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MPR parallel work decision

Final decision

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Overview:

In deciding to undertake our mid-period review (MPR) we identified areas we would like to look at further. We termed this workstream MPR parallel work. MPR parallel work looks at both the transmission and gas distribution price controls.

We have looked at two outputs where it is unclear how we will hold companies to account. We have decided to focus on consumer outcomes rather than output detail.

We have also identified two areas of the price controls where we think it is in consumers' interests to make adjustments. First, we will delay the allowances provided to National Grid Electricity Transmission and SP Transmission due to the late delivery of the £1 billion subsea Western HVDC link. Second, we have accepted Cadent's offer to refund consumers £53.9 million for medium pressure iron mains replacement work that has been delayed.

Context

RIIO-T1 and GD1 were the first price controls to reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model. The RIIO-T1 price control sets the outputs that the electricity and gas transmission network companies need to deliver for consumers and the associated revenues they are allowed to collect for the eight-year period from 1 April 2013 until 31 March 2021.

Similarly, the RIIO-GD1 price control set these for gas distribution companies. We have since launched the RIIO-ED1 price control for electricity distribution, which runs on a different timetable.

The RIIO framework is designed to promote smarter gas and electricity networks for a low carbon future. The RIIO price control put much more emphasis on incentives to drive the innovation needed to deliver a sustainable energy network that offers value for money to existing and future consumers.

In deciding on the need and scope for the mid-period review and as part of our annual reporting process, we identified a set of matters we decided to progress through a separate workstream: MPR parallel work.

We published a consultation in February and considered stakeholder responses. We have now made our decisions.

Associated documents

Consultation on mid-period review parallel work

Decision on the mid-period review (MPR) or RIIO-T1

Consultation on the mid-period review (MPR) of RIIO-T1

Decision on a mid-period review for RIIO-T1 and GD1

Consultation on a potential RIIO-T1 and GD1 mid-period review (and associated responses)

RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas

For Initial Proposals, strategy decisions and the RIIO Handbook, please see our dedicated page for RIIO-T1.

Contents

Executive Summary

During the mid-period review (MPR) we identified a number of issues in the transmission and gas distribution price controls that we wanted to look at further. We have progressed these issues through a separate package: MPR parallel work. It has two parts: clarifying output delivery and considering potential price control adjustments.

Clarifying output delivery

We looked at two outputs where it was unclear how we would hold companies to account. We decided to focus on high-level consumer outcomes. This is consistent with RIIO principles and encourages companies to be innovative and efficient, which is in consumers' interests. We looked at:

1. National Grid Gas Transmission (NGGT)'s output to meet the Industrial Emissions Directive (IED) by replacing compressors. NGGT has identified more efficient solutions to meet these environmental requirements.

   As the output includes a purpose and how it should be achieved, it is unclear when the output is met. Our decision is to consider the output delivered if NGGT complies with the IED, in a way that provides the greatest consumer value.

2. SP Transmission's output to provide voltage support to address the possible closure of Hunterston B nuclear power station. Hunterston B is now expected to stay open longer, but changes elsewhere mean there is an ongoing requirement for voltage support. Our decision is to consider the output delivered if SP Transmission manages voltage in a manner that delivers the greatest consumer value.

Potential price control adjustments

We have looked at several different issues and considered whether we should adjust the price control. We decided to make two changes:

1. **Delay allowances provided to National Grid Electricity Transmission (NGET) and SP Transmission for delivering the £1 billion[1] Western HVDC subsea link late.** NGET and SP Transmission report they will deliver the link late due to technical problems with the manufacture of the cable.[2] The companies will likely receive a financial benefit by paying suppliers later despite the delay likely increasing costs to consumers. We have decided to delay allowances to protect consumers.

[1] All allowances are expressed in 2009/10 prices so that they are consistent with the RIIO-T1 final proposals.
[2] We have not yet evaluated the reasons for the delay.

2. **Accept Cadent's[3] offer to refund consumers £53.9 million for work to replace medium pressure iron mains in central London, which Cadent has partly delayed to future price controls.** Cadent said that because of unexpected engineering and stakeholder problems it will only deliver 29 km of the 69 km of work funded. We have decided to accept and implement Cadent's proposed refund.

We have decided not to make any adjustments for the other issues considered. Specifically, we decided to:

- **Not accept SP Transmissions' request to amend its connections volume driver, which it forecasts would increase allowances by £81 million.** Accepting SP Transmission's request would provide it with additional funding in this case, where costs are higher than the allowance, while allowing it to retain benefits elsewhere, where costs are less than the allowance provided. In addition to being unfair to consumers, these changes would dampen the central incentives in RIIO for licensees to develop well-justified business plans, take responsibility for managing the uncertainty that their businesses face, and proactively seek the best way to provide network services.

- **Make no change to the National Transmission System (NTS) Exit Capacity incentive.** British Gas was concerned that the scheme encourages perverse behaviour that increases costs for consumers. Although we acknowledge that it has weaknesses, we have decided to make no change. We think that overall the scheme is incentivising the desired behaviour and that the risks from making changes outweigh any benefits.

- **Make no change to three gas distribution outputs, other than to update reliability (loss of supply) targets.** After reviewing the mechanisms in place, we consider the only change required is to update the reliability (loss of supply) targets. We will continue to monitor these outputs for the remainder of RIIO-GD1 and require companies to provide justifications if they are not met. We would also expect them to improve and, where appropriate, make redress to consumers.

- **Make no change to SP Transmission's trigger mechanism.** SP Transmission requested funding for overhead line refurbishment works, which was originally set to be unlocked if the East Coast 400kv upgrade began. We have decided to make no change, as our Network Outputs Measures incentives will fund these works if they are justified.

- **Take no action in relation to other electricity transmission outputs.** The three specific outputs examined are either being delivered or have an existing mechanism that will make appropriate adjustments if they are no longer required.

[3] Formerly National Grid Gas Distribution.

1. Scope

This chapter outlines the scope of MPR parallel work.

1.1. At the time of the MPR, we identified a range of further issues we wanted to consider in more detail. We termed this MPR parallel work. In our February MPR parallel work consultation, we set out that we thought it was appropriate for us to consider a wider range of actions we might take to the issues we had identified.

1.2. We asked stakeholders whether they agreed with the scope of MPR parallel work and received broad support. Accordingly, we have decided to make no changes to the scope of MPR parallel work.

Our consultation position

1.3. In our February consultation, we outlined a series of possible responses that we would consider. These included:

- Clarifying our approach to output delivery, such as when we will consider existing outputs delivered. This could include changing allowances to match changes in approach.
- Clarifying how we will treat outputs that are delivered late. This could include adjusting how payments will be shared with consumers, what information we expect to be provided and delaying allowances due to the late delivery of an output.
- Considering amendments to SP Transmission's connections volume driver.
- Considering changes to the NTS exit capacity incentive that applies to gas distribution network companies. This could include suspending the incentive.
- Adding existing outputs to licences.
- Amending the gas distribution reliability (loss of supply) output targets.
- Making changes to allowances mid-period and at close out.
- Making commitments about the provision of further allowances in future price controls.

1.4. In regards to the deferred replacement of London medium pressure mains issue, we thought it appropriate to consider action even if deferring the work did not impact the delivery of other outputs. This was in order to protect consumers from the risk of funding the costs of a significant investment twice.

1.5. Lastly, we excluded some matters that were originally included within MPR parallel work, because they are being considered by separate workstreams. These are:

- Network Output Measures, which is the set of output incentives that apply to the delivery of asset replacement and refurbishment works.
- The Environmental Discretionary Reward.
- The Stakeholder Engagement Incentive.
- Strategic Wider Works.
- Preparatory work on a gas transmission re-opener related to the IED.

Responses

1.6. Five respondents agreed (Cadent, SP Transmission, Wales & West Utilities, Northern Gas Networks and SGN) with our proposed scope.

1.7. Northern Powergrid said there should be tight limits on the scope to make adjustments to price controls mid-period. It went on and stated that the scope as set did not cause them any concerns.

Our decision

1.8. We have decided to maintain the scope outlined in our February consultation since no significant concerns were raised.

2. Clarifying output delivery

The RIIO price controls include a series of outputs, what network companies are required to deliver in return for the revenue set. Changes in circumstance or the identification of better ways to solve problems make it ambiguous in some cases when we will consider an output delivered.

We have looked at two outputs and clarified when we will consider the outputs to be delivered. In both cases, we will consider the output met if it is delivered in a way that provides greatest consumer value.

2.1. Each RIIO price control sets a series of outputs: what network companies are required to deliver in return for earning the revenue set.

2.2. Since the start of RIIO-T1 and RIIO-GD1, circumstances have changed. In some cases, where the output is ambiguous, it is unclear when we will consider the outputs delivered.

2.3. Will we consider the output delivered only if exactly what we specified is delivered? Or will we consider the output delivered as long as the overall purpose of the output is achieved, regardless of what method was used?

2.4. In our February consultation, we considered how we would resolve ambiguity for two specific outputs:

- NGGT's compressor output; and
- SP Transmission's voltage control output.

2.5. We have now decided that we will maintain the position we consulted on. We will consider the two outputs met if they are delivered in a way that provides the greatest value to consumers.

