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Dear Geoff,

National Grid Electricity Transmission: Response to Ofgem's Consultation on a potential RIIO-T1 and GD1 mid-period review

National Grid Electricity Transmission plc welcomes the opportunity to respond on whether there is a need to initiate a mid-period review in electricity transmission.

Summary

In summary we do not believe there are issues which necessitate the need for a mid-period review process. The Final Proposals set a legitimate expectation of matters which would (and would not) fall within the scope of the mid-period review. As we set out in detail below, we believe a number of proposed matters fall outside scope and those matters falling within scope are not sufficiently material to merit instigating a review. We do however consider that there are existing mechanisms and procedures which can be used to progress certain of the areas outlined, albeit outwith a mid-period review process.

The changes to outputs, whether or not driven from Government policy change, are within the range of uncertainty anticipated at the onset of RIIO. They are effectively managed through the existing uncertainty mechanisms and broader allowance framework which adjust revenue allowances to reflect the changing picture. In our opinion the existing framework continues to drive behaviours that are in the interests of consumers and we have made decisions that benefit customers in terms of how we adapt our plans to reflect the emerging picture. We will continue to do so over the second half of RIIO with the continued pace of change which means we constantly need to review our plans.

We agree with Ofgem that it is important that the key principles of the eight year RIIO price control are maintained. It is widely recognised that making retrospective changes to regimes underpinning large, long term investment is ultimately damaging to consumers. To review or unpick the core RIIO framework and incentives (such as uncertainty mechanisms or allowances) would be outside the scope of the mid-period review and create significant risk of effectively creating two four year price controls and undermining long term customer interests.

We agree that there are some areas where new outputs are evolving. These include the new requirements coming out of the ITPR enhanced System Operator (SO) process, the development of onshore competition, and the developing market facilitation and EU Codes requirements. We agree these could be material; however the developing nature of these is likely to mean that only the ITPR enhanced SO role may be in a position to reach a conclusion in the timescales of a MPR. This change is linked to the broader discussion on the SO structure associated with the development of onshore competition in electricity transmission which is unlikely to fit neatly within a MPR timetable. Under some options being considered, the changes could be significant and involve realigning incentives and outputs to determine where they are the responsibility of SO or TO. Hence we suggest that these areas might better be dealt with, once the impacts are clear, through separate processes similar to that undertaken for Electricity Market Reform and without the timescale constraints imposed by an MPR. This would be consistent with Ofgem's letter of 16th April 2015 to us on ITPR outputs and funding which said that whilst funding could be addressed in a mid period review, that there are alternative appropriate routes that could be considered.

We agree there are some areas where clarification of how the RIIO principles would apply and further guidance would be useful. There are existing mechanisms that allow this to happen such as the ongoing consultation and development of the asset health methodologies and the annual performance reporting process. We are committed to working with Ofgem to provide this further clarity to our stakeholders and believe these are the best mechanisms to progress these items as they are outside of the scope of the mid-period review.

We set out further our views on the high level questions below and our response to the specific questions on electricity transmission in the Annex.

Purpose and Scope of a mid-period review

As background to the mid-period review, it is worth reflecting on the development of the RIIO framework and how it has been functioning to date. RIIO was established by Ofgem as an innovative framework which broke new ground in focusing on the outputs that network companies deliver for their customers rather than the inputs to achieve them. It set out a longer contract of eight years and a focus on total costs as opposed to focusing on particular opex or capex solutions to allow flexibility and stimulate innovation and new ways of delivering the outputs. It also placed a greater emphasis on stakeholder engagement and customer satisfaction. For the electricity transmission control, careful consideration was given to creating a balance of revenue drivers and fixed allowances to reflect the significant uncertainty of the changing energy landscape that would underpin the outputs required to be delivered by the electricity transmission business. These mechanisms reflected the expectation that requirements would inevitably change over RIIO. The RIIO framework also includes transparent and extensive annual reporting to stakeholders on outputs and performance.

The RIIO framework's longer duration has allowed us to invest in business improvements to work better for electricity consumers. The critical outputs for electricity transmission of providing and operating safe, reliable and sustainable networks that allow customers to meet their energy needs are being delivered. The framework has stimulated improvements in customer and stakeholder satisfaction levels and environmental performance. The framework has also led to a significant drive for innovation and finding new and more effective ways of delivering outputs over the longer timeframe. For example, on the basis of the eight year approach we have invested in long term changes to our operating model such as the roll out of a company-wide programme of process and performance excellence to drive a sustainable continuous improvement approach based on lean working and end to end process optimisation. In addition, we have invested heavily in creating an entirely new way to plan and deliver our asset management work through a multi-year change programme. Performance reporting continues to be enhanced to provide more transparent and effective information to stakeholders on outputs and costs and we recognise this needs to continue to improve as RIIO evolves. Our overall performance is within the range Ofgem has anticipated for well performing networks giving further assurance that the regime is working as intended.

It is important that these key principles of the eight year nature of RIIO are maintained in any consideration of a mid-period review. The networks are incentivised to make the right decisions in the long term interests of customers and our performance should be judged over the eight year RIIO term. Therefore we agree that there should be a high hurdle of materiality for considering reviewing the framework and care taken to preserve the incentive mechanisms which were developed to ensure that we do not introduce any uncertainty which might undermine long term cost reductions for consumers.

Q1 Do you have any views on the additional clarity we have provided on the RIIO-T1 MPR scope?

We have considered Ofgem's proposed revisions and clarifications to the scope of the mid-period review. RIIO-T1 Final Proposals defined the scope of the mid-period review to consider new outputs required as a result of changes in Government policy or new outputs desired by stakeholders or network users.

We note that Ofgem acknowledge the proposed MPR scope, in this consultation, has been widened to include items not expressly indicated in the Final Proposals for RIIO specifically in relation to:

a) the desire to provide additional clarification of rules that apply to output delivery, and

b) widening the consideration of new outputs required for consumer or network users' needs to change existing outputs (including outputs that are no longer required)

For scope change a), we concur that there may be merit in clarifying at this stage how the RIIO framework will apply at the end of the eight year period. However, we do not think this should be added to the scope of a mid-period review and could be done separately and made transparent through ongoing performance reporting and guidance notes. For example we are reviewing and developing our Network Output Measures (NOMs) methodology. This process should continue separately to any mid-period review, as based on our knowledge of the challenge of working through this complex area, we are concerned that the timescales of a mid-period review would inhibit the industry developing the best methodology for customers. Another example is the ongoing work we are doing with stakeholders to prioritise and manage the visual impact of our existing assets in areas of outstanding natural beauty. We have developed a policy enactment process with our stakeholders and Ofgem which will hopefully see new outputs being delivered in the second half of RIIO and into RIIO-T2.

