WALES&WEST UTILITIES

Wales & West House
Spooner Close
Celtic Springs
Coedkernew
Newport NP10 8FZ

Tŷ Wales & West
Spooner Close
Celtic Springs
Coedcernyw
Casnewydd NP10 8FZ

Telephone/Ffôn: 0800 912 29 99
Fax/Ffacs: 0870 1450076
Email/Ebost: enquiries@wwutilities.co.uk
www.wwutilities.co.uk

Akshay Kaul
Director Network Price Controls
Systems & Networks
10 South Colonnade
Canary Wharf
London

By Email: riio2@ofgem.gov.uk

14th March 2019

RIIO-2 Sector Specific Methodology Consultation – WWU response

Dear Akshay,

We welcome the opportunity to provide our views on the RIIO-2 Sector Specific Methodology Consultation.

The responses we provide in this document build on our response to the Ofgem RIIO-2 Framework consultation[1], our letter to you dated 7 November 2018, and significant participation across the RIIO-2 workgroups throughout 2018 and 2019 to date. We also thank you for the opportunity to hold one to one meetings with a number of your officials. We will continue to support further RIIO-2 workgroups through to the conclusion of this consultation process.

Our response is structured as follows:

1. This cover letter
2. An executive summary of our key points
3. Responses to the RIIO-2 Sector Specific Methodology
4. Responses to the Gas Distribution Annex
5. Responses to the Finance Annex
6. Responses to the Gas Transmission Annex

We have followed the numbering convention utilised within the consultation documents, responding where necessary. Our response is marked as not confidential and may be published in full. Should you have any queries on the responses please do not hesitate to contact me.

Yours sincerely

Steve Edwards
Director of Regulation & Commercial

[1] WWU RIIO 2 Consultation response 2nd May 2018

Contents

WWU RIIO-2 Sector Specific Methodology Response Executive Summary

As we develop our future business plans, Ofgem should note:

- We are putting customers at the heart of our business plan
- We are preparing our network for the future
- We are learning from RIIO-1 and building on the successes for our customers
- We continue to provide robust and independent expert material to inform our feedback to Ofgem and our business plan

We agree with the foreword provided by Martin Cave, the GEMA chairman, stating that "the gas and electricity networks are essential to the functioning of society and our economy."

The executive summary draws out our key feedback points on the RIIO-2 package recommendations as a whole using the headings from the Sector Specific Methodology and referencing specific proposals for gas distribution.

As it stands the RIIO GD2 package would significantly undermine our ability to fund our core regulatory obligations.

For example, Ofgem's proposed working assumptions for revenue allowances in respect of the cost of equity and debt are neither justified nor sustainable.

We do not accept the limiting parameters within which Ofgem has framed its approach to financeability.

Our analysis leads us to conclude that Ofgem's recommendations as they currently stand will not achieve a fair and balanced outcome for the sector as a whole and would not be in customer interests.

Our headline responses to each of the key consultation areas are set out below:

4. Reflecting what customers want and value from networks

We are broadly supportive of the overarching approach of moving to three key outcome themes and agree with the three broad headings.

To build on the sector improvements delivered by all gas distribution networks in RIIO GD1, we must ensure we have the appropriate approach to target setting, rewards and penalties for RIIO GD2 and beyond.

The RIIO framework with company absolute and static targets, has encouraged active collaboration between networks for the benefit of all consumers and other stakeholders - with a fair balance of reward and penalty between networks and consumers - for example Customer Satisfaction, Shrinkage, and Health & Safety performance improvements. To illustrate this, the top performing scores at the start of RIIO GD1 would now be below the lowest current scores of GDNs.

If there is a move to dynamic and relative targets in RIIO-2, then it is likely that this collaboration will reduce. This is because assisting other Network Operators to improve their performance can have the effect of reducing one's own incentive income where targets are relative.

Changing Output and incentive targets annually (dynamic targets), would lead to an unbalanced risk and reward outcome for networks over a shorter 5-year period.

5. Enabling whole system solutions

Wales & West Utilities is at the forefront of work on whole systems, and have a proven track record of demonstrating and delivering solutions to deliver the energy transition required for customers and businesses - especially the fuel poor and vulnerable. This track record has been developed over the RIIO GD1 period.

Our Bridgend study[2] in 2015 demonstrated that no single energy vector can deliver the energy trilemma. It also highlighted the cost challenge for the vast majority of people should any change be required to their energy systems. Our network innovation funded Project Freedom[3] (hybrid heating) and Pathfinder energy system modelling tool are now being held up as exemplars to solve the biggest whole system challenge we have – low cost, low carbon heat within a sustainable energy mix.

We therefore welcome the focus on whole system solutions and fully support a flexible framework that will unlock the benefits of whole system solutions for our customers, especially those who are fuel poor or vulnerable.

We will continue to work with Ofgem and stakeholders on the mechanisms that we can utilise during RIIO-2 and beyond. We would support potential Price Control Deliverables and/or Output Delivery Incentives with 'use it or lose it' mechanisms, potential re-openers and upfront funding where we can clearly show that network investment is the lowest overall cost for customers whilst still meeting appropriate risk and safety standards.

An example of this would be the funding of compression costs on the gas distribution network to facilitate more renewable gas injection, where this would result in lower overall costs to decarbonisation compared to alternative electricity or transmission investments.

6. Ensuring future resilience

We welcome the focus on future resilience as a key theme for RIIO-2. We will set out our plans for asset, cyber and workforce resilience in our RIIO GD2 business plan.

Whilst it is sensible to build on the substantial work undertaken within RIIO GD1, it is imperative that we avoid a repeat situation where output targets are not set ahead of the price control period. A repeat of this situation will not allow timely assessment of network performance by stakeholders.

---

[2] https://www.wwutilities.co.uk/media/2718/integrated-gas-and-electricity-networks-support-the-journey.pdf

[3] https://www.wwutilities.co.uk/about-us/our-company/future-of-energy/

We are currently engaged in the industry work groups, along with all other work groups, on asset resilience and will work with Ofgem and stakeholders to develop the appropriate detailed framework that will best deliver for all stakeholders. We cannot comment on the Ofgem proposals at this point, as we are still early in the process of determining the required levels of asset resilience. However, we do recognise that with long life assets, investments in one period can benefit future periods.

We welcome the recognition of the threat of cyber security and we are working with Ofgem and others on the current cyber resilience status that will inform our plans and funding requirements for RIIO-2.

Workforce resilience is a particularly key issue for networks, and we welcome the recognition of this within the consultation documents. We entirely agree it is up to us to deliver a workforce strategy as part of our business plan submission - we would then expect appropriate funding for efficient and necessary costs that will support future resilience.

Ofgem highlights the requirement for collaboration between networks on this issue, and as stated throughout this response, we very much support a collaborative approach that delivers customer benefits across the whole sector.

7. Managing uncertainty

We will include our specific uncertainty mechanism proposals within our RIIO GD2 business plan. We agree that uncertainty mechanisms should protect both consumers and networks against things outside of our control. In terms of maintaining confidence with long term debt and equity investors, we are concerned that Ofgem's stance on allowances for the cost of debt and equity, and the overall package in terms of risk and return will undermine that confidence and reduce their willingness to invest. We would note that rating agencies are already expressing concerns. This is covered in more detail in the 'fair returns and financeability' section below.

The regulatory appeals process

Ofgem has signalled its intention (paragraph 2.2) to "consider the extent to which a successful appeal has consequences, if any, on other components of the price control."

The appeals process is a very important part of the governance process and a subsequent update from Ofgem post an appeal must not undermine the appeal outcome. Following clarification from Ofgem[4], it would appear that Ofgem is intending to give itself the power to override the substantive outcome of an appeal by making an adjustment to overall revenues which removes from the company all or part of the gains that it has made through the appeal.

As part of CSQ1 we respond to the proposal so far as we are able but there is a serious lack of information as to what Ofgem is proposing and why. Our main point is that Ofgem's consultation on this issue is inadequate. We strongly encourage Ofgem to consult again, providing a far more detailed explanation of the policy and of how it would work.

---

[4] Ofgem response to WWU question during consultation period

Wales & West Utilities Limited
Registered Office:
Wales & West House, Spooner Close, Celtic Springs,
Coedkernew, Newport NP10 8FZ
Registered in England and Wales number 5046791

8. Driving innovation and efficiency through competition

The RIIO framework rightly puts innovation at the heart of what network companies do. We support the framework decision to retain a stimulus package. We also support the strategic use of a future national innovation competition to focus on key national challenges – such as the future of heat.

To support the UK and Welsh Governments' industrial strategies and clean growth ambitions, it is critical that networks continue to collaborate to develop and deliver solutions for all stakeholders, including industries and domestic customers with a particular focus on the vulnerable and fuel poor.

We continue to work collaboratively with the other networks, Ofgem and other stakeholders and the feedback we get is that the RIIO National Innovation Allowance (NIA) is a key fund that allows SMEs and other organisations to bring new thinking into energy that will benefit consumers.

The NIA is a flexible and practical mechanism to allow a range of third parties to help us develop a range of 'technology readiness level' innovations for today and tomorrow's challenges. Removal of this allowance will limit our ability to efficiently secure much needed input to the energy challenges we face.

We agree that customers must see the benefits of the circa £1 per year per customer investment. We are therefore working hard with the Ofgem innovation team and other stakeholders to develop a robust benefits measurement process that we hope to use in the very near future.

We agree with the UK Government's recent consultation that the RIIO innovation stimulus package is an exemplar. More details of our stakeholder informed innovation strategy and key publications can be accessed via the link:
https://www.wwutilities.co.uk/about-us/our-responsibilities/innovation/

9. Simplifying Business Plan assessment

We support mechanisms that would simplify the price control process as long as they do not give rise to material unintended consequences.

We welcome the opportunity to engage with Ofgem and stakeholders to discuss options for an updated business plan and totex incentive regime.

We have repeatedly expressed our concerns that the timescales are extremely tight for RIIO 2 business plan submissions – with draft business plans to be delivered to the RIIO 2 Challenge Group by July 1, and Ofgem's decision document only being available from the end of May 2019. Similarly, the timeline for submissions later in the year are equally challenging.

It is concerning that we are still awaiting Ofgem's release of the Financial Model which was due early in 2019, along with the Business Plan Data Templates – particularly given that completed versions of both are required as part of the 1 July 2019 submission to the RIIO Challenge Group.

We support a transparent and up front symmetrical business plan incentive mechanism that incentivises ambitious and cost-effective business plans, and agree that the assessment must cover quality and value for money, amongst other areas.

We do not support the Ofgem indicative matrix that appears to fix a downside penalty and “share” an upside reward. Such a mechanism does not reflect any stakeholder views voiced at the Ofgem working sessions we have attended. Neither is it in keeping with maintaining a balanced regime - and could act to limit the ambition in submitted business plans.

10. Fair Returns and Financeability

Ofgem’s proposed working assumptions on allowances for the cost of debt and equity for the business plan submission are not justified. Our answers to the questions raised by Ofgem in the finance section (FQ1-FQ37) outline our concerns. Clearly, it is important that working assumptions for business plan purposes are soundly based.

With regard to financeability our detailed answer is set out at FQ22 of the finance section. In summary we do not accept the limiting parameters within which Ofgem has framed its approach to financeability. Financeability must be assessed against the particular circumstances of each company and cannot be considered on the basis of a purely notional company.

The financing duty is concerned with the need to secure that licence holders can finance the activities which are the subject of obligations placed on them. It applies in respect of all actual companies that hold licences, and not in respect of a notional company. Option B, is not an appropriate basis on which to proceed. In any event, however Ofgem's financing duty may be interpreted, it cannot be a proper discharge of that duty to 'put the onus on companies to take appropriate action'. By definition, the duty must place obligations on Ofgem itself. These cannot be delegated to the very companies that are the intended beneficiaries of the statutory duty.

We are also disappointed that Ofgem's guidance to companies on how to assess financeability, which was due to be issued at 'the beginning of 2019' is still not available at the time of responding to this consultation. When the guidance is available, we would suggest that Ofgem allows companies an opportunity to provide a supplementary response to this consultation in the light of it.

11. Achieving a reasonable balance in RIIO-2

We welcome Ofgem’s aims to achieve a reasonable balance between:

- Risk and reward
- Accuracy and simplicity
- Efficiency and fairness

Wales & West Utilities Limited
Registered Office:
Wales & West House, Spooner Close, Celtic Springs,
Coedkernew, Newport NP10 8FZ
Registered in England and Wales number 5046791

We have made a number of points above that contribute to the 'reasonable balance' tests, and in this section, we bring together a high level analysis of the 'balance checks' Ofgem aims to achieve.

In summary, we do not see a reasonable balance from the package of recommendations and proposals within the current sector specific methodology consultation. In particular;

1) Risk and reward

The combination of unjustified and largely untested multiple mechanisms (new and existing) to the cyclical reset of price control allowances adds significant risk to networks whilst severely limiting their rewards. Examples include:

- Risk:
  - Indexation of equity allowance
  - Equity adjustments to reflect expected versus allowed cost performance
  - Use of a flawed methodology to fund historic and future debt costs
  - A cashflow floor mechanism
  - The adoption of CPIh from RPI, and concerns on how investors will be kept whole
  - Introduction of "Price control deliverables"
  - Use of (sector based) return adjustment mechanisms

Against these additional "Risk" items are a number of proposals that will significantly undermine ambition for investment and innovation. Examples include

- Return:
  - Base equity proposals – more than 50% lower than current base equity returns
  - 15% to 50% totex sharing mechanism range which is a significant reduction from the current 63%
  - Dynamic and relative Outputs and Incentives
  - Asymmetric business plan incentive – the sharing of a 2% reward versus an absolute 2% penalty

2) Accuracy and simplicity

The mechanisms outlined above will add complexity which is not necessary over a shorter 5-year price control period.

There is little discussion on the customer bill impact and the materiality of the "accuracy" test within the consultation document.

The proposed reductions in base equity returns & cyclical reset of cost allowances will deliver a reduction in customer bills, all else being equal.

We question the marginal benefits of the further complexity being recommended to the process.

In summary, there is a significant amount of additional complexity that may result in minimal customer benefit and bill impact. Ofgem should carry out and share a full quantitative impact assessment before the introduction of new and untested mechanisms.

3) Efficiency and Fairness

Customers and other interested parties play a major role in our business and both Ofgem and customers receive a substantial amount of information from us. We report each year a significant level of cost, output, workload and revenue information to Ofgem and this information is also made public.

The eight gas distribution networks have revealed the efficient costs of delivering the existing outputs over this RIIO-1 period to date. Outperformance is shared annually and cost levels will (and rightly) be reset for RIIO GD2. Therefore, Ofgem has all the information and tools to calibrate efficient Totex allowances without the need for untested Return Adjustment Mechanisms at the next price control reset. This is particularly important given our own final performance outcome could be unjustly impacted by anomalies arising at other networks.

- We have highlighted above our concerns with the use of relative and dynamic cost and output measures within a 5-year price control period.

- We have also highlighted above in section 10 our concerns on Ofgems current propsals for debt and equity funding.

- If networks are funded to and perform at an efficient cost level, whilst delivering stakeholder required Outputs, it is only fair that any out or underperformance is shared between networks and customers. There are several mechanisms being proposed within the RIIO-2 recommendations that would prevent networks benefitting in a fair manner (for example, annual resetting of output levels).

In summary, we do not see a reasonable balance from the package of recommendations and proposals within the current sector specific consultation.

WWU proposals

In this section of our executive summary, we make some specific proposals which we believe would enhance outcomes for stakeholders in RIIO GD2

The outcome for GD2 should continue to closely align the regulated networks with Ofgem's overall objectives - through the setting of strong and stretching incentive. This should include the efficient delivery of investments and services that underpin key national and regional policy requirements – whilst at the same time protecting the most vulnerable in society. These include the Industrial Strategy, the Clean Growth Strategy, the Wales, Scotland & England climate change targets and the 2019 Spring Statement.

The framework should also promote affordable, and sustainable network services for homes and businesses. – and where appropriate networks can provide additional services to support vulnerable customers and communities.

The existing RIIO framework and our performance have delivered significant benefits for customers.

Some examples of these are;

- Our charges have fallen to £121 in 2017/18 from £149[5] in 2013/14 in constant 2017/18 prices - a 19% reduction. This is a clear indicator that RIIO is working well for consumers.

- Significant customer service improvements from 8.69 out of 10 in 2013/14 to 9.15 out of 10 in 2017/18. We have also Distinction status with the Institute of Customer Services.

- Investment that has lowered carbon emissions and improved reliability.

- Ground breaking innovations such as Hybrid heating that will help decarbonise heat whilst minimising the cost and in home disruption on consumers.

- 8,500 Fuel Poor connections in 5 years, coupled with vulnerable customer support which together are supporting those who are most in need across our geography.

- We are on course to meet our Stakeholder defined Output measures whilst returning over £40m back to customers.

- The gas network provides over 80% of energy for heat, circa 40% of energy for electricity, and the storage and flexibility that is already supporting a significant increase in renewable electricity.

- Awarded 6th consecutive annual ROSPA gold award, which recognises our continued health and safety performance

- Despite all these achievements in GD1, our shareholders will absorb around £220 million of a shortfall in allowances for efficiently incurred debt costs. This is unsustainable, particularly if as currently forecast it is replicated in GD2.

- Lowered gearing, with support from shareholders through lower distributions to a level significantly below the allowed equity rate of 6.7%.

- Maintained strong debt ratings with S&P and Fitch.

Please see the Ofgem Annual Report 2017/18[6] for all the gas distribution network outcomes to date.

---

[5] WWU bill in 2017/18 prices as per annual RRP

[6] https://www.ofgem.gov.uk/network-regulation-riio-model/current-network-price-controls-riio-1/network-performance-under-riio

WWU high level principles to achieve a better "balance" of key Ofgem aims

We agree that the RIIO package can be developed and improved. We welcomed the independent review of RIIO by CEPA and despite its limitations in scope, we support a number of its conclusions and also disagree with some of them.

In summary we outline below some high-level principles that would better deliver for customers during and beyond RIIO-2:

- We would support a simpler package without losing any of the material accuracy.
- We will take on more operational risk of outperformance or underperformance but we accept this as part of the "repeat game"
- We aim to deliver efficiency and benefits for both customers and networks

Utilising the existing RIIO Framework, some of the suggestions in the consultation document and our proposals should position Ofgem to make good regulatory decisions to achieve appropriate outcomes for stakeholders. This can be achieved by:

- ➢ Introducing appropriate workload volume drivers for the Iron Mains replacement programme – addressing the lack of linkage between Primary Outputs and workload requirements – a specific issue for gas distribution from RIIO 1
- ➢ Introducing the indexation of Real Price effects – reducing the scope for up front forecasting errors, and removing windfall gains/losses to network companies.
- ➢ Reviewing the Totex sharing factors - addressing the risk/reward balance between networks and customers.
- ➢ Strengthening the customer voice with a local Customer Engagement Group and a national RIIO-2 Challenge Group–improving the quality and legitimacy of the business plan process.
- ➢ Setting allowances for cost of equity and debt capital that support financeability rather than undermine it

The package of measures outlined above removes the need for untested and ex-post measures that would add further complexity and uncertainty, and turn RIIO-2 into a rate of return based form of regulation.

The regulatory framework must continue to strongly incentivise regulated networks to efficiently deliver the investments and services that underpin the key national and regional policy requirements. Only in this way will we retain the close alignment between how WWU and other regulated networks allocate their scarce resources and the ongoing safety, performance and cost improvements that customers are right to demand.

We support Ofgem's focus on a whole systems approach to ensure stakeholders gain maximum benefit from our gas and electricity networks and expertise.

We look forward to continuing to work with the Ofgem RIIO-2 team and other interested parties as the framework develops and as the sector specific methodologies are consulted upon.

RIIO-2 Sector Methodology

Output categories

CSQ1. Do you have any view on our proposed approach for considering the extent to which a successful appeal has consequences, if any, on other components of the price control?

We have had some difficulty in responding to this question, because it is unclear from the consultation paper what 'proposed approach' Ofgem intends to adopt, or why any change is needed to the current arrangements for dealing with the outcome of an appeal.

As a result, we asked for further clarification from Ofgem and we did receive a response.

Ofgem's proposal is set out in a single paragraph (2.20), and is expressed in language that is highly abstract and opaque. It does not explain clearly what problem Ofgem believes to exist in the present arrangements, how exactly Ofgem intends to address it, or what benefit this will deliver.

The only things that are clear from the consultation paper are that Ofgem wishes to make available to itself a mechanism that it could use after it has lost a statutory appeal against its price control licence modifications, and that this mechanism would allow it to make further adjustments to price controls that are in some way related to the outcome of the appeal. It is suggested that the adjustments would be entirely at Ofgem's discretion, and might include changes to the price controls of licensees who played no part in the appeal process.

However, the potential scope of these adjustments, the circumstances in which the discretion could lawfully be exercised, and the manner in which it would be likely to be exercised are not described in the consultation paper. Nor is it explained why the proposed mechanism is required or what problems would exist if it were not introduced. In particular, it is unclear whether Ofgem is intending to introduce a mechanism that would allow it to make technical consequential changes to the controls, or whether it has in mind something of greater policy significance.

In consequence, the paper on this issue lacks the clarity that would be expected, and the consultation is deficient in this respect. It does not provide sufficient information for us to consider and respond to Ofgem's proposal.

Because of these deficiencies, we asked for further information, and Ofgem[7] provided us with a statement explaining Ofgem's intent in a little more detail. The key elements of this were as follows:

> *'The interests of consumers are best served by setting the overall level of the price control at a fair level…*

[7] Ofgem response to WWU question during consultation period

The process of arriving at a network company price control settlement is of such a nature that there are likely to be a range of different potential approaches and associated outcomes. A price control settlement is made up of many component parts…and individual components of the settlement may be interlinked. Overall, the key consideration remains whether the result is fair and achieves the right balance.

There is a risk that appeals disrupt interlinked components and/or the overall balance of the price control settlement. We therefore propose a discretionary mechanism in RIIO2 to deal with any unintended consequences arising out of a successful price control licence modification appeal. In appropriate circumstances, this could allow Ofgem to correct any such disruption and to maintain a fair balance…'

This leaves many questions unanswered, but the one thing it appears to make clear is that Ofgem's policy proposal is intended to be a significant one which is not confined to technical or consequential matters but extends to adjusting the 'overall level' of the price control in the light of the outcome of the appeal.

This makes the absence of an adequate explanation or development of the policy in the consultation paper even more concerning.

We respond to the proposal here so far as we are able, bearing in mind the serious lack of information as to what Ofgem is proposing and why. For this purpose, we take into account what was said to us by Akshay Kaul, and proceed on the basis that this describes the principal intent of Ofgem's policy. However, we provide this response without prejudice to our main point that Ofgem's consultation on this issue is inadequate. We strongly encourage Ofgem to consult again, providing a far more detailed explanation of the policy and of how it would work.