2.6. Our approach to focus on the output purpose could also be applied to other outputs. In each case, we will need to consider the nature of the output and why it was set. Given the complexity of a price control, in some cases, this approach may provide outcomes that are not in consumers' interests. Where this is the case, we will not adopt this approach.

2.7. Below we outline the reasons for our approach generally. We then explain why we decided to apply this approach for the two outputs considered.

When we will consider an output delivered

Our consultation position

2.8. Our February consultation proposed that we would consider outputs met if the network companies deliver them in a way that provides greatest value to consumers.

2.9. We thought this approach would encourage companies to find alternative ways of delivering and manage changing circumstances. We also thought it would avoid the risk of companies building things that are not needed.

2.10. In determining whether this approach could be applied to other ambiguous outputs, we said we would need to consider the nature of the output and why it was set. Given the complexity of a price control, there may be some cases where the above approach is not in consumers' interests. We said we would not apply this approach in these circumstances.

2.11. We asked stakeholders if they thought it was right to focus on the output purpose, where there is ambiguity, to decide when an output is delivered.

2.12. We also asked stakeholders what they thought about our alternative options including focussing on the detailed specification and output declassification. We asked if they would achieve our purpose and whether they could think of any other alternatives.

Responses

2.13. Twelve of the 13 respondents agreed with our approach.

2.14. SGN said it would welcome a transparent and consultative process being applied to any potentially subjective assessments in relation to the delivery of outputs that could be considered ambiguous.

2.15. SP Transmission agreed in principle that a focus on the output purpose is often appropriate, but also said that the focus of output accountability should be on recognising where this is achieved and where it is not. SP Transmission noted that this may well require a case-by-case approach where different outputs require different considerations. SP Transmission considered that we should, therefore, continue to consider both the output specification and the output purpose in our approach to output accountability.

2.16. While Citizens Advice welcomed our approach in principle, it did raise a concern that our approach may encourage network companies to include costly projects in their business plans. Companies would do this in the expectation that they will be able to convince us to amend the output in the future to be outcome focussed, which they can deliver at lower costs with an alternative delivery method.

2.17. Citizens Advice also stated that as this issue arose as a result of an ambiguity in the design of the RIIO price control that Ofgem should:

- reduce the percentage of revenue that the companies retain from the totex incentive mechanism, and
- be clear how we propose to resolve this for the next RIIO price control.

2.18. Electricity North West didn't state whether it supported our approach. Electricity North West considered it is essential that licensees are confident that they will retain a share of any savings that are delivered through finding different solutions to deliver outcomes for customers.

Our decision

2.19. Given the broad support, we have decided to maintain our approach to focus on the output purpose.

2.20. We repeat, however, that given the complexity of a price control, there may be some cases where the above approach is not in consumers' interests. We would not apply our approach in these circumstances.

2.21. We do not intend to make changes proposed by Citizens Advice: to change the percentage companies retain through the totex incentive mechanism. As we said in our 2011 RIIO-T1 strategy decision, we think that making retrospective changes to adjust the totex incentive mechanism would harm regulatory confidence around price control incentive mechanisms, which is not in consumers' interests.

2.22. In regards to SGN's comment about undertaking a transparent and consultative process, we note that we have consulted on how we will hold NGGT and SP Transmission to account in respect of the two outputs considered.

National Grid Gas Transmission's compressors output

Background

2.23. We specified an output for NGGT that included both an output purpose (complying with the IED) and how this should be achieved (through installing new compressors[4]).

2.24. NGGT has since identified more efficient solutions to meet the environmental requirements of the IED. At one location, NGGT will retrofit a catalytic convertor to

[4] Compressor stations maintain pressure to keep gas flowing though the National Transmission System.

the existing compressors and at another station it will install compressors of a different type than envisaged at the outset of the price control.

2.25. It was unclear whether the output set required the delivery of specific compressor units or NGGT's compliance with the requirements of the IED.

Our consultation position and responses

2.26. In our February consultation, we proposed to focus on the output purpose: compliance with the IED. We would consider the output delivered if NGGT can justify that it complied with the IED in a way that has delivered the greatest value to consumers.

2.27. We thought this approach would promote innovation and finding new efficient ways of delivering. NGGT will share with consumers the benefit of any cost savings (and cost increases) through the totex incentive mechanism.

2.28. We proposed taking no action if NGGT deviated from the approach envisaged as long as the new approach could be demonstrated to be in consumers' interests.

2.29. We asked stakeholders if they agreed with our proposed approach to hold NGGT to account if it complies with the IED requirements, in a way that delivers the most consumer value.

2.30. Nine respondents agreed with our approach, British Gas, NGGT, SP Transmission, Wales & West Utilities, Northern Gas Networks, SGN, Western Power Distribution, Northern Powergrid and the Energy Networks Association. The remainder did not comment specifically on this issue.

Our Decision

2.31. Having considered the responses to this issue, we have decided to maintain our approach. We will consider the output delivered if NGGT complies with the IED, in a way that delivers the greatest value to consumers.

SP Transmission's voltage control output

Background

2.32. SP Transmission's price control includes an output to provide voltage support to address the possible closure of Hunterston B nuclear power station. The output is defined as:

Voltage support to comply with Grid Code and NETS SQSS on possible closure of Hunterston Power station and transmission system reconfiguration in the west coast. [5]

2.33. The closure of the Hunterston B power station has been delayed beyond the end of RIIO-T1. Although Hunterston B is now not expected to close in this price control there have been other changes in generation. As a result, SP Transmission still expects to provide voltage support, although in a different manner than forecast.

Our consultation position and responses

2.34. In our February consultation, we proposed holding SP Transmission to account for delivering this output in a manner that delivers the greatest consumer value.

2.35. We asked stakeholders if they agreed with our approach to consider the output delivered if SP Transmission manages voltage across its network efficiently.

2.36. Seven responses supported our proposed approach, SP Transmission, Wales & West Utilities, SGN, Northern Gas Networks, Western Power Distribution, Northern Powergrid and the Energy Networks Association. British Gas disagreed.

2.37. British Gas disagreed with our proposed approach as it believes there is no ambiguity to address. It considered that the closure of Hunterston B power station is clearly included as part of the output in SP Transmission's licence and, therefore, the delay in closure should mean that this output is no longer needed. It is an unforeseen event and should be funded through SP Transmission's price control underspend.

Decision

2.38. We have decided to maintain our approach. We will consider the output delivered if SP Transmission manages voltage in a manner that delivers the greatest consumer value.

2.39. We disagree with British Gas and think the output definition is ambiguous. We note that the output is focused on voltage control, rather than the delivery of specific assets, and is for the *possible* closure of Hunterston B.

[5] Special condition 6I, Table 1: Baseline Wider Works Outputs

3. Potential price control adjustments

The second part of the MPR parallel work considers adjusting the price controls to address specific issues.

We have identified two adjustments which we think are in consumers' interests to make.

First, we intend to ensure that NGET and SP Transmission do not benefit from the late delivery of the Western HVDC, a £1 billion subsea link.

Second, we have decided to accept Cadent's offer to refund consumers for work it is unable to deliver. This relates to replacing medium pressure iron mains in central London, which is partly delayed to future price controls.

We also outline our assessment of a range of other issues where we think no change is required.

3.1. In our February consultation, we explained that we designed the RIIO model to provide confidence and transparency. We said we would seek to avoid any retrospective adjustments to the package agreed in final proposals.[6]

3.2. However, we have identified two changes that we think are in consumers' interests to make. These are:

- removing the timing benefit for the late delivery of Western HVDC link, and
- accepting the return of funding for deferred replacement of medium pressure pipes in London.

3.3. Our view is that making these changes will improve the RIIO price controls and will not harm regulatory confidence.

Western HVDC link

3.4. The Western HVDC link is a £1 billion link between Scotland and Wales, jointly developed by NGET and SP Transmission. The Western HVDC link will increase the capacity of the transmission system. In turn, this will reduce the need to manage constraints.

[6] Ofgem 2010, *Handbook for implementing the RIIO model,* para 5.6

3.5. The link was due to be delivered in 2016/17, but has been delayed to 2017/18. NGET and SP Transmission report that the delay is primarily caused by technical problems with the manufacturing of the cable.[7]

3.6. The delay will likely result in greater constraint payments, increasing costs to consumers by roughly £70 million[8]. Despite these higher costs, we expect NGET and SP Transmission to financially benefit from the delay by paying suppliers later while still receiving allowances as if the link was delivered on time.

3.7. We have now decided to adjust the regulatory framework so that NGET and SP Transmission do not benefit from delivering the Western HVDC link late while increasing costs to consumers. We will do this by delaying allowances. We will make the necessary changes to allowances in the price control financial model once the Western HVDC link has been delivered.

Background

3.8. Transmission networks do not have unlimited capacity. There are limits to how much energy can be transmitted at certain times and locations.

3.9. Where there is limited or no spare capacity, there is a 'constraint' on how much electricity can flow. These constraints can occur when new generators connect to the existing network if there isn't enough spare capacity.

3.10. Where it is economic to do so, transmission owners reinforce the network to provide the additional capacity required. Until the reinforcement is completed (and where it is not economic to build new transmission assets) National Grid, in its role as system operator across GB, manages these constraints. This can be achieved by paying generators to limit how much electricity is produced.