For the second proposed scope change b), we appreciate the intent to provide symmetry in the consideration of output changes but we note this is a widened requirement and not one that might have been a reasonable expectation at the time of Final Proposals for review at the mid-period stage.

The RIIO framework is an eight year control with outputs largely defined as outcomes over that eight year period. The arrangements are sufficiently flexible and are based on customer led scenarios which are updated annually. We have adapted our plans to reflect the changing picture amd hence the nature and phasing of our work has inevitably changed. Uncertainty mechanisms were explicitly considered and defined to adjust revenue allowances to reflect changes in the unlerlying customer requirements. In some cases, agreed allowances are not directly associated with specific outputs, such as the non-varying load related allowance, albeit these allowances are ultimately related to providing the transmission capacity required by our customers. This was explicitly considered as part of the overall framework of uncertainty mechanisms and allowances at the onset of RIIO with a number of alternatives of linking more direct revenue drivers being discounted on the grounds of too much complexity. Reopening these core elements of the framework would go against the principle Ofgem has set out of not changing the incentive mechanisms in place and hence is outside of the scope of the review. We therefore agree with Ofgem's desire not to create two four year price controls and hence the mid-period review process should not be used to adjust existing outputs or review how outputs are being delivered particularly if the outcomes still have to be delivered, such as network output measures and wider works.

Question 2: Do you consider the issues we have identified for RIIO-T1 in this consultation fall within this scope?

We set out in the Annex our view on each of the specific areas identified by Ofgem for electricity transmission. To summarise:

In Scope and worth reviewing (albeit outwith a MPR)

- Policy and funding surrounding the development of onshore competition and the enhanced role of the SO and potential requirements of the TO (however MPR timing risks constraining conclusions)
- Market Facilitation and EU Codes (uncertain scope and timing so may be better to address when impact clearer)
- Future role of the SO (uncertain scope with the potential for considerable industry change and so should be considered separately when impact clearer)

In Scope but not meriting review

- Changes to outputs as a result of Government policy (analysis suggests RIIO framework is fit for purpose)

Out of Scope and not meriting review

- Environmental Discretionary Reward (EDR) and Stakeholder Engagement Schemes (these are existing incentives and the current mechanisms allow guidance to be given to Independent Panels)
- Innovation tax relief (not material and covered by existing uncertainy mechanism)
- Availability of Scottish island links (existing incentives apply through loss of supply incentive hence would be resetting incentives)
- Clarification of output requirements that sit outside of revenue drivers (part of core incentive framework and totex incentive mechanism applies)

Out of Scope but useful clarification

- Network Output Measures methodology (ongoing development process already underway)
- Submission Quality for Strategic Wider Works (SWW) and monitoring needs cases (can be done through a clarification to the SWW guidance note as mechanisms already incentivise this)
- Connections and wider works not easily correlated to a specific funding mechanism (not identified anything material at this stage but worth keeping under review)
- RIIO-T2 outputs (can be done through existing process agreed for 2017 forecasts)

- Clarification of treatment of late or non-delivery of outputs (guidance and confirmation would be helpful building on where rules are in place such as non-load and Western HVDC stated principles)

Question 3: Are there any other issues within the defined scope that we have not included when assessing the need for an MPR for RIIO-T1?

Our ongoing engagement with our stakeholders continues to shape our priorities and plans for developing the network. Aside from the areas covered in this consultation, there are some major areas of development which will need to be managed over the second half of RIIO such as the rapid development of embedded generation, ongoing European energy market development and continued management of the environmental impact of new and existing assets However the uncertainty over their scope and timing together with the availability of alternative processes to introduce any necessary change suggest there is no need for these to be included in the mid-period review.

There are also a number of other elements which have evolved since the onset of RIIO (including e.g. the role of the SO, the connection of large volumes of embedded generation) where our operations and investments have adapted to meet stakeholder needs that were not foreseen and reflected in the original RIIO allowances. We have considered the overall impacts on outputs in the round consistent with the principles we have outlined above and the scope for the mid-period review set out in Final Proposals.

I hope that you find this response useful, If you would like to clarify anything in our response please do not hesitate to let either myself or Richard Court (Richard.court@nationalgrid.com) know.

Regards

Mark Ripley
Director, UK Regulation

Annex: Responses to specific questions relating to Section 2: Electricity Transmission and Section 5: Cross Sector Issues

Question 4: Based on our current assessment there may be some issues in Electricity Transmission that could be addressed through an MPR. Do you agree with this assessment?

We believe there are no issues which necessitate the need for a mid-period review.

As we set out in our covering letter under Question 2, many of the issues raised in the MPR scoping consultation do not fit within the defined scope that we had a legitimate expectation would apply to a MPR based on RIIO-T1 final Proposals.

We agree some issues would merit further clarification. However this is already being pursued for some (e.g. Network Output Measures (NOMs) methodology development) via existing industry processes.

Other issues which are within scope such as the changes arising to the roles of the SO and the TO from ITPR and the Extension of competition n onshore competition are still evolving. It might therefore be difficult to resolve some of the uncertainty and give sufficient consideration to some of the complex interactions within the MPR timeframe to ensure a robust outcome. Given this we suggest they might be better addressed using processes similar to that used for EMR (Electricity Market Reform).

There may be material cost impact from EU/GB market change that is in scope of a MPR, specifically in the area of implementing EU code market change. Particularly the Balancing code and Congestion Management code implementation have uncertainties associated with them that have not been fully clarified in the timescales envisaged when MPR scope was set. How EU codes are implemented could mean substantial changes to our Information Technology systems. While we consider appropriate funding should be set for relevant agreed outputs, at this time, we do not expect there to be sufficient clarity to put forward a detailed and specific funding request within MPR timescales. Therefore we propose that the efficient funding for implementing EU codes, should this become material, is addressed outside a MPR. This could be done in a similar way to EMR (and without any loss of transparency to stakeholders) once there is adequate clarity of the requirements and likely costs.

Within the areas raised in “Appendix 3 – Final Proposals Issues” that are within scope of a MPR, we support the view that it is not necessary at this time to revisit: disallowed tower flooding costs, Integrated Network Investment (“East Coast Proposal”), Flood and erosion protection or Non-Load related expenditure.

