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By Email: riio2@ofgem.gov.uk

4 September 2020

Dear Akshay,

RIIO-2 Draft Determinations – WWU response

We welcome the opportunity to provide our views on the RIIO-2 Draft Determinations issued on 9 July 2020.

Our responses provided in this document build on our previous responses, significant participation across the RIIO-2 workgroups and various correspondence and bilateral meetings with Ofgem.

Our response is structured as follows: -

1. The executive summary of our response;
2. A high-level summary of each section of the DD consultation;
3. Responses to the RIIO-2 Core Document;
4. Responses to the RIIO-2 Finance Annex;
5. Responses to the RIIO-2 Gas Distribution Annex;
6. Responses to the RIIO-2 Wales & West Utilities Annex;
7. Responses to the NARMS Annex;
8. Responses to the Gas Transmission Annex; and
9. List of Appendices - there are a number of additional documents provided to support our DD responses and to provide further evidence.

We have responded by following the structure of the Ofgem consultation documents, clearly marking the consultation question or paragraph number which relates to our response. I can confirm that our response is not confidential however please note that some of our appendices are confidential and are clearly marked as such. Should you have any queries on our responses please do not hesitate to contact me.

Yours sincerely

S J Williams.

Sarah Williams
Director of Regulation

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Wales & West Utilities

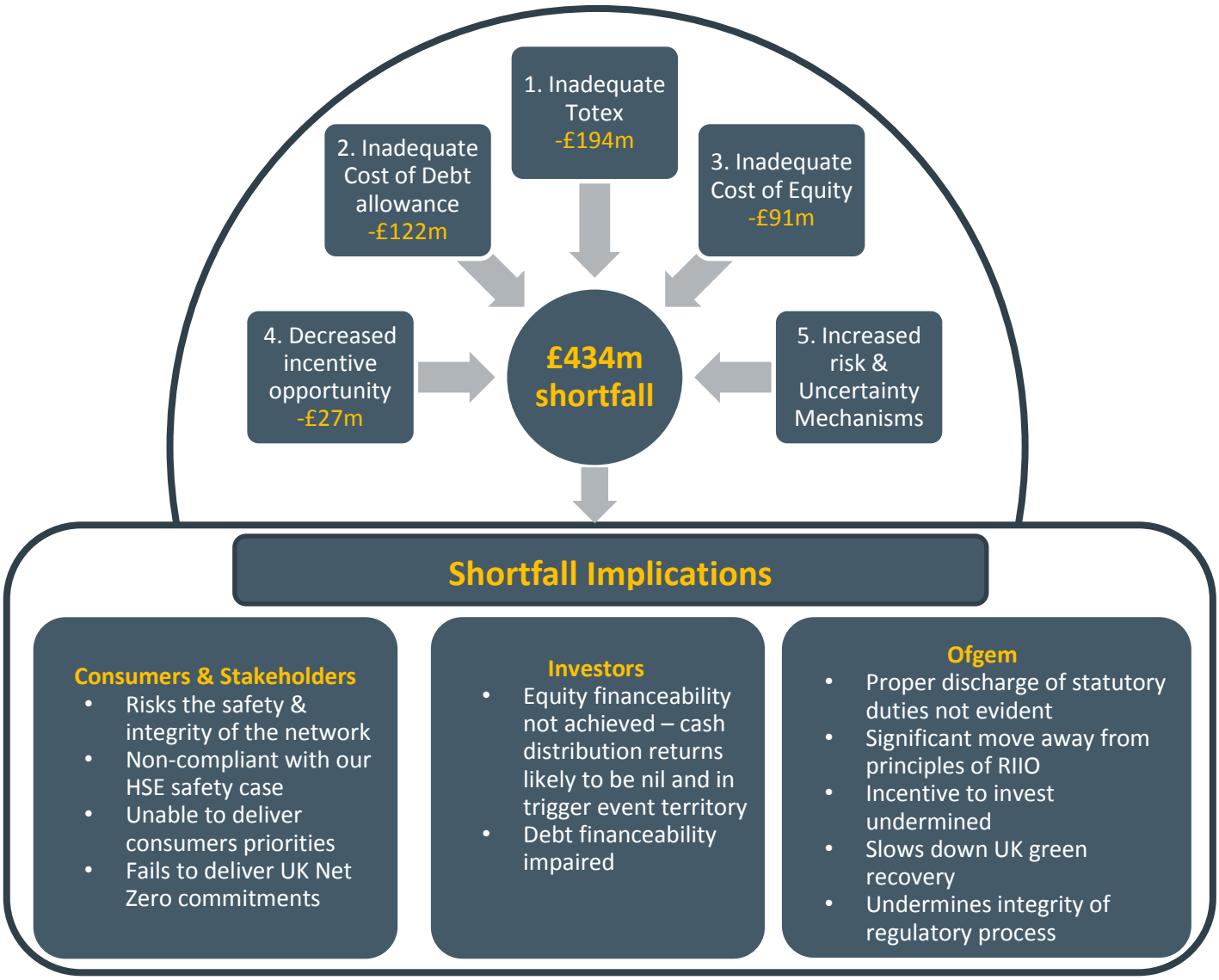
RIIO-2 Draft Determinations- Summary of Our Responses

WALES&WEST UTILITIES

WWU RIIO-2 Draft Determination Response Executive Summary

Overall package

Our overall reaction to the Draft Determination (DD) is one of major concern - the severity of the package risks the integrity of our network, is not compliant with our Health and Safety Executive (HSE) safety case and is not in the interest of consumers or investors. This is summarised as follows: -



Customer and Stakeholder Input

Our Business Plan (BP) was the result of an unprecedented amount of stakeholder engagement and was further enhanced by significant input from our own Customer Engagement Group (CEG). Both ourselves and the CEG are therefore hugely disappointed to see that stakeholder requirements appear to have been largely ignored in the Draft Determinations. We will not be able to deliver clear customer priorities given the substantial cut in allowances.

Inadequate Totex Allowances - £194m shortfall
A Totex reduction of 16% would significantly affect the safety and integrity of our network and fails to deliver our customers and stakeholders priorities.

There is at least £194m of essential network expenditure missing from our Totex allowances in GD2. This expenditure is critical to delivering a safe and reliable network, enabling us to support those living in vulnerable situations and to pave the way to deliver the UK legally binding Net Zero targets. The risks and consequences of the missing allowances need to be fully understood by Ofgem and corrected in the Final Determinations (FDs). The shortfall is summarised below and the detail is contained in the relevant sections of our response.

Shortfall	Area	Consequence
£54m	Repex & Multi Occupancy Buildings (MOBs)	• Unable to comply with our HSE approved safety case risking our Licence to Operate. • Fails to protect the safety of customers with 1000+ pa increase in high volume gas escapes by 2030 • Increases emissions and prevents us transitioning our network to hydrogen ready, in conflict with government net zero policy and ambition • Under-investment in high rise buildings which Grenfell has shown is unacceptable to society
£35m	IT & Cyber security	• Seriously impacts the integrity & security of our network • Move to Net Zero target will not happen without sufficient investment in Systems and telecoms • Removes the ability to deliver digitalisation priorities in GD2
£24m	Loss of metering & Smart metering	• Deterioration of emergency service levels • Inability to support Smart meter roll out
£30m	Regional Factors	• Deterioration of service levels • Reduces the ability to keep customers safe with less resources
£3m	Net Zero Pathfinder model	• Excellent opportunity for UK to benefit from whole system modelling to deliver the Green Recovery
£4m	Vulnerability	• Support for customers living in vulnerable situations will stop • No investment to keep customers safe from CO
£22m	Efficiency challenge	• Deterioration of service levels • Inability to deliver customer priorities • 1.2-1.4% is unjustified & unachievable • Very top of CEPA stated range
£22m	Benchmark position	• Deterioration of service levels • Inability to deliver customer priorities • Lack of justification for the move to 85th percentile • Reliance on single model not statistically robust • Built upon modelling riddled with errors
£194m	**Totex**	• Does not deliver our current and future customer requirements • Risks the long-term viability and sustainability of our network

Inadequate Cost of Debt Allowance (£122m shortfall)

The cost of debt (and associated derivatives) efficiently undertaken by WWU should be allowed over their life at the notional leverage level. Ofgem's methodology does not ensure that. For a long-term business, this is a fundamental design flaw. The DD proposals would lead to a shortfall, currently estimated at £122m for GD2.

Inadequate Cost of Equity Allowances (£91m shortfall)

An updated report from Oxera (FQ7A - Cost of Equity Update (Oxera)) provides compelling evidence for an allowed cost of equity range of 6.0% to 7.08% We remain committed to our Business Plan rate of 6.1%, subject to all other allowances being appropriately set. The report explains why Ofgem's proposed cost of equity allowance is not structured on appropriate Risk-Free Rate, Beta or Total Market Return levels.

Ofgem's proposed allowed rate of 3.95% would lead to an estimated shortfall of £91m over GD2 which when combined with the inadequate allowance for debt means shareholders are facing the prospect of zero cash returns. This would be a perverse outcome for an efficiently operated and financed business.

Financeability

Given the serious revenue shortfalls noted above, we believe that Ofgem would not properly discharge its statutory duties relating to existing and future consumer interests, and finance, with a customer bill reduction of 12% for GD2 following a reduction of 7% over GDPCR1.

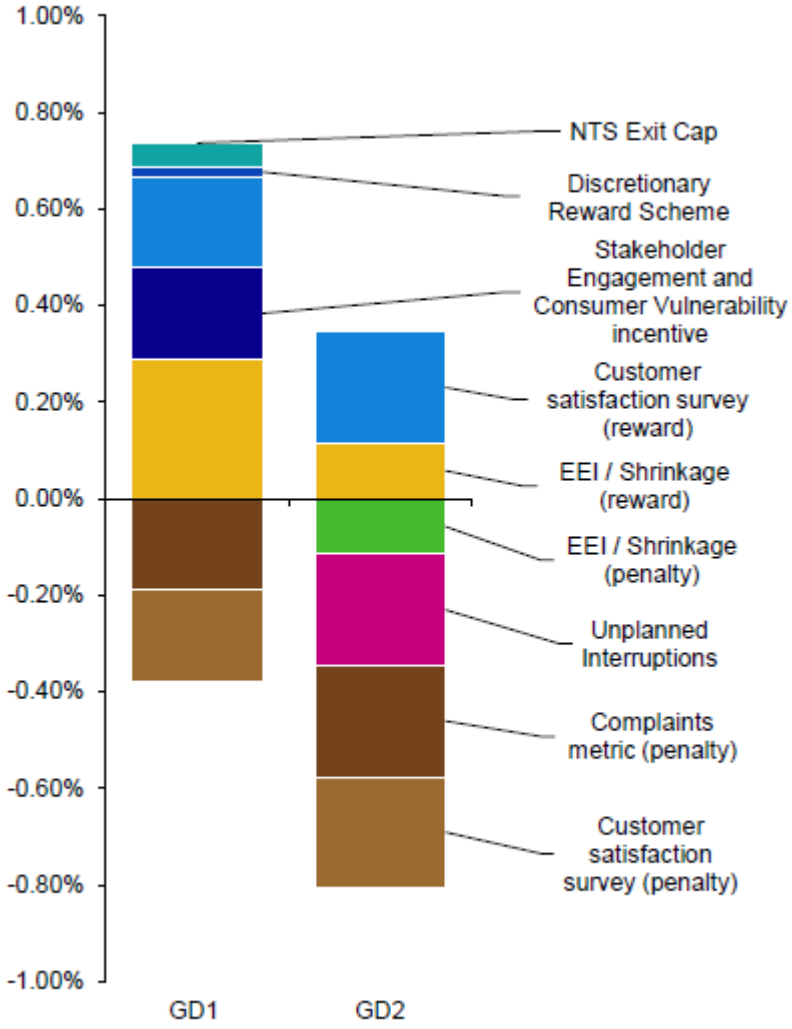
Ofgem is aware that we have undertaken significant measures to date on capital structure, with support from shareholders, to underpin financeability for GD2 and beyond. The finance duty imposes obligations on Ofgem, not on WWU, and we have yet to see how that duty would be properly discharged.

We are of course willing to discuss this important area further.

Decreased Incentive Opportunity - £27m shortfall

The DD represents a significant move away from the incentivisation framework introduced in RIIO-1, to the extent there is no realistic incentive for companies to deliver enhanced performance in GD2. This is shown in the figure below:-

Figure 1: WWU's RIIO incentives in RoRE terms



Sources: Ofgem GD2 Draft Determinations, Analysis of Ofgem data

WWU available reward

GD1 +0.74%
GD2 +0.35%

WWU available penalty

GD1 -0.38%
GD2 -0.81%

WWU incentive income

GD1 Ave £6m pa income received

GD2 Ave £1m pa income projected

The upside on incentives has halved and the downside has more than doubled compared with GD1 - and is dramatically skewed towards the downside. This does not reflect credible incentive regulation and is not in the interests of customers or investors. This is discussed more fully in an independent report produced by KPMG which is attached as Appendix - Analysis of the RIIO-GD2 Draft Determinations (Incentives).

Increased risk and Uncertainty Mechanisms (UMs)
We recognise the need and value of UMs for some elements of the package as we enter GD2 - the uncertainty surrounding Net Zero spend would be a clear example of this. However, we have concerns around the mechanisms and thresholds proposed, which could result in Net Zero investment being impacted by a slow and bureaucratic process.

There is also a risk that we would not recover the investment needed to deliver the requirements - and this combined with a serious challenge to our financeability, will inevitably lead to a risk-averse approach to investment which is not in the long-term interests of consumers. The impact of Uncertainty Mechanisms in the RIIO-GD2 package is explored further in an independent paper from KPMG; attached as Appendix - Analysis of the RIIO-GD2 Draft Determinations (Uncertainty). In summary, during RIIO-1 only 54% of the funds requested under reopeners were released to companies. This highlights how accessing funding through reopener mechanisms is fundamentally uncertain and the risk of underfunding is high.

We advocate a more certain and flexible approach to UMs where: -
Spend is agreed in advance of incurring the spend to enable speed of investment and minimise the risk of underfunding;

- The trigger threshold set at nil - given tightness of control and resultant inability to deal with cost shocks;
- A lower aggregate cap level to support smaller scale local investment; and
- UMs to be triggered more frequently and by the companies in addition to Ofgem.

Process Integrity
The level of engagement between Ofgem and the networks over the past 18 months has been positive and constructive however we are concerned by several failings in the DD process summarised as follows: -

- Several changes included in the DD without prior consultation (e.g. cost assessment benchmark moved to the 85th percentile and the introduction of a new 95/5 sharing mechanisms for Network Asset Resilience Measures [NARMs]);
- The late issue of documents, models and relevant files has seriously reduced the time available to properly assess and respond to the DDs;
- The much greater complexity of this price control compared to previous ones is disproportionate - and is at odds with Ofgem's stated commitment to simplification;
- Ofgem's Impact Assessment was only completed three weeks after DD publication raising serious questions about the integrity of information available to the Gas and Electricity Markets Authority (GEMA) board when approving the DD; and
- A significant volume of errors in the DDs raises questions about the quality and integrity of the process and the lack of assurance undertaken by Ofgem.

We attach a comprehensive list of our concerns (Appendix RIIO2 Process Concerns) on the Ofgem process which was also sent to you separately dated 1 September 2020.

Conclusion

The WWU Business Plan we submitted for GD2 was premised on continuing to deliver the excellent level of service and performance we have achieved through GD1 whilst at the same time keeping our charges down to the minimum. The DD seriously compromises our ability to deliver for customers, is risking the long-term viability of our network - as well as undermining our ability to remain financeable in GD2 and beyond and needs to be reconsidered by Ofgem prior to the publications of FDs.