3.11. Electricity typically flows from the north (where generation exceeds demand) to the south of Great Britain. The Western HVDC link will increase the capacity of the transmission system, by allowing more electricity to be transmitted between Hunterston in Scotland and Deeside in Wales. National Grid has forecast that the link will significantly reduce constraint payments by around £140 million per year.

3.12. We expect the late delivery of the link to delay the forecast reduction in constraint payments. Actual costs will depend on when the link comes online and what generation and demand patterns arise.

[7] We have not yet evaluated the reasons for the delay. We will make this assessment on receipt of further information from the companies. Later in this document we set out what information we expect the companies to provide.

[8] National Grid has estimated that constraint costs will fall from £140m pa to £0 when the Western HVDC is completed. As we think the delay is likely to be only 6 months we have halved this estimate to get an estimate of £70 million. Actual costs could be higher or lower than this rough estimate. See: National Grid 2015, *Connect and Manage Forecast Report,* April p.15

3.13. Due to the delay, we expect NGET and SP Transmission to pay suppliers later. Allowances were set on the basis that the link would be completed on time. The companies will receive the allowances ahead of when costs are incurred resulting in a timing benefit, as they can hold onto the funding before it is spent.

3.14. In setting the price control, we did not specify any penalties to apply in case of late delivery of the Western HVDC link. Instead, we said we would review deviations from the agreed completion timescales to determine whether these constitute a contravention of the licence conditions.[9]

3.15. We also said we would consider whether or not the companies took reasonable and efficient steps to mitigate the impact of such events.[10] If the relevant licence conditions have not been complied with then the Gas and Electricity Markets Authority (GEMA, the relevant decision-making body to whom Ofgem works) may consider taking enforcement action, which could result in the imposition of financial penalties and/or redress payments. As part of such considerations it would look at the level of consumer detriment that may have arisen. Any decision to open a formal investigation, and, in the event subsequently a formal finding of breach is made, any decision as to possible penalty or redress, are matters for GEMA applying its enforcement guidelines[11] and penalty policy[12] respectively. Any GEMA enforcement processes and decisions occur independently of the processes set out in this document.

Our consultation position

3.16. In our February consultation, we proposed to delay allowances due to the late delivery of the Western HVDC link. The intention was to ensure that the companies do not benefit from a project delay despite consumers likely being worse off.

3.17. In coming to this position, we considered two options:

1. Do nothing. This would allow the companies to retain the timing benefit from delivering the Western HVDC link late.

2. Delay the allowances to remove the timing benefit.

3.18. We thought that doing nothing failed to adequately protect consumers. Consumers have funded the companies to deliver an output by a specific deadline, which will not be met.

[9] Ofgem 2012, *Decision on funding arrangements for the Western High Voltage Direct Current link ("Western Bootstrap")*, p.10
[10] Ofgem 2012, *Decision on funding arrangements for the Western High Voltage Direct Current link ("Western Bootstrap")*, p.10
[11] Enforcement Guidelines
[12] Statement of policy with respect to financial penalties and consumer redress

3.19. We were concerned that the companies would stand to receive a financial benefit arising from late delivery. We considered that this provided a perverse incentive that should be removed.

3.20. We thought that delaying the allowances better protected consumers. This option ensures revenues are better aligned with the delivery of the output. It also removed the financial benefit that the companies may receive and the consequent perverse incentive.

3.21. We considered that this approach was consistent with approaches we employ elsewhere.[13]

3.22. We asked stakeholders whether they agreed with our proposed approach to delay allowances due to the late delivery of the Western HVDC link.

3.23. We also asked:

1. *Whether they had any views on how we should delay allowances.* We outlined two options. The first was to re-profile allowances to match actual spend.[14] This would remove all timing gains but preserve changes in overall cost. The second was a more simple approach to shift the allowances in line with the delay.

2. *How we should treat payments and in-kind benefits from suppliers paid to compensate for the delay.* We could intervene and pass these payments directly through to consumers, or we could allow the companies to share in the benefit through the totex incentive mechanism.

3.24. Lastly, we also set out what information we expect the network companies to provide once the link is operational. These information requirements are in Appendix 1 to this decision document.

Responses

3.25. Nine of the 13 respondents commented on our proposal. Responses were divided. NGET, SP Transmission, Citizens Advice and British Gas all supported our proposed approach while Electricity North West, Northern Powergrid and Western Power Distribution did not.

[13] Such as our Transmission Investment for Renewable Generation mechanism.
[14] We would do this by first working out what percentage of total spend was incurred each year. We would reallocate the allowed expenditure profile in line with these percentages. For instance if 20% of total costs were incurred in 2016/17 we would allocate 20% of the allowance to 2016/17.

Stakeholder views on our proposed approach

3.26. Both the affected companies, NGET and SP Transmission, supported our approach. SP Transmission said that it was reasonable and would benefit consumers. NGET agreed in principle that networks should not benefit from the late delivery of an output through the timing difference as this is not in consumers' interests.

3.27. Citizens Advice and British Gas also agreed. Citizens Advice said network companies should not receive a timing benefit as a consequence of late delivery. British Gas suggested that we consider whether it is appropriate for companies to be exposed to wider risks associated with late delivery.

3.28. Other stakeholders raised concerns with our approach.

3.29. Electricity North West said it was concerned at the suggestion that networks could be held to account for the wider consequences of delays in a way that was not envisaged at the price control nor in the licence.

3.30. Electricity North West considered that the only circumstance that justified such an adjustment to the price control is the company being under financial distress.

3.31. Similarly, Northern Powergrid did not support our proposed approach as it considered that the threshold for re-opening the price control had not been met and that re-opening the price control risks undermining investor confidence. Northern Powergrid also said that it is not clear how strong the perverse incentive is and notes that this is not considered a strong enough reason to adjust SP Transmission's connections volume driver.

3.32. Western Power Distribution considered that re-profiling allowances should be reserved for projects where this type of adjustment has been signalled at the start of a price control and should only apply to a small number of very high value projects. It said that our proposed approach is an 'un-signalled' change which increases risks for licensees.

3.33. Western Power Distribution and Wales & West Utilities said if we extend the principle of re-profiling allowances in other projects, we should be symmetric so that if projects are delivered early, we should shift allowances forward. Similarly, Northern Gas Networks noted that consumers' interests can also be served by bringing forward or escalating allowances, where appropriate, to deliver outputs and outcomes early.

3.34. The Energy Networks Association said that it wasn't clear whether delaying allowances is appropriate in this case. It considered that as a principle any necessary adjustments should be applied through the totex incentive mechanism, but recognised in the particular circumstances of the Western HVDC link that the totex incentive mechanism may not adequately deal with the timing variation.

Stakeholder views on the method to delay allowances

3.35. Only the affected companies responded to this question, both suggesting that the timing difference is best addressed by adjusting the allowance profile to reflect actual spend rather than a simple shifting of allowances.

Stakeholder views on the treatment of damages

3.36. NGET, SP Transmission, Wales & West Utilities, Electricity North West and the Energy Networks Association all considered that any payments received from the suppliers should be shared with consumers through the totex incentive mechanism. This was to ensure there were incentives for companies to include compensatory conditions in contractual arrangements and to pursue compensation.

3.37. In contrast, Citizens Advice said that it is appropriate that any damages that the companies receive be passed directly through to consumers to provide some amelioration of the increased constraint costs to consumers.

Stakeholder views on information requirements

3.38. NGET committed to providing the information requested within three months of project commissioning, while SP Transmission said it is looking forward to working with us to develop the required detail further.

3.39. Citizens Advice said we should fully review the reasons for this delay and, if they are not adequately explained, we should consider enforcement action including redress payments.

Our decision

Delaying allowances

3.40. After considering each of the responses, our decision is to maintain our approach to delay allowances to remove the timing benefit, as this best protects consumers. This removes a gap in the price control where companies receive a benefit derived from delivering an output late, which has resulted in a detriment to consumers, in this case through higher constraint costs.

3.41. We disagree with Electricity North West's view that by delaying the allowances, we are holding the companies to account for the wider consequences of delay. We have outlined an approach to hold the companies to account for delivering an output to a specified time in return for the revenue set (ie re-profile allowances to match actual spend). We think it is appropriate to shift allowances for the Western HVDC link as the output has not been delivered on time, which is not in consumers' interests.

3.42. We do not agree with Electricity North West's view that we should adjust a price control only when licensees face unacceptable financial deterioration or Northern Powergrid's position that we should apply a higher threshold. We think the appropriate test is whether making the adjustment protects consumers, in line with our principal objective. In this case, we think consumers are best protected by re-profiling allowances to reflect the late delivery of an output. The benefit to consumers from delaying allowances outweighs other considerations.

3.43. We do not agree with Northern Powergrid that this decision is inconsistent with our decision on SP Transmission's connections driver. As Northern Powergrid recognise, the perverse incentive was only one part of our decision, which was mainly driven by our desire to appropriately protect consumers.