Finally, there is a risk that if any of the new issues that are outside the MPR scope were now captured, that key facets of RIIO could be undermined. These are having an eight year price control period (rather than two four year controls) and clarity (for stakeholders) on the scope of any RIIO re-openers (including MPR). Undermining these facets risks damaging the long term benefits to consumers.

Question 5: We ask for detailed views, particularly from the TOs, on how the operability of the RIIO-T1 NOMs incentive mechanism could be improved. As part of this, we would like evidence on the manner in which any potential revisions may better facilitate the delivery strategy of outputs, in line with current needs of consumers and network users, and the materiality of such change.

We consider that measures concerning the "operability of the RIIO-T1 NOMs incentive mechanism" are outside the previously defined scope in Final Proposals of a MPR. We are already engaging with Ofgem and wider stakeholders on aspects of NOMs as part of our activities to ensure RIIO delivers network performance at the lowest long term overall cost to consumers.

RIIO-T1 is the first regulatory package that links the delivery of NOMs that are a leading indicator of network reliability, to our businesses performance. The Network Output Measures were originally developed during TPCR4 (the first methodology was approved in March 2010 following extensive work and stakeholder consultation). In the RIIO-T1 period, the NOMs methodology was updated to align with the changes introduced as part of RIIO-T1. The three TOs consulted with stakeholders on the changes to the methodology during January 2014 and we incorporated the stakeholder comments including Ofgem's comments into the methodology. The revised methodology was submitted to Ofgem on 13 May 2014 for approval. Ofgem sent a letter to the three TOs on 20 June 2014 setting out extensive development work for the NOMs. A programme of work was agreed with Ofgem in August 2014 and the three TOs have been working together to complete this work programme since that date. The three TOs held a stakeholder consultation during October and November 2015 to cover the development work which can be found here:

http://www.talkingnetworkstx.com/current-consultations.aspx .

Ofgem have recently identified significant additional development work and the three TOs have proposed a programme that goes out to end of March 2017. The methodology published as part of the consultation shows TO's latest thinking for how our NOMs could be measured. They combine both the asset health (e.g. of a Transformer) and that particular asset's criticality in terms of safety, environmental and system performance, into a replacement priority. The outcome for consumers under this methodology is that the poorest condition assets which have the largest consequence of safety, environmental and system unreliability are prioritised for intervention over those in locations where the consequences of issues are lower. This targets investment to give greatest benefit to our stakeholders.

Our transmission licence contains specific Network Replacement Output targets agreed with our stakeholders that we will deliver by the end of the RIIO-T1 price control. The transparent methodology and clear targets, coupled with an 8 year price control have allowed us to develop and implement innovative asset management approaches. We have shared examples of how we have done this in practice. We have undertaken a wide review of our approach to managing switchgear by a range of interventions such as refurbishment, reconditioning and replacement. This has resulted in our new approach to switchgear replacement where reuse and modification of existing civil work structures to accommodate modern switchgear types is saving [redacted] in RIIO-T1 with savings of up to £256m for consumers when compared to traditional approaches. We have developed an eight year strategy to deliver the Network Replacement Output targets by the end of RIIO-T1 and we are now actively engaged working towards those targets. Changes to the targets mid-period, or the way we understood NOMs was to work, risks turning an eight year control into two four year controls, resulting in changing the sharing of risks and benefits between us and our customers. This could undermine our confidence over the risks and benefits of investing in long term strategies in future price controls which wuld not appear to be in the best interests of customers in the longer term.

Methodology for Trading of NOMs Categories and Clarity of Treatment of Under/Over Delivery

The approved NOMs methodology and associated Network Replacement Output targets to achieve by the end of RIIO-T1, along with Ofgem's incentive mechanism for treating justified or unjustified under or over delivery [reference FP's Table 2.1] means there is a framework within this part of our RIIO-T1 package. However, we do consider that development of the NOMs approach to enable trading between the Network Replacement Output targets and clarity in certain other aspects such as how under/over delivery will be treated could deliver benefits to stakeholders and are actively working on these aspects with Ofgem and other Onshore Transmission Companies.

As the Network Replacement Output targets are set in our licence, we and our stakeholders recognised the benefits to consumers that could come from some flexibility in exactly what work is done to deliver the overall NOM's targets. This led to a programme of work being scoped out and agreed by Ofgem to develop a trading approach between Network Replacement Output targets so that alternative outputs that deliver an equivalent level of network performance can be delivered at the lowest long term overall cost to consumers. The first phase of the work ("Stage 1") to develop the trading methodology has taken place through 2015 and it is now drawing to a close with significant progress made. It included a stakeholder consultation in October and November 2015 and received broad support from our stakeholders. We found stakeholder input valuable and have acted upon it. We have recently proposed to Ofgem a further programme of work ("Stage 2") which we expect will bring further benefits to stakeholders such as deliver improved clarity on the treatment of under/over delivery and how the risk monetisation approach developed in Stage 1 will be used in practice.

We look forward to continuing the engagement with Ofgem and our stakeholders and hence we do not see the necessity to consider these issues further as part of the scope of a MPR. Should, however Ofgem consider that this is within scope then we would be concerned that:

- there would be a risk of a significant resource clash between our staff being needed to model NOMs for the 2016 RRP submission and at the same time undertake any modelling and analysis necessary for MPR, and
- the need to fit the new phase of NOMs methodology development within the limited MPR timetable would risk unnecessarily curtailing or rushing the new phase of NOMs methodology development.

It is not clear that either of these outcomes would bring any benefit to stakeholders compared to the current process where significant progress is being made and a commitment exists to further work from all onshore Transmission companies.

Question 6: We are seeking views on whether the Environmental Discretionary Reward is driving the right business changes within the companies and providing the outputs that consumers and network users need.

In our view the Environmental Discretionary Reward (“EDR”) is driving the right business changes and is aligned to the outputs that customers and network users have indicated they need. In practice, Ofgem has the ability to change the operation of the EDR to ensure it drives the right business changes through the annual guidance it provides to companies and the assessment panel. Therefore we do not consider that reviewing the Environmental Discretionary Reward EDR should be within the scope of the MPR.