Subject to these caveats, we make the following points.

First, we are surprised that Ofgem's proposal has been made at all. The statutory provisions under which licence modification appeals may be taken to the CMA were first introduced over seven years ago under the Electricity and Gas (Internal Markets) Regulations 2011. Ofgem was consulted on, and in discussion with DECC closely involved in shaping, the terms of those regulations.

Moreover, to date there have been four appeals to the CMA under those provisions or their Northern Ireland counterparts. The first two of these appeals related to the RIIO-ED1 licence modifications and Ofgem was a party to them (*British Gas* and *Northern PowerGrid*). These appeals took place in 2015. Because they were the first appeals, the CMA, after hearing considerable legal argument, set out how it interpreted the legislation and described the key elements of its approach to a statutory appeal.

It is clear from the record of the appeals that Ofgem did not object to any fundamental aspect of the interpretation or approach adopted by the CMA. Nor to the best of our knowledge did it subsequently express any concern about the manner in which the appeals process worked. The CMA followed the same approach in the Northern Ireland cases, which took place during 2017-18 (*Firmus* and *SONI*).

In effect, for reasons we will outline shortly, Ofgem's proposal – so far from '*maintaining the integrity of an effective appeals mechanism*' as the consultation paper states – is entirely at odds with the way in which the appeals mechanism has been designed to work. Since Ofgem was involved in the design of that mechanism, and raised no fundamental objections to it in the appeals to which it was a party, it is surprising that it now proposes what appears to be a radical departure from the statutory process.

Second, to the extent to which the proposal deals with technical '*interlinkages*' between the parts of a price control being appealed and those which are not – for instance where there is some formulaic relationship between those respective parts which means that a change to one should logically result in a change to the other – the CMA has already stated that it feels able to deal with this itself.

The question arose in legal argument in the *British Gas* and *Northern PowerGrid* cases, and in its final determinations the CMA decided as follows:

> *'We consider that the question as to whether there are sufficient links between the parts of the Decision which are challenged and parts which are not challenged must be decided on a case-by-case basis taking into account the circumstances of each case. Where there are such links, we would, in the first instance, have expected GEMA to have highlighted these and addressed them in its response. GEMA merely stated in its Response that the decision is 'made up of a number of discrete but inter-connected determinations that together give rise to the decision itself'. We accept, however, that if, in the evidence submitted to the CMA, such links become apparent, we may take this into account where appropriate.'*
> *(para 3.51 of Northern PowerGrid and para 3.52 of British Gas)*

In other words, where there are technical interlinkages between the appealed components of a price control and any non-appealed components of that control, it is open to Ofgem (and indeed Ofgem is '*expected*' by the CMA) to identify what these are. The CMA has made clear that it will be able to take these interlinked elements of the price control into account where it considers it appropriate.

It follows, in accordance with the CMA's determinations in previous cases, that interlinkages between different elements of a price control both can and should be addressed within the appeal itself. There is therefore neither a need, nor any legitimate basis, for Ofgem to be addressing them subsequent to, and outside, the appeal process.

Third, however, it appears from Akshay Kaul's statement that Ofgem is not primarily concerned with technical interlinkages between different components of the price control, but rather with a big picture issue – namely, whether following a successful appeal the '*overall level of the price control*' will remain '*fair*' so that it still '*achieves the right balance*'. It appears that Ofgem now considers there to be a risk that, if a company succeeds on appeal, this will '*disrupt*' the overall price control so that it no longer represents a '*fair balance*'.

We strongly disagree with this line of thinking, which proceeds on a basis that is legally and logically flawed.

Ofgem's approach appears to rely on the unsound assumption that the overall level of a price control as determined by Ofgem is, by definition, fair and balanced, so that any additional revenue obtained by a licence holder as the result of a successful appeal will be likely to upset that balance and result in the company being over-remunerated to the detriment of consumers.

There is no basis in law or in logic for this assumption. Under the licence modification arrangements that were in place before the current statutory appeals mechanism was introduced, it might have been possible to attribute to a price control which was accepted by a company the status of a fair balance. This is because licence modifications required the consent of the company, so that a price control that had been accepted was one on which both Ofgem and the company were able to agree.

However, under the current arrangements, price controls no longer have to be agreed, but are merely determined by Ofgem subject to the right of the licence holder to appeal. Even where a company has declined to exercise its right of appeal, no significance can be attached to that fact. The CMA made this clear in the *British Gas* and *Northern PowerGrid* cases:

> *'We do not disagree that price control decisions may be taken and accepted on a global basis or reflect an 'in the round' assessment by GEMA and the DNOs. However, whilst we accept that, to some extent, the slow-track DNOs that did not appeal accepted the price control level as a global bargain, we do not see why this is relevant, in itself, to the position of an individual DNO or other appealing party who did choose to appeal.'*
>
> (para 3.49 of *Northern PowerGrid* and para 3.50 of *British Gas*)

Moreover, since under the current appeals mechanism the CMA does not conduct a *de novo* review of the price control and assess it in the round – as it had done under the old system of references; an approach it explicitly considered and rejected in the *British Gas* and *Northern PowerGrid* cases – no validation of the overall revenue allowance within the control takes place as part of a CMA appeal.

As to this point, the CMA has been entirely clear:

> *'We would note also that an appeal in which the merits must be taken into account does not constitute a rerun of the original investigation or a de novo rehearing of all the evidence. The CMA must limit its consideration to the statutory grounds of appeal to the extent that such grounds are raised by the appellant.'*
> *(para 3.21 of Firmus)*

It follows that the only guarantor of a fair overall balance being struck in a price control is that each of the individual components of the price control is fair. Indeed, Ofgem appeared to accept this in the previous appeals when it said (as already quoted above) that a price control is '*made up of a number of discrete but inter-connected determinations that together give rise to the decision itself*'.

This was a point accepted by the CMA, and the key word used in it is '*discrete*'. The decision to adopt each individual component of the price control is a discrete determination which must be capable of justification on its own terms.

Wales & West Utilities Limited
Registered Office:
Wales & West House, Spooner Close, Celtic Springs,
Coedkernew, Newport NP10 8FZ
Registered in England and Wales number 5046791

Logically, it follows that if each component of the price control can be justified, then the price control as a whole will be justified. If, however, one or more components are '*wrong*' as the CMA defines it, then by virtue of that fact the overall balance of the control must also be treated as wrong unless and until those components have been corrected.
There is no logically valid concept of a price control having a fair balance that exists independently of the fairness (or otherwise) of the individual components which collectively make up that control.

In particular, there is no valid basis for considering that Ofgem's own estimation of what constitutes a fair overall balance should be treated as if it were an *a priori* fact, so that any modification flowing from a successful appeal must necessarily be assumed to upset that balance and require adjustment to restore the balance. On the contrary, if Ofgem has made errors in determining individual elements of the price control, then it must also have made an error in determining the overall level of the control. If a company succeeds in proving individual errors on appeal to the CMA, it is entitled to the overall adjustment which flows from the correction of those errors.

Consequently, Ofgem's proposal proceeds based on a serious logical flaw, being based on the presumption, for which there can be no justification, that the overall level of the price control has been set in a fair and balanced way, even if the price control mechanism contains errors.

<u>Fourth</u>, it follows from all of this that if Ofgem were to proceed with its proposal, it would undermine rather than maintain the integrity of the appeals process.

<u>**Put at its simplest, and whatever protections it may be subject to in the detailed legal drafting, the one thing that is clear from Akshay Kaul's statement is that Ofgem's proposal is designed to give itself the power to override the substantive outcome of an appeal by making an adjustment to overall revenues which removes from a company all or part of the gains it has made through the appeal.**</u>

This is inconsistent with the nature of the statutory appeals process as interpreted and applied by the CMA, and would fundamentally undermine legal due process by giving the losing party to an appeal the right to reverse its effects without any further right of challenge to the CMA.

We are aware of no other case in UK regulation in which a regulator has taken to itself the power to alter the outcome of a statutory appeals process in this way. We consider that it is contrary to basic principles of good administration and the rule of law, and do not believe that any lawful justification could be developed for it. In any event it is clear that it would require an exceptional justification, and Ofgem has offered no convincing rationale of any description.

<u>Fifth</u>, there is already a mechanism available to Ofgem if it considers that, in the light of the outcome of an appeal, further modifications to a price control are required. It is, moreover, an entirely lawful mechanism that neither undermines the original appeal process nor places any reliance on logically insupportable presumptions.

This is to make further modifications to the price control using the same statutory power as was used to introduce the original price control. The legal effect of this is that those subsequent changes will themselves be subject to a right of appeal to the CMA by any company affected by them. This will allow the CMA to scrutinise whether the changes are justifiable, and act as guarantor that they are not simply designed to override the effect of its original determination.

This is the proper approach to follow if, for whatever reason, Ofgem believes that it can justify making consequential changes to licences as a result of having lost an appeal. It preserves the rights of the companies and maintains the integrity of the appeal process. And it requires no implementation, since the relevant statutory provisions are already in place.

By way of contrast, the effect of Ofgem's proposal, as Ofgem is no doubt aware, would be to allow it to modify licence conditions at its discretion, circumventing the statutory right of appeal to the CMA, and therefore subject only to the much more restrictive remedy of judicial review.

This cannot, in our view, be a proper way to proceed. But at the very least Ofgem's proposal should have been supported by a statement of why it considers that the existing statutory mechanisms for licence modification are inadequate to this cases with which it is concerned, and why it believes that the existing statutory appeal rights do not need to be preserved. Instead it has not drawn attention to these issues at all, still less explained or justified its proposed approach.

<u>In conclusion</u>, and for all the reasons given above, we do not believe that Ofgem has adequately consulted on this proposal. To the extent that we can understand it, in the light of the supplementary information provided, we reject it entirely as an inappropriate and insupportable development.

CSQ2. Do you agree with our proposed three new output categories?

Yes – We are supportive of three overarching outcome themes. As we develop our future business plans, Ofgem should note:

- We are putting customers at the heart of our business plan
- We are preparing our network for the future
- We are learning from RIIO-1 and building on the successes for our customers
- We continue to provide robust and independent expert material to inform our feedback to Ofgem and our business plan

We agree with the foreword provided by Martin Cave, the GEMA chairman, stating that *“the gas and electricity networks are essential to the functioning of society and our economy.”*

CSQ3. Are there any other outcomes currently not captured within the three output categories which we should consider including?

Yes, value for money is a key outcome and is missing but we recognise this is dealt with through the business plan and cost assessment process with key input provided by our stakeholders, the Ofgem RIIO-2 Challenge Group and our Customer Engagement Groups.

CSQ4. Do you agree with our proposed overarching framework for licence obligations, price control deliverables and output delivery incentives?

The proposal represents a significant change to the existing framework, which has served consumers well during RIIO GD1. We provide some cautionary notes below that we should consider before implementing significant changes.

Licence obligations – should only be used where necessary to set an absolute minimum level of service; we must be cautious about adding too many and/or introducing double jeopardy (e.g. Licence Obligations and Output Delivery Incentive penalty) as this increases company risk. All licence obligations must be appropriately funded.

Price Control Deliverables – we would ask Ofgem to exercise caution to ensure Price Control Deliverables do not remove the incentive to deliver innovative totex solutions, which deliver the same/similar outcome, whilst representing better value for customers.

For example, if we can refurbish rather than replace an asset to deliver similar outcomes to the customer, and this solution costs less, networks should benefit from this outperformance, which is also shared with consumers. This is a key principle within a RIIO framework.

Output Delivery Incentives – we support the principle of Output Delivery incentives and welcome the opportunity for company specific ODIs. We are keen to have further workgroup sessions to assess the overall package. The RIIO GD1 Outputs and incentives have driven some good outcomes for customers and provided strong incentives for network performance.

CSQ5. Do you agree with our proposals to introduce dynamic and relative incentives, where appropriate? Are there any additional considerations not captured in our proposed framework which you think we should take into account?

We do not agree with proposals to set targets that are relative to other GDNs. Neither do we agree that incentives should change during the shorter five-year price control period.

These changes would add uncertainty and discourage collaboration amongst the networks, which could adversely affect service levels. Relative and dynamic incentives would represent a significant change to the risk we face and that would need to be reflected in Cost of Equity.

CSQ6. Do you agree with our proposals to allow network operators to propose bespoke outputs, in collaboration with their User Groups/ Customer Challenge Groups?

Yes, although Ofgem should acknowledge the limited time left prior to business plan submission in Gas Distribution to develop these in collaboration with our stakeholders and Customer Engagement Group.

We also need to consider how we can ensure consistent and fair assessment of costs through the toolkit where we have company specific Outputs and different target performance levels

CSQ7. When assessing proposals for bespoke financial ODIs, are there any additional considerations not captured which we should be taking into account?

We agree that bespoke outputs are for "key areas of high importance to consumers" and as such Ofgem will need to trust the outcomes from the local stakeholder engagement, including the Customer Engagement Groups, when assessing companies bespoke ODI proposals.
We should understand the quantum of the total package and this should be a consideration within the decision-making process. We would welcome workshop sessions with Ofgem and others to consider this point

Enabling whole system solutions

CSQ8. Do you feel we have defined the problem correctly?

Designing our Future has been a long-standing priority for WWU and the future of energy aspect has received significant attention since 2015.

Our evidence and experience is being shaped by significant research and collaboration with actual customers, actual buildings and actual collaborations in real towns across our region. [8]

During that time, we have experienced change in the energy landscape unlike anything experienced in the previous five decades. So far, we have played a significant, but largely unseen role in facilitating the decarbonisation of electricity by connecting flexible gas generation plants to the distribution network.

We now have around 2GW of flexible electricity connected to our network, generated from gas which provides a significant contribution across our region when low carbon sources are no available.

We therefore agree that energy systems and their networks are becoming increasingly interlinked. We have seen the actual increase linkage as demonstrated by the following developments over the RIIO GD1 period:

- We supply c.2,000 micro generation sites (CHPs)
- We have 37 power stations connected with 1.76 GW total capacity
- We have 1.7 TWh green gas connected to our network (19 AD sites)
- We flexibly deploy 58 GWh of storage each day (UK 210 TWh seasonally)

The significant evolution of the energy system will continue and the gas distribution network within that means that the RIIO framework does need to be capable of supporting the energy evolution. As coal generation for electricity is phased out; and nuclear generation is delayed, we must ensure we have resilience to support the welcome increase in renewable electricity generation. That resilience is being provided by the gas network.

[8] Bridgend Phases 1,2 and 3, WWU pathfinder, Cornwall energy study. All can be found at https://www.wwutilities.co.uk/about-us/our-company/future-of-energy/

We have welcomed some of the Ofgem focus on whole systems development but we must ensure this thinking and way forward is “whole systems” and not just a focus on electricity transmission and distribution.

We have also welcomed the recent publication by Sustainability First “Circling the square: Rethinking utilities regulation for a disrupted world”. This discussion document clearly highlights the requirement for a more flexible and longer-term focussed form of regulation.

Statistics from BEIS demonstrate that emissions from total energy are circa:

- 27% transport
- 37% heat
- 36% electricity and other

The energy bill to consumers and industry is also made up of heat, power and transport costs.

Therefore, if we are to decarbonise the energy system and provide resilience at lowest cost for customers it is crucial to consider “whole systems” in the context of heat, power and transport.

The developments we outline above have supported a significant increase in renewable electricity generation. The gas network is a vital asset that is transporting over 80% of GB energy on a peak winter’s day (and circa 50% on an average day) and providing the flexibility and storage - especially at peak - that is delivering a significant contribution to low cost, low carbon energy for business and domestic customers.

Our experience therefore highlights that the challenge is more than just co-ordination.

We suggest the real issue is that costs and values in each part of the system are not well understood and so investment may not be prioritised efficiently and opportunities might be missed.

This is particularly true for gas distribution where every consumer is by definition a duel fuel consumer. Investment in gas networks should therefore consider the impact on the duel fuel bill. For example, the cost of flexible power generation goes up to cover storage on gas networks (GD2) and hence avoid a higher cost of electricity solutions in ED2 or ET2.

CSQ9. What views do you have on our proposed approach to adopt a narrow focus for whole systems in the RIIO-2 price control, as set out above?

This is a concern and more work is needed in this area. We have welcomed the opportunity to participate in the whole systems workshops.

There needs to be a broader focus on whole systems development although we acknowledge this will take time. There are a number of examples that support this case:

- Cross vector appliances, such as hybrid heating systems can have different impacts on the two networks.

- Investment drivers need to be seen in a whole systems perspective, such as upstream energy generation, e.g. distributed renewable generation, wind or green gas.
- Cross vector interconnection such as peak generation plant goes beyond the narrow approach.
- Transport considerations could have an impact on either network, hence will be an investment driver.
- Whole systems solutions may go beyond the networks, for example battery storage could be an alternative to DNO reinforcement or gas storage to enable peak generation plant connection.

The key point is not to start with one vector, e.g. electricity and then try to back solve for other vectors, e.g. heat and transport. This, in our view will lead to a significant lost opportunity given the interlinkages we are already experiencing and as outlined above.

To date, there has been an historic preference to look at electricity decarbonisation at the expense of understanding the whole energy system challenges and potential benefits.

We have welcomed the emergence of the National Infrastructure Commission and its assessment that highlighted the need to focus on heat, power and transport. There is also a growing demand from local cities and regions to understand regional energy systems and roadmaps.

The role of the gas network and the flows of energy from generation to homes and business is not well understood and many still do not understand the scale of energy (80% on a peak winter's day) that is transported through the gas network.

We acknowledge that Ofgem needs to translate the complex energy challenge into efficient investments between the gas and electricity networks but that is the challenge.

We are engaging extensively with the Ofgem systems team, BEIS, UK Committee on Climate Change, Energy Networks Association and crucially customers that use our system. We will also continue to provide leadership and robust evidence that we hope can support making the right investments to support the key outcomes required.

Therefore, broader costs and value need to be considered when prioritising spend which should be reflected at a BEIS / government policy level.

Networks should then be incentivised through RIIO to do the right thing overall. This could mean different things in different regions.

CSQ10. Where might there be benefits through adopting a broader scope for some mechanisms? Please provide evidence.

A number of examples are provided above in CSQ9, but further examples are in the area of heat. The options for heat present different costs and disruption to consumers.

A whole systems approach to heat decarbonisation will present the lowest cost solution, the least disruption and most likely chance of being successful. This has been recognised by the UK Committee on Climate Change, which has changed its advice to one that includes the gas networks as part of a low carbon energy future.

This advice, most recently published in February 2019, recommends the widespread roll out of hybrid heating systems using renewable electricity when available (UKCCC estimate 80% of the time) and natural gas the rest of the time. They recommend replacing the remaining 20% of the carbon footprint by replacing the fossil gas with green gases (biogases and hydrogen).

The case for hybrids vs full ASHP is confirmed by the results of our FREEDOM project and illustrates the consumer benefits of this strategy and lower subsidies need to progress such a decarbonisation approach.

CSQ11. Do you have reasons and evidence to support or reject any of the possible mechanisms outlined in this chapter? Do you have views on how they should be designed to protect the interests of consumers?

This December 2018 consultation has highlighted potential problems with:

1. Incentives
2. Information
3. Behaviours
4. Processes

Ofgem has then identified six potential ways to target the areas:

1. Business Plan incentive
2. Ensuring network innovation has a whole system focus
3. Co-ordination and information sharing incentive
4. Balancing financial incentives between traditional and whole systems behaviours
5. Ensuring a flexible framework to meet whole system needs
6. Whole system discretionary funding mechanism

We are supportive of all six of the potential mechanisms and could see a role for each of them within the RIIO-2 settlements. The key challenge is identifying how each could play a role, and the balance and linkages between them (noting the overarching three tests that Ofgem is applying to RIIO-2). We would also need to understand how any RIIO based mechanisms interlinked with any BEIS / Government incentives.

We would support further collaborative workshops with Ofgem and others to explore options.

CSQ12. Which of the possible mechanisms we have outlined above could pose regulatory risk, such as additionality payments or incentivising the wrong behaviour?

Please refer to response to **CS Q11** above.

CSQ13. Are there obstacles to transferring revenues between networks that disincentives networks from using a coordinated solution (please give details and suggest any changes or solutions)?

There is evolution required as many of the interlinkages and new knowledge has evolved through RIIO 1 and will continue. One barrier is the different timelines at which price controls take effect. E.G electricity DNOs two years after Electricity Transmission RIIO-2.

Some real basics demonstrate the issues within gas. There is no charge for pressure / flex capacity from the NTS to GDNs. Increases by NTS and decreases by GDNs on pressures and flexibility are made on a discretionary basis and may 'hide' potential opportunities for coordinated solutions. This is not always helped by the fact that bookings are not seasonal and that some methodologies sit outside Uniform Network Code.

Future opportunities exist between gas and electricity. For example, there are options when it comes to placing value on the flexible energy storage and generation that is coming through the gas system to benefit electricity resilience. This might encompass purchasing flex or paying fir increased pressure. So, one approach would be to require a duty for NTS to quote for higher pressure. Another approach would be to have an obligation to quote for accepting a lower pressure.

There are a number of challenges but we would support further workshops and thinking in this area. The key is for the framework to be flexible to allow these evolutions.

Perhaps the framework and allowances should specifically include a “future of energy research fund” given the complexities to be worked through with large potential benefits for industry and domestic customers.

CSQ14. Can you recommend approaches that would better balance financial incentives between networks to enable whole system solutions?

We are investing significant time and effort on engaging with National Transmission gas and regional electricity DNOs that form part of our region. We are also developing a regional forecast energy scenario noting the interlinkages within the energy system. There is further work to do.

If time permits, we should consider possible joint NTS / GDN further work to explore the best options for effective and flexible use of transmission and distribution grids. This should include directly impacted current and future stakeholders to understand how they want to use the system.

In addition, a sensible step to be made at some point would be to align ED price controls to the rest.

CSQ15. Are there other mechanisms that we have not identified that we should consider (please give details)?

We have outlined above the potential for more joint work on forecast energy scenarios and are developing a WWU regional forecast energy scenario. This highlights an opportunity to develop more collaborative and regionally focussed planning and data sharing. We will continue to take this forward.

An implementation fund for whole systems implementation should be considered. For example, the cross GDN innovation project ‘Optinet’ is being funded through innovation. If successful, it will enable multiple biomethane sites to operate in the same vicinity, enabling a significant increase in decarbonised gas capacity. Under current proposals, there is no mechanism for rolling this out any further.

CSQ16. Are there any additional framework-level whole system barriers or unlocked benefits, and if so, any price control mechanisms to address these?