3.44. Nevertheless, we think that the perverse incentives are also different. In the case of the Western HVDC link the perverse incentive is to deliver outputs late, causing consumer detriment, as it potentially causes the companies a financial gain. However, in relation to SP Transmission's connection volume driver, the perverse incentive is to build inefficient solutions included in the driver as they receive an allowance, rather than efficient assets. Our decision on SP Transmission's connections driver sets out the other incentives in place that would discourage SP Transmission from acting inefficiently despite the potential perverse incentive (see paragraphs 3.134 to 3.140). We also considered the impact of providing additional allowances on the incentives all network companies face to prepare well-justified business plans and minimise long-term costs (paragraph 3.117).

3.45. Western Power Distribution and Wales & West Utilities both stated that companies should be rewarded for delivering outputs early, for symmetry. The MPR parallel work has not considered general policy changes to RIIO 1 and we think it is appropriate that these are left out of scope.

3.46. We do not agree with the Energy Networks Association that the totex incentive mechanism adequately shares the benefit of the delay in this case. We do not think it is appropriate in this circumstance for the companies to share the benefit when an output is being delivered late and where this is to the detriment of consumers.

Method of delay and treatment of damages

3.47. We will make our decision on the method of delaying allowances and the consideration of liquidated damages once we receive, and consider, SP Transmission and NGET's submission on the delay. We will consult stakeholders further on our proposed approach in due course.

Reporting requirements

3.48. We will require the joint venture between SP Transmission and NGET to submit a report detailing the circumstances surrounding the delay. The information we require is listed in appendix 1.

London medium pressure

3.49. Cadent (formerly National Grid Gas Distribution) is funded to remove or abandon medium pressure iron mains in London. Removing these iron mains will make the gas network more safe and reliable.

3.50. Cadent now reports that the majority of planned medium pressure work cannot go ahead due to a combination of engineering and stakeholder challenges. Cadent intends to undertake the remaining work in future price controls.

3.51. Cadent has offered to return £53.9 million in funding for the work that will no longer be undertaken in RIIO-GD1.

3.52. We have decided to accept Cadent's proposal to ensure that consumers do not fund Cadent for the same work twice.

Background

3.53. Cadent provided evidence in its business plan that it would be economic and efficient for some of the medium pressure iron gas mains in London to be abandoned. These old mains are up to 150 years old and contribute to gas leakage.[15]

3.54. We provided Cadent with an allowance of £93 million to reduce the risk related to 69 km of medium pressure iron mains in RIIO-GD1.

3.55. Cadent has since identified that it will not be possible to complete all of the work funded during RIIO-GD1. It now considers that it can only abandon 29 km in RIIO-GD1. It plans to complete the remaining work in future price controls.

3.56. Cadent offered to return £53.9 million in allowances, which is proportional (per km) to the length of mains not being replaced.

[15] This work is in addition to work mandated by the Health and Safety Executive to abandon smaller mains with diameters up to eight inches (Tier 1).

Our consultation position

3.57. We proposed to accept Cadent's offer to refund £53.9 million to consumers and lower the combined lengths target by 40 km.

3.58. As Cadent will not be able to deliver the work funded, we thought it would be appropriate that the allowances are returned to consumers. This is to ensure that consumers do not fund Cadent twice for the same work.

3.59. We also considered an alternative option of not accepting Cadent's proposed refund. To ensure consumers do not double fund Cadent, this approach would also not provide any further funding for Cadent in future price controls.

3.60. We thought accepting Cadent's proposal now was the best option for two reasons. First, it would ensure that Cadent does not benefit from a timing gain where funding is provided well in advance of when the work will occur. Second, there is no methodology in place for setting allowances for future price controls. Accordingly, we cannot be certain that the method used to set allowances will not double fund Cadent.

3.61. We asked for stakeholders' views on whether they agree that we should accept Cadent's proposal to return the £53.9 million.

Responses

3.62. Nine respondents commented on this issue, of which seven agreed with our proposals (Citizen's Advice, Wales & West Utilities, Northern Gas Networks, SGN, Northern Power Grid, Cadent and the Energy Network Association).

3.63. Western Power Distribution broadly agreed with our approach but questioned the quality of Cadent's business plan and how the refund would interact with incentive mechanisms, such as the Information Quality Incentive (IQI).[16]

3.64. British Gas disagreed with our proposal and stated that the proposed refund is too low because the unit cost for the deferred work is more complex and, therefore, more expensive. British Gas also considered that this is non-delivery that should incur a penalty. It also said that any funding in the next price control should be capped at the level of this refund.

Our decision

3.65. We have decided to proceed with our proposed approach and accept Cadent's £53.9 million refund to consumers and reduce the combined lengths

[16] The Information Quality Incentive rewards network companies that submit forecast costs that aligned with our assessment of efficient costs.

target by 40km. Our decision will ensure that consumers do not fund Cadent for the same work twice.

3.66. We acknowledge Western Power Distribution's comment about the interaction with incentives such as the IQI. However, we consider that changing key financial parameters such as this is out of the scope of this parallel work, as it was for the MPR. Moreover, we think that considering interactions with the IQI would be inconsistent with our general approach when we adjust allowances, for instance with reopeners etc.

3.67. We also acknowledge British Gas' comments. However, we consider that:

- The value of the refund is appropriate as it is consistent with the unit rate used in Final Proposals.
- There are no non-delivery penalties associated with the delivery of the London medium pressure work.
- It is more appropriate to consider the level of funding provided in the next price control as part of the process of setting that price control.

3.68. We will not be reducing Cadent's target for reducing risk on their network and expect them to meet this safety requirement. Safety issues are ultimately regulated by the HSE and Cadent will still be obligated to meet these requirements.

3.69. The relevant adjustments to the Price Control Financial Model (PCFM) will be the subject of a statutory consultation.

Connections volume driver

3.70. We included uncertainty mechanisms in RIIO-T1 to adjust revenue allowances for unforeseen circumstances. One type of uncertainty mechanism is a volume driver: a provision that automatically adjusts allowed revenue as a volume measure varies (eg number of new connections).

3.71. SP Transmission's licence includes a connections volume driver that funds connections based on the specific assets installed from a menu in its licence.[17] The connections volume driver provides no allowances for assets not on the menu.

3.72. SP Transmission requested we change the volume driver by adding new assets to its menu. This change would provide allowances for these new assets, which SP Transmission considered are required to deliver technically justified and cost-efficient design solutions. SP Transmission considers that these new assets

[17] Special Condition 6F.

should be added because there is a greater number of connections in different locations than originally envisaged.

3.73. We have decided not to make the proposed changes. We think SP Transmission's request would provide additional funding where it expects to spend more than the allowance while allowing it to retain benefits elsewhere where costs are less than the allowance. In addition to being unfair to consumers, these changes would dampen the central incentives in RIIO for licensees to develop well-justified business plans, take responsibility for managing the uncertainty that their businesses face, and proactively seek the best way to provide network services.

Background

3.74. SP Transmission is required, subject to certain conditions, to connect generators to the transmission network.[18]

3.75. The price control provides funding to connect generators. There are separate mechanisms to address the delivery of sole-use assets (which are for the use of a single customer) and another for the delivery of shared use infrastructure (shared by other users).

3.76. SP Transmission has a £112 million allowance to connect 1,073 MVA[19] of shared-use generation connection capacity. For connections above this threshold, a 'connections volume driver' provides additional allowances based on the assets used to make a connection. The assets and the allowance for each asset is listed in a menu within SP Transmission's licence.

3.77. SP Transmission originally forecast to deliver 1,073 MVA of shared-use generation connections capacity over RIIO-T1. It now forecasts to deliver 4,229 MVA. Much of this increase is in concentrated areas. For example, in the Coalburn/Linmill area, over 800 MW is contracted to connect compared to the 70MW originally forecast.

3.78. SP Transmission reported that due to the change in location and quantity of connections different types of assets will be required, for example increasing the capacity of existing lines rather than building new ones. These assets are not included in the current connections volume driver so SP Transmission will receive no allowances if it installs these assets. Although no allowances will be provided, SP Transmission will receive funding for 50% of costs incurred through the totex incentive mechanism.

3.79. SP Transmission has requested that we add the new asset solutions to the shared-use connections volume driver mechanism. This change will allow the mechanism to provide allowances for deploying assets not currently included in the licence menu.

[18] Transmission Licence Standard Condition D4A.
[19] MVA (megavolt amperes) measure the total capacity of the connections.

3.80. SP Transmission forecasts that adding these assets to the connections volume driver would increase its allowance by £81 million.[20]

3.81. SP Transmission also put forward an alternative proposal to fund each new asset installed based on the unit costs for its closest equivalent asset already included in the volume driver menu.

Our consultation position

3.82. We proposed not to accept SP Transmission's request.

3.83. We recognised that SP Transmission may need to spend more than the allowance the connections volume driver provides. However, we considered this is no different from SP Transmission being required to spend more than what a fixed allowance provides. We saw this risk as being similar to SP Transmission needing to do additional work it did not foresee or the scope of a project expanding, resulting in an additional cost. SP Transmission bears this risk in a price control settlement, although some of this risk is shared with consumers through the totex incentive mechanism.[21]

3.84. We considered that if we make no changes in areas where SP Transmission expects to spend less that the allowance provided we should also make no changes in areas where SP Transmission expects to spend more than the allowance. To do otherwise would be asymmetric and unfair to consumers. It would leave the risk of higher costs solely on consumers while allowing SP Transmission to benefit from lower costs where they arise.