Examples of what has been delivered as a result of this incentive can be found in our 2014/15 Executive Statement:
http://consense.opendebate.co.uk/files/nationalgrid/transmission/EDR_Executive_Statement.pdf

Environmental and sustainability issues are incredibly important areas that we take very seriously and the incentive helps to support industry focus on this. We look forward to being able to continue to demonstrate this in our next submission for RIIO-T2. For completeness there were a few practical suggestions we fed back during the last round on the mechanics of the submission. As always we would welcome the opportunity to work with Ofgem in the run up to RIIO-T2 to identify the right environmental outputs/incentives for that period.

If other stakeholders feel there is a case for change to the operation of the EDR, then Ofgem already have the ability, through the existing annual process and the guidance they can set out to companies and the assessment Panel, to make any adjustments that are felt to be appropriate. Given this existing capability and the absence of any clear defect in the regime it is unclear what benefit is gained from bringing it within the MPR process.

Question 7: We are seeking views on whether the stakeholder incentives are driving the right behaviours to get the outputs that consumers and network users need.

In our opinion, the incentives are working by providing a stimulus to us as set out below. They are subject where appropriate to periodic consideration of the KPI's. There was a stakeholder consultation as recently as summer 2015, followed by a decision by Ofgem in November 2015, as noted in Ofgem's MPR scoping consultation document. Therefore we do not consider that reviewing the customer and stakeholder incentives should be within the scope of the MPR.

We are committed to delivering for our customers and stakeholders, so actively engage with them as part of the existing frameworks and will continue to do this moving forward through RIIO-T1.

Stakeholder incentives were included as part of our RIIO-T1 package to help focus and support us on what is important for our customers and stakeholders. They have helped us to increase focus on how we improve. We have provided feedback here on each of the stakeholder incentives in turn.

Customer and Stakeholder Satisfaction

- We believe that the satisfaction incentive is an appropriate way in which to support changes in behaviours and to measure performance. We have used this incentive as an important driver to support our increased focus on customers and stakeholders throughout our business, in the knowledge that changing the way we do things will have the consequence of providing better overall service to our Customers and Stakeholders and that this will be reflected in our satisfaction scores.

Stakeholder Engagement:

- In summary we believe that the incentive is driving the right behaviours to get the outputs that customers and stakeholders need. Specific examples of where we have used the scheme to support driving improvements can be found in our recent 14/15 submission: Part 1 and Part 2.
  http://consense.opendebate.co.uk/files/nationalgrid/transmission/Electricity_Stakeholder_Engagement_Incentive_Submission_Part_1_2014-15.pdf
- http://consense.opendebate.co.uk/files/nationalgrid/transmission/Electricity_Stakeholder_Engagement_Incentive_Submission_Part_2_2014-15.pdf
- The consultation refers to the fact that the Stakeholder Engagement Incentive Submission (SEIS) references other incentives, such as the satisfaction incentive and

projects under the RIIO innovation schemes. We do not believe that this constitutes 'double counting' however, as the different schemes and incentives are measuring different aspects of our behaviours and performance.

- For example, submissions made under the innovation schemes are evaluated on their potential value to customers/consumers – the 'what' is the most important element of these schemes. However, whenever we have referenced an innovation project in our SEIS submissions, we know that Ofgem's panel will be evaluating us on the 'how'. For example, the SEIS incentivises us to work with others to seek and share best practice in the interests of stakeholders – these interactions and potential partnerships sometimes lead to innovation scheme submissions, but they are not the same thing – one is a product of the other.
- Similarly, we quote our stakeholder satisfaction survey results in our SEIS submissions, but these are in support of our case studies and other evidence and get a very minor mention in the documents. We would be surprised if Ofgem's panel used this information to contribute to our final SEIS score.
- Also, the SEIS evaluation criteria are quite specific, whereas the overall satisfaction rating is very broad by its nature. If it is Ofgem's intention to use the SEIS to help to drive improvements in the areas covered by the assessment criteria (serving challenging groups, thinking innovatively, demonstrating a holistic approach to stakeholder engagement, supporting engagement through robust processes, and striving for best practice), then we believe that the scheme provides a valid measure of how/if we are changing our behaviours in these areas.
- In addition, the two incentives measure our behaviour and performance in relation to different groups of stakeholders. For the satisfaction incentive, we interview those stakeholders directly impacted by our activities, whereas the SEIS incentivises behaviours which improve the outcome to a much wider group of stakeholders, including end consumers. For example, we have used SEIS case studies in the past which highlight the innovative ways we have engaged with local communities and how we have tailored our engagement to meet the needs of individuals with particular needs – these individuals are not covered by the scope of the satisfaction incentive for Transmission networks.

Question 8: We have set out some initial thinking on the following issues: submission quality for Strategic Wider Works projects, further guidance on monitoring needs cases for projects in construction, the potential need for an availability incentive for Scottish island links, and potential funding requirements for NGET's enhanced SO function, as well as on onshore competition roles. What are your views on these?

Strategic Wider Works (SWW) submissions:

All TOs have wide obligations to act economically and efficiently set out in the Electricity Act 1989 (the Act) together with specific obligations within our Transmission Licences. These existing legal obligations apply equally to our SWW submissions as well as all of our other duties and activities.

If Ofgem believed it necessary, then additional clarification could be included in the SWW Guidance Document regarding the proposals that TOs are required to submit and taking into account all the relevant duties placed upon us. Indeed, changes to the process for SWW projects are already under discussion between Ofgem and onshore TOs. Therefore we do not believe this issue should be within the scope of the MPR, neither do we see any benefit to including it in such a process.

In identifying and proposing a SWW project to Ofgem, we need to meet our economic and efficient duty but also have regard to the:

- Electricity Act 1989, Section 38 (Schedule 9) (Preservation of Amenity and Fisheries)
- National Parks and Countryside Act 1949
- Countryside Rights of Way Act 2000
- Section 40 of the Natural Environment and Rural Communities Act 2006
- Planning Act 2008

The changes to the process for SWW projects (referred to above) include some suggested steps (e.g. data templates/ workshops/ regular dialogue) and introduction of an “Initial Need Case” stage. We anticipate our next SWW initial need case submission will include changes in these areas which will improve how the submission meets Ofgem’s requirements. We would welcome clarification in the SWW Guidance Document of how the Planning and SWW funding processes can work effectively together (given that the Secretary of State decides through the planning process what the right solution is for all stakeholders).

Given the changes to the process we are building into our approach to our next SWW initial need case submission, we currently anticipate Ofgem will likely update the SWW Guidance Document during 2016 to formalise the position. We suggest that updating the SWW Guidance Document is the most appropriate way forward and that any issues need not be pursued under a MPR.

