cost benefit case.

Increasing third party involvement and IPR

We agree that there would be benefits to industry providing clarity around IPR arrangements. As an industry we have learnt a lot about IPR over the RIIO-1 period and we also note the extensive work carried out by the Energy Innovation Centre (EIC) in this space. The publication of joint guidance by the ENA would allow certain parties to engage more fully with the NIA process. We note that, under current innovation arrangements, we already engage extensively with third parties.

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

We will require more detail on how this will work in advance of setting up any NIA projects, and would like to understand the likely consequences of not meeting quality assurance requirements. Finally, we believe that the quality assurance test will need to recognise that projected outcomes from projects are based on assumptions made in advance of any trials. The learning generated throughout a project may result in these assumptions having to be reviewed, which may impact on the outcomes which were predicted at the start of the project. In some cases, this may even lead to the project being stopped or amended to ensure that it still provides best value. Therefore, we believe that any QA should focus on quality of delivery and not necessarily on outcomes defined at the beginning of the project.

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

We agree with the proposed approach. However, we note that it has limitations. The amount of money requested in RIIO-1 was set based upon the challenges faced at that time, with a strong focus on connecting renewable energy. The challenges we now face requires a broader focus on supporting the transition to Net Zero through whole system approaches to transport and heat, as well as continuing to facilitate the connection of renewable generation. We also note there are regional differences which have emerged since RIIO-1 funding was allocated. In Scotland, we have tighter targets for phasing out new internal combustion engine cars (2032) and delivering Net Zero (2045). The devolution of power in the context of energy efficiency and heat will also lead to differences in approach, network impacts, and potential innovative solutions.

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

We welcome the strong focus on modernising energy data, and recognise data is key to unlocking system and consumer benefits and managing the transition to net zero. Digitalisation also improves the accessibility and optimisation of energy data allowing the wider industry to develop and innovate

together. This aligns well with investments we are making in digital capabilities in RIIO-ED1 and our trajectory to digital maturity.

We will provide separate commentary on the draft licence conditions, once made available. While we agree with the overall direction of travel, it is important that the drafting of licence conditions allows for flexibility in how companies take their digitalisation strategies and action plans forward and choose to apply data best practice. In designing and applying the regulatory framework, Ofgem must recognise the experimental and iterative nature of the digitalisation process, and the importance of company strategies being user-led, evolving with their needs. There is otherwise a risk of creating unintended consequences, for example by being too prescriptive or penalising companies seeking to trial new approaches that may not always be successful.

Digitalisation Strategy and Action Plan

We support the introduction of a new Licence Obligation requiring the companies to publish a Digitalisation Strategy and accompanying Action Plan.

We expect funding required to implement our plans to be recovered through baseline allowances, justified through cost benefit analysis looking at the short, medium and long term. However, we recommend that Ofgem keeps open the option to use uncertainty mechanisms where requirements change or evolve.

We would welcome clarity from Ofgem on the funding justification for digitalisation. As recognised by Ofgem, much of the value of data is realised through new third-party products/services and efficiencies that will facilitate future customer needs. It is therefore critical that Ofgem capture the societal benefits of digitalisation and open data when reviewing DNO investment plans.

In the context of RIIO-ED2, data and digitalisation will also be critical to enabling DSO functionality and Net Zero, by allowing DNOs to plan and operate their networks in a way which maximises the benefits of smart systems and flexible solutions for consumers, while facilitating decarbonisation. This will also involve working with third-parties to make data available and facilitate the provision of new and innovative services to DNOs and beyond. However, further clarity is required to understand requirements, build a framework and determine the potential cost implications and regulatory mechanisms required to deliver on time and in an efficient way. For example, new skills, personnel and ways of working will be required to fully realise the benefits of digitalisation, which we are actively considering. Considerations of which company-specific and industry tools are required to facilitate this is important and should be coordinated through the appropriate industry processes and built into our business plans.

Data Best Practice

We are already striving to ensure we follow best practice and learn from the successes of other sectors. We support the development of new guidance on data best practice. However, we question whether the use of a licence obligation is appropriate in the context of “best practice”. Best practice involves setting out key principles supported with examples, not specific methodologies, therefore implying an element of discretion in its application. On the other hand, licence obligations usually apply in the context of clear and unambiguous requirements. We would encourage Ofgem to consider whether such an approach is suited to the uncertain nature of the digitalisation process. We would also ask that Ofgem clarify its intended approach to enforcing the new proposed obligation.

We strongly agree that data should be “presumed open”, as per the recommendation of the EDTF, recognising the need to ensure data is protected as appropriate through a Data Triage Process. However, further work is required to understand the implications of a “presumed open” approach in terms of timeline for delivery and associated costs. This will be supported by the ongoing industry initiatives such as the Modernising Energy Data Access competition, in particular the emerging work around Shared Data access.

Our view is that data practice best guidance should apply to any data that relates to electricity network assets and operations, and that is required and efficiently gathered to enable the safe and efficient operation of the network.

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?

It is firstly important to recognise that the value of separating the DSO functions from the DNOs has not been established. Equally, as Ofgem rightly note in paragraph 6.12: “the decision and implementation of fundamental changes to institutional arrangements at distribution level will require significant consideration, industry changes and costs, and processes and tools that are outside the scope of the price control methodology”.

We request Ofgem continue to uphold this position through the price control submission process through to the start of RIIO-ED2. It is vitally important for DNOs preparing business plans that clear and consistent guidance is given, and the overarching policy direction does not materially change or incrementally evolve until the conclusion of RIIO-ED2 submissions and proper impact assessments have been undertaken.

We do however recognise Ofgem’s desire to set out optionality within RIIO-ED2 for future institutional change. Our reading of the SSMC indicates three proposals have been set out: (1) As noted in paragraphs 6.20-6.24 proposals reference ‘technical enablers of separation’ & ‘new ways of cost reporting’; (2) Ofgem’s intention to use the proposed DSO incentive framework to provide insight on how to set a foundation for how DSO functions could be incentivised separate from the DNO in the future and; (3) a DSO re-opener is proposed, which Ofgem continues to scope.

On proposal (1), the ‘technical enablers of separation’ we understand this to refer to the baseline requirements for DNOs to embed data standards and interoperability that are outlined in appendix 5 of annex 2 to the SSMC, which we note has already been identified as key functionality through the work of the Open Networks project. SSEN is working with the BPDT Working Group to identify those cost categories that can be attributed to DSO and reported under M19 of the RIIO-ED2 BPDT and the Regulatory Reporting Pack (RRP) during the remainder of RIIO-ED1. This exercise is confirming there is a great deal of overlap between delivering the requested DSO functionality and the continuous improvement of core activities in a well-run DNO. It should be recognised that striving to maintain separation in these areas, in anticipation of a future Ofgem decision, that may never materialise, adds cost and could result in a less efficient outcome for customers through lost integration synergies.

The incentive outlined in proposal (2) is also affected by this overlap and is unlikely to be effective outside the key enabler of market development. Those functions encompassing planning & network development and network operation requiring IT & OT investment we think are better captured in opening base

revenue with an ex-ante allowance. Within market development there is better scope for the application of an ODI although there should still be a core level of expectation based on the demands that Ofgem are placing on networks in RIIO-ED1 and that should be funded accordingly.

The final proposal (3) is we understand to be re-opener to facilitate further institutional change, should this be deemed required in the RIIO-ED2 period. We think is fine to include though we would expect Ofgem to engage in comprehensive assessment and consultation of the DNO-DSO functions, costs and capabilities before deciding to use this re-opener. We reiterate our stance that work in this area should not commence until after the start of RIIO-ED2 in order to give DNOs clear and unambiguous focus in preparing business plans.

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?

We agree that the business plan incentive is a good tool for encouraging DNOs to go beyond baseline expectations. However, this will only work if DNOs include CVPs specifically related to DSO within their submissions. If companies do not include CVPs then the BPI can only be used to penalise companies who fail to meet the baseline standards set out by Ofgem.

We do not agree that by default it is appropriate for all DNOs to adopt higher revealed standards of other companies which go beyond the baseline. In some circumstances the standards outlined could be licence area specific and so not universally appropriate to extend. We highlight our concerns with this particular approach in our response to COQ53.

It is also ambiguous within the SSMC what specifically Ofgem intend to impose on DNOs, and we ask for clarification. Paragraph 6.33 refers to 'good practice', which we note could differ from the definition of 'higher expectations'. Imposing the perceived 'good practice' of one DNO onto others when delivering baseline expectations should not be allowed. So long as the baseline standards are met DNOs should be given discretion on how to deliver this within the detail of their proposals.

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

Yes, we think this is sensible. However, a standard methodology across companies is important in order to develop a fair and transparent incentive framework from these. We urge Ofgem not to apply fully bespoke metrics or standards to individual companies, which could without intention allow them to receive a higher reward for services provided by other network companies but not rewarded. A standard methodology with bespoke arrangements like the approach established for the Interruption Incentive Scheme would be more beneficial.

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?

We agree with the proposal to include a DSO ODI. However, we think it requires a clearer definition than that set out in the SSMC. An ODI should not reward companies for meeting the baseline performance

expectations established for all companies at the start of the price control. An ODI should only reward companies that exceed clearly agreed-upon baseline expectations that reflect customer and stakeholder needs. Equally an ODI should penalise companies for failing to meet these expectations. A DNO should be held neutral where expectations are met. We believe this is fair and consistent with the operation of other price control incentives because baseline funding agreed through the settlement should be used to drive baseline expectations, with incentives rewarding or penalising divergence.

Equally the criteria for reward and penalty should be clearly set out and agreed prior to the start of the price control. Our view that the DSO ODI should be structured as a quantitative financial incentive. This should be clear and unambiguous, and based on a numeric benchmark. We believe this would be clearer and more transparent. Baseline expectations which cannot be covered by the numeric benchmark should not be subject to a subjective ex-post assessment performance.

For the avoidance of doubt, we do not agree with the approach proposed by Ofgem for the DSO ODI to sit in parallel to other ODIs and cover “behaviours less well served by mechanistic financial incentives”. We think this is too subjective, lacks transparency and risks significant divergence of standards applied across DNOs when assessing performance.

Activities that could be rewarded by an ODI might include accommodating a higher proportion of flexibility than originally planned, absorbing higher levels of LCT connections than forecast, facilitating higher than expected transactions of a peer-to-peer nature, and coordinating a greater number of distribution solutions to issues on the transmission network than expected.

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?

No, we think this should be an annual performance assessment against a quantitative metric, which should be clear and unambiguous. We believe this would be clearer, more transparent, aligned with other incentives in the RIIO-ED2 price control and better suited to the context of rapid growth of a liquid market and fast developing technologies as we transition to a smart grid.

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

As noted within the SSMC rewards and penalties “should be strong enough to incentivise good behaviour but not disproportionately reward or penalise companies”.

As noted in our response to questions OVQ20-OVQ21 we do not support the structure of the ODI proposed by Ofgem. Rather we believe the ODI should be an annual performance assessment against a quantitative metric. Further consideration is required on how to link this financial performance and where the appropriate cap and collar values should be. Although we expect this to be consistent with other ODIs and in the region of 50 to 100 basis points on baseline revenue.

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?

We welcome the clarification offered on the DSO roles, principles and associated baseline expectations in Appendix 5 of the SSCM. These are clearly based on the DSO functions that were outlined by the ENA's Open Networks project in 2018 following extensive stakeholder consultation. SSEN, along with the other DNOs, have already commenced building the Open Networks functionality. However, there is clearly a question of scale as we progress to RIIO-ED2, which is to be expected in an emerging smart grid and nascent flexibility market. Addressing the baseline expectations will become more challenging as levels of LCT adoption and DER provision grow. Further investment will be required to facilitate the associated levels of complexity.

Areas that are still to be addressed include the outputs of the Access SCR, greater clarity on the utilisation of DNO assets to provide network solutions without distorting the market (decision on CLASS), and the parameters for market failure.

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?

We do not see specific electricity distribution barriers to whole system solutions continuing to emerge within the RIIO-ED2 period. We note though that electricity distribution operates on a different regulatory submission timescale from other RIIO-2 sectors and those more broadly in water for example. It important Ofgem continue to acknowledge this and recognise that the emergence of whole system solutions will be continuous through the price control period rather than fully set ex-ante through baseline submissions.

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

Aligned with our response to question OVQ24 we urge Ofgem to continue to acknowledge this and recognise that the emergence of whole system solutions will be continuous through the price control rather than fully set ex-ante through baseline submissions.

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

We support Ofgem's proposals to channel innovation funding into projects with clear links to whole-system outcomes.

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

We support proposals to introduce a CAM. We think this is sensible and prudent for facilitating whole system outcomes.

We support Ofgem's proposals not to include a materiality threshold for this re-opener. We believe this sets a clear framework which focuses on consumer value, rather than costs, which will have been set up-front in the price control baseline.

However, we think Ofgem should reconsider a financial incentive. We believe an incentive is required to reduce any hesitancy from network companies to transfer allowances that could potentially reduce the opportunity for RAV growth. We are concerned that Ofgem's proposals to allow network companies to

agree commercial terms on the “compensatory value for this risk to be passed between them” may not work well in practice. We believe that this could lead to hesitancy on the part of the company taking on any new project from another company as a direct result of the potential for loss of TIM outperformance benefit obtained through the commercial agreement which is unlikely to be known at the design stage. As a reasonable alternative we propose CAM incentive mechanism could apply to the consumer value achieved as a result of identifying a whole system solution. The cost of the original solution compared to the cost of a whole system approach could be shared between consumers and participating networks. Assuming a 50% sharing factor, 50% of the total consumer benefit would be returned to consumers and the remaining 50% split between the participating networks. The party then assigned as responsible for delivering and constructing the whole system solution would continue to be subject to their company specific RIIO-2 TIM incentive rate for any efficiencies gained during construction, operations etc.

We support Ofgem’s proposal not to include a 'foreseeable' criterion as set out within the draft determinations for RIIO-T2 and RIIO-GD2. Although we note this reference was absent from the SSMD. We ask Ofgem to clarify this within the SSMD?

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

We propose Ofgem allows for annual application windows as this will ensure solutions are only brought forward once both parties involved are ready. This will also avoid delays to connection infrastructure development, which could arise if two fixed application windows are used. It will also provide for better alignment with the RIIO-ED2 regulatory cycle and time for DNOs to bring forward projects.

We support an annual application window in May, which gives network companies enough time to assess financial positions after other company specific re-openers have been assessed. However, we urge Ofgem to lay out a clear commitment for their own assessment of projects through the CAM, including commitment to a two-month window to complete assessments and reach decisions. We believe this is necessary to avoid unnecessary delays to project and realisation of consumer benefits.

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?

We see a number of circumstances where the introduction of the CAM licence condition into RIIO-ED1 could have benefits. Firstly, we note that there are a number of existing projects in RIIO-ED1 that are likely to require bespoke arrangements to cater for a whole system solution. These include:

- SHEPD financial contribution towards proposed electricity transmission links to Shetland to reflect benefits to distribution customers resulting from avoided reinforcement costs. We note Ofgem’s statement in its December 2019 decision document² that any contribution would be “transparently and robustly implemented and would be subject to the formal licence change and code modification processes.”
- Introduction of innovative whole-system solutions in RIIO-ED1: for example, our South West Active Network (SWAN) project which we introduced because the amount of Distributed Energy Resources connected and connecting to the distribution networks was believed by the ESO to be impacting on the transmission network.

We also note Ofgem's plans to introduce a new licence condition relating to whole systems. The parallel introduction of a supporting mechanism through the CAM licence condition could better enable DNOs to put forward whole system solutions.

We would welcome discussions with Ofgem on the extent to which the CAM licence could be an appropriate and effective tool for managing whole system approaches that are already being deployed in RIIO-ED1. However, the timing of the introduction of the licence condition will be key, as will be the need to ensure that the licence drafting is appropriate and caters for the scenarios we have outlined here.

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?

We think that the potential impacts of Access SCR proposals on business plan development are directionally correct at a high level. Though we would note additionally that implementation may require industry-wide system and process change, as highlighted in our recent response to the Ofgem Request for Information, as well as transitional arrangements. The precise extent of any changes should be included within the RIIO-ED2 framework to allow recovery of these costs.

We are also mindful of the potential impact that any 'minded to' consultation positions on the wider industry in RIIO-ED1 and RIIO-ED2. This is particularly important if the connections boundary is set shallower. An announcement could result in schemes being delayed in RIIO-ED1 until the new connection charging regime comes into force. This impact would need to be reflected in our business plans for RIIO-ED2 but also forecasts for the remainder of RIIO-ED1.

In terms of implementation timescales, as previously discussed with Ofgem, given the scale and nature of changes required under the SCR, we believe the 2023 timeline is ambitious. That said we believe there are many advantages associated with introducing significant change at the start of a price control and are keen to work with Ofgem to see how the implementation timescales can be met. We think preliminary work on code modifications should start following the 'minded-to' decision without fettering Ofgem's discretion. However, in order to give us the best chance of meeting the timescale it is crucial that a clear minded to position is given in November, with a single preference, rather than several options. The preliminary work on code modifications could then be reviewed/ amended when the final decision is made in March 2021.

We have previously noted, significant changes to the depth of connection boundary and/or Access Rights, along with changes to use of system charges is likely to result in concerns being raised by those customers who have already paid for reinforcement and rights to the system. If they also now face the prospect of higher use of system charges in areas of constraint, we are concerned this may lead to requests for return of funds to individual customers. At this stage it is not possible to quantify the scale and nature of the impact or costs without a detailed understanding of Access SCR proposals, but this is an area that stakeholders are already raising, and a coordinated response is urgently required in terms of any proposals to mitigate this risk e.g. by introducing grandfathering rights or transitional arrangements. We are mindful that this has been raised and discussed with Ofgem previously and urge Ofgem to ensure this taken forward with DNOs and addressed in the Minded to Consultation this year.

Finally, the extent to which the impacts outlined in the SSMC influence or change the business plan is contingent on the outcome of stakeholder engagement, network modelling and the outcome of CBAs.

Further these impacts could be highly locational dependent and subject to the influence of other factors, such as network planning standards. As the impact of improving price signals will not be immediately felt until Access SCR reforms are implemented, the true impact will not be known until within the RIIO-ED2 period. This emphasise the importance of strong uncertainty mechanisms to adjust revenues to respond to changes in customer behaviour, should changes in investment be required or to also accommodate any potential delay in the introduction of the SCR or the introduction of grandfathering or transitional arrangements.

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?)

Access SCR reforms must commence at the start of RIIO-ED2. Misalignment between the two would create complexity, disruption and uncertainty which is not in the interest in consumers.

Based on the engagement we have had with Ofgem and the high-level impacts of Access SCR, as identified in the SSMC, we should be able to accommodate the ‘minded-to’ consultation position within our baseline for the draft business plan submission in July 2021, provided that this is released in November/ December 2020 as per Ofgem’s previous communication on timelines.

However, we note that if the ‘minded-to’ consultation release is delayed into 2021 or is significantly divergent in its position from the trajectory on which DNOs have engaged with Ofgem, then accommodating changes will become more challenging. This is because the process of developing draft RIIO-ED2 business plan submissions for July 2021 is well underway; and draft stakeholder engagement, plan optimisation, and internal governance must be complete by at least by April 2021 to ensure this is credible for submission.

If Ofgem’s SSMC timelines are also followed for the final decision on Access SCR (Spring 2021), then accommodating the final decisions into the final business plan submission should be possible.

Finally, we note there is still a possibility of release dates for Access SCR consultations and decisions being delayed. Ensuring alignment of Access SCR and RIIO-ED2 plans is critical and therefore it may be necessary to consider the creation a re-opener mechanism to accommodate changes to the RIIO-ED2 business plan as a result of timeline delays should these arise in 2021 and business plan submissions can not be updated in time due to a delay in Access SCR.

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

We propose DNOs should be required to sign-post clearly through a business plan submission annex the parts of the submission which have been materially influenced by Access SCR reforms known, within reason to DNOs at time of publication. We propose this should, where applicable identify costs and volumes which have changed within the baseline submission, and underlying rationale.

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?

None at present.

OVQ34 Do you think we need specific mechanisms in RIIO-ED2 to manage the potential longer-term impacts of COVID?

For our two electricity distribution licensees, we are currently working on the basis that the operational impacts of COVID-19 will be managed through RIIO-ED1. However, we are mindful that given the recent increase in cases, further restrictions have been implemented by GB and Scottish Governments and there are suggestions that restrictions may need to be in place for some time yet. The likelihood of other measures also being implemented over the winter is viewed as a real risk at this stage. As such the potential for longer term impact is more significant than we had previously anticipated but still uncertain.

Any potential impact is likely to be felt in the following areas:

- ways of working e.g. when we schedule planned work such as planned interruptions or how we manage faults to ensure minimum disruption to customers including families or individuals isolating or working from home;
- how we interact with customers and stakeholders to meet requirements around social distancing;
- how we execute work to ensure safe ways of working while also meeting social distancing requirements;
- transport e.g. to ensure we comply with restrictions regarding the number of people in a vehicle etc.;
- how we support customers and communities e.g. those on the PSR register, or those shielding and how we ensure we provide relevant and timely advice and support to all;
- supply chain impact, with restriction in availability of plant, materials etc.; and
- contractor availability

While at this stage we do not believe there is a need for a specific mechanism in RIIO-ED2 to manage the impact in RIIO-ED2, we propose that this be kept under review by Ofgem as part of the RIIO-ED2 process and through monthly DNO reporting under the Easement Framework.

SSMC Annex 1 – Delivering value for money services for consumers

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

We welcome the further guidance provided by Ofgem on bespoke ODIs. We agree with Ofgem's proposals for setting upper and lower limits on the value of bespoke ODIs. As with CVPs, we note that only a small number of bespoke ODIs were accepted by Ofgem in RIIO-T2 and GD2, and we would urge Ofgem to provide additional information on its expectations regarding bespoke ODIs in line with our comments in response to COQ54.

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

We agree that further clarity is required on the treatment of bespoke PCDs. We note Ofgem's proposal to propose a minimum value for bespoke PCDs of £15m. We think this approach is reasonable, provided it is clear that not all projects worth over £15m will be automatically classified as a PCD.

More importantly, Ofgem should develop a clear, robust and proportionate framework for PCDs to be applied in RIIO-ED2, which does not erode the incentive properties of TotEx. In particular, we would urge Ofgem to provide clarity on the extent to which PCDs will be defined as an outcome, or as an input or specific solution, and how PCDs will apply in the context of programmes. It is important that the PCD framework enables flexibility and encourages efficiencies and innovation, in order to deliver the best possible outcome for customers.

We will be raising specific points on PCDs and Ofgem's proposed guidance document in response to the upcoming RIIO-T2 and GD2 licence drafting consultation.

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

We support the continuation of the CSS as it has driven meaningful improvements in RIIO-ED1. From stakeholder feedback to date, we believe the survey continues to focus on areas that are most relevant to customers. However, there is merit in expanding the scope further to include PSR or consumers in vulnerable circumstances to ensure no one is left behind, which we are pleased Ofgem have proposed. By drawing out PSR or those in vulnerable circumstances, it would also allow us to quickly identify issues associated with the transition to net zero and act to resolve or remove potential barriers. However, due to the significant engagement that would be required to do this and to support customers in this area, we see the potential for an increase in costs and would urge Ofgem to include the reporting of PSR or consumers in vulnerable circumstances as part of the reward and penalty incentive. We also feel the incentive would drive DNOs to ensure 'no one is left behind' if there was a potential for a penalty around PSR customers, and to warrant the 'above and beyond' engagement that would be required – ensuring all customers who fall under CSS would receive the same standard of customer service.

We are keen to look at wider developments beyond the sector for measuring customer satisfaction, such as those introduced by the Institute of Customer Service (IoCS) in 2019 which include additional elements such as trust, effort and ethics, which consumers in a modern society may value. This could also allow DNOs to be benchmarked against other industries or sectors and provide a more holistic view of the service we provide. This would need to be tested with stakeholders to ensure it reflects the services they

value from a regulated distribution network company. We note that Ofgem have stated they do not believe the balanced scorecard methodology to be fit for purpose for this industry, however we do not agree with this position and note that it is embedded and successfully working in other regulatory sectors.

We have commissioned Explain Market Research to test our proposals, help us understand the efficiency of the CSS concepts we are exploring and identify the value customers place on this. The high-level results were shared with Ofgem in June 2020 and whilst we appreciate this was a small sample, results indicated customer preference for a move away from the traditional survey towards a replacement hybrid mechanism.

We do not think Ofgem has fully articulated its reasoning for retaining the current weightings for CSS. These weightings were put in place to focus company improvements in performance on connections, the poorest performing area at the time. There have been great improvements in the Connections area and we consider there is merit in refocusing the incentive. Therefore, we would ask Ofgem to reconsider the weightings of the CSS. Given the ever-increasing reliance on electricity, move to greater distributed generation, and the growing impact of climate change on our networks, we would suggest more focus is placed on interruptions. This would continue to drive current performance, reflecting the fact that power cuts affect a larger number of customers, including our customers in the most vulnerable circumstances and has a greater negative impact to customers in their home settings.

Therefore, further consideration should be given to the weighting for individual elements following further stakeholder engagement and analysis to ensure the framework remains challenging, drives incremental improvements in service and adds value.

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

Target setting methodology

We have concerns with the SSMC proposal to set targets based on RIIO-ED1 average performance across all DNOs. Determining the average performance for ED1 would not be achievable until the end of this price control and would potentially not be defined until quarter 1 of RIIO-ED2. DNOs need to have a clear understanding of the targets ahead of the start of RIIO-ED2 in order to prepare and have the correct processes and highly trained staff in place to meet our customers' needs and expectations. We also note that if RIIO-ED1 historical data is to be used, data relating to COVID19 impacted years would need to be removed. Therefore, we would suggest a different approach, based on IoCS data and benchmarking information, and looking at external customer service data around what poor, average and exceptional customer service looks like.

RIIO-ED1 targets have driven the correct behaviour and seen an increase in performance across the DNOs. Dynamic targets can become quite complicated and have a higher cost. Therefore, we feel the continuation of static target scores is the best approach to take for RIIO-ED2. We would be open to discussing a mid-period interim review as has been suggested in recent working groups. We think any such exercise should be based on performance across industries, to ensure we are aligned with the likes of ICoS and other industry customer service standards.

Deadband approach to setting rewards and penalties

Ofgem has not clearly articulated the need for the introduction of a deadband. We think the introduction of a deadband could disincentivise real improvements in performance within the deadband, to the detriment of consumers. There is a risk that the approach could also discourage collaboration amongst DNOs.

We are not supportive of the approach and think that the RIIO-ED1 approach (i.e. no deadband) would better reflect the improvements in services experienced by customers. If Ofgem are to consider a deadband then this should be symmetric to recognise scores below the target could still be very high. This is because the proposed target setting methodology will lead to high targets, and it is possible that DNOs could be penalised for performance that is still excellent in comparison to other industries.

We also note that Ofgem has not provided sufficient information on the methodology to be used to set the deadband range.

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

Ofgem have not provided sufficient information to enable us to comment on the proposed target setting methodology. However, the current RIIO-ED1 metric has successfully driven performance improvements.

We note that Ofgem have indicated that they intend to retain the same categories (Day 1, Day 30, Repeat and Ombudsman complaints) and the same weighting for these categories. If the targets remain the same but the mechanism around the weightings change and the penalty banding changes, then this could have implications for how we manage complaints operationally. We are especially concerned about the complaints metric score benchmark point.

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

We are supportive of Ofgem's proposal to remove the Stakeholder Engagement and Consumer Vulnerability Incentive. The current incentive is too subjective and requires significant resources on all sides.

However, it is important to note our concerns that the new "strategy-based" incentives (e.g. the vulnerability and major-connections incentives) could be managed in the same way as SECV and therefore could present the same challenges in the future. In designing these incentives, we would encourage Ofgem to learn the lessons from the SECV process. We provide more detailed feedback in response to the relevant question.

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

We are always supportive of engaging with our customers and offering a consistent service across similar customer groups. However, the proposed extension of the customer satisfaction survey will create a number of challenges. Whilst we are happy to work with Ofgem to develop a solution which could work, we note there are a number of considerations and challenges to overcome as follows:

- LVAL, LVDG and LVHV segments would significantly extend the types of customers included in CSS.
- The range of work in the proposed segments is very wide and more complex than currently within LVSSA and LVSSB.
- In order to limit the expansion of customer types into the CCS the proposed segments would require a cap or limit to be put in place, in effect creating new segments.
- Some DNOs have already passed the competition test for some of these segments which could result in different targets for DNOs.

LVAL, LVDG, LVHV are wide-ranging segments, which include both infrequent domestic customers requiring minor connections and more regular customers ranging from consultants, SME's and local authorities to large, national, builders and developers. LVHV and LVAL are some of the most active segments of all. Through extending minor connections as proposed the incentive would move away from a focus on prominently domestic customers which would create an imbalance in the CSS and would weight the quality of service for a single domestic dwelling the same as a new 50 house development.

LVAL, LVDG, LVHV can involve a wide-ranging scope of works with different costs and timescales, very different to the current minor connections. The current minor connection segments includes connections of up to 4 properties at LV, with no abnormal loads. Through extending the minor connections as proposed the technical specification of the connection would extend to HV, may include a wide range of plant including new substation and transformers and extensive installations of OHL and cable. The complexities of such a scope of work are fundamentally different and more onerous than with current minor connections. In addition these works are sometimes dependent on statutory approvals and third party consents which can often lead to delays outside of the DNO's control. Such impacts are likely to adversely influence the customers view of service provision resulting in a negative impact on the DNO's score and incentive.

To overcome the challenges outlined above, there is the potential for introducing a capacity or number of services cap within a segment so that some are captured under CSS and others are not. In effect, this creates a new incentive boundary. This would generate a new segment. DNOs are working together with Ofgem to review categories which could be moved into CSS and establish an appropriate capacity or number of services cap. At this stage we would question whether it was Ofgem's intention to introduce new segments into the RIIO-ED2 framework.

Ofgem have stated in recent working groups that segments passing the competition test at individual DNO level will be excluded from the incentive, the extension of the CSS and extension of TTC. This could lead to an imbalance between DNO's, potentially requiring different targets to be set and removing the global nature of the incentive. In addition and related with the response provided in the preceding paragraphs with regard to complexity, timescale and customer type, it will generally be far harder to achieve a high level of customer satisfaction for customers in the proposed new segments. This will require existing CSS targets to be reduced to take account of the new segments and it will be very difficult to agree an acceptable target given the lack of available data. Clearly, relaxing an existing target may run counter to the general approach from Ofgem.

On the balance of the concerns raised above we would ask Ofgem to reconsider their position to include LVAL, LVDG and LVHV within CCS.

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

We agree with the considerations identified in the consultation however the proposed scope is very wide and complex to implement. We would prefer our suggested approach discussed in response to OUTQ7. We believe there are a number of nuances and details which Ofgem need to consider in assessing whether to extend CSS into other segments. We have set out these challenges in OUTQ7.

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

We believe that the TTC and TTQ incentive has delivered value for customers in RIIO-ED1 and there is a need to retain this incentive to ensure that customers continue to benefit from a focus on reducing the time taken to quote and deliver connections.

We would suggest Ofgem do not have differing segments for each DNO in TTC and BMCS, as it is important we provide the same high level of service to customers, regardless of their region.

Ofgem are considering extending the scope of TTC to LVAL, LVDG and LVHV. We would not agree with this approach as it will significantly increase both the complexity and the type of customers included within the incentive. Currently, the majority of customers captured under the TTC are domestic customers or small contractors. Should the new segments be included, this would extend the scope of the TTC for example to cover large commercial organisations or local authorities. The overlap with Major Connections would become significant.

In addition, larger, more complex projects generally result in more complex and bespoke customer needs, greater supply chain issues and more complex wayleaves and consenting. We request Ofgem grant exemptions, especially for larger jobs, which involve more complex works with a greater degree of dependency on statutory approvals from highway authorities and third-party landowners for wayleaves. Moreover, customers sometimes prefer their works to be delivered in stages. For example, a small housing developer may wish to first energise 5 plots of a 15 plot development and delay the next 10 plots to a later date but wishes for the quote to be issued and accepted for the whole scheme.

We would agree with Ofgem's view that the SCR may trigger a possible change in customer behaviours leading to an increase in the volume of connection applications which could negatively impact the TTQ and TTC performance. A move to a shallow boundary will largely impact higher segment jobs i.e. LVAL and LVHV and it is highly likely that DNOs will experience high volume of applications under these segments. The impact of the SCR needs to be carefully assessed by Ofgem to ensure that a fair and realistic target setting approach is implemented.

If Ofgem decide to extend to wider segments, such as DG and LVAL/HV then we strongly believe that targets should take into account past performance in these particular market segments so as to accurately and meaningfully reflect progress to date and customer expectations around timings. However, if wider market segments are not included in the incentive then we would be supportive of setting targets based on average past performance.

We would welcome clarification from Ofgem as to how the baseline standards will be determined after considering the above.

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

We are less supportive of a reopener for TTC midway through the price control. In RIIO-ED1, the majority of DNOs have delivered a solid TTC performance and customers have benefitted from quicker connections. This success was achieved in absence of a penalty mechanism. Fundamentally, we do not see a need to introduce a penalty when the existing mechanism has successfully delivered customer value, and we recommend retaining the use of static targets to provide certainty to DNOs and customers.