A high-level summary of each section of our DD Response

RIIO-2 Draft Determinations – Core Document

Embedding the consumer voice in RIIO-2

- We have an overriding concern that despite increasing the voice of the consumer being a core principle of RIIO2, the draft determinations appear to largely ignore the customer and stakeholder feedback.

- This is disappointing given the extensive engagement we undertook, the amount of money we invested to support this and how integral their feedback was in developing our plan.

- We valued the significant contribution of our CEG and we are keen to continue with our CEG into GD2 so that they provide an ongoing consumer challenge to our business from an independent perspective.

- From the draft determinations, we are unclear as to whether the anticipated value of the CEGs and RIIO-2 challenge group were realised from Ofgem's perspective. There appears to be little acknowledgement of their reports and contributions.

Quality of service – setting outputs for RIIO-2

- We agree with the focus on digitalisation in GD2, however, our disallowed IT spend will hamper our ability to support this. We need to work with Ofgem to ensure the essential allowances are included in the final determinations (FDs).

- We are committed to limiting our impact on the environment as a sustainable business; however significant efficiency challenges outlined within the Draft Determination will impact the balance of sustainability and a reduced ability to deliver that ambition and what consumers want.

Ensuring efficient cost of service

- In principle we agree with RPEs indexation however Labour indices should be reviewed and RPEs should also be applied to plant and equipment.

- Ofgem's efficiency challenge at 1.2% ~ 1.4% (£40m) is unrealistic and unachievable. We disagree with using the upper end of the CEPA range.

- CEPA's analysis and Ofgem's decision which result in it selecting the upper bound from CEPA's range of estimates, present multiple issues:
    - disregarding CEPA's advice and relying only on value added (VA) productivity measure completely ignores the gross output (GO) measure;
    - using labour productivity for OPEX only, instead of total factor productivity (TFP) is not appropriate;
    - relying only on the weighted all-industries average is an unsuitable weighting approach and ignored CEPA's unweighted approach;
    - choice of time period is inappropriate and lacks consideration of forward-looking uncertainty, and
    - inappropriate application of further uplift for innovation funding.

Managing uncertainty

- We are concerned that the current uncertainty mechanisms add risk into the price control settlement which combined with a serious challenge to our financeability, will inevitably lead to a lack of investment.

- The changes introduced for GD2 - lower returns, smaller base Totex and reduced Totex Incentive Mechanism mean that the Networks have no head room to incur unfunded expenditure in GD2 compared to GD1 or absorb cost shocks.

- Uncertainty mechanisms must be designed to allow networks to recover their expenditure in a timely manner without being exposed to risk.

- Where there is risk associated with recovering this expenditure such as thresholds or risk of expenditure being disallowed Networks may find that they cannot borrow to fund this expenditure.

- KPMG analysis commissioned by WWU (Appendix Analysis of the RIIO-GD2 Draft Determinations (Uncertainty)) demonstrates that during RIIO-1 only 54% of the funds requested under reopeners were released to companies. This highlights how accessing funding through reopener mechanisms is fundamentally uncertain and the risk of underfunding is high.

- We recognise the need for UMs for some elements of the package, however, we have concerns on the design of the current mechanisms and some investment is at risk of being impacted by a slow and bureaucratic process. We are keen to ensure we can deliver the priorities of our customers and stakeholders and the design of the current uncertainty mechanisms will not enable us to do that.

- We have some specific recommendations on changes that can be made to these mechanisms which can be summarised as follows:

    1) Materiality thresholds are too high for WWU to voluntarily incur expenditure as there is a risk that we won't trigger the thresholds and then spend would go into Totex overspend - we recommend this is set to zero;
    2) Only having one application window in January 2022 is not the correct design, in our view annual windows would be more appropriate; and
    3) It is inappropriate for Ofgem to be able to trigger a re-opener at any time. The rights should be symmetrical. For Net Zero it is inappropriate that only Ofgem should be able to trigger the re-opener, networks should be able to trigger re-opener too.

- We disagree with Ofgem's rejection of our loss of land development claims re-opener. We have submitted the additional information requested and seek a licence condition the same as National Grid Gas Transmission's (NGGT) Quarry and Development Loss Re-Opener.

- For large loads re-opener, this needs to be cumulative not just for individual large loads.

Net Zero and innovation

- We recognise the need for UMs for some elements of the package as we enter GD2, especially to enable Net Zero, which is uncertain. However, we have concerns that the current mechanisms mean that projects in our network to deliver Net Zero would not be funded due to the high threshold.

- We engaged EY (see Appendix Q21A - Support for Net Zero related investment in RIIO-2 (Ernst & Young)) to undertake a review of our c.£150m net zero GD2 investment which was included in our business plan. They assessed each of the areas against the various reopeners proposed in the DDs. Their findings were that the none of the investment required to support green gas, green vehicles, system operability or GD3 Repex would be funded.

- EY found there was potential for funding of flexible electricity generation under the Net Zero Reopener or the New Large Loads reopener however the restrictive application windows could delay important investment.

- In order to deliver the local priorities of communities in Wales and the South West, we are keen to see changes to the mechanisms which support investment. Our proposal are summarised as follows: -

    - A zero threshold to ensure all efficient investment can be delivered;
    - More frequent, ideally annual, windows to apply to support a proactive and agile approach;
    - GDNs to be able to trigger the reopener in addition to Ofgem given that is where the knowledge is of the required investment;
    - Ability to aggregate within the reopener to deal with smaller, valuable projects; and
    - Explicit upfront criteria to provide certainty of funding for networks.

- We are pleased to see Ofgem have allowed the Network Innovation Allowance (NIA) expenditure we requested in our business plan. We are keen to work with Ofgem to develop the rules of the NIA and Strategic Innovation.

Approach to the Totex and Business Plan Incentive Mechanisms

- We are disappointed following extensive work on our Consumer Value Proposition (CVP), comprehensive independent substantiation and significant challenge from our CEG, we have not received a reward for the elements of our plan which we believe go above and beyond BaU.

- We note that the only CVP award is for performance which is broadly aligned to what we've already achieved in 2019; we are concerned that commitments have not been checked against the existing BaU performance of other companies. This is an inconsistent approach which needs to be addressed ahead of the FDs.

- We note the positive comments about our Pathfinder model - albeit no allowance or CVP reward was provided by Ofgem at this stage. Further evidence is attached in Appendix Q37A - Whole system data and pathfinder CVP. to this response to demonstrate the benefits of sharing the models and data more widely.

Interlinkages in RIIO-2, post appeals review and pre-action correspondence

RIIO-2 Interlinkages

- We recognise that there are certain elements of the price control that are subject to what Ofgem calls 'mechanistic' interlinkages in the sense that there are formulaic or mathematical connections between them.

- We do not recognise the category that Ofgem describes as comprising of 'less mechanistic' interlinkages which: 'involve a certain degree of regulatory judgment'; relate to 'decisions that are taken at a global level'; and 'need to be considered "in the round".'

- We do not believe that the underlying bases on which Ofgem seeks to define and identify interlinkages are sound, in line with precedent, or supportable.

- A price control is the aggregation of discrete components. If each component is appropriate, the price control will, by default, be appropriate in the aggregate.

- In energy the appeals mechanism is designed around discrete components; the Competition and Markets Authority (CMA) has previously rejected the request to review the settlement ‘in the round’ and instead reviews these ‘discrete’ components only.

Post-Appeals Review

- We reject Ofgem’s proposition to seek to modify the price controls after the event of an appeal, except to the extent strictly necessary to comply with any determination by the CMA; this is fundamentally incompatible with the statutory framework, and would undermine the integrity of the statutory appeals process and the role of the CMA.

Pre-action Correspondence

- We do not consider that the pre-action correspondence that has been proposed by Ofgem is justified or appropriate in the circumstances.
- Ofgem will already be fully informed of the differences between its proposals and the views of the companies, and by the time it makes its final decisions will have had several opportunities to address these and to avoid the risk of a dispute.

Impact of COVID-19 on the price controls

- We are committed to working with Ofgem as the impacts of Covid-19 develop.
- Given there is still uncertainty over the cost impact, there will need to be specific mechanisms in RIIO-2 to manage the longer-term impacts.
- GD2 outputs and cost allowances will need to be adjusted accordingly for all work types which have been affected by Covid-19 in GD1 and will need to be delivered in GD2 (and were not known at the time of BP submission).
- We propose a mechanism to deal with this could include an annual adjustment mechanism which ensures timely corrections are made to charges to take account of increases in actual cost vs allowances.
- Consideration could also be given to a cost overlay which is applied ex-ante to the FDs following an initial assessment of where the costs impacts are being seen or are anticipated.

RIIO-2 Draft Determinations – Gas Distribution Annex

Quality of service – setting outputs for RIIO-GD2

Meeting the needs of consumers and network users

- We had serious concerns about the disallowance of our £4m vulnerability spend - which we now understand was an Ofgem error. It is imperative that the required allowances are provided otherwise we will be unable to deliver our commitments which customers have asked us to deliver.
- WWU are pleased to see many of the bespoke output proposals put forward in our Business Plan adopted into the revised Guaranteed Standards of Performance (GSoP) across the GDNs.
- The level of Customer satisfaction scores (CSAT) expected in GD2 exceeds the level of service our customers requested. Additionally, we are concerned regarding the asymmetric deadband being proposed.
- We support the WWU interruptions target however we are keen that this is a national target to ensure all customers receive the same level of service cross the UK.

Deliver an environmentally sustainable network

- GDNs have an important role to play in reducing carbon and this is an area that benefits from incentivisation and we are keen to ensure the right behaviours are incentivised.

- However, the proposed approach to the GD2 Shrinkage Incentive limits incentivisation and needs careful consideration.

- Our concern is that the incentive based on system pressure and Mono-ethylene Glycol (MEG) alone would be too narrow and only incentivises performance in these areas and not the bigger picture of total emissions.

- We are committed to improving our environmental performance however we are unable to increase our ambition within the allowances currently proposed.

Maintain a safe and resilient network

- We support the driver for an Allowance Adjustment Mechanism on Repex PCD however think the 2% and 10% restrictions on allowances for mains and services respectively are too small with little flexibility to manage changes to the risk profile of pipes and changing stakeholder requirements.

- NARMs was a metric designed to give the Networks the flexibility to respond to changing requirements and we are concerned that the use of PCDs for Capital projects prevents the correct asset management decisions being made at the correct time.

Cost of service – setting baseline allowances

- A reduction of 16% in Totex allowances presents a serious concern and puts the long-term viability of the network at risk.

- There is £194m of essential expenditure currently missing from our Totex allowances across GD2 (£38.8m pa) which is required to deliver a safe and reliable network for our customers and other stakeholders, including HSE, summarised as follows: -

Shortfall	Area	Consequence
£54m	Repex & Multi- Occupancy Buildings (MOBs)	Unable to comply with our HSE approved safety case risking our Licence to Operate. Fails to protect the safety of customers with 1000+ pa increase in high volume gas escapes by 2030. Increases emissions and prevents us transitioning our network to hydrogen ready, in conflict with government net zero policy and ambition Under-investment in high rise buildings which Grenfell has shown is unacceptable to society.
£35m	IT & Cyber security	Seriously impacts the integrity & security of our network. Move to Net Zero target will not happen without sufficient investment in Systems and telecoms. Removes the ability to deliver digitalisation priorities in GD2.
£24m	Loss of metering & Smart metering	Deterioration of emergency service levels. Inability to support Smart meter roll out.
£30m	Regional Factors	Deterioration of service levels. Reduces the ability to keep customers safe with less resources.
£3m	Net Zero Pathfinder model	Excellent opportunity for UK to benefit from whole system modelling to deliver the Green Recovery.
£4m	Vulnerability	Support for customers living in vulnerable situations will stop. No investment to keep customers safe from CO.
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£22m	Benchmark position	Deterioration of service levels. Inability to deliver customer priorities. Lack of justification for the move to 85th percentile. Reliance on single model not statistically robust. Built upon modelling riddled with errors.
£194m	**Totex**	Does not deliver our current and future customer requirements. Risks the long-term viability and sustainability of our network.

- It is imperative that we work with you to ensure the risks and consequences of this missing allowances are fully understood and why this level of Totex must be allowed in the Final Determinations.

We have major concerns about the allowance setting process and can be summarised as follows: -

- The Ofgem modelling is excessively more complex than GD1, with limited time to understand, analyse and respond in the DDs;

- We have identified a number of errors which raises concerns on how the Ofgem work has been assured in advance of DDs;

- The reliance on one single Totex model is not robust with R2 deterioration between price controls from 0.93 to 0.87;

- Inconsistency in cost treatment between GDNs when similar evidence provided; creating a postcode lottery across the UK;

- Surprised benchmark set at 85th percentile – this is inappropriate;

- Further ongoing efficiency challenge - circa 1.2~1.4% is unachievable; and

- Mains replacement allowances do not adequately cover the most recent market tender evidence.

Incentives

- The DD represents a significant move away from the incentivisation framework introduced in RIIO-1, to the extent there is no realistic incentive for companies to deliver enhanced performance in GD2.

- The upside on incentives has halved and the downside has more than doubled compared with GD1 - and is dramatically skewed towards the downside.

- The RIIO-1 incentive package led to c.£6m earned by WWU whereas at best, the forecast incentive RIIO-2 package will be a max £1m and potentially even ended up in penalty; which for a high performing network illustrates the move aware from incentive regulation which is not in the interests of customers or investors.

- Further analysis by KMPG on the DD incentive package and a comparison to PR19 is contained as Appendix Analysis of the RIIO-GD2 Draft Determinations (Incentives)

Adjusting baseline allowances to allow for uncertainty

Please also refer to the summary to Section 4 of the Core Document.

- We support the reopener proposed on Tier 1 stubs, MOBs.
- The reopener on <7bar diversions should be extended to include >7bar.
- We are very concerned that Ofgem have rejected WWU's reopener proposal which poses an increased risk for distribution vs transmission (who have this included in their licence already).
- We support the volume driver PCD for connections.
- We propose that the costs of the Joint Office of Gas Transporters should be treated as 'pass through' in a similar way to the Xoserve costs.
- We support the continuation of the large loads re-opener subject to it being available for multiple projects that have unfunded reinforcement that collectively meet the threshold.

RIIO-2 Draft Determinations – Wales & West Utilities Annex

Setting outputs

Common Outputs

- We support the Fuel Poor Network Extension Scheme (FPNES) volume driver.
- We support the WWU interruptions target however we are keen that this is a national target to ensure all customers receive the same level of service.
- We support the driver for an Allowance Adjustment Mechanism on Repex PCD however think the 2% and 10% restrictions on allowances for mains and services respectively are too small with little flexibility to manage changes to the risk profile of pipes and changing stakeholder requirements.

Bespoke Outputs

- Whilst the WWU bespoke outputs where rejected, we were pleased to see that our GSoP proposals into revised common outputs for the GDNs, and the voluntary interruptions output will be measured by a reputational reporting across the GDNs.

CVP

- We are disappointed we did not receive a reward for our CVP.
- We are concerned that future commitments of some networks have not been checked against the current performance of other companies; an inconsistency of approach that could result in additional allowances for some and no allowance for others where the performance is already being achieved.
- We note the positive comments about our Pathfinder model - albeit no allowance or CVP reward was provided by Ofgem. Further evidence is attached to this response to demonstrate the benefit and achieve a reward/allowance.

Adjusting baseline allowances to allow for uncertainty

- We do not agree with the rejection of our bespoke UM on the loss of land development claims; this increased risk for distribution vs transmission and presents an adverse impact on financeability assessment in GD2 without an uncertainty mechanism.
- We were grateful to the Ofgem team for a bilateral meeting to discuss this further.
- We have now provided significant supporting information and evidence to support the need for a reopener – see Appendix Analysis of the RIIO-GD2 Draft Determinations (Uncertainty).