3.85. We also did not think that SP Transmission's alternative proposal, to provide funding for the nearest asset options, would be in consumers' interests. This creates the same problems as adding new asset solutions to the volume driver as it provides additional funding not envisaged when the price control was set. It was also not clear to us how the approach could work. We did not think this could be implemented without a licence change.

3.86. We asked stakeholders whether they agreed with our proposed approach not to amend SP Transmission's connection volume driver.

Responses

3.87. We received seven responses. Four respondents agreed with our proposal and two did not. One respondent thought it needed more detail to reach a view.

[20] £81 million is SP Transmission's forecast of the increase in allowances if there is a licence change.
[21] Under the totex incentive mechanism, SP Transmission shares the cost difference between allowances and actual costs with consumers. If costs are lower than forecast SP Transmission retains 50%. Similarly, if costs are higher it incurs 50% of the additional cost.

3.88. Citizens Advice, British Gas, Wales & West Utilities and Northern Powergrid all supported our approach. British Gas considered that SP Transmission's proposal would weaken the incentives on network operators to efficiently manage expenditure allowances. Wales & West Utilities said it supported a symmetrical approach to the application of allowances. Northern Powergrid said that our proposed approach is fully aligned with the principles in the RIIO handbook and is, therefore, appropriate.

3.89. The Energy Networks Association said that it is difficult to reach a clear position on our proposal not to amend the connections volume driver. It said that economic and efficient allowances should be provided for necessary additional outputs, with potential for innovation recognised.

3.90. The Energy Networks Association also said that the information provided in the February consultation seemed very limited. It suggested that we consider setting out the background to the question in greater detail with a comparable degree of analysis.

3.91. Northern Gas Networks did not support our approach. It said while the level of detail made it difficult to fully understand the complexities, the issues faced by SP Transmission would seem to be one of the volume driver being both incorrectly specified and ineffective at managing the uncertainty and risk. It said our proposal seems to be a reversal of our position that these risks cannot be fully allocated to SP Transmission.

3.92. SP Transmission considered our proposed approach is in conflict with RIIO principles and our general duties under the Electricity Act 1989.[22] Of the concerns it raised, we have identified two main ones.

3.93. First, SP Transmission considered that our proposal conflicts with the policy intent of the connections revenue driver.

3.94. SP Transmission considered the purpose of the connections volume driver was to flex revenues to ensure that it was protected from uncertain events beyond its control.[23] Specifically, the connections volume driver accommodates customer driven changes to the volume and location of customer-driven generator connections.[24]

3.95. SP Transmission said that we had not intended to limit it to the options listed in its licence.[25] SP Transmission considers that as it has identified other options

[22] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.1
[23] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.2
[24] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.2
[25] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.14

which are more economic and efficient, it is reasonable and in consumers' interests, for its licence to be amended.[26]

3.96. Secondly, SP Transmission said that our approach did not recognise that it is delivering (what it considers to be) additional outputs and accordingly it is necessary that we provide additional allowances.[27]

3.97. SP Transmission stated "...the existing mechanism's express purpose is to provide allowed expenditure for additional shared use infrastructure capacity, an uncertain output..."[28]

3.98. SP Transmission considered that it is capacity delivered (which in its view is an output) which determines allowances, rather than the solutions adopted.[29] SP Transmission pointed to Special Licence condition 6F.12 which it considers "…proves the argument that this is a volume driver mechanism based on additional capacity calculated in MVA above the baseline threshold of 1073MVA."[30]

3.99. SP Transmission also raised other concerns, including that:

1. Our approach undermines innovation and efficiency.[31]

2. Our approach is inconsistent with:

    a. Our proposal to resolve ambiguity with NGGT's compressor output, where we focus on the output's purpose rather than asset specifics (discussed in paragraphs 2.8 to 2.31).[32]

    b. Previous changes to SP Transmission's licence regarding Special Licence condition 6H (Arrangements for the recovery of uncertain costs) and Special Licence Condition 3D (Stakeholder Satisfaction Output). [33]

3. Our consultation is misleading[34] and we misunderstood and misrepresented its proposal.[35]

4. We incorrectly assert that funding additional assets is an overspend.[36]

[26] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.14
[27] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p. 9
[28] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.9
[29] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.11
[30] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.11
[31] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.12
[32] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.13
[33] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.14
[34] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.3
[35] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.6

5. Our approach creates a paradox as SP Transmission cannot deploy more efficient solutions (as it is not funded) or the solutions included in the connections volume driver, as it has identified more efficient alternatives.[37]

Our decision

3.100. We have decided to maintain our proposed approach. We will not amend SP Transmission's connection volume driver and will not provide any additional allowances.

3.101. We have made this decision as we think making the change would be asymmetric and unfair to consumers. SP Transmission's request would provide additional allowances while allowing it to benefit elsewhere where it underspends.[38]

3.102. Amending the revenue driver would provide additional funding beyond what was set out and agreed in the price control settlement. It would also insulate SP Transmission from the risk of higher than forecast costs (where costs exceed allowances) while leaving consumers exposed to the risk that they pay above efficient costs (where allowances exceed costs).

3.103. In addition to being unfair to consumers, we think SP Transmission's request acts against consumers' long-term interests. Insulating companies from risk undermines the central incentives in RIIO for companies to develop well-justified business plans and to minimise long-term costs.

3.104. Although we acknowledge that the connections volume driver creates an incentive for SP Transmission to act inefficiently, we think there are sufficient mechanisms to protect consumers if this occurs. We also think there are incentives (the timely connections incentive, the stakeholder engagement incentive and the environmental discretionary reward) which will encourage SP Transmission to act in the long term interests of consumers.

Our approach does not conflict with the policy intent of price control

3.105. RIIO is an upfront, or ex ante, price control that sets the outputs that network companies are required to deliver, and the revenue they are able to earn for delivering these outputs efficiently.[39]

3.106. RIIO price controls are set based on forecasts of a range of factors such as output requirements, demand and cost of delivery. There is always a possibility that

[36] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.11
[37] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.13
[38] As outlined in our 2015-16 RIIO-ET1 annual report, SP Transmission forecast to spend £113 million less than their allowance (£2015/16) over the 2013-2021 period. We understand that this forecast assumed that we would accept their proposed changes to the connections volume driver.
[39] Ofgem 2010, *Handbook for implementing the RIIO model*, p.3

the revenue set could be higher or lower than necessary to cover the costs of providing network services.[40]

3.107. RIIO does not insulate companies from the risk of higher costs than provided. Rather, we designed RIIO so that it encourages companies to 'play a full role.' This means, in part, taking responsibility for managing the uncertainty that their businesses face.[41] Under RIIO, we expect network companies to bear their own business risk.[42]

3.108. The RIIO model does allow a limited number of uncertainty mechanisms to ensure that efficient delivery is financeable and long-term value for money is delivered.[43]

3.109. For the transmission price control, we decided to include volume drivers as an uncertainty mechanism. We provided guidance on what the companies should consider:[44]

> *We ask that TOs include, in their business plans, the forecast baseline for these costs and proposals for the values of volume drivers. … The volume drivers may be differentiated according to different types of connections projects. … If a TO considers that volume drivers will not be sufficient, it should include proposals in its business plan for additional uncertainty mechanisms, taking account of the suggestions we have made for potential high cost connections projects.*

3.110. SP Transmission proposed an asset-based connections volume driver based on a menu of assets for shared-use connections, which we accepted.[45] It did not propose, and we did not include, any additional uncertainty mechanisms to amend the connections volume driver.

3.111. SP Transmission was best placed to assess the forecasting risks and propose the approach it considered preferable. It was up to SP Transmission to develop an uncertainty mechanism that worked to address the risk it identified.

3.112. We acknowledge that circumstances have changed. SP Transmission now thinks the most economic and efficient solutions required are not listed in the menu of assets. Consequently, the allowance provided will be less than the efficient costs required to economically and efficiently build shared-use infrastructure. However,

[40] Ofgem 2010, *Handbook for implementing the RIIO model*, para 11.1
[41] Ofgem 2010, *Handbook for implementing the RIIO model*, para 1.10
[42] Ofgem 2010, *Handbook for implementing the RIIO model*, para 11.3
[43] Ofgem 2010, *Handbook for implementing the RIIO model*, para 11.3
[44] Ofgem 2011, *Decision on strategy for the next transmission and gas distribution price controls RIIO-T1 and GD1 Uncertainty mechanisms, para 6.7 and 6.11*
[45] Ofgem 2012, *RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd, Final decision – Supporting document,* para 6.27

consistent with the overarching RIIO framework SP Transmission should bear this risk.[46]

3.113. We expect SP Transmission to be able to finance the works it has identified are needed to meet its obligation to develop and maintain an efficient, co-ordinated and economical system of electricity transmission.

3.114. At the time of the price control we identified, under a range of stress tests, that SP Transmission could expect a return on regulated equity between 3.7% and 10.7%, around the baseline return on equity of 7%.[47] SP Transmission agreed that the proposed financial package was appropriate for its circumstances and presented a fair balance of risk and reward. SP Transmission also noted that its own analysis had produced a slightly greater overall risk range.[48]

3.115. We expect that if SP Transmission builds the assets required to deliver the economic and efficient solutions, it will earn a return on regulated equity of 9.2%. This is higher than the baseline return on equity we set and towards the upper end of the range we identified.