The reopener suggested by Ofgem in recent working groups would be based on an assessment of years 1 to 3, with targets being reset for years 4 and 5. If Ofgem were to go down this route, we would need to understand exactly how Ofgem will implement the proposed approach and how a potential penalty would be determined. The reopener has the potential to be skewed towards the downside and could restrict DNOs from improving performance in this area as a result of the uncertainty created by the process.

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

Yes, we agree with the methodology Ofgem propose to set the new TTC targets, which is based on average industry performance in RIIO-ED1. However, targets will need to be set and confirmed by Ofgem ahead of the start of RIIO-ED2. To enable this, we would suggest taking an average of the first 4 years of RIIO-ED1.

A linear reward mechanism has worked well throughout RIIO-ED1, where most DNOs have demonstrated improvement in TTC year on year. This consistent and predictable approach works for DNOs and for our customers as we have a clear view of the progress that is required throughout the price control.

The ‘Hockey Stick’ mechanism Ofgem are proposing is very much like the deadband concept proposed in BMCS. With the introduction of tighter targets reflecting RIIO-ED1 performance improvements, and the potential incorporation of new market segments within TTC, we would urge Ofgem to avoid of this mechanism. It could have unintended consequences and disincentivise performance improvements, and would discourage collaboration of the industries.

Moreover, we strongly believe that exemptions need to be applied to factors that are outside the control of DNOs. Customer needs in terms of staging of work, as highlighted in OUTQ9, can vary, and we also need to take into account the needs of our customers in vulnerable circumstances – aspects which are beyond DNO control. DNOs should not be penalised for delays reflecting customer needs, and Ofgem should ensure incentives help support DNOs to provide the best customer service for all our customers.

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?

In general, we agree with the proposed connections principles. However, we require further clarity on specific points as some of the keys requirements under each principle are very high-level.

It is critical that Ofgem provide further clarification through working groups to allow us to understand the exact nature of each proposed baseline standard. As a good example SSEN already publish granular heat maps covering both generation and demand at GSP, BSP and Primary substation level, in effect down to 11kV. We believe this meets Ofgem’s baseline standard for granularity. However, if Ofgem’s view is that granularity should be provided below 11kV, this needs to be explicitly stated. We note that this approach in particular is likely to require additional funding through business plans to implement wider rollout of LV monitoring technology on distribution assets to help record active flows on the network, and would require a clear steer from Ofgem on timeline for implementation.

With regards to the requirement to offer flexible connections to customers, we remain concerned that a shallow boundary outcome under the Access SCR may lead to changes in customer behaviours which will fundamentally act as an impediment to flexible connections if the locational capacity signals don’t meet

customer requirements. We request Ofgem capture the future need for flexible connections as part of any SCR impact assessment.

Generally, the baseline connections principles Ofgem have proposed are appropriate and will help ensure customers' needs are met. We would encourage a continuation of the detailed discussions facilitated through the working groups on these. A minority of the proposed baseline standards could result in increased costs to customers, which has not yet been tested through stakeholder engagement. For example, a curtailment assessment can be provided for a flexible connection where it is requested by the customer but if we were required to provide that assessment for every flexible connection quote it may lead to an increase in connection offer expenses to cover the cost of the network analysis. We would also welcome clarification on types of products and services that are referred in the connection principles.

Work is required around the applicability of these principles to each market segment – a piece of work the DNOs are currently jointly undertaking. This will ensure Ofgem and the DNOs are clear as to what is required as a principle for each segment. We would encourage Ofgem to continue working with the DNOs to understand and correctly identify which market segments the principles should apply to.

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?

We are supportive of the use of a business plan incentive tool to encourage DNOs to go above and beyond baseline expectations. However, we do not agree that by default it is appropriate for all DNOs to adopt higher revealed standards of other DNOs which go beyond the baseline.

In some circumstances the standards outlined could be licence area specific and so not universally appropriate to extend. We highlight our concerns with this particular approach in our response to COQ53.

We also believe it is critical to re-run the Competition Test, or a similar but simpler process, to assess which segments remain without Competition. The industry has moved forward significantly since the Competition test was run in 2013, competition is far more extensive and customers have more options. To base the qualifying segments for RIIO-ED2 on an assessment from 10 years previous when there has been so much change does not seem logical and would lead to differing approaches and impacts to customers across DNOs.

Furthermore, we do not agree that the competition test should be re-run part way through RIIO-ED2, with a subsequent resetting of targets. DNOs need to know in which segments this incentive (and others) will be applied to ensure the correct processes are in place and to understand how rewards will be applied.

Reviewing the competition test during RIIO-ED2 could also lead DNOs to submit connection strategies as part of their business plan covering different segments to those that would need to be captured following a re-run of the competition test. DNOs may have potentially secured baseline revenue, changed business processes, developed CVPs and be in a position of penalty or reward which would then need to be revisited and realigned. We do not believe Ofgem, or the DNOs, would want to be required to manage this level of uncertainty.

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?

We have a number of concerns with Ofgem's proposals for incentives based on the development of a strategy and then assessment at the end of the RIIO-ED2 period.

For all of these, the assessment process must be fair, transparent and objective, with opportunities for regular feedback from Ofgem and stakeholders throughout the price control period, without creating a complex yearly process. Ofgem must also clarify whether DNOs will be assessed solely against their own strategy, and how the process will reflect that DNO strategies can, and should, evolve during the period.

With regards to the proposal for a Major Connections User incentive, we do not agree that ex-post assessment is the right assessment method to assess performance to reward/penalise DNOs. The needs of the customers are expected to evolve at a rapid pace especially with the anticipated high volume of LCT connections with new customers entering the market in the RIIO-ED2 price control period. It is critical for DNOs to understand how they are performing, preferably on an annual or bi-annual basis as this will provide opportunity to act on issues or concerns raised by the customer.

Regular feedback would encourage further performance improvements as seen in RIIO-ED1 and would enable a more qualitative approach. However, we would recommend the introduction of more quantitative and mechanistic metrics to support the qualitative assessment and ensure consistency across DNOs. This could be applied to activities such as accommodating a higher proportion of flexibility than originally planned, and absorbing higher levels of LCT connections than forecast.

We would require further details on how Ofgem believe the incentive should operate, including size of potential rewards and penalties available, and how these are going to be set. The criteria for reward and penalty should also be clearly set out and agreed prior to the start of the price control. We note that Ofgem have not clearly explained in the SSMC whether the proposed ODI would be symmetric or be penalty only. We do not think that a penalty only mechanism would be appropriate given the nature of connections and the changing landscape. Ofgem has not provided sufficient information on its rationale for introducing a penalty only incentive.

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

Please see our response to OUTQ14. As highlighted, given the changing nature of the connections landscape, we think a yearly or biannual assessment process would be more appropriate. This should be supported by the use of quantitative metrics as much as possible,

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

We agree with the principles of GSoPs and with the proposal to retain these for all connection customers in RIIO-ED2.

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?

Yes, we agree.

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

We are supportive of the removal of ICE. However, it is useful to note the benefits ICE has delivered in RIIO-ED1. The use of improvement projects specifically raised by customers has provided a very visible way to track improvement which is also dynamic and so reflects the changing nature of the industry. We therefore see benefit in retaining those commitments through the connections strategies which are more tangible, measurable and reportable. However, the ICE assessment methodology has been process heavy for all those involved, and we would encourage Ofgem to reflect on the ICE experience when designing the Major Connections Customers ODI.

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?

We are supportive of the proposed approach to ensure an appropriate range and level of support for consumers in vulnerable situations.

We agree that we should be offering tailored, bespoke services for PSR or vulnerable people, and that the PSR criteria should be enhanced or extended to ensure that transient and financial vulnerability is also supported. Financial vulnerability could be heightened in RIIO-ED2 due to the current and on-going challenges with economic climate and slow rate of recovery. The COVID-19 pandemic also means that many more customers are likely to find themselves in vulnerable circumstances.

We would require further details on how Ofgem believe the incentive should operate, including size of potential rewards and penalties available, and how these are going to be set. The criteria for reward and penalty should also be clearly set out and agreed prior to the start of the price control.

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?

We are supportive of the proposed vulnerability principles and standards, and feel these are suitable and appropriate for RIIO-ED2 especially with the recent climate and economic challenges our customers have faced.

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?

We have a number of concerns with Ofgem's proposals for incentives based on the development of a strategy.

For all of these, the assessment process must be fair, transparent and objective, with opportunities for regular feedback from Ofgem and stakeholders throughout the price control period, without creating a complex yearly process. Ofgem must also clarify whether DNOs will be assessed solely against their own strategy, and how the process will reflect that DNO strategies can, and should, evolve during the period.

We would not support a 5 year penalty/reward mechanism. A more appropriate mechanism would be a mid-point incentive/reward, combined with ex post assessment, and/or we would support a glide path approach, as discussed at recent working groups. It is important that all DNOs and the regulator

understand how companies are performing, with customers at the heart of everything we do. If we are not assessed until after RIIO-ED2 has closed out, we will not be aware of how we are performing or where we could have improved and at what point of the plan.

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

Please see our response to OUTQ21. For the vulnerability ODI, we are supportive of an assessment of performance at least in the middle as well as the end of the price control to reward or penalise companies against their strategies. This would enable sufficient time for DNOs to demonstrate how they have implemented their strategies and built partnerships to deliver for consumers. This should be supported by the use of strong qualitative information, combined with quantitative metrics where appropriate. We propose that potential quantitative metrics could be explored through the working groups. We also think this should be a symmetrical assessment and rewards should be considered in the middle and at the end of the price control.

We think that the assessment of performance at middle and end of the price control could be complemented by a light-touch annual review of the strategies carried out by the CEG that could feed into the assessment process.

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

Yes, we agree with the approach to retain the unplanned interruptions target. Across the country, we consider this to have worked well for consumers in RIIO-ED1 in delivering improvements in quality of service; and we agree with Ofgem's position in the SSMC that some correcting of minor errors in the methodology is also required. For unplanned outages, we note the current target model is based on several complex factors; and that this complexity is recognised and accepted as necessary by Ofgem.

With regards to the RIIO-ED2 target setting process, we ask Ofgem to provide greater clarity on when it intends to set targets. We acknowledge the recommendations from the National Audit Office report which favoured setting targets later in the process than the strategy decision for RIIO-ED1. However, we feel leaving target setting to after business plan submission potentially means our baseline business plan does not meet targets in an economic and efficient way. We remind Ofgem of the RIIO-2 design principles for setting outputs and incentives as laid out in the Chapter 6 of the RIIO-ED2 framework decision by Ofgem in December 2019, specifically:

"As a general rule, the delivery of a target level of outputs should be funded through baseline allowances, rather than through incentives. Target levels should be set so that the benefit to consumers of achieving target levels is broadly balanced by the cost in higher network charges."

It is important that Ofgem adhere to this principle by allowing network companies enough allowance to meet the targets set by Ofgem.

Additionally, we ask Ofgem to clarify the years of historic performance data which will be used to set the target. Our view is that the last year of performance data used to set the target will need to be 2020/21; if, as Ofgem intend, targets are set at draft or final determinations in 2022. The 2021/22 data will not be ready in time for inclusion.

We support Ofgem's proposal to apply an improvement factor for companies who have a performance at the time of setting targets (i.e. the latest performance value) which is lower than the target produced by the methodology. Though we believe the chosen improvement factor of 0.5%, as set out in the SSMC, is not properly justified and could be construed as being arbitrary. It is important that no company is allowed to 'stand still' on IIS performance in RIIO-ED2. We request that Ofgem sets out a full justification for this proposed number, including the value to consumers.

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?

Whilst overall, we agree with the approach proposed, we remain concerned that there are still issues with the existing methodology that could result in expected performance improvements that consumers are not willing to pay for, especially in more rural communities. As targets continue to get tougher, they are likely to coincide with diminishing marginal benefits from each performance improvement. We think Ofgem could have taken the opportunity in preparation for RIIO-ED2 opportunity to review other approaches more comprehensively.

We would welcome a commitment from Ofgem to comprehensively review the target-setting methodology for RIIO-ED3, including a review of willingness to pay of consumers with the current approach and alternative approaches. This should reflect that consumers across the country have different thresholds on willingness to pay; and alternative target setting approaches, such as rolling average targets may better reflect these differences; whilst simultaneously being sufficiently tough on DNOs to drive genuine performance improvement; and be designed in a way which avoids systematic over or under performance. This should also recognise the inherent differences in legacy network design and topology across the country. Which can create varying levels of optimal performance in networks, as the prevalence and impact of network incidents can be inherently different. We feel other approaches may be simpler, compared to the acknowledged complexity of the current approach, and thus be easier to explain to our customers, consumers and stakeholders.

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

We agree with Ofgem's position in the SSMC not to revisit the unplanned interruptions targets in the price control period. We need to be able to give our consumers and stakeholders certainty for the price control period. Changing mid-price control would be difficult to implement, could create confusion and is not supported by evidence from stakeholders to justify its need.

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

Yes, we agree with Ofgem's proposed position not to introduce further convergence of DNOs' targets over time. It is important target setting should not leave anyone behind whilst at the same time not penalise consumers in different areas of the country, especially those in rural and island communities. Like Ofgem, we acknowledge convergence can yield benefits by speeding up the achievements of comparable levels of reliability. However, as Ofgem acknowledge, the cost to consumers may vary greatly from one region to the next and there is no evidence to support willingness to pay. As noted in our response to question

OUTQ24, we generally feel a willingness to pay study update is required ahead of RIIO-ED3 and further convergence of targets will be an important consideration to capture.

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

We support Ofgem's proposal to retain the incentive for planned interruptions performance and to continue to use the methodology employed in RIIO-ED1 for target setting.

We are committed to serving our customers in a manner which exceeds the minimum requirements of our licence. Planned interruptions incentives are an important part of achieving this; but so too is maintaining and enhancing our positive reputation which we seek to hold within our communities. We share Ofgem's views that there is no need to amend the target setting process or change weightings with the unplanned target.

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?

We believe there is no need to amend the mechanism, which we think works well for consumers. We believe the existing approach is simple and clear and any change to these targets could result in new costs to consumers which there is no evidence they are willing to pay for.

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

Like Ofgem we believe the VoLL figure from RIIO-ED1 should be updated in line with inflation at a minimum for RIIO-ED2; although we are surprised that Ofgem propose to use RPI inflation rather than CPIH inflation, which is the index being used elsewhere in the price control. We urge Ofgem to adopt a consistent approach in the interest of providing a fair value to consumers.

We also urge Ofgem to ensure the VoLL methodology is at least consistently applied across the price control and as far as possible with other areas of the energy sector. Irrespective of the methodology used to calculate VoLL, we do not believe consumers' underlying fundamental reliance on electricity change depending on where the VoLL figure is used.

We acknowledge the benefits of moving to a more disaggregated approach to calculating a single value of VoLL and can see advantages of having DNO specific VoLL figure which may more accurately represent willingness to pay. However, we would not support a use of the results from the Electricity North West (ENWL) study for setting a disaggregated VoLL, which does not include Scottish data and is therefore not expansive enough. Any move to a disaggregated approach to calculated VoLL must ensure that Scottish consumers' needs are captured.

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

As mentioned in our response to question OUTQ29, we believe that a disaggregated approach to calculating VoLL could be advantageous, but we would not support the approach proposed by ENWL unless the study was updated to include Scotland. This update would need to be appropriately validated, including updating the ratio of domestic to SME customers, to be reflective of current Office for National Statistics data. Without these updates, our strong preference is for Ofgem to update VoLL as per the RIIO-ED1 methodology with appropriate adjustments 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?

As mentioned in our response to OUTQ29, the VoLL methodology should be at least consistently applied across the price control and as far as possible with other areas of the energy sector. Irrespective of the methodology used to calculate VoLL we do not believe consumers' underlying fundamental reliance on electricity changes depending on how the VoLL figure is used.

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

There must be a revenue cap and an analogue collar value for the IIS. We note the question and SSMC only refer to a cap. A revenue collar like that in RIIO-ED1 for IIS is vitally import. Whilst consumers should be protected against excessive profits, so should DNOs be protected against excessive losses. Without the collar DNOs would not be incentivised to take innovation risk to beat the IIS target levels and generate improvements for consumers. When setting the cap and collar, Ofgem must consider the wider RIIO-ED2 regulatory package; including interactions with the Return Adjustment Mechanism. We must ensure there is no distortionary effect on incentives, leading to adverse impacts on consumers, when values are set. As such we are unable to comment on whether the value of 250 bps is sensible currently without a full assessment of the complete regulatory package. We expect Ofgem to detail the full RIIO-ED2 regulatory package at the latest at through the draft determinations.

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?

Yes, we agree. Without a robust evidence base including an assessment of willingness to pay it would be inappropriate to introduce target levels for performance or an incentive. We also note that designing a short-term interruption incentive is challenging, given interactions with current unplanned (long) interruption targets and a need to carefully calibrate for severe weather-related adjustments. Nevertheless, we agree with the current direction of travel to improve the quality and consistency of short interruption reporting across DNOs. There is benefit in collecting more data on this topic ahead of RIIO-ED3.

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

We do not think that Ofgem have sufficiently laid out the details of such a standard within the SSMC. The likely benefits, consumer impacts, and the interaction with multiple interruptions guaranteed standard has not been considered. We are also concerned that a minimum standard as set out in the SSMC would represent a form of delayed incentive, and yet it has not been subjected to the robust assessment process required for an incentive to be included in the price control.

We support Ofgem's ambition to keep DNOs focused on all types of interruptions, rather than only those that contribute to their IIS performance. However as presented we feel current proposals lack significant amounts of detail and so cannot be implemented.

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

The changes agreed through the RIIO-ED1 Quality of Supply working group to adjust the Occurrences Not Incentivised submission in line with data available in engineering recommendation (ENA-G43) give an outline of the data to be captured to better understand short interruptions. This information should be helpful to determine if an incentive is viable.

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

We agree the SWEE mechanism should be retained. We agree with Ofgem that “adverse weather can have material impacts on the networks themselves and the conditions in which DNOs must operate to restore supplies. We do not believe it would be economic to fund measures that mean the networks are fully resilient in all weather conditions”.

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?

No, we do not agree with this proposal. We recognise that, compared to SWEE, it is used relatively infrequently. However, it does offer an important tool for dealing with non-weather-related unexpected events which network companies can face from time-to-time. Ofgem’s concerns around the slightly unintended use of a mechanism, especially for a mechanism which covers high impact low probability events is not a sufficient reason to consider its removal. We understand that Ofgem are concerned that the mechanism is being used for situations other than it was initially intended to cover. This can be overcome by introducing a narrower, more specific, definition of its use within the licence, rather than removing the mechanism completely. Additionally, we do not believe the administrative burden associated with claims is a suitable reason for justification of removal of a mechanism associated with exogenous events beyond the network companies’ control. Removing the mechanism could create significant added risk of companies being penalised for factors outside of their control. Finally, we note that if Ofgem remove the mechanisms then adjustments to the data used in the target setting methodology for unplanned interruptions must be made, so that targets set using historical data are set consistently with the proposed approach used to measure performance in the upcoming RIIO-ED2 regulatory period.

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

Having a pre-determined threshold is necessary and as Ofgem note in the SSMC “provides a level of clarity to DNOs, to their customers, and to Ofgem”. For SWEE we would not advocate changing the exceptional event threshold for category 1, 2 or 3. We think this has worked well. We agree that the threshold absolute values per DNO licence area should be updated using average performance from the last 10 years, as proposed in the SSMC.

For OEE, as noted in our response to question OUTQ37 we believe Ofgem should introduce a narrower and more specific licence definition of its use, rather than removing the mechanism completely. For the avoidance of doubt, the OEE definition should also include transmission and third-party related incidents which cause faults on our network. Based on current design standards, it is uneconomical for DNOs to build resilience to these.

For both SWEE and OEE, aligned with our response to question OUTQ23, we ask Ofgem to review when it intends to set thresholds, so business plans can be built appropriately to meet targets.

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

For SWEE, consistent with RIIO-ED1, we believe our performance relevant to incidents relating to the underlying impacts of severe weather should be excluded. For OEE, as noted in our response to question OUTQ37 and OUTQ38, Ofgem should introduce a narrower and more specific licence definition of its use rather than removing the mechanism completely.

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?

We agree with the principles of GSoPs, however we feel some updates are required to the wording of the Statutory Instrument, specifically to rationalise and ensure consistency in submissions and fairness for all consumers. In the past this has led to differing approach to reporting by DNOs and the actual standards being delivered relative to the requirements. We anticipate this can be dealt with in parallel through the relevant RIIO-ED1 working groups.

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?

Yes, we agree.

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

Yes, we agree that some form of mechanism for WSC is required in RIIO-ED2. The scheme is well intentioned, and we think on the whole benefits consumers.

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

As noted in the SSMC the 'use-it-or-lose-it' allowance is applicable to all networks except SSEH in RIIO-ED1. For SSEH we continue to believe a form of ex-ante allowance for named schemes is applicable for RIIO-ED2. We believe this is appropriate for the significant geographic sparseness of the network that we serve. Should our stakeholders continue to support this we intend to bring forward scheme proposals as part of our business plan submission for the specific parts of the network which come under the WSC classification, which are supported by requirements for investment and stakeholder engagement. We think the relative certainty this provides is in the interest of consumers who are impacted whilst also ensuring we can deliver against these clear commitments.

For our South licence area, we continue to believe a form of dedicated WSC is required, and the option of merging with IIS would bring significant complexity to an already complex IIS mechanism, and could be a detriment to consumers. We think evidence from stakeholders on the underlying needs within a DNO licence area should inform whether a 'use-it-or-lose-it' allowance is retained in its current form; or has its parameters amended; or is replaced in full or partially by an ex-ante allowance. We ask Ofgem to reserve their decision on this until after DNOs present stakeholder informed business plan submissions in 2021.

We additionally ask Ofgem to consider the evidence of DNOs in context of the consumers they serve and the service they experience rather than automatically seeking to standardise an approach for funding to

most licence areas. We do not believe standardisation is always in the interest of consumers, especially if DNOs present clear stakeholder supported cases for alternative approaches to funding to meet their unique challenges.

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

We provide feedback on the different components of the proposed NARM framework for RIIO-ED2 below. We also provided feedback on the NARM framework for RIIO-T2 and GD2 and its potential applicability to RIIO-ED2 in our response to Draft Determinations.

We are open to working with Ofgem and other stakeholders in the run-up to SSMD to resolve key issues, e.g. reference costs to be used in CNAIM. Our view is that other elements of the NARM framework are likely to require additional development as we move towards Draft Determinations.

Adoption of long-term risk

We are supportive of Ofgem's proposals to better reflect and report on long-term risk through NARM. The recently updated CNAIM v.2.0 which the ENA consulted on last month¹ includes changes to enable the risk values assigned to an asset to be expressed as a "long-term risk" value. This will help better reflect the impact of DNO interventions on the overall network risk.

We have major concerns around the timings for the introduction of long-term risk and implications for our business plans, with models yet to be tested and a decision outstanding on the CNAIM v.2.0. We will work closely with Ofgem to resolve the uncertainties around the reference costs, cost base, etc. as presented by the ENA working Group to the SRRWG, which will allow the submission to be more reflective. This will also allow enable referencing not only in the Business Plan process but in allowances, target setting and in period reporting.

Commonality of reporting

Overall, we agree that there will be benefits to ensuring consistency of approach to reporting against the CNAIM across the sector. Recent updates to the CNAIM methodology include changes that will drive a more common approach to reporting. However, clarity is required around non-pressurised cable assets which are based on reactive post asset failure models rather than predictive failure models. This raises the question whether it is appropriate to include these in the reporting metric on total monetised risk. Our preferred approach would be to only include 58 of the 61 proposed categories, excluding the non-pressurised cable assets until a more suitable mechanism is built into the methodology for RIIO-ED3.

We are open to discussing options to review the role of Information Gathering Plans (IGPs) in RIIO-ED2. We will continue to keep our IGP under review, making amendments as appropriate and in line with reporting requirements. However, any formal framework for making changes to IGPs should recognise that these are DNO-specific and should be proportionate.

Production of guidance document

We continue to work closely with other DNOs to develop an Engineering Guidance document, referred to as the Good Practice Guide (GPG) for CNAIM v2.0, on data input to the CNAIM.

¹ <https://www.energynetworks.org/news/publications/consultations-and-responses/>

We agree with Ofgem's view that the proposals to introduce greater commonality in reporting when combined with the Engineering Guidance document means that there is no need to introduce an additional Asset Data Quality Incentive for RIIO-ED2.

We welcome Ofgem's clarification² that the focus of the Engineering Guidance document will be focused on RIIO-ED2 and will not play a role in any close-out assessment for RIIO-ED1 or any other part of the current RIIO-ED1 period.

Revision of methodology

We agree that the CNAIM should be kept regularly under review, and should account for any changes to the NARM framework, including greater coverage of assets and alignment across the sector. However, this should be proportionate and targeted at changes to be implemented in the following reporting period to minimise exposure to any rebasing mechanism. As highlighted above, the ENA recently consulted on an updated CNAIM v.2.0. Our preference would be to ensure that sufficient clarity is provided at the Sector-Specific Methodology Decision stage to ensure the final CNAIM v.2.0 reflects the new NARM framework for RIIO-ED2, without the need for further consultation.

With regards to the revision of key input values, we agree that these should be set at the same level as equivalent parameters in CBAs. We do not think that this would constitute a formal change in methodology requiring a full consultation process, and a revised version could be issued directly.

Expansion of methodology

We are supportive of Ofgem's proposals to expand the coverage of NARM in RIIO-ED2 through a common set of 58 Asset Register Categories models, with three non-pressurised cables as optional.

With regards to non-NARM assets, we would like to work closely with Ofgem and other DNOs to explore potential options for regulatory treatment and identify a solution that is proportionate and drives the right behaviours. In the SSMC, Ofgem proposes three different approaches and highlights a number of challenges associated with these. At this stage, we do not consider that sufficient information has been provided on how these mechanisms could potentially operate for us to understand the advantages and disadvantages of each approach.

The SSMC suggests that non-NARMS assets will be subject to an uncertainty mechanism where challenges cannot be overcome. We are also concerned that Ofgem has not provided sufficient information on how a non-NARM asset re-opener would operate in order for us to provide a full response and enable Ofgem to reach a decision at SSMD. Given the tight timings associated with the publication of SSMD in December 2020, we would urge Ofgem to consider retaining the current status quo as an alternative. We consider that this approach could be retained for RIIO-ED2, with the aim of developing the framework for non-NARM assets for RIIO-ED3. This would enable Ofgem and the DNOs to work together to further develop options for the treatment of these assets, recognising the challenges associated with collecting condition data. This detail could be incorporated into a published roadmap for the development of CNAIM during RIIO-ED2 for ED3 and beyond incorporating all remaining asset classifications in the appropriate way as

² SRRWG, 10 September 2020

outlined during the Safety Resilience and Reliability Working Group presentations already made by the ENA working group.

Incentives associated with NARM

Overall approach

We agree that DNOs should be incentivised to efficiently deliver their NARM output. We are broadly supportive of the principle that, where a DNO fails to deliver its output target, associated cost allowances will be returned to customers (justified under-delivery), with a penalty associated with any failure to justify under-delivery (unjustified under-delivery). We also agree with the proposal that DNOs should be exposed under the TIM to the cost of delivering more than their output targets (unjustified over-delivery), and will be held cost neutral where over-delivery has been justified.

We also agree that:

- monetised risk improvements delivered through investments funded under other mechanisms should not be included in NARM for RIIO-ED2;
- material changes unrelated to DNO asset interventions should be excluded from the mechanism; and
- companies should be held neutral for NARM methodology changes

With regards to material changes, in the RIIO-T2 and GD2 Draft Determinations, Ofgem's proposal is to hold companies neutral to reasonable levels of data cleansing changes. We would like further clarity from Ofgem on what constitutes reasonable levels of data cleansing in this context.

Our main concern is with the lack of reference in the SSMC to the introduction of a deadband for RIIO-ED2. We think a deadband is key to ensuring proportionality and that effort is focused on material deviations from the target, outside of the deadband, that may not be in the interest of consumers. We would welcome confirmation from Ofgem that a deadband will be introduced for RIIO-ED2.

Response to T2 and GD2 Draft determinations

We welcome the confirmation provided by Ofgem³ that the RIIO-T2 and GD2 proposals for a NARM Funding Adjustment and Penalty Mechanism will not apply automatically to RIIO-ED2. We are ready to work with Ofgem in the run-up to RIIO-ED2 Draft Determinations to develop an appropriate mechanism for RIIO-ED2, which places the right incentives on companies and protects customers.

We recognise the issues raised by Ofgem in its Draft Determinations for RIIO-T2 and GD2 and agree it is important that customers are protected against windfall gains. However, this also needs to be balanced with allowing sufficient flexibility for companies to deviate from their plans, where appropriate. We have concerns that the proposed solutions could have unintended consequences, by potentially driving behaviours which are not in consumers' interests. We also question the proportionality and efficiency of the mechanism. We highlight key concerns and possible alternative approaches below. Ultimately, the design of an appropriate NARM Funding Adjustment and Penalty Mechanism will need to be based on a

³ SRWWG 10 September 2020

thorough analysis of performance in RIIO-ED1. This will enable Ofgem and stakeholders to better understand any issues arising out of RIIO-ED1 and design an appropriate mechanism in response.

Proposals to adjust unit costs

As a starting point, our view is that companies should retain the full TIM benefits of any genuine efficiencies achieved during the period. We understand Ofgem's concern that the current mechanism potentially allows companies to make unjustified windfall gains. We note that there are already robust controls in the ED sector. With the improvements and changes to the proposed CNAIM v2.0 draft for use during RIIO-ED2 risk from potential gains is being reduced further. If Ofgem were to introduce downward adjustments to unit costs then this should happen by exception only, where company performance deviates significantly from the target and any associated deadband (see point above), and companies are unable to provide evidence that they acted in consumer interest.

Secondly, if Ofgem chooses to introduce an adjustment to unit costs, we believe that this should be symmetrical, recognising that in some circumstances increases in unit costs will be outside company control. Under the current RIIO-ED1 mechanism, where focus is on overall delivery, increases in unit costs in one area are likely to be compensated through efficiencies and decreases in unit costs in other areas. However, a downside only ex-post unit cost adjustment would constrain this ability to make trade-offs, even where justified, exposing companies to a greater amount of uncertainty and risk. There is also a risk that this will disincentivise companies from carrying out certain activities that would otherwise be in consumers' interests, in particular difficult, costly, but necessary, replacements.

We note that there are alternative options for addressing Ofgem's concerns around windfall gains, the TIM providing an initial level of protection. We propose some options for consideration below. In addition, Ofgem is proposing the introduction of an overarching Returns Adjustment Mechanism (RAM). We have concerns around the RAM, as highlighted in our response to the relevant questions, and we would urge Ofgem to consider whether the introduction an additional retrospective unit cost adjustments is proportionate and necessary.

Before Ofgem reaches a decision on the application of a NARMs Adjustment and Penalty mechanism in RIIO-ED2, we think further discussion is required around the nature of the problem Ofgem is seeking to address in electricity distribution, with full consultation on a range of detailed targeted proposals.

Requirements around justification of cases

As highlighted in our response to RIIO-T2 and GD2 Draft Determinations, any requirements for justification of cases should therefore be proportionate, and we do not think that this should involve the provision of large amounts of detailed information, which would be inefficient and inconsistent with the RIIO framework and the original NARMs policy intent. The treatment for justification needs to be proportionate to the unit cost and volume of activity, in particular within the ED sector which is characterised by proportionately higher volumes of low-cost assets.

Use of NARM in justifying investment decisions

We agree that for RIIO-ED2, NARM should provide a useful tool for justifying investment decisions, in conjunction with EJPs and CBAs. In many cases, where there are programmes of work to be delivered for high volume/low cost investments, the output of long term risk calculation within the revised CNAIM has

the potential to negate the complexity for detailed EJPs incorporating CBAs where the reporting matrix of monetised risk has the potential to be a more effective indicator of a positive net present value for the investment. Proposals to utilise this mechanism for justified investment in the upper risk index categories would be welcomed as proportionate treatment for these asset categories in the Business Plan submission. Again we would welcome further discussion on this proposed treatment and to work with Ofgem and the other DNOs to identify where this mechanism would be consider appropriate. We would also welcome further engagement with Ofgem to ensure that EJP and CBA templates are used appropriately and proportionally for the assets under consideration and guidance documents are tailored to electricity distribution to reflect these considerations.

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

We agree with Ofgem’s proposals not to introduce specific outputs or incentives related to workforce resilience in RIIO-ED2. We also agree DNOs should provide sustainable workforce resilience strategies as part of their Business Plan submissions.

We welcome Ofgem’s recognition of the challenges network operators face in attracting and maintaining a sustainable workforce. As a DNO, we have also started to think carefully about the need for new skills that will be required in ED2 including those associated with the transition to DSO.

We agree that there could be some benefit in DNOs working together, and with their CEGs and relevant industry bodies to explore common metrics and reporting. We would welcome further clarity from Ofgem on its expectations in this space.