Monitoring the needs case for projects in construction

We agree with Ofgem’s comment that it is not in consumers’ interests for a TO to continue spending on a project where the needs case has fallen away. We monitor the need for all investments formally through the Network Development Policy (NDP) which is run annually by the GBSO, with results transparently published in November’s Electricity Ten Year Statement (ETYS) and the Network Options Assessment (NOA) as well as through other internal processes such as our project delivery reviews.

Our experience is that the risk of construction spend without a need case (or appropriate user commitment) is low, save for the costs of managing stopping and protecting the residual value to consumers, where possible, of the work done to date because TOs risk having expenditure disallowed if it is shown to be manifestly inefficient.

If required, the SWW Guidance document could be amended (through the existing process) to address additional monitoring of project need cases or to improve transparency of TOs approaches. Therefore, notwithstanding the fact that we consider this issue is outside the anticipated MPR scope, we are unclear of any specific benefit of including this aspect in a MPR over the process of more general updates to the SWW Guidance Document.

Scottish Island Links

This potential issue was known at the start of the RIIO-T1 price control and is not driven by changes in government policy. Therefore we consider the introduction of a new incentive or adjustments to existing incentives, part way through RIIO-T1 as out of scope and will potentially undermine the stability and clarity and eight year RIIO approach gives. However we agree that the issue of incentives on TOs to ensure their network is available is an important one. The extent to which any additional availability incentive should apply to Scottish TOs in respect of island circuits (or indeed more generally) should be considered as part of RIIO-T2.

Availability incentives should also apply to new competitively appointed transmission companies which we understand will be considered as part of the ECIT project (and can be done so as part of that project).

ITPR enhanced SO role and Onshore Competition roles

As SO, NGET is now undertaking additional activities which were not included in our price control submissions for RIIO-T1. An initial breakdown of efficient costs associated with these SO activities has been provided separately to Ofgem. .

The funding of additional ITPR activities may be in a postion to be considered with MPR timescales. However the new roles are linked with wider discussions surrounding the onshore competition roles and the future structure of the SO.

We agree that proposals to introduce onshore competition has the potential to impact on both the activities of the TO and SO, over and above those envisaged at the time of the RIIO-T1 submissions. We welcome Ofgem’s confirming that a review to consider additional funding for relevant new outputs may be appropriate. We note that this issue is being considered in detail by Ofgem’s “Extending Competition In Transmission” project (ECIT). This project is progressing well but there remain many details to be developed before the impact on our business will be clear. Therefore, until proposals are clearer regarding our role and supporting activities, a discussion about detailed funding for onshore competition activities will be difficult. The degree to which the SO and TO roles separate as a result of ITPR / ECIT will potentially have a number of cost consequences impacting allowances, incentives and who delivers which outputs. Some options would represent considerable industry change (arguably justifying its own process) and it seems to us that it is well beyond the scope of a MPR – especially given the MPR timetable. Kersti Berge's letter of 16th April 2015 to us on ITPR outputs and funding expressed a view that MPR could be the mechanism to consider funding, but said that, "In the event that there is no mid-period review, but we [Ofgem] are persuaded that additional costs to the SO are material, we will consider alternative appropriate routes for considering the funding".

We therefore consider the approach similar to that adopted for EMR (as noted above) would be the most appropriate way to address the necessary changes to our Licence to reflect new outputs and allowances once the full implications of ITPR / ECIT are clear.

Question 9: We wish to understand if there has been a material change in outputs due to the changes in government policy related to renewables subsidies. We ask that the TOs provide information on which connections and wider works are being taken forward compared to the ones that the unit costs were based upon and whether any variation is within the bounds of what was expected to be captured.

We consider this may fall within the scope of a mid-period review, subject to clarity around what constitutes a clear change in government policy, but do not consider the issue merits review. The changes to the underlying generation background are within the range of uncertainty anticipated at the onset of RIIO and our analysis suggests the existing uncertainty mechanisms are working as intended in adjusting allowances accordingly when considered within our overall load related funding package.

We identified a number of uncertainties at the time that our RIIO-T1 package was put in place. Our Load Related investment section
http://www.nationalgrid.com/NR/rdonlyres/53AD0D16-81C6-437B-9B1A-F2346599A6B7/52199/2012_NGET_detailed_plan_loadrelated_redactedsecure.pdf
of our RIIO business plan identified a number of government policy areas that were then under development, including the broad direction of government policy such as to introduce a capacity market (EMR) and to provide support to certain generation technologies until they could be funded in the open market. It was understood by stakeholders that subsidies would likely be reduced and ultimately phased out as the new generation types became economically viable.

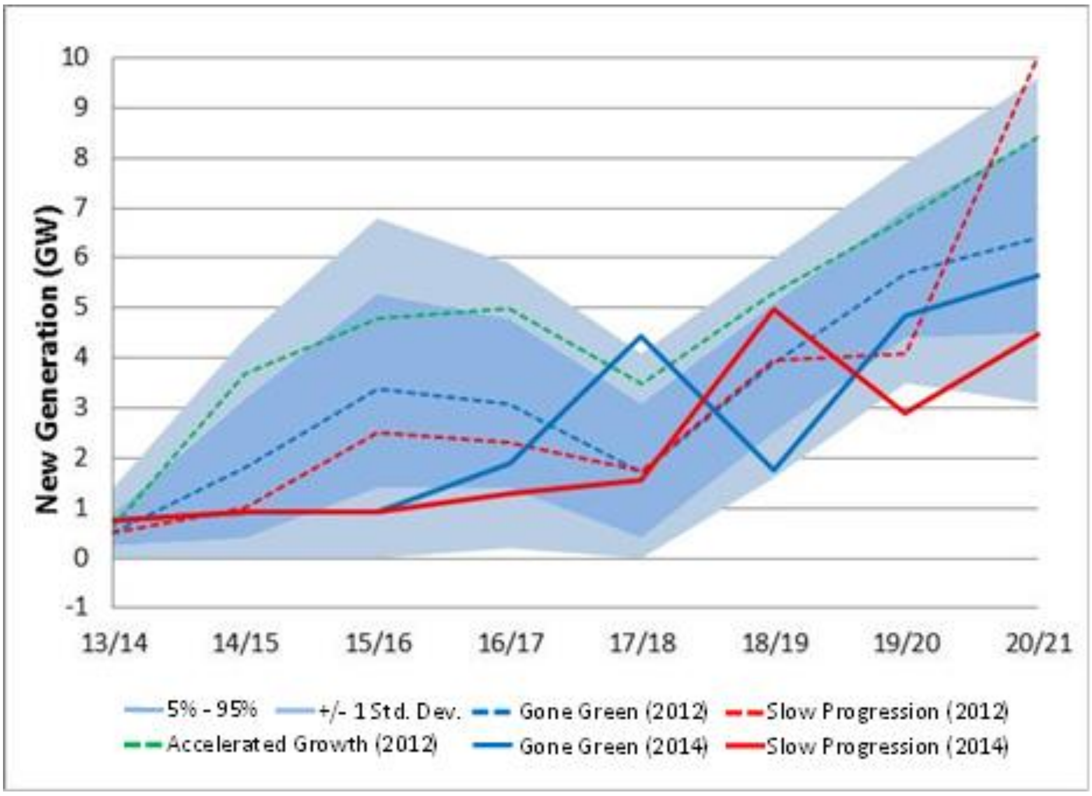
Therefore, we believe that it is unclear that there has been a "clear change to government policy". The current government action to review and revise subsidy rates for different technologies can be seen as a continuation (albeit somewhat accelerated) of government policy that has been in progress since before the RIIO-T1 package was established. Some further implementation steps have been established to manage the transition to low carbon, secure and affordable electricity supplies, however it is uncertain that these represent a "clear policy change".