3.116. Our decision reinforces the currently regulatory framework and is not, as SP Transmission has suggested, a regressive departure.[49] It maintains the risk allocation determined at the price control settlement.

3.117. The alternative, amending the connections volume driver, shifts risk from network companies to consumers and undermines the central incentives in RIIO. It reduces the incentive for companies to invest time and prepare well-justified business plans as risks can be transferred to consumers.

3.118. Accepting the proposed change would signal to network companies that we will reward them for identifying unforeseen changes in circumstances and justifying increases in funding. This would encourage all network companies to shift their focus towards engaging us rather than delivering long-term value to consumers.

SP Transmission is not delivering additional outputs

3.119. We do not agree with SP Transmission's view that it is delivering additional outputs and that it is, therefore, necessary to provide additional allowances.

3.120. Outputs set out what network companies must deliver in return for the revenue set. They ensure companies focus on long-term value and do not deliver

[46] Under the totex incentive mechanism, SP Transmission will only incur 50% of the cost above the allowance provided.
[47] Ofgem 2012, *RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd, Final decision – Overview document,* p.18
[48] Ofgem 2012, *RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd,* Para 5.21 & 5.23
[49] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.2

unsatisfactory consumers outcomes by compromising on delivery. For instance, network companies could reduce investment (such as by reducing replacement expenditure) in a way that wouldn't be perceivable but could result in higher costs in the future.[50]

3.121. We included three connections-related outputs in SP Transmission's price control, as set out in Table 1. As noted in paragraph 3.137, GEMA may also take enforcement action if we consider SP Transmission is not meeting its regulatory obligations.

Table 1. SP Transmission's connection-related outputs

Output	What it means
An output to meet existing legal requirements for connections.[51]	If SP Transmission doesn't meet the timing requirements in its licence it can be penalised by up to 0.5% of revenue.
An output for baseline shared-use capacity of 1,073MVA.[52]	SP Transmission is required to connect 1,073 MVA of connections in return for the baseline allowance of £112m
An output for each asset included in the shared-use volume driver schedule of costs.[53] For instance, a 400kv 132kv substation has a unit cost of £23.412 million and an output of 460 MVA.	For SP Transmission to receive an allowance for each item in the menu the asset must deliver the additional capacity specified. These capacities are for individual assets rather than the capacity of the new generation infrastructure overall.

3.122. We do not think that SP Transmission is delivering 'more' or 'additional' outputs. SP Transmission is required to connect generators who accept reasonable terms, which forms part of the first output listed in Table 1.

3.123. Nowhere does SP Transmission's licence or our final proposals specify generation connection capacity above the 1,073 MVA to be an output.

[50] See CEPA 2009, *The use of RPI-X by other network industry regulators,* p.28 and Ofgem 2010, *Handbook for implementing the RIIO model*, para 1.10
[51] Ofgem 2012, *RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd,* SPTL p.15, Table 1
[52] See the summary table of uncertainty mechanisms (Ofgem 2012, *RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd,* SPTL p.19, Table 4) and in the final proposal supporting document (Ofgem 2012, *RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd,* Supporting document, para 6.3, 6.26, 6.33, 6.34)
[53] Ofgem 2012, *RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd,* Supporting document, p.48, Table 6.2

3.124. The connections volume driver does not calculate outputs. It is an uncertainty mechanism that provides additional allowances for connections above the 1,073MVA threshold.

3.125. SP Transmission points to the 'Dflag' in Special Licence Condition 6F.12 and 6F.14 as evidence that generation connection capacity above this level is an output. We do not agree.

3.126. The Dflag is part of the algebra used to calculate the allowances. It specifically deals with how allowances will be adjusted when SP Transmission crosses the 1,073 MVA threshold.

3.127. The Dflag ensures that the connections volume driver provides no allowances before the 1,073MVA threshold is exceeded.

3.128. In the year the threshold is crossed, allowances are provided by both the baseline allowance and by the connections volume driver. The Dflag works out what proportion of the connections were above the threshold and moderates the allowance provided by the connections volume driver. For instance if 30% of the connections fell below the threshold, it reduces the allowance provided by the connections volume driver by 30%.

Other concerns raised by SP Transmission

3.129. SP Transmission also raised other concerns, which we address in turn.

3.130. Firstly, SP Transmission said that our approach undermines innovation and efficiency.

3.131. SP Transmission said that our approach would prevent the deployment of more efficient solutions such as the high temperature low sag lines and wooden poles. It also said that our decision puts it in an untenable position to deploy solutions that may not be the most efficient, or to delay works until they are 'appropriately funded.'

3.132. We recognise that this particular connections volume driver creates an incentive for SP Transmission to use solutions included in the licence. This is because SP Transmission receives an allowance for solutions on the menu but none for those not included.

3.133. We also acknowledge that SP Transmission has identified solutions that are more efficient and brought this issue to our attention.

3.134. However, we do not agree that our approach undermines innovation and efficiency. There are a number of mechanisms in the regulatory framework that discourage SP Transmission from acting inefficiently.

3.135. If SP Transmission delivers inefficient solutions, we can take action to ensure consumers are not exposed to the additional costs. If SP Transmission uses assets included in the connection volume driver when the economic and efficient thing to do would have been to use other options, we will remove any inefficient expenditure from the totex incentive mechanism and any allowances triggered. This will ensure that SP Transmission cannot financially gain from delivering inefficient solutions.

3.136. If SP Transmission seeks to unreasonably delay connections or offer unreasonable terms, generators can raise a dispute with us, which we will determine, based on the facts of the case.

3.137. Complementing these processes is the ability of GEMA (the relevant decision-making body to whom Ofgem works) to take enforcement action if we consider that SP Transmission is not meeting its regulatory obligations.

3.138. There are additional incentives to encourage SP Transmission to act efficiently and economically.

3.139. If SP Transmission delays connections or seeks to connect generators using inefficient solutions this could lessen the financial rewards provided to SP Transmission through the following mechanisms:

1. The timely connections incentive. If SP Transmission fails to meet the timing requirements in its licence, it can suffer a penalty of up to 0.5% of revenue per year.

2. The Stakeholder Engagement Incentive. SP Transmission is eligible for an annual reward of up to 0.5% of revenue based on an assessment of activities, but needs to demonstrate it is acting on input/feedback from stakeholders.

3. The stakeholder satisfaction output. This provides a financial penalty or reward of up to 1% of annual revenue, based on the results of a stakeholder satisfaction survey.

4. The Environmental Discretionary Reward. Components of the reward, worth up to £6m per year, include demonstrating a strategic understanding and commitment to low carbon objectives and connections for low-carbon generators.

3.140. Our Innovation Rollout Mechanism also allows SP Transmission to apply for an adjustment to its revenues for the delivery of innovative solutions. Funding will be available in the second window for proven innovations that meet the specified criteria.

3.141. More broadly, we note that the incentive to deploy specific types of solutions is driven by the asset-based nature of SP Transmission's connection volume driver.

Other funding mechanisms do not provide such strong incentives to use specific solutions. Rather they provide an incentive for companies to identify lower cost ways of delivering consumer value. For instance, the revenue drivers in place for other Transmission Owners and for SP Transmission's sole-use generation connections provides funding per unit of capacity connected regardless of assets used. If the network companies can identify cheaper ways of providing a connection, they retain a proportion of the cost reduction.

3.142. Secondly, SP Transmission said our approach is inconsistent with:

1. Our approach to resolve ambiguity with NGGT's compressor output (discussed in paragraphs 2.8 to 2.31).[54]

2. Previous changes to SP Transmission's licence regarding Special Licence condition 6H (Arrangements for the recovery of uncertain costs) and Special Licence Condition 3D (Stakeholder Satisfaction Output).

3.143. We consider that each of these issues is different. None of these cases relate to amending the price control to provide additional allowances.

3.144. With NGGT's compressor output, we sought to resolve how we would hold the company to account given the output was ambiguous as it included both an overall purpose and how it should be achieved. As outlined in the output accountability section, we decided to focus on the output's purpose.

3.145. The issues associated with our decision on output accountability are different to SP Transmission's request to amend its connections volume driver. We did not decide to amend any associated allowances in a way that was not envisaged when the price control was set.

3.146. Although the issues are different, we consider our approach for revenue drivers is consistent with our approach to accountability. We intend to hold SP Transmission to account for delivering its output to connect network users and we are not making any change to the allowances provided.

3.147. We also think that the rationale for making the two license changes that SP Transmission highlights are different:

1. The change to Special Condition 6H was to implement the price control as decided in the Final Proposals (an element was earlier inadvertently omitted).[55]

[54] SP Transmission 2017, *Response to consultation on Mid-Period Review parallel works,* p.13
[55] Ofgem 2013, *Modification of special conditions 6H and 1A of the electricity transmission licence held by SP Transmission Ltd and reasons for decisions pursuant to sections 11A and 49A of the Electricity Act 1989*, para 6

2. The change to Special Condition 3D was made to finalise an element of the price control that was not complete when it was set.