A major barrier to an ambitious plan is the Totex comparison between companies and the sharing mechanism. An ambitious plan that saves the dual fuel customer money, by increasing investment in say Gas Distribution (whilst saving more on investment now not required on Electricity Distribution) would be seen as inefficient compared to a standard plan under Ofgem’s current cost assessment tool kit, which is focussed on minimising the sector cost alone.

If the ambitious plan is not supported, the sharing mechanism would be adversely impacted.

A mechanism to exclude both decarbonisation and whole systems investment from these mechanisms would be beneficial to consumers.

Reopener mechanisms and thresholds are also a barrier and a ‘use it or lose it’ allowance would be a more straightforward way of encouraging lowest cost decarbonisation and whole systems approaches.

CSQ17. Are there any sector specific whole system barriers or unlocked benefits, and if so, any sector-specific price control mechanisms to address these?

In addition to the points we have outlined above, the lack of transparency of cost/value/incentives across the whole system (including connected loads) makes this difficult to assess. Perhaps a separate consultation looking specifically at this question would be of significant value in order to engage with a broad range of stakeholders.

Another area that might also benefit from a review going forward is the different metrics and timelines in which balancing is carried out. In other words, peak electricity is instantaneous, peak gas tends to be daily, and electricity is balanced half-hourly whereas gas is balanced daily.

Stakeholders have suggested that an impact assessment for investment in GD2 should include the benefits accrued in carbon reduction and decarbonisation.

CSQ18. Which of the proposed mechanisms would be most suitable in circumstances where a broader definition of whole system is likely to deliver benefits to network consumers?

Out of the six proposed mechanisms listed under **CS Q11** and within the consultation, all could be suitable. The key challenge will be the practical application of incentives and funding mechanisms given the different licence and timings of price control periods.

Asset resilience questions

CSQ19. Do you agree with our proposals to use monetised risk as the primary basis for network companies to justify their investment proposals for their asset management activities?

In addition to Monetised Risk, there are a number of drivers for investment such as law of the land and stakeholder requirements. These will drive a large part of a Gas Networks investment plan so it would not be appropriate to use monetised risk as the primary justification.

The monetised risk models are a good basis for a Cost Benefit Analysis (CBA) model although there are gaps and we have network specific CBA models to cover these. We also note, Ofgem has released a standard CBA tool for use in the RIIO-GD2 plan justification that will allow us to bridge the gap between monetised risk and CBA.

Our view is that the Ofgem standard CBA would provide the justification for a non-mandatory investment plan. This plan would then be put through the monetised risk models to set a RIIO-GD2 target.

Monetised risk is in its infancy and has not been used to determine allowances in a Price Control in gas yet and therefore, needs to be used with some caution.

CSQ20. Do you agree with our proposals to define outputs for all sectors using a relative measure of risk?

We believe that measuring relative rather than absolute risk in this context helps to clearly demonstrate to stakeholders the benefit of investments made.

It has been suggested that the delta is only measured for assets on which a network plans to intervene on in their RIIO-GD2 business plan. NOMs was developed under the direction of Ofgem to provide a measure of a network company's management of total asset risk. This principle is sound so we would not want to move to using it as a tool to just measure risk on a subset of assets. This approach assumes the investment plan would not change from that submitted to Ofgem in December 2019 through to the end of RIIO-GD2. This makes it extremely complex to update monetised risk targets as the investment plan changes through the price control. This could stifle innovation and dis-incentivise companies from responding to changing stakeholder needs within a price control.

There needs to be some caution here on the comparability of measures across sectors. Whilst some key principles exist, the model development across sectors has been carried out independently with many differences. As such, they are not comparable currently.

CSQ21. Do you agree with our proposals for defining outputs using a long-term measure of the monetised risk benefit delivered through companies' investments?

Long term benefits of investment should certainly be considered in developing a business plan. Care needs to be taken when measuring outputs using a long term view of risk due to the significant impact of deterioration over the long term. Uncertainty around deterioration can be addressed in CBA modelling to ensure a robust investment plan but there is no mechanism to deal with that uncertainty in the current monetised risk target framework.

Our view is that long term benefits can be dealt with in CBA modelling but the monetised risk target should remain as delta at the end of RIIO-GD2. This makes it easier to understand for stakeholders and ensures a comparability across the Gas Networks that could be difficult in the longer term due to the significant impact of deterioration rates over a longer period.

CSQ22. Do you agree with our proposed approach to setting allowances and outputs?

In addition to Monetised Risk, there are a number of drivers for investment such as law of the land and stakeholder requirements. These will drive a large part of a Gas Networks investment plan so it would not be appropriate to use monetised risk as the primary justification.

The monetised risk models are a good basis for a Cost Benefit Analysis (CBA) model although there are gaps and we have network specific CBA models to cover these. We also note, Ofgem have released a standard CBA tool for use in the RIIO-GD2 plan justification that will allow us to bridge the gap between monetised risk and CBA.

Our view is that the Ofgem standard CBA would provide the justification for non-mandatory investment plan. This plan would then be put through the monetised risk models to set a RIIO-GD2 target.

CSQ23. Do you have views on the proposed options for the funding of work programme spanning across price control periods?

Either proposed option could be used for projects of a significant scale. We would support a proportional approach to ensure smaller value projects are not included. This could drive a behaviour of chasing projects for completion by 31st March 2026 which can be inefficient.

The use of dead-bands around the targets in GD1 has been a successful way of managing this.

CSQ24. Do you have any views on the options and proposals for dealing with deviation of delivery from output targets?

Monetised risk includes large societal costs as well as direct costs to a GDN and its consumers. As such it is not proportionate in terms of the impact of under-delivery on future consumer bills to penalise companies by the monetised risk value. This value could be many times greater than the cost of physically doing the work

The consultation only considers consumer value. A company can be impacted by HSE enforcement action that was driven by another network. The cost of this can be significant and where this is out of the control of a network company, they should not be penalised.

CSQ25. Do you have any views on the interaction of the NARM mechanism with other funding mechanisms?

We support some clear rules and guidance on which activities contribute to monetised risk output delivery and the principle that work should not be double funded.

There is a balance to be struck here as the level of investment that is required purely for NARMs with no other drivers could be relatively small. NARMs was designed as a measure of how a company manages risk on its network so this should not be too constrained by the original driver for the work if the output is still a risk improvement.

CSQ26. Do you have any views on ring-fencing of certain projects and activities with separate funding and PCDs? Do you have any views on the type of project or activity that might be ring-fenced for these purposes?

Projects and activities with separate funding, PCDs or legislative requirements are measured in other ways that hold a GDN accountable for work delivery.

Risk trading as a principle may result in more work on an asset in the ring-fenced category being the most beneficial solution for our stakeholders. If ring-fencing prevented this, we would not support it.

Workforce Resilience

CSQ27. Where companies include a sustainable workforce strategy as part of their business plans, what measures do you think could be established to hold companies to account for delivering these plans, without distorting optimal resourcing decisions?

We fully support the view that workforce resilience is vital to the success of our business and welcome the enhanced approach being taken by Ofgem in this area. We firmly believe that we cannot deliver for our customers without a skilled and committed workforce. We have worked extensively during GD1 and previously, to develop a culture where our colleagues are central to our delivery. We are already working collaboratively with others in the sector, and in particular with the other gas networks, on areas such as training delivery, niche training requirements and development programmes.

We are pleased to see that Ofgem acknowledges that we face challenges on recruitment and retention. Where we see upward pressure on pay and benefits we will fully evidence this in our business plan. We support the proposal that efficient costs for workforce resilience should be funded as part of the RIIO2 allowances.

We are working with the EU Skills cross sector group on workforce resilience to develop a consistent approach. We are committed to providing a detailed Workforce Strategy document as an appendix to our business plan – this would include workforce plans versus our defined workloads, key skills and recruitment needs and retention strategies which would include our approach to reward, engagement, development etc.

In terms of measures:

- We would prefer that measures are high level and in the context of commitments made in business plans.
- We propose an Investors in People accreditation as a broad and recognised measure of good people processes and suitable levels of development.
- We would welcome a diversity commitment – and a measure which will hold companies to account on improvements/progress made. Given the differences in demographics across networks we do not believe that absolute measures or targets would be appropriate.
- We would propose an annual people resilience statement – signed up by our Exec to confirm that we are able to deliver for our customers, particularly in times of stress on the network (e.g. a 1 in 20 winter).

Physical security

CSQ28. Do you agree with maintaining the existing scope of costs that fall under Physical Security, i.e. costs associated with the PSUP works mandated by government? Please explain your reasons and suggest alternative definitions you believe should be considered.

National Grid Gas Transmission (NGGT) and the Gas Distribution Networks (Northern Gas Networks (NGN), Wales & West Utilities (WWU), Cadent and SGN) have established a cross industry working group as a part of the delivery of the Physical Security Upgrade Programme (PSUP) for security requirements at Critical National Infrastructure (CNI) Sites. This working group propose that the funding arrangements for shared gas sites are amended and that the PSUP guidance is updated to reflect this.

All definitions are in accordance with the PSUP Guidelines (December 2018).

For the scenario where the site user is the sole driver of PSUP at a shared site, the current arrangements state that the capital costs for PSUP shared sites sits with the site user and the site owner is responsible for ongoing operating cost (Opex) once the scheme is completed.

Our proposal is that a single network company is responsible for both Capex and Opex as this reflects the most effective way of delivering this work therefore the best value for consumers.

CSQ29. Do you agree with our proposed approach of ex ante allowances for PSUP works mandated by government? Please explain your reasons and suggest alternative approaches you believe should be considered.

We agree with the proposed approach of ex-ante allowances for PSUP works mandated by government. Due to the specific nature of the requirement of PSUP schemes, experience of delivering these schemes through RIIO-1 and relative inflexibility in deviation from scope, each company should be able to provide robust forecasts of project cost for delivering compliance with the PSUP obligations. As such, the ex-ante funding mechanism is an appropriate approach for determining allowances for PSUP works that have been mandated by government.

CSQ30. Do you agree with our proposal to include a reopener mechanism to deal with costs associated with changes in investment required due to government-mandated changes to the PSUP?

As the PSUP programme is sensitive to changes in threat and asset criticality, a company may have an obligation imposed by government in RIIO-2 for which it has not received the appropriate funding. We do not consider it fair that the company carries these costs and as such agree that a reopener should be included to deal with any additional investment that is required due to government mandated changes to the PSUP.

CSQ31. We would also welcome views on the frequency that is required for any reopener, e.g. should there be one window for applications during RIIO-2 and, if so, when?

As the PSUP programme is sensitive to changes in threat and asset criticality, a company may have an obligation imposed by government in RIIO-2 that requires a rapid response. The ability to apply for funding at any time through the price control, or in line with the Department for Business, Energy and Industrial Strategy (BEIS) review process (every 2-3 years) would ensure a more agile and efficient response to changes to PSUP. This approach allows enough time to plan for work that could be delivered in RIIO-2 but would also allow for deferral to RIIO-3 if there is any uncertainty in the timing of delivery of schemes.

Cyber resilience

CSQ32. Do you agree with the scope of costs that are proposed to fall under cyber resilience, i.e. costs for cyber resilience which are (1) incurred as a direct result of the introduction of the NIS Regulations, and (2) above 'business-as-usual' activities? Please explain your reasons and suggest further or alternative costs you believe should be considered.

No, we do not agree with this principle. The introduction of Network and Information Systems Regulations (NIS) enforces a framework for risk management and potential penalties for failing to comply. There is a cost overhead for the workload in managing the governance but cyber security forms a critical part of our business plan even without regulation. This has not been identified as a separate item in previous business plans but the undeniable increased threat and increased complexity from driving efficiency through technology and automation has resulted in the need to increase cyber security investment. This also includes consideration of additional resource, skills and capability, not just traditional security products such as Anti Virus and Firewalls.

CSQ33. Do you agree with our proposed approach of ex ante 'use-it or lose-it' allowances? Please explain your reasons and suggest alternative approaches you believe should be considered.

We understand the sentiment of the approach and broadly support this approach. However, we also recommend that our cyber security strategy and associated costs (baselined within the business plan), should maintain some flexibility due to a) the unpredictable nature of the changing cyber threat and b) each investment being risk based at a point in time. Our Network and Information Systems (NIS) improvement plan (to be submitted by December 2019), will be aligned to the scope agreed with Ofgem (as the Competent Authority) and recognised as above BAU, therefore requiring appropriate funding.

CSQ34. Do you agree with our proposal to include a re-opener mechanism for cyber resilience costs? Please also provide your views on the design of the re-opener mechanism.

Yes, this is important, given the nature of the fluctuating risk profile in this area. We expects to submit a strategic improvement plan by December 2019, aligned to the Cyber Assessment Framework (CAF) submission process. This will be informed by the guidance that Ofgem are due to release in June 2019. The strategic plan will align specifically to the above BAU requirements of the NIS regulation, to the best of our knowledge at the time. If regulation or European code does subsequently change, or the risk profile changes unexpectedly due to the adoption of new technology or geopolitical concerns that may pose a risk to our business, a mechanism such as a re-opener will be required to facilitate the submission of an additional improvement plan.

Real price effects

CSQ35. Do you have any views on our proposed factors to consider in deciding on appropriate input price indices? Do you have any evidence justifying the need for RPEs and any initial views on appropriate price indices?

We support the use of indices for RPEs but they need to be reflective of the gas industry and cost pressures we are experiencing. We are currently working with consultants to understand the effects of the proposals.

CSQ36. Do you agree with our initial views to retain notional cost structures in RIIO-2, where this is an option?

We would need to understand the definition and calculation of an 'Efficient cost structure' to comment but agree a standard structure should not drive 'gaming' in RPEs. Using the upper quartile companies as a guide for 'Efficient cost structure' would be suitable.

CSQ37. Do you agree with our initial views to update allowances for RPEs annually and to include a forecast of RPEs in allowances? Do you have any other comments on the implementation of RPE indexation?

We agree that these are reflected annually using the relevant indices if the indices are available and stable over years.

Ongoing efficiency

CSQ38. Do you agree with our proposal to use the EU KLEMS dataset to assess UK productivity trends? What other sources of evidence could we use?

We would support the use of EU KLEMS to assess UK productivity trends. We also need to consider specific challenges and innovation within the gas industry when considering ongoing efficiency. We will share any additional information that we source regarding this topic.

Managing the risk of asset stranding

CSQ39. Do you think there is a need for a utilisation incentive at the sectoral level? If so, how do you think the incentive would operate coherently with the proposed RIIO-2 price control framework for that sector?

We broadly agree with Ofgem that a sectoral level incentive for utilisation is not required.

We have provided responses to the “enabling whole systems solutions” (questions 8 to 18) which provide our insights into the current and future use of gas. Whilst annual demands may be falling slightly, peak demands are not. We would be happy to discuss this further with Ofgem as required.

CSQ40. Do you have any views on our direction of travel with regard to anticipatory investment?

We broadly support a whole systems workgroup and direction of travel. We also acknowledge that effective use of cost benefit models is appropriate. We would be happy to engage with Ofgem on further discussions on the composition, structure and terms of reference for such an industry group.

CSQ41. What type of projects may be appropriate for a risk-sharing approach?

We have not identified any specific projects at this time

CSQ42. How can we best facilitate risk-sharing approaches for high-value anticipatory investments?

We would support the use of use or lose it allowances or a re-opener mechanism linked to changes in legislation or indeed outcomes from new groups such as the workgroup identified by Ofgem within the consultation.

CSQ43. How can we guard against network companies proposing risk-sharing arrangements for project they may have undertaken as business as usual?

This should be covered within the RIIO-2 Licence drafting following appropriate workgroups on the subject.

Innovation

CSQ44. Do you agree with our proposals to encourage more innovation as BAU?

We agree with the principle in relation to solutions that need testing in an operational environment i.e. technology readiness level 8 (TRL 8). Positively, WWU can evidence that a high proportion of our projects have been progressed without incentive funding, where the risk is lower. Many of these new and innovative products, techniques & equipment have gone on to be imbedded and rolled out within the organisation.

However, the risk in encouraging more innovation as BAU will be for those projects that are below TRL 7. It is a fact that the incentive funding has supported over 95% of our projects below TRL 7 and that these projects may not have been started without the NIA. The risk and impact of this decision will be a reduction in the ambition of networks, which will likely take lower risk projects that focus on solutions rather than tackling the problems to be resolved.

Another key consideration will be the risks associated with the treatment of intellectual property and learning dissemination, since the higher TRL projects are those that can be rolled out to unlock the business benefits.

The statement in 8.16 will discourage projects that carry risk since it requires every project to deliver to BAU – we know from our own portfolio that this is an unrealistic challenge.

CSQ45. Do you agree with our proposals to remove the IRM for RIIO-2?

Yes, there is no challenge in removing this pot. Networks have not utilised this funding widely and we agree that if an innovation is proven successful then the business case will support its roll out without an incentive fund.

CSQ46. Do you agree with our proposals to introduce a new network innovation funding pot, in place of the Network Innovation Competition, that will have a sharper focus on strategic energy system transition challenges?

We agree and support the proposal to replace the NIC. A defined strategic challenge list will bring better structure to available funding.

Key to its success will be the detail on the new governance arrangements to establish the key challenges, and we would wish to play a part in this.

Also key to its success is a process that provides transparency of forthcoming themes, timescales, indication of early disruptive or later demo style projects and a simple application process.

CSQ47. Do you have any views on our proposals for raising innovation funds?

This appears to mirror the funding mechanism provided by the existing NIC and if that is the case, this would appear a sensible way to raise the funds.

CSQ48. Do you think there is a continued need for the NIA within RIIO-2? In consultation responses, we would welcome information about what projects NIA may be used to fund, why these could not be funded through Totex allowances and what the benefits of these projects would be.

Innovation will happen in RIIO2 as part of normal business ensuring that best practice is adopted throughout the regions of our business. In addition to this business as usual innovation we have completed a wide and varied range of projects, working collaboratively to take higher risks and solve problems where the solution is unknown. Our innovation portfolio has driven our future energy system transition work, our safety performance, improvements for our customers, our approach to workforce skills and resilience and securing value in our procurement activities. NIA has encouraged collaboration between networks and we are proud to have driven that focus, avoiding duplication & allowing networks to learn from each other's projects through forums such as GIGG. Specific examples of these initiatives have been shared in our bilateral meetings with Ofgem.

NIA encourages more early stage disruptive innovation, BAU funding encourages more incremental style innovation

We acknowledge that benefits are difficult to measure and the benefit measurement framework seeks to address many of the areas identified by Ofgem including a TRL heatmap. How learning from projects has informed new projects and how innovation has moved into BAU to provide a better view of the benefits delivered takes time to mature into delivered benefits and typical payback periods are more than 20 years. The full benefits of the innovation programme is too early to be seen.

We have experienced a variety of benefits from projects that include cost saving, cost avoidance, improvements to safety, reliability, service, and environment as well as progressing knowledge and providing societal benefits.

CSQ49. If we were to retain the NIA, what measures could be introduced to better track the benefits delivered?

A large number of networks have developed an innovation measurement framework. The framework includes outcome measures which address many of the areas highlighted in the consultation document.

- "Demonstrate how innovation has moved into BAU" – the framework includes measures looking at the % of mature innovation (TRL 8) moved into BAU and the time taken for these projects to move into BAU.
- "Provide a better understanding of the benefits delivered through innovation" – we are proposing to adopt a common approach to forecasting and tracking innovation benefits to improve the information available on potential benefits from innovation.

- "Concerned that innovation funding has been used for operational and maintenance projects which could have been funded through BAU" – the measurement framework would require companies to report on the focus (in terms of money and number of projects) of innovation across technology readiness levels which are a helpful indicator of innovation maturity.
- "Need to demonstrate how learning from past projects has informed new projects" – the measurement framework includes tracking how many innovation projects have spawned follow on projects.

There has been a successful trial of the innovation measurement framework and we have had support from the large number of stakeholders we have engaged with which includes BEIS, Citizens Advice, and Ofwat.

Networks are currently considering how to adapt the framework based on the feedback received and we want to work with Ofgem to develop the innovation measurement framework further.

CSQ50. Do you agree with our proposals for electricity distribution companies prior to the commencement of RIIO-ED2?

We welcome collaboration across all sectors and if there is customer benefit by cross sector collaboration despite the timings of the RIIO ED2 Price control, we would support mechanisms that support engagement.

Competition

CSQ51. Have we set out an appropriate set of models for both late and early competition to explore further?

Assuming the current qualifying criteria apply (new/separable/high value) we are not against the model in principle. However, we understand that none of our projects would qualify.

CSQ52. Do you agree with the proposed criteria we have set out for assessing the suitability of late competition models? Would you suggest any other criteria, and if so, why?

Assuming the current qualifying criteria apply (new/separable/high value), there is no assessment of whether there is a viable market – this could be added to the criteria.

CSQ53. Do you have any views on the costs and benefits we have used for our draft impact assessment on late competition?

No response

CSQ54. Are there any considerations for a specific sector we should include in our IA?

No response

CSQ55. What are your views on the potential issues we have raised in relation to early competition? How would you propose mitigating any issues and why? Are there additional issues you would raise?

Assuming the current qualifying criteria applies (new/separable/high value) we don't believe this would apply to us and thus cannot comment.

CSQ56. Are there other potential drawbacks of early competition?

Potential drawbacks are: planning and timing constraints, specification changes, and missing innovation opportunities.

CSQ57. Do you consider that there are any existing examples of early competition (including international examples or examples from other sectors) which demonstrate models of early competition that could generate consumer benefit in the GB context?

No response

CSQ58. What are your views on the advantages and disadvantages of the high-level approaches to early competition outlined? How would you recommend mitigating any disadvantages?

No response

CSQ59. Do you have any views on the potential criteria for identifying projects for early competition discussed above? Would you suggest any other criteria, and if so, why?

No response

CSQ60. Do you agree with the criteria we have set out for assessing who should run competitions? Based on these criteria, which institution do you consider is best placed to run early and late competitions?

Ofgem would not be independent to this process (they are an interested party).
We feel that any 3rd party would not be able to provide appropriate solutions. We would be wary that there would always be a bias towards lowest cost, without due consideration for quality / outputs / service / whole life costs and other regulatory requirements (e.g. HSE). The solution should first be fit for purpose, second offer value for money.

CSQ61. Do you agree with how we have described native competition? Do you agree we should explore the proposals described above to enhance the use of native competition? Are there any other aspects we should consider?

GDNs already operate and comply with EU procurement regulations, which operate the principles of equal treatment, non-discrimination, proportionality and transparency. GDN's also takes this a step further by operating Procurement policies that require greater levels of competition and to maintain competitive tension through frameworks and mini-competitions.

CSQ62. How do you think competition undertaken by network companies should be incentivised? Is the use of Totex the best approach? Will this ensure a level playing field between network and non-network solutions including the deployment of flexibility services?