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

Overarching approach

We agree with Ofgem’s proposals for DNOs to submit both a Cyber-Resilience IT plan and a Cyber Resilience OT plan. We agree that BaU activities relating to IT should be subject to the TIM support with Ofgem’s proposals to introduce a “use-it-or-lose-it” allowance for cyber-resilience OT driven by the NIS Regulations.

Re-opener

We agree with the proposal to introduce a mid-period re-opener to capture any potential changes to statutory and regulatory requirements, and any new emerging threats or risks. Companies should also be able to use the re-opener to revise plans based on their increasing maturity in this space. Given the constantly evolving nature of the threat, Ofgem should consider an annual window for this particular re-opener.

CAF

We note references to the National Cyber Security Centre’s Cyber Assessment Framework (CAF) and Ofgem’s own guidance. We see the CAF as a generic tool to ensure that we have the right management systems in place. As we develop our maturity in cyber risk management, we are identifying areas of risk. These will not necessarily affect our self-assessment against the CAF but need to be addressed. We are

supportive of the principles set out, and believe the focus should be on risk reduction rather than CAF outcome improvement.

We look forward to further engagement with Ofgem's cyber team as we continue to develop our business plan.

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

There are potential interactions with Ofgem's proposals relating to physical security and telecommunications resilience. There will be activities linked to the roll-out of a cyber secure operational technology network that will have a number of potential different drivers (cyber security, physical security, BT21CN, Active Network Management). We would welcome further discussion on where Ofgem expects these to be captured in the business plan. Please see our response to OUTQ54 for further details.

The roll out of DSO capabilities will require close consideration of associated cyber security implications. The concerns are twofold with an increase of interfaces (and therefore in the points of entry) and an increased number of controllable customer assets. A pragmatic approach to ensuring cyber security, while not unduly limiting the role out of flexibility services, will be key.

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?

We welcome Ofgem's recognition of the importance of climate resilience and climate change adaptation. In recent years, we have been experiencing more extreme weather including heat waves, extreme rainfall, high winds and more summer storms than ever before, and we expect climate change impacts to continue to worsen. This will have many implications for our network. We are therefore broadly supportive of Ofgem's proposals, provided there is a clear remit for activities and how these might interact with other areas (e.g. NARM, IIS, other resilience activities).

We note that there already a number of relevant activities in this space, in particular the ENA working group Climate Change Adaptation Reporting Group, and obligation to report on climate change adaptation measures under the Climate Change Act 2008. We would welcome clarification from Ofgem on interactions between existing activities and the proposed new climate resilience taskforce. There would need to be clarity around the role of any new taskforce.

Finally, in the document, Ofgem suggests that the new taskforce could also play a role in the development of a "wider" resilience metric. We would welcome clarification on the extent to which any new wider resilience metric would focus on climate change specifically, and how it might inform RIIO-ED3. We provide further comments on the wider resilience metric in response to question OUTQ53 below.

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?

We think that there would be benefit in further exploring how climate change might affect existing threat vectors (e.g. extreme climate events, including extreme heat and storms), looking to parts of the UK network that have had more experience dealing with such events, and developing appropriate long-term mitigation strategies. This work is already underpinning our thinking and will form part of our Environmental Action Plan, including but not limited to Flood and Environmental Resilience.

We would also welcome and encourage increased knowledge sharing across infrastructure bodies. As referenced in the SSMC, disruption in one sector can have serious implications in others and the failure to proactively and appropriately manage climate change risk can have a catastrophic impact to our networks - as can be seen in the recent landslide incidents on the rail networks in Scotland. Therefore, in order to create a robust longer term mitigation strategy, we need to engage with other DNOs and/or ENA, wider infrastructure, and environmental bodies to help set out an appropriate level of climate mitigation to protect assets at risk from climate change.

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

We agree with Ofgem's proposal to retain the RIIO-ED1 approach to flood resilience, whereby allowances are provided as part of the business plan. We are continuing to work to ensure our network meets the requirement set out in the ENA's Engineering Technical Report 138 (ETR) and the National Flood Resilience Review (NFRR).

We note Ofgem's proposal to introduce a new wider resilience metric. We have set out our views on this in response to question OUTQ53.

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

Given the recent flooding related incidents we have had across all types of infrastructure in GB, DNOs should at least report against the original and evolving plans throughout the price control, with a focus on what we have committed to do with our stakeholders through the Annual Environmental Report, and why there have been any revisions to those plans. We should also report the benefits of any investment and could also reference progress against legal requirements where appropriate, for example ETR 138.

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

We agree with Ofgem's proposal to retain the RIIO-ED1 approach for tree cutting, whereby allowance is provided as part of the business plan. We are continuing to work to ensure our network meets ESQCR requirements and relevant best practice/ standards documents.

DNOs are facing increasing challenges in this space as a result of ash die-back. This will need to be factored into companies' business plans and Ofgem's assessment of these.

We note Ofgem's proposal to introduce a new wider resilience metric. We have set out our views on this in response to question OUTQ53.

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?

We note that climate change resilience considerations already underpin many of our day-to-day activities, and the impact of climate change is being felt in many different ways (e.g. storms, extreme heat). It is important that overall regulatory framework continues to evolve in a way that reflects this.

We recognise that there may be benefits to developing a wider resilience measure. There are a number of points that will require further thinking and clarity in order to enable work to go ahead:

- Scope: based on proposals in Ofgem’s consultation, our current understanding is that this would likely cover environmental resilience/ climate change resilience, flooding, and tree-cutting. We think it is worth considering whether this could reasonably be extended to cover other factors such as resilience of underground networks and thermal capacity;
- Added value: any new resilience measure would need to add value and avoid unnecessary duplication with existing measures and associated reporting. Our view is that a new resilience measure would need to be developed in such a way as to ensure it meets the needs of customers and stakeholders;
- Nature of measure: we do not think that it would be useful to introduce a new single metric that covers a range of different areas. Rather, we would support a “dashboard” approach to any new resilience measure;
- Role: we would need to understand to what extent any new measure would be used to hold companies to account during RIIO-ED2 or feed in to RIIO-ED3 business plans. Our understanding of Ofgem’s proposals is that the intention is to focus the measure on providing information to external stakeholders and the wider public. We propose this could be done in our Annual Environmental Report as required in ED2

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

Blackstart

We agree with Ofgem’s proposal to retain existing RIIO-ED1 arrangements for Black Start, with funding provided through the price control and the introduction of a re-opener.

Our view is that further work needs to be done to enable distributed energy resources and flexibility solutions to support Black Start. This should incorporate learnings from the Distributed ReStart and RaaS innovation projects

The resilience requirements for both on-site equipment and telecommunication links will need to be provided for. This is also likely to need to extend to customer sites providing flexibility. We welcome clarification from Ofgem on how these should be captured as part of our business plan.

Physical security

We agree with Ofgem’s proposal to retain existing RIIO-ED1 arrangements for physical security, with funding provided through the price control and the introduction of a re-opener.

As outlined in our response to OUTQ47, we note potential interactions between physical security and cyber resilience, where physical security upgrades may be required but will not have CNI as the main driver, with other potential drivers including cyber security, more active and integrated network equipment, and BT21CN (please see below “telecommunications resilience”). Our view is that allowances and the re-opener should cover physical security upgrades driven by enhanced cyber security measures. We would welcome clarity on how these activities should be captured in our business plan.

Finally, we note that physical security includes CCTV, some of which will be impacted by the Public Switched Telephony Network (PSTN) switch-off (see below). We would welcome clarification on whether the provision of new communications circuits should be captured as under physical security allowances.

Telecommunications resilience

We agree that developments relating to telecommunications resilience must be carefully monitored and captured in the business plan. We think a proactive approach is required in this space, including accelerating the availability of spectrum.

We have already highlighted some of the interactions between telecommunications resilience, and Black Start and physical security above. An additional issue requiring careful consideration involves DNOs' ability to communicate with customers during a storm, which is at risk from proposed PSTN switch-off in December 2025. Following the switch-off, landlines will no longer work during a power cut. This will have a number of implications for DNOs:

- We cannot use landlines to contact our customers during a power cut, and they cannot use landlines to contact us;
- We cannot rely on landlines for voice communications during a black-start. We have c. 700 sites which rely on them today;
- Touchtone services will cease to work. This includes fax but also includes a lot of our bulk supply point metering and may impact some CCTV

Our intention is to capture these last two issues as part of our OT plan. We would welcome confirmation that this is the correct approach.

We note Ofgem's proposal to provide an update at Draft Determinations. We would welcome discussions with Ofgem on the potential introduction of a re-opener mechanism for telecommunications resilience, in line with proposals on other components of resilience. This could, for example, be used to manage the issue outlined in our first bullet point above.

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?

Please see our response to OUTQ54.

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

We think that a more proactive approach is required. Please see our response to OUTQ54 for further details.

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

Net Zero targets for 2045 in Scotland and 2050 in the rest of the UK are now legally binding and network companies have a critical role to play in enabling the transition to a low carbon energy system. Achieving the most effective transition requires an adaptive regulatory regime. Across our two licence areas we have 75 local authorities; 65 of these have declared Climate Emergencies, with some setting net zero targets between 2025 and 2030. Our stakeholders are increasingly demanding rapid change, and we need to play our part.

Reducing the environmental impacts of running our business and contributing to decarbonisation of the energy system is front and centre to our considerations across the SSE group. As such we support the

intentions of the proposed Environmental Framework. However our stakeholders have indicated their strong support for financially incentivising DNOs to drive down their own controllable emissions. We would encourage Ofgem to explore potential financial incentives to further drive DNOs to deliver a sustainable network. The sole reliance on a reputational incentive is not in line with broader policy direction and the ED2 period is on the critical path to Net Zero.

Introducing incentives to embed the ambition of the EAP has merit and would require further consideration. We propose DNOs, stakeholders and Ofgem work together to further explore options in the run-up to Draft Determination. Incentives should only cover activities which are within our control and where accurate measurements can be undertaken, including of the counterfactual. In addition, regional differences are hugely influential, and targets should be informed by local stakeholders and value delivered, rather than common to all companies.

Further clarity around some of the baseline commitments would further ensure rates of decarbonisation and reduction in environmental impact is consistent across all DNO's. Please see our response to OUTQ58 for further details.

Producing a stakeholder led Environmental Action Plan that we report on annually will further strengthen DNO accountability and is something our stakeholders would value. The introduction of an environmental reopener to manage any legislative change is also welcome given potential upcoming changes, in particular related to SF6. We expand on our position in response to OUTQ60.

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?

We welcome the proposed introduction of an Environmental Action Plan (EAP) as part of the RIIO-ED2 business plan submission. We will work with our stakeholders to develop targets for activities included in the EAP, to be funded within the business plan and monitored through robust and transparent annual reporting.

We agree with the proposed scope of the EAP objectives to decarbonise the networks and reduce the wider environmental impact of network activity. We would also welcome the opportunity to include bespoke activities over and above what is set out in the Business Plan minimum requirements that meets the needs of stakeholders.

We would encourage Ofgem to ensure consistency across all DNOs when it comes to setting targets particularly in relation to the requirement to set science-based targets (SBTs). Currently there is a requirement for all DNOs to set SBTs but there is no clarity as to whether those targets either need to be accredited by the Science Based Target initiative (SBTi) or whether they should be aligned with either; (a) a well below 2 degree which is aligned with Paris Agreement or; (b) a 1.5 degree trajectory which is aligned with Net Zero.

The difference between both SBT trajectories is quite significant and thus could result in separate pathways developing between DNOs - and will most certainly directly impact the efforts and level of activity required from each of the DNOs. We encourage Ofgem to be more prescriptive here to ensure the delivery of an environmentally sustainability network across all of the UK. We agree that the target

years should be set by the DNOs themselves, which allows each DNO to produce a plan reflective of their own network, and stakeholder needs.

In terms of gaps, we note that Ofgem have indicated that they are proposing to address the accelerated removal of polychlorinated biphenyls (PCBs) through an uncertainty mechanism which is mentioned in Annex 2, page 94. However, PCBs have not been included in the EAP proposed minimum requirements, understandably given the current position and the ongoing work with BEIS, ENA and Ofgem to better understand the final position on PCBs. However, once developed and the uncertainty mechanism is triggered, companies could then include PCB commitments at that time and report accordingly to stakeholders. In the meantime, we could continue to provide an annual update on industry developments.

The baseline requirements also call for common approaches to be adopted across all DNOs, we would welcome clarity in the SSMD from Ofgem to specifically call out what these are and in particular address specific questions around common methodologies, supplier codes and appropriate tools which we have set out in our Business Plan Guidance feedback.

Providing this clarity will ensure business plan minimum requirements are consistently met.

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?

We believe the annual reporting through the Environmental Impact Report will increase transparency of the DNOs activities, however will be limited to the ambition of each DNO and what they subsequently include in their EAP. We understand from the working groups that the annual report is thought to be a stakeholder facing document, where stakeholders can assess performance against commitments made with their direct input. It is not clear whether Ofgem will set a template for this report, whether this report will be used to assess DNO performance against regulatory mechanisms, and whether we will need to submit this officially to Ofgem as part of the RRP submission for example. Clarification is welcome in the SSMD.

Clarity of the common approaches to be adopted as mentioned in the baseline requirements, in addition to direction on SBT trajectories will provide further transparency across DNOs.

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

We support the proposal to introduce a re-opener to accommodate environmental legislative change. It is essential that the framework and mechanisms for RIIO-ED2 provide flexibility to respond to an identified need, in a timely manner and in a way that protects the integrity of the price control under which we operate. Further clarity on how the re-opener mechanism will operate is required.

During RIIO-ED1 we have seen the effect of the mid period POPs (PCB) legislation change which has a significant effect on all DNOs. This legislation change was not expected and thus an indication that we cannot at this stage predict what future environmental legislative change may occur in the 2023-2028 period.

We welcome further guidance on how this reopener works, and any areas of exclusion. There is a need to ensure that when developing this re-opener attention is given to:

- Using this new mechanism to fill any gaps left by established or proposed new uncertainty mechanisms for RIIO-ED2;
- How the mechanism would work alongside other existing or proposed mechanisms in particular the Net Zero Reopener;
- Accepting that the mechanism should be capable of adjusting upwards as well as downwards;
- Providing enough flexibility to allow the mechanism to be triggered when required; and
- Allowing network licensees, not just Ofgem, to trigger the mechanism”

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

We largely support the removal of the Losses Discretionary Reward. We note that DNOs have only received limited rewards in Tranch 1 and no rewards in the last 2 tranches, and our view is that the submission process has been disproportionately burdensome against benefits reaped. On this basis, we would like to work with Ofgem to further explore how the regulatory framework could incentivise companies to make positive change with regard to losses working from the recommendations of the ENA Technical Losses Task Group.

As it stands, with the removal of the LDR, CVPs and bespoke outputs will be the main tools for incentivising with losses in RIIO-ED2. We welcome Ofgem keeping these options open for losses.

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

Yes, we support the proposal to retain the visual impact allowance for RIIO ED2. Early feedback from our stakeholders indicate that they also support this mechanism within the price control.

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

We support the proposed approach to setting the funding pot for the visual impact allowance as it has been developed through Willingness to Pay research prior to RIIO-ED1, and includes reference to RIIO-T2 Willingness to Pay studies. We would suggest that this could be further reviewed when results of RIIO-ED2 Willingness to Pay work are available.

SSMC Annex 2 – Keeping bills low

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

We agree that TotEx benchmarking should be included as one of the tools for cost assessment. However, it is critical this is balanced against other forms of assessment including those that allow for an assessment which better reflects factors such as regional differences/factors, differences in network configuration, age profile, etc. Our SSEH distribution licensee, for example, covers one of the largest geographical areas, yet has the lowest number of customers. This is an important consideration to note when assessing costs.

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

We generally support the continued use of a MEAV and CSV approach, as per RIIO-ED1. These are tested and understood metrics. However, we do agree that changes should be made to accommodate the additional drivers that have been proposed, discussed and agreed through the Cost Assessment Working Groups (CAWGs). We do not believe it appropriate to use RAV as one of the main cost drivers. We believe this would risk rewarding previously inefficient behaviours.

As per our response to COQ1, it is important that benchmarking can take account of network-specific factors, where these are clearly demonstrated/evidenced, i.e. regional differences/ factors, differences in network configuration, age profile, etc.

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

We believe there is a role for both sets of data in RIIO-ED2 modelling but given the level of change anticipated in the sector over this period, we believe greater emphasis should be placed on forecast data. Clearly, this is contingent on sufficient accuracy and confidence in company forecasts.

With regards to historic data, we believe the following considerations are relevant:

- The significant time and effort that all network companies have invested in RIIO-ED1 to improve their data. It is important that historic data is appropriately used in RIIO-ED2 modelling and does not inadvertently or otherwise penalise companies that have made improvements in this area;
- It may be appropriate to place more weight on more recent historical data; and
- Appropriate treatment of one-off events, which have the potential to skew data

COQ4 At what level should we set the efficiency benchmark?

We believe the efficiency benchmark should be set at Upper Quartile (75th percentile), based upon agreed cost drivers and excluding regional factors and other network-specific costs. We do not believe there is merit in establishing a more challenging efficiency benchmark. We do not believe this will drive or deliver sustainable behaviours, particularly when companies are faced with the resulting cost allowances at a disaggregated level.

Ofgem's proposal to set an efficiency benchmark at the 85th percentile in RIIO-GD2 Draft Determinations has been widely criticised by gas distribution companies. We have noted some of the underlying reasons below:

- Poor reward for Frontier company and provides little incentive to deliver further savings;
- Inappropriate to use past performance to set a forward-looking benchmark, in particular in the context of wide-reaching changes expected in the energy sector in RIIO-2;
- Level of benchmarking should be linked to level of confidence in benchmarking models, as highlighted by Ofgem in RIIO-ED1⁴, and further acknowledged by the CMA in the 2015 Bristol Water reference⁵; and
- Failure to include future investment requirements as we move towards the need to meet Net Zero requirements in RIIO-ED2.

We note that the approach of using a benchmark that is higher than the 75th percentile is not in line with regulatory precedent, as further demonstrated by the CMA's provisional findings on the four water company appeals in PR19⁶.

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

We welcome the opportunity to develop cost pools for a middle-up approach as a possible way of avoiding some of the disadvantages that come from a 'top-down' and/or 'bottom-up' approach. By establishing relationships between activities and creating cost pools, we believe this will help to remove some of the inefficiencies within the various models. However, given the different views across the DNOs, the challenge will be developing these cost pools. We broadly agree with the proposed criteria developed by CEPA and we would welcome work within the CAWG to define and design these cost pools further to agree a common approach.

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

We believe a middle-up approach would be best based upon high level, robust categories, such as customer numbers or network length. We would welcome the aggregation of cost types approach, such as LRE, NRLE, NOCs, as presented by ENWL in one of the CAWG. Considerations shall however be given to the close out process and allow trade-offs between these categories.

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?

We believe there is merit in exploring CEPA's proposed totex and opex plus approach. This aligns with our own views and preference for a more aggregated approach.

In terms of opex activities where there are trade-offs that support CEPA's proposed approach, the following are a number of examples:

- The relationship between inspections and maintenance expenditure and fault expenditure;
- The relationship between contractor expenditure and business support and capital costs;
- and

⁴ https://assets.publishing.service.gov.uk/media/5ebebdc1e90e071e2a937fce/Ofgem_Redacted.pdf p.4

⁵ Competition and Markets Authority (Oct 2015), 'Final Determination 2015', paragraph 4.222

⁶ Competition and Markets Authority (Sep 2020), 'Provisional Findings Report', paragraph 4.296

- The relationship between indirect and capital costs. For example, increased engineering analysis (and targeted asset inspection) can better target intervention and reduce the volume of activity that is required

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

Whilst we recognise the benefits in using disaggregated, granular data to encourage cost reductions and aid transparency, we believe there are risks in using bottom-up, activity-level, disaggregated modelling. These include the micro-management of specific activities at the expense of others, setting an unachievable 'package' of cost allowances that cannot accommodate trade-offs, and complex modelling that cannot react to late adjustments in the setting of the price control. Disaggregated modelling must therefore be used carefully and only where it is appropriate.

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?

We believe there is merit in applying a combination of aggregated and disaggregated approaches, with an aggregated approach lending itself better to determining the overall efficiency of each DNO; and a more granular, disaggregated approach being more suited to testing whether proposed allowances are achievable and appropriate.

In terms of weighting, based on experience from RIIO-ED1, where ultimately the aggregated model was found to be more robust, we believe Ofgem should place a higher weighting, i.e. more than 50%, on its aggregated modelling. However, the ultimate weighting should be informed by the confidence underpinning each model. If learning is embedded from RIIO-ED1 and the level of disaggregation is practical and the model is clear and transparent, it may be appropriate to adopt a more balanced approach.

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

As per our response to COQ9, we believe there is a role for disaggregated modelling approaches, providing the level of disaggregation is appropriate, practical and clear and there is sufficient confidence in the model and its outputs. We therefore believe disaggregated modelling should be used to align the allowance with activity and, in turn, set PCDs.

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

We agree that despite a wide variety of regression models that could be chosen, Ordinary Least Square (OLS) modelling best aligns to the modelling selection criteria as set out in COQ13, as it is well understood within the cost assessment processes.

However, it is key not to preclude other tools and we would welcome the possibility of alternative models to the ones selected, such as the Stock-Watson Dynamic OLS (DOLS) approach, which has been used in studies to estimate the energy demand in other countries. OLS assumes there should be no correlation between the error term and independent variable and the error term and dependant variable, however, this is not always the case. On initial review, DOLS helps to overcome this, particularly in small data

samples. Further investigation would be required to define whether this tool would be more useful, however this demonstrates that there may potentially be better options.

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

We believe the Cobb-Douglas functional form to be a well understood approach due to its relative simplicity and use during the RIIO-ED1 period.

We would welcome and support the potential development of other forms of calculating functional form to help generate more flexible models, e.g. as originally used by Ofwat with the development of translog/semi-translog models. We do appreciate that such models add an element of complexity so are open to further discussion during CAWGs.

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

We agree with the model selection criteria, acknowledging the best practice approach taken in choosing the options. We are also supportive of the order in which the selection criteria are set. We believe an economic/technical rationale first approach which should help support the subsequent selection criteria.

Transparency is key to generate understanding amongst both DNOs and external stakeholders. As RIIO-ED2 is aiming to be stakeholder led, focus should be placed upon making the numbers understandable to all parties. RIIO-ED1 fell short in this area with last minute changes that we would argue failed the transparency test.

Finally, robustness is vital in order to understand sensitivities that the model will accept. Part of the reason we support a simple TotEx model is that it is simple to see overall impact with the changing of a variable. In contrast to a disaggregated model with many moving parts, which changes can have unseen impacts to wider parts of the model. This is a particular worry regarding the development of cost pools as discussed within COQ5.

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

SSEN agrees with the proposed criteria for assessing regional and company specific cost factors. The RIIO-ED1 requirements still stand that DNOs must provide a high level of evidence to clearly define, justify and quantify each specific factor to Ofgem, and that the DNO has managed these factors appropriately.

We also agree that any factors should be material in nature, although this level of materiality should be relative to the size of the company rather than a predetermined value.

In addition, we would recommend including in the proposed criteria that Regional and Company specific factors must not already be captured through a cost driver. This will ensure that DNOs do not benefit twice from any such factors that are agreed.

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

We believe in an approach of both pre and post modelling adjustments for different areas of regional and company specific cost factors as per the approach adopted within RIIO-ED1.

Pre-modelling adjustments – as per RIIO-ED1 we believe Regional Labour and Urbanity & Sparsity should be included as pre-model adjustments. We believe this is the most sensible approach as these factors will affect a broad range of data within the cost tables. For setting a cost baseline, we believe benchmarking modelling will be significantly more reliable.

While we acknowledge the risk that the criteria for selecting the factors will need to be suitably robust in order to avoid any inaccurate adjustments, we believe a mix of well-defined quantitative criteria and suitable qualitative reviews should help mitigate this issue.

Within-modelling adjustments – we would welcome further work on urbanity and sparsity adjustments, in particularly the assessment and calculation of density drivers.

Post-modelling adjustments – for regional and company specific factors that are not applicable across all companies, we believe a post-modelling adjustment would be the most suitable approach to address costs that are not within efficiency controls. These will be for costs that we believe cannot be captured through pre-modelling adjustments, with one such example being the agreed RIIO-ED1 factor of travel and accommodation costs to remote islands as incurred by SSEH.

As commented in response to question 5.33 we would welcome further work on both approaches to better understand the statistical significance of each and determine which would be the most suitable on reflection against historical data.

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

We have seen little to no evidence presented by CEPA³ or Ofgem in its assessment of RPEs in the Draft Determinations to confirm that this has been carefully considered and evaluated. In our SHE Transmission Business Plan, we provided significant evidence around the volatility of indices and in particular the unreliability of using certain indices to set cost allowances. We also noted that for the indices to be truly reliable they would have to reflect the underlying cost base and in particular translate as changes in our expenditure. As part of that we would be required to manage the risk by placing contracts with the supply chain that reflected these indices therefore protecting the company from downside risks over the course of RIIO-2. We also note that the CMA has allowed ex-ante funding for labour costs in relation to RPEs subject to true-up but, but not for any other material or plant costs as proposed by Ofgem for RIIO-T2 and GD2.

We equated this to two different options, a) we pass this risk on to the supply chain which would ultimately cause an increase in costs to consumers, or b) we absorb the risk and try to manage the volatility in indices over the RIIO-2 period. We therefore believe that RPE indexation is likely to increase costs to consumers to this new risk for ongoing management during RIIO-2. As a result, we proposed that no indexation of RPEs was used during RIIO-2 with the only category warranting a reliably and steady estimate of RPEs being labour costs. This appears to have been ignored in Ofgem's Draft Determinations as well as CEPA's analysis. We also note that CEPA has not considered the volatility of indices except for evaluating the impact on totex at a high level⁴.

We are therefore unable to provide a full assessment of the proposals, their robustness or validity other than noting errors and absence of data. We also note that the underlying calculation for the opening allowance was not provided by Ofgem during the consultation period either. We believe significant further

consultation and engagement is required on RPEs and in particular with reference to the overlap with ongoing efficiency as we noted in our Business Plan⁵. The overlap and possible double count is a serious matter and we have provided evidence of this with supporting evidence from Oxera⁶. This is outlined extensively in the report provided by Oxera and our response to ongoing efficiency. The CMA has also noted this in their Provisional Findings for PR19⁷ whereby they note the risk of double counting and overlap with ongoing efficiency, RPEs and wider efficiency cuts.

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?

As we have noted in our response, we do not believe there is adequate justification or evidence supporting RPE indexation. However, if RPE indexation is adopted we see no reason why a materiality threshold would apply as it unnecessarily leaves a certain amount open to gains and losses. We would recommend that no materiality threshold is applied if indexation is adopted. We will review RPEs as part of our Business Plan submission setting out our policy and justification accordingly.

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

As noted above, Ofgem need to avoid double counting with ongoing efficiency, and also with regional factors. The application of common indices may inadvertently and incorrectly distort regional factors. This will need to be evaluated as part of Business Plan submissions for RIIO-ED2.

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

We note that the CMA has applied an ongoing efficiency assumption of 1% for the four appealing Water companies. This is materially lower than Ofgem's proposal for T2 and GD2 of 1.2-1.4%, which is above the top of the range estimated based on evidence. We also note that the 1% assessment is at the top of a plausible range for ongoing efficiency based on the market data. We therefore propose that evidence is re-evaluated and the most appropriate ongoing efficiency measure should be more balanced based on the evidence including for related sectors. It is worth noting that economic outlook across the UK and globally could have a material impact on ongoing efficiency due to the demand for infrastructure assets. The overlap with RPEs is an area that requires careful analysis and consideration. To date Ofgem's approach has been materially incorrect in this regard in Draft Determinations.

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?

We see no reason to adopt a break from regulatory precedent in considering ongoing efficiency measures and we would advocate for consistency in utilising Growth Output (GO) and Value Added (VA) measures. We note the CMA has relied more on the GO measure in their redetermination of PR19 whereas Ofgem has relied upon the VA measures. We note that the plausible range is significantly lower than Ofgem's estimate for GD2 and ED2 of 1.2 - 1.4% as noted in COQ19.

⁷ Competition and Markets Authority (Sept 2020), 'Provisional Findings Report'

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

Further work is required by Ofgem to develop and implement a business plan assessment process which is robust, transparent and fair.

As noted in our response to questions OVQ4-OVQ7 the position outlined by Ofgem across the overview document and annex 2 of the SSMC significantly lacks in clarity.

We note the four models for Strategic Investment outlined in figure 6 of the SSMC overview document; however, we also note Ofgem has published four alternative options for forecasting in figure 5 of annex 2 for cost assessment. Furthermore, Ofgem has stated a preference to use option 3 within figure 5 of annex 2 “a common set of scenarios from which DNOs would select their own “best view”.”

We note the comment in paragraph 7.22 of annex 2 “Option 3, is to fulfil a specific function (benchmarking). This does not necessarily mean that this approach should form the basis of the investment plan.” We think this could give rise to an inconsistency between the model used for cost benchmarking and that used for volumes relevant to investment planning, and that this will likely lead to confusion and inconsistency in business plan development assessments. Also, it is not clear what information and data Ofgem expects to receive from network companies to fulfil the functions of benchmarking and plan development if they are to be derived from different models or sources.

We ask Ofgem to provide clarification on the relationship between these models, and how information should be provided in the business plans? Our preference would be that consistency is maintained between Strategic Investment models and options for forecasting (for the purposes of benchmarking) in RIIO-ED2, with DNOs required to submit one data set which can be used for both purposes.

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

We note that this questions have significant interaction and overlap with question OVQ4-OVQ9. As a general point in our reading of the SSMC overview document and annex 2 we are concerned that there remain areas which require clarification and further consideration in the round from Ofgem. Similar concerns are also raised in our response to questions OVQ4-OVQ9 and COQ21. These should be addressed by Ofgem to avoid confusion and to enable the development of robust and credible business plans.

Establishing network impacts is distinct from establishing a forecast of future demand, which questions OVQ4-OVQ8 and COQ21 deal with. It is also somewhat distinct, though significantly overlapping with the process for funding and demonstrating investment efficiency which question OVQ9 and COQ25 deal with through our response to proposals on utilisation incentives and extending the scope of Load Indices.

Critical to establishing network impacts are the points raised by Ofgem in paragraphs 7.29 and 7.30 of annex 2 to the SSMC: “DNOs then need to identify the impact any increases in peak demand are likely to have on their networks”; and that “on some networks, there is currently limited information available on the utilisation particularly down to LV level.”

We would go further by noting that the process of establishing network impacts is complicated not just by the availability of data but by the computational scale of the assessment in question. With thousands of feeders and transformers across all voltage levels, it is impossible to assess these on an individual basis.

There is considerable spatial, temporal and directional uncertainty in the path to Net Zero. This means that processes are required to quantify the uncertainty faced, synthesise this uncertainty into a decision on network impacts and investment; and to ensure this process remains flexible through time. The process should also acknowledge some investing ahead of certainty of need might be in the long-term interests of customers. Where the societal cost of failing to meet Net Zero and the customer cost of failing to meet LCT demand (e.g. customers can not charge cars) is greater than the investment costs today.

We note there is no reference to managing spatial uncertainty on network investment levels to a corresponding scenario within Ofgem's frameworks for Strategic Investment. We also note that the impacts on societal and customer costs are not covered extensively within the SSMC. A cost benefit analysis approach is required for determining the optimal placement of investments. This process needs to quantify the uncertainty faced spatially and temporally then synthesize that uncertainty into a decision about network investment. The process must assess how different investment options (including do nothing) and flexibility solutions compare against each other and find a way to reach an optimal decision. It should, when appropriate take account of societal and customer costs of investment decisions.

We intend to build our ex-ante baseline business plan submission on the above principles of cost benefit analysis. We have commissioned work from Imperial College London to inform our thinking in this area; and we are working with established consultancies with experience in this area as well.

As noted in our response to question OVQ9 we propose DNOs publish an annual Capacity Strategy document along side the Network Development Plan (NDP).

We believe this could supplement and enhance the obligations currently in place to publish the Long Term Development Statement (LTDS) and the Network Development Plan (NDP). For this to work we foresee the following process being enacted by each DNO:

- NDP would give a regular update on the most constrained parts of our network across all voltages according to our latest scenario data and network modelling
- Following the production of the NDP an annual Capacity Strategy document would be publicly produced giving the output of a Cost Benefit Analysis decision on the most constrained parts of the network indicating:
 1. Investment decisions taken for the next year, including wire and non-wire flexibility alternatives;
 2. A pathway of investment decisions for future years across different scenarios, including where the DNO may need to invest and the opportunities for greater use of flexibility services;
 3. DNOs capacity utilisation strategy update related to DNO decisions; supported where appropriate with output from Load Indices and additional HV and LV monitoring localised on the most constrained parts of the network; and
 4. Relative change in our baseline plans year-on year (i.e. how much of the baseline plan is adjusted by the £/MW volume driver and why)
- Finally, we recommend the ongoing role of our Customer Engagement Group in the RIIO-ED2 period to provide a formal and independent level of challenge and review of the Capacity Strategy prior to submission to Ofgem

- The volume driver unit cost will be applied to investments for the next year justified through the Capacity Strategy document

We envisage that this process will be akin to the process used by the ESO in their production of the Electricity Ten Year Statement (ETYS) and the Network Options Assessment (NOA). Through the licence we envisage a set of requirements on the level of analysis which is undertaken and reports which must be produced by each DNO, including timing.