   The licence change set the values used to calculate financial rewards or penalties under the stakeholder satisfaction output arrangements. The licence change was made after the start of the price control as we did not have sufficient information to define all the parameters of the incentive at the outset and instead set a provision to subsequently determine the values.[56]

3.148. Thirdly, SP Transmission considered that our February consultation was misleading and that we misunderstood and misrepresented its proposal. We disagree. We consider that we outlined SP Transmission's request fairly in our consultation. We also published SP Transmission's submissions, which framed its request in its own words.

3.149. Fourthly, SP Transmission said we incorrectly asserted that funding additional assets is an overspend. An overspend occurs when a company spends more than an allowance that has been set. When we said 'overspend' in our consultation we simply meant that SP Transmission is forecasting to spend more than its allowance in this area. An overspend (or indeed an underspend) does not imply that the expenditure incurred is inefficient or otherwise.

3.150. Lastly, SP Transmission said that our approach creates a paradox as it can deploy neither the more efficient solutions (as it is not funded) nor the solutions included in the connections volume driver, as it has identified more efficient alternatives.

3.151. We do not think there is any paradox to resolve. SP Transmission is required to develop and maintain an efficient, co-ordinated and economic system of electricity transmission. This means it is required to deploy the economic and efficient solution to connect generation regardless of whether specific provision is included within the price control. Our decision does not limit the amount of capacity SP Transmission can deliver; it maintains the revenue that SP Transmission can recover in line with the price control settlement.

Information provided in the February consultation

3.152. We note the Energy Networks Association's view that the information provided in the February consultation document was limited and its suggestion that we set out the background to the question in greater detail. We believe we provided sufficient information to enable respondents to provide a view. We also published the two letters sent to us by SP Transmission, a member of the Energy Networks Association, which set out its proposal and the relevant background.

[56] Ofgem 2016, *RIIO-T1: Consultation on values within the stakeholder satisfaction output arrangements,* p.8

NTS exit capacity incentive

3.153. The NTS exit capacity incentive scheme is a mechanism included in the RIIO-GD1 price control to encourage Gas Distribution Network companies (GDNs) to efficiently book exit capacity from the NTS.

3.154. The scheme rewards GDNs for reducing capacity bookings. Reducing capacity at the points with the highest forecast exit charges provides the greatest financial rewards.

3.155. British Gas responded to our November 2015 MPR consultation raising a number of concerns about the scheme. In particular, it said that the scheme is flawed as it encourages perverse behaviour that could increase costs for consumers.

3.156. We have decided not to make any changes to the scheme. Overall, we think the incentive scheme is encouraging the desired behaviour and will lead to lower costs for consumers in the long term.

3.157. We acknowledge that the scheme has weaknesses. However, we think the risks from making changes to the scheme now outweigh any benefits. Making changes now could damage regulatory confidence and increase costs to consumers in the longer term.

Background

3.158. GDNs book capacity at NTS exit points to meet demand from end users on their network. Each exit point has a capacity charge associated with it, determined by NGGT in accordance with its charging methodology.

3.159. Exit capacity costs incurred by GDNs are passed through to shippers as part of GDNs' own transportation charges. This means that GDNs are not exposed to higher or lower costs and do not gain financially from managing these costs efficiently.

3.160. The NTS exit capacity incentive was introduced to encourage GDNs to efficiently book capacity. The scheme rewards GDNs for using less capacity at an exit point relative to a baseline. The reward is based on the forecast charge at that exit point published three years ahead by NGGT. The higher the forecast price at a point, the greater the reward. For each GDN, the total reward each year is determined by aggregating rewards or penalties across all exit points connecting to their network.

3.161. We think the incentive scheme has led to the right behaviour so far, in that it encourages GDNs to reduce exit capacity bookings at the most expensive exit points. Aggregate exit capacity use (across all GDNs) has reduced from 4,454 GWh/d in 2013-14 to 4,242 GWh/d in 2015-16.

3.162. British Gas responded to our November 2015 MPR consultation raising a number of concerns about the scheme. In particular, it said that:

- The scheme gives "incentives to book capacity at more expensive offtake points", because forecast prices may not be aligned with actual prices.
- GDNs are "benefitting through the incentive" by switching from flat capacity (which is covered by the incentive) to flexibility capacity (which is outside the scope of the incentive).[57]
- The incentive rates are too high because NGGT's forecast prices have been higher than out-turn prices. This means that incentive rewards have been higher than the cost savings achieved by the GDNs through lower capacity bookings in the short term.
- Baseline capacity targets used to calculate incentive rewards were too lenient, ie too high.

Our consultation position

3.163. We considered British Gas' concerns and acknowledged that the scheme could potentially be improved. However, having considered the concerns and addressed each in turn in the February consultation, we proposed that we should not change the scheme at this stage.

3.164. While the incentive scheme has worked as intended so far, we acknowledged that there are risks going forward. However, on balance, we thought that the risks from changing or stopping the scheme before the end of the current price control period outweighed any potential benefits.

3.165. We asked stakeholders whether they agreed that we should not make changes to the NTS exit capacity incentive.

Responses

3.166. Eight of the 13 respondents commented on this question. Six were in agreement with our proposal (Northern Gas Networks, SGN, Northern Powergrid, Energy Networks Association, Cadent and Wales & West Utilities).

3.167. Although in agreement, Wales & West Utilities used the opportunity to raise wider concerns over the NTS charging regime. Northern Gas Networks would also welcome a review of transmission charging arrangements.

[57] Unlike flat capacity, flexibility capacity is not guaranteed to be available when it is needed.

3.168. British Gas, who originally raised the concerns over the scheme, reiterated the cost to consumers, but did not raise any additional concerns. It also stated its expectation of a full review for RIIO GD2.

3.169. Citizens Advice disagreed with our proposal, stating that we cannot justify continuing with an incentive scheme that costs more than it saves consumers. It said that if we adopted a principle to adjust incentive schemes that were costing more than they were saving, it need not lead to uncertainty.

Our decision

3.170. We have decided to maintain our proposed approach to make no change to the incentive mechanism.

3.171. Although we acknowledge Citizens Advice's concerns, we do not consider that this short-term cost reflects the long-term impact of the incentive. As outlined in the February consultation, there are a number of risks from changing or stopping the scheme mid-period:

- Any change that leads to lower or no rewards could weaken the incentive for capacity reductions. GDNs may then take a risk-averse approach to meeting their 1-in-20 supply obligations by increasing their exit capacity bookings. This could increase costs to consumers in the short term through higher exit capacity charges and in the longer term through additional investment triggered on the NTS.

- Changing an incentive scheme mid-period could lead to uncertainty about other schemes (across all RIIO sectors) and may have an impact on financing costs. This could adversely affect consumers.

3.172. On balance, we think that the risks from changing or stopping the scheme before the end of the current price control period outweigh any potential benefits.

3.173. In regards to Wales & West Utilities' comments on the issues with the current NTS charging regime, we do not consider it appropriate to address this as part of MPR parallel work.

Gas distribution outputs

3.174. In our May 2016 decision document on the scope of the MPR, we said we would look at several gas distribution outputs. In particular, the:

- **Safety (repair risk) output,** which measures the risk of gas escapes that do not warrant emergency action.

- **Reliability (loss of supply) output**, which measures the number and duration of planned and unplanned interruptions.

- **Reliability (maintaining operational performance) output**, which is composed of several leading indicators of operational performance.

3.175. These outputs have no directly linked allowances (aside from one part of the reliability (maintaining operational performance) output), are not part of any incentive schemes and the level of performance required is not specified in licences.

3.176. Instead, there are reputational incentives. We measure and report performance in our annual reports. We also use these metrics to identify whether we need to investigate network company performance in more detail.

3.177. We considered whether we should improve how we hold companies to account for delivering these outputs, such as including the outputs in the licence or changing targets.

3.178. We have decided that current arrangements are generally working to achieve their policy objectives. However, we will be amending the targets for the reliability (loss of supply) output. We believe this will improve arrangements as current targets may lead to a deterioration in performance over the remainder of RIIO-GD1.

3.179. We will continue to monitor these outputs for the remainder of RIIO-GD1 and require companies to justify where they fail to meet these outputs. We will expect them to improve and, where appropriate, to make redress to consumers.

Safety (repair risk)

Background

3.180. Repair risk measures the safety risk presented by gas escapes that are individually assessed as not warranting emergency action. The repair risk output requires GDNs to maintain, as a minimum, their 2012-13 repair risk score. The repair risk metric takes into account factors such as proximity to buildings and duration of the escape. Cadent initially developed the output as a management tool to prioritise gas escapes that did not present a high safety risk but still needed repair. Safety aspects of gas escapes are subject to the Gas Safety (Management) Regulations 1996, enforced by the Health and Safety Executive.

3.181. Three of Cadent's gas distribution networks (London, North West and West Midlands) failed to meet this output in two consecutive years: 2013-14 and 2014-15. In March 2016, Cadent (then National Grid Gas Distribution) acknowledged that it did not meet the output and donated £3 million to National Energy Action to help it tackle fuel poverty.

Our consultation position and responses

3.182. We considered whether we needed to make changes to this output so that it encouraged the right behaviour from the companies. One option we considered was attaching a licence condition.