Providing outputs are delivered then we feel that the Totex incentive is appropriate. These are the key principles of RIIO.

CSQ63. What views do you have on an approach where Totex allowances would be based on costs revealed through competition, with a margin or fee for the competition-running entity?

Depending on how the margin or fee is set, this could potentially dis-incentivise the GDNs to find best value. The worse result would be any kind of 'gain-share' or 'savings percentage'. These are typically false economies and do not drive the correct decision making.

CSQ64. Do you think the ESO could have a role to play in facilitating competition in the gas sectors?

We feel that no 3rd party would provide appropriate solutions - there would always be a bias towards lowest cost, without consideration for quality / outputs / service and other regulatory requirements (e.g. HSE).

Business Plan and Totex incentives

CSQ65. What are your views on our proposed approach to establishing a business plan incentive?

We support the principle of a business plan incentive however we disagree with the Ofgem assessment that the RIIO1 arrangements were not effective.

We are concerned that there are many elements of the proposed approach which are currently unclear in the consultation document and remain unclear following the cross-sector workshop on 7 March.

We are unclear as to whether Ofgem will assess their 'confidence' in costs based on the company information or the sector information. For example, one network may have good evidence which would demonstrate high confidence which could be eroded away by poor sector evidence which Ofgem assess as being lower confidence in that costs category, therefore leading to a lower sharing. This is an important clarification required in the May 2019 decision document.

We are unclear about the interplay between cost assessment and the setting of the blended sharing factor. We understand cost assessment will be used to decide on the category with the BP cost element of the BP Incentive, however is this also going to be used in setting the sharing factor? Clarification is required here.

CSQ66. Under the blended sharing factor approach, should the scope of stage 2 evaluation of cost assessment be based on the entire Totex or only on cost items that we consider we can baseline with high confidence?

If a blended sharing factor approach is adopted, we consider that stage two of the BP assessment on costs should only take account of partial totex not entire totex. The nature of a 'low confidence baseline' is that the estimation of these costs is uncertain and therefore there is a higher likelihood that the company's forecast would be further away than Ofgem's forecasts (particularly if this is set at just 4%). Excluding these 'low confidence baseline' costs from the assessment ensures a more robust cost assessment process.

We would welcome a further workshop that would review the whole RIIO-2 sharing factor process given the lack of clarity that we have at this stage on such a material factor of the overall RIIO-2 package. This needs to take place ahead of the May decision document.

CSQ67. What should be the method for categorising cost forecast as High, Medium or Low? Are the indicative boundaries of 1.0 (High to Medium) and 1.04 (Medium to Low) appropriate?

We welcome the principle of transparency in publishing the criteria for cost assessment at this stage. However, we are concerned that these two boundaries present an unnecessary 'cliff edge'. For example, a company whose costs are 4.0% above Ofgem's assessment will be awarded 'average' whereas a company whose costs are 4.1% above would be awarded 'poor' with a fixed 2% Totex penalty. There needs be more of a range and/or continuum as the difference of 0.1% could simply be a result of errors/rounding or a misunderstanding of the work being proposed, yet this has a disproportionate impact on networks rewards and penalties.

In addition, we require clarification of whether the 'Ofgem cost forecast' is based on the Ofgem view of upper quartile or frontier performance – with only a 4% tolerance this must be upper quartile.

Finally, a range of 4% is very small – for example if one network plans to undertake a large capital project (eg pipeline replacement) there is a risk that this could lead to more than 4% additional cost when benchmarked against other companies who are not planning to invest in such a project. It seems perverse that this would then place that company in the poor category.

CSQ68. What should be the range for the business plan reward/penalty? Is the range of ±2% of Totex equivalent appropriate for incentivising high quality and ambitious business plan submissions (e.g. Value or Good Value)?

We are pleased to see the upfront publication of the rewards and penalties.

However, we are very disappointed at the asymmetric nature of these. To apply an absolute penalty (of 2%) against a shared reward (of up to 2%) limits company ambition and increases the regulatory 'stick' at the expense of a 'carrot'. The inherent uncertainty around a potential shared reward is disappointing.

Wales & West Utilities Limited
Registered Office:
Wales & West House, Spooner Close, Celtic Springs,
Coedkernew, Newport NP10 8FZ
Registered in England and Wales number 5046791

In addition, as set out in our response to **CSQ68**, the current categories lead to unnecessary ‘cliff edges’ in terms of rewards and penalties. For example, a company may just make it into the value category with a 1% reward against another who is, by a subjective qualitative assessment, marginally below and receives no reward. We would prefer a smoother continuum which allows for shades of reward/penalty eg 1.2%, 1.3% etc rather than the current ‘cliff edge’.

CSQ69. Do you agree with our assessment of the IQI? (if not please provide your reasons). Do you agree with our proposal to remove the IQI?

We do not agree with the Ofgem assessment of IQI.

The strength of the IQI for GD1 was not set in time to influence the quality of business plans so to say that it is ineffective is unproven. We did not have sight of the RIIO GD1 IQI matrix ahead of business plan submission. However, in ED1 there is evidence that the strength of the IQI has ensured quality plans against which some DNOs are underperforming and others who are outperforming.

We would urge Ofgem to publish the tests which were applied as per footnote 88 within Para 9.31.

CSQ70. Do you have views on the effectiveness of the blended sharing factors approach and in particular the incentive it provides on companies to submit more rigorous Totex submissions?

This is an untested approach and therefore its effectiveness is unknown. The complexity of a blended sharing factor also fails to support the principle of simplicity.

The reference in para 9.60 “in RIIO-1 a sharing factor of 50% has been used” is incorrect for gas distribution, we have a sharing factor of 63% which is now proposing to be instantly and significantly cut down to a maximum of 50% without any justification or rationale.

We would also request clarity from Ofgem on whether the 15% and 50% is binary or whether this is a range, this was requested at the workshop on 7 March but no clarification was given.

We would recommend Ofgem consider a more symmetrical approach to the sharing factor for example to match the 15% for low confidence costs with an 85% for high confidence costs; or a principle along these lines.

Just a point of clarification, we do not capitalise costs based on IQI strength. We must comply with accounting rules in the UK.

CSQ71. Do you agree with our assessment of the blended sharing factor in comparison to the Ofwat cost sharing mechanism? If not, please provide your reasons.

Your assessment is a just a qualitative view and therefore incomplete and subjective, therefore we cannot make any further comparisons to the Ofwat sharing mechanism.

CSQ72. Considering the blended sharing factor, what are your views on the factors (e.g. predictability, ability to effectively deal with uncertainty) or evidence that could be used to distinguish between costs that can be baselined with high confidence and other costs?

We are working with Ofgem to develop a robust cost assessment toolkit. This, combined with the comprehensive RRP data which Ofgem receive annually and the BPDTs, provides significant evidence to support the cost assessment process and to provide confidence.

Where there are increasing costs compared to GD1, we would expect Ofgem to rely on market information and trends, external independent data or competitive tenders supplied by the companies and/or use the RPE data as appropriate.

CSQ73. Do you have any views on the level of cost disaggregation we should apply to calculate the blended sharing factors approach on (regulatory reporting pack level or another level)?

We would remind Ofgem of the principle of simplification. The level of cost disaggregation to apply to the blended sharing factor needs to be proportionate. We would ask Ofgem to clarify which areas of cost they see as low confidence and the materiality of these; we understand from the workshop on 7 March 2019 that the cross-sector policy team are working with the cost assessment team on this.

CSQ74. Do you have any views on whether the proposed business plan incentive coupled with the blended sharing factor will drive the right behaviours?

We are concerned that the current tools across the board for RIIO2 are significantly impacting financeability and blunting ambition; neither of which are good for consumers.

We note that many of these questions are asking for our views on the sharing factors and cost assessment elements but we would also like to comment on the quality assessment of the BP incentive. In our view, there is little guidance on how the quality of our plans will be assessed and there is a definite need for more objective assessment criteria to remove the risk of ambiguity. This is particularly important given there is a financial reward and penalty attached to both the cost and quality assessment. We would point out that low cost does not automatically result in high quality.

As indicated in our response to the Business Plan Guidance (dated 15/02/19) we would recommend an approach that provides networks with clear guidance in terms of

- an overview of the focus areas for the business plan;
- the questions against which the plans will be assessed; and
- Ofgem's view against each of the individual areas in terms of quality, ambition and innovation

We would welcome further guidance in relation to the relative weight Ofgem plans to put on the various elements of our plan and how contrasting priorities will be dealt with.

An example would be where we have robust evidence that shows consumers are willing to pay more for additional services but this increases our base costs; in this instance would Ofgem give more weight to the consumer engagement (quality) or would more weight be given to the cost assessment (cost) outcome? We would recommend Ofgem publish any planned weightings that will apply to the BP assessment.

In addition, we would like to understand how Ofgem will use the CCG and CEG input in its business plan assessment.

CSQ75. What views do you have on our assessment of the sharing factor ranges?

Please refer to our response to **CSQ70** above.

CSQ76. Are there any other factors that you think we should take into account in the design of sharing factors?

A robust quantitative impact assessment is required at the company level for the RIIO-2 package proposals.

We would ask that Ofgem look at the other tools which are also being developed in the RIIO2 toolkit; all of which are designed to reduce returns and outperformance opportunity.

As an example, the blended sharing factor is one of many which is limiting company ambition by not appropriately rewarding efficiency which, by its nature, is becoming more difficult to achieve given lower allowances.

We would encourage Ofgem to consider factors which encourage rather than limit ambition and deliver a more balanced package for companies.

CSQ77. Do you have any evidence on the scope for productivity improvements in the different sectors?

We are currently undertaking a robust external piece of work to help us establish a reasonable view for companies of our age and type.

We have commissioned a consultant to review the level of productivity improvements that are likely in RIIO-2 in gas distribution. We will share the report with Ofgem once finalised.

CSQ78. Do you have views on whether adjustments to sharing factor levels after the price control is set are desirable or necessary?

We do not support amendment of the sharing factors once the price control has been set, this undermines the regulatory contract and can result in lower NOW ambition.

CSQ79. Under which circumstance do you consider such adjustments should take place?

As our response to **CS Q87,** we do not support adjustments after the price control has been set.

CSQ80. When do you consider an adjusted sharing factor should be calculated?

As our response to **CS Q87**, we do not support adjustments after the price control has been set.

Ensuring Fair returns

CSQ81. Do you agree with our comparative assessment of RAMs set out in Appendix 4?

No we do not agree with the subjective comparative assessment of the RAMs set out in Appendix 4. There is no mention of fairness, it does not recognise the dominance of Cadent within gas distribution and the small company risk in the weighting. The examples are 3 companies of equal size – which is not reflective of our sector.

CSQ82. Do you agree with our proposal not to give further consideration to using discretionary adjustments?

We agree with Ofgem and do not support discretionary adjustments of this nature. The Licence should be clear so that networks, the regulator and the customer know what the contract is.

SQ83. Do you agree with our proposal to introduce an individual performance-based adjustment approach (Class 1) for the transmission sectors?

Our proposals that we outlined in our executive summary would not require RAMs in any sector. A well calibrated outcome is better for consumers without unnecessary and complex return adjustment mechanisms. If a RAM is to be included it must be based on individual performance and not a sector mechanism.

CSQ84. Do you agree with our proposal to introduce a sector average-based adjustment approach (Class 2) for the GD sector?

No, a sector-based mechanism is completely wrong for gas distribution. There are only eight GDNs in four ownership groups, Cadent is 50% of the sector and SGN 25%. Our financeability cannot be dependent on other organisations performance.

Our proposals that we outlined in our executive summary would not require RAMs in any sector. A well-calibrated outcome is better for consumers without unnecessary return adjustment mechanisms. If a RAM is to be included, it must be based on individual performance and not a sector mechanism.

CSQ85. Do you agree with our proposal we should not adjust companies downward if they perform below their base cost of equity or upwards if they perform above their base cost of equity?

We do not understand how this would apply. We need further clarification from Ofgem on this.

CSQ86. Would a return adjustment threshold of ±300bps RoRE achieve a good balance between providing scope for companies to outperform and ensuring return levels are fair?

If this was linked to individual company performance, this may be appropriate. It is wholly inappropriate if linked to sector performance.

CSQ87. What are your views on the proposed use of RoRE as a return adjustment metric? Would it be suitable for the gas and electricity transmission sectors and the gas distribution sector?

Any review of company financial performance before considering a RAM would need to take into account all relevant company financial information that contributes to performance. Therefore, a wider RORE is part of the assessment. RORE does not reflect investor returns.

We welcome the recent progress Ofgem has made by expanding the RORE scope to include performance against debt & tax allowances as part of its 2017/18 annual report on RIIO-1. This progress will promote transparency for all stakeholders.

CSQ88. Should we include financial performance within the scope of return adjustments? If not, what is the rationale for excluding financial performance?

Yes, if return adjustments are to be used, then all relevant elements of financial performance against the price control must be considered. Without this there could be significant unintended consequences for networks and consumers.

CSQ89. Should we implement adjustments through a 'true-up' as part of the annual iteration process or at the end of the price control as part of the close-out process?

We have an established annual iteration process but there are a number of additional mechanisms proposed that will add significant administration and complexity to the annual iteration process. Within a reduced 5 year period, it may be appropriate to consider a true up at the end of RIIO-2. We would be happy to discuss this further with Ofgem.

RIIO-2 achieving a reasonable balance

CSQ90. Do you agree with our assessment of the measures we have identified to make the price control more accurate?

As we have outlined in our executive summary we do not agree with the Ofgem assessment of simplicity v accuracy. There are a number of "repeat" mechanisms that will deliver a sufficient level of accuracy without the need for the large number of complex mechanisms such as RAMs. The current package of proposals is significantly more complex than the existing RIIO 1 package.

CSQ91. Are there other measures we should take to improve the accuracy of the price control?

There are a number of proposals included in the consultation documents that would add significant complexity. We recommend that their requirement is reviewed on the basis that a fair price control is set in the first instance and therefore a reduction in proposed measure is required rather than an increase.

CSQ92. Are there other steps we could take to simplify the price controls, without significantly affecting the accuracy of the control?

We agree that the RIIO package can be developed and improved. We welcomed the independent review of RIIO by CEPA and despite its limitations in scope; we support a number of its conclusions and also disagree with some.

In summary we outline below some high level principles that would better deliver for customers during and beyond RIIO-2:

- We would support a simpler package without losing any of the material accuracy.
- We will take on more operational risk of outperformance or underperformance but we accept this as part of the "repeat game"
- We aim to deliver efficiency and benefits for both customers and networks

Utilising the existing RIIO Framework, some of the suggestions in the consultation document and our proposals should position Ofgem to make good regulatory decisions to achieve appropriate outcomes for stakeholders. This can be achieved by:

- ➢ Resetting cost allowances and workload allowances to reflect RIIO-1 performance whilst recognising RIIO-2 cost pressures - this would reduce cost allowances.

- ➢ Introducing appropriate workload volume drivers for the Iron Mains replacement programme – addressing the lack of linkage between Primary Outputs and workload requirements – a specific issue for gas distribution from RIIO 1

- ➢ Introducing the indexation of Real Price effects – reducing the scope for up front forecasting errors, and removing windfall gains/losses to network companies.

- ➢ Reviewing the Totex sharing factors - addressing the risk/reward balance between networks and customers.

- ➢ Strengthening the customer voice with a local Customer Engagement Group and a national RIIO-2 Challenge Group–improving the quality and legitimacy of the business plan process.

- ➢ Updating Ofgem RORE measure of returns – (noting the positive updates to scope in the 2017/18 Ofgem annual reports)

- ➢ Enabling shareholders of an efficiently run company to earn a fair return for the risks that they face. Fair return being measured using a complete RoRE calculation to better reflect the return equity investors are achieving from the regulated business – improving the transparency and legitimacy of the measurement and reporting of shareholder returns.

- Updating the debt allowance to reflect actual costs incurred, subject to an efficiency test – this will avoid windfall gains and losses.

The package of measures outlined above removes the need for untested and ex-post measures that would add further complexity and turn RIIO into a rate based form of regulation.

In summary, the regulatory framework must continue to incentivise regulated networks to efficiently deliver the investments and services that underpin the key national & regional policy requirements whilst protecting the most vulnerable and fuel poor.

CSQ93. Do you agree with our consideration of the risks facing these companies? Do you think the measures we are proposing will mitigate these risks? Does the expected level of return indicated by our proposals reflect these risks?

The current package falls short of what is needed for sustainable development. We do not agree that the measures being proposed will be in the long-term interests of customers.

We do not accept the limiting parameters within which Ofgem has framed its approach to financeability. We are also concerned the lack of appropriate evidence to support the Ofgem position across a number of the financing elements. Where evidence has been evaluated, some significant errors have been made. In summary, there is a lack of analysis and rationale to support conclusions.

Our analysis leads us to conclude that the current Ofgem recommendations will not achieve the appropriate overall balances targeted by the Ofgem aims, as stated within the consultation document.

CSQ94. Have we achieved a reasonable balance with our proposals in seeking to achieve an accurate price control with return adjustment mechanisms only being used as a failsafe? Should we instead have a simpler price control and put more reliance on return adjustment mechanisms?

Please see our response to CSQ92. We do not conclude that a reasonable balance will be achieved by the current Ofgem proposals.

CSQ95. Have we achieved a reasonable balance in our proposals in considering return adjustment mechanisms alongside the expected-allowed return wedge? Should we instead only rely on one mechanism? What additional value would this bring?

Both mechanisms are untried and untested. We don't consider either are needed in a well calibrated price control.

We do not accept the limiting parameters within which Ofgem has framed its approach to financeability. We are also concerned the lack of appropriate evidence to support the Ofgem position across a number of the financing elements. Where evidence has been evaluated, some significant errors have been made. In summary, there is a lack of analysis and rationale to support conclusions.

CSQ96. Have we got the right focus on the areas that are of most value to consumers?

We welcome the additional focus being given to vulnerable customers. Fuel poverty continues to rise – especially across our region (23%) for Wales and we must continue to focus on these areas. Over RIIO GD1 we have also seen changes to the way the gas network is being used to support renewable electricity (Peak usage and growth in small gas fired power stations). The decarbonisation of heat and transport are now the two major challenges for energy decarbonisation and we must continue to focus efforts in these two areas. We must increase focus on these areas. There is too little focus on decarbonisation of gas and use of gas based transport (especially for larger vehicles) within the consultation.

We are concerned with the disproportionate focus on network returns, significant increase in complexity and we must not let this dominate the key consumer issues we highlight above. Therefore, we are concerned about the lack of focus on the bigger issues and too much focus on sector returns. We have noted the recent Sustainability First discussion paper on future of regulation and broadly support a number of its observations.

CSQ97. Are we proposing a methodology that allows us to achieve a reasonable balance between the interests of different consumer groups, including between the generality of consumer and those groups that are poorly served/most vulnerable? Are we missing any group?

See **QS96**

CSQ98. Are we proposing a methodology that allows us to achieve a reasonable balance between the interests of existing and future consumers?

RIIO was introduced to better support the significant energy challenges faced and to incentive regulated networks to deliver current and future challenges efficiently. We are significantly concerned that the short term focus on returns will undermine the larger challenges we face. We note with interest the sustainability first paper on this particular issue and broadly support a number of points it makes. The RIIO 1 package is delivering for current and future consumers but we are concerned over many of the RIIO-2 proposals as highlighted throughout this response.

Preliminary impact assessment

CSQ99. What are your views on the approach we are proposing for assessing impact of our RIIO-2 proposals?

The current Ofgem narrative impact assessment is wholly insufficient. A full robust quantitative impact assessment is required.

We do not accept the limiting parameters within which Ofgem has framed its approach. We are also concerned the lack of appropriate evidence to support the Ofgem position across a number of the financing elements. Where evidence has been evaluated, some significant errors have been made. In summary, there is a lack of analysis and rationale to support conclusions.

CSQ100. What are your views on the assumptions we have made in our assessment to date

The current Ofgem narrative impact assessment is insufficient. A full robust quantitative impact assessment is required.

CSQ101. What are your views on the uncertainties we have identified for the purpose of this assessment

The uncertainties identified are largely in line with our views. There are some key omissions and inconsistencies between sectors. E.g. Land development. We will highlight these within our business plan submission.

CSQ102. What additional evidence should we consider as part of our ongoing assessment?

Please see response to CSQ99. In addition, we would welcome more recognition of the objective feedback being provided from networks and other stakeholders at the RIIO-2 workshops. There is mixed evidence of Ofgem using the valuable stakeholder feedback.

It is also unclear how the feedback from CEG and CCG panels will be utilised. The views of these two groups must be considered.

3. Meet the needs of consumers and network users

GDQ1. What are your views on the overall outputs package considered for this output category?

We have welcomed the ability to participate in the customer and social working groups to date. We were pleased to see many of the discussions are reflected in the consultation document. In particular, we are pleased to see introduction of a new vulnerability incentive.

We note that the overall package is yet to be defined, particularly in terms of the financial incentive. We discuss our views below.

GDQ2. For each potential output considered (where relevant):

a) Is it of benefit to consumers, and why?

b) How, and at what level should we set targets? (e.g. should these be relative/absolute)

c) What are your views on the design of the incentive? (e.g. reward/penalty/size of allowance)

d) Where we set out options, what are your views on them and please explain whether there are further options we should consider?

We disagree with the proposals to set targets that are relative to other GDNs and change throughout the price control ("dynamic relative") as this adds uncertainty and discourages collaboration amongst the networks which could adversely impact service levels. Targets must be resolute.

We support continued financial incentives for service levels however would ask Ofgem to note that the rate of improvements seen in GD1 is not sustainable when, for example, we are now achieving greater than 9/10 on CSAT.

GDQ3. What other outputs should we be considering, if any?

During the working groups we have proposed a more holistic and independent view of customer satisfaction for example, ICS Service Mark, which we note have not been taken forward in the consultation. We are, however, pleased that we have the opportunity to add bespoke outputs into our GD2 business plans which are supported by our customers.

GDQ4. What are your views on the RIIO-GD1 outputs that we propose to remove?

We note the removal of DRS and welcome the new consumer vulnerability package in its place which is more targeted and will provide value to customers that are in need

GDQ5. What activities beyond those outlined in paragraph 3.12 should we consider when defining the role of the network companies in supporting consumers in vulnerable situations?

We would recommend that Ofgem consider the additional following activities

- Identifying and appropriately taking into account vulnerability when undertaking planned work
- Linking up with partners to provide income, tariff, energy efficiency and behavioural advice and support which will help tackle fuel poverty and leave a legacy of benefits following our interaction with that customer

Overall, we would recommend Ofgem consider the benefits of requiring networks to achieve Inclusive Service Provision (BSI 18477) accreditation which offers third party assurance of services offered and business-wide awareness of vulnerability.