Secondly, that defining where we are today as a government policy change needs to be assessed against more information as we see the recent changes unfold. If a change in government policy significant enough to trigger a mid-period review has taken place, then this could most closely be linked to the transition from a coalition Conservative and Liberal Democrat to a Conservative majority Government. This only took place in May 2015, and so it's too soon to say what impact this will have or to understand if the changes are complete or not, and furthermore how this will impact our investment needs going forwards. We also consider that if government policy has changed, that such changes could happen again within RIIO-T1 (e.g. as a result of the recent Paris climate change negotiations).

We also included a specific, "Managing Risk and Uncertainty" http://www.nationalgrid.com/NR/rdonlyres/4F6EF249-C014-4B70-BEF6-3A821BDE978E/52234/2012_NGET_managing_risk_and_uncertainty_redactedsecure1.pdf document as part of our business plan submission. This showed the significant ranges of uncertainty for a range of the outputs we deliver that specifically included an assessment of the uncertainty for generation connections and wider works boundary transfer capability outputs. We have reviewed our current forecast of output delivery for our load related categories and have confirmed that these are contained within with potential ranges of likely outputs that stakeholders could need within the RIIO-T1 period.

Page 59 of the Risk and Uncertainty Annex of our March 2012 submission included a graph that showed potential generation scenario variances across the period. If this graph is re-created (see Figure 1 below) to include the actuals to date and the current RRP forecast of new connections, it can be seen that the outcome of the generation is still broadly within the bounds of what was expected when the price control was established. Although there is some apparent volatility, this is driven by a small number of large projects that are forecast in individual years.

Figure 1



Generation connecting directly to us is lower than many of the scenarios considered. We are seeing a significantly increased amount of embedded generation connections, particularly for renewable technologies, which we are seeking to accommodate (though we do not have an embedded generation uncertainty mechanism driver to fund any necessary works apart from in two specific zones). There are many contributory factors to these changes including commodity prices, the falling cost of renewable technologies, together with falling demand. The levels of load related outputs we currently foresee delivering in our best view are within the ranges considered possible when our RIIO-T1 framework was set.

We have set out below our initial analysis on which connections and wider works are being taken forward compared to the ones that the unit costs were based upon and whether any variation is within the bounds of what was expected to be captured.

Derivation of the generation uncertainty mechanism UCA

This spreadsheet shows National Grid's view of the calculations that Ofgem used to derive the Unit Cost Allowance (UCA) for the generation uncertainty mechanism along with a comparison to our March 2012 submission (25.7GW), Ofgem's defined baseline (33.2GW) and the 14/15 RRP (11.2GW). Our UCA is calculated as £27.4/kW compared to the Ofgem stated value of £26.8/kW in Final Proposals.

[Spreadsheet redacted]

The calculations show that in setting the generation UM unit cost allowance, Ofgem took account of the total cost of projects, including any pre-construction costs, for projects within the March 2012 submission (i.e. including costs from before the T1 period) and also a number of additional projects that were forecast or had already been completed.

This derivation of the UCA will therefore correctly claw-back, on a generic basis, all allowances in the T1 period along with any allowances given in TPCR4 through either the Work In Progress or Transmission Investment Incentive mechanism.

There are currently only a handful of new projects that are forecast to connect in the T1 period within the 14/15 RRP and that weren't used to calculate the unit costs. These are:

[redacted]

As can be seen, the new projects that were not included in the UCA calculation have a higher forecast UCA than was derived by Ofgem. Recalculating the UCA to include these projects means our derived UCA would have increased by £0.2/kW, which extrapolating the Ofgem Final Proposals value would increase it from £26.8/kW to £27.0/kW.

Derivation of the Wider Works uncertainty mechanism UCA

This spreadsheet shows the calculations that Ofgem provided to us showing how they derived the UCA for each of the wider works boundaries (we believe these values are pre-efficiency). This shows that each UCA was based on the expected reinforcements at the time of the March 2012 submission, with the segregation between below and above baseline defined by Ofgem.