3.183. However, on reviewing the output we believe that it is operating as intended. We proposed making no changes.

3.184. We asked for stakeholder views on our proposed approach of continuing to monitor this output for the remainder of RIIO-GD1 and requiring companies to justify where they fail to meet this output.

3.185. Eight of the 13 respondents addressed this question. All agreed with our proposed approach, although some made some additional points.

3.186. Wales & West Utilities raised whether this output should be monitored over an eight-year period, rather than annually, for the next price control. It considered this was appropriate for outputs that can be heavily affected by weather in one year.

3.187. Although Northern Gas Networks agreed with our proposal, it also considered there should be an additional mechanism in place to deal with repeated failures to deliver an output. For example, a company could be required to create an improvement plan and the targets in the plan could be added to the licence. It acknowledged this may be more appropriate to consider as part of plans for RIIO-GD2, rather than now.

Our decision

3.188. We have decided not to make any changes to the safety (repair risk) output, for the same reasons noted in our consultation.

3.189. As such, we continue to think that consumers' interests will be best protected by the status quo and no changes are necessary in relation to this output.

3.190. We continue to expect any GDNs that do not meet this output to provide evidence of why they haven't and to work promptly to bring about improvements, which may include a plan, as suggested by Northern Gas Networks. We will also continue to monitor this output and publish performance against this output in our annual report. Additionally, we expect companies to engage with consumers and us in developing this aspect of their business plans for the next price control.

Reliability (loss of supply)

Background

3.191. This output measures the number and duration of planned and unplanned interruptions on the gas distribution network, over the eight years of RIIO-GD1. The aim of this output is to drive gas distribution companies to reduce the impact of interruptions on consumers. They can do this by minimising the duration and, where possible, the number of planned and unplanned interruptions. We expect companies to proactively engage with consumers to minimise the inconvenience caused by interruptions.

3.192. Although we stated in final proposals that we would review the output at the end of RIIO-GD1, we were concerned that some of the current targets are failing to drive the behaviour required to meet the aim of the output. Three out of four gas distribution companies (SGN, Northern Gas Networks and Cadent) are forecasting to fail at least one of the areas, mainly unplanned interruptions.

3.193. We recognise that at the time of setting the price control, the companies did not have a deep understanding of appropriate targets in these areas, as it was a new output for GD1. Following several years of reporting interruptions, this understanding has improved and errors that were included in targets have been identified. This means we now better understand some of the uncertainties that were not taken into account when setting the target, in particular outages in multiple occupancy buildings (such as apartment complexes and blocks of flats), which can result in longer than average interruptions.

Our consultation position and responses

3.194. We proposed amending the targets to promote the right behaviour and reduce the impact of interruptions on consumers.

3.195. We also considered the option of attaching a licence condition. However, we thought there would be benefit from continuing to monitor and understand more about this output before considering attaching a licence condition.

3.196. We asked for stakeholder views on our proposal to change the targets and continue to monitor performance for the remainder of RIIO-GD1, requiring companies to justify where they fail to meet this output.

3.197. Eight of the 13 respondents addressed this question in their responses. All agreed with our proposed approach to continue monitoring this output, without putting it in the licence. However, two respondents disagreed with our proposal to amend the targets.

3.198. Western Power Distribution disagreed with amending the targets, stating that changes to targets should not be made during a price control period and that failure to meet the targets should not be a reason to reset them.

3.199. British Gas also disagreed with our proposal to amend the targets, but did not say why.

3.200. Wales & West Utilities, Cadent and the Energy Networks Association supported the changes to the targets, however, they all commented that multiple occupancy buildings should not be included in the targets for the output and should be treated separately.

Our decision

3.201. We have decided to amend the targets for the reliability (loss of supply) output and not to introduce them into the licence.

3.202. We acknowledge Western Power Distribution's comments on amending targets mid-way through a price control. However, we consider that amending the targets will better incentivise companies to improve performance, to the benefit of consumers.

3.203. The current targets are ineffective at driving desired behaviour, since we did not have comprehensive information on the factors that influence interruptions when we set them. Leaving these targets in place for the remainder of GD1 could lead to a deterioration in performance, which leads to a worse outcome for consumers in the form of more or longer interruptions.

3.204. We will take the different issues affecting multiple occupancy buildings into account in setting the overall revised targets.

3.205. We will monitor performance against these new targets and report on it annually.

3.206. We are currently working with the GDNs on setting these revised targets and will update in due course.

Maintaining operational performance

Background

3.207. This eight-year output is a measure of network reliability. We set a number of secondary deliverables to act as leading indicators of performance. These give us a sense of how each company is performing. We can then investigate further if required.

3.208. These deliverables are a combination of annual and eight-year targets. Every year, we monitor performance of each GDN against the deliverables and include this performance in our annual reports. Some of these deliverables are being reported on for the first time in RIIO-GD1.

Our consultation position and responses

3.209. We considered attaching a licence condition as an additional way of holding companies to account. However, we believed the output was operating as intended and did not propose to introduce a new licence condition.

3.210. Companies are forecasting to meet this output. We have picked up any concerns with performance to date during our annual reporting process and companies have addressed them. For instance, SGN's Southern Network failed to meet the target for number/duration of telemetered faults[58] in the first two years. SGN has taken action to improve performance in this area, meeting the target in 2015-16. This output was intended to have an associated reputational incentive, through the publication of performance, and this is currently proving effective. We intended to continue publishing GDNs' performance against the deliverables each year in our annual report.

3.211. We asked for stakeholder views on our proposed approach of making no changes to the output, continuing to monitor this output for the remainder of RIIO-GD1 and requiring companies to justify where they fail to meet this output.

3.212. Six of the respondents addressed this question and all agreed with our proposal.

Our decision

3.213. We have decided not to make any changes to the reliability (maintaining operational performance) output.

3.214. We will determine whether the output has been met at the end of RIIO-GD1, based on performance against these deliverables and would expect each one to be met to achieve the overall output.

3.215. One of the deliverables was the demolition of gas holders, for which an allowance was given to the GDNs. We will take performance against this deliverable into account when determining the allowance we give for this activity in the future.

SP Transmission's trigger mechanism

Background

3.216. SP Transmission's business plan indicated that it was more efficient to refurbish specific overhead lines at the same time as building the East Coast 400kv upgrade.

[58] Telemetry provides the companies with continuous data on the operational state of the remote, unmanned outstations and report faults to the distribution control stations.

3.217. As it was uncertain when the East Coast 400kv upgrade would occur, we included a trigger mechanism as part of the price control to unlock allowances for the overhead line refurbishment when the upgrade began.

3.218. The upgrade has now been delayed until the next price control so these allowances will not be unlocked. However, SP Transmission reports that the overhead line refurbishments are still required in RIIO-T1. SP Transmission was concerned these refurbishments will go unfunded as the East Coast 400kv upgrade will not occur.

Our consultation position and responses

3.219. In our February consultation we proposed to take no action on the basis that if any expenditure is justified it will be funded through our Network Output Measures mechanism. This approach is in line with other asset replacement or refurbishment works that are not funded elsewhere.

3.220. We asked stakeholders if they agreed with our proposed approach to this trigger mechanism.

3.221. We received five responses (SP Transmission, British Gas, Wales & West Utilities, Western Power Distribution and Northern Powergrid) all supporting our proposed approach.

Decision

3.222. As stakeholders have raised no concerns with our approach, we have decided to maintain our approach and take no further action.

Electricity transmission other outputs

3.223. One part of MPR parallel work is clarifying what actions we would take for late or non-delivery of specific electricity transmission outputs.[59]

3.224. We proposed not to take any further action on these outputs beyond what was set at final proposals. This is because all outputs are either delivered, being delivered or have an existing mechanism to deal with late or non-delivery.

3.225. We asked stakeholders if they agreed with our approach to these outputs.

3.226. Four respondents (SGN, British Gas, Wales & West Utilities and Northern Powergrid) agreed. No response raised any concerns.

[59] The construction of a tunnel in Islington, 4 Switch Mesh GIS Substation, and location-enabling (exit sole-use), which is made up of a 275kv circuit breaker, two super grid transforms and a grid supply point.

Decision

3.227. As a result, we have decided to maintain our approach and take no further action as part of the MPR parallel work process.

Appendices

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Appendix 1 – Information requirements for late delivery of Western HVDC link

We expect NGET and SP Transmission to explain the late delivery of the Western HVDC link. We expect a comprehensive submission. This should outline:

- What date the Western HVDC was originally intended to be operational.
- When the delay occurred.
- What caused the delay.
- What actions were taken (or not taken) to manage the risk of the delay. This should include evidence of the efficiency of the decisions made (or not made) and actions taken (or not taken).
- What actions were taken to mitigate the impacts of the delay. This should include evidence the efficiency of the decisions made (or not made) and actions taken (or not taken).
- What the impact of the delay was on consumers. This assessment should form two parts:

  a) The impacts on the delivery of the Western HVDC project itself (such as changes in cost).

  b) The impacts on the price, quality, safety, reliability and security of supply on the electricity system as a whole (eg increases in constraint costs).

- Whether NGET/SP Transmission will receive any benefit from the delay. We expect this to include (but not be limited to) paying suppliers later, payments (or in-kind benefits) from suppliers for late delivery.
- Anything else considered relevant.