We believe that introducing this process meets the criteria we laid out above and importantly provides a deeper level of transparency and consistency across network companies to develop capacity in an economic and efficient way. Further it adopts a process consistent with that applied in other sectors and previously accepted by Ofgem.

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

Please see response to COQ24.

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

We have chosen to respond to questions COQ23 and COQ24 collectively as they significantly overlap.

Comparing flexibility to network based solutions is critical within the cost benefit analysis process. It is also vital for furthering the role of the DSO and native competition. We fully intend to include flexibility solutions within our cost benefit analysis. We also intend to continue this process forward through the RIIO-ED2 period. In our proposals for a Capacity Strategy document (see OVQ9 and COQ22) the role of ongoing flexibility comparisons is a prominent feature.

We agree with Ofgem's comments in the SSMC annex 2 that "the lack of historical data for flexibility costs presents an additional challenge. Flexibility markets are still at an early stage in GB, with the earliest flexibility tender only in 2018."

As Ofgem acknowledge flexibility markets are at an early stage, we propose to carry out extensive market testing to understand how these could evolve. However, we seek further clarification on how it foresees categorising flexibility costs for the purposes of business plan assessment? We recommend Ofgem considers the classification of these costs based on the level of market testing DNOs are able to demonstrate as part of their business plans.

However, regarding Ofgem's proposal in paragraph 7.43 to compare flexibility with network-based solutions on a like-for-like basis we would like further detail on the costs included in this comparison. As articulated within the SSMC this is not fully clear. For example, there is no proposal on the treatment of fixed costs. We ask Ofgem to lay-out the exact costs in foresees included in this comparison.

Fixed costs incurred by network companies are ultimately passed through to consumers and so to enable a level playing field assessment they must be accounted for through the analysis. We recognise as markets grow there is opportunity to reduce these costs through economies of scale and synergies. This will vary by DNO licence area, so in the absence of further guidance from Ofgem we propose DNOs through their

DSO strategy and Cost Benefit Analysis for Strategic Investment, as part of the business plan submission, outline the allocation of costs and provide evidence that these are accounted for in the most economic and efficient way.

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

As acknowledged within the SSMC the proposals are at an early stage and until further detail is provided our comments are based on information presented to date. The SSMC does not provide extensive detail on how LI are proposed to be used as an output, or how this will link in with other areas of the price control. We ask Ofgem to do this, with a focus on the load related Strategic Investment proposals which we think this will have the greatest interaction with.

We are not however convinced that evidence exists to support the extension of LI to all voltage levels on the network. The cost benefit case for this is still to be established. There may though be some merit in extending load monitoring in a targeted way to focus on areas of the network which are most likely to see investment requirements in RIIO-ED2 period owing to existing network capacity constraints.

How LIs are used alongside other mechanisms needs careful consideration though we urge Ofgem to take on board the points we make in our response to question OVQ9 on the use of utilisation incentives, which we see as fundamentally flawed as a concept. There may however be merit in including the output from LIs within our proposal for a reported annual capacity strategy document. Focused on specific areas of the network the LI much like they operate in RIIO-ED1, can be an excellent informer of the efficiency of load related expenditure. However, the RIIO-ED1 rationale remains “that given the number of factors that contribute to level of network utilisation, setting outputs for LIs in RIIO-ED1 would not provide a robust way to measure DNOs performance over the price control.”

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

Our preference is for Option 2, where incremental costs are captured in a memo table. Option 1, whilst providing similar benefits to Option 2, is more resource-intensive to implement and, as such, would be more expensive. We do not believe Option 3 provides Ofgem with sufficient transparency. We think Option 2 strikes the right balance.

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

We agree with maintaining the RIIO-ED1 approach to assessing Non-Operational CAPEX costs which combined a mixture of qualitative and quantitative approaches to best allocate allowances based on unique DNO circumstances. Despite this, we believe a few areas may require extra focus due to expected future changes.

Due to the current work pattern impact of COVID-19 we welcome further analysis on what impact this may have to Non-Operational property costs. Furthermore, as with vehicles and transport within CAI (COQ30) we believe net zero focus should be a cost driver reflecting the drive towards zero emission vehicles where possible.

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

We believe it is appropriate to maintain the RIIO-ED1 approach to assessing NLRE in RIIO-ED2. However, in so doing, it is important that consideration is given to the following:

- For disaggregated modelling of asset replacement, age-based asset data should be used alongside health index data (and network-specific factors, where appropriate). Any adjustments applied to volume should be transparent;
- If a middle up modelling approach is applied we would like to ensure that any increments or reductions to linked tables (i.e. faults) as a result of this approach should be applied at disaggregated level;
- It would be more appropriate to place more weight on recent cost and volume data, which is more reflective of the current cost base; and
- For Op IT, we would note that this area will be impacted by transition to DSO costs

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

SSEN are broadly in agreement to maintain the RIIO-ED1 approach for assessing CAIs on existing costs. However, it is important that consideration is given to the following:

- Review the approach to assessing regional or company specific factors (e.g. Submarine Cable Faults, Tree Cutting, Remote Generation) and in some cases cost drivers to ensure it is still reflective of the current operating environment;
- It would be more appropriate to place more weight on recent cost and volume data, which is more reflective of the current cost base;
- Costs and reimbursement for Cable Damage should be reported separately given the unit rate impact that larger third-party damages can have to underlying run rates when benchmarking disaggregated unit rates; and
- For 1 in 20 Severe Weather events, given climate changes, we would suggest these costs be added as a pass-through cost if they occur, rather than assessed as part of the business plan given the uncertainty and difficulty of using historical disaggregated data to predict future storm events

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

SSEN are broadly in agreement to maintain the RIIO-ED1 approach for assessing CAIs on existing costs. However, it is important that consideration is given to the following:

- Expected DSO costs in RIIO-ED2, with clarity required on the assessment of these incremental CAI costs to enable us to fully articulate our position on CAI assessment
- It would be more appropriate to place more weight on recent data, which is more reflective of the current cost base (particularly for Street works)
- For Vehicles and Transport, an additional cost driver associated with Net Zero, as costs will significantly increase whilst DNOs transition towards zero emission vehicles.

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

Given the two approaches, we would favour the TotEx approach using MEAV as a cost driver with potential review of asset additions to reflect any increase of volumes as per Core CAIs. As per our response to COQ30, given there is uncertainty included in the cost categories regarding transition to DSO, which is also expected to impact Business Support costs, we would reserve the right to comment further on these approaches pending further details on the assessment of any new costs or cost categories.

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

We agree with the overall concept of CBA application as the process will demonstrate all options have been considered from a cost and stakeholder perspective, provide Ofgem with an understanding of each DNO's strategy or proposal, and highlights the option that provides the best value.

We also welcome additional clarity around the "do minimum option" definition in paragraph 8.9. We agree that this "baseline" option should be a reference to what would happen with the least possible investment, making clear what the impacts are with minimal to no investment on the network. We would welcome further discussion on this point through the working groups.

However, it is noted that a model template has not been finalised and is yet to be issued by Ofgem. We would like to stress the importance of getting this agreed and issued to ensure consistency across all DNOs and allow us time to incorporate in our Business Plans.

Furthermore, we would like the finalised instructions to consider approaches using supporting models, such as the model developed by Baringa for load related expenditure. Is Ofgem expecting supplementary models to be submitted along with the Ofgem developed CBA model?

Finally, we note in paragraph 8.13 that the price base requested is in 18/19 prices, which does not tie in with our overall business plan data tables and may create consistency issues going forward.

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

Please see our response to COQ35.

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

Please see our response to COQ35.

COQ35 Do agree with our proposal to adopt the principals outlined above to guide the production of EJPS and focus the engineering submission?

In principle, we agree with Ofgem's proposals for EJPs. However, as with CBAs, we note that templates have yet to be issued, and there is limited detailed information available for example around the materiality threshold for EJPs. We would welcome further discussion on EJPs through the working groups.

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?

We note that the current Business Plan Guidance requires DNOs to demonstrate compliance with the DAG as a minimum requirement, and we are basing our business plan on this. We are open to discussions with Ofgem on improving the efficiency of regulatory processes, and would welcome clarity on the extent to which Ofgem proposes to implement changes ahead of the business plan submissions, which could prove difficult to implement. We also note Ofgem's proposal to bring together all data assurance requirements under the one licence condition. We would welcome further discussions on ways in which we can ensure that the data assurance framework for RIIO-ED2 is clear, transparent and proportionate. We think this would be a good opportunity to discuss the need for an annual report and the extent to which this provides value.

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

We have significant concerns with Ofgem's proposed approach to managing uncertainty generally across RIIO-2, which we think could have serious implications for companies' ability to deliver Net Zero for consumers.

The heavy reliance on uncertainty mechanisms, mainly in the shape of re-openers, is overly burdensome for Ofgem, network companies, and stakeholders, creating significant uncertainty and risking unnecessary delays to investment. We recognise the need to protect customers and believe that the right balance could be achieved through greater use of baseline funding, combined with more mechanistic approaches such as volume drivers.

Notwithstanding the points above we are content with the list of common uncertainty mechanisms applicable to all DNOs for RIIO-ED2 as outlined in the SSMC. Aligned with the structure of the SSMC we provide our response to proposals related to the Net Zero reopener, CAM, options for strategic investment in; and we provide our response to proposals related to environmental legislation and cyber and physical site security in questions related to Annex 1. Responses to key regulatory finance proposals, including debt, equity and indexation are set out later on in this document in the finance section.

Our response here therefore relates only to: blackstart; rail electrification and; uncertainty mechanisms for areas outside of DNOs' control.

Blackstart

Yes, we agree with the need for a Blackstart uncertainty mechanism. It is important that DNOs can invest to meet any changes to standards and procedures for system restoration as mandated by Government.

Rail electrification

Yes, we agree with the need for a Rail electrification uncertainty mechanism. We also agree it is important to extend this to companies that may not have network rail connections.

Uncertainty Mechanisms for areas outside of the DNOs' control

We agree with the need for the pass-through mechanisms outlined in paragraph 11.29 of annex 2 of the SSMC.

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

We welcome Ofgem's position to allow DNOs to bring forward proposals for bespoke uncertainty mechanisms where there is clear evidence of costs outside a network companies control and only materially impact one, or a small portion of DNOs. In the process of developing our RIIO-ED2 business plan we are considering where bespoke uncertainty mechanisms would be applicable and will bring forward proposals in our submission which are evidenced based and well justified in line with Ofgem's business plan submission guidelines.

There are however areas where we feel Ofgem should consider uncertainty mechanisms applicable to all DNOs. This includes 'Economic climate uncertainty' and 'Wayleaves and diversions'. We note the position established through the Draft Determinations for RIIO-T2 and RIIO-GD2 not to allow for uncertainty mechanisms associated with changes in legislation, policy and standards. We believe this to be an oversight from Ofgem and would urge re-consideration. We outline our rationale below. We are happy to work with Ofgem to further define these mechanisms so that they work for consumers.

We also believe the environmental legislation uncertainty mechanisms should explicitly reference changes to SF6 regulations within its scope.

Economic climate uncertainty

We believe Ofgem, through the Draft Determinations for RIIO-T2 and RIIO-GD2, has failed to properly consider the impact that changes in Government policy and legislation on post-Brexit trade tariffs could have. For RIIO-ED2 we believe Ofgem should reconsider this position and introduce a specific uncertainty mechanism related to Economic climate uncertainty.

There is considerable uncertainty in this area during the time that the UK Government negotiates details of the UK's future relationship with the European Union and engages in new trade deals with other world countries. For some time and until new enduring trade arrangements are in place, network companies face the possibility of paying higher prices, due to temporary and permanent trade tariffs for costs of goods and materials sourced in global markets. These changes will not be covered within existing arrangements to account for changes to the prices in goods such as RPEs and inflation indexation. Nor in many cases do network companies have the option to change supply chains to other global locations or internal source quickly to avoid these impacts, often because the nature of the products we are purchasing is specialist, and we enter into longer-term procurement contracts with suppliers to yield economies of scale benefits for consumers. The sudden imposition of trade tariffs would be an exogenous change that could materially impact costs and we urge Ofgem to allow for a re-opener which is triggered upon changes to the UK's foreign trading arrangements being known. We believe such a re-opener can be subject to the same materiality threshold as others.

Wayleaves and diversions

Landholder compensation claims are largely outside company control and costs associated with wayleaves and diversions are increasingly uncertain. For example, we are now starting to see claims from commercial property owners and substation lease agreements are expiring, which can have a significant financial impact. Our preferred approach would be to enable companies to propose baseline allowances that are well evidenced and based on an understanding of existing cases, coupled with a re-opener or

logging up mechanism to ensure companies are ultimately in a position to recover efficient costs. This is likely to be a significant issue in RIIO-ED2 and we are keen to engage with Ofgem early on in the process to ensure we agree an appropriate way forward.

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

Below we outline our views in the mechanisms proposed for removal by Ofgem within the SSMC.

Subsea cables

We note Ofgem's proposal to remove the re-opener mechanism associated with subsea cable costs for our SHEPD licence area, and that this mechanism was to specifically provide additional funding to protect subsea cables following the publication of the National Marine Plan in 2015.

We believe this decision may be premature and that further costs associated subsea cable may be incurred by SHEPD, which at this time are uncertain and could extend beyond cable protection costs to include items such as decommissioning to align with Marine Scotland requirements.

However, we recognise this was a bespoke uncertainty mechanism for SHEPD RIIO-ED1 and would continue to be treated as such in RIIO-ED2. This means it is the responsibility of DNOs to justify proposals and design for these within their business plans. We intend to do this and would welcome recognition from Ofgem in the Sector Specific Methodology Decision that this is the appropriate course of action, rather than referencing a blanket removal.

Load-Related Expenditure (LRE) and High Value Projects

We note paragraph 11.33 of annex 2 in the SSMC: "we do not expect to retain either of these mechanisms in their current form. Our approach will be dependent on the wider strategic approach to investment and supporting pathways to Net Zero in RIIO-ED2."

We would like to draw to Ofgem's attention there may still be a requirement for a High Value Projects re-opener like the RIIO-ED1 mechanisms covering load and non-load related investment. We would welcome further engagement with Ofgem on its applicability including interaction with other mechanisms such as the Net Zero re-opener proposed by Ofgem.

Link Boxes

We note that Ofgem has not mentioned the Link Box re-opener and would ask for confirmation that it is being removed.

Innovation Rollout Mechanism

We also support proposals to scrap the Innovation Rollout Mechanism in RIIO-ED2. It has seldom been used and is extremely inflexible.

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

We have concerns with the proposed approach to re-openers for RIIO-ED2 which we discuss below. We also do not agree with some of the proposals put forward as part of RIIO-T2 and GD2 for example the significant shortening of re-opener windows, and the lack of clarity around timescales. The introduction of a fair and robust framework for re-openers that provides clarity to stakeholders and confidence in

regulatory decision-making will be central to the successful delivery of Net Zero. This will allow companies to continue providing high-quality services to their customers, and work with their supply chain to plan ahead and deliver efficiencies.

We agree that uncertainty mechanisms will have an important role to play in RIIO-2 where too much uncertainty exists to include costs and outputs in baseline allowance.

It will be crucial that Ofgem step back to consider and assess the overall combined impact of these mechanisms, in particular the significant increase in regulatory burden for Ofgem and the licencees, as well the additional uncertainty that is created. We urge Ofgem to develop a re-opener framework for RIIO-ED2 which enables investment to progress at pace.

Application windows

In principle, we support bringing the application window for re-openers forward from May and shortening the re-opener window. We recognise the benefits this can bring by allowing more time for clarification questions and to allow more decisions to flow into the Annual Iteration Process (AIP) for that year. However, these benefits are only realisable if Ofgem also commits to a clear timetable for assessment and decision-making, supported by enough resource within Ofgem to enable fair, robust and timely decisions. We believe the specific proposals outlined by Ofgem are not practical for electricity distribution company planning resources. An application window in late January typically coincides with the winter storm season, with DNO resources at all levels prioritized on the safety and security of our network and customers' supplies. We propose Ofgem delay the application window to late February to avoid these hold ups.

We also have concerns with Ofgem's proposals to significantly reduce the application window. Ofgem must allow licencees companies enough time to prepare submissions, practically work through internal governance, and ensure availability of appropriate staff members. We propose Ofgem allow for a two-week application process, at least.

Application requirements

We have concerns about some of the proposed licence drafting on re-openers discussed at Licence Drafting Working Groups for RIIO-T2 and GD2. In particular, we note that Ofgem are proposing to remove a number of the safeguards that are currently in place in the RIIO-ED1 licence as follows:

- Adjustments kicking in where Ofgem does not take action within a specified period of time: we note that RIIO-2 is a complex price control, with numerous mechanisms needing to be operated at any one time by Ofgem. Our concern is that companies will be faced with a choice either to delay investment, awaiting a final decision from Ofgem, or take on a significant amount of risk by progressing projects without Ofgem approval. There is also no longer a link between Ofgem decision-making and adjustments to revenue as part of the AIP;
- Company financial performance excluded from consideration under reopener mechanisms: it is critical to the integrity of the regulatory framework that Ofgem commit to assessing company submissions on their own merits, without consideration of wider company performance

Ofgem must ensure that appropriate safeguards are put in place to ensure a fair and transparent process. We do not think that it would be appropriate for Ofgem to automatically apply the same approach to ED2 without further discussions and formal consultation.

Authority triggered re-openers

We do not agree that the Authority should have the opportunity to trigger re-openers at any point during the price control. This would have significant implications in terms of ensuring companies are allowed enough time to plan ahead and ensure that they have the right resources and information available. This is critical to ensuring fair and transparent decision-making on re-openers.

Materiality thresholds

We are concerned that the proposed approach to setting of the materiality threshold could lead to unfair and unjustified treatment in the application of re-openers across companies and be a detriment to consumer value in certain parts of the country. The design of the proposed threshold using the TIM incentive rate within the calculation will mean companies with a lower TIM incentive rate will be disincentivised from bringing forward legitimate re-opener requests in the interest of their consumers. This is an unnecessary second penalty for low baseline cost certainty which is harmful to consumers. It could also prevent some projects which could be subject to competition being taken forward, which could be harmful to consumers. We would therefore recommend a materiality threshold is set in absence of the TIM mechanism.

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

Yes, we support the proposals outlined in the SSMC. The additional proposals on flexibility and a DSO incentive will further incentivise early competition.

We do though ask Ofgem to clarify if a native competition plan is required in the business plan submission, as was the case for RIIO-T2 and GD2.

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?

Yes, there are similarities between these processes, and it is important overlaps and interactions are carefully considered to avoid confusion with any advancement of early competition in the distribution sector. Chiefly it is important to separate the role of procuring flexibility and tendering for network-based solutions through an early competition process. The DSO currently has processes in place to procure flexibility to manage network constraints, which involve competitive tendering. With the new flexibility proposals and ODI incentive for DSO in RIIO-ED2 these will intensify. Early competition should focus on high value and separable network assets only after a network solution has been identified and following exhaustion of a flexibility tender. Separating these processes will ensure a clear and transparent process to system development, which firstly distinguishes the type of solution which is necessary and then determines who is best placed to deliver that solution.

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

We support the ambition of Ofgem to explore opportunities for early competition where appropriate and in the interest of consumers.

As Ofgem develop an early competition model we urge that the interests of consumers are prioritised and properly evidenced. Competition should be designed in a way that avoids unnecessary complexity and ensures the timely delivery of network projects, delivery of Net Zero, protection of security supply and reliability of supply and safety. The process of competition should not delay projects from maximising their benefits. Further, the benefits of new alternative solutions to those indicatively identified by DNOs should be well justified from a capital and system operating cost perspective. All of this should be examined and evidenced through a specific impact assessment. For the avoidance of doubt, we do not support the introduction of mixed approaches e.g. early in some cases but late competition models in others. This we believe would add unnecessary complexity.

Along with other DNOs we have developed seven key principles which we feel should be reflected in any model developed, these are highlighted below:

Seven key principles to reflect in any new competition framework

- 1 **Demonstrating additional consumer value** – Shouldn't be '*competition for competition's sake*'. Additional consumers benefits, compared to the status quo, must be delivered and clearly evidenced. Further Impact Assessment work is needed to determine whether early and/or late competition models should be introduced into the ED2 framework.
- 2 **In pursuit of Net Zero** – any proposals to introduce competition models in RIIO-ED2 should be designed in a way that avoids unnecessary complexity and ensures the timely delivery of distribution projects - key to supporting the transition to a net-zero economy.
- 3 **Importance of a legislative framework** – appropriate powers and legislative frameworks must be in place prior to developing competition to protect consumers. Ofgem must have powers to take action against 3rd parties where obligations are not met and services are not delivered.
- 4 **Transparent competition criteria** – must be defined in advance of RIIO-ED2 so DNOs (and 3rd parties) have a clear understanding of future projects, which could potentially be subject to an early and/or late competition model.
- 5 **Maintaining a level playing field** – any competition models adopted must be designed in a way which promotes a level playing field for all service providers to ensure the same standard and level of protection is provided for network security and customer service, as currently provided by licensees.
- 6 **Transition to DSO** – many of Ofgem's early competition objectives could be delivered through DSO functions by considering flexibility solutions as an alternative to build reinforcement solutions. Any early competition framework should therefore flow from the DSO function agreed for RIIO-ED2.
- 7 **One size models won't fit all** – given the differing nature of the distribution network and in recognition of its existing competitive markets, the early and late competition models developed for RIIO-ED2 will not necessarily be fit for purpose and will need careful review.

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

The RIIO-ED2 Late Competition Impact Assessment provides limited insight, is too high-level and even fails to meet its own stated aims. We consider it to be long on narrative but short on quantitative detail, with limited benefits identified for stakeholders and consumers. Below we outline our observations and suggested remedial actions to overcome shortcomings.

Failure to meet its own objectives

Several of the stated aims of the document are not achieved. For example, there is no complete presentation of results from the cost benefit analysis model or demonstration of 'break even' analysis. Whilst it could be inferred from the separate material presented on costs and benefits that there is a positive value from late competition, these results are not synthesised into a single model which allows stakeholders to independently test the veracity of assumptions. We request Ofgem publish the cost benefit model and update the paper with a more substantive commentary on its findings.

Further, we notice that there is no quantification of the bill impact for energy consumers; nor is there any assessment of whether late competition will better encourage the achievement of decarbonisation targets and encourage innovation. These are stated policy objectives and we would expect at a minimum for these points to be explicitly addressed in an impact assessment. Bill impact is particularly important because it will be divergent across DNO licence areas. We request Ofgem update their analysis and paper with a more comprehensive assessment of the achievement of these benefits, especially bill impact by DNO licence area.

Costs of competition need further evaluation

Ofgem have made a good first pass attempt to evaluate the costs associated with running a competition; however, we feel there is further work to be done to fully understand these costs.

The range of £0.5m-£1m for pre-tendering needs further evidencing as it is unclear how these have been calculated.

For tender costs, we do not think it is appropriate to use a single cost estimate rather than splitting out the costs of different delivery models. We feel that a single cost estimate masks assumptions and doesn't give a full range picture. Additionally, interface costs should not be included as a sensitivity, instead they should be included as a core cost.

We also disagree that the risk of delay and non-delivery for projects subject to late competition models is low. We are disappointed that Ofgem have not undertaken quantitative analysis to set this into context and have chosen to rely on anecdotal evidence. The processes for late competition are yet to be fully tested at transmission, so we reject the assertion that these are fully established. New delivery models inherently attract higher risk, and while we recognise these can be mitigated through learning in time. We feel Ofgem should give a more comprehensive assessment to cost risks associated with delay.

Lack of substance and quantification in the benefits case

We do not consider that the benefit case for late competition has been properly articulated. Whilst we recognise the narrative in chapter 3 of the document may be intuitively logical, it is too high-level and makes several sweeping assumptions.

Paragraph 3.2 notes: "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."

It is this lack of quantitative assessment which dilutes the credibility of the analysis and makes it difficult to use to justify late competition in the distribution sector. We are disappointed that Ofgem appear to have made no attempt to address this lack of quantitative assessment and request this is done ahead of any of further policy development.

We do not consider that the experience from the offshore transmission regime (OFTO) is directly transferable to the onshore distribution sector. We do not believe as presented this can be used as a reasonable proxy for estimating the consumer savings. The cost savings estimates of 19-23% compared to regulated counterfactuals have never been tested, as no regulated company has bid to deliver these projects. They therefore remain hypothetical. Nevertheless, even if they are used as a starting point it should be recognised that onshore distribution is a different investor proposition from the OFTO regime with different costs structures, asset lives and associated levels of risk, even for investments which are highly capital intensive. It is also an industry at a different level of maturity compared to OFTO; distribution has already benefited from successive price controls reducing the costs and improving efficiency of incumbent network owners. We would have expected Ofgem to account for these structural differences within the analysis and to have made a more serious attempt to quantify the benefits given their understanding of the sector.

Results from similar sectors and other countries are useful triangulation points to reality check and directionally verify overall results. They are not however reliable sources of data or assumptions, given they represent assets with different level of exposure to wider economic forces and very different regulatory regimes. This changes the costs and risk profiles associated with these assets, and means the findings and models need to be treated with care.

The delivery model used for late competition will also have a significant impact on the realisable benefits, not just the costs of running the competition. This is a piece of sensitivity analysis which is missing from the impact assessment and could have a significant impact on value of competition to consumers. There could be differences in realisable benefits between CADO and SPV. We urge Ofgem to update the analysis in paper with a quantitative assessment of these.

Finally, we believe further sensitivity testing on the geographic distributional benefits of competition is required, with attention paid to consumer costs. Unlike OFTO and onshore transmission, charging regimes are regional specific for distribution. This could mean the benefit case changes dramatically for regions with higher or lower overall costs of service compared to the mean. We request Ofgem updates its analysis to discover the sensitivity of the benefits case to difference in charging regimes.

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.

All three models remain at a very early conceptual stage of development and Ofgem has recognised that there are several outstanding issues yet to be addressed before they could conceivably be progressed. None of these models has, in fact, been applied to any project and, indeed the CATO/CADO model would require primary legislation before it could be taken into consideration. Moreover, there are serious concerns as to whether any of these models could be implemented in compliance with Ofgem's statutory duties and the current licensing framework.

With regards to the CPM and SPV models, beyond the brief overviews provided in the supporting appendices of the SSMC, Ofgem's document does not contain any meaningful detail on the design of the models which limits our ability to comment on their suitability.

We remain concerned, however, that Ofgem is continuing with the implementation of its proposed CPM licence condition in transmission. The CPM "model" is no better developed than the other potential models Ofgem has referred to. There has been no specific CPM consultation setting out Ofgem's view of how CPM will be applied and operated during RIIO-2. When Ofgem's initial thinking on CPM was first raised in the context of RIIO-T1, SSE raised several substantive concerns in relation to the operation of the financial model underpinning the overall CPM policy. We are not aware that Ofgem has undertaken any work on the financial model since it was initially considered in 2018 and understand that Ofgem decided that the required further work should be paused at the beginning of 2019. We strongly refute Ofgem's suggestion that application and operation of the CPM does not form part of overall policy. Ofgem has also continued to state that TOs do not necessarily need to adopt the proposed Amberside Model when considering project financing and the possibility remains that a TO (or DNO) could bring forward a separate project financing model. SSE and other TOs stressed the importance of introducing a standardised, robust, auditable model which is fit for purpose and can be replicated across all competitively assessed projects. Across the network companies, the value of schemes under which Ofgem may apply the CPM has the potential to exceed multiple billions of GBP. Therefore, the governance of any associated financial model must be enshrined within the regulatory framework consistent with the Price Control Financial Handbook and Price Control Financial Model (PCFM). The approach to governance would also extend to the management of change, consultations and appropriate external audit of the model. Failure to do so would not be in accordance with Ofgem's statutory duties.

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

As no comprehensive impact assessment with cost benefit analysis of competition models assessed for onshore distribution has been undertaken, there is a clear lack of any compelling justification as to why the late competition models should be adopted.

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

Whilst the 'new' and 'high value' criteria are reasonably simple to determine, there is an element of technical assessment required when deciding whether a project is 'separable'. In a distribution context this will need to reflect the radial, rather than meshed design, of distribution networks compared to transmission; and the impact on network management must also be a key consideration.

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)?

The options set out by Ofgem in paragraph 12.34 of the SSMC at a broad level appear appropriate, although they lack any detail of how they would work in practice. We therefore cannot provide substantive comment at this stage.

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

See response COQ50.

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

We have answered question COQ49 and COQ50 together given their significant overlap.

Care must be exercised if Ofgem choose to bundle, split or re-scope a project to make it suitable for competition. Any three of these actions could result in project delays and the accrual of costs to consumers. They also run the risk of delivery synergies being lost, which DNOs can inherently deliver. DNOs are often able to deliver scale efficiencies when delivering multiple projects simultaneously, which benefit the consumer. These could be lost for example for an asset split from others. Operability of these assets on an enduring basis must also be considered to ensure third party operation/ ownership remains the most economical solution, particularly given this could span multiple voltages and geographic areas.

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

We have concerns with Ofgem's approach to implementing the CDIR method in setting the TIM efficiency incentive rate. Our feedback on the CDIR approach should be read in conjunction with our response to COQ52 on the design of the BPI. In particular, the CDIR approach, by focusing on the extent to which Ofgem is able to set an independent forecast, does not directly incentivise companies to provide ambitious plans. It is therefore important that the CDIR is supported by a strong BPI with genuine opportunities for reward where plans are robust, ambitious, and reflect stakeholder input.

Our view is that the TIM should continue in RIIO-ED2 as a strong incentive on companies to be efficient and deliver innovations for customers. However, as demonstrated in RIIO-T2 Draft Determinations, there is a risk that the CDIR approach could lead to weak TIM sharing factors, which we believe would not be in the interest of customers.

We recognise that Ofgem is looking to address perceived issues around the levels of totex outperformance in RIIO-1 and asymmetry of information. Before the CDIR approach is implemented for RIIO-ED2, we think Ofgem should consider the extent to which this is proving to be a genuine issue in RIIO-ED1, based on the latest available evidence. We also note that Ofgem are proposing a number of additional mechanisms in RIIO-ED2 to protect customers, including a Return Adjustment Mechanism⁸ and the use of PCDs. We believe that there is a significant risk of overcorrection in RIIO-ED2, with the framework risking disincentivising behaviours that are in the interest of customers.

With regards to the nature of costs in electricity distribution, we consider that a higher proportion of costs should fall under the "high-confidence" cost category, given the greater availability of comparators in the sector. We welcome the additional guidance provided by Ofgem in the SSMC on evidence to be considered in determining whether costs are "high-confidence". However, we think additional information is required

⁸ Please see our answer to the relevant question in the Finance annex for details of our concerns with Ofgem's RAM proposals for RIIO-ED2.

and we would urge Ofgem to start an open and honest dialogue to ensure expectations are clear, and a robust, justifiable, and objective approach is taken to the categorisation of costs.

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

We do not agree with the design of the BPI and have significant concerns with the way it has been applied in RIIO-T2 and GD2. We outline issues which we think Ofgem will need to resolve for the BPI to be fit-for-purpose for RIIO-ED2. We are keen to work closely with Ofgem and wider working groups to address these over the coming months.

As a general observation, we note that rewards have been extremely limited and that no company has earned a reward in stage 4 of the BPI. This suggests that the BPI incentive is skewed towards the downside, and we further note that similar levels of penalty are being proposed for companies that have and have not passed minimum requirements, suggesting a disproportionate approach to applying penalties. Overall, we question whether the BPI, as applied in RIIO-T2 and GD2, has achieved its stated aim and drives the right behaviours.

BPI Stage 1

Ofgem needs to set clear expectation for stage 1 of the assessment process. We provide further comments on Ofgem's proposals to reset minimum requirements in response to COQ53 below.

BPI Stage 2

There has been a clear disconnect between Ofgem expectations surrounding CVPs and companies' understanding of these in RIIO-T2/ GD2, as highlighted by the small number of CVPs accepted by Ofgem. There is a need to ensure lessons are learnt and clarity is provided up-front, and we welcome the additional guidance provided by Ofgem in its updated Business Plan Guidance document.

For RIIO-ED2, we need to ensure CVPs are genuinely stakeholder driven and supported by strong evidence of consumer benefit. We are concerned by the number of CVPs rejected by Ofgem at Draft Determinations despite strong evidence of stakeholder support and consumer benefit. Given the nature of CVPs, it is also important that Ofgem and DNOs work closely together to determine a reasonable and proportionate approach to valuing CVPs, well ahead of Draft Determinations.