RIIO-2 Draft Determinations – NARMS Annex

We have been working alongside Ofgem and the other GDNs for many years to develop NARMs (previously known as NOMs) which is a sophisticated tool for asset health and risk management. However, the planned usage for GD2 is no longer appropriate and there are some fundamental changes to the sharing mechanism being introduced which have not been previously discussed or consulted upon which seriously restrict our ability to respond to customers and stakeholders throughout GD2.

Our views in summary are as follows:

- NARMs is a well-developed 'risk management' tool; however, it's not fit for purpose as a 'delivery' tool. Its complexity restricts our ability to consult with consumers on the benefits.

- The new NARMs sharing mechanism introduced without consultation (5%:95% to consumers); removes any stimulus to innovate and restricts our ability to adapt to stakeholder requirements.

- NARMs models were re-issued multiple times; we are therefore concerned around the quality of these models and question the level of assurance sought by Ofgem.

- NARMS is now incredibly complicated; we need to ensure the effort is proportional to the value which don't believe is currently the case.

RIIO-2 Draft Determinations – Gas Transmission Annex

- We agree the efficiency of the total (distribution and transmission) system could be improved to an extent by enhanced obligations.

- The current frameworks (Uniform Network Code (UNC) and NGGT Methodologies) will need to be updated to remove some of the current inefficiencies in the booking processes e.g. User Commitment.

- We propose a licence obligation on NGGT to develop frameworks that promote Total System efficiency including for Flat, Flex and AOP.

Wales & West Utilities

RIIO-2 Draft Determinations Core Responses

WALES&WEST UTILITIES

3. Embedding the consumer voice in RIIO-2

Summary Response

- We have an overriding concern that despite increasing the voice of the consumer being a core principle of RIIO2, the draft determinations appear to largely ignore the customer and stakeholder feedback.
- This is disappointing given the extensive engagement we undertook, the amount of money we invested to support this and how integral their feedback was in developing our plan.
- We valued the significant contribution of our CEG and we are keen to continue with our CEG into GD2 so that they provide an ongoing consumer challenge to our business from an independent perspective.
- From the draft determinations, we are unclear as to whether the anticipated value of the CEGs and RIIO2 challenge group were realised from Ofgem's perspective. There appears to be little acknowledgement of their reports and contributions.

Enduring role of the UGs and CEGs

Q1. What role should Groups play during the price control period and what type of output should Groups be asked to deliver? Who should be the recipients of these outputs (companies, Ofgem and/or stakeholders)?

Our CEG added significant value to the business planning process, challenging us to go above and beyond for consumers however they are now questioning their value due to the lack of influence the group had on the draft determinations.

During GD2, we therefore question an enduring role for CEGs and the RIIO Challenge Group, when their influence on DD decision-making appears to be minimal. Without a clear understanding of their remit in championing the consumer voice and how their views will be factored into Ofgem's decisions, retaining and recruiting CEG members is likely to suffer. Also, with a proposed 16% cut in our allowances, our ability to be able support the costs of the CEG and the enhanced stakeholder engagement needs to be prioritised.

If CEGs continue they should provide support for outputs for all stakeholders, including Ofgem and consumers; challenging gas networks' delivery plans to ensure consideration of stakeholders' changing needs and preferences. We are keen to understand Ofgem's view of the value of their role so far and any thoughts on the role they can play going forward.

Q2. What role should Groups take with respect to scrutinising new investment proposals which are developed through the uncertainty mechanisms?

We support the ongoing role of the CEG which could include a level of scrutiny over the uncertainty mechanism investment notwithstanding the limitations of the groups given they are typically only committed for 1 or 2 days per month, however the value they offer is typically in challenging the companies from a consumer angle.

For investment proposed under the uncertainty mechanism, CEGs can challenge their development through the eyes of the consumer, in the same way as during GD2 Business Plan development and provide an independent view to Ofgem.

Q3. What value would there be in asking Groups to publish a customer-centric annual report, reviewing the performance of the company on their business plan commitments?

We are aware that there is a significant amount of new reporting required under the new RIIO2 arrangements and we need to be sure the effort is proportional to the value. An annual customer-centric report prepared by the CEG could evidence gas networks' performance during GD2 from an independent perspective. This could form an additional submission to either the annual stakeholder report or our annual Regulatory Reporting Pack.

In any event, clear guidance must be set to allow for comparability across companies and best practice sharing should be encouraged by the regulator. It is important that we understand upfront how this would be used by Ofgem and how this fits with the raft of regular reporting we provide as networks.

Q4. What value would there be in providing for continuity of Groups (albeit with refresh to membership as necessary) in light of Ofgem commencing preparations for RIIO-3 by 2023?

Maintaining continuity of the CEGs, albeit with some membership changes, will reduce set-up costs and other resource implications in starting up new Groups. Experienced CEG membership will be an advantage in commencing GD3 preparations. We will require appropriate funding in the price control settlement to fund the CEG going forward.

4. Quality of service – setting outputs for RIIO-2

Summary Response

- We agree with the focus on digitalisation in GD2, however, our disallowed IT spend will hamper our ability to support this. We need to work with Ofgem to ensure the essential allowances are included in the final determinations (FDs).

- We are committed to limiting our impact on the environment as a sustainable business; however significant efficiency challenges outlined within the Draft Determination will impact the balance of sustainability and a reduced ability to deliver that ambition and what consumers want.

Cross-sector outputs

Q5. Will the combination of the two proposed Licence Obligations support the delivery of a digitalised energy system and maximise the value of data to consumers?

Digital technologies are an essential enabler for the move to a low-emission energy system and to meeting the UK Net Zero targets. We are committed to modernising energy data and making this available for the benefit of all, both inside and outside of Wales & West Utilities.

Our data digitalisation strategy is based on a number of key principles:

- We support the Energy Data Taskforce's recommendations, as outlined in 'A strategy for a modern digitalised energy system'. In particular, we support the two key principles - Principle 1: Digitalisation of the Energy System and Principle 2: Presumed Open.
- We value the importance of consulting with stakeholders to understand what data really supports the UK energy network and the transition to the future energy network.
- We publish data where it has passed the tests of being relevant and/or useful for consumers and stakeholders.
- We make data easily available, always at no cost.
- We always maintain compliance with legislation covering the use of data, in particular; the General Data Protection Regulation (GDPR).

We believe that best practice guidance is extremely useful and are therefore supportive of the Licence Condition requiring Networks to use Energy System Data in line with Data Best Practice guidance.

It should be noted that our ambition in digitalisation does require investment in IT. We cannot deliver our plan without sufficient funding. Most of our IT spend has been disallowed and our suggestion of a re-opener for digitalisation has been rejected.

The IT allowance provided to date will severely impede our ability to sustain a reliable IT & Telecoms programme, risking the integrity of the business applications and infrastructure that underpin our business processes and operations. This will be included and explicit in our IT plan resubmission. If funding is not restored in IT, we will be forced to prioritise safety related IT systems and our current digitalisation strategy simply will not be delivered.

The second Licence Condition requires networks to update Digitalisation strategies every 2 years and share progress at least every 6 months. We believe this is reasonable and gives transparency to consumers and other interested stakeholders. We do have concerns around the requirement to update our current strategy by December. It is dependent on disallowed IT funding being re-instated and we will have no visibility of this prior to Ofgem's Final Determinations. We will need time to digest and update our Digitalisation Strategy accordingly. We would suggest a February deadline for update would be more appropriate.

Q6. Do you agree with our proposed frequency for publication of updates to the digitalisation strategy and the digitalisation action plan, respectively?

We welcome the change from the Open Letter requirement to update a strategy annually to updating every two years. We believe annually is too frequent for a strategy and regular reporting on progress is more valuable to stakeholders.

Q7. What kinds of data do you think should comply with the data best practice guidance to maximise benefits to consumers through better use of data?

We regularly consult with a wide range of stakeholders to understand their data needs. There are a number of key themes around asset data and network capacity, usage and constraint data. We would suggest these should be included but we think other stakeholders outside of the networks should be influencing the answer to this question.

Q8. Do you agree that the Groups could have an enduring role to work with the companies to monitor progress and ensure they deliver the commitments in their engagement strategies?

We believe the CEG challenges supported our delivery of a robust GD2 Business Plan, reflecting more than 20,000 consumer voices. However, we share their disappointment in not seeing this reflected in Ofgem's Draft Determination. Consumers were positive about supporting the most vulnerable in society and for net zero investment, but we cannot see how this has influenced Ofgem's decision-making.

We question an enduring role for CEGs and the RIIO Challenge Group, when their influence on DD decision-making appears to be minimal. Without a clear understanding of their remit in championing the consumer voice, retaining and recruiting CEG members is likely to suffer. Also, with a proposed 16% cut in allowed costs of enhanced stakeholder engagement, our investment should prioritise consumer involvement in our GD2 delivery planning. Please also refer to our answers to Q1-Q4 of the core document.

Q9. Do you agree with our proposal to accept the proposals for an ODI-R for and the other proposals set out above as EAP commitments and to require progress on them to be reported as part of the AER?

We believe the introduction of an ODI-R for an Annual Environmental Report (AER) meets the requirements of stakeholders.

We are committed to limiting our impact on the environment as a sustainable business; as reflected in our business plan. Significant efficiency challenges outlined within the Draft Determination will impact the balance of sustainability within our business where natural, human, social, manufactured and financial capitals must co-exist to drive sustainable change. To limit the financial impact on consumers and increase the reach of our Environmental Action Plan (EAP), our ambition required employees across the business to contribute. Efficiency challenges across WWU will result in a reduced ability to deliver that ambition and what consumers want[1].

Whilst defining our EAP, we were careful to ensure our targets meet the SMART (specific, measurable, attainable, relevant and time-bound) targets required by Ofgem[2]. Subscribing to targets that are not attainable will erode consumer and stakeholder trust within WWU and the wider utility sector. Therefore, we believe annually reporting our progress against SMART commitments in an easily accessible EAR will benefit our stakeholders.

[1] Wales & West Utilities, Our Business Plan for 2021-2026, A sustainable business in a changing and dynamic sector, December 2019 Appendix 5F – Synthesis reports on outputs, commitments and environment.

[2] Consultation – RIIO-2 Draft Determinations – Core Documents, Ofgem July 2020, p. 37, Section 4.55

5. Ensuring efficient cost of service

Summary Response

- In principle we agree with RPEs indexation however Labour indices should be reviewed and RPEs should also be applied to plant and equipment.
- Ofgem's efficiency challenge at 1.2% ~ 1.4% (£40m) is unrealistic and unachievable. We disagree with using the upper end of the CEPA range.
- CEPA's analysis and a number of Ofgem's decision which result in it selecting the upper bound from CEPA's range of estimates, present multiple issues:
    - disregarding CEPA's advice and relying only on value added (VA) productivity measure completely ignores the gross output (GO) measure;
    - using labour productivity for OPEX only, instead of total factor productivity (TFP) is not appropriate;
    - relying only on the weighted all-industries average is an unsuitable weighting approach and ignored CEPA's unweighted approach;
    - choice of time period is inappropriate and lacks consideration of forward-looking uncertainty, and
    - inappropriate application of further uplift for innovation funding.

Driving Efficiency

Q10. Do you agree with our proposed RPEs allowances? Please specifically consider our proposed cost structures, assessment of materiality, and choice of indices in your answer.

Yes, we agree RPEs should be indexed. However, we have some observations on the current Ofgem assumptions;

- Plant and equipment are currently excluded on material grounds - it may of failed on materiality grounds but its linked to fuel and metal indexes. This is part of many areas throughout the cost assessment process that's deemed immaterial while assessed alone but when aggregated become a material cost.
- The inconsistency between setting frontier shift and RPEs - the frontier shift is set on an ex-ante basis while the RPEs are indexed with an annual true-up. We believe you have ignored that labour productivity is equal to real wage growth in the long run and thereby if frontier shift is set on an ex-ante basis, the labour RPE should also be set on an ex-ante basis or both should be indexed.

In reviewing the current methodology, it has been observed we have yet to have been supplied with the RPE calculations to validate we agree with the current values in the Licence model (LIMO).

Q11. Do you agree with our proposed ongoing efficiency challenge and its scope?

No, we do not agree with this excessive efficiency challenge. We proposed a £18m ongoing efficiency challenge (0.5%) but currently you have applied £40m (1.2 - 1.4%).

CEPA's analysis and a number of Ofgem's decision which result in it selecting the upper bound from CEPA's range of estimates, includes a number of issues:

- disregarding CEPA's advice and relying only on value added (VA) productivity measure and completely ignoring gross output (GO) measure,
- using labour productivity for OPEX, instead of total factor productivity (TFP),
- relying only on the weighted all-industries average with unsuitable weighting approach and ignoring CEPA's unweighted approach,
- inappropriate choice of time period and lack of consideration for forward-looking uncertainty, and
- inappropriate application of further uplift for innovation funding.

There are a number of factors we fundamentally disagree with;

- Time period: Ofgem uses 1997-2016 as the timeframe for analysis suggesting that this comprises two business cycles (i.e. 1997-2006, 2006-2016). However, this is upwardly biased, by 0.3%-0.6% p.a., as it does not represent two complete business cycles (the first period, 1997-2007, is one of growth).
    - CEPA suggests that weight should be given to gross-output (GO) based measures, which are 0.3%-0.6% p.a. lower than value-added (VA) based results. Oxera also presented evidence on a GO-basis. However, Ofgem ignores GO based results due to 'practical difficulties', instead using VA, so their estimate is further upwardly biased. As such, further analysis, including alternative estimation approaches to derive GO-based measures,[3] and evidence on this point is required.
    - CEPA focus on labour productivity for OPEX, yet labour only accounts for a portion of OPEX. This resulted in a 0.2% higher assumption for OPEX than other areas. This is another source of upward bias. In contrast, Oxera, in their report for WWU, used TFP in all cases but different comparator sectors for the different cost areas. Further analysis and evidence on this point is required.
- Weighting approach: CEPA's reference figures were based on an unweighted average across sectors for the lower bound and a weighted average for the upper bound of a comparator set of sectors. The weighting approach is based on the relative importance of the sectors in the economy (as in RIIO-1), which does not account for the industry-specific cost structure of GDNs. Oxera used a weighted approach, based on industry cost structure, of a slightly different comparator set

[3] This requires further research on possible options.

- Uplift for innovation funding: Ofgem added a 0.2% overlay from further productivity improvements from innovation. However, all comparators have the equivalent of 'innovation funding' (CEPA also states that there could be a double count). Furthermore, CEPA's calculation is simplistic (based on assuming a return from innovation funding) and has a number of unsubstantiated assumptions (e.g. a lot of projects that have been funded through the innovation scheme are related to service quality rather than cost reduction).

- Potential partial double count: While Ofgem has made an adjustment for GDNs assumptions on frontier shift before applying its own frontier shift, it has adjusted on the basis of a 'blended' average. This may be problematic as the key issue for the double count is what assumption the frontier companies have assumed. Whether this has resulted in a problematic double count requires checking. If so then this error should be addressed by Ofgem and an alternative approach proposed (e.g. in T2 all companies' frontier shift assumptions are removed prior to analysis).

Given our view on the excessive efficiency challenge we have engaged with independent economists to provide a critique of Ofgem's assumptions. For further information on the points mentioned above please see Appendix Q11A - RIIO-GD2 ongoing efficiency (Oxera) and Q11B - Frontier Productivity Growth (First Economics**)** which both set out the flaws within the assumptions on ongoing efficiency.