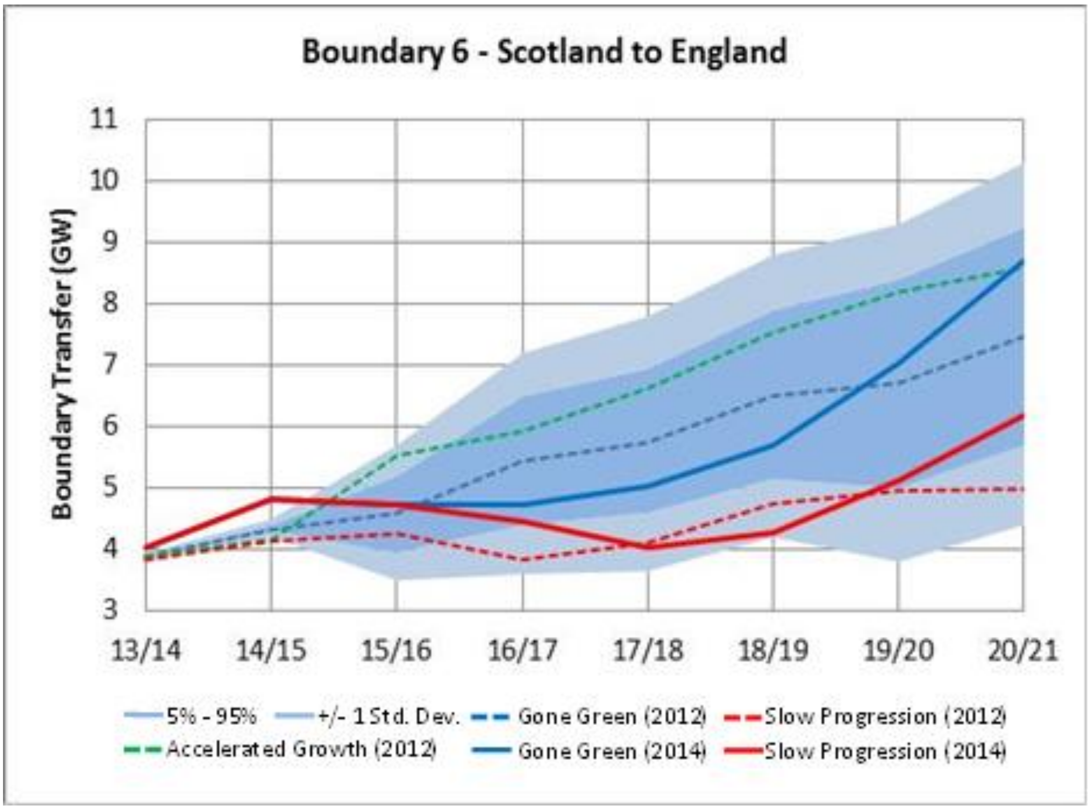
The project costs that were used to derive this UCA excluded a value for pre-construction costs on each scheme, assessed using a generic 1%/2%/4% assumption. This assumption of pre-construction cost was included in the baseline, non-variant allowance.

[Spreadsheet redacted]

As can be seen from the calculations, the below baseline UCA for each boundary was derived from the selected, known reinforcement options within the March 2012 submission. The above baseline UCA for each boundary was derived using the known projects that were not included in the baseline defined by Ofgem, some of which were not within the best view submission.

As previously discussed, the wider works mechanisms will make adjustments using boundary specific UCAs. Broadly, where there is no longer any requirement to reinforce, the allowances will be reduced to reflect this non-delivery (excluding any ex-ante pre-construction allowance). The following graph (Figure 2), which includes the data from page 82 of the Risk and Uncertainty Annex of the March 2012 submission, shows the B6 boundary capacity forecasts compared to the current scenario.

Figure 2



In conclusion, we consider that it is not apparent that a, “clear change in government” policy has taken place and that changes in implementation of policy have been too recent to feed into a Mid Period Review. Also our current forecasts of output requirements for our customers broadly lie within the anticipated ranges when RIIO was set.

Question 10: We ask that the network companies provide information on any connections and wider works that are not easily correlated to a specific funding mechanism in the licence. We also ask that evidence is provided of the materiality of such issues as part of any response.

Almost all of our work correlates to a specific funding mechanism in the licence. There are a few potential instances where new technologies such as t-pylon may not fit easily into existing mechanisms. Also we have already seen embedded generation connections substantially in excess of our RIIO business plan forecasts that may impact on investment on the transmission system and for which we only a mechanism in two zones.

Connections

The majority of connections works are directly correlated to the generation or demand uncertainty mechanisms defined within the Licence.

- All enabling infrastructure works for new connections are captured by the Local Enabling (Entry) and Local Enabling (Exit) categories within the RRP submission and are covered by Special Conditions 6F and 6L respectively.
- The Local Enabling (Entry – Sole Use) and Local Enabling (Exit – Sole Use) categories are expected to be trued-up at the end of the RIIO-T1 period and so are directly correlated to an expected funding approach.

Wider Works

A significant proportion of wider works are directly correlated to an uncertainty mechanism***.***

- All baseline, incremental and strategic wider works are included within an uncertainty mechanism.

Correlation of spend and allowances to uncertainty mechanisms

£m - 09/10 prices	**RRP 14/15**	**% of total**	**Ofgem FP baseline in PCFM**	**% of total**	**Delta**	**UM**
Local Enabling (Entry – sole-use)	[redacted]	0%	[redacted]	0%	[redacted]	True-up
Local Enabling (Exit – sole-use)	[redacted]	7%	[redacted]	11%	[redacted]	True-up
Local Enabling (Entry)	[redacted]	19%	[redacted]	22%	[redacted]	Generation
Local Enabling (Exit)	[redacted]	5%	[redacted]	6%	[redacted]	Demand
Wider Works (UM)	[redacted]	61%	[redacted]	52%	[redacted]	IWW, SWW and Planning

Wider Works (other) including TSS	[redacted]	8%	[redacted]	10%	[redacted]	Non-varying allowance
TOTAL						

As can be seen, around 10% of the allowances do not relate to a specific uncertainty mechanism. This compares to around 8% of the current forecast being spent in this same area using the same categorisations.

A detailed breakdown of the works that are within this non-variant, 'non-output' category has been provided to Ofgem as part of the 14/15 RRP SQ process.

There are some detailed potential areas for improvement in the design of funding mechanisms that could more neatly align funding mechanisms with the solutions we identify, though we consider these may be appropriately addressed as part of development of RIIO-T2. An extensive discussion with Ofgem and effective stakeholder consultation took place for RIIO-T1 regarding the level of sophistication in the T1 framework to drive the greatest benefit for consumers and what that would mean in terms of increased complexity. Given an objective to identify simple and transparent mechanisms this resulted in the package of mechanisms we have, including some non-variant (i.e. without an uncertainty mechanism) load related funding being agreed.

Question 11: We welcome views on whether there needs to be clarification of output requirements and treatment of activities (load related projects in particular), that sit outside of the revenue drivers, where they are no longer required or have been substituted.

As explained in our response to question 10, the majority of our spend on load related projects is aligned with an existing revenue driver.