GDQ6. Can you provide any evidence that shows how the boundary we have set out for the networks' role in consumer vulnerability could impact the benefits received by consumers in vulnerable situations?

We are actively engaged with Welsh Government and Local Authorities across our network to try to coordinate their access to funding with our funding and the FPNES.

The energy suppliers have put minimal ECO funds into the support of new heating systems during GD1 and there is uncertainty over the role of ECO beyond 2021

Therefore, the link up of the FPNES to other schemes that support the First Time Central Heating are uncertain and out of the GDNs control based upon the boundaries set. The impact of this is that those most in need may be unsuccessful in accessing the FPNES and hence unable to benefit from lower heating costs.

GDQ7. What is your preference on the two approaches we have outlined to implement the allowance, and why?

Our view on the two approaches is as follows

- Option 1 does allow flexibility but a core programme of works over several years will provide certainty to partners and allow for tendering of services
- Option 2 does restrict the flexibility around the main programme of works which may change in the period to 2026

GDQ8. What examples can you provide of initiatives that could be funded through the allowance, and please explain why these activities would not go ahead without specific price control funding?

Examples for WWU would include:

- Development and provision of support beyond the basics alternative heating and cooking requirement in the licence
- Campaigns and partner working to encourage sign up to the Priority Service Register and spread and embed CO awareness
- Provision of free CO monitors to Priority Customers
- Partnership working to identify priority customers and fund agents to assist those homes through income maximisation, fuel tariffs and debt, energy advice and referral to finding, behaviour changes
- Development of data tools to identify PSR households and homes at risk of CO

Without funding in the price control there would be no access to funds elsewhere to support these types of initiatives which would hugely benefit those with the most needs.

GDQ9. What is your preference on the three potential options we have outlined for a consumer vulnerability package, and why?

We support Option 3 - the Combined package. However, recommend core funding needs to be guaranteed for services which go 'above and beyond' subject to demonstrating the outcomes for customers. We do not support an alternative subjective DRS style assessment which has only ever funded part of what we do.

GDQ10. What should we include in the FPNES eligibility criteria in RIIO-GD2 to facilitate a well targeted, but effective scheme?

We request that the FPNES criteria is clearly defined before the start of the price control and not changed during GD2.

The current criteria is focused on low income homes and those in fuel poverty. In addition, this provides flexibility via the Local Authority declarations to identify and support homes on the edge of poverty.

We do not support the demonstration of eligibility becoming so onerous that it becomes a blocker to alleviating fuel poverty, for example the reluctance of families to share personal information or disproportionate administration costs.

We support the use of data mapping tools to identify and qualify eligible homes in a smart and efficient way.

GDQ11. How should we incentivise the GDNs to improve the targeting of the FPNES?

We would support the requirements of the scheme to include a post completion survey of households who have benefited from the scheme to test the impact on the home of the new heating system to demonstrate how fuel poverty has been addressed / improved by the installation. This learning could further support targeting thereafter.

GDQ12. How can we ensure that the FPNES is better coordinated with other funding sources to provide a whole house solution for the household?

ECO, its successor and any other any government scheme must have a commitment to new gas First Time Central heating. Also, the calculation of the funding needs to support the whole system and not leave low income households having to contribute an amount which is above their means and results in nothing happening.

It is worth noting that as GDNs, whilst we aim to influence, we cannot drive the policy or rules of these schemes.

GDQ13. What are your views on us requiring or incentivising the GDNs to ensure that households receiving FPNES connections also achieve a target level of energy efficiency?

Following an FPNES connection, the households new heating system will, in most cases, improve the EPC rating of E, F or G rated property by two bands. However, it is worth noting that a band C rating is very high and will not be achieved by a new heating system alone.

Given that Ofgem are unable to support the GDNs having access to funding for other internal measures, such as insulation inside the property, changing windows etc we are unable to influence the energy efficiency rating above the benefits of a gas central heating system.

In addition, there would be a cost implication of this proposal in that every home would need an energy assessment up front and post the measures; this would need to be funded.

GDQ14. Do you think the value of the FPNES voucher would need to be amended if the targeting of the scheme is increased? Please provide any evidence to support your view.

The maximum value of the fuel poor voucher in WWU is currently £2200- £2300.

The average cost of a service is £1,600 leaving a maximum £400 to £500 for admin costs we claim an average cost of £1,800 per connection.

Admin costs need to cover not only those connection that go ahead but finding properties in the first instance, and then assessing a larger number of homes to identify the qualifying homes

Requirements to gather further information, carry out EPC assessments, demonstrate the effectiveness of the scheme though post completion surveys will all drive costs upwards. Therefore, the value of the voucher would need to be reassessed if such changes are proposed for RIIO2.

GDQ15. What is your preferred option for revising customer payment caps?

We support the removal of the cap for GS1 (unplanned interruption) given the inconvenience caused to the customer. In respect of the other caps, we would support keeping them however the level of the cap should be set at a level proportional to the inconvenience caused to that customer. We would also note the need for continued exemptions, for example when we are unable to contact a customer, access their property or they ask us to get back to them at a later date.

We are pleased to confirm that we have voluntarily doubles our compensation as a direct result of consumer feedback

GDQ16. Where, within the consultation ranges, do you think the standard and payment levels should be set?

We are already paying a voluntary payment effectively doubling the statutory payment following feedback from our customers. We would therefore propose this is taken as a guide on the basis it reflects not only the inflation element since the regulations started, but also customer expectations.

However, we would recommend that the compensation payments are sense checked and are proportional to the impact on the customers – for example the current proposal would mean that a customer would only get paid £41 to £75 per day for being off gas yet they would get paid £69 to £100 per day for a delay in reinstating their property which feels disproportionate to the comparative inconvenience.

We support the payments being linked to inflation linked to protect the consumer in perpetuity.

GDQ17. Should any existing GSOP exemptions be removed or changed and should any additional exemptions be considered?

GSoP exemptions must be retained, should be common across all GDNs and clearly stated in GSoP guidance documents. For example, a customer should not be entitled to compensation if we have been unable to contact them or access their property or if they ask us to get back to them at a later date.

GDQ18. Do you support the proposal to make all GSOP payments automatic for RIIO-GD2 and why?

We support the proposal to make all GSOP payments automatic to protect priority customers and to demonstrate excellent customer service.

We will be introducing automatic payment for GS13 (planned interruptions) in April 2019.

We are also working to ensure GS3 (priority customers) is consistently recorded and automatic payment made if there was a failure to offer alternative heating and cooking. This may take until 2020 to introduce and embed.

GDQ19. Are new GSOPs (or amendments to existing GSOPs) required and what might these look like?

We are currently consulting along with the other GDNs on new GSoPs for discussing with Ofgem before the summer.

This will include:

- Appointment standard for reconnection following mains replacement work
- Service to be offered to support a priority customer through a planned or unplanned interruption
- Amended timescales and payments for notification of works or failing to notify or offer a service

GDQ20. Should there be a licence condition to prevent standards for the restoration of unplanned interruptions deteriorating (GSOP1)? If so, how should we set the target, and should we take into account geographical differences. Please consider alongside our wider proposed interruptions package.

We are keen to understand the context behind the increased focus on interruptions – we recognise this is an issue in electricity where customers can be without supply once every two years however in gas the chance of an unplanned interruption is only once in a lifetime on average. In addition, there is protection under GSOPs for customers where we pay compensation if the duration lasts longer than 24 hours (which may be reduced to 18 hours as part of this consultation). We therefore believe the protection already exists for gas consumers.

We agree with the view that a licence condition is unnecessary however if Ofgem did choose to implement a licence obligation, it must only be set at a backstop minimum level of service and must include appropriate exemptions, for example large scale incidents, 3rd party damage etc to prevent the risk of a company breaching their licence through no fault of their own.

GDQ21. Is the existing 90% target pass rate for connections GSOPs still appropriate, if not how should it be revised?

The Licence Obligation target of 90% for connections GSOPs is appropriate and allows us to resource in the most efficient way possible. It is also important to note that remaining customers (up to 10%) who do not receive this level of service are compensated accordingly.

GDQ22. Should licence conditions with target pass rates be introduced for any other GSOPs?

No, we believe there is sufficient protection for customers and companies are already incentivised to minimise failures as every failure results in payment to the customer.

GDQ23. What do you think of the proposed new output based on average restoration time for total unplanned interruptions?

We support the measurement of interruptions using an 'average time' because this is a sound way to compare GDNs, they are easily understandable and explainable to stakeholders

However, it is important that large events and interruptions to multi occupancy buildings (MOBs) are be measured separately

Ofgem should set a common target across all GDNs given as there is no evidence to support a variation in the duration of interruptions across the UK given the causes of interruptions are common (leaking non-PE services)

It is important that previous relative good performance should not penalise a company by setting a tighter target compared to others.

GDQ24. Should any interruption events be excluded from the average restoration time incentive for total unplanned interruptions, and why?

We believe that it would be important to separate the reporting of interruptions into 3 categories – 1) standard 2) MOBs 3) large events

Large events are rare, only 7 so far for WWU in GD1 (35 UK wide). Their impact on the overall numbers is, however, extremely large and disproportionate. The inclusion of these could mean the difference between achieving or failing a target without GDN controllability.

It is safety critical to manage the restoration process during a large event to ensure that all supplies are isolated / air is purged from the system and appliances are then subsequently restored. This process needs to be controlled and methodical. It is not comparable with the electricity or water industries where supply is just turned back on

GSOP incentives are already in place to penalise poor performance and to compensate the customers affected.

GDQ25. What are your views on separating interruptions that occur in MOBs into a specific output?

We support separating out interruptions that occur in MOBs as well as large events.

4. Deliver an environmentally sustainable network

GDQ26. What are your views on the overall outputs package considered for this output category?

If the intention is as stated that this focused on "decarbonisation of the energy system" we don't think the package goes far enough to recognise the role networks are playing in low cost, low carbon heat. We are disappointed that Ofgem are not proposing an incentive for decarbonisation of heat however we welcome the move to fund well justified projects in addition to the other mechanisms proposed. Specifically, GDNs can support the decarbonisation of the economy in the following areas:

- Power generation – enabling the lowest cost renewables (intermittent wind and solar) by providing low capital cost, low load factor (<8% by 2050) gas engine generation.
- Providing supply to low carbon energy centres, many of which have a CHP at the heart of them.

Wales & West Utilities Limited
Registered Office:
Wales & West House, Spooner Close, Celtic Springs,
Coedkernew, Newport NP10 8FZ
Registered in England and Wales number 5046791

- Providing hybrid energy to heat networks, enabling low cost, reliable, low load factor back up and peak supply to compliment low carbon sources.
- Heavy transport – HGV and buses are already providing low/zero pollution, low/zero carbon alternatives to diesel or petrol vehicles.

The output package as it stands does not encourage an ambitious business plan in this area, but we have been encouraged at the working groups of potential change in this area.

As in our response to the sector specific consultation questions, a whole systems approach to heat decarbonisation will present the lowest cost solution, the least disruption and most likely chance of being successful.

GDQ27. For each potential output considered (where relevant):

a) Is it of benefit to consumers, and why?

b) How, and at what level should we set targets? (e.g. should these be relative/absolute)

c) What are your views on the design of the incentive? (e.g. reward/penalty/size of allowance)

d) Where we set out options, what are your views on them and please explain whether there are further options we should consider? "

With regard to the shrinkage output, we believe that the gas distribution network is on the 'home straight' of the mains replacement programme and this will lead to the near elimination of shrinkage from network leakage. The conclusion of the programme is very structured and there would be limited value in an incentive in this area. From the perspective of the other two areas that the GDN can influence, we would have the following observations:

- Pressure Control:
  Around 95% of iron mains are now under pressure control following significant investment and targeting in GD1. The improvements in average system pressure have now levelled off and we see no further opportunity in this area. Appendix CC2[9] illustrates recent year's average system pressures, noting no further improvements.

- Gas Conditioning:
  Only lead yarn joints, typically installed on pit cast iron pipes react to agents such as MEG. Due to the very low proportion of this material in the network, we stopped gas conditional prior to GD1. Appendix CC3[10] illustrates the point with one of WWUs city Networks (Newport) illustrating in red the remaining cast iron. It is a

[9] Environment Appendix March 2019 pg. 7
[10] Environment Appendix March 2019 pg. 8

very small proportion and highly dispersed, hence not being suited to gas conditioning.

We therefore support Ofgems option 3 for a reputational incentive to maintain the gains achieved in GD1.

With regard to an incentive around other business carbon footprint, this is less than 5% of overall carbon emissions, but most of this results from fuel and pipe used for the mains replacement programme. This carbon investment is highly efficient with a carbon payback (in emissions reduction from iron pipe replaced) in less than one year. Whilst we have improved these emissions in this area in GD1, there is limited further scope for reduction without heavy investment in say CNG vehicles, whose additional cost has not been supported by stakeholders. We have followed the recommendations provided by the external ESOS audit requirements. Reducing the programme to avoid these emissions would be counter-productive.

The reduction of emissions from methane is a key challenge for us and the UK and noting the vast majority of our emission come from natural gas leakage from our iron mains, we are considering a broader incentive (possibly financial) that could be linked to the replacement of natural gas with Biogas.

We will continue to work with other networks and stakeholders and bring forward proposals in our business plan.

GDQ28. What other outputs should we be considering, if any?

As noted in **GDQ26**, we are demonstrating that GDNs can play a key role in the decarbonisation of the economy, not only on heat, but power and transport as well. We believe a strong incentive should be provided to encourage ambitious plans in this area, something requested by stakeholders.

GDQ29. What are your views on the RIIO-GD1 outputs that we propose to remove?

Since the beginning of GD1, all networks have embedded environmental management systems, certified by ISO14001 and are required to participate in the government introduced ESOS scheme. The removal of outputs would not damage environmental performance.

GDQ30. What are your views on the priorities we've identified for the gas distribution sector in delivering an environmentally sustainable network? Should measures proposed for electricity and gas transmission, such as BCF reporting and strategies for including in Business Plans, also apply to gas distribution?

See response to **GDQ27**

GDQ31. Do you agree with our proposed approaches to funding GDN activities over RIIO-GD2 related to Heat decarbonisation?

The mechanisms set out cover a number of scenarios, but others do not appear to be covered, particularly in the ‘low and no regret’ category, but may be more significant than the ‘limited’ nature the consultation suggests. An example would be the introduction of flexible MP/IP/HP networks enabling for significant increase in biomethane connections and capacity. There has been strong stakeholder support from decarbonisation groups, politicians and devolved government to increase the available capacity of the network to enable biomethane introduction in much higher volumes as set out in 2019 Spring Statement by the government.

A joint GDN innovation project 'Optinet' is exploring the options including smart network control and compression could see a significant increase in biomethane capacity. See appendix CC[11] Ambitious business plans would exploit this and see projects which are more than the limited nature suggested.

Finally, the general principles in 2.10, 2.11 and 2.15 of the GT document seem inconsistent with the GD document (4.28) including that they wish to "ensure the NTS is sufficiently flexible to accommodate new and more diverse sources of supply" note also 2.27 the GSO manages the NTS in a manner that leads to lower overall costs and effectively supports the transition to the low carbon energy system. Also, 2.11 network capability (in the GT doc) could be an approach applied to GDNs as well as GT?

With regard to reopeners, in paragraph 4.39 we need to consider devolved policy as well such as a change in Welsh Government Policy.

On the point around uncertainty, many more respected organisations believe that maintaining the gas network will be essential to decarbonising heat and the wider economy. This has been showed to be the lowest cost pathway and recently the UK Committee on Climate Change has changed its advice to one that includes the gas network. This advice, most recently published in February 2019, recommends the widespread roll out of hybrid heating systems using renewable electricity when available (UKCCC estimate 80% of the time) and natural gas the rest of the time. They recommend replacing the remaining 20% of the carbon footprint by replacing the fossil gas with green gases (biogases and hydrogen). This is further supported by the government's 2019 spring statement.

The case for hybrids vs full ASHP is set out in appendix CC5[12] and illustrates the consumer benefits of this strategy and lower subsidies need to progress such a decarbonisation approach.

GDQ32. Are the GDNs' Distributed Gas Connections Guides and distributed gas information strategies helpful and effective? If not, how could they be improved?

We have funded strategies that go beyond the guide and information. Stakeholder feedback has been very positive and highly complementary, but would require funding in GD2.

The expenditure for WWU's 'green gas team' is currently an adverse opex cost compared to GDNs who do not provide this service and hence is likely to be under threat under any opex regression. There is no incentive mechanism proposed in the consultation document to reward ambitious plans to replicate such a service in other GDNs or maintain it in WWU.

[11] Environment Appendix March 2019 Pg. 5

[12] Environment Appendix March 2019 Pg. 8 – 9.

5. Maintain a safe and resilient network

GDQ33. What are your views on the overall outputs package considered for this output category?

We support the removal of the outputs proposed to be removed as they do not drive the right behaviours nor are they meaningful to our stakeholders.

NARMs or monetised risk was developed to allow a common currency of risk across all asset groups. Therefore, we support its use as a measure of how a GDN manages risk on its asset base.

Networks should be held to account for their investment plan and their allowances but care needs to be taken when making detailed work volumes 'PCDs' as this can limit the ability to react to changing stakeholder needs and remove the stimulus to innovate.

If there is only penalty related to NARMs then there needs to be real clarity provided by Ofgem on what constitutes 'justified' and 'unjustified' intervention.

GDQ34. For each potential output considered (where relevant):

a) Is it of benefit to consumers, and why?

b) How, and at what level should we set targets? (e.g. should these be relative/absolute)

c) What are your views on the design of the incentive? (e.g. reward/penalty/size of allowance)

d) Where we set out options, what are your views on them and please explain whether there are further options we should consider?"

Repex outputs - we support repex being measured with other asset groups under NARMs. This enables GDNs to respond to the changing needs of stakeholders and encourages networks to seek innovative approached to manage risk on the asset base. Whilst Tier 1 mains have a mandated minimum length, there are still scenarios where new data or changing stakeholder requirements may result in a GDN risk trading and replacing more tier 1. Therefore, the output framework and ring-fencing should allow for this.

GDQ35. What other outputs should we be considering, if any?

The suite as proposed provides a broad range of meaningful outputs that are appropriate for RIIO-GD2.

The development of outputs associated with records and data accuracy would be of benefit to consumers. However these would need to be bespoke to companies in RIIO-GD2 but a more common measure could be developed for use in RIIO-GD3

GDQ36. What are your views on the RIIO-GD1 outputs that we propose to remove?

We believe outputs should pass the tests of being comparable across GDNs, driving the correct behaviours and meaningful to key stakeholders. The outputs proposed to be removed don't pass these tests so we are supportive of their removal.

GDQ37. What are your thoughts on our proposals for Tier 1 outputs?

We have a mandated length or tier 1 main and support a PCD to measure delivery of this. Whilst Tier 1 mains have a mandated minimum length, there are still scenarios where new data or changing stakeholder requirements may result in a GDN risk trading and replacing more tier 1. Therefore, the output framework and ring-fencing should allow for this.

GDQ38. Do you think we should set an output for replacing non-PE services?

The replacement volumes of metallic services are largely driven by what is encountered during mains replacement and services that leak and require repair. As such, volumes are difficult to predict. As an example, WWU has seen swings in service relays after escapes of circa 2,000 between a very harsh winter and a mild winter.

Setting a target could drive GDNs to bulk service programmes which are proven to be inefficient and would result in areas being worked in twice - once to replace services and again to replace mains under the iron mains replacement programme.

It is more appropriate to measure compliance with service management policy:
(i) replace all steel services when replacing the parent main
(ii) replace any steel service that leaks
(iii) replace steel services in identified 'leakage hotspot' areas. GDNs are held to account for this by HSE.

GDQ39. Do you think we should set outputs for asset maintenance repex activities?

The Monetised Risk methodology allows for innovative asset management techniques. As repex maintenance techniques are developed they will be incorporated. As such, we do not believe additional outputs are necessary.

GDQ40. What are your thoughts on not including Mains Replacement Level of Risk Removed, GIBs and fractures as output measures for RIIO-GD2?

Monetised Risk is a better measure of the wide range of stakeholder requirements.

Fractures and GIBs are good indicators over long periods of time but are not meaningful measures within a year so we support the removal of these as output targets. We do however support continuing to report these numbers.

MRPS level of risk removed cannot be directly linked to investment and does not provide a useful comparator across GDNs. it can also drive networks to complete inefficient repex projects. We therefore support its removal as an output measure but we believe its use as a prioritisation tool should continue in RIIO-GD2.

GDQ41. Do you agree with our proposed approach to repex uncertainty mechanisms?

We support the proposed approach to uncertainty in repex

GDQ42. What are your views on our proposal to use final offtake capacity prices rather than T-3 offtake capacity price estimates in the calculation of incentive rewards and penalties in RIIO-GD2?

We support the retention of a financial ODI as this does incentivise us to book efficient levels of NTS exit Capacity.

During RIIO GD1 we have experienced significant volatility in NTS exit prices and we have been exposed to unsustainable non funded costs whilst the 2 year lagged true mechanism takes effect. This exposure has been above £10m PA - well above a re-opener threshold. We must correct this unintended consequence for RIIO GD2.

The existing NTS funding mechanism for GDN costs is distorting the impact of NTS price changes to its direct connects and loads connected to the gas distribution network - this cannot be right.

We recommend aligning the NTS charges and GDN costs so that each party - including the industrial customers, so that each party is held whole.

In terms of the incentive, we do not support an in-period adjustment mechanism as this distorts the risk/reward balance within a 5 year period. We would need further engagement with Ofgem and NTS to understand if final offtake prices can be used in practice.

GDQ43. Do you consider that an output(s) is necessary:

a) for MOBs recording keeping (in the form of a bespoke Price Control Deliverable)?

b) for other specific areas of GDN record keeping (if so which areas)?

c) to cover GDN record keeping requirements as a whole? "

We recognise the importance of this issue with MOBs and would support the development of appropriate common outputs through Ofgem working groups. However, it is worth noting that we already submit information as part of the RRP process which should be considered before implementing a new output in this area.

The development of outputs associated with records and data accuracy would be of benefit to consumers. Our view is these would need to be bespoke to companies in RIIO-GD2 due to time available to develop a meaningful and valuable framework, but a more common measure could be developed during RIIO-GD2 for use in RIIO-GD3

6. Cost Assessment

GDQ44. Do you agree with our intention to evolve the RIIO-GD1 approach for RIIO-GD2?

We fully support the evolution of the approach especially focussing on the best view of cost drivers to improve the R^2 of each regression. Grouping relevant categories together helps reflect how we manage these activities and reduces the risk of 'cherry picking' through cost allocation inconsistency.

GDQ45. Do you have any comments on our initial views for cost assessment, including appropriate cost categories, cost drivers, analysis toolkit and how we combine the analysis?