BPI Stage 3

Ofgem have not set out with sufficient clarity how the BPI will work for RIIO-ED2, in particular in relation to the stage 3 penalty mechanism. We think it is important that a clear process is set out early on and we would welcome worked examples from Ofgem to ensure we understand implication for our business plan. We are asking Ofgem to provide further clarity on at least the following points:

- The extent to which projects removed from the baseline prior to stage 3 will nonetheless be subject to a penalty in stage 3;
- How activities involving costs that Ofgem deem to be both "low-confidence" and "high-confidence" will be classified, and whether an entire activity will be classified as "low-confidence" even where not all costs involved are classified as such;
- How costs associated with flexibility (non-wire) alternatives to managing distribution constraints will be treated. The associated markets are still maturing. We recommend Ofgem considers the

classification of these costs based on the level of market testing DNOs are able to demonstrate as part of their business plans; and

- How overheads associated with disallowed costs will be treated, to avoid unintended consequences and a disproportionate amount of overheads being disallowed

BPI Stage 4

As highlighted above no rewards have been provided in RIIO-T2 and GD2 Draft Determinations under stage 4 of the BPI, even where companies have benchmarked as the most efficient. We question the extent to which the design of the BPI genuinely allows for rewards, with the RIIO-T2 and GD2 Draft Determinations suggesting a skew towards the downside.

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)?

We do not agree with Ofgem's proposals to reset baseline standards based on DNOs' draft business plan submissions. We have already highlighted the importance of setting clear expectations for business plans, learning the lessons from RIIO-T2 and GD2, and therefore have significant concerns with this approach:

- Ofgem is already consulting on minimum requirements for the business plans through the SSMC, giving stakeholders ample opportunity to provide feedback, helping to ensure minimum requirements meet expectations and are sufficiently stretching;
- The proposals fail to recognise the time constraints associated with any revisions to the business plan following this exercise. It is unclear when Ofgem would intend to reach a decision and how long companies would have to update their business plan and retest it with their stakeholders;
- This creates significant risks in terms of the costs associated with the delivery of an enhanced baseline. Crucially, this undermines the concept of stakeholder-led business plans, which is at the heart of Ofgem's RIIO-ED2 framework. The approach is also at odds with the concept of CVP, by failing to recognise the differences in customer needs; and
- The extent to which any enhanced standards will be subject to a fair, open and transparent consultation process is unclear, in particular given tight timings.

We note Ofgem's proposal that an alternative approach could be applied in paragraph 1.30, however no further details are provided.

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

We welcome the additional guidance provided by Ofgem on CVPs, though we note that CVPs should be driven by customers and stakeholder evidence and proposed caps should act as guidance. We also think additional clarification is still required on a number of points.

Ofgem must clearly set out how it intends to assess CVPs and how it will define ambition. In RIIO-T2 and GD2, we have seen proposals being rejected that clearly went above and beyond minimum requirements, and were supported by stakeholders. Ofgem needs to set clear assessment criteria and ensure the assessment process is objective and transparent.

We note Ofgem's proposal to assess individual CVPs on their own merit. We think this assessment should also consider how a proposed package of CVPs fits in with a DNO's wider plans and ambition for RIIO-ED2.

We are also unclear on the extent to which Ofgem's assessment will involve an element of comparison, and the extent to which this is appropriate given the stakeholder-driven nature of CVPs.

Further details must be provided by Ofgem on how it intends to take into account stakeholder feedback and other qualitative information in its decision-making and assessment of value. While we agree that DNOs should provide methodologies for monetising benefits to consumers, Ofgem must here also provide clear guidelines on what constitutes a "robust" methodology, and ensure decision-making is objective and transparent. We would like to see Ofgem engaging with DNOs on CVP proposals early on in the process to ensure agreement can be reached with Ofgem ahead of Draft Determinations.

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?

We note the importance of providing as much clarity as possible on Ofgem expectations at SSMD to enable sufficient time for us to reflect these in our Business Plans and in our stakeholder engagement. We touch in this issue in a number of places in our response. In particular, it is important that Ofgem provide additional clarity on IDPs (EJPs and CBAs) including templates and overall approach. We understand that this will be the topic of upcoming working groups.

Where Ofgem intend to ask for additional information or detail that was not being reported in RIIO-ED1, it will be important to recognise that this both forecasts and historical information may not be available in the desired format from our prime source systems. Engineering and managerial assessments will be used to provide any further breakdowns.

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?

No additional comments.

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?

The Business Plan Guidance includes references to minimum requirements (also referred to as minimum standards), principles and baseline expectations.

We note that minimum standards will be imposed through the introduction of Licence Obligations (LO). For each set of minimum requirements, we would welcome clarity from Ofgem on whether this will involve the introduction of new licence conditions and/ or amendments to existing licence conditions. We would ask Ofgem to take a proportionate approach to setting out new licence conditions.

Minimum requirements are clearly set out and signposted for the vulnerability and connection strategies (paragraphs 3.9 and 3.10), and the EAP (paragraph 3.25). We ask that Ofgem, in any updates to the Business Plan Guidance, clearly and unambiguously identify and signpost minimum requirements, to avoid any confusion. For example, paragraph 2.8 refers to minimum requirements outlined in paragraph 2.7, however these are not clearly labelled as such.

We note references to baseline expectations and principles (for example in relation to the DSO Strategy). It is not clear whether these also constitute minimum requirements and what their status is.

Based on the current Business Plan Guidance, it is unclear which minimum requirements will form part of Ofgem's assessment under Stage 1 of the BPI. However, we have provided commentary on minimum requirements, principles and baseline expectations where appropriate in response to questions in the Overarching Document and accompanying annexes.

We note that Ofgem has in various places in the SSMC identified potential PCDs and LOs. However, we think there is not always a consistent approach to identifying these in the summary tables and text. We ask that Ofgem provide clarity at SSMD.

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

Please see our response to COQ54.

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?

We are actively reviewing our data and implementing a data governance tool to support the management of our datasets. This is a fundamental part of our Digitalisation plan and an important key enabler for DSO. Many of these datasets are technical, operational and asset datasets rather than focusing on business information. The implementation of a Data Dictionary supports better internal data integration, but also facilitates external data sharing, a critical component of Open Data. These datasets are therefore our primary focus.

We are undertaking investigative work on how improving our data maturity could support internal business management for quite specific use cases, and to understand the resource requirements of such activities. If Ofgem are keen to take advantage of these investments in data infrastructure, clear guidance on which data sets are required and how they intend to be used is important so these use cases can be integrated into the ongoing work.

SSMC Annex 3 – Finance

We have provided the following evidence⁹ in support of our submissions to Ofgem and the CMA (as part of RP3 and PR19 appeals), demonstrating Ofgem have:

1. Incorrectly relied on novel approaches to the treatment of inflation by deflating Total Market Returns (TMR) using a ‘backcast’ of CPI inflation currently under review by the ONS;
2. Incorrectly equated the risk of energy networks to that of UK Water which market data on observable beta’s does not support;
3. Incorrectly applied the estimates to the Risk Free Rate within the CAPM by using spot rates on government gilts instead of a more appropriate proxy as supported by academic evidence. The CMA has agreed with this evidence presented by the ENA as part of PR19;
4. Incorrectly applied an ‘outperformance wedge’ to RIIO-GD2 and T2, thereby creating an adverse incentive which is likely to cause harm to consumers. We also note that the data published by Ofgem at Draft Determinations relies on RIIO-1, which is not complete, as well as other regulatory price controls in energy and other regulated sectors. This is inappropriate and potentially unreliable as data is missing and not verifiable, in addition to being highly irrelevant to the price control;
5. incorrectly aimed at the bottom of the range and therefore breaking from regulatory precedent as set out recently by the CMA’s decision on PR19 where elected a point estimate in the 75th percentile of the range was selected.
6. Incorrectly relied on cross-checks of inferior quality and reliability such as the Dividend Discount Model (DDM), infrastructure fund discount rates, OFTOs, and Market to Asset Ratios (MARs). The CMA has not relied on this evidence in reaching their TMR range for their decision on PR19;
7. Incorrectly interpreted evidence on debt beta and not considered observable market data. We note that the CMA has estimated a debt beta of 0.04 consistent with the evidence presented by energy networks.

Ofgem has relied on significant methodological changes to support a materially lower return on equity, rather than changes in market data. We ask that Ofgem reflects on this evidence and the CMA Provisional Findings on PR19 in reaching a decision for the Sector Specific Methodology for RIIO-ED2.

Separately, we note that Ofgem has switched to the Utilities Index for the cost of debt. We note that this has no defined credit rating, meaning energy networks will carry credit risk. We also do not believe Ofgem has correctly calculated the additional costs of borrowing, in particular the New Issue Premium (interpreted by an error in estimating the Halo Effect), and also the impact of transitioning to CPIH. Ofgem must take care to ensure debt costs can be fully recovered and there is no risk of underfunding during the period.

⁹Oxera (2019), ‘The cost of equity for RIIO-2’, prepared for the ENA

Oxera report, The cost of equity for RIIO-2 – A review of the evidence, Prepared for the ENA, (Feb 2018) available at: https://www.oxera.com/wp-content/uploads/2018/07/ENA-cost-of-equity_2018-02-28.pdf.pdf

Oxera (2020), ‘Are sovereign yields the risk-free rate for the CAPM?’, prepared for the Energy Networks Association, 20 May.

Finally, with regard to the financeability framework, we have concerns regarding the notional company definition and how this has changed since the SSMD for RIIO-T2 and GD2. We note that the assumption around the proportion of Index Linked Debt (ILD) has increased from 25% to 30%. When reviewing the RFPR data for 2018/19, we note that the proportion of ILD across the energy network sector is actually lower at 25%. When removing NGGT and NGET this falls further to around 10%. We also note Ofgem has changed the gearing to 55% for T2 while also including the outperformance wedge in their financeability assessment. These actions have the effect of artificially improving credit ratios and risks masking a financeability issue over RIIO-2. If the cost of capital is increased by Ofgem reflecting the evidence presented and the CMA's provisional findings on PR19 then these assumptions are not required. We note Ofgem must go further than the CMA given the relative risk of electricity compared to water networks as well as remove the outperformance wedge. It is worth noting also that SSE has been put on negative watch by Moody's¹⁰ which is in part caused by the pressure on cash flows and credit metrics from RIIO-T2 and ED2. This is inconsistent with the target credit rating of BBB+ or Baa1. Moody's¹¹ have latterly announced that they see the CMA announcement on PR19 as credit positive while summarising the CMA's view of Ofwat's financeability duties.

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

Ofgem argue that the Utilities index is a more appropriate fit for the sector given the composition of the index and its incorrect analysis on the halo effect. We have reviewed the basis of the Utilities index with analysis undertaken by NERA¹². They identify the following elements which we believe need to be reflected upon by Ofgem prior to confirming the Utilities index as the most appropriate index for setting the Cost of Debt (CoD) for RIIO-ED2. Ofgem must ensure they adhere to the principles set out in RIIO-1 and RIIO-2 in particular noting that significant justification is required to deviate from the previous regulatory policy on the CoD.

The Utilities index does not have a defined credit rating meaning the mix of the index may change over time to a materially different credit rating to those of energy networks. The risk of mismatch on investment grade credit rating between Ofgem's target rating and the CoD index seems to have been ignored by Ofgem thereby creating a funding risk for networks over RIIO-2. This is illustrated in Table 1 below which is a smaller set of only utilities with any investment grade.

¹⁰ Moody's 'SSE plc, Update following change in outlook to negative' (25 Sept 2020)

¹¹ Moody's 'Regulated Water – UK, CMA appeals give higher returns' (30 Sept 2020)

¹² NERA Cost of Debt Indexation for GDNs and TOs for RIIO-2 (Sept 2020)

Table 1 – Utilities index compared to iBoxx non-financial corporate index¹³

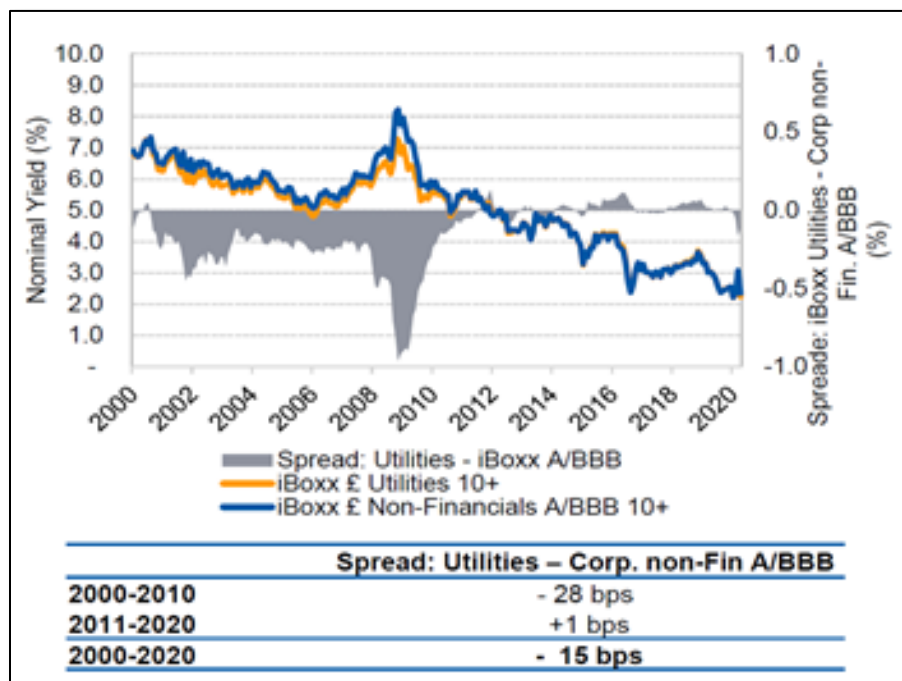
	iBoxx £ Corp Non-Financial A (10+Year)	iBoxx £ Corp Non-Financial BBB (10+Year)	iBoxx £ Corp Utilities (10+Year)
Sector	All Corporates, ex. Financials	All Corporates, ex. Financials	Utilities
Maturity	22 years	17 years	21 years
Credit rating	A	BBB	Investment Grade
# bonds	~ 50	~ 100	~ 80
% GB Regulated	~ 20%	~ 30%	~ 50%

The Utilities index has tended to track the iBoxx index over time which we interpret as showing the indices have been similar and that the Utilities index may not differ when credit rating is similar which is shown by Figure 1 below. This shows that Utilities index was predominantly A rated up to 2011 in transitioned into A/BBB since 2011 hence the narrowing of the spread¹⁴. The switch to the Utilities index is therefore not necessary except for introducing funding risk through differences in credit rating where the index can deviate from the target rating for energy networks over the RIIO-2 period.

¹³ *ibid.*

¹⁴ NERA note that the spread was 28bps up until 2011 and has since reduced to 1bp with the change in credit rating.

Figure 1 – Comparing the spread of the Utilities index to the A/BBB iBoxx index¹⁵



The other items we would highlight is that an index has the tendency to become a pass-through depending on the size and quantum of issuance over the RIIO-ED2 period. When considering the incentive properties that Ofgem's principles have been grounded around, there is a risk this index does not provide an appropriate incentive to fund over the long term compared to the wider market. There is a significant proportion of regulated utilities in the Utilities Index and it appears inappropriate not to benchmark against organisations with similar credit ratings and tenors that is within the iBoxx corporate non-financial A/BBB indices. We therefore believe the more appropriate index, considering all elements above, and the Ofgem policy set out in the RIIO-T2 and GD SSMD¹⁶, and in RIIO-ED1 is to use the A/BBB non-financial corporate bond iBoxx index as the appropriate mechanism for CoD over RIIO-ED2.

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?

For the benefit of RIIO-ED2 we propose that Ofgem should select an appropriate working assumption based on what Ofgem believe they are minded to elect to use for RIIO-ED2. This allows a more robust and accurate assessment to be undertaken as part of Business Plan submissions instead of ex-post. For example, for GD2 and T2, the working assumption used is significantly different to the CoD mechanism proposed at DDs. This therefore required companies to re-assess their business plans, financeability, and cost of debt mechanism during the DD consultation process which was extremely tight given the wide range of issues arising from Ofgem's DD.

¹⁵ NERA Cost of Debt Indexation for GDNs and TOs for RIIO-2 (Sept 2020)

¹⁶ Ofgem SSMD – Finance Annex (May 2019)

If Ofgem is minded to use the Utilities index or another calibration of the iBoxx A/BBB index then that should be the basis of the working assumption. We do however, as noted in FQ1, propose that Ofgem should not deviate from the A/BBB index as a minimum. Ofgem need to be clear what they believe the additional costs of borrowing are based on the analysis done up to that point.

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?

As noted in FQ2, we believe Ofgem should propose a working assumption and the basis of that working assumption for use in Business Plans. However, Ofgem should not set the CoD mechanism until business plans have been finalised and submitted across the sector meaning there may be changes at both Draft and Final Determinations similar to what we saw in RIIO-ED1.

At this stage, we have evaluated the CoD considering what has been proposed for GD2 and T2 and note that the CoD allowance has been calibrated incorrectly in those sectors for various reasons. These include the failure of Ofgem to include an appropriate level of costs of borrowing, incorrect analysis on the halo effect and New Issue Premium (NIP) and changing the indexation mechanism to the utilities index.

We also note that Ofgem has proposed a bespoke cost of debt mechanism for SHET plc without detailed justification consistent with the approach adopted at RIIO-T1. We would therefore advocate and recommend that Ofgem utilise comprehensive analysis of company funding and market conditions as was done during RIIO-ED1 to ensure the calibration of the cost of debt allows DNOs to recover an efficient level of debt during 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?

Ofgem has concluded in DDs for GD2 and T2 that they find evidence of a halo effect of 4bps when analysing the Utilities index. They also assert that this is evidence of there being no New Issue Premium while also ignoring any costs associated with the switch to CPIH in RIIO-2.

On additional costs of borrowing, we have not had any specific comment or evidence presented to us based on historical debt issuance or from market participants. We also believe, based on our risk assessment of the price control (including the timing and volatility of cash flows), that we would be required to hold significantly higher amounts of liquid resources. NERA¹⁷ have reviewed Ofgem's analysis and decision regarding additional costs of borrowing for the ENA and its conclusions are summarised in Table 2.

Table 2 – NERA summary of Ofgem analysis compared its own

	Ofgem	NERA (September 2019)	NERA (August 2020)	Comment
Transaction Costs	6 bps	7 bps	7 bps	Ofgem draws on company data but excludes apparent outlier NERA's analysis includes all companies within sample

¹⁷ NERA Cost of Debt Indexation for RIIO-2 for TOs and GDNs (Aug 2020) and NERA Additional Costs of Borrowing for TOs and GDNs (Aug 2020)

Liquidity/RCF cost	3 - 5.5 bps	4.5 bps	4.5 bps	Both Ofgem and NERA draw on companies' assumptions on RCF size and cost
Cost of carry	1.5 – 11 bps	16 – 45 bps	11 – 23 bps	Ofgem assumptions on cash at OpCo and Group unreliable. NERA approach assumes 12-24 month pre-financing, half met by RCF
New Issue Premium (NIP)	0	13 bps	9 bps	Ofgem's analysis does not draw on precise measures of spread and therefore estimate of halo/NIP is unreliable NERA's spreads calculation duration matched and support range 4 -14bps
CPI indexation costs		12 bps	15 bps	Ofgem assumes that companies do not require compensation for basis risk NERA's analysis based on recent cost of CPI issuance and CPI swaps
Total	17 bps	53-82 bps (68bps)	47 – 59 (53bps)	Ofgem: mid-point of its range

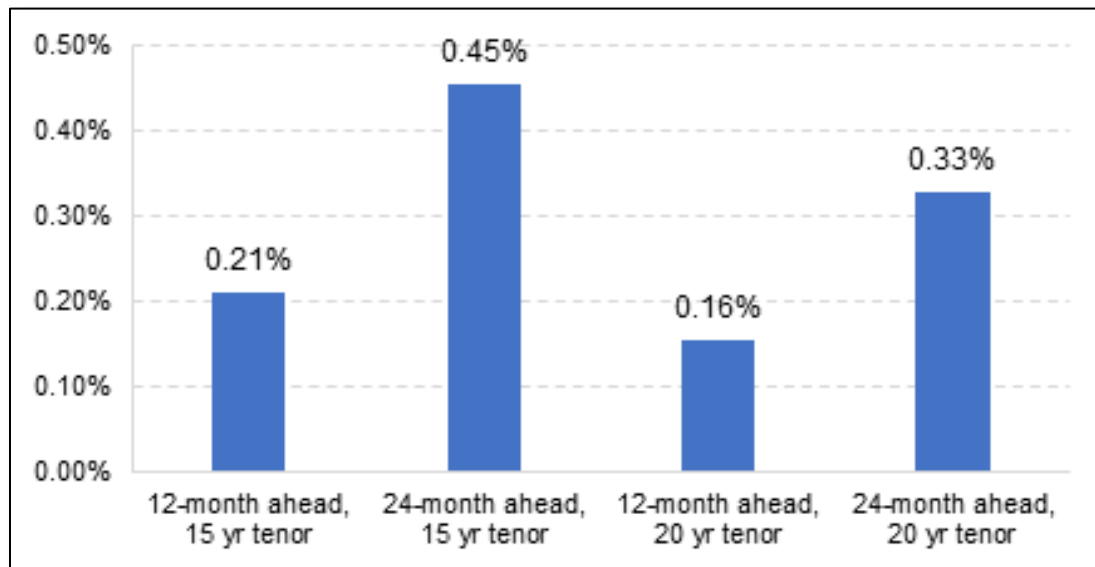
Sources:

Ofgem (July 2020) Consultation – RIIO-2 Draft Determination – Finance Annex, p. 14

NERA (September 2019) Halo effect and additional costs of borrowing at RIIO-2, A report for ENA, p. 18

Firstly, we agree with Ofgem's allowances for Transaction Costs and Liquidity RCF cost which is consistent with NERA's analysis. However, NERA have identified that Ofgem has not considered costs of carry costs above the bottom of its range. When considering the market evidence, the range of uncertainty and indexation, we believe Ofgem is being overly prudent on the costs of carry. We consider that Ofgem need to uplift the additional costs of borrowing as a result of this element. NERA do not find any evidence that the cost of carry is below 11bps as illustrated by Figure 2 below. NERA also consider what the impact is of utilising an RCF to support liquidity requirements where they find that the minimum cost of carry is 11bps.

Figure 2 – NERA analysis on cost-of-carry based on 12 to 24 months pre-financing and 15-20 year debt tenor (excluding RCF)



For **New Issue Premium (NIP)**, the analysis undertaken by NERA identifies that there is a NIP of around 10bps. The evidence for a NIP is based on the analysis of the Halo Effect. Ofgem find a small halo effect when considering the Utilities Index of 4bps and conclude NIP is therefore zero. However, NERA identify a negative halo effect of 13bps due to the NIP on either the Utilities Index or the A/BBB iBoxx non-financial corporate indices.

NERA's analysis is consistent with its previous report where they found that Ofgem had not controlled for tenor precisely. Ofgem retains its methodology from the SSMD for the DDs for GD&T whereby they claim the BoE nominal spot curve is a zero coupon curve whereas the bonds issued by companies are not zero coupon and that NERA have miscalculated the relative spread due to a duration mismatch. Ofgem assert that the market convention is to price a corporate bond over the nearest benchmark gilt and not the exact tenor of an interpolated curve. However, NERA find that - when considering duration matching - its results are consistent with the previous report. They demonstrate that Ofgem's approach does not control for tenor correctly and is therefore not a reliable measure of network bond performance. NERA set out why duration matching is appropriate and consistent with academic evidence and therefore we consider that Ofgem should be adhering to best practice.

Ofgem also ignore the **switch to CPIH** from RPI and the associated additional cost of borrowing by switching to CPIH Index Linked Debt (ILD). This is relevant because Ofgem has relied upon the notional company assumption of 30% CPIH ILD to mask a credit rating problem yet only model future debt costs based on nominal debt. If Ofgem's assumption on CPIH ILD for its financeability analysis was accurate, then they should be consistent and allow for switching costs in the CoD allowance. Therefore, when NERA evaluate Ofgem's approach they find that Ofgem has ignored basis risk in its assessment as part of this inconsistency in applying CPIH ILDs. NERA assert that a change in the RPI-CPI wedge would materially deteriorate key credit ratios without the suitable funding in place. As a result we consider that Ofgem should include costs associated with ILD. When considering market evidence for issuing CPI-linked bond yields, NERA find that there is evidence which supports a premium of 50bps which translates to a 15bps

additional costs of borrowing if Ofgem's 30% ILD assumption is retained. For the CoD allowance, Ofgem need to include an allowance for the CPIH related costs to be ensure efficient financing costs are recovered by the notional company. We note there is an error in Ofgem's assumption on ILDs in the DDs for GD2 and T2 and this will need to be reflected when considering the notional company definition in RIIO-ED2 prior to the submission of business plans and the associated financeability analysis.

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?

NERA also review Ofgem's approach to deflating the nominal 'all-in' yields to CPIH real allowances for the CoD. Ofgem's approach is to use the 5-year OBR forecast for CPI. Ofgem's approach was based on two separate methods to derive a real CoD allowance in CPI terms from a nominal iBoxx index:

- i. Retain RIIO-1 breakeven approach but include an expected RPI-CPIH wedge when deflating the nominal iBoxx yields;
- ii. Use an expected value for CPIH directly, such as the OBR's longest term CPI forecast as a proxy or the Bank of England inflation target of 2%

Ofgem prefer to use OBR's CPIH forecasts as the basis of deflating the nominal debt. NERA analyse the basis of each forecast and method concluding that they agree that Breakeven Inflation is not a reasonable approach to derive the real cost of debt allowance. They prefer to use the HMT Consensus as a wider market view rather than just the OBR forecast. They do however note that an alternative methodology is to adjust for the outturn inflation meaning there is no under or over-recovery on inflation. We believe this may be the best approach and, although it introduces some volatility, this may be merited to avoid there being gains or losses due to outturn inflation differing from forecast inflation.

Allowed return on equity

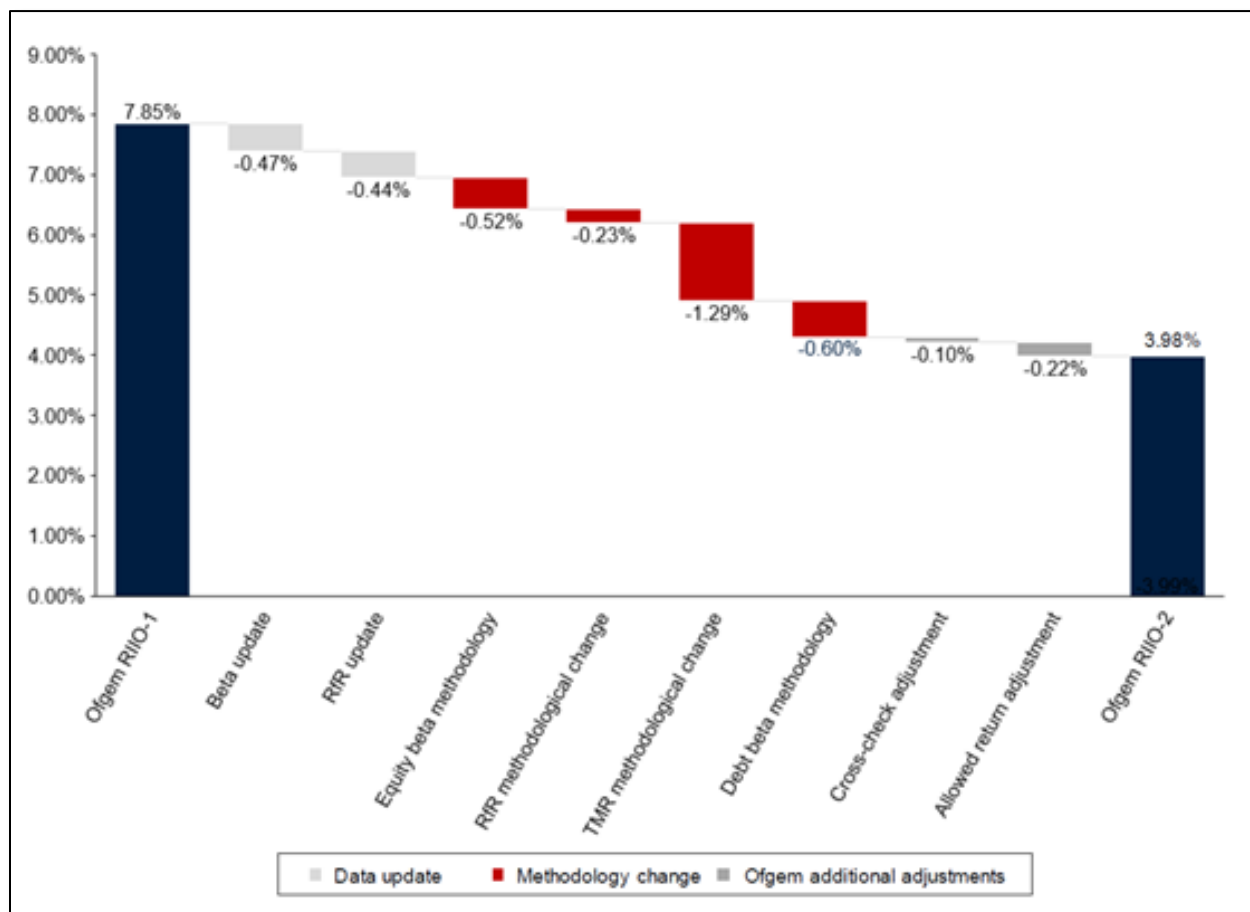
FQ6 In light of the equity methodology we set out in Draft Determinations for GD&T, do you have a view on how implementation could best be applied to the ED sector?

As we have participated in the ENA Finance Working Group (FWG) work since the commencement of RIIO-2 consultations by Ofgem, we have reviewed Ofgem's methodology as part of that group. In doing so we have made several submissions as part of the ENA FWG as well as being part of the same Group as SHE Transmission plc (SHE-T). As a result, several submissions have been made including the most recent submission to Ofgem from SHE-T regarding DDs on the Cost of Equity proposal for T2 and GD2. We are supportive of that submission in particular highlighting the significant number of errors Ofgem has made in setting the allowed return on equity for RIIO-2. Ofgem has utilised methodological changes which is a significant departure from regulatory precedent, observable market evidence and academic finance theory and practice.

We have set out with comprehensive, observable and robust evidence, Ofgem has made a series of errors in reaching their cost of equity in Draft Determinations for RIIO-2. In Figure 3 below the changes adopted by Ofgem is emphasised illustrates that almost 70% is direct methodological changes, almost 10% is Ofgem specific adjustments and the remaining 20% is market data updates only. **We have highlighted throughout this section the errors made by Ofgem across the CAPM parameters and these need to be**

corrected as part of RIIO-T2, G2 and ED2. We note that several of these errors have been adjusted by the CMA in their Provisional Findings on the PR19 including the Risk Free Rate, TMR, and the debt beta.

Figure 3 – Cost of Equity Bridge between RIIO-1 and RIIO-218



Our evidence and response to Ofgem’s proposed Cost of Equity (CoE) range is based on the evidence and analysis undertaken by Oxera since the commencement of RIIO-2 and its first report in February 2018 on behalf of the ENA¹⁹. In particular this includes evidence collated and submitted to the CMA as part of the ENA’s response to the NERL appeal on RP3 and the water companies’ appeal to the CMA on PR19. This evidence is collated and presented by Oxera in an updated version of its report from February 2018 and November 2019²⁰ and included as part of our submission to the Draft Determinations. The primary issues have been identified where Ofgem has made an error which include where Ofgem has:

¹⁸ Oxera ‘The cost of equity for RIIO-2’, (Sept 2020) Figure A1.2

¹⁹ Oxera report, The cost of equity for RIIO-2 – A review of the evidence, Prepared for the ENA, (Feb 2018) available at:

https://www.oxera.com/wp-content/uploads/2018/07/ENA-cost-of-equity_2018-02-28.pdf.pdf

Oxera reports referenced in this submission have been included as appendices to OXera’s Cost of Equity report dated September 2020 submitted on behalf of the ENA to Ofgem.

²⁰ Oxera report, The Cost of Equity for RIIO-2, Prepared for the ENA, (Nov 2019)

1. Incorrectly relied upon the CPI back cast that was utilised by the UKRN study by Wright et al (2018) when estimating the real TMR;
2. Relied upon the geometric rather than the arithmetic average when calculating the historical TMR;
3. Incorrectly calculated the debt beta and not relied upon market and academic evidence in reaching its conclusion;
4. Relied upon UK Water asset beta comparisons in error in relying upon its range for the observed asset beta;
5. Not utilised an appropriate proxy for the Risk Free Rate (RFR) in the calculation of the CoE using the Capital Asset Pricing Model (CAPM);
6. Aimed at the bottom of the range in the CoE therefore breaking from regulatory precedent and putting investment at risk to the detriment of consumers;
7. Failed to properly account for the higher risk of energy networks relative to UK Water when setting the CoE or in its evaluation of the overall package of potential returns;
8. Erroneously applied the Miller-Modigliani (MM) theorem by misinterpreting academic literature where its estimates for the CAPM violate the MM proposition;
9. Relied upon inferior cross checks including misinterpreting evidence and placing undue weight on CoE comparisons to push down its estimate for RIIO-2. Ofgem should be relying on directly observable evidence including the ARP vs DRP cross check to inform its CAPM estimate on the CoE;
10. Not given due consideration to evidence presented to them over the RIIO-2 period including placing more weight on methodological changes when calculating the CoE meaning almost 80% of the changes are due to changes in methodology or Ofgem specific adjustments and not market data²¹

We have summarised the updated range as calculated by Oxera correcting for errors above prior to then summarising the evidence for the errors made by Ofgem in calculating the RIIO-2 CoE. We have then summarised our view of the cross checks used by Ofgem or other parties in setting the CoE for RIIO-2.