7. Managing uncertainty

Approach to setting uncertainty mechanisms (UMs)

Summary Response

- We are concerned that the current uncertainty mechanisms add risk into the price control settlement which combined with a serious challenge to our financeability, will inevitably lead to a lack of investment.

- The changes introduced for GD2 - lower returns, smaller base Totex and reduced Totex Incentive Mechanism mean that the Networks have no head room to incur unfunded expenditure in GD2 compared to GD1 or absorb cost shocks.

- Uncertainty mechanisms must be designed to allow networks to recover their expenditure in a timely manner without being exposed to risk.

- Where there is risk associated with recovering this expenditure such as thresholds or risk of expenditure being disallowed Networks may find that they cannot borrow to fund this expenditure.

- KPMG analysis commissioned for WWU (Appendix Analysis of the RIIO-GD2 Draft Determinations(Uncertainty)) demonstrates that during RIIO-1 only 54% of the funds requested under reopeners were released to companies; This highlight how accessing funding through reopener mechanisms is fundamentally uncertain and the risk of underfunding is high.

- We recognise the need for UMs for some elements of the package, however, we have concerns on the design of the current mechanisms and some investment is at risk of being impacted by a slow and bureaucratic process. We are keen to ensure we can deliver the priorities of our customers and stakeholders and the design of the current uncertainty mechanisms will not enable us to do that.

- We have some specific recommendations on changes that can be made to these mechanisms which can be summarised as follows:

    1) Materiality thresholds are too high for WWU to voluntarily incur expenditure as there is a risk that we won't trigger the thresholds and then spend would go into Totex overspend – we recommend this is set to zero.
    2) Only having one application window in January 2022 is not the correct design, in our view annual windows would be more appropriate.
    3) It is inappropriate for Ofgem to be able to trigger a re-opener at any time. The rights should be symmetrical. For Net Zero it is inappropriate that only Ofgem should be able to trigger the re-opener, networks should be able to trigger re-opener too.

- We disagree with Ofgem's rejection of our loss of land development claims re-opener. We have submitted the additional information requested and seek a

licence condition the same as NGGT's Quarry and Development Loss Re-Opener

- For large loads re-opener, this needs to be cumulative not just for individual large loads

Q12. Do you agree with our proposed common approach for re-openers?

We take each point in turn below, however, our major concern is that the materiality thresholds at 1% after the Totex Incentive Mechanism (TIM) adjustment are too high and we recommend this is reduced.

Application Windows
Our view is that re-openers should be annual or at least every other year, with an obligation on networks to notify Ofgem by the end of the preceding November if they intend to trigger a re-opener in the following January, this will enable Ofgem to plan for the necessary resources.

Application Requirements
The changes introduced for GD2 - lower returns, smaller base Totex and reduced Totex Incentive Mechanism mean that the Networks have no head room to incur unfunded expenditure in GD2 compared to GD1 or absorb cost shocks. Where there is risk associated with recovering this expenditure such as thresholds or risk of expenditure being disallowed Networks may find that they cannot borrow to fund this expenditure.

We agree that where expenditure is uncertain and cannot be funded through base Totex uncertainty mechanisms are appropriate; however, they must be designed to allow networks to recover their expenditure in a timely manner without being exposed to risk. Without an appropriate mechanisms Networks are unlikely to be able to fund expenditure even though they see that there would be customer benefit.

For expenditure that is unpredictable, for example reinforcement under the large loads re-opener, or land claims then we agree that the process, detail and evidence required needs to be clearly defined and this needs to be established ahead of the RIIO-2 period.

Where expenditure is on projects initiated by Networks such as Net Zero then we suggest that an appropriate process is for the expenditure, including any preparatory expenditure, and outputs to be agreed before the project commences with funding being provided for each stage with claw back provisions to protect customers from funding expenditure that does not deliver the agreed outputs. This mechanism will reduce funding risks for Networks, who receive no financial benefit from delivering these projects. Without a more balanced mechanism there is a significant risk that discretionary projects will not be delivered, resulting in an inability to deliver the priorities of customers and local communities.

Authority Triggered Re-openers

Triggers for re-openers should be clear and appropriate. Both networks and Ofgem should be able to trigger re-openers annually and there should be no asymmetry, for example we strongly disagree with only allowing Ofgem to trigger the Net Zero re-opener and cover this more in our response to Core Question 22.

We agree that Ofgem should be able to trigger a re-opener subject to the same scope and materiality thresholds as are applied to applications made by a licensee, this is consistent with the arrangements in GD1. We disagree with the ability of Ofgem to trigger a re-opener at any time.

The design of the Application Windows should consider both the needs of Ofgem and Networks and if Ofgem requires more opportunities to trigger re-openers then these should be available to Networks as well. We think that the ability to trigger re-opener windows should apply to both Ofgem and Networks equally.

Ofgem have provided no justification for their proposed asymmetry other than the "fail safe" would protect both consumers and licensees. Core Document 7.25 argues that allowing Ofgem to trigger a re-opener would protect licensees. In our view this should be replaced by a right for the Networks to request an additional re-opener where a significant change has materialised (to use the wording in Core Document 7.25). This would allow the affected party to initiate the process rather than having to rely on Ofgem doing so.

Materiality threshold
We note that some re-openers such as Cyber Resilience OT and IT and Non-Operational IT and Telecoms capex have a threshold of zero which we support due to the uncertain nature of the level of investment required throughout the price control.

Conversely, for those reopeners with a 1% threshold after TIM; this is equivalent to £4m for WWU which is set too high, requiring networks to commit to considerable expenditure with no certainty of recovering it and no reward for taking the risk.

As Ofgem has accepted the principle that some re-openers should have a zero threshold we propose that Ofgem adopt the common design of a zero threshold to all re-openers. To give on example, there is no logic for having a threshold for Physical security when Cyber resilience has a zero threshold. They both deal with threats to Networks' ability to operate but are treated inconsistently.

Given that networks earn no reward for working at risk, the materiality threshold is far too high to expect networks to voluntarily bear the cost. We propose that the materiality threshold for all re-openers is set at 0%, that is any expenditure incurred under a re-opener can be recovered.

Without these changes, the only time networks are likely to incur expenditure under an uncertainty mechanism is where they have no option, for example where network funded

specific reinforcement is required to connect a load under the GDN large loads re-opener, which is a licence obligation, or where we have to install physical security to sites that are Critical National Infrastructure to comply with BEIS Physical Security Upgrade Programme Guidance Document. In these cases where Networks have to incur expenditure, putting in arrangements that mean that expenditure cannot be recovered in full and Networks have to treat it as Totex overspend is unreasonable at best and is effectively a penalty.

We would urge Ofgem to reduce the thresholds for the uncertainty mechanisms to zero in the final determinations to protect the interests of both networks and customers.

Aggregation
If the individual re-opener thresholds are not set at zero then we agree that a process for aggregating claims that do not meet individual re-opener thresholds is appropriate; however, we do not agree with the design proposed.

We propose the following principles should apply to the aggregation mechanism described in core document 7.34:

1) Expenditure under any uncertainty mechanism should be treated in the same way regardless of which or how many uncertainty mechanisms it was incurred under.

2) The higher aggregation threshold and the minimum individual materiality threshold should be set at a level not to discourage efficient expenditure in the areas covered by the uncertainty mechanisms.

3) We agree that any re-opener that exceeds the materiality threshold itself should be excluded from the aggregation process.

Principle 1) ensures that there is not a perverse incentive on networks to concentrate discretionary activity into one, or a few, uncertainty mechanisms in order to ensure that a threshold is met and therefore the efficient expenditure recovered.

Principle 2) ensures that companies have a realistic likelihood of being able to meet thresholds. If thresholds are too high, then companies are unlikely to voluntarily risk incurring efficient expenditure that may not reach the threshold to be considered for an increase in allowance.

If the individual re-opener thresholds are not set at zero then we propose that:

1) the higher aggregation threshold parameter should be the same as the threshold for individual re-openers rather than the indicative 3% of annual average base revenues in the consultation;
2) the minimum individual materiality threshold should be zero instead of the indicative 0.5% of annual average base revenues.
3) The application windows for this aggregation mechanism should be the same as for the individual re-openers namely each year or every other year.

Cross-sector uncertainty mechanisms

Q13. Do you agree with our proposals on a materiality threshold, a financial incentive, a 'foreseeable' criterion, and who should trigger and make the application?

We support the materiality threshold on the CAM re-opener being zero, given the unknown possibilities in this area and not understanding the potential costs on DNOs and transmission.

We believe a financial incentive should be encouraged to ensure joint working, best possible customer outcomes and least cost solutions, especially if the costs will not be subject to TIM. The foreseeable criterion is flawed on the basis not all price controls are aligned so investments can only be assessed on a regulatory cycle for that industry. The trigger should come from both companies in agreement only.

Q14. Do you consider that two application windows, or annual application windows, are more appropriate, and should these be in January or May?

Given the number and value of uncertainty mechanisms now included in the price control, we would propose an annual window. Ideally the re-opener window would be May each year so the revenue can be adjusted in the annual AIP in November each year, but given annual regulatory reporting and the level of significant evidencing required January would be a suitable month, this enables time following the end of the regulatory year to access and provide relevant information to support the uncertainty claim. Given CAMs cuts across different industries there is an impact on time sensitivity and different regulatory priorities, further supporting the annual window**.**

Q15. Do you consider that the RIIO-1 electricity distribution licences should be amended to include the CAM, or wait until in 2023 at the start of their next price control?

We would recommend that the electricity licences are amended now in order to support flexibility and cooperative working before the start of their price control in 2023, if not, the CAM mechanism will not be used until at least 2023.

Q16. Do you agree with our proposed re-opener windows for cyber resilience OT and IT, and our proposal to require all licensees to provide an updated Cyber Resilience OT and IT Plan at the beginning of RIIO-2?

We support the principle of a re-opener however this must not be at the expense of base revenue which is essential in managing and reducing risk on behalf of consumers on a proactive an enduring basis.

We do not agree that two re-opener windows for Cyber Resilience of OT and IT is sufficient; annual reopeners would support a more agile approach to changes in requirements in this area.

We were disappointed that Ofgem would not accept a revised Cyber OT plan from WWU in September 2020. However, following correspondence and during our bilateral

discussions we have requested that WWU are included in the proposed mechanism which is being introduced for other GDNs in the draft determinations which provides an allowance of 0.05% of RAV. Our rationale is summarised in a letter attached as Q16A - Draft Determination Cyber OT Allowance Justification

Q17. What are your views on including the delivery of outputs such as: CAF outcome improvement; risk reduction; and cyber maturity improvement, along with projects-specific outputs?"

Whilst we welcome the incentive to manage and reduce risk across our organisation in support of our core outputs, to specifically implement risk and project outputs at a micro-management level is not the role of the regulator.

Risk appetite has been clearly deemed the responsibility of the private organisation and not the regulator. We are also concerned that his will introduce additional reporting overheads for which no allowance has been requested to date and so would require an amendment to our business plan.

Q18. Do you agree with our proposal for the Non-operational IT and Telecoms capex re-opener?

Yes we agree, subject to getting our IT Capex allowances reinstated we believe this Capex re-opener will help support any advances in technology relevant to our business or unforeseen IT spend relating from major system and economic changes.

Q19. Do you agree with our approach to using a re-opener mechanism for changes to government physical security policy?

We have invested in GD1 to deliver compliance with current government physical security policy. We have included spend in our GD2 base Totex for the upkeep of the systems installed to date. Due to uncertainty, it is appropriate for a GD2 re-opener mechanism for any further changes to policy that trigger significant capex investment. We do have some concerns in the frequency of the re-opener windows and would welcome a more flexible approach to re-openers with more windows of opportunity. Annual re-openers would be our preferred option to ensure we can adapt quickly and invest in a timely way to protect customers.

Q20. Do you agree with our approach regarding legislation, policy and standards?

We note the proposal not to have an uncertainty mechanism for these items. We have proposed pass through of costs of the Joint Office of Gas Transporters under GDQ48 to take account of possible developments in industry governance whether driven by policy or industry led developments to improve governance.

8. Net Zero and innovation

Summary Response

- We recognise the need for UMs for some elements of the package as we enter GD2, especially to enable Net Zero, which is uncertain. However, we have concerns that the current mechanisms mean that projects in our network to deliver Net Zero would not be funded due to the high threshold.

- We engaged EY (Appendix Q21A - Support for Net Zero related investment in RIIO-2 (Ernst & Young)) to undertake a review of our c.£150m net zero GD2 investment which was included in our business plan. They assessed each of the areas against the various reopeners proposed in the DDs. Their findings were that the none of the investment required to support green gas, green vehicles, system operability or GD3 Repex would be funded.

- EY found there was potential for funding of flexible electricity generation under the Net Zero Reopener or the New Large Loads reopener however the restrictive application windows could delay important investment.

- In order to deliver the local priorities of communities in Wales and the South West, we are keen to see changes to the mechanisms which support investment. Our proposal are summarised as follows: -
  - A zero threshold to ensure all efficient investment can be delivered;
  - More frequent, ideally annual, windows to apply to support a proactive and agile approach;
  - GDNs to be able to trigger the reopener in addition to Ofgem given that is where the knowledge is of the required investment;
  - Ability to aggregate within the reopener to deal with smaller, valuable projects; and
  - Explicit upfront criteria to provide certainty of funding for networks.

- We are pleased to see Ofgem have allowed the Network Innovation Allowance (NIA) expenditure we requested in our business plan. We are keen to work with Ofgem to develop the rules of the NIA and Strategic Innovation Fund (SIF) including the use of the benefits measurement framework.

Q21. Do you agree with our overall approach to meeting Net Zero at lowest cost to consumers? Specifically, do you agree with our approach to fund known and justified Net Zero investment needs in the baseline, and to use uncertainty mechanisms to provide funding in-period for Net Zero investment when the need becomes clearer?

Net Zero is a key UK government deliverable which networks are well placed to deliver. We agree that consumers must be protected from unnecessary expenditure; however, it is essential that expenditure is allowed that will facilitate cost effective moves towards Net Zero.

We agree that Net Zero is uncertain, and it is not clear what will be required or when it will be required so some form of uncertainty mechanism is required. However, to be effective, an uncertainty mechanism must itself not have any uncertainty in its design. However, the current design does not achieve this, and we describe what we think is a better design in our answer to Core Question 22.

We have commissioned EY (See Appendix Q21A - Support for Net Zero related investment in RIIO-2 (Ernst & Young) to consider whether the design of the current uncertainty mechanisms would enable the projects that WWU has proposed to further Net Zero objectives to go ahead. Their conclusion is that none of our projects would be funded under the proposed arrangements. These projects are often enabling projects that for example, make the network more able to accept more biomethane injection.

We accept that it is necessary to ensure that expenditure is efficient and that it is easier to tie mechanisms to government policy or legislation. However, this will mean that the net zero priorities for communities in the South West and Wales will not be delivered under the current reopener mechanisms. We urge Ofgem to reconsider the design of these mechanisms ahead of final determinations.

Q22. Do you think the package of cross sector and sector-specific UMs provides the appropriate balance to ensure there is sufficient flexibility and coverage to facilitate the potential need for additional Net Zero funding during RIIO-2?

WWU do not believe that the UMs will provide a suitable mechanism to enable the investment required to begin the Net Zero journey. Appendix Q21A - Support for Net Zero related investment in RIIO-2 (Ernst & Young) highlights both areas of concern and potential amendments to the mechanisms to stimulate the change needed to meet the revised Climate Change Act.