The working groups through spring 2019 will inform our detailed view on specific cost drivers, and we are contributing by running our own regressions and alternative cost drivers which we have previously shared through the CAWG. We agree with aggregating the cost categories to reduce the risk of allocation errors which will result in an improved correlation between driver and costs. We presented alternative methods of benchmarking costs in November 2018 and fully support looking at these alternatives and discounting as appropriate.

GDQ46. Do you have any views on our proposed options for loss of metering work?

WWU's metering contracts are due to end in March 2021. Given the direction from Ofgem in the consultation this does not allow adequate time to embed enduring solutions before 1st April 2021. We support Ofgem providing funding with evidence and this would be consistent with the treatment of other GDNs during GDPCR1.

GDQ47. Do you agree with our proposal for implementing symmetrical adjustments for regional or company specific factors?

Symmetrical adjustments are appropriate when the base cost and regional factors are understood and company specific, using the overall average of GDNs will not reflect the balance and U shape curve of these factors (positive and negative). We support collaborative work on regional factors and expect Ofgem to engage with the networks on evidencing and methodology.

7. Uncertainty mechanisms

GDQ48. What are your views on the proposed uncertainty mechanisms and their design?

We provide our comments on Debt index, taxation, equity, cashflow floor and indexation of RAV within our responses to the finance annex.

We are broadly supportive of the other proposed uncertainty mechanisms but we have identified some inconsistencies between GD and GT. We will identify any further mechanisms we propose within our business plan.

One important point that we must retain is the “aggregate” impact within the licence drafting. Given the number of uncertainties listed as re-openers, we could be exposed to millions of pounds of additional unfunded costs if each impact is just below an individual threshold level for recovery. A continuation of the existing aggregate threshold would maintain existing risk levels for customers and networks.

GDQ49. Are there any additional uncertainty mechanisms that we should consider across the sector and if so, how should these be designed?

We have been exposed to significant land development costs outside of our control and therefore will require a re-opener mechanism. We understand this already exists within gas transmission in RIIO-T1. We may also need something on the impact of any DCC full membership or any other significant impact linked to faster switching or industry commercial arrangements.

GDQ50. What are your views on the RIIO-GD1 uncertainty mechanisms we propose to remove?

Streetworks legislation, lane rental and associated permit costs are still subject to potential material change and we should retain these.

GDQ51. What do you think is the most appropriate approach for funding the GTs' expenditure for Xoserve in RIIO-2 and why?

The Funding Governance and Ownership review is now embedded well within industry arrangements. There is an Xoserve Board that consists of representatives from Shippers, IGTs and regulated gas transporters. The total industry annual budget and plan is now subject to extensive industry consultation. For all of these reasons the reduced Xoserve costs that are contained within the transportation charge should be pass through. Pass through better reflects governance arrangements now in place. This was a natural progression discussed when FGO was developed.

GDQ52. If Xoserve takes on any services beyond its core Central Data Service Provider role, how should we treat the costs and risks associated with these additional services through the price control?

The costs borne by gas distribution customers should only reflect the RIIO GD2 and T2 outputs, licence obligations or uniform network code obligations required by them

Should Xoserve provide services beyond its core Central Data Service Provider (CDSP) role then these should be provided by a different funding mechanism or legal entity than that used for the CDSP dependent on the nature of the request. As an example, shippers may request services and this can be funded directly by shippers. If the water sector wished to use Xoserve, then a separate legal entity may be required within Xoserve to deliver these services with the appropriate risk factored in the costs.

RIIO-2 Sector Methodology Annex – Finance

Cost of Debt

FQ1. Do you support our proposal to retain full indexation as the methodology for setting cost of debt allowances?

We do not support the use of a trailing average index which is insensitive to the timing of efficiently raised debt and derivatives.

Ofgem does not have a straightforward task to set allowances for each Company in the gas distribution network ("GDN") sector to adequately compensate the cost of debt. The sector has significant differences in reported effective rates of debt finance costs, notably between Cadent and Wales & West Utilities Limited ("WWU") ; Cadent accounts for about 50% of sector RAV, and WWU and Northern Gas Networks Limited ("NGN") have completely different positions on RPI linked debt.

This fact pattern plainly demands a flexible approach by Ofgem if it aims to meet its four guiding principles[13] and maintain compliance with its statutory duties. We are concerned the proposal to retain full indexation will not enable an appropriate level of allowances to be set for WWU and we also question if Ofgem is establishing the right approach for the GDN sector over the long term.

Ofgem stated that full indexation and partial indexation were…" flexible enough to be tailored to individual company circumstances, if required".[14] Partial indexation is ruled out, unless new information provides reason to reassess this position.[15] We await Ofgem's proposals to set an appropriate allowance for WWU's circumstances. In particular, we note:

1. Ofgem is considering whether the very significant debt buyback costs associated with the sale by National Grid of its gas distribution businesses to Cadent should be included in the allowance.[16]

2. Ofgem is considering whether to include derivative costs and income in allowance setting, this is plainly an improvement from past control periods, where Ofgem excluded derivatives without any rationale or supported by prior consultation. WWU's debt and derivative costs, incurred by WWU's shareholders, were transacted efficiently, and this has been confirmed in two independent reports by Oxera Consulting LLP ("Oxera") to WWU, copies of which were sent to Ofgem in May 2018 and February 2019.

---

[13] Paragraph 6.17 of Ofgem's Framework Decision document July 2018
[14] Ofgem (December 2018) RIIO-2 Sector Specific Methodology Annex Finance para 2.5
[15] Ibid, para 2.19
[16]Ibid, page 11, footnote 6.

3. Ofgem's proposal for continuation of full indexation will be subject to their continued assessment of whether any improvements could be made.[17] Ofgem will assess:

    a. The trailing period,
    b. The choice of rating in the Iboxx index
    c. Transaction costs
    d. Cost of carry of prefunding debt
    e. Cost of maintaining adequate liquidity
    f. Small company premia
    g. Halo effect

We refer Ofgem to NERA's report to the ENA on cost of debt and ask Ofgem to respond to that report. NERA concludes, inter alia, using the current cost of debt methodology, that the entire GDN sector would underperform in RIIO-2, mainly due to embedded debt and derivative costs. [18]

Even if that problem would be resolved, and even with appropriate allowances for items in 2a-2f above, we remain concerned that a significant shortfall in the allowance for WWU would continue into RIIO-GD2. Therefore, we do not agree with Ofgem's proposed working assumption for an RPI stripped cost of debt of 0.72%.[19] In particular, Ofgem's proposed allocation of the allowance based on relative RAV amounts (i.e. an allocation regardless of the efficiency of incurred debt finance costs across each of the companies in the sector) would lead to a continuation of windfall gains and losses experienced throughout RIIO-GD1. This should impel Ofgem to reconsider its approach. However, apparently, its willingness to reconsider is subject to: "…. a high bar to evidence would need to be met before we would materially alter our existing approach to full indexation".[20] As noted in our answer to FQ22, we do not agree with this presumptive stance, and the question for Ofgem should be: what is the right approach to take at this time in light of its statutory duties and available evidence?

We are encouraged that Ofgem will "seek to broadly align expected debt costs and debt allowances across each sector over *__the long term__*, (WWU emphasis added) with a cross check of allowances versus expected costs for the RIIO-2 price control period and potential impact of finance-ability".[21] This is appropriate, given the long-term nature of asset investment and capital (debt and equity) in the sector. Long term investors, both debt and equity, would have a legitimate expectation that the cost of debt allowance will be adequate for efficiently raised debt and derivatives, not just over the five-year period for RIIO-2, but over the life of their investments, with no regulatory risk to that allowance arising after the long-term debt or derivative transaction has taken place. We note the importance given by the UK Government to the principle that economic regulation should provide a stable and objective environment *__to making long term investment decisions__*

---

[17] Ibid para 2.22
[18] "Cost of debt at RIIO-2 ; A report for ENA, March 2019. NERA Economic Consulting. Ofgem should note that the NERA report is a "holding" report, and a further report may be issued to provide updates on transaction, cost of carry and liquidity costs.
[19] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance', para 2.28 : the CPIH stripped 1.74% restripped to 0.72% using the wedge proposed of 1.009%.
[20] Ibid , para 2.19
[21] Ibid, para 2.25

with confidence[22] (WWU emphasis added). However, the proposed full indexation approach would impede such decisions, because investors could not be assured that an efficiently incurred long term debt or derivative transaction would be fully compensated over the life of that instrument. Plainly, this is not good regulatory policy.

To conclude, Ofgem should adopt a more flexible approach than is proposed, with a long-term focus. Investors and their companies need to have regulatory rules governing cost of debt allowances which are very clear as to what is meant by efficiency, particularly for long term debt and derivative transactions, and should not have to face regulatory uncertainty on the allowance for those transactions after they have taken place. [23]

FQ2. Do you agree with our proposal to not share debt out-or-under performance within each year?

We do not agree. As with other elements of the price control, such as Totex, under/out performance should be shared, particularly where there is wide dispersion of costs. Ofgem's reasoning, and our replies thereto, are as follows[24]:

- "Implementation issues, mainly on cost verification".
- We disagree, because it is not difficult to verify the cost of debt and derivatives and their efficiency or otherwise.
- "Allocating materially more company financing risks to consumers".
- Ofgem has not explained why this would arise. It is not necessarily the case that more risk in this area would be allocated to consumers for the GDN sector.
- "Exposing consumers to the impacts of companies pursuing higher risk strategies".
- Ofgem has not explained what they meant by this or cited any evidence.
- "The requirement for additional rules/constraints to avoid manipulation".
- There may be a requirement for some additional rules, but this should be judged in the context of Ofgem's four guiding principles.

In ruling out cost sharing, Ofgem states: "However, we recognise that cyclical price controls always involve some element of sharing between companies and consumers, as each price control gives us the ability to assess historical costs and set new allowances for future periods".[25] We recommend that Ofgem undertake an impact

---

[22] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-foreconomic-regulation.pdf

[23] Ofgem has ruled out a pass through methodology, but we ask it to reconsider. WWU's proposal to Ofgem in 2018 was to apply a pass through approach but subject to a rigorous efficiency test for every single debt instrument raised and to be raised.

[24] Ofgem (December 2018) RIIO-2 Sector Specific Methodology Annex Finance Para 2.12

[25] Ofgem (December 2018) RIIO-2 Sector Specific Methodology Annex Finance Para 2.20

analysis of cost sharing for the GDN sector, given the wide dispersion of costs therein, to reveal costs and benefits and use this information to inform its thinking.

FQ3. Do you have any views on the next steps outlined in Paragraphs 2.22 to 2.25 for assessing the appropriateness of expected cost of debt allowances for full indexation?

Please refer to our views on these paragraphs in our response to **FQ1** and **FQ2.**

FQ4. Do you have a preference, or any relevant evidence, regarding the options for deflating the nominal iBoxx as discussed at Paragraph 2.14? Are there other options that you think we should consider?

In terms of deflating the nominal Iboxx index using the Office of Budget Responsibility ("OBR") CPI forecast, this should lead to an improvement over the existing methodology which uses break-even inflation determined from gilt yields. A further adjustment to CPIH would be needed.

However, we refer to our answer to **FQ30** which outlines our concerns on Ofgem's commitment to achieve NPV neutrality through the proposed WACC true up for the RPI-CPIH wedge. Deflating nominal debt yields (and other costs that should be allowed for) to achieve a real CPIH stripped cost of debt allowance should be judged in the context of the answer to **FQ30.**

Risk-free

FQ5. Do you agree with our proposal to index the cost of equity to the risk-free rate only (the first option presented in the March consultation)?

The proposal to index the cost of equity using a variable risk-free rate ("RFR") within the Capital Asset Pricing Model ("CAPM") would, if implemented, be a significant change from Ofgem's past regulatory practice.

Ofgem's rationale and evidence is:

- The contention that indexation can protect investors and consumers from inaccurate ex ante estimation due to market changes in the RFR, with para 3.42 suggesting that a 100 bps error could lead to an error exceeding £400m across all network price controls it manages over a 5 year control period[26]

- The risk to consumers of forecasting errors, noting that the impact varies to the level of equity beta. Ofgem notes that the forecasting error for RIIO-1 is significantly reduced by the geared beta of 0.9.[27]

- The long term cost to consumers of an inaccurate forecast.[28]

[26] Ibid ,para 3.30
[27] Ibid para 3.37 to 3.42
[28] Ibid, para 3.45

- Ofgem aims to avoid "aiming up" on an ex ante basis[29]

We make the following points:

1. Use of long term nominal gilt yields should be considered, instead of long term IL gilt yields which tend to be suppressed due to structural imbalance in supply and demand. This may provide for a more stable and objective measure before inflation adjustment

2. Inflation adjustment: We note in the UKRN report that "robust estimates of the future RPI-CPI wedge are needed" and suggests the use of OBR forecasts.[30] However, that report does not address the implications of forecasting error and how to address those errors in the context of securing NPV neutrality from the switch to CPIH. We note that the OBR has overestimated the wedge by 30bps, that its forecasts are available only twice annually, and wedge movements on a current year basis have been as high as 70bps.[31] These are significant in the context of NPV neutrality.

3. The one-month average using October prior to the following regulatory year is proposed on the basis that it would "reflect the latest information available to us on investor expectations". However, this would mean that over the 5-year RIIO-2 period, the RFR would be based on just 5 months of data. We therefore ask Ofgem to consider a longer historic data series, e.g. one year, to provide more stability and more fully reflect the RIIO-2 period.[32]

4. Ofgem should consider how the proposal to use indexation would not adversely impact finance-ability. Should the RFR under indexation, updated each year, be materially less than on an ex ante basis, leading to lower revenue allowances for the cost of equity, then core credit metrics could be adversely impacted.

5. There is a negative correlation between the ERP and RFR, which implies that indexation of only the RFR may lead to significant errors.

The allowance for the cost of equity relating to RFR should be the same on an ex ante basis and on an indexation basis, with no additional risk to investors. Given the points above, we therefore recommend that Ofgem undertake further analysis. We note that the ENA has procured guidance from NERA, which Ofgem should review. NERA presented their findings to Ofgem at the ENA offices on February 27th, 2019.[33]

FQ6. Do you agree with using the 20-year real zero coupon gilt rate (Bank of England database series IUDLRZC) for the risk-free rate?

Please refer to our response in **FQ5** above.

---

29 Ibid, para 3.45
30 UKRN report "Estimating the cost of capital for implementation of price controls by UK regulators" : Appendix D, page 110.
31 Ibid, Appendix D, page 120.
32 Ofgem (December 2018) RIIO-2 Sector Specific Methodology Annex Finance , para 3.48
33 NERA report : Cost of equity indexation using RFR : A report for ENA, March 2019:

FQ7. Do you agree with us using the October month average of the Bank of England database series IUDLRZC to set the risk-free rate ahead of each financial year?

Please refer to our response in **FQ5** above.

FQ8. Do you agree with our proposal to derive CPIH real from RPI-linked gilts by adding an expected RPI-CPIH wedge?

Please refer to our response in **FQ5** above.

TMR

FQ9. Do you have any views on our assessment of the issues stakeholders raised with us regarding outturn inflation, expected inflation, and the calculation of arithmetic uplift (from geometric returns)?

Total Market Returns – use of Bank of England millennium inflation data set instead of the DMS inflation data set

- Ofgem stated : "We are not at this stage persuaded by arguments that we should rely on Dimson Marsh Staunton inflation data rather than the Bank of England data"**.**[34]

- Based on guidance from NERA to the ENA,[35] we note:
  - The Millennium dataset does not provide a reliable measure of CPI inflation prior to 1987
  - This has been acknowledged by the ONS and academic research
  - NERA conclude that the use of this dataset substantially explains why UKRN's conclusions on TMR are below previous UK regulatory precedent, including CMA precedent
  - NERA also conclude historical real TMR should be estimated using RPI inflation, which is the most reliable measure of historical inflation going back to 1900

- We ask Ofgem to reflect on the NERA points and respond to them.

Total market returns - Geometric to/from arithmetic adjustment:

- Ofgem and other regulators received advice in 2003 and 2006 that the uplift from geometric to arithmetic should be 100bps to 200bps. Ofgem interpret the 2018 UKRN report guidance in this area as an upward adjustment of 77bps from geometric to arithmetic. [36] However, recent regulatory practice and precedent has

[34] Ofgem (December 2018) RIIO-2 Sector Specific Methodology Annex Finance ,para 3.82
[35] NERA report for ENA Finance Group ; Review of UKRN Report Recommendations on TMR dated 20/11/2018
[36] Ofgem (December 2018) RIIO-2 Sector Specific Methodology Annex Finance ,Appendix 2

used a downward adjustment of a maximum of 30bps from arithmetic to geometric.

Therefore, Ofgem's proposal to adopt the UKRN report position would, if implemented, result in a significant change from past regulatory practice.

- We note from a report produced by NERA for the ENA[37]

  - The UKRN report does not provide new evidence to support predictability of returns. The UKRN authors cite a single source of evidence from the 1990's, although that evidence would have been available at the time of the 2003 report, when the authors concluded that there was no clear-cut empirical evidence. Indeed, one of the authors of the UKRN report, Stephen Wright, also previously concluded in a 2003 paper that the evidence on the predictability of historical returns is "extremely limited".

  - Recent literature does not support predictability of returns over long run horizons.

  - The UKRN report ignores established approaches to derive unbiased estimators of TMR over long investment horizons. These estimators support an unbiased estimator close to the arithmetic mean.

  - In its 2014 NIE decision, the CMA referenced the Blume and JKM estimators. These TMR estimators suggest a downward adjustment to the arithmetic mean of a maximum of 30bps.

We conclude that Ofgem has not presented enough evidence or rationale to support its proposal for change. We ask Ofgem to address the points made in the NERA report referenced above.

FQ10. Do you have any views on our interpretation of the UKRN Study regarding the TMR of 6-7% in CPI terms and our 6.25% to 6.75% CPIH real working assumption range based on the range of evidence?

1. Given Ofgem's proposal to switch from RPI to a lower inflation index CPIH, and the absence of an historic CPI data set, we would expect very careful judgement from Ofgem in adjusting nominal observed TMR onto a real CPIH basis.

2. We look to Ofgem's rationale and evidence to establish if this core expectation would be met in the context of arriving at a real TMR on a CPIH basis.

3. Ofgem places significant reliance on the UKRN report, so we consider if that report adjusts TMR correctly for the proposed switch from RPI to CPIH.

[37] NERA report for ENA Finance Group ; Review of UKRN Report Recommendations on TMR dated 20/11/2018

4. Professor Wright has confirmed to Ofgem the TMR range of 6% to 7% in terms of CPI, drawing on the historical CPI inflation published by the Bank of England ("BOE") Millennium dataset.[38]

5. We reiterate our answer to FQ9 :
Based on guidance from NERA to the ENA,[39] we note:

   - The Millennium dataset does not provide a reliable measure of CPI inflation prior to 1987

   - This has been acknowledged by the ONS and academic research

   - NERA conclude that this error in the UKRN report substantially explains why UKRN's conclusions on TMR are below previous UK regulatory precedent, including CMA precedent

   - NERA also conclude historical real TMR should be estimated using RPI inflation, which is the most reliable measure of historical inflation going back to 1900

6. The BOE dataset suggests that historical average CPI and RPI are similar – this seems wrong because over the period for which RPI and CPI have been measured, RPI has almost always been above CPI.

7. We consider that the points raised by NERA warrant careful reflection by Ofgem.

8. We note Ofgem's comment that the UKRN study focuses on the expected value of real returns, rather than the expected value of inflation[40]. However, the process of adjusting from observed nominal TMR to real TMR values is plainly important to investors, and is essential to Ofgem's determination of allowed returns on RAV given the deferral of inflation cash flows relating to nominal WACC, particularly if the inflation index is to be changed with a commitment to NPV neutrality.

9. We note Ofgem sought clarification from Professor Wright on the interpretation of the UKRN report on TMR real returns with regard to inflation.[41] However, we believe that there is another interpretation held by Burns, an author to that report. We ask Ofgem to consult with Mr Burns and seek clarity on his position on the real TMR range.

Ofgem's checking of the TMR range:

1. **Investment managers and advisors:** In relation to Financial Conduct Authority ("FCA") regulated TMR return indications from investment managers outlined by

[38] Ofgem (December 2018) RIIO-2 Sector Specific Methodology Annex Finance ,para 3.62
[39] NERA report for ENA Finance Group ; Review of UKRN Report Recommendations on TMR dated 20/11/2018
[40] Ofgem (December 2018) RIIO-2 Sector Specific Methodology Annex Finance para 3.81
[41] Ibid para 3.61

Ofgem,[42] a presentation from Oxera to Ofgem and the ENA on 24 February 2019[43] noted the following:

- TMR estimates from investment managers are affected by FCA regulations and likely understate projected returns
- Evidence from investment manager FCA regulated return estimates are heavily qualified to the extent that the indications do not contain enough information to support investment decisions
- TMR estimates from FCA regulated investment managers average of 6-7% nominal TMR are low – underlying evidence suggests a higher range
- TMR estimates from FCA regulated investment managers are geometric and therefore need to be uplifted to arithmetic

We conclude that the evidence presented in para 3.77 to 3.78 is not appropriate in the context of setting TMR within CAPM for the GDN sector.

Cross checking with long run outturn averages measured in US$ terms[44]

- Ofgem contends that the historical series of UK CPI inflation can be approximated by converting historical US CPI inflation into UK inflation using changes in the USD:GBP exchange rate. It argues that:
  - using CPI (i.e. its own choice of CPI) to deflate historical nominal equity returns brings UK real market returns measured in GBP into line with UK returns measured in USD;[45]
  - the equivalence of returns is sufficient to alleviate concerns raised by stakeholders about the unreliability and inappropriateness of CPI as a historical measure of inflation and about the downward adjustment to arithmetic uplift.[46]

If Ofgem wishes to use this approach as a cross check, we would expect it to assess the DMS inflation index in addition to its use of the BOE Millennium data set, reflect on its choice of averaging periods, apply these consistently to both sets, and set out arguments as to why purchasing power parity would hold in practice, instead of theory.

Therefore we ask Ofgem to review the available evidence again, apply it consistently, and reflect on its arguments.

---

[42] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance', paras 3.77-3.78
[43] Oxera presentation slide deck dated 14 February 2019 : Rates of Return used by investment managers. Ofgem should also refer to Oxera's follow up report dated 6 March 2019 : "Rates of return used by investment managers"
[44] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance', paras 3.67-3.70
[45] Ibid, paras 3.68–3.69.
[46] Ibid, paras 3.67-3.70

Cross checking with the Dividend Growth Model[47]

Ofgem uses updated DGM projections from CEPA, showing lower TMR with an average of around 8% nominal from 2014 to 2018 with a slightly wider range of 7.5% to 8.5% suggested in appendix 3 of the Finance Annex. We note CEPA's model uses:

- Short-term (from years 1-5) GDP growth estimates based on OBR UK GDP forecasts.