Table 3 below summarises the RIIO-2 CoE estimates comparing Oxera's 2020²² submission, Ofgem's DDs and in particular the CMA Provisional Findings on PR19. This shows that the CMA is more in line with Oxera's analysis in particular on the Risk Free Rate (RFR) and the debt beta. Additionally the movement in the TMR is more aligned with the bottom end of Oxera's range. The asset beta is lower for water companies than for energy companies based on market evidence which we have set out in our response with supporting evidence from Oxera.

²¹ Oxera (2020), 'The cost of equity for RIIO-2' page 60 figure A1.2

²² Oxera (2020), 'The cost of equity for RIIO-2'

Table 3 – Summary of RIIO-2 Cost of Equity Estimates

Cost of Equity	Oxera Sept 2020		CMA on PR19	Ofgem DD	
	Low	High	Point Estimate	Low	High
Real TMR (%)	7.00	7.50	6.95	6.3%	6.8%
Real RFR (%)	-1.00	-1.00	-0.96	-1.5	-1.5
ERP (%)	8.20	8.29	7.91	7.73	8.23
Asset Beta	0.38	0.41	0.34	0.34	0.39
Debt Beta	0.05	0.05	0.04	0.13	0.13
Equity Beta at 60% gearing	0.88	0.95	0.76	0.66	0.79
Real Cost of Equity at 60% gearing (%)	6.00	7.08	5.08	3.64	5.00
Equity Beta at 55% gearing	0.78	0.85	N/A	0.60	0.71
Real Cost of Equity (%)	5.27	6.23	N/A	3.18	4.40

Source: Oxera analysis adjusted to 55% and 60% gearing and do not including the 22-25bps downward adjustment for expected outperformance as advocated by Ofgem.

We believe this demonstrates that Ofgem's DD for the CoE and the basis for RIIO-2 is incorrect and must be adjusted significantly. Ofgem must go further than the CMA has gone in PR19 based on the market evidence and relative risk to water. Therefore, when evaluating the CoE, we have considered each parameter within the CAPM which is the primary source of determining the CoE.

TMR

There has been a significant amount of evidence and analysis collated and reviewed as part of estimating the TMR which affects multiple regulated sectors. We have seen this issue arise as part of the appeal to the CMA by NERL for RP3 and now most recently the PF by the CMA on PR19. As noted by the CMA²³, the estimate of the TMR needs to be amended to reflect historical real returns. As a result, Ofgem has erroneously relied upon historical inflation data which is not reliable and have set the TMR too low. This *novel* approach to adjusting for inflation is not widely recognised as a reliable approach to estimating TMR by several parties including Oxera as set out previously in responses to the RIIO-2 Framework Consultation²⁴ and the SSMC²⁵. Ofgem has relied upon the analysis by Mason, Pickford, Wright (MPW)²⁶ and the TMR recommendations they made which rely upon CPI as the reference measure of inflation when analysing historical real market returns going back to 1990. MPW then recommends using CPI

23 CMA – Anglian Water Services Ltd, Bristol Water plc, Northumbrian Water Ltd and Yorkshire Water Services Limited price determinations provisional findings (Sept 2020)

24 RIIO-2 Framework Consultation (Mar 2018)

25 Ofgem RIIO-2 SSMC Finance Annex (May 2019)

26 We have excluded Burns from the reference to this particular point as he disagreed with the other authors on a number of areas as set out in the UKRN study.

inflation published by the Bank of England (BoE) Millennium dataset. MPW estimate a TMR of 6-7% (CPI-real) based on long-run realised returns.

As a result, Oxera set out that the historical TMR should be calculated using the *official* RPI inflation measure and Oxera set out two possible methods for achieving this. Oxera's preferred method is to add the forecasted RPI-CPIH wedge to RPI-real historical returns restated using today's RPI methodology. The alternative is to deflate nominal returns by CPI inflation, adjusting for the bias in the historical estimates of CPI. Oxera created an adjusted RPI series as part of its work for Heathrow Airport Limited (HAL)²⁷ submitted to the CMA in the NATS appeal and when applying either method the results are similar when deflating the TMR.

The CMA has relied upon this analysis in reaching its determination on PR19²⁸.

Arithmetic vs Geometric

When converting a historical average to an unbiased market discount rate using the TMR, the arithmetic average is a more appropriate measure than the geometric. Cooper (1996)²⁹ calculates a discount rate investors should use to given an unbiased estimate of the present value of future cash flows. In doing so Cooper (1996) concludes that the TMR should be at least as high as the arithmetic average of historical returns. This is as opposed to the JKM estimator³⁰ which is not seen as the appropriate discount rate for investors when evaluating future cash flows. The JKM estimator is an unbiased estimator of the growth rate to use to project the future value of a portfolio of securities and not that used for by investors or for capital budgeting decisions. Therefore the JKM estimator is not the most appropriate methodology when setting a price control as the priority is to determine what rate do investors use to discount future cash flows. **Ofgem continues to misunderstand the difference between compounding and discounting in its estimate of TMR and has therefore incorrectly used the geometric average of historical equity returns which produces a lower estimate than undertaken by Cooper (1996)³¹.** The Ofgem approach understates the allowed return compared to the discount rate used by investors when valuing regulated companies and when companies make decisions about capital budgeting through investment appraisals. This is how we make capital budgeting decisions as a company and as a listed company we also consider that this is the appropriate practitioner approach.

As of the DMS 2019 report, the long-run geometric and arithmetic averages of real UK equity market returns were 5.4% and 7.2% respectively. The DMS 2020 edition shows UK equity market returns of 5.5% and 7.3% meaning the nominal UK equity market returns are 9.3% and 11.1% showing an upward increase in the TMR. **When accounting for the downward bias of using the indirect approach, correcting for Ofgem's errors on the inflation measure and over-reliance on inferior or inappropriate cross checks (see**

²⁷ Oxera 'Estimating RPI-adjusted equity market returns, prepared for HAL (Aug 2019)

²⁸ CMA – Anglian Water Services Ltd, Bristol Water plc, Northumbrian Water Ltd and Yorkshire Water Services Limited price determinations provisional findings (Sept 2020)

²⁹ Cooper, I. (1996) 'Arithmetic versus geometric mean estimates: Setting discount rates for capital budgeting', *European Financial Management*, 2:2 1996 pp 156-67

³⁰ Jacquier, E., Kane, A. and Marcus, A. (2005), 'Optimal Estimation of the Risk Premium for the Long Run and Asset Allocation: A Case of Compounded Estimation Risk', *Journal of Financial Econometrics*, 3:1, 37-55.

³¹ Cooper, I. (1996) 'Arithmetic versus geometric mean estimates: Setting discount rates for capital budgeting', *European Financial Manthe RFR for agement*, 2:2 1996 pp 156-67

further details below) Oxera conclude that the TMR is 7.0 to 7.5%. The CMA has found that the TMR should be at least at the bottom end of the range at 6.95%

Risk Free Rate (RFR)

Oxera³² has updated its methodology on the RFR and submitted this to CMA as part of PR19 based on whether sovereign yields are a good proxy for the rate of return on a zero-beta asset. The academic evidence sets out that for the CAPM the RFR is defined as a zero-beta asset that investors borrow and lend at. Oxera find that using spot yields on government bonds underestimates³³ the practical value of the RFR for use in the CAPM. The impact of this underestimation inadvertently violates the Modigliani-Miller (MM) proposition that the WACC should be invariant with respect to the level of gearing. Oxera find that, as Ofgem has estimated the CPIH-real RFR as -1.5%, they have violated this assumption through using the spot yields on government bonds. In doing so Oxera has considered adding a premium to government bonds compared to using AAA-rated corporate bonds adjusted for default risk. In doing so they found that when adjusting for these items they found that the MM theorem holds and there is less variability in the WACC for a change in gearing. **Oxera use the mid-point between these two methods to arrive at an RFR of -1.0% in its CoE range albeit their preferred method is using the adjusted AA-rated bonds. This is what the CMA has decided in their PF for PR19³⁴.**

Risk and Beta

The primary financial measure of risk is beta which is to measure systematic risk and does not capture company specific risks or other sources of risk such as political or regulatory risk³⁵. This is the equity beta and is affected by the asset beta which ignores the capital structure, with the gearing and debt beta which reflects the level of debt and risk of default on the debt. Oxera set out the evidence on beta estimates for the CAPM and consider the choice of comparators, technical estimation issues, debt beta, asset beta and the relationship of gearing. We have set out our thoughts with reference to this evidence below.

Asset Beta

Oxera's previous methodology³⁶ used a European and UK comparator set of energy networks and took the high end of the range formed on 2yr and 5yr averages for the sample. In updating the methodology, they have continued to rely upon liquid stocks considering just a UK sample including UK Water, as well as a European sample of energy networks. Oxera argue that UK Water and Energy Networks have

³² Oxera (2020), 'Are sovereign yields the risk-free rate for the CAPM?', prepared for the Energy Networks Association, 20 May.

³³ Sharpe, W. (1964), 'Capital asset prices: A theory of market equilibrium under conditions of risk', *Journal of Finance*, 19:3, pp. 425–442.

³⁴ CMA – Anglian Water Services Ltd, Bristol Water plc, Northumbrian Water Ltd and Yorkshire Water Services Limited price determinations provisional findings (Sept 2020)

³⁵ Oxera (Aug 2020) summarise analysis of an event study undertaken for National Grid around regulatory announcements and identify a material shift in risk caused by regulatory cycles and announcements.

³⁶ Oxera (2018), 'The cost of equity for RIIO-2', 28 February 2018

distinctly different risk profiles and therefore energy comparators both UK and European are more appropriate³⁷.

Oxera highlight the errors made by CEPA's analysis for Ofgem, including the use of illiquid stocks in its comparator set³⁸. In addition to this European comparator set, Oxera has used National Grid's 5-year asset beta of 0.38 as the low end of its range, and the 5-year average asset beta across all comparators of 0.41 as the high end of its range³⁹. Oxera's range is 0.38-0.41 and focus on quantifying the non-CAPM risks elsewhere in its analysis and do not use this cut-off to generate the asset beta range⁴⁰. They note that their range is '*conservative*' as the CAPM does not account for other risks networks are exposed to which they have quantified in their study.

We also note that in Ofgem's analysis, they equate the risk of UK energy networks to UK Water when justifying the asset beta range. There seems no justifiable reason why National Grid in particular is not an appropriate asset beta that should carry substantially more weight than UK Water comparators. Although National Grid has trended higher than UK water betas, it is also likely to be an underestimate of the National Grid beta estimate. As we had set out in our Business Plan and associated Frontier Economics⁴¹ reports on beta decomposition, we have shown that the lower risk US business of National Grid pulls the beta estimate down. Oxera simplify this by comparing electricity and gas networks beta between the UK and US showing a differential of 0.30 with the UK higher in electricity.

Debt Beta

Oxera⁴² has undertaken a substantial amount of analysis on debt beta using observable market data. They review the CEPA report⁴³ and illustrate that considering two methods for estimating debt beta using the direct and indirect methods that the debt beta Ofgem selects is unjustifiably high. Oxera provide evidence on debt beta which is best summarised by way of Figure 4 below. This shows that Ofgem's estimate of 0.125 debt beta is based on incorrectly referencing Oxera analysis. The more appropriate level is around 0.05 which is consistent with RIIO-ED1 and that used by the CMA for the NIE decision. Additionally, the data for UK water shows a debt beta no higher than Oxera's estimate when using the indirect method and broadly in line with Oxera's estimate when using the direct method.

³⁷ Oxera (2020), 'The cost of equity for RIIO-2'

³⁸ CEPA (2020), 'RIIO-2: Beta estimation issues', 9 July.

³⁹ Oxera (Aug 2020) state that '*the economic disruption driven by COVID has dramatically increased volatility in 2020. As a result, both 2-year betas and the European comparators have drifted away from their historical norms.*'

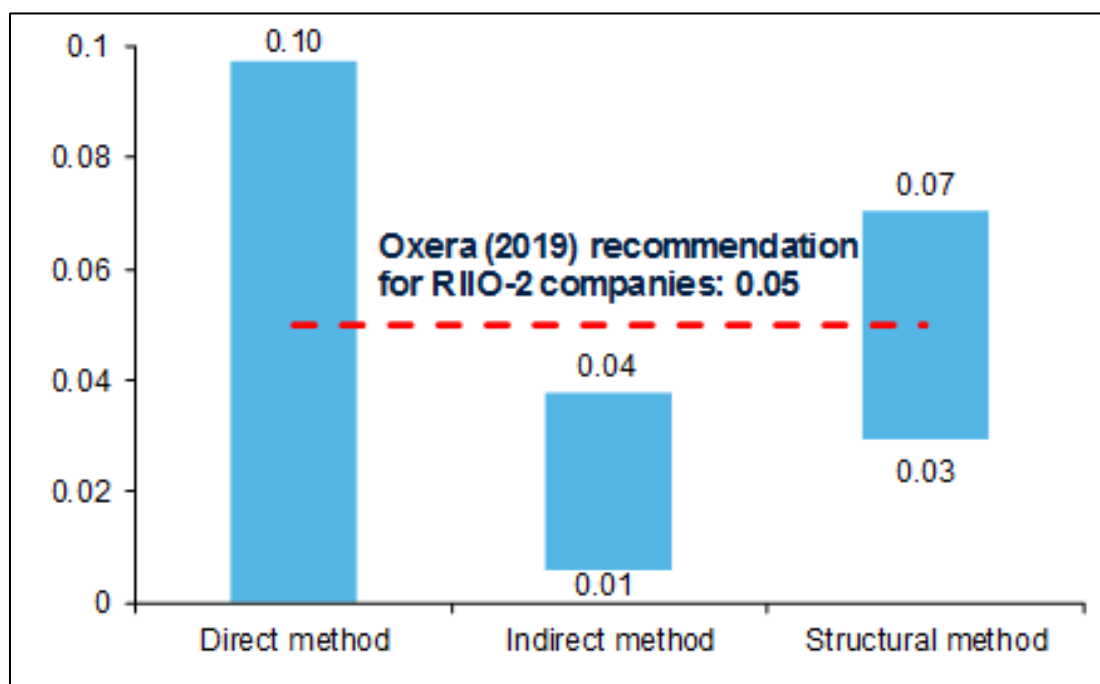
⁴⁰ This is to address Ofgem's earlier criticism that the previous methodology was too arbitrary to justify focusing on the top half of the Oxera range.

⁴¹ Frontier Economics (Jan 2020), 'Beta Decomposition' a report for National Grid and SSE

⁴² Oxera (Jun 2020), 'Estimating debt beta for regulated entities', prepared for the ENA, repeated again for Oxera (2020), 'The cost of equity for RIIO-2'

⁴³ Oxera (2020), 'Estimating debt beta for regulated utilities', 4 June.

Figure 4 – Evidence on debt beta



Oxera⁴⁴ also corrects CEPA's errors in its report and after correcting for these errors reach the same conclusion as its own report in that the debt beta should be around 0.05. Additionally, Oxera finds that the academic evidence (Fama and French (1993)) was misrepresented by CEPA in its report supporting Oxera's debt beta estimate. **We also note that the CMA⁴⁵ has found that the debt beta should be 0.04 for UK water consistent with the analysis undertaken by Oxera.**

Gearing and the WACC

Oxera has undertaken comprehensive analysis of the MM theorem when reviewing Ofgem's application of gearing and setting the WACC⁴⁶. They find that its estimates for RFR, debt beta, and cost of debt result in a better fit to the MM model than Ofgem's own estimates. Ofgem has referred to the NATS/CAA appeal to the CMA⁴⁷ where they were concerned around changes to the WACC by changes in the gearing when compared to the MM theorem. After correcting for the errors made by Ofgem, the Oxera estimates more accurately fit with the MM model and illustrate the extent of the errors made by Ofgem. As a result, the WACC is not very sensitive to changes in gearing as stipulated by the MM proposition. **Oxera note that Ofgem's manual change to the CoE by 10bps is to force the inputs to comply with the MM theorem where after correcting for Ofgem errors as noted above, it is clear this manual arbitrary 10bps is not required and should be removed by Ofgem.**

⁴⁴ Oxera do this in the reports entitled 'The cost of equity for RIIO-2' (2020) and 'Estimating debt beta for regulated entities' (Jun 2020) both prepared for the ENA.

⁴⁵ CMA – Anglian Water Services Ltd, Bristol Water plc, Northumbrian Water Ltd and Yorkshire Water Services Limited price determinations provisional findings (Sept 2020)

⁴⁶ Oxera (2020), 'The cost of equity for RIIO-2', section A2.6

⁴⁷ Competition and Markets Authority (2020), 'Provisional Findings Report', Appendix D, para. 4.

Cross Checks

There are several cross checks which can be considered as supplementary evidence to the traditional CAPM approach. Oxera advocated for the use of cross checks in its seminal 2018 study which Ofgem latterly included in both the RIIO-2 Framework Consultation, SSMC and SSMD as part of its CAPM three step process. The primary cross checks SHE Transmission have considered over that period are set out in Table 4 below where we have summarised our evaluation of the weighting that should be placed on each cross check. This is based on the reliability or observability of the evidence, availability of academic and market evidence and whether it is a methodological change or it is subject to material judgement.

Table 4 – Summary Analysis of Cost of Equity cross checks

Cross Check	Weighting and Reliability
ARP vs DRP	This is a superior cross check as it is based on market data. We therefore place more weight on this cross check when comparing to the CAPM estimate of the CoE.
DDM Models	This is evidence which could be termed a cross check but is subject to input sensitivity and forecast information. The Bank of England model is in line with Oxera's analysis and therefore some weight may be placed on this as a cross check with some careful consideration of the associated inputs.
OFTO returns	This data is unreliable as it is not comparable to regulated networks as an asset class. The data is also not available for interrogation and is likely to be highly sensitive to assumptions as these assets reach maturity. OFTOs have little to no regulatory oversight to verify the actual performance of each OFTO.
Infrastructure fund discount rates and Ofgem's investment manager cross-check	As we have noted, this evidence is considered survey data and therefore does not carry the weight of observable market evidence. When the analysis is corrected for Ofgem errors, it is more supportive of the range proposed by Oxera.
Market to Asset Ratios (MARs)	Oxera analyse MARs noting that the premia can be explained by several factors not attributed to the allowed return on equity. This evidence is therefore not a reliable cross check and little weight should be placed upon this by Ofgem when setting a price control.
Beta re-gearing and MM cross checks	Oxera term this a cross check to validate inputs to the CAPM. Ofgem's point estimates do not comply with this theorem. This is conceptually reliable and has been referred to by the CMA in its Provisional Findings for the NERL appeal ⁴⁸ .

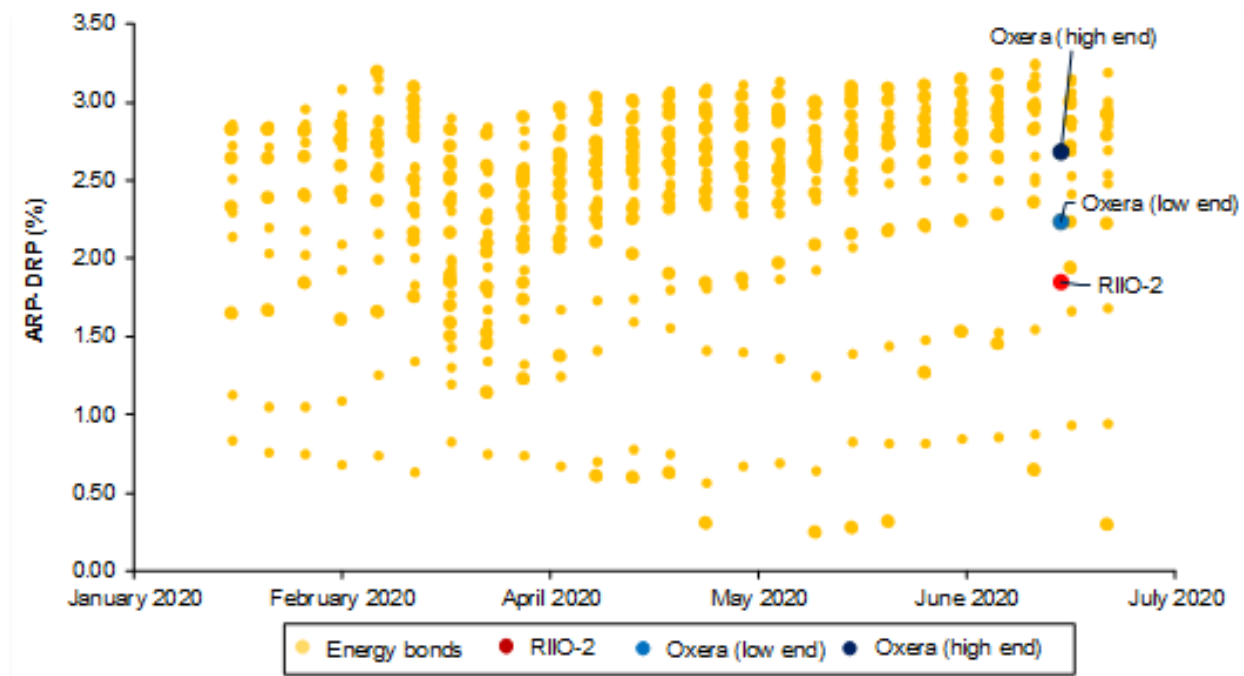
⁴⁸ Competition and Markets Authority (2020), 'Provisional Findings Report',

Asset Risk Premium and the Debt Risk Premium

Oxera has provided compelling academic evidence relating to the Asset Risk Premium (ARP) and the Debt Risk Premium (DRP) of regulated networks. Oxera⁴⁹⁵⁰ analyse the relationship between the ARP and DRP as an appropriate cross check for estimating the cost of equity for RIIO-2. Due to the security ranking of debt over equity, the rule must hold that the premium to equity holders is higher than for debt holders. In providing its analysis, Oxera empirically reviews evidence using market evidence of bonds issued by UK utilities and regulated entities and bonds issued by US utilities. Oxera note in its analysis that Ofgem has understated the asset risk premium differential to the debt risk premium by a significant amount from Ofgem's estimate. Oxera assert that this estimate provides a conservative estimate of the allowed WACC and is therefore more than a simple cross check albeit it does not replace the CAPM derived WACC. We also note that Oxera respond to the misrepresentation of their evidence in their report.

Oxera has also considered UK regulatory precedents in its analysis and present this in the report. They provide analysis summarised effectively by Figure 5 below which compares the differential from UK energy bonds to its Cost of Equity range and to Ofgem's range.

Figure 5 Comparison of the ARP–DRP differentials implied by Ofgem's and Oxera's estimates to the ARP–DRP differential implied by contemporaneous evidence on UK energy bonds



Source: Oxera analysis

This illustrates that Ofgem's estimate is materially lower than market evidence clearly justifies. Oxera's estimate lies in the 24th percentile and the 58th percentile for the low and high end of its range

⁴⁹ Oxera report, Review of RIIO-2 finance issues – Asset and debt risk premiums, Prepared for the ENA (March 2019)

⁵⁰ Oxera report, Asset risk premium relative debt risk premium, Prepared for the ENA (Aug 2020). See Oxera – Asset Risk Premium relative to Debt Risk Premium (ENA report)

respectively. As we have set out, Ofgem need to correct for its errors and increase the range for the cost of equity in line with observable evidence. **Oxera conclude that the 50th percentile of the ARP-DRP differential implies a real CoE of 6.35% supporting their CoE range in their report.**

Dividend Discount Model

Ofgem has relied upon weak evidence using the Dividend Discount Model (DDM). In conjunction with CEPA and with reference to Ofwat and the CAA, Ofgem identify a nominal TMR using CEPA's DDM approach between 7.4% to 8%. Oxera set out in February 2018 and again in 2019 and 2020⁵¹ that when using the BoE's DDM they calculate an RPI-real TMR of 7.5%. Oxera do not place the full weight of evidence on the BoE DDM but note in their report that this still supports their TMR range. We note that Ofgem use a different specification of the DDM in the SSMD relying on long term GDP forecasts in the UK. The use of UK GDP as a proxy for long run dividend growth compared to analyst forecasts or global GDP is not appropriate given 70%-80% of UK companies derive earnings from overseas. We also note this model is sensitive to inputs and therefore not as reliable as directly observable market evidence.

OFTOs

Ofgem refer to OFTO rates of return which is inappropriate due to the nature of these investments.

These investments are fully constructed point to point assets and therefore as an asset class hold different risks to operating a large integrated regulated network. This is in addition to the substantial and ongoing construction requirements, regulatory obligations, and other events political and regulatory which affect the ongoing operation and risk profile of regulated networks. The term of investment is 25 years with little to no regulatory oversight and these assets have not yet reached maturity. There is an element of *winners curse* that could reside in these assets whereby we only see the winning party outcome and not the other bidders who lost. Even considering that data, we are unable to rely upon the analysis as this evidence is not available for review. The only critique of this evidence was by the National Audit Office (NAO)⁵² who quantified a materially higher rate of return or IRR. Any inclusion in outperformance over the period or a small terminal value significantly increases the IRR more in line with the NAO analysis. Additionally, these structures are typically extremely highly leveraged and benefit from unique financial structures which are not available to regulated networks. Ofgem has incorrectly relied upon this as a valid and reliable cross check.

Investment Managers and Infrastructure Funds

Ofgem continues to incorrectly interpret nominal estimated returns from asset managers and financial organisations. Ofgem previously relied upon infrastructure discount rates and investment managers analysis and continues to rely upon this evidence in the DDs. Ofgem then uses the artificially low investment manager evidence as a CAPM cross check to test its range for CoE, again resulting in a cross check supporting an artificially low estimate of CoE.

In Ofgem's DD, they misinterpret and change some of the investment manager evidence. Specifically, nearly the entirety of the decline in Ofgem's estimated TMR is due to a change in the investment horizon

⁵¹ Oxera (Feb 2018), 'The cost of equity for RIIO-2' prepared for the ENA, Oxera (Nov 2019), 'The cost of equity for RIIO-2' prepared for the ENA and Oxera (Sept 2020), 'The cost of equity for RIIO-2' prepared for the ENA

⁵² National Audit Office, Review of OFTO Tender Round 1 and 2 (Nov 2011)

for Schroders. If the original horizon had been used for comparison, Ofgem would have reported a TMR of 7.90% rather than 4.90%. In addition to changing the investment horizon from 30 years to 10 years, Schroders also calculates its UK estimate using US data. Given the obvious data outlier and the fact that this is not a direct UK estimate it should be excluded. In essence this data point should be disregarded in the analysis even if it were deemed reliable. The other data point that significantly decreased was Blackrock's estimate. As noted by Ofgem, this is not a like-for-like comparison as Ofgem changes from an EU TMR in December 2018 to a UK TMR in December 2019. Oxera⁵³ illustrate that investment managers projects increased on average from 7.3% to 9.5% over time and after adjusting for the Cooper (1996) estimator for averaging.

Oxera⁵⁴ analysed this information and provided a report outlining why Ofgem's analysis is incorrect as part of our business plan submission. Ofgem misinterpreted the basis for which these estimates are provided publicly where they are heavily regulated by the Financial Conduct Authority (FCA) and therefore cannot be relied upon as a guide to future returns as set out in the FCA Code of Business. Additionally, this evidence can be classed as survey evidence in that it is not as observable as actual outturn performance or indeed expectations of investors. Oxera highlighted that academic research refers to this evidence as less reliable, for example, Brealey, Myers, and Allen (2016) state *"Do not trust anyone who claims to know what returns investors expect."* The CMA has also commented on the empirical reliability of survey evidence where they *"have preferred to consider underlying data on which survey respondents presumably base their views"*. Survey evidence therefore suffers from significant empirical drawbacks and less weight should be given to it. Oxera note that even if this evidence could be relied upon, Ofgem need to adjust nominal returns from the geometric to the arithmetic average leading to a significant uplift in the nominal TMR which is more in line with Oxera's analysis of the evidence⁵⁵.

Market to Asset Ratios

Ofgem also argues that Market to Asset Ratios (MARs) for the three listed water companies (Severn Trent, United Utilities, and Pannon) support its allowed return by way of supporting the PR19 cost of equity proposed by Ofwat. This is at best an inferior reference point that relies upon a range of factors and interpretations as opposed to concrete observable data. The ENA provided evidence to the CMA explaining why Ofwat is wrong to argue that its analysis of MARs supports its case that the cost of equity it set for AMP7 is not too low⁵⁶. Oxera evaluate MARs whereby they can identify drivers for market prices⁵⁷. For example, they find that non-regulated portion of the business, accrued dividends, expected takeover premium can more than explain the premia for Severn Trent and United Utilities. In other words, the premia can be explained without the argument that the allowed return on equity is too high.

RFR Indexation

Cost of equity indexation is not an appropriate mechanism for a price control and introduces further complexity and volatility unnecessarily. The methodology should reflect outturn inflation instead of

⁵³ Oxera (2020), 'The cost of equity for RIIO-2' prepared for the ENA.

⁵⁴ Oxera report, Review of RIIO-2 finance issues – Rates of return used by investment managers (March 2019)

⁵⁵ Oxera report, The cost of equity for RIIO-2, Prepared for the ENA, (Aug 2020)

⁵⁶ ENA response in PR19:

https://assets.publishing.service.gov.uk/media/5ed0f2b3d3bf7f45fb321450/Energy_Networks_Association_submission.pdf

⁵⁷ Oxera (2020), 'The cost of equity for RIIO-2, prepared for the ENA, section A2.5

relying on forward estimates of inflation to adjust to the real RFR. We also note, as above, that the RFR rate requires a premium to be applied to be consistent with the MM theorem and reflect an appropriate RFR for use in the CAPM. We also do not believe the relationship between the ERP and the RFR is exactly 1:1 and therefore this methodology should be reviewed over RIIO-2 and at most considered for RIIO-3 as further evidence arises.

Aiming up

There has been substantial literature on the concept and regulatory practice of ‘*Aiming up*’ in a range when setting the Cost of Equity for a price control or regulatory determination. Past regulatory best practice has been to aim up in the range due to the uncertainty in setting the cost of equity and to, in principle, avoid the risk of underinvestment.

We note that the CMA has also aimed at the 75th percentile in its range consistent with regulatory best practice in previous price controls. This is higher than the mid-point (50th percentile) the CMA initially concluded on RP3 for the NERL appeal. This is a result of the risk of the potential harm to society by setting the cost of capital too low. We therefore believe Ofgem should be aiming towards the top of a range where the empirical and academic evidence is significantly in favour of that methodology. **Regulatory precedent also supports aiming towards the upper end of the cost of equity range to mitigate the risk of underinvestment and adverse impact on consumers⁵⁸.**

Outperformance Wedge

Ofgem argues in DD⁵⁹ that aiming up would not necessarily lead to more investment. They illustrate this by using a stylistic and simple example proposing there is a trade-off between the incentive to invest to earn a return above its cost of capital and the incentive to outperform through the totex sharing mechanism. Ofgem is therefore assuming that a chunk of the return is earned by way of baked in generous allowances in totex. If that were the case, then companies would only invest IF outperformance was a realistic prospect. In the event that outperformance is not a realistic prospect, then companies would be investing below their cost of capital therefore would not be incentivised to make the investment. This means certain investments would not occur because the opportunity to outperform does not exist. One should also remember that even IF outperformance was a realistic prospect, i.e. it is a *one-way bet*, then Ofgem has already taken 22-25bps off of that supposed guaranteed outperformance. If investments are all delivered with outperformance Ofgem will remove that outperformance through totex allowances in the next price control, which is counterintuitive to the logic within its simple stylised example.

On the principle of the outperformance wedge, this has significant negative incentive properties and when considering more than one price control this mechanism is more likely to cause harm to consumers. For example, if companies perform in line with the 22-25bps outperformance assumption during RIIO-2, the likelihood is that an outperformance wedge of at least this size will be applied in RIIO-3. If companies do not perform in line with the 22-25bps outperformance this will be supposedly recovered by companies by way of an ex-post adjustment and this outperformance adjustment would not be applied in RIIO-3. In

⁵⁸ Frontier Economics, Adjusting baseline returns for anticipated outperformance – An assessment of Ofgem’s proposals, Prepared for the ENA (March 2019)

⁵⁹ Ofgem Draft Determinations Finance Annex, para 3.146

that sense, why would a company aim to achieve 22-25bps or more in RIIO-2 if the equivalent amount is removed from them in RIIO-3? The counterfactual is that companies actively do not deliver the 22-25bps outperformance as they will receive it as an ex-post adjustment while also potentially avoiding a RIIO-3 penalty. The cost to consumers is therefore still 22-25 bps within RIIO-2 regardless of company behaviour.