EY assessed each area of expenditure in the WWU business plan against each of the funding mechanisms Ofgem are proposing in the DD. The conclusion was that the majority of the investment would not be funded with the possible exception of the investment to support flexible generation which would be at risk of delayed funding if it were to qualify under the Net Zero or the Large Loads Re-opener. Here is a summary of their findings:-

Investment		Net Zero Re-opener	Heat policy re-opener	CAM re-opener	New Large Loads re-opener	SIF	NIA
Flexible Generation	Pipelines for capacity and/or storage	Re-opener may be appropriate for these projects, but dependency on Ofgem to trigger re-opener could delay investment	Projects do not relate to heat policy	Re-opener may be appropriate for these projects, it requires agreement from the other relevant licensee which may not be forthcoming in a timeline manner	Re-opener may be appropriate for these projects, but single application window could delay investment	Not categorised as an innovation project by WWU	Not categorised as an innovation project by WWU
	Below 7 bar reinforcement (MP & IP)						
Green Gas	Compressors	Projects individually do not meet Net Zero materiality threshold Most projects too small to be eligible for aggregation	The trigger for the re-opener requires changes to gas regulation, connections charging arrangements or policy, which is not relevant to these projects	Projects do not involve the delivery of another energy company deliverable	Project does not relate to new connection		
	Smart Systems				Projects individually do not meet large load threshold Most projects too small to be eligible for aggregation		
Gas Vehicles	Reinforcement						
System operability	New IT systems and functionality						
	Increased manpower						
GD3 repex preparation	Recruitment and training				Projects do not relate to new connection		
South wales industrial cluster							

In summary:

- The assessment indicates that smaller Net Zero investment projects, that are not innovative and cannot be included in baseline Totex (due to some volume and timing uncertainty), but could proceed under current government policy, do not have a route to funding during the RIIO-2 period.

- Furthermore, Ofgem's exclusive right to trigger the Net Zero re-opener could unnecessarily delay investment as network companies will have to make representations to Ofgem about a relevant change in circumstances in order to prompt Ofgem to undertake a series of consultations before amending the network companies' licences to implement any adjustments deemed appropriate.

- RIIO-2, as proposed by Ofgem in its DDs, does not provide network companies with an incentive to undertake these types of investment without a route to funding through the regulatory framework.

- We are unable to undertake our Net Zero related investment without funding support through the price control. We have clear evidence that the benefits of these investments exceed the costs (see slide 4 of Appendix Q21A - Support for Net Zero related investment in RIIO-2 (Ernst & Young)).

- The UK's pathway to achieving the Net Zero target has yet to be defined, and the size of the challenge means there is no guarantee that the target will be achieved. National Grid's latest Future Energy Scenarios (FES) publication sets out "four different credible pathways for the future of energy over the next 30 years", but one of these pathways doesn't achieve the Net Zero target as the pace of decarbonisation is not fast enough and there is not enough societal change.

- As such, there is no clear rationale for excluding investment (by WWU or other networks) that is net beneficial for customers and helps to deliver the Net Zero target, on the grounds that the projects do not meet all of the administrative criteria for any of the re-openers or mechanisms included in Ofgem's RIIO-2 DDs (see page 9 and 10 of Appendix Q21A - Support for Net Zero related investment in RIIO-2 (Ernst & Young)). Targeted amendments to the design of Ofgem's relevant proposed re-openers and mechanisms, that are in keeping with the principles of the RIIO-2 regulatory framework, could enable these benefits to be realised.

Pages 11 to 13 of Appendix Q21A - Support for Net Zero related investment in RIIO-2 (Ernst & Young) suggests some ways in which the mechanisms could be adapted to support Net Zero. We have reviewed these and have proposed in our answer to Core question 12 changes to the common re-opener design parameters that we believe supports Net Zero funding and ensures consistency across all the re-opener mechanisms.

Net Zero re-opener

Q23. Do you have any views on our proposed approach to a Net Zero re-opener?

We note that while “input from stakeholders is vital in allowing the proposed mechanism to work” that Ofgem is reserving to itself the power to trigger this re-opener mechanism. We think that networks must be allowed to formally request that this re-opener is triggered. Without any formal process for deciding whether this re-opener is triggered it runs the risk of not responding to the needs of companies and their consumers.

We recognise that Ofgem needs to protect the interests of consumers and not allow expenditure that is not cost effective; however, networks will not make a return from Net Zero projects funded by the Net Zero uncertainty mechanism. This means that if there is a risk that they will incur costs that are subsequently not recoverable it will make such projects financially unattractive.

There clearly needs to be a balance between networks bearing all the risk which may result in very few projects being delivered which will threaten the delivery of the UK Net Zero target and measures to protect consumers from expenditure that is not cost effective in moving toward Net Zero.

In our view this would be achieved by: -

1) Zero thresholds as described in our answer to Core Question 12;
2) Networks should be allowed to trigger the Net Zero re-opener in addition to Ofgem;
3) There should be Annual application windows to provide a flexible and agile approach;
4) The triggers should relate to achieving Net Zero in a cost-effective way over an appropriate lifetime;
5) The application process and assessment criteria need to be clearly and unambiguously defined ahead of the start of the RIIO 2 price control period so that networks can clearly see what evidence of efficiently incurred costs and benefit is required when they make applications for completed projects;
6) The application will be prospective for proposed projects. It will enable costs to be claimed both for those involved in preliminary work to establish the project as well as those expected to be incurred during the project. The network would agree to deliver the projects for the stated sum by the stated date and deliver the stated benefit with any underspend or overspend would be subject to Totex sharing. This would provide a clear incentive for the network to propose well designed and deliverable projects; and
7) If a zero threshold is not provided, then projects that did not meet the threshold would be eligible for the aggregation mechanism (please see our answer to Core Question 12 on the need for a lower aggregation threshold).

Innovation

We would like to thank Ofgem for supporting our broad innovation aspirations detailed in the business plan.

The continuation of the NIA funding mechanism will allow us to collaborate widely to create solutions to meet the challenging targets of Net Zero and address consumer vulnerability. Additionally, in supporting innovation, Ofgem has also developed the Net Zero & Heat Policy re-openers and the new SIF mechanism. Such mechanisms need clear alignment, co-ordination and be accessible which is essential to achieve maximum benefit. A key factor to the successful use of these mechanisms is a clear line of sight of forthcoming themes, timescales, contribution levels and a simple application process.

Q24. Do you agree with our proposals for the RIIO-2 Strategic Innovation Fund?

We support the proposals to replace the NIC with SIF. It is important to change the existing NIC funding mechanism to operate more flexibly and provide the ability to respond quickly to emerging needs. However, we consider that the £5m minimum spend is too high leaving a gap between SIF and NIA, which is in place to support smaller scale projects (nominally up to £0.1m). We suggest that the threshold is removed and set on a case by case basis as each innovation challenge is released.

Q25. Do you have any comments on the additional issues that we seek to consider over the coming year ahead of introducing the Strategic Innovation Fund?

The Ofgem working groups in August did not provide detailed information of the SIF scheme or its governance arrangements to enable a considered response.

The transition to SIF poses the risk of a significant funding gap for the first year of RIIO-2. Visible, transparent and urgent timelines are necessary to support the ambitious plans for the BEIS-led Hydrogen roadmap and afford networks sufficient opportunity to form project ideas and identify project resources.

The formation of a new Net Zero Innovation Board to set the strategic direction and specific challenges is a fundamental change. We want to support this change and play a part in its success. To do this we recommend that the important factors to consider are alignment to the National Innovation strategies that recognise what our customers and stakeholders have told us and the provision of a forward-looking roadmap of challenge themes to encourage network companies to fully engage and respond to the individual innovation challenges.

The scoping of projects and formation of industry collaboration consortium takes careful thought leadership and planning and the third-party administrator will play a pivotal role in getting this right and making the initiative a success.

Q26. Do you agree with our approach to benchmarking RIIO-2 NIA requests against RIIO-1 NIA funding?

For WWU, GD1 is a good starting point for GD2, but we recognise some parts of the country are leading with the role out of hydrogen, i.e. NW England and Scotland. It would be appropriate for higher NIA funding in these areas to accommodate this innovation.

Q27. Do you agree with our proposal that all companies' NIA funding should be conditional on the introduction of an improved reporting framework?

Many of the requirements detailed in 8.74 of the core document are already well established amongst the gas networks and have been shared with Ofgem, most recently at the Innovation working group on 13 August. For example, sharing of project proposals to support collaboration between companies and prevent duplication is a standard process in the Energy Networks Association (ENA) Gas Innovation and Governance Group (GIGG) forum and more widely with the Electricity Innovation Managers. The enhanced processes include the addition of the new benefit measurement framework, published implementation logs and upgrades to the smarter networks portal and will be formally presented to Ofgem for acceptance.

Q28. What are your thoughts on our proposals to strengthen the RIIO-2 NIA framework?

We are committed to developing the framework through the innovation working groups alongside Ofgem and the other networks.

Q29. Do you have any additional suggestions for quality assurance measures that could be introduced to ensure the robustness of RIIO-2 NIA projects?

The challenge to increase confidence in the independence and robustness of research and ensure governance requirements needs to be proportionate to the level of funding and effort of the individual project. Applying a blanket requirement for peer review or an independent audit of every project may not provide the best use of resources and may create cumbersome processes that do not lead to desired improvements. The Innovation Working Group on 13 August did not provide any examples where recent NIA projects lacked robustness or quality reports as an output and failed to support the need for any additional steps for project reporting.

At WWU we produce a summary closedown report that follows a robust internal quality check process as well as a substantial technical report. Both documents are shared on the smarter networks portal.

Q30. Do you agree with our proposals to allow network companies and the ESO to carry over any unspent NIA funds from the final year of RIIO-1 into the first year of RIIO-2?

Yes, this is important to enable networks to transition to the new price control period, particularly given the impact of Covid-19 on the delivery of projects in the final year of GD1

Q31. Do you agree with our proposal that all work relating to data as part of innovation projects funded via the NIA and SIF will be expected to follow Data Best Practice?

Yes we support this proposal.

9. Increasing competition

Q32. Do you agree with our proposed position on late competition?

We agree that the criteria for late competition should remain as 1) over £100m 2) separable and 3) result in a new asset. WWU does not have any projects that meet any of these three criteria in GD2.

Q33. Do you agree with our proposed approach on early competition?

WWU does not agree with the approach outlined in the Core Document. The threshold should be aligned with that for late competition (£100m not £50m) and the desired outcome has not been articulated.

We are interested if the position is just to consult more, and we question why this is not being done hand in hand with Late Competition. No timeframe is given for making a decision and the proposed February 2020 date for sharing ideas for Early Competition plan is after Final Determinations which is too late to make any adjustments

10. Approach to the Totex and Business Plan Incentive Mechanisms

Summary Response

- We are disappointed following extensive work on our Consumer Value Proposition (CVP), comprehensive independent substantiation and significant challenge from our CEG, we have not received a reward for the elements of our plan which we believe go above and beyond BaU.
- We note that the only CVP award is for performance which is broadly aligned to what we've already achieved in 2019; we are concerned that commitments have not been checked against the existing BaU performance of other companies. This is an inconsistent approach which needs to be addressed ahead of the FDs.
- We note the positive comments about our Pathfinder model - albeit no allowance or CVP reward was provided by Ofgem at this stage. Further evidence is attached to this response to demonstrate the benefits of sharing the models and data more widely.

The Business Plan Incentive

Q34. Do you agree with our view that SHET, SPT, SGN and WWU passed all of the Minimum Requirements, and as such are considered to have passed Stage 1 of the BPI?

We were pleased to have met minimum requirement given the significant time and effort we put into complying with the BP guidance and the extensive assurance KPMG undertook on our behalf. We have limited information to make an assessment on whether the other companies met their minimum requirements.

Q35. Do you agree with our rationale for why NGET and NGGT should be considered to have failed Stage 1 of the BPI?

We have limited information to make an assessment on whether the other companies met their minimum requirements.

Q36. Do you agree with our rationale for why Cadent and NGN are considered to have passed Stage 1 of the BPI?

We have limited information to make an assessment on whether the other companies met their minimum requirements.

Q37. Do you agree with our overall approach regarding treatment of CVP proposals?

We are disappointed that the extensive effort in developing our CVPs has not been recognised. The costs of developing the CVP proposals and obtaining external verification have been significant. The Ofgem definition of what is expected as Business as Usual (BAU) should have been clearer and better guidance on the criteria for the CVPs and a cap on value would have helped networks to focus on a smaller number of well justified proposals. This is a serious learning point for Ofgem for RIIO-ED2.

We are also concerned that the criteria for the assessment has not been applied consistently:

- Transmission companies have been given a reward for maintaining or improving the ecology whereas GDNs were told this was a part of Corporate Social Responsibility.
- Rewarded for dealing with gas escapes that is a BAU role for a GDN, but other CVPs for theft of gas or tackling fuel poverty where not rewarded.

Additionally, Ofgem have not compared or checked the rewarded CVP commitments against the existing performance of other companies. NGN were given a CVP reward based on their commitment to improve responses to repairs by the end of GD2; the level of their commitment is broadly aligned to what we've already achieved in 2019 (the last full years data available); yet no reward has been given to WWU for our BAU performance which is already exemplar.

When we questioned Ofgem through the Draft Determination Queries (DDQ) process as to whether we can now update our CVP to achieve the same reward as NGN, Ofgem told us this opportunity was no longer available. They pointed out they needed "to be fair and non-discriminatory, treating licences in an equivalent manner". However, not rewarding WWU is neither fair nor representative of consistent treatment.

We note the positive comments about the potential of our Pathfinder model - albeit no allowance was given by Ofgem. This has the potential to add enormous value in modelling future energy use and availability – a fact already proven by the limited utilisation so far. This is adding real value to stakeholders planning the future of energy, and we encourage Ofgem to review again the significant benefits of this innovation. Please see Appendix Q37A - Whole system data and pathfinder CVP and Q37B - CVP Whole system data and pathfinder CVP model for our updated CVP paper and model re Pathfinder.

Q38. Do you agree with our proposed clawback mechanism to treat received CVP rewards?

We agree with the claw back mechanism for either non-delivery or a lower level of delivery up to the value of the award. This protects customers not just in those networks but across the UK Annual reporting and the end of GD2 close out report must be detailed and robust and should also be independently verified.

11. Interlinkages in RIIO-2, post appeals review and pre-action correspondence

Summary Response

RIIO-2 Interlinkages

- We recognise that there are certain elements of the price control that are subject to what Ofgem calls 'mechanistic' interlinkages in the sense that there are formulaic or mathematical connections between them.
- We do not recognise the category that Ofgem describes as comprising of 'less mechanistic' interlinkages which: 'involve a certain degree of regulatory judgment'; relate to 'decisions that are taken at a global level'; and 'need to be considered "in the round".'
- We do not believe that the underlying bases on which Ofgem seeks to define and identify interlinkages are sound, in line with precedent, or supportable.
- A price control is the aggregation of discrete components. If each component is appropriate, the price control will, by default, be appropriate in the aggregate.
- In energy the appeals mechanism is designed around discrete components; the CMA has previously rejected the request to review the settlement 'in the round' and instead reviews these 'discrete' components only.

Post-Appeals Review

- We reject Ofgem's proposition to seek to modify the price controls after the event of an appeal; this is fundamentally incompatible with the statutory framework, and that will undermine the integrity of the statutory appeals process and the role of the CMA.

Pre-action Correspondence

- We do not consider that the pre-action correspondence that has been proposed by Ofgem is justified or appropriate in the circumstances.
- Ofgem will already be fully informed of the differences between its proposals and the views of the companies, and by the time it makes its final decisions will have had several opportunities to address these and to avoid the risk of a dispute.

Q39. Do you have any views on the interlinkages explained throughout this chapter?