- Long-term (from year 6 to perpetuity) growth based on outturn UK real GDP growth from 1950 to 2017 plus an assumed CPIH inflation rate of 2%.

Ofgem does not cross check the CEPA model outputs to the established Bank of England (BOE) research on DGM. Further, it is not clear if CEPA take account of share buybacks and volatility. We believe the CEPA model does give adequate weighting to international growth trends more reflective of the FTSE profile.

Therefore, we ask Ofgem to review the CEPA approach. We would expect Ofgem to source DGM estimates from a wider range of organisations which publish DGM results for wider usage, such as Bloomberg and the Bank of England.

Further, we note that NERA[48] has concluded (i) that there is no market evidence to support a decline in either realised or expected returns (ii) that recent market evidence is consistent with a broadly constant TMR over time, (iii) correctly applied, forward looking DGM estimates of the TMR do not support a reduction in investors expected returns, and (iv) CEPA and PWC DGM models show TMR rates below the BOE DGM estimates, due to implausibly low assumptions on dividend growth.

We ask Ofgem to review the evidence in NERA's report.

FQ11. Do you have any views on our reconciliation of the UKRN Study to previous advice received on TMR as outlined at Appendix 2?

1. We disagree with the argument advanced in the UKRN report to lower the value of the geometric to arithmetic average uplift – please refer to our answer to FQ9. Therefore, the 'lower arithmetic uplift amendment' should be removed.

2. We disagree with Ofgem's argument for interpreting the historical real equity returns as being relative to CPI due to higher comparability in GBP and USD terms – please refer to our answer in FQ10. Therefore, the 'higher BoE inflation amendment' should be removed.

[47] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance', paragraphs 3.71-3.78
[48] NERA report to ENA Finance Group dated 20th November : "Further evidence on TMR"

Equity beta

FQ12 Do you have any views on our assessment of the issues that stakeholders raised regarding beta estimation, including the consideration of: all UK outturn data, different data frequencies, long-run sample periods, advanced econometric techniques, de-gearing and re-gearing, and the focus on UK companies?

1. Geared beta in RIIO-GD1 is 0.9, based on a leverage of 65%.

2. Ofgem propose a geared beta range of 0.646 to 0.762 based on notional leverage of 60%, as a working assumption for business plan purposes.[49]

3. Beta estimation requires careful judgement, and the difficulty is compounded by a general lack of comparable data. We note differences on conclusions drawn by the authors of the UKRN report.[50]

4. Ofgem disagreed with certain arguments from Oxera and NERA.[51] We would refer Ofgem to a report from Oxera to the ENA which, inter alia, which responds to these points in detail.[52]

5. Our main remarks are:

   - With regard to the econometric approach to beta estimation, Indepen and the UKRN reports suggest that alternative models to OLS should be considered. [53]Adoption of an alternative statistical method would depart from regulatory practice in this area, which tend to use OLS. There is no compelling evidence or rationale presented by Ofgem that any such alternative, and thus departure from regulatory practice, would be superior to OLS.

   - With regard to comparator sample, we note Indepen's remarks[54] in using international comparators, but this should not preclude Ofgem from considering the evidence available from European utilities, given the small number of listed utilities in the UK. We note that the UKRN report used two UK listed water companies, but Citizens Advice and Ofgem consider the sample should be wider; Indepen suggested six utilities including BT; we note that Ofgem did not consider BT to be appropriate.[55]

   - With regard to period of analysis, we ask Ofgem to consider the position taken (use of market data for a period of up to five years) by the CMA in the Bristol Water case (2015) and provide a compelling rationale with supporting evidence as to why it should depart from that precedent.

---

[49] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance', paras 3.109
[50] UKRN report "Estimating the cost of capital for implementation of price controls by UK regulators" : page 9
[51] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance', paras 3.106
[52] Oxera : "The estimation of beta and gearing" report to the ENA March 2019
[53] Indepen (2018), 'Ofgem beta study – RIIO-2 Main Report', December page 7
[54] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance', Para 3.103,
[55] Ibid, para 3.108

- With regard to data frequency, we note that Indepen has not endorsed the use of quarterly data suggested in the UKRN report. It is plain that the use of quarterly, instead of daily, data removes a significant amount of information from the process and would break with UK regulatory practice.[56]. We ask Ofgem to provide a compelling rationale with supporting evidence to justify the use of quarterly data

- With regard to gearing, if Ofgem sets a price control based on a higher gearing than gearing derived from observable market values, the equity beta should be re-geared. This is consistent with finance theory and regulatory practice. We disagree that raw equity betas are useful if there are significant differences between market gearing levels and the notional gearing assumption to be adopted. We disagree with the exclusion of pension deficits by Ofgem in the comparator sample adopted by Ofgem.[57]. We question the reliability of the adjusted gearing ratio adopted by Ofgem to de-gear equity betas, not least because it is based on an assumed differential between enterprise value and RAV of 1.1x. We ask Ofgem to provide a compelling rationale with supporting evidence to justify its approach.

- With regard to debt beta, we note Ofgem has adopted a narrowed range of 0.15 to 0.1 from a regulatory precedent range of 0.05 to 0.22. We ask Ofgem to examine debt beta of UK listed utilities, based on a recent time period. We note that Oxera has suggested a debt beta of 0.05 based on its review of UK listed utilities.[58]

- We note that one of the authors of the UKRN report, Burns, considered the use of quarterly data by the other authors as "highly unusual", and did not satisfy the criteria in the report.[59]

We note that Ofgem will review beta again following consultation responses and business plan submissions. Should Ofgem continue to propose a lower geared beta than the 0.9 in use for RIIO-1, we would expect, in addition to a satisfactory response to the points raised above and by Oxera, a detailed explanation for why systemic risks have reduced, analysing the nature of those risks and their trends, with independent consultant input, and to have any proposals based on that explanation to be subjected to consultation.

FQ13. What is your view on Dr Robertson's report?

The report from Dr Roberston is of interest.

FQ14. What is your view on Indepen's report?

We refer to our answers to **FQ12** above which references Indepen. Further, we are not convinced by Indepen's suggestion that EV/RAV ratios may be used to determine the

[56] CMA (Bristol Water case 2015)
[57] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance'Page 39, table 12
[58] Oxera : "The estimation of beta and gearing" report to the ENA March 2019
[59] UKRN report "Estimating the cost of capital for implementation of price controls by UK regulators" : page 9

beta range by reference to the potential inconsistency cited.[60] We note Ofgem used a ratio of 1.1 EV/RAV on two listed water companies observed on October 19th, 2018. We think market equity betas should be degeared with market gearing ratios for consistency. Use of EV/RAV multiple would not improve on that approach in our view and Ofgem has not explained why it would improve. The mid-point of the resultant equity beta range, i.e. 0.7 would represent a 23% reduction to the geared beta of 0.9 in RIIO-1 – that is a considerable reduction, but there is no qualitative evidence presented that systemic risks have reduced to support that reduction.

FQ15. What is your view of the proposed Ofgem approach with respect to beta?

We refer to our comments on beta in **FQ12** above

FQ16. Do you agree with our proposal to cross-check CAPM in this way?

In respect of Ofgem's proposed cross checks we comment as follows:

Market Asset Ratios[61]

1. We have noted the MARs and bid premia presented. There is no explanation of the Y axis title "Adjusted MAR Premium" on figure 11 – what has Ofgem adjusted?

2. However, more generally this data is not supported by any detailed analysis of the factors driving that data. This is very difficult to do, i.e. to produce an analysis that is convincing on unobserved factors (e.g. investor assumptions) and reconcile the data to observed factors in a reliable manner. To some extent, Ofgem have acknowledged this.[62]

3. Our stance is supported by the position taken by Burns in the UKRN report[63]. He notes: "Identifying a satisfactory explanation for highly observed transaction premia is a challenge". We note the other authors to that report took a different position to Burns, but they did qualify their position in saying, inter alia: The contrast between the expected returns on regulated firms, and the realised returns elsewhere in economies should be borne in mind".

4. Finally, in respect of the MARs data presented for the three listed water companies:

    a. The MARs data presented show declining MARs in 2018/19 towards 1.0 or less. This suggests that investors in those companies do not currently expect a return on RAV to exceed their costs of capital.

    b. The market value of debt in these companies (and hence enterprise value) would have increased from 2016 following BOE monetary policy

---

[60] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance' page 36
[61] Ibid, Para 3.118 to 3.128
[62] Ibid, para 3.127
[63] UKRN report "Estimating the cost of capital for implementation of price controls by UK regulators" : page 13

easing measures which reduced interest rates – but this would not necessarily enhance equity value, given high levels of embedded debt.

c. Comparability of listed water companies to energy networks, listed or unlisted, is questionable.

We conclude that if a MARs cross check is to have any influence in the context of setting a regulatory cost of equity, the analysis should be robust and detailed enough to provide a compelling explanation. Until that data and analysis becomes available, we consider that MAR's should not be used as a cross check for regulatory purposes.

Professional forecasts from investment managers and advisors

Please refer to our answer to **FQ10**.

Infrastructure fund discount rates[64]

Ofgem's justification for using the funds' discount rates (of the five infrastructure funds) as a cross-check to determine the upper bound of the RIIO-2 cost of equity range is based on:

- the relative risks of the investments in the funds;
- prevailing net asset value (NAV) premia of the funds;
- a reduction in the funds' discount rates in recent years.

We note Ofgem has not compared the risk profiles in the above funds to regulated energy network businesses. It is not adequate merely to acknowledge that the risk profiles are different.[65] Ofgem should produce analysis in this area if this cross check is to have any influence. Nor has it produced up to date information on NAV and discount rates. If this work would be carried out, a valid cross check might arise. However, the validity of the cross check could be significantly impeded by the intrinsic difficulty of comparing relative risks and making credible adjustment to the funds returns for comparison to regulated energy networks.

Therefore, the evidence and analysis presented by Ofgem is not adequate and we ask Ofgem to reconsider and carry out further work to assess if a credible cross check in this area can be constructed.

FQ17. Do you agree that the cross-checks support the CAPM-implied range and lend support that the range can be narrowed to 4-5% on a CPIH basis?

We disagree with Ofgem's conclusion that the cross checks "when taken in the round" provide "general support for its CAPM implied cost of equity". [66] We refer to our responses in FQ16 and FQ10 (for TMR) on the cross checks used by Ofgem.

---

[64] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance', Para 3.134 to 3.144
[65] Ibid, para 3.134-3.144
[66] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance', 3.146

For the avoidance of doubt, we do not agree to Ofgem's proposed working assumption for the cost of equity. Overall, Ofgem's evidence and arguments fall significantly short to support a real RPI stripped TMR of less than 6.5%[67] and a geared beta of less than 0.9.[68]

FQ 18. Are there other cross-checks that we should consider? If so, do you have a proposed approach?

We refer Ofgem to a report from Oxera[69] which examines if Ofgem's proposed working assumption for cost of equity is valid. It tests if the differential from the asset risk premium less debt risk premium implied by Ofgem's working assumption would be consistent with market evidence. The evidence suggests that Ofgem's proposed allowance for the cost of equity is insufficient to compensate for the relative risk of holding equity rather than debt in the same asset. This suggests that the combination of assumptions used for the CAPM parameters is extreme, and that one or more of the parameters should be revised upwards to provide a sensible market-based result for the cost of equity.

We consider this report to be relevant evidence in support of an appropriate allowance for cost of equity. We ask Ofgem to treat it as such and to respond to it.

Expected and allowed return

FQ 19. Do you agree with our proposal to distinguish between allowed returns and expected returns as proposed in Step 3

We disagree with this proposal. We refer Ofgem to the presentation given to them by Frontier Economics on 27 February 2018 and subsequent Frontier report as the basis of our position. [70]
We consider this report to be relevant evidence in support of an appropriate allowance for cost of equity. We ask Ofgem to treat it as such and to respond to it.

FQ20. Does Appendix 4 accurately capture the reported outperformance of price controls?

Appendix 4 does not fairly capture outperformance for RIIO-1 as the RORE measure is not correct in that it excludes performance on debt and tax.

We note that Ofgem has improved its RORE measure in its annual report on performance in 2017/18 by the network companies it regulates. Further improvement can be made – for example, by showing also showing RORE in terms of cash received by shareholders.

[67] As determined by the CMA in the NIE case, and based on Oxera's report to ENA of February 2018
[68] Geared beta for the GDN sector in RIIO-GD1 is 0.9 based on 65% leverage.
[69] Oxera report to ENA : "Asset and debt risk premiums", March 2019
[70] Frontier Economics Limited report to ENA dated 27 February 2019 : "Adjusting baseline returns for anticipated outperformance" and subsequent report to the ENA : Adjusting baseline returns for anticipated outperformance-an assessment of Ofgem's proposals". March 2019

FQ21. Is there any other outperformance information that we should consider? We welcome information from stakeholders in light of any gaps or issues with the reported outperformance as per Appendix 4.

Appendix 4 focuses on RORE returns, but disregards actual and expected risks in achieving those returns. Clearly, any assessment of performance must take account of risk within CAPM. Ofgem should evaluate this further. We note that CEPA, advisors to Ofgem were intending to provide a relative risk analysis for Ofgem but to date we are not aware if this work has been carried out.[71]

Appendix 4 focuses on RORE returns earned, not received. As noted in FQ 20, we encourage Ofgem to show its improved RORE on a cash returns basis, in addition to an earned basis, to shareholders.

Financeability

FQ22. What is your view on our proposed approach to assessing financeability? How should Ofgem approach quantitative and qualitative aspects of the financeability assessment? In your view, what are the relevant quantitative and qualitative aspects?

To begin, we do not accept the limiting parameters within which Ofgem has framed its approach to financeability.

First, we believe that it is inappropriate for Ofgem to set the cost of debt on the basis that '*a high bar of evidence would need to be met before we would materially alter our existing approach*'. This assumes not only that the existing approach is right until proven wrong, but that it should be regarded as so entrenched that the burden of proving it wrong is an extremely high one.

There is no proper basis for this approach either in law or policy. The current methodology for cost of debt was adopted for the first time in RIIO-1; there is no reason for treating it as having a special status, presumptively deeming it correct, or requiring that it needs to be displaced by a '*high bar of evidence*' before any alternatives will be considered. The only question for Ofgem should be what is the right approach to take at this time in the light of its statutory duties and the available evidence. It should approach this question with an open mind.

Second, financeability, of all things, must be assessed against the particular circumstances of each company and cannot be considered on the basis of a purely notional company. The financing duty is concerned with the need to secure that licence holders can finance the activities which are the subject of obligations placed on them. It applies in respect of all actual companies who hold licences, and not in respect of a notional company. For this purpose, Ofgem must take companies as it finds them. The duty cannot be satisfied by providing only for the financeability of a notional company if this does not reflect the real world circumstances of one or more licence holders.

[71] Ofgem presentation slide deck to ENA October 2018 : Cost of equity parameters : comparing perspectives from consultants, Beta section, page 13

By starting with a strong and unjustified presumption in favour of the current approach to the cost of debt, and then assessing financeability on a notional company basis, Ofgem proceeds on a basis that is fundamentally flawed and for that reason alone is bound to lead to inadequate outcomes.

It follows that Option B, which is a product of these two errors, is not an appropriate basis on which to proceed. We accept that companies should take those actions that they reasonably can in order to ensure their own financeability. We agree that Ofgem is entitled to act on the expectation that they will do so. However, we do not agree that this provides a complete answer to the financeability question, or that it relieves Ofgem of responsibilities under its own financing duty.

In the financeability section of the consultation paper, Ofgem has rightly started with its own financing duty. As a statutory duty placed on Ofgem by Parliament, which it is required to fulfil in the exercise of its functions – including, in particular, when it sets price controls – this is the proper starting point and must clearly be treated as placing some requirements on Ofgem. We note, however, that Ofgem does not say anything about how it interprets its duty or what it considers the fulfilment of that duty to entail in practice. Since Ofgem acknowledges the relevance and importance of the duty, it was incumbent on it as part of the consultation process to explain how it approaches, and intends to fulfil, its statutory obligation. The consultation is deficient for not doing so. We strongly encourage Ofgem to consult adequately on this matter.

In any event, however Ofgem's financing duty may be interpreted, it cannot be a proper discharge of that duty to '*put the onus on companies to take appropriate action*'. By definition, the duty must place obligations on Ofgem itself. These cannot be delegated to the very companies who are the intended beneficiaries of the statutory duty. Placing the onus on companies is the avoidance of responsibility, and not its fulfilment.

Moreover, as a matter of practice, even after it has taken all of the actions that are reasonably within its control, a company may still experience financeability difficulties in the light of the price control as determined by Ofgem. Ofgem appears to assume that each company will always be able to address these problems, solely by virtue of its own actions, by bridging any gap that exists between its actual circumstances and those of the notional company. But there is no theoretical or evidential reason for believing that this will be true in all cases.

This is particularly so where Ofgem has based its assessment of the notional company on historical averages, as in the case of the cost of debt. For reasons that we have developed elsewhere we do not consider that this is a sound basis on which to proceed. The use of averages will logically tend to over-remunerate some companies and under-remunerate others. In our view, neither outcome should be acceptable to Ofgem, in the light (respectively) of its duties to consumers and companies.

Where a company is under-remunerated, it may well, in particular if it is relatively close to the average (and therefore to the circumstances of the notional company), be able to take steps in relation to its capital structure or dividend policies that allow it to close the financeability gap. But the further away it is from the circumstances of the notional company, the less likely it is to be able, by taking reasonable steps that are within its control, to resolve the issue.

In our view, where a company finds itself in such a position, and where this is not the result of actions previously taken by it which were inefficient in themselves, that must be because Ofgem's approach to setting the cost of capital has failed to give proper effect to its financing duty and/or failed to have proper regard to the circumstances of the individual companies being regulated.

It is plain, as we have already outlined above, that these problems are deeply embedded in Ofgem's approach, and that they will inevitably lead to inappropriate price control outcomes for at least some companies. These problems are only amplified by Ofgem's inadequate treatment of the financeability issue in the consultation; by seeking to place the onus on companies to resolve difficulties caused by its own approach, it merely highlights the extent to which it is not discharging its own statutory duties.

In passing, we should note that we are also disappointed that Ofgem's guidance to companies on how to assess financeability, which was due to be issued at '*the beginning of 2019*' is still unavailable at the time of responding to this consultation. That guidance would have been a relevant factor both in understanding Ofgem's position fully and in framing a response.

When the guidance is available, we would suggest that Ofgem allows companies an opportunity to provide a supplementary response to this consultation in the light of it.

FQ23. Do you agree with the possible measures companies could take for addressing financeability? Are there any additional measures we should consider?

Please refer to our answer to FQ 22 for the first question. We should add that WWU's shareholders have received distributions below the allowed equity rate in RIIO-1 to support WWU's leverage reduction towards notional leverage by 2020/21 whilst bearing the full impact of the significant shortfall in the allowance for cost of debt. This is not a sustainable position for the long term. It is Ofgem's responsibility to set appropriate revenue allowances in the first instance.

As for the second question, we would encourage Ofgem to consider measures typically in place between companies and senior lenders of highly secured capital structures. For example, licence holders could be required to publish forward looking financial ratios on an annual and perhaps semi-annual basis for the regulatory control period. Such information should be valuable to a range of stakeholders, and would support the integrity of the regulatory ring fence.

FQ24. Do you agree with the objectives and principles set out for the design of a cashflow floor?

We do not agree.

A KPMG report to the ENA Finance Group on this matter covers most of our objections.[72] KPMG concluded, inter alia: "It is not justified by a specific market failure; it is unlikely to correspond to an efficient market outcome, where the latter would imply pricing in financial headroom required to deal with risks and ensure financeability of *all* capital

[72] KPMG report to ENA Finance Group: Assessment of Ofgem's Cash Flow Floor Proposals, March 2018

sources. It shifts risks from debt to equity without justification; it appears designed to provide liquidity, but cannot improve financial viability (and it is unclear why the market could not provide the same solution if networks were financeable in the first place). There is also a significant risk that the floor will weaken financeability checks as a binding constraint on regulatory determinations and hence undermine overall business financeability, while introducing additional costs and distortions. It is also likely to create wrong incentives".

We ask Ofgem to review the KPMG report, address the criticisms raised within it and respond in detail.

We also note that Ofgem believes it must have regard to actual company financial structures and costs to make the proposal work.[73] This seems inconsistent with its approach to cost of debt allowance with its focus on a notional company concept. We ask Ofgem to explain why this apparent inconsistency is justified.

FQ25. Do you support our inclusion and focus on Variant 3 of the cashflow floor as most likely to meet the main objectives?

We do not support the basic concept and therefore do not support Variant 3. Please refer to our answer to **FQ24.**

Corporation tax

FQ26 Do you support our proposal that companies should seek to obtain the "Fair Tax Mark" certification?

- We support the proposal relating to the Fair Tax Mark
- However, the Fair Tax Mark is not available to WWU as WWU is not UK owned.

FQ27. Is there another method to secure tax legitimacy other than the "Fair Tax Mark" certification? Could we build upon the Finance Acts (2016 and 2009) with regards to the requirement for companies to publish a tax strategy and appoint a Senior Accounting officer?

WWU maintains a formal "low risk" status from HRMC. We ask that Ofgem consider this as an alternative to the Fair Tax Mark.

Publication of tax strategy and appointment of a Senior Accounting Officer ("SAO") are already legal requirements under statutory tax legislation – therefore adoption of these measures into the regulatory licence would not further enhance tax governance, risk management and compliance.

[73] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance' Para 4.22

FQ28. For Option A, how should a tax re-opener mechanism be triggered? Is there a materiality threshold that we should use when considering the difference between allowances and taxes?

Differences between tax paid and tax revenue allowances should first be understood before action should be considered. There are many legitimate reasons why these differences will continue. Therefore, we do not support a predetermined set threshold to invoke a re-opener. However, this can be reviewed again following business plan submissions.

For example, there are invariably tax consequences of commercial actions taken by companies that are not funded under the price control, e.g. derivative costs in RIIO-1. Such tax consequences should not be used to reduce tax allowances or increase tax clawback if the costs were not initially funded through the control.

RAV indexation (CPIH)

FQ29. What is your view on our proposal for an immediate switch to CPIH from the beginning of RIIO-2 for the purposes of RAV indexation and calculation of allowed return?

The proposal for an immediate switch from RPI to CPIH instead of a phased switch places greater burden on Ofgem in securing that such a switch would be value neutral for consumers and investors.

FQ30. Is there a better way to secure NPV-neutrality in light of the difficulties we identify with a true-up?