But if companies behave by not pursuing the 22-25bps outperformance wedge then consumers are harmed in RIIO-3 by the value at least 22-25bps of lost enduring efficiency (this is on the basis that efficiency in one price control runs into perpetuity in future price controls as is expected by incentive-based regulation). Therefore, we see that in principle Ofgem is causing at least the same harm in RIIO-3 that it believes it is providing for in RIIO-2. Ofgem has not considered this long-term impact on consumers or efficiency and instead relies upon it to get headline lower cost of equity and to 'mask' a financeability problem. Ofwat for PR19 has already set out its argument as to why an ex-post or adjustment to allowed returns is not required in its price control⁶⁰. They have noted they do not believe there has been systematic outperformance in Water and that they have struck the price control elements robustly enough that they can rely upon each mechanism accordingly. Ofgem however, have removed a significant proportion (and potentially all) sources of outperformance and there appears to be little or no justification as to why the price control cannot be set robustly as Ofwat believes for PR19.

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?

The market evidence that is available is that energy networks are higher risk than UK Water contrary to Ofgem's assessment in the DDs for T2 and GD2. We have therefore relied upon the assessment undertaken by SHE-T in their response to the DDs noting the difference between UK Water and UK Energy Networks. This has been set out below but in relation to the relative risk of to GD2 and T2 we have not drawn any conclusions at this stage until we have evaluated the price control settlement and regulatory mechanisms as well as the changing investment requirements over the coming period across all sectors. Once more information is available we will review the relative risk as ED2 is not at the stage of GD2 and T2 and therefore any comparison would to be updated and include some significant assumptions.

Ofgem has made number of statements over the RIIO-2 period around the risk of UK Water compared to UK Energy Networks. This has been centred around the discussion on the most appropriate methodology for setting the cost of equity compared to each sector as part of this cycle of price control reviews. In particular it is worth highlighting that four water companies have referred their price control to the CMA and it is by no means a precedent for the right level of cost of equity or potential RoRE ranges.

As we have set out by SHE-T in their response to Ofgem's Draft Determination on the cost of equity and financeability we need to consider the balance of a price control based on the level of risk and potential return opportunity. In this section, we have summarised our own assessment of the relative risk and return opportunity compared to UK Water and in particular focused on the Ofgem quantification of risk in its Draft Determination⁶¹. This section is therefore set out as follows:

1. Observable Measures of Risk
2. Qualitative Assessment of Risk

⁶⁰https://assets.publishing.service.gov.uk/media/5eff32803a6f4023cdba3438/Citizens_Advice_submission_2_.pdf p.10

⁶¹ Ofgem RIIO-2 Draft Determinations – Finance Annex (Jul 2020)

3. Financeability Risk and Quantifying the Risk Differential

We have also reflected our evaluation of the absolute efficiency challenges set by each regulator compared to the scale of investment required over the forthcoming period and technological challenges faced by regulated companies in each sector.

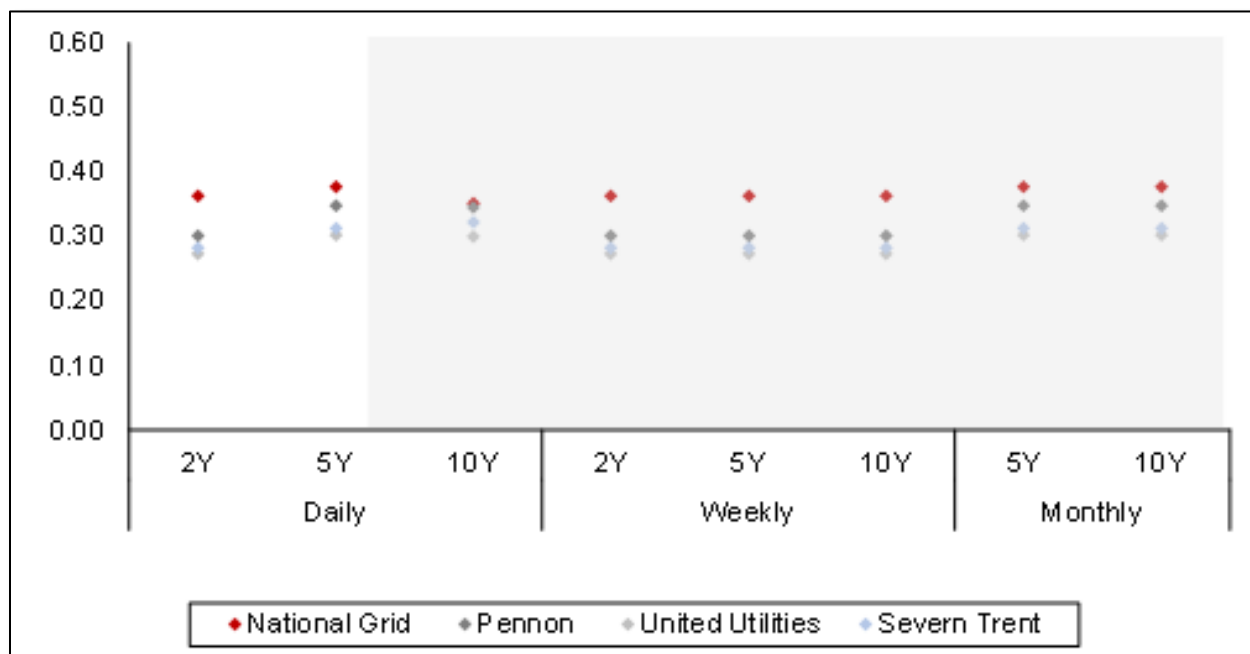
Observable Measures of Risk

It can be challenging to collate and evaluate information to evaluate the level of risk for each company in different sectors. In doing so we have to rely upon a robust analysis of different drivers, company and industry specific factors overlaid by a comprehensive risk framework. In the absence of that analysis, the most appropriate approach is to evaluate what measures are available, observable and considered robust for determining risk of companies in different sectors. In doing so we can use the observed betas of listed UK water companies (United Utilities, Pennon and Severn Trent), and two listed UK energy companies (National Grid and SSE). The two energy companies have proportions of their organisations that are not UK regulated networks. In the case of National Grid, they have a large US business, and SSE is now comprised mainly of a renewables business in terms of relative scale of the Group.

When we consider these risk measures we review the market analysis on betas over a period of time to determine the relative risk of water to energy networks. If we exclude SSE given its changing business composition over a period of time including the disposal of its retail business and instead focus more on National Grid⁶² as a direct comparison. We observe that National Grid's asset beta remains above the water companies as shown in Figure 6 which shows the asset beta estimates for the entire UK comparator sample for the full range of frequencies and estimation windows.

⁶² Oxera (2020) excluded SSE's beta in its analysis as it has trended materially upwards departing from National Grid and European regulated networks. In our opinion this is a prudent approach.

Figure 6 – Asset betas for listed UK comparator companies under different frequencies and estimation windows



Note: The cut-off date is 31 July 2020. The area to the right of the five-year daily asset betas has been shaded to reflect the notion that our range is derived from the two-year and five-year daily estimates, while the rest of the data points are only used as cross-checks⁶³.

This comparator set provides a range of 0.27–0.38 when using on two- and five-year daily beta estimates. More importantly the results show that National Grid has been above the pure-play water companies over the period showing that the relative **observable** risk is higher in electricity networks than water. It is therefore not appropriate to rely solely on this range as it would underestimate the true beta for UK energy networks as it is biased downwards by two critical factors:

1. Water company betas being materially lower than National Grid. This is also the case for pure-play water companies whereby when excluding Pennon the asset beta for water companies is still below National Grid's beta.
2. National Grid's beta being understated by the fact its US business exhibits a lower beta than its UK business either by comparison of data between the UK and US or by disaggregating National Grid's beta⁶⁴.

We believe this illustrates that electricity networks are observably higher risk than water companies without undertaking any further analysis. However, in addition to this, we note that a preliminary analysis of this issue was presented in the Indepen Report, which Ofgem relies on for arriving at its asset beta range. The preliminary analysis in that report found that National Grid's US betas are 0.15 to 0.19 lower than National Grid's UK betas.⁶⁵ Osera also note that other studies have found that the betas of US electricity networks has been 0.30 lower than the UK electricity networks. This further illustrates that

⁶³ Osera analysis based on Bloomberg data.

⁶⁴ This was undertaken by Frontier Economics for SSE and National Grid (Dec 2020)

⁶⁵ Indepen. (2018), 'Ofgem Beta Study – RIIO-2 Main report', pp. 38–9, https://www.ukrn.org.uk/wp-content/uploads/2019/01/final_beta_project_riio_2_report_december_17_2018_0.pdf.

National Grid's beta should be the bottom of the asset beta range at between 0.36 and 0.38 and is likely understated due to its lower risk US business.

The European energy networks have on average higher betas than National Grid and therefore higher than UK water. This is observable evidence that markets see electricity networks as higher risk than UK Water. The European evidence for two- and five-year daily data suggests a wider and higher asset beta range of 0.34–0.52 compared to the UK evidence (0.27–0.36). Strangely, Ofgem also mentions on page 46 that energy networks may be riskier than water firms, and its own beta analysis consistently suggests that National Grid is riskier than the two pure-play water companies.

When we reviewed Ofgem's analysis and reference to the CEPA⁶⁶ report, we note that Ofgem has summarised its conclusions more strongly than was the case in this report. CEPA writes that *'[it recognises] that GB energy networks may be judged riskier than water networks – or at least that the sources of systematic risk are sufficiently different that water networks are an imperfect investment substitute for a pure play energy network in RIIO-2'* and differ due to exposure to the **'Net Zero'** initiative.

The CEPA report also mentions that placing heavier weights on water companies as comparators will mechanically lower the estimated asset beta for energy companies, implying that water companies are relatively less risky than energy companies.⁶⁷ CEPA notes in Table 2.3 of its report on page 25 that energy companies are likely riskier than water companies in terms of demand, competition, and investment cyclicity. They do not find a difference in political/regulatory risk. CEPA's Table 2.3 therefore identifies multiple dimensions on which energy companies may be riskier than water companies and no cases where the opposite is true.

We believe Ofgem has failed to recognise that the risk of Energy Networks is higher than UK Water when considering *observable* market evidence.

Qualitative Assessment of Risk

When we review Ofgem's assessment in Table 18 of the DD's of the qualitative characteristics of risk, we note that they summarise similarities between energy and water more strongly than the claims made by CEPA. When ultimately concluding that water and energy companies are similar in terms of regulatory exposures, Ofgem ignores that rapid technological change, such as HVDC technology, and an increased focus on decarbonisation suggest that the fundamental risk of energy networks is greater than that faced by water networks.

For example, in July 2018, National Grid introduced a new scenario for meeting carbon targets—'Community Renewables'.⁶⁸ This scenario differs in that it assumes that the carbon targets are met under

⁶⁶ CEPA, 'RIIO-2: Beta estimation issues', p. 5.

⁶⁷ CEPA, 'RIIO-2: Beta estimation issues', p. 5. quotes 'A slightly lower range might be considered appropriate the more emphasis is placed on the similarities in the water sector regulatory frameworks and the price control building blocks in the two sectors'.

⁶⁸ National Grid (2018), 'Future Energy scenarios', July, p. 15, Figure 2.1 Scenario matrix, <http://fes.nationalgrid.com/media/1363/fes-interactive-version-final.pdf>. For comparison, see the previous year's version: National Grid (2017), 'Future Energy scenarios', July, pp. 14–17, 'Scenario descriptions', <http://fes.nationalgrid.com/media/1253/final-fes-2017-updated-interactive-pdf-44-amended.pdf>.

a system with a high degree of decentralisation.⁶⁹ The large roll-out of decentralised intermittent generation may require significant adaptation from the grid. In March 2019, the UK government banned gas heating for new houses, with the aim of decarbonising domestic heating.⁷⁰ This raises the question of what utilisation gas networks will be able to achieve throughout the RIIO-2 period and beyond, and it is another example of heightened risk for energy networks compared to water networks.

If we replicate Ofgem's table reflecting the reality of the risk analysis between electricity and water, we do not conclude the same as Ofgem. We also consider more explicitly other direct risks which Ofgem has not clearly considered in our table marked as [new] in the table. This is based on T2 evaluation of DD and therefore would be updated for ED2 accordingly.

Table 5 – Comparison of qualitative risk of regulated energy and water networks in GB (for TOs)

Driver of risk	Energy networks may bear lower systematic risk than water networks because...	Energy networks may bear similar system risk as water networks because....	Energy networks may bear higher systematic risk than water networks because....
RoRE Range	We identify no items where risk would be lower for water than energy.	Both sectors are subject to regulatory reviews on a cyclical basis and are based in the UK.	Market observations for risk are significantly higher for energy than water but returns are lower. The RoRE range is significantly lower and with a materially lower equity buffer ⁷¹ .
Return Adjustment Mechanisms and outperformance wedge	Ofwat have no restrictions on potential outperformance and no outperformance wedge which is credit negative.	Both sectors are regulated within the UK as above.	Energy has the risk of ex-post adjustments, risks associated with other network company's performance.
RIIO-2 indexation	We see little evidence of risks being greater for water than energy.	Not applicable.	Significant shift in indexation for RPEs, cost of equity which introduces more cash flow volatility than water.
Totex Expenditure requirements	Totex requirements are substantially lower over the period and long term in absolute terms in Water.	Both energy and water are subject to efficiency incentive mechanisms.	Significantly greater totex requirements in energy to delivery NetZero as also noted by CEPA.

⁶⁹ See 2017 FES Workbook, tab 'ES3', and 2018 FES Workbook, tab 'ES2'.

⁷⁰ Harrabin, R. (2019), 'Gas heating ban for new homes from 2025', BBC News, 13 March, <https://www.bbc.co.uk/news/science-environment-47559920>, accessed 3 October 2019.

⁷¹ Remembering that four water companies have appealed PR19 to the CMA.

Reputational and business risks	Not applicable.	Reputational risks similar on security of supply.	Disruption in electricity distribution and transmission causes significantly greater than water disruption as seen by the National Grid blackout in 2019 which was a significant cost to the economy.
Efficiency challenge [new]	Lower efficiency challenge applied by Ofwat in PR19.	Not applicable.	Significantly greater efficiency challenge applied in energy networks compared to water leading to more downside risk and overspend.
Regulatory uncertainty [new]	Little requirement for reopener mechanisms.	Not applicable.	For Transmission we have seen a significant increase in the number of regulatory uncertainty mechanisms and reopeners. The scale of regulatory intervention has increased substantially with a more micro-management of regulatory decisions in particular for expenditure. If this were to persist for ED2 then this would possess a greater risk than PR19 and UK Water
Technological Change [new]	Significantly less technological risks in Water compared to energy.	Not applicable.	The pace and requirement of investment and new technology in electricity is significantly higher than in Water across electricity distribution and transmission

Therefore, when we consider the qualitative analysis, we see no reason as to why energy networks are lower or similar risk to UK Water. Observable and qualitative measures clearly indicate a significant risk premium is required for energy networks yet we see lower returns than Water, greater downside and less opportunity to outperform in RIIO-2 so far based on GD2 and T2 DDs.

Financeability Risk and Quantifying the Risk Differential

Ofgem state that they do not agree with companies' objection to injecting equity to boost financeability over RIIO-2⁷² on the basis that some Water companies are following this practice to improve financial resilience. This is an incorrect characterisation of the injection of equity in Water where companies actual

⁷² Ofgem RIIO-T2 and GD2 Draft Determinations – Finance Annex (July 2020), page 116, para 6.7

gearing is/was substantially higher than the notional gearing. This is not the case in Energy Networks and as we have set out in our financeability analysis, Ofgem has used a change in notional gearing to mask a credit rating problem caused by setting the cost of equity too low for RIIO-T2.

Our approach (and that of Oxera) was criticised by Ofgem because a precise value was not quantified for the additional premium associated with these risk differentials between water and energy. Ofgem also considers that Oxera should have used water companies as comparators for energy networks yet acknowledges water companies are likely to be lower-risk. In relation to quantifying a differential we believe that observable market evidence justifies a higher cost of equity and a removal of a significant proportion of the efficiency challenge. Both of these create significant downside risk and given the errors made by Ofgem must be corrected to ensure energy can deliver the necessary transition to NetZero reflective of the risk the industry faces.

Financeability

FQ8 Do you agree with our proposal to align the RIIO-ED2 financeability approach with the approach we have taken for GD&T?

We do not agree with Ofgem's proposal to align the financeability approach set out in the DD's for GD2 and T2 in RIIO-ED2 due to Ofgem's approach in masking financeability issues in RIIO-2 by using various levers in order to solve credit rating ratio issues instead of correcting for errors on the CoE.

Ofgem's measures are associated with assumptions on the notional company around Index Linked Debt (ILDs) and the company gearing. The assumption on ILD has been increased from 25% to 30% when the industry average is 25% and when excluding NGET Gas and Electricity this falls to below 10% on average. The actual company gearing is just over 60% across the industry and Ofgem has used a change in notional gearing due improve financeability as a result of setting the Cost of Capital too low.

Therefore due to the number of issues that have been highlighted in the Draft Determinations by the GD&T operators including but not all-inclusive such as both cost of equity and cost of debt being set too low. The inclusion of an outperformance wedge for justifying credit metrics is a break from regulatory precedent and deemed credit negative by credit rating agencies. Additionally, Ofgem needs to undertake comprehensive sensitivity analysis including plausible downside scenarios.

As per the CMA⁷³, concludes in their Provisional Findings on PR19 that the cost of capital has been set too low by Ofwat. Moody's⁷⁴ also note that the CMA has undertaken a financeability assessment considering *'downside scenarios including overspending and operational performance penalties that would not apply to a purely "notional" company'*. They also note that the CMA stated that increased allowed returns, spending allowances and cost sharing rates would allow companies to finance their functions in their redetermination. This is part of their assessment that the CMA provisional redetermination is credit positive and therefore this is evidence that financeability is a key component where the cost of capital must be set appropriately based on the evidence.

Ofgem's DD also contained several of the same errors as noted by the CMA which needs to be adjusted by Ofgem. In doing so Ofgem would not need to rely on these measures and as we have set out previously as part of the ENA Finance Working Group, Ofgem need to correct for other errors not contained in the

⁷³ CMA – Summary of provisional findings report (September 2020)

⁷⁴ Moody's, 'Regulated Water – UK, CMA appeals give higher returns' (30 Sept 2020)

CMA's determination on beta and the outperformance wedge. We also note that that energy is higher risk than UK Water as noted in FQ7 and therefore the cost of capital needs to be set higher than Water.

FQ9 Are there any reasons why this approach should differ for RIIO-ED2?

As we have noted above in FQ8, the approach to ED2 financeability cannot and should not align to the approach taken by Ofgem for DDs in T2 and GD2 given the errors identified in Ofgem's methodology. The financeability assessment must be robust, consistent and avoid errors to ensure it reflects the underlying circumstances of the network financeability position over the price control and longer term. We do not believe any adjustments made by Ofgem should be allowed to mask pressure on credit ratios which would cause longer term damage to consumers. The definition of the notional company is therefore critical to that assessment. We note that the assumptions Ofgem has used on gearing and index linked debt (ILD) is incorrect as set out in DD for GD2 and T2. Additionally, the scale of the efficiency challenge and cost cuts is higher than previous price controls and as proposed by the CMA on the PR19 provisional findings,⁷⁵ as well as the likelihood of outperformance and under performance. When these items are corrected for the credit ratios fall significantly below the thresholds required to maintain Baa1/BBB+ ratings stipulated by Ofgem in DDs for GD2 and T2.

We also note that the inclusion of any outperformance wedge is credit negative and the rating agencies have confirmed that the lower allowed returns and large efficiency cuts in T2 will cause downward pressure on credit ratios. For example, SSE plc has been placed on negative outlook by Moody's due to the impact of RIIO-2 for several factors therefore illustrating that the financeability assessment is incorrect⁷⁶.

FQ10 Do you have a view, supported by evidence, regarding the appropriateness of different measures to address any financeability constraints?

It has been noted that Ofgem is relying upon significant equity injections and dividend constraints to support financeability in T2 as well as the errors noted above. For example, Ofgem's own financial model it shows that to sustain a dividend yield of 3% over the period SHE-T would need to increase its leverage above the notional level of 55%. We therefore believe that Ofgem should remove the outperformance wedge, align gearing appropriately with the sector, and set the allowed rate of return for debt and equity in line with market evidence. By removing the errors made in the CoD and CoE Ofgem would alleviate financeability issues arising due to RIIO-2 and ensure that the UK remains a competitive location to attract international investment to drive NetZero.

FQ11 Do you have any views on the proposed scenarios to be run for stress testing?

We do not believe Ofgem have applied a sufficient range of stress testing on financeability. This is illustrated by the errors made by Ofgem on gearing and ILDs as well as the probability of underperformance. Ofgem should remove the outperformance wedge as this is a break from regulatory best practice when undertaking financeability analysis by relying on outperformance to boost credit ratios. We also note that Ofgem has failed to recognise the significant efficiency challenge in T2 when evaluating financeability and the probability of underperformance. For example, we note that Ofgem's own analysis indicate that credit ratios would improve or not change materially when overspend of 10%

⁷⁵ The CMA noted that the ongoing efficiency assumption of 1.1% proposed by Ofwat was too high and elected to substitute this with a 1% assumption. Ofgem have proposed 1.2-1.4% for ongoing efficiency which is higher than the CMA has determined for PR19.

⁷⁶ Moody's Credit Opinion SSE Plc (September 2020)

and 20%. This is simply nonsensical whereby a network company credit ratios would improve despite significantly overspending over a price control period.

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?

We require further information from Ofgem as to how they see this proposal working in practice before we can provide a view on whether or not we agree. A key issue for SSE Distribution regarding this proposal is that the two licensees under SSE Distribution are both part of the wider SSE Plc group. Our credit rating report is determined based on the overall SSE Group which also includes the Renewables and Transmission businesses and so the impact of credit rating falls may not be solely linked to the performance of the SSE Distribution companies.

Regarding a financial resilience report there are a number of reports that are currently produced which provide information on the licensees financial resilience including:

- Statutory accounts prepared on a going concern basis
- Availability of resources statement
- Viability statement as required by the UK Corporate Governance Code

All of which are independently audited by our external auditors on an annual basis. In order to provide a view on Ofgem's proposal for additional reporting we would need to understand what additional reporting would be required that the above does not already provide. There would need to be a justification of why this information is required and in what form and why it would be more valuable, reliable and appropriate than what is produced at the moment.

Corporation tax

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?

SSE Distribution strongly believe that licencees should be fully funded for their actual tax costs and that consumers only pay for those actual tax costs. We also believe that, as regulated networks, adopting some form of accreditation for transparency on tax would be a positive step for consumers.

Thus, taxation should be treated as a pass-through cost if licencees can demonstrate compliance (or a demonstrable equivalent level of compliance) with a tax accreditation standard. We are accredited under the Fair Tax Mark.

We do not support the alternative mechanisms proposed by Ofgem in the DDs for GD2 and T2 or the proposal to pursue option A, as these do not appropriately ensure licencees pay their actual tax due. This is not in the best interest of consumers and does not recognise companies with responsible tax track records.

FQ14 Are there any reasons why this approach should differ for RIIO-ED2?

As per FQ13 SSEN Distribution strongly believes taxation should be treated as a pass-through cost if licencees can demonstrate compliance (or a demonstrable equivalent level of compliance) with a tax accreditation standard. We are accredited under the Fair Tax Mark.

Indexation of the RAV and allowed return

FQ15 Do you agree with our proposal to implement CPIH inflation?

Ofgem has not yet undertaken any analysis to justify this transition immediately and why a transition period was not considered as part of the consultation process akin to PR19. We note that the immediate switch and acceleration of cash flows is to mask a financeability problem and yet fails to do so without a number of other inappropriate assumptions regarding the notional company. We would also note that any transition has to be NPV neutral and adjustments made to debt funding to ensure efficient financing costs can be fully recovered.

FQ16 Are there any reasons why this approach should differ for RIIO-ED2?

As noted above, a more robust approach to justify the switch to CPIH is required for stakeholders to engage with this complex subject. Ofwat undertook a comprehensive engagement considering a range of elements including RPI-ILDs amongst other factors which Ofgem has not undertaken. We also note that Ofgem has not considered the longer term impact of this switch to CPIH and its interaction across the price control. We would again note that any change should be NPV neutral, all aspects of the price control adjusted such as CoD and CoE and in particular not used to mask a financeability problem in RIIO-ED2.

Regulatory Depreciation

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?

We have no objections to the ED2 depreciation rates remaining in line with the closing regulatory asset life of 45 years. We believe 45 years is a suitable asset life and is aligned with our overall average economic lives of our network assets. We will keep this under review as part of our business plan process and set out our final policy at that time considering evidence presented by TOs, GDNs, and the information at the RIIO-ED1 CMA appeal for the slow track DNOs.

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?

At this stage we do not believe a change is required to the closing RIIO-ED1 asset life of 45 years and this should remain constant at 45 years throughout the RIIO-ED2 period. However, we will review this again as part of our business plan submission.

Capitalisation Rate

FQ19 Do stakeholders support licensee specific rates for the ED sector?

We support the proposal for licensee specific rates for the ED sector as long as this proposal is a single rate for the RIIO-2 period based on our assessment of outturn expenditure bearing in mind ex-ante totex and uncertainty mechanism related totex similar to what was undertaken in RIIO-1. For the GD2 and T2 DDs we did not agree with the idea of changing capitalisation rates on an annual basis either for outturn values or for allowances. We believe this introduces further uncertainty and revenue volatility by varying capitalisation rates on an annual basis and would introduce complexity into the price control unnecessarily. Also we note capitalisation rates are not supposed to be used to support financeability

excessively and are in essence to be the natural rate based on historical and forecast rates set at the outside of a price control.

We also note that there is potentially unintended consequences associated for the totex incentive mechanism. In advance of RIIO-1, Ofgem sought to equalise incentive rates for capital and operating expenditure through introducing totex and changing the capitalisation rate may distort this incentive rate.

FQ20 For one or more aggregations of totex, should we update rates ex-post to reflect reported outturn proportions for capex and opex?

We do not agree due to the adverse incentive properties it introduces to totex which goes against the principles of RIIO. This was a well discussed topic at the outset of RIIO-1 as part of the RIIO Handbook whereby the equalisation of capex and opex to totex and the application of a capitalisation rate was a clear policy decision at that time. This was focused primarily on aligning incentives on capital and operating costs and ensure the most appropriate investment and expenditure was incurred for the benefit of consumers. We believe the changing capitalisation rate would necessitate a change in the incentive properties for totex which is not the intended requirement. The equalisation of incentives through the Totex Incentive Mechanism and use of a single capitalisation rate was to avoid these adverse incentives between opex and capex. We have seen no analysis to justify this change in approach and believe it would be a material change in regulatory policy without adequate evidence, analysis or justification on Ofgem's part to deviate from a policy position set out at the price control.

Directly remunerated services

FQ21 Are there any reasons why the RIIO-ED2 approach to directly remunerated services should differ from RIIO-ED1?

We agree with the proposal to retain the approach to directly remunerated services from RIIO-ED1 to RIIO-ED2 and have no material reasons as to why this should differ.

Disposal of Assets

FQ22 Do you support our proposal to continue the RIIO-ED1 approach to disposal of assets for RIIO-ED2?

Yes, we agree that the proceeds from the disposal of assets during RIIO-2 should be netted-off against totex from the year in which the proceeds occur. This is consistent with RIIO-ED1 financial arrangements and incentivisation intentions.

Executive Remuneration/Dividend

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?

SSE Distribution are part of the same Group as SHE-T and so our executive remuneration and dividend policies are aligned which is explained in SHE-T RIIO-T2 Business Plan⁷⁷. We do not agree that additional reporting on executive pay/remuneration and dividend policies on an annual basis will help to improve

⁷⁷ SHE Transmission: A Network for Net Zero, RIIO-T2 Business Plan

the legitimacy and transparency of a company's performance under the price control. The draft determinations provide no supporting evidence as to why additional reporting is required by third parties and so it is inconsistent with Ofgem's information collection and reporting simplification objectives. Ofgem has also provided no supporting evidence to mitigate the potential legal considerations that may arise with the collection, holding and publication of this information. As stated within the original response from the ENA there is of course an interplay between the requirements of relevant statutes under which Ofgem and our members operate and report, which raises a further question as to whether the proposed requirement can be considered consistent with good regulation.

Executive remuneration: We do not support providing additional information on executive remuneration. This information is already included in the Statutory Financial Statements for the SSEN companies, prepared under applicable statutory accounting frameworks and which are all subject to external audit under ISA's. As highlighted by the ENA a requirement to disclose personal data/information for publication is not one that Ofgem should impose and also conflicts with requirements in respect of good corporate governance and the disclosure of directors' remuneration set by Parliament, the FCA or any exchange on which a company's securities are listed. It is not clarified in the draft determinations where this additional information would be disclosed but if the proposal were to be the RFPR, this document would not be subject to the same reporting or auditing standards.

Dividend policy: As stated in our business plan our dividend policy is based on a range of factors considered by the Board of Directors including delivering our Business Plan, maintaining our investment grade credit rating and providing an appropriate rate of return to shareholders. We do not agree with the requirement to report on this annually as Ofgem does not provide a robust case for what value annual reporting of this would add. In our business plan we highlight that our dividend policy for the RIIO-T2 period does not deviate significantly from our historic approach and that each year will consider our commitments to deliver our Business Plan while ensuring we comply with our licence requirements to maintain an investment grade credit rating and for Availability of Resources.

Return Adjustment Mechanism

FQ24 Do you agree with our proposal to introduce a symmetrical RAMs mechanism?

We do not agree with the proposal to introduce a symmetrical RAMs mechanism is more likely to cause harm than good to consumers in RIIO-2. Ofgem have failed to set out the long-term impact of this mechanism and whether or not there is any proven advantage to consumers, investors or companies. Based on the draft determinations, Ofgem have introduced negative weighted incentive proposals and stripped away the opportunity to outperform and therefore the mechanism is irrelevant and will provide no or little value.

Analysis as per the report carried out by first economics⁷⁸ through the ENA FWG also supports our objection to introducing a RAM mechanism as it emphasizes that earned rewards by companies are part and parcel of a healthy regulatory regime and should not be adjusted by regulators claiming it is to protect against failures within the setting of the price control.

⁷⁸ <http://www.first-economics.com/earwakerfincham.pdf>

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?

It is too early to assess the impact of the 300 basis point threshold on either of the SSE Distribution licensees and more work will be required as part of our business plan submission. We have therefore relied upon the assessment undertaken by SHE-T in their response to the DDs⁷⁹. This analysis on Ofgem's proposal to introduce a single threshold level of 300 basis points (bp) either side of baseline allowed return on equity excluding business plan incentive and debt/tax performance supports our response to FQ24 on the irrelevance of the RAM mechanism.

SHE-T's analysis highlights if SHE-T were to achieve the maximum of its output incentives cap or collars this would only account for circa 50 bp out of the 300bp in the RAM mechanism. In order to then trigger the 300bp threshold SHE Transmission would then need to out/underperform on its base totex by circa 40%. Due to the level of out/underperformance in both incentives and totex required to trigger the mechanism it would be highly unlikely this would be reached and so questions why an additional mechanism needs to be added to the price control that will add little value. We note that we do not agree with the RAMS mechanisms as a result of the adverse impact if it were triggered albeit the value of such a mechanism appears significantly flawed based on the analysis of DDs for GD2 and T2.

FQ26 Do you have any other comments on our proposals for RAMs in RIIO-ED2?

As per responses to FQ24/25 we do not agree with Ofgem's proposal for RAM's in RIIO-2 and do not believe Ofgem have justified a robust case for what value this additional mechanism will add to the price control.

⁷⁹ SHE Transmission Draft Determination Response (September 2020)

Appendix 2 – SHE Transmission response to Ofgem’s RIIO-T2 and GD2 consultation questions on pre-action correspondence and post-appeal review

***Core Question 41:** 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?*

- 1.1 Ofgem⁸⁰ is proposing to carry out post-appeal reviews “where this would be of assistance in ensuring the overall coherence and consistency of the regulatory settlement” and, following any successful CMA appeal, to make adjustments to wider aspects of the RIIO-2 price control where it considers it would be appropriate to do so (the **Post Appeal Proposal**).⁸¹
- 1.2 SHE Transmission strongly disagrees with the Post Appeal Proposal. As set out in more detail below, the Post Appeal Proposal would risk undermining the purpose of the statutory appeals framework, which guarantees parties affected by licence modification decisions an ex-post right of appeal to an *independent* appeal body, with an expectation that the appeal process will result in finality and certainty. The relevant decision-maker is the CMA and Ofgem has no power to undermine or circumvent the appeal outcome decided by the CMA. Since the appeal process already empowers the CMA – as the independent decision-maker – to consider and rule on any interlinkages as part of its assessment of price control appeals there would be no legitimate purpose in Ofgem undertaking a “post-appeal review”. Indeed, the only apparent outcome of such a review would appear to be that Ofgem would confer upon itself the right to have a “second bite of the cherry” in relation to points which it had unsuccessfully argued before the CMA (see section A).
- 1.3 Further, that a post-appeal adjustment by Ofgem is not permissible is demonstrated by the fact that this would open the door to yet a further chain of appeals, thereby circumventing the statutory deadlines for resolving any disputes relating to price control decisions (see section B). It is a core principle of the statutory appeal regime that the appeal decision of the CMA is the final word on the price control decision. It is not open to Ofgem to re-take aspects of its decision in this way and, if attempted, would necessarily be highly inefficient and would result in disproportionate costs for the affected parties (as well as for Ofgem).
- 1.4 As a practical matter and aside from the key concerns of principle raised in Sections A and B, the parameters of the Post Appeal Proposal are characterised by a high degree of uncertainty (despite concerns raised by respondents to the RIIO-2 sector specific consultation⁸²), including in relation to:

⁸⁰ Ofgem and GEMA are for present purposes used synonymously.