We recognise that there are certain elements of the price control that are subject to what Ofgem calls 'mechanistic' interlinkages in the sense that there are formulaic or mathematical connections between them - for instance because they rely in part on certain common input data. Where such connections exist, we consider that they will be focused and specific, and should be identifiable by considering the methodology used to calculate each of the relevant price control parameters.

However, we do not recognise the category that Ofgem describes as comprising of 'less mechanistic' interlinkages which: 'involve a certain degree of regulatory judgment'; relate to 'decisions that are taken at a global level'; and 'need to be considered "in the round".' We do not consider that this second category is a coherent or meaningful form of interlinkage or that it is consistent with what we, and we believe the Competition and Markets Authority (CMA), mean by the use of the term 'interlinkage' (or equivalent terms) when considering relationships that exist between parts of the price control.

We would make the following points:

1. In the Northern PowerGrid and British Gas appeals, Ofgem submitted to the CMA that a price control determination is 'made up of a number of discrete but inter-connected determinations that together give rise to the decision itself'[4].

2. We agree with this description. The different components of a price control are 'inter-connected' in the sense that they collectively operate to determine the total allowed revenue that a licence holder may recover in any regulatory year. But they are also 'discrete' in the sense that they are – subject only to any mechanistic interlinkages – freestanding components each of which operates on its own terms, being established on the basis of a series of individual determinations.

3. A price control is the aggregation of these discrete components. If each component is appropriate, the price control will, by default, be appropriate in the aggregate.

4. In the Northern PowerGrid and British Gas appeals, the CMA rejected the argument that it was required to review a price control 'in the round' or on a 'global basis'[5]. It concluded that it needed to review only the discrete elements that were appealed. It allowed, by way of exception, that there might be cases in which it would need to take care that overturning an appealed element did not have 'knock-on consequences' for other unappealed aspects of the control (i.e. any interlinkages)[6].

[4] CMA – *Northern PowerGrid v GEMA*, Final Determination at para 3.51, *British Gas Trading v GEMA*, Final Determination at para 3.52.
[5] CMA – *Northern PowerGrid v GEMA*, Final Determination at para 3.49, *British Gas Trading v GEMA*, Final Determination at para 3.50.
[6] As per the previous footnote.

5. By seeking to define the concept of interlinkages using the very same terminology of 'in the round' assessment and 'global' judgment that the CMA rejected as a basis for the appeal of price controls, it appears that Ofgem wishes to collapse the very distinction that the CMA was expressly making. Ofgem's concept of non-mechanistic interlinkage is defined so widely that, if applied, it would effectively undermine and reverse the conclusions reached by the CMA .

6. Whether or not this is the intention, we do not consider that it could be appropriate. Its inconsistency with prior case law suggests that Ofgem's concept of interlinkages is excessively wide and cannot be supported.

7. We also note that this approach is inconsistent with Ofgem's prior recorded statement that price controls comprise a series of 'discrete' elements. Chapter 11 does not once use that language or any equivalent terminology, makes no reference to the concept, and does not explain why Ofgem's previous recorded position should be treated as wrong or why its current one is now to be preferred. In our view, Ofgem's previous statements more accurately reflected the real nature and characteristics of a complex price control.

8. In addition, where Ofgem offers examples of what it wishes to classify as being non-mechanistic interlinkages, the descriptions appear too nebulous to support the idea that there is any meaningful interlinkage at all.

9. For example, the cost of equity is largely determined in accordance with the well-established CAPM model, subject to assessment of the values to be attributed to the parameters needed for its calculation. It is unclear how that determination is contingent on, or the calculation sensitive to, the large number of factors listed at paragraph 11.11. It is not clear from Ofgem's reasons for its draft determination in relation to the cost of equity how its decision was affected by those factors or would be changed if they were to be different than those proposed.

10. Similarly, the narrative description of the proposed interlinkages to the cost of debt, as set out at paragraphs 11.15 and 11.16, reads as if these factors mechanistically had a bearing (a 'knock-on effect') on the calculation of the cost of debt or the calibration of the index. But the suggested cause-effect relationships are not ones that, outside of extreme scenarios, we would recognise. The purported connections appear to be too tenuous to constitute a genuine interlinkage.

11. However, we refer to these two cases only by way of examples. We do not respond individually to all of the other cases specified by Ofgem, because, as will be plain from our broader observations above, we do not believe that the underlying bases on which Ofgem seeks to define and identify interlinkages are sound, in line with precedent, or supportable.

Q40 Are there other interlinkages within our RIIO-2 package that you think are relevant to the three pillars identified in this chapter?

We have not identified any such interlinkages. As is clear from the answers to Q39, we do not share Ofgem's approach to the subject of interlinkages generally.

Q41. Do you have any views on our proposal to include a statement of policy in Final Determinations that in appropriate circumstances, we will carry out a post appeals review and potentially revisit wider aspects of RIIO-2 in the event of a successful appeal to the CMA that had material knock on consequences for the price control settlement?

We do not consider that Ofgem has adequately explained its proposal, or justified the need for any statement of policy. We would make the following points:

1. The CMA is capable of addressing any interlinkages that exist between an appealed element of the price control and any non-appealed elements. In its letter to Ofgem dated 30 October 2019, it indicated that it expects Ofgem in the first instance to identify any interlinkages, and any appellant to address them in its submissions. It is clear from this that interlinkages, if any, should be draw to the attention of the CMA, so that they are open to consideration by it within the context of an appeal.

2. Assuming that there are interlinkages between appealed and non-appealed parts of the price control, the CMA has previously held that it will take these into account 'where appropriate'[7]. In a case in which it was satisfied that it ought to do so, and where the appeal was allowed, it would have four options open to it:

    a. to decline to make any determination in relation to the interlinked elements, (for example, because they are non-material);
    b. to remake Ofgem's decision, having regard to the interlinked elements as well as the appealed ones;
    c. to remake Ofgem's decision, but direct Ofgem to consider the interlinkages; or
    d. to quash the decision and remit it to Ofgem, with a direction to consider the interlinked elements as well as the appealed ones.

3. In the first two cases, there would be no action for Ofgem to take. In the second two cases – which are the only examples given in the Draft Determination of cases where Ofgem's 'statement of policy' would apply - Ofgem must act in accordance with the CMA's direction. Moreover, in these latter two cases, any licence modification arising from the consideration of the interlinked elements would, in accordance with the statutory framework, be subject to a new consultation and therefore a further right of appeal.

[7] CMA – *Northern PowerGrid v GEMA*, Final Determination at para 3.51, *British Gas Trading v GEMA*, Final Determination at para 3.52.

4. In the light of this, it is unclear what role Ofgem considers that a statement of policy written at the time of the Final Determination could fulfil. If the CMA did not deal with the interlinked issues itself at the conclusion of an appeal, it would direct Ofgem how and when to do so. Since the appropriate treatment of the issues is bound to be fact sensitive, no statement of policy could hope to anticipate either all the types of interlinkages that might arise, or all the forms of CMA direction that may be given. Nor could any statement of policy override a CMA direction if the two turned out to be inconsistent in practice.

5. Therefore, it is difficult to see the merits of Ofgem's proposal. For this reason, we are concerned that when Ofgem talks about interlinkages it means something different than what we mean, and what we believe the CMA to mean, by the same terminology.

6. As we understand it, the CMA is referring to formulaic or mathematical connections between parts of the price control. By definition, whether and to what extent these exist depends on the detail of the control and the facts of the case – '*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*'[8]. This is clearly a reference to focused and specific connections between one part of a price control and another.

7. Ofgem instead refers to a review of the 'wider aspects' of the price control which may be carried out after a successful appeal in order to ensure 'the overall coherence and consistency of the regulatory settlement'. This language is at the same time both broad and ambiguous.

8. If Ofgem is suggesting here, as it has appeared to suggest in the past, that it may seek to modify the price controls after the event of an appeal to unwind (in overall terms) any benefit that has been obtained by a successful appellant, we would reject that proposition as one that is fundamentally incompatible with the statutory framework, and that will undermine the integrity of the statutory appeals process and the role of the CMA.

9. We note: that the CMA rejected (in the *Northern PowerGrid* and *British Gas Trading* appeals) the suggestion that appeals should assess a price control 'in the round'; that Ofgem did not oppose that conclusion at the time; that it has since been applied in two further cases[9]; and that the CMA restated it in its letter to Ofgem of 30 October 2019. Any policy which seeks to reintroduce such an approach on a post-appeal basis, if that were Ofgem's intention, would not be in line with the statutory framework and could not be supported by, or made the proper subject of, a policy statement.

10. In summary, so far as we understand the proposal, Ofgem's proposed statement of policy is either unnecessary and unhelpful on the basis that it will duplicate (and may be inconsistent with) what the CMA already has the power to do, or is likely to be fundamentally incompatible with the statutory framework for appeals. In either case there is no sound basis for adopting it.

[8] As per the previous footnote.
[9] *Firmus Energy v NIAUR* (2017) and *SONI v NIAUR* (2017).

Q42. Do you have any views on the proposed pre-action correspondence, including on the proposed timing for sending such to Ofgem?

We do not consider that the pre-action correspondence that has been proposed by Ofgem is justified or appropriate in the circumstances. We would make the following points:

1. The nature and role of pre-action correspondence is well understood in the context of other forms of litigation. The most obvious analogy in relation to price control appeals is its use in the judicial review of decisions made by regulators or other public authorities.

2. However, all such pre-action correspondence has three features. First, it follows the event (in this case the decision) that creates the ground for legal action. Second, its purpose is to enable the party being challenged to understand the case against it so that it can change its position and avoid the time and cost of litigation. This second element is particularly important where the authority making the decision might not otherwise have had cause to engage directly with the claimant before receiving the letter before claim. Third, and consistent with the second point, the correspondence is bilateral, and the potential claimant receives a response so that it can understand the nature of the defence that will be advanced by the decision-maker, and therefore be in a position to make a properly-informed choice as to whether to proceed with the proposed. Litigation.

3. None of these features is present in Ofgem's proposal. First, the decision that is the potential subject of statutory appeal is the decision to modify the conditions of a licence in order to give effect to the RIIO-2 price control. However, Ofgem proposes that pre-action correspondence outlining grounds of appeal should be sent *before* that decision has been made. In consequence Ofgem appears to be proposing that it ought to be notified of the grounds of appeal before any grounds of appeal can have arisen in law.

4. This would be a completely unprecedented use of pre-action correspondence, with no analogy in any other context. The purpose of pre-action correspondence is not to speculate about the grounds of appeal that might exist once a putative final decision has been made. On the contrary, until such time as a final decision is made, Ofgem is presumed, and indeed required by law, to continue to consult in accordance with all of the standards applicable to a fair consultation process. As such it is required to retain an open mind and conscientiously take into account representations made by price controlled companies and all other interested parties.

5. Since the final decision for this purpose is the decision to modify the conditions of licences in order to give effect to the Final Determination (whether with or without amendment), the requirements to consult in an open-minded way continue to apply up to and including the conclusion of that stage of the process.

6. None of this is compatible with the notion, implicit in Ofgem's proposal, that the Final Determination is to be treated as the trigger point for a pre-action letter. That could only make sense if it were a legally-operative decision, which it is not. In practice, it implies that the consultation on the licence modifications is regarded by Ofgem as merely formulaic. Since it is in fact the only formal statutory consultation in the entire RIIO-2 process, and is subject to all of the statutory and other legal duties attaching to any such process, we do not believe that this can be a proper way to regard it.

7. Second, there is no suggestion in anything that Ofgem has said that the purpose of the proposed pre-action correspondence is to seek to avoid unnecessary appeals by allowing Ofgem an opportunity to amend its position. On the contrary, the purpose appears to be merely to give Ofgem more time to prepare itself to meet an appeal from a decision that it regards as fixed and unchanging. That is not a proper basis for pre-action correspondence.

8. Third, Ofgem appears to view the pre-action correspondence process as a unilateral exercise, imposing obligations on appellants but not itself. This, again, is without any precedent or justification.

9. We note that, when quoting the CMA letter of 30 October 2019, Ofgem elides two separate points made by the CMA. The first is that the CMA would welcome prior notification of the likelihood of appeals, including their potential scope. This is for the benefit of the CMA itself so as to allow it to understand in advance the resource commitment that it may be required to make in determining one or more appeals. The second is that the CMA encourages what it calls 'active engagement' between potential appellants and regulators as a form of 'good practice'.

10. These are distinct requirements. So far as Ofgem is concerned, active engagement, at least on the part of the price controlled companies (we note that appeals may be brought by various other third parties whose engagement with Ofgem might be of a different or more limited for), is a feature of the entire RIIO-2 process and does not require pre-action correspondence.

11. Ofgem will already be fully informed of the differences between its proposals and the views of the companies, and by the time it makes its final decisions will have had several opportunities to address these and to avoid the risk of a dispute. This is not, therefore, analogous to judicial review cases in which pre-action correspondence is necessary since Ofgem would otherwise have no opportunity to change its course and avoid a legal challenge.

12. Moreover, we note, the CMA does not purport to require pre-action correspondence of the sort that Ofgem envisages, whether as part of its expectation of engagement with the regulator or for its own resource management purposes. In the context of the statutory framework it is doubtful whether it would have had the power to do so. But it any event it has not.

Consequently, as a potential party to any appeal, and therefore unavoidably self-interested in this matter, it can be neither appropriate nor justifiable for Ofgem to seek to impose on other potential parties' obligations which the CMA itself, in its role as appeal tribunal, has not attempted to impose.

12. Impact of COVID-19 on the price controls

Easement framework

Summary Response

- We are committed to working with Ofgem as the impacts of Covid 19 develop.
- Given there is still uncertainty over the cost impact, there will need to be specific mechanisms in RIIO-2 to manage the longer-term impacts.
- GD2 outputs and cost allowances will need to be adjusted accordingly for all work types which have been affected by Covid-19 in GD1 and will need to be delivered in GD2 (and were not known at the time of BP submission).
- We propose a mechanism to deal with this could include an annual adjustment mechanism which ensures timely corrections are made to charges to take account of increases in actual cost vs allowances.
- Consideration could also be given to a cost overlay which is applied ex-ante to the FDs following an initial assessment of where the costs impacts are being seen or are anticipated.

Q43. Do you think we need specific mechanisms in RIIO-2 to manage the potential longer-term impacts of COVID-19? If yes, what might these mechanisms be?

Yes, there will need to be specific mechanisms in RIIO-2 to manage the longer-term impacts of Covid-19. The timing of the RIIO-2 price control will mean that we will not have certainty over the adverse impacts on our service levels, workloads and efficient costs in time for these to be included in the final determinations.

There are likely to be impacts of Covid-19 which will last for the duration of RIIO-2. There are workloads that we have been unable to complete in 20/21 which we will be required to deliver in GD2, for example we will have around 150km of additional mains replacement work to complete in GD2 as a result of Covid-19 which was not forecast in our business plan so both outputs and cost allowances will need to be adjusted accordingly for all work types which have been affected by Covid-19 in GD1.

Additionally, there are likely to be restrictions which continue well past April 2021 in relation to social distancing and future waves of Covid-19 which will decrease our productivity and increase our efficiently incurred costs. The supply chain is likely to be impacted by the effects of Covid-19 in both the short and long term which may lead to difficulty accessing stock and resources affecting our efficient costs. This is not an exhaustive list and there are other impacts which we are in the process of discussing with Ofgem via the Gas Regulation Group regular meetings.

We would recommend that a variety of options are considered to deal with the impacts of Covid-19 in RIIO-2, including an annual adjustment mechanism which ensures timely corrections are made to charges to take account of increases in actual cost vs allowances. This could potentially be delivered via a new bespoke Covid-19 licence term or through the existing license condition 'miscellaneous pass through' term.