The RIIO-T1 Final Proposals included, where possible, uncertainty mechanisms that alter allowances depending upon the exact quantity of outputs that are required. This particularly applies to load related allowances, but it was also recognised that it may not be possible to cover all load related activities by uncertainty mechanisms. In the run up to the final proposals, NGET and Ofgem worked together to develop uncertainty mechanisms considering a wide range of solutions. These proposals included additional uncertainty mechanisms to flex our allowances, but involved additional complexity for stakeholders. The range of potential uncertainty drivers were reduced (to those which now operate in RIIO-T1) to reflect stakeholders' desire for simple and transparent funding mechanisms. Therefore, the load related element in Final Proposals included a category of funding which is non-varying and was not linked to specific outputs or uncertainty.

The appropriate allowances were therefore set as part of our RIIO-T1 package with some baseline load related funding as well as uncertainty mechanisms for our broad load related output. No mechanism or expectation was put in place that indicates the review of these non-variant load related allowances would take place. So we expect the RIIO-T1 outcome across our load related activities that are subject to both uncertainty mechanisms and baseline funding to be treated in the round and be subject to the Totex incentive mechanism. This ensures that benefits and costs are shared between network companies and customers.

Clearly, over time, the requirements of our load related customers and what stakeholders need from us will change. (It is worth noting that the 2015 System Operability Framework identifies a number of emerging system operability issues for which solutions (some of which may involve investment) have yet to be identified). We accepted this, and continue to see this as our risk to manage over the eight year period of RIIO-T1, save for the specific MPR scope.

There are also a number of other elements which have evolved since the onset of RIIO (including e.g. the connection of large volumes of embedded generation) where our operations and investments have adapted to meet stakeholder needs that were not foreseen and reflected in the original RIIO allowances. We have considered the overall impacts on outputs in the round consistent with the principles we have outlined above and the scope for the mid-period review set out in Final Proposals.

Question 12: How material do you consider the RIIO-T2 outputs issue to be? Do you consider this is an issue that we should take forward?

Ofgem removed all allowances in T1 for future outputs in Initial Proposals. This was changed in Final Proposals to provide indicative funding, recognising the need to fund projects that deliver outputs in a future period. The current mechanism set out in our licence requires a forecast of new connections and network requirements almost four years ahead of the start of the next period to determine an initial allowance (revenues are defined for t=18/19, hence the Annual Iteration Process (AIP) in November 2017 requiring a July 2017 data submission).

This forecast will be based on committed generation and demand connections (i.e. those with signed bilateral agreements) and the Network Development Policy (NDP) outputs forecast. We support waiting until 2017 as set out in our licence to consider the issue as there will be a more robust view of the likely level of outputs required and the potential scale of any issue and therefore what the appropriate approach is for all stakeholders. Indeed there may be merit in re-considering the timing of the submission for T1+2year output forecasts as well as the duration of the period covered.

Section 6: Cross Sector Issues

Question 20: Do you agree that we should clarify some areas where it isn't clear how late or non-delivery will be treated? If so which areas do you consider would benefit from such clarification?

We consider that in most aspects of the RIIO-T1 approach that specific uncertainty mechanisms, some fixed allowances and frameworks (e.g. NOM's over/under delivery and justified/unjustified treatment matrix) were put in place to enable us to deliver the right outputs for our stakeholders. RIIO also considered and put in place mechanisms for managing instances where the outputs needed by stakeholders changed, but where we had started efficiently investing in developing an output through TPWW and TPG in our licence. Therefore the RIIO framework ensures we are incentivised to deliver only those outputs that are still required and to ensure delivery happens in the right timescales.

For many of our RIIO-T1 outputs, revenue directly adjusts for the required level of output delivery. We've seen this working by reducing our revenues and thereby lowering costs to consumers as a result to changes in load related and wider works outputs now no longer required from the baselines set.

Where a specific tailored mechanism to manage uncertainty has not been defined then we expect that the Totex Incentive Mechanism (TIM) applies between consumers and companies.

Some specific very large investments in our Baseline Wider Works were funded at the start of RIIO-T1 contained in section 6I table 1 of our Transmission Licence. Funding for these schemes was also considered in our uncertainty mechanisms, such that if they were not required the allowances would be clawed back. Because the delivery year for these specific schemes is written into our Transmission Licence then this creates an obligation to deliver them in the specified year. We have sought to deliver these outputs in the best interest of consumers, and reflecting the guidance provided in Ofgem's letter of July 2012[1] on this subject, and we now anticipate a delay to the Western HVDC link output. We would welcome further guidance from Ofgem on how late delivery will be treated in future circumstances as at present the default mechanism of treatment under the licence breach mechanism seems disproportionate and may not necessarily align decision making with consumers interests.

[1] Ofgem wrote to us in July 2012 setting out some guidance on the regulatory treatment of the western HVDC Link. This was, "we will review deviations from agreed completion timescales to determine whether these constitute a contravention of the TOs' licence conditions. In such circumstances, we will consider whether late delivery constitutes a failure by the TOs in relation to the timely delivery requirements specified in the licence. In considering whether this is the case or not, we will look at the factors leading to the late delivery, the amount of consumer detriment caused and the extent to which the TO could be held responsible for events as well as whether or not they took reasonable steps to mitigate the impact of such events where they could do so efficiently."

Question 21: How material do you consider innovation tax relief has been and is likely to be for the network companies? Do you consider this is an issue that we need to pursue as part of any MPR? We request that network companies provide estimates of the benefits accrued so far due to this tax relief as part of their response?

We do not consider innovation tax relief to be an issue that needs to be reviewed as part of the mid period review. There is no need for corporation tax matters to go through the mid period review because there are existing uncertainty mechanisms in the RIIO framework that already adjust our tax allowances under a range of circumstances including, but not limited to, changes in legislation or HRMC interpretation. These are covered by the tax trigger uncertainty mechanism.

In addition, we do not consider this item to be in scope of a mid-period review as whether or not HRMC interpretation can be considered a Government change, there has not been a change in outputs.

Notwithstanding our views on the validity of being in scope for the mid-period review, we have set out below the estimated tax reduction benefits that we will achieve per annum.

It should be noted that expenditure within the "innovation stimulus", due to the specific tax rules, may not qualify for enhanced tax reliefs. For the RIIO-T1 period to date, the expected permanent tax benefit for "innovation stimulus spending" for Electricity Transmission is expected to be a reduction in tax payable of £349k. This is not considered material and there is no expectation that there will be any significant change to this benefit going forward. We do believe it is appropriate for networks to make appropriate claims if the expenditure is eligible for the enhanced reliefs.