⁸¹ DD, paras. 11.31-11.33.

⁸² Several respondents to the RIIO-2 sector specific consultation (including SSE) observed that details of Ofgem’s post-appeals review proposal were unclear in their responses. See: https://www.ssen-transmission.co.uk/media/3329/riio-2-sector-specific-methodology-consultation-response_080519.pdf

- (a) the appeal outcomes that would trigger such a review (although we assume that its application would be broader than any issues on which the licence modification decision was remitted back to Ofgem with specific directions);
 - (b) the scope of such a review;
 - (c) the process for such a review and any adjustments to the price control; and
 - (d) precisely how Ofgem considers that such a review could be conducted in accordance with the CMA's final decision.
- 1.5 It is also unclear whether Ofgem is still considering the possibility of carrying out post-appeal reviews in relation to FDs concerning parties that had *not* appealed the decision and, if so, in what circumstances.⁸³
- 1.6 The lack of clarity that Ofgem has to date provided in relation to the post-appeals review process is concerning.
- 1.7 Overall, the significant and detrimental impact that the Post Appeal Proposal would have on regulatory finality and certainty is highly troubling (see section C).

A. The Post Appeal Proposal risks undermining the statutory appeals framework

- 1.8 Ofgem argues in the DD that it could carry out post-appeal reviews without undermining the statutory appeals framework. This position is counter-intuitive as the proposal is not envisaged by the statutory regime. The only explanation offered in the DD is the statement that "[a] review *would be conducted in compliance with the final decision of the CMA on any appeal.*"⁸⁴ It is unclear precisely how Ofgem intends to achieve this in practice. However, for the reasons set out below, any post-appeal adjustment to the price control by Ofgem that has not been specifically mandated by the CMA would, by definition, undermine affected parties' ex-post right of appeal to an independent body.

Parties affected by a licence modification decision are entitled to an ex-post appeal to an independent decision-maker with an expectation that the appeal process will result in finality and certainty.

- 1.9 As Ofgem is aware, the current energy price control appeal regime is a consequence of legislative amendments made in Great Britain⁸⁵ and Northern Ireland⁸⁶ following the introduction of the EU Third Energy Package (the **Third Package**). Directive 2009/72/EC (the **Electricity Directive**), one of the two Third Package directives, requires that national regulatory authorities take autonomous decisions and are able to undertake their regulatory tasks independently and in an efficient and

⁸³ RIIO-2 Sector Specific Methodology, para. 2.20.

⁸⁴ Draft Determination, para. 11.33.

⁸⁵ See Part 9 of the Electricity and Gas (Internal Markets) Regulations 2011 (No. 2704), which modified EA89.

⁸⁶ See Part 2 of the Gas and Electricity Licence Modification and Appeals Regulations (Northern Ireland) 2015(SR 2015 No. 1) which modified the Electricity Order.

expeditious manner.⁸⁷ It also requires Member States to ensure that suitable mechanisms are in place, such that a party affected by the decision has a right of appeal to a body independent of the parties involved and government bodies.⁸⁸

- 1.10 In line with the requirements of the Electricity Directive, the Electricity and Gas (Internal Markets) Regulations 2011 (the **Regulations**) granted greater autonomy of decision-making to regulatory authorities, subject to the introduction of a clear and protected ex-post right of appeal for those affected.⁸⁹
- 1.11 As papers from the 2010 Department of Energy and Climate Change (**DECC**) consultation (the **Consultation**) show, the Government took the view that the ex-ante licence modification appeals process then in operation needed to be amended in order to comply with the Electricity Directive. The Government went on to conclude that *“the best way to implement these requirements, ensure a coherent and consistent regulatory regime, ensure robust regulation in the consumer interest and appropriate scrutiny of Ofgem’s decisions, is to replace the current licence modification process with an ex-post right of appeal.”*⁹⁰
- 1.12 This point is reiterated in the Explanatory Notes to the Regulations which note that the ex-post appeals process was considered a necessary pre-condition to Ofgem’s power to make autonomous decisions.⁹¹ This right is therefore central to the statutory regime and any proposal with the intention or effect of undermining this objective would be contrary to the intention of both EU and UK government institutions who put into effect these amendments.

The CMA is already empowered to consider interlinkages in its appeal determinations

- 1.13 Ofgem explains that it would use post-appeal reviews *“to consider whether it was necessary to adjust an element of the price control including allowances, outputs and incentives, that are linked to aspects of our decision that are overturned on appeal before the CMA.”*⁹² However, save where the CMA has given specific directions for Ofgem to do so, such consideration would not be in accordance with Ofgem’s powers. Furthermore, it would be neither necessary, nor appropriate, at the post-appeal stage.
 - (a) First, it is clear from the CMA’s decisional practice and recent comments to Ofgem that the existing mechanism for appeal to the CMA already adequately caters for potential “interlinkages” between matters raised on appeal and other aspects of the price control as part of the CMA’s decision-making on price control appeals:

⁸⁷ Electricity Directive, article 35(5)(a).

⁸⁸ Electricity Directive, article 37(17).

⁸⁹ Hansard, Lord Marland. Available at: [https://hansard.parliament.uk/Lords/2011-10-17/debates/11101732000221/ElectricityAndGas\(InternalMarkets\)Regulations2011..](https://hansard.parliament.uk/Lords/2011-10-17/debates/11101732000221/ElectricityAndGas(InternalMarkets)Regulations2011..)

⁹⁰ Implementation of the EU Third Internal Energy Package, Government Response, DECC – Department of Energy and Climate Change, January 2010, para. 2.15.

⁹¹ Explanatory Memorandum to the Electricity and Gas (Internal Markets) Regulations 2011, para. 4.14. See also: Implementation of the EU Third Internal Energy Package, Government Response, DECC – Department of Energy and Climate Change, January 2010, para. 2.15.

⁹² Para. 11.32.

- (i) For example, in the 2017 Firmus Energy Determination the CMA observed that *“In the ED1 Determinations, we recognised the risk of knock-on effects changing one aspect of a complex regulatory decision might have. The principle we adopted in those cases and we adopt here is to consider on a case-by-case basis any evidence submitted to the CMA regarding links between the parts of the decision which are challenged and parts which are not. However, based on submissions in this appeal, we concluded that changing the GIS costs would not have consequential effect on other parts of the UR’s determination”*⁹³ (emphasis added).
- (ii) The CMA reiterated this view even more recently in its response to Ofgem’s open letter (the **Response**), in which it stated: *“We confirm that, as stated in our guidance and in accordance with previous appeal determinations, the CMA will take interlinkages into account”*⁹⁴ (emphasis added), and that *“[i]t is correct that an appellant cannot “cherry pick” just one specific unfavourable component of a regulatory assessment, assumption and decision where that is not in practice a separable decision, and can only be considered alongside other linked decisions.”*⁹⁵
- (b) Secondly, in line with the decisional practice of the CMA, the burden of raising a defence based on knock-on effects lies with the regulator in the first instance.⁹⁶ As a matter of principle, Ofgem must raise any potential interlinkages in its submissions to the CMA on appeal. Having done so, it cannot be right that Ofgem is entitled to carry out a post-appeal review simply because it failed to convince the CMA of its position on appeal. If Ofgem does not raise any issue of interlinkages before the CMA, having had the opportunity to do so, it is likewise not open to Ofgem to seek to do so following the CMA’s decision.
- (c) Thirdly, in the event that the CMA considers that a licence modification decision requires reconsideration or redetermination in order to address the subject matter of the appeal and / or any interlinked issues, then it would already be able to address any such matter – and indeed is well equipped to do so – under its existing powers under the Electricity Act 1989 (**EA89**) which enable it to do one or more of the following:
 - (i) quashing the decision;

⁹³ Para. 8.25. See also CMA SONI Determination, para. 13.3.

⁹⁴ Para. 13.

⁹⁵ Para. 16. See also: para. 2.23 of the Consultation, which provided that: “as price control decisions are essentially a package of balancing measures, there is the potential that upholding an appeal on a single element could have a knock-on effect on other elements of the package and upset the balance of the price control mechanism as a whole. The appeal body would therefore have discretion to consider additional elements or the whole package of the price control decision if the evidence submitted shows that reviewing individual elements is likely to upset the balance of the whole package” (emphasis added).

⁹⁶ CMA BGT ED1 Determination, para. 3.52; CMA NPg ED1 Determination, para. 3.51.

- (ii) remitting the matter back to Ofgem for reconsideration and determination in accordance with any directions given by the CMA; or
 - (iii) substituting the CMA's decision for that of Ofgem and giving directions to Ofgem or any other party to the appeal.⁹⁷
- (d) Therefore, contrary to the suggestion in the DD, there is no need to provide Ofgem with an additional right of review to consider interlinked issues in the price control after the appeal has concluded.⁹⁸ It is notable that Ofgem has offered no explanation in the DD or elsewhere as to why any concerns that it may have about the “*coherence and consistency*” of the price control should not be capable of being addressed by the CMA in the exercise of its broad statutory powers.
- 1.14 In these circumstances, it is hard to escape the conclusion that Ofgem's Post Appeal Proposal amounts to no more than an attempt (in no way endorsed by the CMA) to provide itself with an opportunity to have another bite at the cherry. It would plainly be inappropriate for Ofgem to seek to unwind or modify the intended effect of the CMA's decision in this way, particularly in circumstances where – as explained above – the CMA had already taken possible interlinkages into account.
- 1.15 Given that: (1) the UK Government's position that affected parties' right of appeal to an independent body requires the CMA to be the ultimate arbiter in any points of dispute; and (2) the CMA will consider any knock-on effects raised by Ofgem when determining the outcome of an appeal and can, where it considers it appropriate, remit a matter to Ofgem for reconsideration, any post-appeal adjustments to the RIIO-2 price control initiated by Ofgem would undermine affected parties' right to an ex-post appeal to an independent body.
- B. Post-appeal adjustments to the RIIO-2 price control initiated by Ofgem would open the door to a further chain of appeals
- 1.16 The swift resolution of appeals against price controls is essential to provide Ofgem, transmission owners and consumers with finality and certainty. The importance of finally resolving price control appeals as swiftly as is reasonably possible is a core aspect of the overriding objective of the CMA's procedural rules for energy licence modification appeals, namely to “*enable the CMA to dispose of appeals fairly and efficiently and at proportionate cost within the time periods prescribed by the Acts*” (our emphases).
- 1.17 The same considerations also underpin the statutory time limits for appellants to prepare and submit an appeal (20 working days) and for the CMA to determine such an appeal (six months from the date on which permission to appeal is granted).⁹⁹ In deciding upon these time limits, the

⁹⁷ Section 11F, EA89.

⁹⁸ DD, para. 11.32.

⁹⁹ Para. 1(3) of Schedule 5A and Sections 11G(1)(a) of EA89. Exceptionally, the six-month deadline may be extended by up to one month but only where Ofgem is satisfied that there are “special reasons why the determination cannot be made within the specified period” (section 11G(3)(b) EA89).

Government observed that it had had regard to the need to provide an adequate balance between cost and the degree of scrutiny appropriate for price control appeal determinations.¹⁰⁰

- 1.18 Ofgem’s proposal would effectively undermine the overriding objective and circumvent the time limits set out in the EA89. As Ofgem will be aware, any post-appeal licence modification decision initiated by Ofgem would be subject to the statutory consultation period and, if implemented, would give rise to a new right of appeal for all parties affected by the new decision and would restart the statutory time limits, thereby prolonging the period of uncertainty that comes with an appeal for all stakeholders. As the CMA noted in the 2017 Firmus Energy Determination: *“It is undesirable that issues should be deferred when, as in the present case, they have been the subject of lengthy and detailed consideration by the regulator, and there has been sufficient opportunity for a thorough exchange of views between the regulator and the regulated company. Such an approach may lead to a potential proliferation of regulatory decisions (and related appeals) as well as fluctuations in regulated prices.”*¹⁰¹ The Post Appeal Proposal would also go against the long-established principle of finality of litigation, first established in the 1843 case of *Henderson v Henderson*¹⁰² which provides that where a matter has been the subject of litigation and adjudication by a court, it was required of the parties that they *“bring forward their whole case”*.¹⁰³
- 1.19 In addition, for the reasons explained above, any such re-appeals would be a highly inefficient way to handle the issue of interlinkages and would unavoidably result in unnecessary and therefore wholly disproportionate costs for all parties involved – again in direct opposition to the CMA’s overriding objective. Exacerbating these concerns is the fact that Ofgem’s proposal does not contain a deadline for completing such reviews and nor does it suggest a limit on the number of times that Ofgem could carry out such a review. On that basis, the uncertainty caused by Ofgem’s proposal would continue indefinitely and the process could repeat itself several times throughout the lifetime of the RIIO-2 price control.

C. The lack of clarity offered by Ofgem would further undermine the current price control appeals framework

- 1.20 As has been previously raised at the RIIO-2 sector specific methodology stage,¹⁰⁴ the lack of clarity in relation to how Ofgem considers the Post Appeal Proposal would operate in practice is itself problematic.
- 1.21 As noted above, a number of fundamental aspects of the proposal remain unclear, including which appeal outcomes would trigger such a review, what the scope of such a review would be, what the process for such reviews and any adjustments to the price control would be and whether Ofgem would be subject to any deadlines or limits on the number of times it could carry out such a review, and precisely how Ofgem considers that such a review could be conducted in accordance with the CMA’s final decision. It is also unclear whether Ofgem is still considering the possibility

¹⁰⁰ Consultation, paras. 2.34-2.35.

¹⁰¹ Para. 4.91.

¹⁰² (1843) 3 Hare 100. This aspect of the decision was cited with approval in *Takhar v Gracefield Developments Limited* [2019] UKSC 13, a 2019 Supreme Court case, para. 20.

¹⁰³ Page 115.

¹⁰⁴ RIIO-2 Sector Specific Methodology Decision, para. 2.19; RIIO-2 Sector Specific Methodology Consultation Response, p.39.

of carrying out post-appeal reviews in relation to Final Determinations concerning parties that had not appealed the decision. The lack of clarity in relation to all of these points would further undermine the certainty and integrity of the current price control appeals regime.

- 1.22 The Post Appeal Proposal's lack of certainty contrasts with the position, already provided for in statute, where the CMA remits a matter back to Ofgem for reconsideration and determination in accordance with specific directions (see para 1.4(a) above). In this scenario, the only role of the regulator is to re-visit the specific aspects of the decision which have been referred to it by the CMA in full compliance with the CMA's directions. Ofgem cannot prejudice the CMA's decision on remedies in this way.
- 1.23 In summary, not only would the Post Appeal Proposal risk undermining the purpose of the statutory appeals framework, and the finality and certainty that parties are entitled to expect from the appeal process, but it would also give rise to the possibility of further appeals, thereby prolonging the period of uncertainty for all stakeholders. Notably, the CMA in no way endorsed Ofgem's justifications for the Post Appeal Proposal in the CMA's Response; to the contrary, it clarified that it was equipped to finally determine points of dispute having regard to interlinkages and would do so where it was appropriate for it to do so. For all of these reasons, Ofgem's Post Appeal Proposal should be altogether abandoned.

Core Question 42: Do you have any views on the proposed pre-action correspondence, including on the proposed timing for sending such to Ofgem?

- 1.1 Ofgem proposes in the DD an expectation that potential appellants "come 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" (the **Pre-Action Proposal**).¹⁰⁵ Ofgem requests this information in the period after the publication of the FDs (from early December) and before its licence modification decision (from early February) (the **Proposed Window**).¹⁰⁶
- 1.2 As a preliminary point, SHE Transmission notes that in respect of any appeal of Ofgem's licence modification decision following the FD Ofgem would be the defendant. The process for appealing Ofgem's decisions is set out by statute and in the relevant appeal rules and related guidance made by the Competition and Markets Authority (**CMA**) pursuant to its statutory role as the appeal body. Decisions as to the appropriate process to be followed in relation to appeals and the process leading up to any appeals are for the CMA and not for one of the parties.
- 1.3 One of the fundamental principles of fairness of the appeal process is that of equality of arms between parties. Ofgem is not, and cannot be seen to be, in any privileged position over that of an appealing licensee in the appeal process. In that context, it is not within Ofgem's power to seek to add any gloss or additional requirements to those of the statutory framework and the CMA's appeal rules. There are already serious concerns about the manner in which Ofgem has sought to correspond with the management of the CMA (which itself has no power to take

¹⁰⁵ DD, para. 11.36.

¹⁰⁶ DD, para. 11.36.

decisions regarding individual appeals as this is a matter reserved to the panel established for the purpose of hearing the appeal) in respect of any future appeals. SHE Transmission reserves its rights in that regard. Any attempt by Ofgem in the context of the FD, as a potential defendant to litigation, to seek to curtail or to add to the process set out in the statute or the CMA rules in relation to an appeal of its own decision would be ultra vires and manifestly unfair.

- 1.4 In addition to this overarching point of principle, it is inappropriate for Ofgem to seek to request privileged, and in the case of SHE Transmission likely market sensitive, information regarding its likely stance on potential litigation during the period in question. Given that any decision to appeal, and if so on which basis, would self-evidently only be taken after detailed and careful consideration having taken detailed legal advice and following an appropriate governance process, Ofgem's proposal is also wholly impractical. Furthermore, providing Ofgem with the information it seeks at the time it is being sought, even if available (which it is unlikely to be) would not address the purported aim of assisting with case management (see section A below). Case management issues relate to the process before the CMA and are therefore for the CMA to manage.
- 1.5 Additionally, for the reasons set out in section B below, the Pre-Action Proposal is ill-suited to the electricity price control appeals process which differs from traditional litigation in which the principal aim of pre-action conduct and correspondence is to allow the parties fully to understand one another's positions in an effort to avoid or limit expensive and time consuming court proceedings, by narrowing the issues in dispute or enabling possible settlement. By contrast, Ofgem's FD is necessarily, and as indicated by the word "final" in its title, a definitive statement of Ofgem's position on material issues under consideration in its price control decision-making. Potential appellants are subject to a strict and intensive statutory timetable in which consultation opportunities are prescribed by statute, culminating in the FD (followed by the licence modification decision to implement the FD). Ofgem could suffer no realistic prejudice if appellants follow the procedure set out in statute and the CMA's rules without any additional gloss by Ofgem. Should it be necessary to take the full period of time prescribed by statute to decide whether, and if so, on what basis SHE Transmission should appeal Ofgem's decision giving effect to the FD, Ofgem will have a full opportunity to present its response to the appeal before the CMA. The CMA's procedure already provides a full opportunity for Ofgem to be heard and appropriate time periods for Ofgem to prepare its representations.
- 1.6 It is notable that Ofgem has offered no justification for seeking to curtail a potential appellant's statutory rights in this way.
- 1.7 In any event, and in accordance with the CMA's appeal rules, SHE Transmission is already incentivised to seek to further the overriding objective to dispose of appeals fairly, proportionately and efficiently. SHE Transmission would therefore seek to conduct any appeal as far as possible in a way that avoided the potential concerns raised by the CMA in its response to Ofgem's open letter (the **Response**).
- 1.8 Since it is outside Ofgem's powers, is manifestly unfair and serves no practical purpose, Ofgem must not proceed with the Pre-Action Proposal. Should Ofgem nevertheless proceed with the Pre-Action Proposal, SHE Transmission reserves its position entirely in that regard in any potential future appeal before the CMA.

A. It is not within Ofgem’s power, or otherwise appropriate for Ofgem to seek to curtail the rights of potential appellants under the statutory appeal regime or to request sensitive and/or legally privileged information in respect of appeals

- 1.9 As a matter of both EU and UK law, parties affected by a licence modification decision have a right of appeal to an independent body which, in the UK, is the CMA.¹⁰⁷
- 1.10 The procedure for appeals against licence modification decisions is primarily governed by Schedule 5A of the Electricity Act 1989 (as amended) (**EA89**). As the independent body responsible for hearing such appeals, the CMA is statutorily empowered to supplement the provisions of Schedule 5A with additional rules of procedure regulating the conduct of appeals,¹⁰⁸ and has done so through the publication of the Appeal Rules. The Appeal Rules provide that their overriding objective is “*to enable the CMA to dispose of appeals fairly and efficiently and at a proportionate cost*” within the statutory time periods.¹⁰⁹
- 1.11 Ofgem¹¹⁰ does not have any statutory role under the EA89 (or elsewhere) to amend or supplement the CMA’s rules of procedure or otherwise amend or gloss the process set out by statute and the CMA. The purpose of establishing the appeal regime was to ensure that Ofgem’s decisions could be reviewed independently and fairly, and any attempt by Ofgem to curtail a potential appellant’s statutory rights would self-evidently compromise the appeals regime and would be inherently unfair. In particular, it is not within Ofgem’s power to request the type of information in its Pre-Action Proposal before the period for commencing an appeal has expired. For Ofgem to insist on having such information sooner would undermine the statutory protection given to potential appellants by Parliament. Moreover, such information would likely be protected by legal privilege and, in the case of SHE Transmission, would also likely be market sensitive. This is important because there could be significant legal risks for SHE Transmission were it to inform Ofgem of its detailed intentions ahead of the market. Any decision to inform the market of its intentions would, self-evidently, only be made at a later stage, once SHE Transmission’s decision had been fully considered following detailed legal advice and an appropriate governance process.
- 1.12 While, therefore, the CMA made a general and uncontroversial statement in its Response that active engagement at the pre-appeal stage is likely to be beneficial for all parties – subject to the proviso that it cannot bind any ultimate decision to appeal¹¹¹ – as would be expected, the CMA did not suggest that Ofgem should seek to impose a more prescriptive framework for pre-action correspondence upon potential appellants. Instead, the CMA reiterated the steps that it might expect an appellant to take during the pre-action stage, which as detailed in Section C below are

¹⁰⁷ See Article 37(17) of Directive 2009/72/EC (the Electricity Directive) and section 11C of the Electricity Act 1989 (as amended). In the UK, this right of appeal has been expressed as a precondition to GEMA being able to make autonomous decisions, see Explanatory Memorandum to the Electricity and Gas (Internal Markets) Regulations 2011, para. 4.14. See also: Hansard, Lord Marland. Available at: [https://hansard.parliament.uk/Lords/2011-10-17/debates/11101732000221/ElectricityAndGas\(InternalMarkets\)Regulations2011](https://hansard.parliament.uk/Lords/2011-10-17/debates/11101732000221/ElectricityAndGas(InternalMarkets)Regulations2011).

¹⁰⁸ Electricity Act 1989, Schedule 5A, para. 11.

¹⁰⁹ Appeal Rules (CMA70), para. 4.1. See also Appeal Guidance (CMA71).

¹¹⁰ Ofgem and GEMA are for present purposes used synonymously.

¹¹¹ CMA Letter from Andrea Gomes da Silva to Jonathan Brearley, CMA Response: clarification of our position on Energy Licence Modification Appeals, 30 October 2019, page 4.

far less onerous and far more qualified than the steps being proposed by Ofgem. The CMA also noted that appellants may have good reason not to follow all of those (more qualified) steps.

- 1.13 Ofgem implies that the Pre-Action Proposal is to address possible case management issues regarding multiple appeals.¹¹² However, it is unclear why Ofgem needs to be the recipient of this type of information given that case management falls within the remit of the CMA, not Ofgem. It is also unclear how the Pre-Action Proposal would in any way help address case management, since this would be a matter for potential appellants to coordinate amongst themselves. If the CMA wished to introduce a more prescriptive framework for pre-action correspondence, that would be a matter for it (following appropriate consultation). However, for the reasons set out below, such a framework would be wholly inappropriate in the context of electricity price control appeals process and, tellingly, the CMA has to date not sought to do so.

B. The Pre-Action Proposal serves no useful purpose in the context of an energy price control appeal

- 1.14 As the Practice Direction on pre-action conduct and protocols in general civil litigation (the **Practice Direction**) and the Pre-Action Protocol for judicial review (the **Protocol**) make clear, the objectives of pre-action conduct are to help the parties to a dispute to understand one another's position and make decisions on how to proceed, to encourage the parties to a dispute to settle the issues without the need for proceedings or, where no settlement is reached, to at least support the efficient management of the proceedings and reduce the costs of resolving the dispute.¹¹³ Notably, while the Practice Direction goes on to provide that before commencing proceedings, both parties should – to the extent that it is proportionate to do so – exchange correspondence and information in furtherance of those objectives,¹¹⁴ the only kind of pre-action correspondence envisaged in the Protocol is information requests from the Claimant to the Defendant.¹¹⁵
- 1.15 In the specific context of an electricity price control appeal, a prescriptive protocol for pre-action correspondence would not further any of the objectives of pre-action conduct, or the CMA's overriding objective:
- (a) Firstly, the statutory price control process has been designed already to provide Ofgem with detailed information regarding companies' positions on issues in the price control – indeed, vast quantities of information are exchanged throughout the process. Therefore, Ofgem will already have a good understanding of potential appellants' likely points of appeal and arguments in support of them in view of the formal and informal submissions made during the price control review process, including the responses to the DDs.
 - (b) Secondly, the price control appeals regime already contains provisions designed to encourage pre-action correspondence between the appellants and Ofgem to the extent this is possible, appropriate and would further the overriding objective. As the CMA noted

¹¹² At DD, para. 11.34 Ofgem refers to submissions made by some respondents to the SSMC who "raised concerns about case management given the risk of multiple appeals to the RIIIO-2 price control licence modifications", and suggested airing matters in dispute in pre-appeal discussions.

¹¹³ Practice Direction, para. 3.

¹¹⁴ Ibid, para. 6.

¹¹⁵ Protocol, para. 13.

in its Response, it has the discretion to make an order in respect of inter-partes costs,¹¹⁶ and when considering whether to do so will have regard to “*all the circumstances, including ... the extent to which each party has assisted the CMA to meet its overriding objective*”¹¹⁷ ... [and] *the manner in which a party has pursued its case or a particular aspect of the case*”. Licensees are acutely aware of these powers and therefore are already incentivised to conduct themselves in a way to facilitate the CMA’s overriding objective.

- (c) Thirdly, the Pre-Action Proposal would be unlikely to serve any useful purpose in terms of settlement or avoidance of litigation. Ofgem has requested that the pre-action correspondence is provided between the RIIO-2 FDs and the licence modification decision to implement the FDs i.e. the Proposed Window. However, the primary purpose of the licence modification decision will be to give effect to the RIIO-2 FDs. Further issues between licensees and Ofgem are raised as part of the statutory consultation process which Ofgem is required to undertake before taking the licence modification decision. SHE Transmission has written separately to Ofgem regarding its significant concerns relating to Ofgem’s proposals to curtail this statutory consultation as a result of the effects of COVID-19. It is wholly inconsistent for Ofgem to seek to curtail the statutory process for further submissions to be made to Ofgem regarding the FD while at the same time imposing additional obligations on licensees to provide information on matters which are unlikely to have been fully considered at that point (such as intention to appeal).
- (d) Fourthly, Ofgem is not proposing that it would respond to any pre-action correspondence from potential appellants in order to narrow the issues between the parties (for example by changing the FD). In practice, SHE Transmission believes that Ofgem is unlikely to have time to do so – particularly since, as a practical point, it is unlikely that potential appellants would be in a position to send pre-action correspondence containing the information described in the Pre-Action Proposal until, at best, very late on in the Proposed Window, if at all (see para 1.19(a) below).

- 1.16 Overall, it is evident that the Pre-Action Proposal will fail to materially further the objectives of traditional pre-action correspondence or the CMA’s overriding objective; instead, it will place a disproportionate burden on potential appellants and put them at an unfair disadvantage in the subsequent appeals process.

C. The Pre-Action Proposal would place a disproportionate burden on appellants and give Ofgem an unfair advantage

- 1.17 As referred to above, the CMA indicated in its Response that in its view active engagement between the parties during the pre-action stage (i.e. up to the date on which the notice of appeal is filed) was beneficial and that it wished to “encourage” pre-action conduct “as good practice”. To this end, the CMA recommended that potential appellants notify the CMA of their intention to appeal and “ideally” the potential scope of any appeal and noted that there could be costs consequences for appellants who acted in a way which, without good reason, makes case management more difficult.

¹¹⁶ See EA89, Schedule 5A, para. 12(3).

¹¹⁷ See Rule 21.5 of the Rules.

- 1.18 SHE Transmission is sympathetic to the CMA's desire to encourage good case management and has no intention of making case management more difficult. However, SHE Transmission's ability to set out its decision on its intention to appeal and/or the contents of any appeal, will be subject to significant practical limitations and will need to be balanced against other considerations, such as the appropriate governance for such an important decision and the potential disclosure of market sensitive information.
- 1.19 In any case, Ofgem's Pre-Action Proposal is far more prescriptive than the CMA's carefully drafted Response and goes far further in terms of the information it is proposing be disclosed. In particular, Ofgem is proposing that pre-action correspondence include the intention of and (as a matter of course) the scope of the 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.¹¹⁸ Even if pre-action correspondence of any nature is appropriate and practicable this level of detail would go significantly beyond what could reasonably be expected of any potential appellant and would be¹¹⁹ disproportionate.
- (a) First, the EA89 grants appellants 20 working days after the licence modification decision to bring an appeal and it is therefore licensees' right to use that full time period to evaluate its potential appeal, which grounds of appeal it will maintain and to take advice from its legal advisers for that purpose.¹²⁰
 - (b) Second, as a practical matter, price control decisions are fundamental to regulated businesses and, accordingly, decisions on whether, and the grounds on which, to appeal can only be made following an in-depth review of the FDs and will typically involve extensive consideration by senior management and will require appropriate governance. Even once a potential appellant has decided that it intends to appeal a price control decision and the broad scope of that appeal, decisions on which errors to appeal against (and which to accept) and the basis on which to challenge these errors still require extremely detailed consideration. In contrast to the pre-action period in a typical commercial dispute, price controls are already subject to very tight statutory deadlines. The time-limit provided by the statute will likely already be very challenging for making such an important decision and companies should not be obliged to provide further information at an even shorter deadline.
 - (c) Thirdly, contrary to the impression given in the DD,¹²¹ the CMA's Response does not suggest that appellants should address interlinkages in pre-action correspondence. In line with the decisional practice of the CMA, the burden of raising a defence based on any interlinkages is with the regulator in the first instance.¹²² Ofgem's suggestion in the DD that appellants disprove the possibility of negative effects is illogical and not part of the statutory process for appeals or of the grounds on which the CMA can consider an appeal.

¹¹⁸ DD, para. 11.36.

¹¹⁹ CMA Response, para. 12-13.

¹²⁰ EA89, Schedule 5A, para. 1(3).

¹²¹ Draft Determination, para. 11.35.

¹²² CMA BGT ED1 Determination, para. 3.52; CMA NPg ED1 Determination, para. 3.51.

- 1.20 In addition, the Pre-Action Proposal would, in direct contradiction of the CMA’s overriding objective, place potential appellants at an unfair disadvantage vis-à-vis Ofgem, and would be in clear conflict with the principle of equality of arms.
- (a) First, as noted above at para 1.15(c), Ofgem is proposing that the pre-action correspondence be a “one way” transaction. Accordingly, potential appellants will derive no benefits from complying with the Pre-Action Proposal (to the extent that it goes beyond the CMA’s current expectations in relation to pre-action conduct). In light of the significant amounts of missing information from Ofgem at the time of publishing the DD,¹²³ combined with the extensive amount of information provided by the licensees to Ofgem throughout the price control process, this request seems all the more unnecessary and one-sided.
 - (b) Second, to the extent that Ofgem is proposing any kind of penalty or consequence for failure to comply with its prescriptive pre-action framework, this is clearly unacceptable. Licensees cannot be subjected to pressure to conform to a procedure which provides less than their statutory allocation for formulating their grounds of appeal. Nor should Ofgem seek to use the licence modification process to seek to give itself an effective extension to its own statutory period granted to it to respond to the Notice of Appeal.
- 1.21 To conclude, while SHE Transmission agrees with the CMA’s general statement that active engagement at the pre-appeal stage can be beneficial, it is wholly inappropriate for Ofgem to seek to determine prescriptive pre-action conduct protocols for potential appellants on top of the existing statutory framework, which has the effect of curtailing the protections for which Parliament has provided. The Pre-Action Proposal is ultra vires, serves no legitimate purpose and is manifestly unfair to licensees. Ofgem cannot proceed with the Pre-Action Proposal in these circumstances.

¹²³ Letter from Michael Ferguson (Head of Regulation, SSEN Transmission) to Ofgem dated 17 July 2020.