1. Ofgem concluded as follows:[74]

   “Therefore, our current view is that NPV neutrality is best secured, in terms of RAV and allowed returns, by a one off, point in time switch from RPI to CPIH, reflecting the expected difference at that time, rather than monitoring the difference over time or truing up for any outturn RPI or wedge values. This is because of complexity and definitional issues that would arise if we attempt to secure unconditional NPV neutrality over time, relative to multiple measures of inflation”. Note that, in general, our methodologies for the cost of equity and the cost of debt emphasise expectations, not outturns; a true up would be inconsistent with this”

2. The proposed one-off switch to CPIH would be a very significant change to the regulatory framework for licence holders regulated by Ofgem, their consumers and investors. It is worth recalling certain principles for effective economic regulation which were reaffirmed by UK Government in 2011, and include[75]:

[74] Ofgem (2018), ‘RIIO-2 Sector Specific Methodology Annex: Finance’ Para 3.103

[75]https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-foreconomic-regulation.pdf

- The need to provide a stable and economic environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence

- The framework for economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return subject to normal risks inherent in markets.

- It is important the regulatory frameworks avoid adding undue uncertainty to the business environment. To a large extent this is achieved by building a stable and transparent regulatory environment with a long track record of consistent regulatory decision making.

3. Moodys have noted: "…the change from RPI to CPIH is likely to be NPV negative".[76]

4. As CEPA, advisors to Ofgem have noted: Based on high-level modelling, we consider that at this stage, the setting of a cost of capital range that best reflects the financing costs faced by an efficient entity should be undertaken independently of financeability. If there are problems identified, then further work is required to make sure that Ofgem meets its statutory duties for the price control.[77] Ofgem need to demonstrate that the allowances for cost of capital on an RPI stripped basis are adequate to support financeability before account is taken of the switch to CPIH, given that it is intended to be value neutral.

5. Use of a lower index such as CPIH would give rise to a significant day one NPV loss to shareholders due to lower future cash flows from RAV depreciation revenue allowances stemming from past investment, prior to any value true up. There are two fundamental questions Ofgem must answer: what is an appropriate level of confidence in setting the wedge level to be applied to the allowed RPI stripped cost of debt and equity? And how should that wedge be determined? Plainly, the answer to the first question would suggest a very high level of confidence. Therefore, when Ofgem refer to "expected difference", if it means a point of indifference or a 50% confidence level, we would disagree – we do not believe that long term investors would accept that as an adequate level of assurance in compensation for a highly probable loss of existing RAV. We do not have an answer at this time for the second question due to its intrinsic difficulty, a difficulty noted by CEPA, advisors to Ofgem.

6. In 2018, CEPA, advisors to Ofgem, noted: "In theory any move away from RPI (or use of CPI or CPIH) will be NPV neutral if the present value of future net cash flows is equivalent to what they would have been under RPI."[78] It further added: "In addition, estimating the relevant 'wedge' over long term is difficult if no direct CPI-linked evidence is available"[79].

---

[76] Moodys report : 14 February 2019: "Credit quality likely to weaken in RIIO-GD2 regulatory period; page
[77] CEPA report to Ofgem Fevruary 2018 : Review of cost of capital ranges for Ofgem's RIIO-2 for onshore networks, section 7.2,page 72.
[78] Ibid, section B.2, page 82.
[79] Ibid, page 82

7. We note in the UKRN report that "robust estimates of the future RPI-CPI wedge are needed", and suggests the use of OBR forecasts.[80] However, that report does not address the implications of forecasting error and how to address those errors in the context of securing NPV neutrality from the switch to CPIH. We note that the OBR has overestimated the wedge by 30bps, that its forecasts are available only twice annually, and wedge movements on a current year basis have been as high as 70bps.[81] These are significant in the context of NPV neutrality. The switch to CPIH will expose companies to ex-post risk of the RPI-CPIH wedge deviating from Ofgem's ex-ante assumed value determined at review.

8. Ofgem's cites complexity and definitional issues in a true back to RPI. The proposed approach is not free from such issues and as noted above, does not address compensation appropriately for a highly probable loss on the day of switch.

9. We note with concern that NPV neutrality is now conditional.[82] Ofgem should explain what conditions would apply and the potential consequences thereof.

10. We note[83] Ofgem asserts that WWU would benefit from the move to CPIH. Ofgem should explain the nature of that benefit. We do not agree that an overall net benefit would arise over the remaining life of RAV. We understand that the switch to CPIH is intended by Ofgem to be NPV neutral. Yet Moody's do not share that view and consider the switch would be averse to investors.

11. We ask Ofgem to assess credit metrics for investment grade status absent the change to CPIH.

12. Ofgem is aware that a significant portion of WWU's debt is linked to RPI through long dated RPI swaps. A switch to CPIH would break the natural net debt to RAV hedge and would result in greater pressures on the future direction of the net debt to RAV ratio - a central credit metric to senior lenders and rating agencies. We ask Ofgem how that increased risk – a direct cause of its proposal to switch to CPIH, would be compensated.

Finally, Ofgem note: "we see net benefits to consumers, in terms of the finance-ability of the sector of moving away from RPI"[84]. Ofgem did not provide a supporting impact analysis for this contention.

In the context of the principles of economic regulation noted, the difficulty of estimating the wedge noted by CEPA, the forecasting errors being made by the OBR, and Moody's position, we ask Ofgem to propose how value neutrality can be achieved with an appropriate level of confidence to keep investors whole. Ofgem's analysis does not constitute an impact assessment of the change, where the full range of potential costs and benefits are considered. This should be carried out.

---

[80] UKRN report "Estimating the cost of capital for implementation of price controls by UK regulators" : Appendix D, page 110.
[81] Ibid, Appendix D, page 120.
[82] Ofgem (2018), 'RIIO-2 Sector Specific Methodology Annex: Finance' para 6.13
[83] Ibid,para 6.7
[84] Ibid para 6.17

Regulatory depreciation

FQ31. Do you have any specific views or evidence relating to useful economic lives of network assets that may impact the assessment of appropriate depreciation rates?

We note Ofgem's policy in para 7.1

We note that Ofgem has recognised, to some extent, asset risks which may result in asset stranding, creating potential costs to consumers, losses to investors, and weakening finance-ability.

Such risks should first be thoroughly assessed within the context of asset beta as part of the CAPM for cost of equity, i.e. whether they are systemic or non-systemic or have features of both.

Any material change to economic lives adopted for RIIO-GD2 should be made on the basis of a full impact assessment and after submission of business plans and a thorough consultation. We are not aware of compelling evidence to amend economic asset lives from those used in RIIO-GD1.

Capitalisation rates

FQ32. Do you agree with our proposed approach to consider capitalisation rates following receipt of company business plans?

We agree that they should be considered following submission of business plans and any material changes proposed should be made on the basis of a full impact assessment and thorough consultation

Notional gearing

FQ33. Do you have any comments on the working assumption for notional gearing of 60%, or on the underlying issues we identify above?

We have not seen any supporting analysis from Ofgem for the proposed working assumption of 60%.

We understand that average gearing in RIIO-1 is closer to 65% than 60% for the GDN sector.

Any change to notional gearing – and we consider a change from 65% to 60% to be a material change - should be considered following a full impact analysis, including impacts on allowances for WACC and financeability. We would expect allowances overall to be set on the same gearing level as in RIIO-1 for the purposes of financeability and in Ofgem's own assessment on whether it would its finance duty. Given the inadequate levels of allowances proposed as working assumptions for cost of debt and equity, there is no rationale or incentive to degear WWU down to 60% using fresh equity. The long-term capital and investment profile of the GDN sector suggests that changes to gearing should gradually preceded by appropriate impact analysis.

Notional equity issuance

FQ34. Do you agree with our proposed approach to consider notional equity issuance costs in light of RIIO-2 business plans and notional gearing?

We agree with Ofgem's proposed approach.

Further, we believe the scope of this proposal should be widened to cover subordinated shareholder debt instruments where such debt is (i) subordinated to all other lender debt, (ii) is not treated as debt by senior lenders or rating agencies in their credit metrics, and (iii) whose interest costs are not included in the updated RORE measure or in notional gearing calculations.

We note that WWU, in restructuring shareholder debt in 2018 involving the issue of new long dated shareholder debt, incurred transaction related costs such as professional fees which will not be allowed for in RIIO-1

Pension funding

FQ35. Do you agree that for RIIO-2 we align transmission and gas distribution with electricity distribution and treat Admin and PPF costs as part of totex?

We note the pass-through funding policy of pensions scheme established deficits

We would agree that the allowances for administration and PPF costs could be treated as TOTEX on the basis that they are treated as operating expenditure within TOTEX and there is no capitalisation element into RAV.

Directly Remunerated Services

FQ 36. Do you have any views on the categories of Directly Remunerated Services and their proposed treatment for RIIO-2?

No response

Disposal of assets

FQ37. Do you have any views on the potential treatment of financial proceeds of fair value transfers of asset (including land) disposals for RIIO-2?

We will give this matter consideration for our business plan submission. However, the approach in RIIO-GD1 of retaining net disposal proceeds for five years and then removing them from RAV (at an uninflated rate) appears reasonable.

2. Context

GTQ1. Do you have any feedback on our proposals for simplifying the RIIO-2 gas transmission price control package, or suggestions for further simplification?

No response

GTQ2. Do you have any views on the extent to which the potential outputs discussed in this document:

a) achieve the appropriate balance and focus on the areas that are of value to consumers and should be included as part of a RIIO-GT2 outputs package;

b) align with our overarching outputs framework as described in the Core Document;

c) we also welcome views on whether there are any alternative outputs and/ or mechanisms not identified here which we should be considering.

In relation to c) Where flex and pressure are released on a discretionary basis as part of the enduring capacity processes an incentive on release would be beneficial ensuring that maximum use of the network is encouraged and providing DNs with certainty over any flex and pressure that they can rely on when determining what capacity, we in turn can make available to customers. This would also assist in ensuring investment happens in the most appropriate network.

3. Meets the needs of consumers and network users

GTQ3. What are your views on the overall outputs package considered for this output category?

Where flex and pressure are released on a discretionary basis as part of the enduring capacity processes an incentive on release would be beneficial ensuring that maximum use of the network is encouraged and providing DNs with certainty over any flex and pressure that they can rely on when determining what capacity, we in turn can make available to customers

GTQ4. For each potential output considered (where relevant):

a) Is it of benefit to consumers, and why?

b) How, and at what level should we set targets? (e.g. should these be relative/absolute).

c) What are your views on the design of the incentive? (e.g. reward/penalty/size of allowance).

It may be appropriate to replicate some of the NTS incentives within gas distribution using a similar scale.? E.g. our demand forecasting might influence theirs, any line pack change on our system can distort the market, maintenance days are also a factor on our network. We would be happy to take this forward with NTS

GTQ5. What other outputs should we be considering, if any?

WWU has received customer feedback that gas quality information is of use to some customers who may need to tune their systems to achieve maximum efficiency. Ofgem have a stated aim to "ensure the NTS is sufficiently flexible to accommodate new and more diverse sources of supply". In this context increased gas quality information provided by the NTS is likely to be essential for any new billing processes that may be introduced to support biomethane injection into DNs without the need to add propane to increase the CV which adds cost and complexity to the process.

The exact nature of the forecasts would need consultation however a D-1 forecast and a D-5 forecast may be a sensible start. For the D-1 forecast some of the gas that will be delivered on day D will already be in the system.

We accept that CV forecasting is complex and is a balance of exit flows (demand) and entry flows from different sources but this would build on the improvement in NTS demand forecasts in GT1 as evidenced by their incentive performance and seems a logic next step that would deliver customer benefit.

GTQ6. What are your views on the RIIO-1 outputs that we propose to remove?

No response

GTQ7. We welcome views from stakeholders on the above options.

No response

GTQ8. Do you think it would be possible to establish clear and appropriate KPIs and deliverables in this area?

We think that it would be challenging to develop clear KPIs for some areas for example day to day interactions and flexibility.

Wales & West Utilities Limited
Registered Office:
Wales & West House, Spooner Close, Celtic Springs,
Coedkernew, Newport NP10 8FZ
Registered in England and Wales number 5046791

GTQ9. We welcome views from stakeholders on the above options.

We have responded to a number of National Grid surveys and there is some difficulty distinguishing between what is feedback to National Grid and what is feedback around UNC or Xoserve processes that are less than efficient. Further as the surveys are done by phone we don't get to see how our comments are recorded.

GTQ10. Does NGGT's forecasts of demand provide a service that is valued by consumers and network users? Please explain why.

WWU now does its own forecasts. National Grid's recent policy of issuing scenarios means that it is unclear what it is using internally, we are pleased that National Grid has recently stated that it will produce and publish a central case.

We assume that this will be used for all National Grid planning and forecasting including investment, pricing and operational planning. It is clearly very important that the same forecast is used for all these areas otherwise inconsistent outcomes may occur.

It is important to understand how the proposed Forecasted Contracted Capacity that is the proposed process under UNC modification 0678 for setting NTS Transportation charges will be used and whether it will be used consistently across NTS processes. As this is still being developed at the time of this response it is impossible to comment further.

GTQ11. Should gas consumers pay for NGGT to produce accurate demand forecasts? What is the value for consumers from increased accuracy?

This would not deliver value to WWU as we produce our own forecasts but we could see value for directly connected sites. Our understanding, based on comments from National Grid, is that they rely on our bookings for Enduring Daily Exit (Flat) capacity, which reflect our own forecasts, as an important input into their forecasts. It would be useful to understand if National Grid use materially different forecasts that our capacity bookings particularly if they assume the demand will be less than our capacity bookings.

4. Deliver an environmentally sustainable network

GTQ12. What are your views on the overall outputs package considered for this output category?
a. For each potential output considered (where relevant):
b. Is it of benefit to consumers, and why?
c. How, and at what level should we set targets? (e.g. should these be relative/absolute).
d. What are your views on the design of the incentive? (e.g. reward/penalty/size of allowance). "

No response

GTQ13. Where we set out options, what are your views on them and please explain whether there are further options we should consider.

No response

GTQ14. What other outputs should we be considering, if any?

See response to **GTQ5** above which has an impact on network users and uptake of green gasses

GTQ15. What are your views on the RIIO-1 outputs that we propose to remove?

No response

GTQ16. We welcome views on whether further regulatory mechanisms are needed to drive NGGT to be more proactive in reducing its impact on the environment and contributing to the transition to the low carbon energy system.

No response

GTQ17. Do you think that the 'compressor fuel use' element of the shrinkage incentive should be included within NGGT's baseline Totex allowance? To what extent do you think elements of shrinkage are within the control of National Grid Gas

The direction for travel for the NTS transportation pricing methodology is currently the subject of UNC modification 0678. Transportation charges will be capacity based and the primary driver will be to recover allowed revenue. This will result in charges that are cost reflective in general terms but that will not provide locational signals regarding where capacity is available nor it the cost to provide it.

Since they will not be cost reflective in terms of specific locations they will not reflect that exit capacity at one location requires more use of a compressor than capacity at another. Although the EU Tariff Code imposes constraints on the structure of transportation charges the approach taken is in the gift of National Grid.

We do not think that the decision not to have locational cost reflective charges should be a reason to remove the compressor fuel use element from the shrinkage incentive.

National Grid could propose UNC modifications and updates to their methodologies to encourage more efficient use of the network. We think that National Grid could be more proactive in this area.

GTQ18. Do you have any views on how NGGT's can make a contribution to the transition to a low carbon energy system and support the decarbonisation of heat?

They could contribute by providing better gas quality information including forecasting of CV as described above in our answer to GTQ5.

They could also be more accommodating with ad-hoc requests for Flexible capacity to support power stations connected to our network that need gas to respond to demands to generate to support the electricity market. As these stations typically generate when renewable generation is not sufficient this would be supporting decarbonisation of electricity.

WWU has recently raised UNC modification 0671 which introduces a process by which capacity can be moved between offtakes, to support the needs of customers such as biomethane producers and flexible generators whose requirements may mean that we need to try and move capacity between offtakes to accommodate their requirements.

In the context of DNs trying to facilitate decarbonisation of the gas supply chain and to indirectly support renewable electricity generation National Grid could be more proactive in supporting this type of initiative. Our modification is in line with the sentiment in paragraph 4.70 of the Transmission document "This may involve adopting coordinated whole systems approach with GDNs to support initiatives that may be distribution led" and in 4.71 "We are proposing to encourage initiatives that involve collaboration with other network owners and, where appropriate, third parties".

GTQ19. Do you think we should consider proposals from NGGT for additional outputs and incentives to support our environmental objectives?

No response

5. Maintain a safe and resilient network

GTQ20. What are your views on the overall outputs package considered for this output category?

No response

GTQ21. For each potential output considered (where relevant):

a. Is it of benefit to consumers, and why?

b. How, and at what level should we set targets? (e.g. should these be relative/absolute).

c. What are your views on the design of the incentive? (e.g. reward/penalty/size of allowance).

d. Where we set out options, what are your views on them and please explain whether there are further options we should consider.

No response

GTQ22. What other outputs should we be considering, if any?

No response

GTQ23. What are your views on the RIIO-1 outputs that we propose to remove?

No response

GTQ24. Do you have views on whether the proposed approach on safety is appropriate for RIIO-GT2?

We think that there is a risk relying on Future of Energy (FES) scenarios for determining network capability requirements, and comparing baselines with a single year which is unlikely to have been 1:20 across all locations.

We do note that there is a reference to expected flows but the question is how these are determined. We refer back to the points made about forecasts in our response to GTQ10 above.

GTQ25. Do you agree with our assessment of the problems with the current arrangements, and how these problems can lead to consumer detriment?

We accept that operating the NTS is complex and has become more so in the last few years. Substitution arrangements, if used effectively, do allow for current capacity above booked levels to be moved elsewhere if needed; however, those arrangements are not fully transparent and would not be sufficient in all cases of reducing capacity requirements.

Transparency is very important and since some of these issues relate to whether Transmission or Distribution networks bear the cost of providing flexibility some method by which the best whole system solution can be assessed and costs allocated will increasingly be required.

GTQ26. Do you agree with our proposal to require NGGT to carry out an initial network capability assessment and submit the results as part of its Business Plan?

Yes, we agree - but this should link into existing processes around the NTS its Ten-Year Statement which will already provide levels for the end of the RIIO-2 period.

GTQ27. Do you agree that if baseline obligated entry or exit capacities are found to be at inappropriately high levels, we should consider revising them downwards in line with NGGT's proposals?

We agree baseline obligated capacities should be reviewed where they are inappropriately high. However, it would be necessary for Users to have appropriate time to revise bookings where arrangements would change as a result.
There would need to be transparency around the process and the also realistic scenarios considered rather than just a central National Grid view.

The NTS should remain obligated to provide entry and exit capacity consistent with all realistic scenarios. It is essential to ensure that appropriate forecasts are used when assessing what levels are appropriate otherwise we may end up in a positon where the baseline obligated capacity is reduced and then Users may have to fund incremental capacity increases.

GTQ28. Do you agree with our proposal to require NGGT to review the arrangements for accessing unsold capacity?

We agree that a fundamental review of a number of issues in this area is required.

GTQ29. Do you agree with our proposed scope for the review? Are there other aspects of access that should be reviewed at the same time?

In our view the scope should include:

- A review of the substitution process which applies to capacity above baseline

- A review of the process of moving capacity below baseline which is the subject of our UNC modification 0671

- A review of the User Commitment regime for both entry and exit. The work this year at UNC transmission workgroup on UNC modifications 0667 and 0671 shows that there are fundamental problems with it particularly where capacity requests are met by substitution and no investment is required.

  The User Commitment regime may have been appropriate in a world of increasing demand and with cost reflective transportation charges but in a world of static or falling demand across the network as a whole and transportation charges that do not convey locational or local cost reflective signals it can lead to perverse incentives.

  We also think that it can lead to misleading information on demand. If a User has an enduring capacity booking at an offtake but during the User Commitment period finds that it no longer requires all that capacity at that offtake but needs more at another it currently has to book the additional capacity at the second offtake but still has to pay for the capacity at the first offtake.

  For NTS this signals an increase in demand which does not exist. This false increase in demand may also then result in NTS refusing a request for Flexible capacity at the second offtake or a third nearby offtake resulting in further inefficiencies in terms of whole system operation.

We have some concerns about potential issues resulting from UNC modification 0678 on NTS transportation charging. As this proposal is still under development it is difficult to be precise. Our understanding is that under 0678, interruptible capacity will be charged at 90% of the firm capacity charge, from its current zero cost. Our understanding is that National Grid are proposing that this revenue is allocated to the Transmission Services Exit Revenue. We support this allocation as it is revenue that relates to use of capacity.

We have similar concerns relating to the treatment of revenue from the Optional Charge that is proposed by some alternatives to 0678 but on National Grid's proposal 0678 itself. Our understanding is that these revenues are currently allocated to System Operator Exit revenue and in the new arrangements they would be allocated to Non-Transmission Services Exit revenue. Our view is that if an Optional Charge is implemented then this should be allocated to the Transmission Services Exit Revenue as it is revenue that relates to use of capacity.

6. Cost Assessment

GTQ30. Do you agree with our intention to evolve the RIIO-GT1 approach for RIIO-GT2?

No response

GTQ31. Do you have any comments on appropriate cost categories or approaches to cost assessment?

No response

GTQ32. Do you agree with our proposed approach to cost categorisation? Please provide an explanation to your answer.

No response

GTQ33. Do you support our view of the need for greater granularity and transparency in cost reporting to further develop our cost assessment capability?

No response

GTQ34. We invite views on whether the proposed toolkit is appropriate or there are there other assessment techniques we should consider for our cost assessment toolkit in RIIO-GT2.

No response

7. Uncertainty Mechanisms

GTQ35. What are your views on the proposed uncertainty mechanisms and their design?

No response

GTQ36. Are there any additional mechanisms that we should be considering across the sector? If so, how should these be designed

No response

GTQ37. What are your views on the RIIO-GT1 uncertainty mechanisms we propose to remove?

No response

GTQ38. What do you think is the most appropriate approach for funding the Gas Transporters' expenditure for Xoserve in RIIO-2? In particular, which approach do you think is in the best interest of consumers?

No response

GTQ39. If Xoserve takes on any services beyond its core Central Data Service Provider role, how should we treat the costs and risks associated with these additional services through the price control?

The costs borne by gas transmission customers should only reflect the RIIO T2 outputs, licence obligations or uniform network code obligations required by them

Should Xoserve provide services beyond its core Central Data Service Provider (CDSP) role then these should be provided by a different funding mechanism or legal entity than that used for the CDSP dependent on the nature of the request. As an example, shippers may request services and this can be funded directly by shippers. If the water sector wished to use Xoserve, then a separate legal entity may be required within Xoserve to deliver these services with the appropriate risk factored in the costs.