Consideration could be given to a cost overlay which is applied ex-ante to the FDs following an initial assessment of where the costs impacts are being seen or are anticipated. Part of this mechanism could be to return the difference to consumers if those increases in costs are not realised.

Additionally, there will need to be a mechanism to adjust the associated output targets to take account of the additional work such as mains replacement.

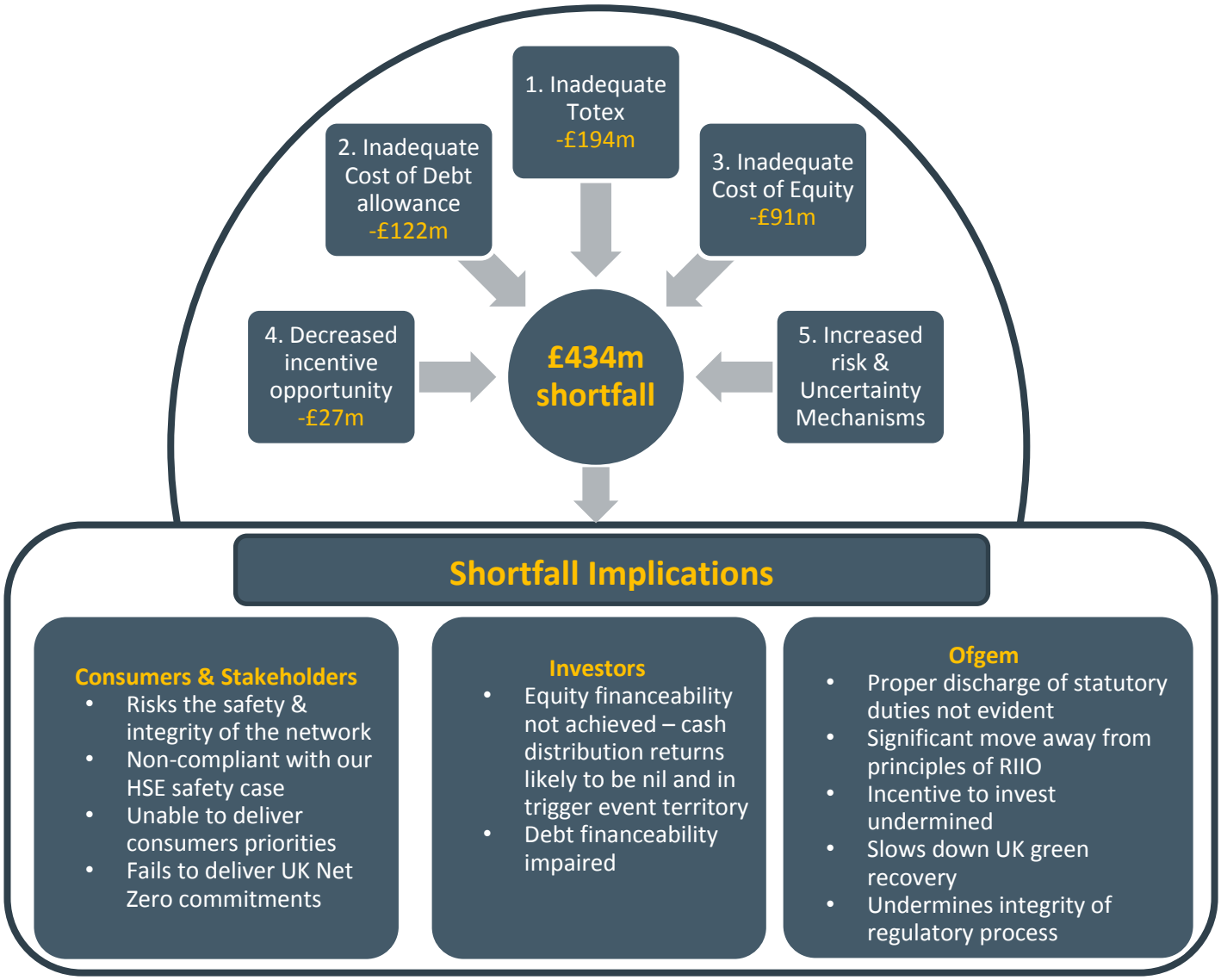
Wales & West Utilities

RIIO-2 Draft Determinations Finance Annex

WALES&WEST UTILITIES

Before we respond to the consultation questions on finance, we outline below our key messages on the Draft Determination:

1. **Overall position is very concerning to WWU:**



We focus below on allowances for WACC, and financeability.

2. Cost of debt – shortfall of £122m for GD2

Ofgem's proposed allowance for GD2 will give rise to a significant shortfall against WWU's efficient cost of debt. The table below demonstrates the scale of the shortfall borne from 2005 to 2021 of £172m, and the expected shortfall for GD2 of £136m in nominal prices (£122m in 2018/19 prices).

Table 1

COST OF DEBT SINCE 2005 : OVERALL SHORTFALL						
		Regulatory control periods				
	Notes	First controls 2005-2008	GDP CR1 2008-2013	GD1 2013-2021	Total 2005-2021	GD2 2021-2026
Allowed cost of debt (real)	1	4.65%	3.55%	2.17%		1.74%
Actual cost of debt (real)	2	2.19%	3.86%	4.67%		3.65%
Surplus/(shortfall) to allowed rate (real)		**2.46%**	**(0.31%)**	**(2.50%)**		**(1.91%)**
Average nominal RAV	3	1,210.2	1,542.3	2,063.5		2,377.5
Notional leverage		62.50%	62.50%	65.00%		60.00%
Average Debt RAV		756.4	963.9	1,341.3		1,426.5
Annual average surplus/(shortfall) : £ nom		18.6	(3.0)	(33.5)		(27.2)
Total surplus/(shortfall) : £ nominal	4	52.7	(15.0)	(267.9)	(230.2)	(136.1)
Total surplus/(shortfall) tax adjusted : £ nom	**5**	**52.7**	**(11.0)**	**(214.3)**	**(172.6)**	**(136.1)**

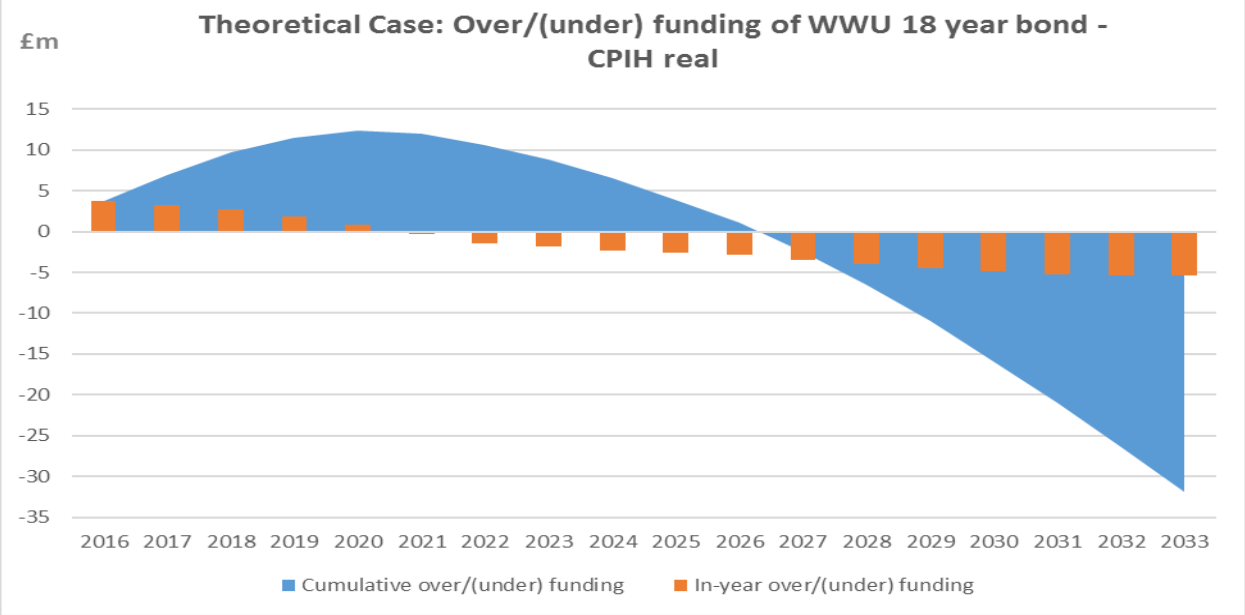
Notes :
1. GD2 rates above are CPIH real and taken from Ofgem's DD. For financeability purposes, WWU will assess on an RPI basis
2. GD2 rate is RPI real and taken from the WWU model reflecting the DD and assuming Ofgem's RPI rate of 2.85%
3. Time weighted RAV for Kd purposes. GD2 figure assumes Totex allowances in the Ofgem DD
4. These are simple derivations from the figures above, the actual total for each period may differ slightly due to weighting differences.
5. Shortfalls prior to GD2 reflect tax surpluses and are estimated. However, for GD2, if actual efficient costs would be allowed, a tax surplus may not arise due to higher expected cash tax costs.

WWU has previously proposed an alternative method to the cost of debt regulatory allowance. When we compare Ofgem's proposed method and WWU's method against Ofgem's four guiding principles, we find Ofgem's method to be fundamentally flawed in design and cannot provide as much protection for the consumer or investor, whilst WWU's method satisfies the principles.[10]

[10] A methodology should have overarching principles. These should be clearly articulated and logically consistent, and we find that Ofgem's principles could be improved in that regard. For example, there is no explanation as to what is meant by "undue risk"; and there is a trade-off between incentivising networks to achieve lowest cost financing without incurring undue risk. Ofgem has not explained how that trade off should be managed. If it considers that networks are best placed to manage that trade off, it needs to explain how this can be reconciled with its proposed methodology.

Table 2.

COST OF DEBT METHODOLOGY : OFGEM .V. WWU – COMPARATIVE ASSESSMENT			
Ofgem Principle	**Ofgem approach**	**WWU approach**	**Comment**
Consumers should pay no more than an efficient cost of debt	Ofgem's method assumes very frequent issuance in relatively small lot sizes, and therefore does not match network issuance frequency, transaction sizes and maturity. Therefore, the allowance would only match each network's efficient costs through coincidence, not by design.	Consumers would be protected because testing for efficiency would be applied at inception of debt incurrence at network level and with assurance added through proposed RFPR reporting containing ex post testing and review results.	Ofgem's method results in gains and losses to networks due to Ofgem's methodology, instead of efficiency at the time of debt incurrence.
The cost of debt allowance should be a fair and reasonable estimate of the actual cost of debt likely to be incurred by a notionally geared, efficient company	Ofgem's averaging methodology creates winners and losers across networks regardless of efficiency at inception of debt incurrence. This is despite almost £25bn of debt being raised efficiently across three sectors, as its own review has demonstrated. Therefore, the allowance is neither fair nor reasonable.	The only limitations to the allowance should be notional leverage, a robust and transparent market test at inception of each instrument and subsequent ex post testing and review through RFRP reporting. These are appropriate constraints and underpin fairness on an enduring basis.	WWU approach provides a perfect fit for issuance by networks whilst subjecting all issuance to a market based efficiency test at incurrence.
Companies should be incentivised to obtain lowest cost financing without incurring undue risk	There is no robust evidence from Ofgem that its methodology provides better incentives when compared to WWU's method. Nor has it defined "undue risk". In this regard, Ofgem has not considered regulatory risk manifested in its changes to methodology. Networks do not know what changes will be made for GD3 and future controls, even though the maturity of most debt raised typically extends beyond a number of control periods. This ongoing regulatory risk is neither necessary nor desirable. Investors cannot be assured that efficiently incurred debt would be remunerated over its maturity.	A strong and transparent market test at inception for each debt instrument is the best method to enhance and sustain efficiency on an enduring basis. It is for networks to manage debt financing risk, they are best placed to manage this risk, not Ofgem.	Ofgem has not provided any evidence to support its contention that its method leads to the best outcome for consumers and investors for each network
The calculation of the allowance should be simple and transparent while providing adequate protection for consumers.	Ofgem's approach of averaging across sectors, with judgements required on which sectors to aggregate, which averaging approach to use, and then forcing calibrations into a trailing average market index method to match an average efficient cost base is unduly complicated, and not as transparent as WWU's proposal. That Ofgem proposes to change its methodology from RIIO-1 to RIIO-2, after changing from GDPCR1 to RIIO-1, is evident that its methodological approach is not enduring. This undermines confidence from a consumer and investor viewpoint	Test is simple, transparent, auditable. Consumers are protected as efficiency is tested and ensured at the outset of each debt instrument. Further safeguards would be added through RFPR reporting by each network to contain ex post testing results and review.	WWU method is superior



Ofgem's method is fundamentally flawed because it does not provide assurance on an ex ante basis that the cost of every debt instrument, raised efficiently, would be allowed over its life. To illustrate, and using Ofgem's own data set, we took an example of an 18 year bond raised in 2015 - it will be seen below that an overall shortfall would arise over the life of that instrument.

This lack of assurance, at the outset of each debt instrument raised efficiently, combined with Ofgem's methodology, means that an efficient network would only receive an allowance equating its efficient cost, at notional leverage, through pure chance, rather than through efficient execution and management. No permutation of calibrating trailing average indices or fixed rate methods on sector wide average costs can ever ensure that allowances are accurately applied to efficient costs at a notionally geared individual network level.

Ofgem has not provided robust evidence that its methodology is superior to all others. The resultant discriminating outcomes across the networks have not been objectively justified by Ofgem.

3. Cost of equity – shortfall of £91m

There would be a significant shortfall on cost of equity allowance. The updated cost of equity report from Oxera accompanying this submission[11] provides compelling evidence for an allowed cost of equity range of 6.00% to 7.08%. Against WWU's Business Plan submission of 6.1%, Ofgem's proposed 3.95% would lead to a total shortfall of £102m in nominal prices (£91m in 2018/19 prices) over GD2, based on an equity RAV of £950m.

[11] Oxera report prepared for the Energy Networks Association, September 2020 : The Cost of equity for RIIO-2. Contained in Appendix FQ7A - Cost of Equity Update (Oxera) of this submission by WWU.

4. Financeability

The pressure on WWU's financeability for GD2 does not stem from inadequate mitigating measures undertaken by WWU. Throughout GD1, mitigating actions have reduced the cost of debt in GD2 - it will be noted from table 1 above that WWU's average cost of debt is projected to reduce from 4.67% in GD1 to 3.65% in GD2. These actions include early buyback of £250m of debt that was due to expire in GD2. Moreover, shareholders have restrained cash distributions significantly below the allowed equity return. This is not unique to GD1 - table 3 below demonstrates the restraint on cash equity returns by shareholders since 2005; average cash distributions being significantly below the allowed return, enabling leverage reduction in GD2 over GD1.

Table 3.

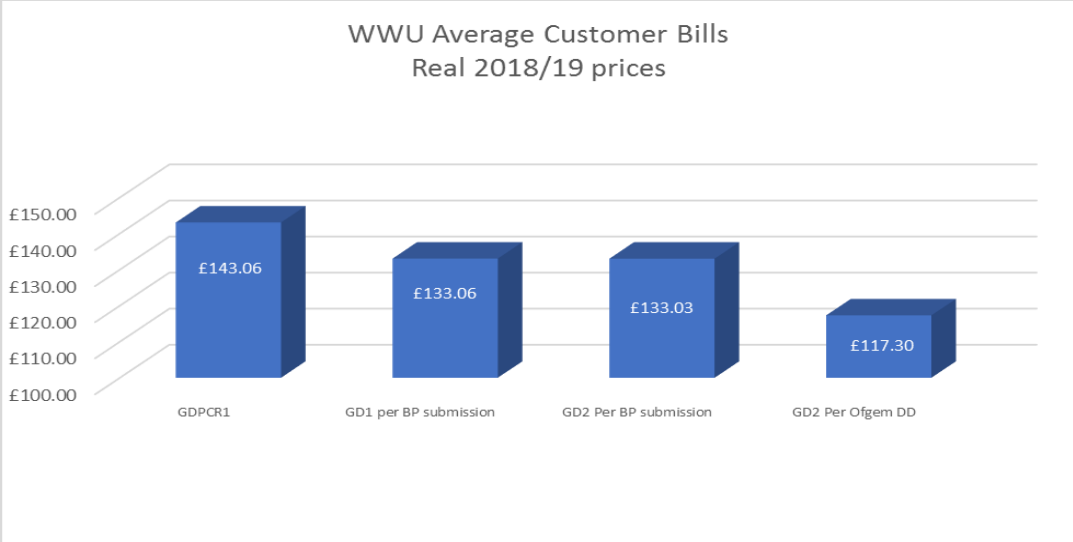
RETURN ON EQUITY RAV	REGULATORY CONTROL PERIODS				
	Short periods 2005-2008	GDP CR1 2008-2013	GD1 2013-2021	Average 2005-2021	GD2 2021-2026
Allowed return (real)	7.25%	7.25%	6.70%	**6.97%**	**3.95%**
Actual cash return (real)	3.22%	1.02%	3.94%	**2.89%**	**?**
Allowed return (nominal)	11.00%	10.74%	9.18%	**10.00%**	**6.05%**
Actual cash return (nominal)	6.83%	4.31%	6.35%	**5.79%**	**?**
Average net debt to RAV	71.25%	73.69%	68.75%	70.76%	**?**
Average RPI to 2021/CPIH in GD2	3.50%	3.26%	2.32%	2.83%	2.02%

As forewarned in our Business Plan submission, when assessed against Ofgem's proposed but inadequate WACC allowances, and now with the Draft Determination proposals of materially lower Totex allowances, a significantly diminished and weaker incentive package, and greater reliance on uncertainty mechanisms, financeability would be seriously threatened, with the greatest impact on our supportive shareholders. The prospect for any cash distribution return on equity in GD2 would be greatly diminished. In the context of an efficiently operated and financed business, we must therefore point to inadequate allowances as the main cause of financeability pressure.

5. Customer bill

There are 3 key messages in the graph below:

- GD1 bill level – reduction of 7% over prior control GDPCR1 from £143 to £133
- WWU's Business Plan for GD2 – no increase over GD1 of £133
- Ofgem's DD – £117.30, a reduction of 12% over GD1, following a reduction of 7% over GDPCR1. This is not a sustainable bill, for reasons explained above.



A severe cut to bill levels in GD2, for a business that is operated and financed efficiently, will harm capital employed, and be detrimental to consumer interests in the medium to long term.

Therefore, we ask Ofgem to review again its proposed package of allowances prior to Final Determination and adjust the proposed WACC and Totex allowances to levels that support long term sustainability of the network and financeability.

2. Allowed return on debt

FQ1. Do you agree with our approach to estimating efficient debt costs and setting allowances for debt costs?

Summarising the position between Ofgem and WWU from the March 2018 Framework Consultation to the 2020 Draft Determination:

1. Although Ofgem did not apply a company/transaction specific debt allowance in previous controls, in its March 2018 Framework Consultation, Ofgem stated that a company specific pass through of efficient costs "could work" and that it was open to proposals in that area.[12]

2. In its response to the above consultation, WWU proposed a company and instrument specific allowance subject to an ex ante efficiency test for transactions undertaken, with overriding limitation of notional leverage. [13] WWU contended its proposal would meet Ofgem's four principles governing the cost of debt allowance outlined in the Framework Consultation.

3. However, Ofgem applied a "high bar" to evidence for it to be persuaded to materially alter its existing methodology - i.e. the full indexation approach.[14] Ofgem's presumptive stance in that regard was based, it appears, on its assertions that its methodology in RIIO-1 "worked well", and that "the best approximation for an efficient company's cost of debt is likely to be a trailing average of market rates."[15] [16] With regard to the first assertion, the methodology in RIIO-1 reduced forecasting error and led to lower allowances, but the latter was due to the downward trend in realised market bond yields, which could not be accurately projected at the outset of RIIO-1. Had such yields turned out higher, higher consumer bills would have ensued - Ofgem's decision to adopt the trailing average approach created this consumer exposure at the outset of RIIO-1. More generally, both consumers and investors are exposed, favourably or unfavourably, to the consequences of whatever methodology is chosen, whether that is a variable rate allowance (trailing average or spot) or a fixed rate allowance, based on company or sector wide average. This is regulatory risk and there is nothing intrinsic in the RIIO methodology that captures and locks in benefits for consumers over the long term in that regard, e.g. should there be a sharp and sustained increase in market rates in RIIO-2, consumers will pay.

[12] RIIO-2 Framework Consultation March 2018, Para 7.27: "A pass-through of efficient debt costs could work if we could be certain that we can always establish if debt costs are efficient. This is a relatively strong assumption, as companies' financing arrangements are only partially transparent. For example, understanding the net effect of bank loans, intercompany loans and derivative financial instruments (including the use of different currencies) make it a difficult task to quantify the actual cost of debt to network companies and/or whether it has been efficiently incurred."
[13] WWU response on 2nd May 2018 to the RIIO-2 Framework Consultation
[14] Ibid 1 above. Para 7.12: "There is a high bar of evidence that would need to be met before we might be persuaded to alter our existing methodology."
[15] Ibid. Para 7.12
[16] Ibid. Para 7.8

As for the second assertion, no robust evidence has been presented by Ofgem that a trailing average of bond yields is the "***best"*** (italicised by WWU for emphasis) approximation of efficient costs, particularly given its assumption of a high frequency rate of debt issuance in small lot sizes, which is significantly out of line with experience across the UK energy sectors according to Ofgem's data.[17]

4. Given Ofgem's presumptive stance, WWU expected Ofgem to apply the same standard of evidence and justification to its own approach, that it imposed on licensees advocating different approaches. Moreover, WWU expected Ofgem to have robustly justified its approach as superior to all others, by reference to its four principles. When we review below Ofgem's proposals in the DD, we keep these expectations in mind.

5. We make the following points about Ofgem's proposals in the Draft Determination:

    i. Ofgem's testing of debt transactions (across the three energy sectors chosen, i.e. Gas Transmission, Gas Distribution and Electricity Transmission) against market rates on issuance was an important development. As Ofgem notes, just eight debt transactions were found to be more than 25 bps off market, proving that the network companies raised debt efficiently in all but a small number of transactions. Clearly, this is robust evidence that consumer interests have not been adversely affected by company specific decisions. With this evidence, we think Ofgem should have reconsidered the company specific approach advocated by WWU and its decision to rule out such an approach in the Framework Decision in July 2018.

    ii. Ofgem seeks to protect the consumer from exposure to such company specific decisions by pooling debt costs across the three sectors and deriving an efficient cost of debt pool that a notional efficient operator would achieve, not what any specific efficient transaction raised by any actual network would cost, as this was ruled out in its Framework Decision in December 2018. Ofgem's rationale for this approach has been noted.[18]

[17] RIIO-2 Framework Consultation, figure 3 page 79, March 2018

[18] Para 2.47 Draft Determination Finance Annex. "We consider the volume of debt within the gas distribution and transmission sectors at over £23bn (excluding intercompany loans) to be sufficient to draw robust estimates of average debt costs and therefore calibrating to these expected costs would represent a reasonable debt allowance for a notional efficient operator in gas distribution and transmission sectors. Reducing the number of sectors to be combined further (so, for example, considering just GD combined with GT or ET combined with GT) would reduce the pool size and increase the risk that the smaller pool is skewed by specific company financing decisions rather than representing a reasonable allowance for a notional efficient operator."

iii. However, it is necessary to consider if Ofgem's merging of cost of debt pools across the three sectors it chose would lead to any meaningful benefit to consumers, given its stated rationale. Notably, there is high concentration of RAV (and therefore debt at notional leverage) within a small number of companies in the three sectors. Cadent represents 48.5% of RAV in the GD sector, and Cadent and National Grid (NGET and NGGT) combined represent 63.6% of the three sectors. [19] Consequently, the debt cost pool created by Ofgem is largely determined by these two companies. This is not surprising, as the highly concentrated profile of RAV and debt in the energy sector is observable. However, it is not apparent that this approach by Ofgem leads to more efficiency and/or more robust delivery on Ofgem's four principles, given its discovery of strong efficiency on market tested debt transactions across the three sectors, and relative to WWU's proposal. If Ofgem wanted to keep as much distance as possible from company/network specific decisions, it could have applied a simple weighting by number of networks, not a weighting by RAV. We note that in its determination of Totex allowances, Ofgem does not apply a RAV weighting and that such Totex allowances are adjusted for company specific circumstances (i.e. regional factors). However, a simple weighting would still not achieve a material improvement over a company specific approach given the small number of companies/networks involved.

iv. Moreover, Ofgem's trailing average methodology assumes a high frequency rate of debt issuance in small lot sizes, graduating from one tenth to one fourteenth of notional debt per annum over GD2, with debt assumed to be issued daily, which is markedly different to energy networks actual issuance of debt[20]. Ofgem has not yet presented robust evidence that this assumed profile of debt issuance is a superior method to achieving efficient cost.

v. Indeed, such an assumed issuance profile would likely preclude the notional efficient operator from the sterling bond market, as each assumed issuance is well below minimum benchmark sizes in that market of typically £250m. The Eurobond market, which some large networks have used, typically has benchmark sizes of €500m. On that basis, the assumed issuance profile of the notional operator would not likely place it onto an efficient frontier.

[19] Using RAV projections in Ofgem's DD Finance Annex Appendix 6
[20] RIIO-2 Framework Consultation, figure 3 page 79, March 2018

With regard to derivatives, Ofgem has proposed to rule out inclusion of these instruments, except for cross currency swaps. [21] WWU argued for inclusion of derivatives when undertaken and provided efficiency was evident at that time. WWU notes the following:

1. Ofgem states that derivatives are difficult to assess if they are incurred against market rates, when undertaken. Yet it is prepared to allow for cross currency swaps which are typically more complex and costly than interest rate swaps. Moreover, the variables relating to most interest rate and inflation swaps are observable and can be market tested by the network and Ofgem.

2. Ofgem notes in para 2.54: "We are not convinced that taking a snapshot of embedded derivatives at one point in time would give us an accurate picture of the costs or benefits over time." Yet derivatives when undertaken, and any changes thereafter, are invariably on an NPV neutral basis, except for transaction charges. Subject to those charges, Ofgem does not need to be concerned with changes made post inception, but could require assurance from networks each year through RFPR.

3. Ofgem's rationale for exclusion of derivatives is largely centred on its view that these are company specific risk management decisions, which should inure to equity investors as they and the companies in which they have invested are best placed to make these decisions. We agree that financing risk measures relating to debt and derivatives are best managed by companies – but it does not follow that allowances should not take account of derivatives. Interest rate risk, real and nominal, is an unavoidable consequence of having debt in a capital structure, notional and actual, therefore no distinction should be necessary between debt and associated derivatives. As for National Grid's assertion (Appendix 7, page 204) that there is "little if any overall benefit to consumers" to having derivatives included, this overlooks well established corporate practice which uses interest rate and inflation derivatives as part of managing the overall cost of debt finance. Therefore, it is reasonable to expect the notional efficient operator to use such derivatives, just as Ofgem assumes it would for cross currency swaps. Moreover, as is well understood, derivatives facilitate greater diversity in utilising debt markets, and such ongoing diverse access is in the long-term interests of all stakeholders to the energy sector.

[21] Para 2.54-2.56: We are conscious that derivatives can be used to shift financing costs from one period to another and that future derivative use is very difficult to predict. The result is that we are not convinced that taking a snapshot of embedded derivatives at one point in time would give us an accurate picture of their costs or benefits over the long term. There are also differing approaches to the use of derivatives, which would suggest that their use represents company-specific risk management decisions, the costs or benefits of which could reasonably be considered to most appropriately reside with equity investors. In line with previous Ofgem exercises and broader regulatory precedent, we therefore propose to conduct our calibration exercise excluding derivatives.

4. Finally, excluding interest rate and inflation derivatives creates potential for significant regulatory asymmetric risk: when market real rates are reducing, the methodology deployed since RIIO-1 tracks that trend within a set of assumptions; but against a persistent rising real interest rate environment, the methodology could be changed in future to a fixed real allowance. [22]Given the long-term nature of assets and capital involved, investors legitimately expect the regulatory approach to provide assurance that the cost of long term transactions efficiently entered into, whether debt or associated derivatives, will be covered by allowances. Ofgem stated its commitment to this principle in its RIIO-1 handbook published in October 2010.[23]

5. In conclusion, Ofgem's proposal to exclude efficiently incurred derivatives other than cross currency swaps would, if implemented, be a wrong policy decision.

For additional costs of borrowing, Ofgem's proposed allowance of 17 bps is significantly less than NERA's range of 47bps to 59 bps, as explained in an updated report accompanying this submission.[24] Further, in terms of deflating a nominal rate, we agree with both Ofgem and NERA that breakeven inflation is not appropriate, and OBR should be used. We ask Ofgem to consider NERA's analyses.

FQ2. Do you agree with our proposal to use the iBoxx GBP Utilities 10yr+ index rather than a combination of iBoxx GBP A and BBB 10yr + non-financial indices?

Because we do not agree to the use of any market index applied on a trailing average basis with an implicit assumption of high frequency issuance in small lot sizes, the proposal to use the Iboxx GBP Utilities 10yr+ index on that basis is not relevant to WWU. It would be relevant if applied on a company and transaction specific basis for new debt when incurred, which would be consistent with WWU's proposed method.

FQ3. Do you agree with our proposal that the RAV growth profile of SHET continues to be materially different to other networks and therefore warrants continuation of a bespoke RAV weighted allowance calculation?

We note Ofgem proposes a company specific allowance for SHET, but not for other licensees. While WWU does not object to the bespoke treatment of SHET, Ofgem's question implies that all other companies are materially the same and that it is legitimate to treat them as such. We do not accept that assumption. Please refer to FQ1 for our views in this area.

[22] The opposite position, i.e. a regulator's decision to switch from fixed to variable in 2012 for RIIO-1, has significantly affected WWU over GD1 – so WWU has and continues to experience a shortfall in the allowance relative to its efficiently raised debt and derivatives, at notional leverage

[23] RIIO Handbook para 12.15. 'Estimating the cost of debt on this basis should provide comfort that new debt, financed at efficient rates – even at levels higher than the allowed return – will be fully funded in the future.' Although this sentence was made in the context of the RIIO-1 index, it confirms the principle that efficiently raised debt will be fully funded

[24] Contained in – Appendix FQ1A - Review of Ofgem's DD additional costs of borrowing, and deflating nominal iboxx (NERA)

3. Allowed return on equity

Step 1 - The Capital Asset Pricing Model evidence

FQ4. Do you have any views on the model to implement equity indexation, as published alongside this document, (the "WACC allowance model.xlsx") or on the annual update process?

The starting value for the RfR should reflect the considerations raised in the updated Oxera report on cost of equity. [25] Subject to that, we have no comments on the model proposed or the annual update process.

FQ5. In light of RIIO-2 Draft Determinations and Ofwat's final determinations for PR19, do you believe that energy networks will hold similar systematic risk during RIIO-2 to water networks during PR19?

We believe gas distribution networks have higher systemic risks than water, not least due to asset stranding risks. We note Ofgem has precluded certain projects from its baseline Totex proposals due to uncertainty and has stated: "We have applied a CBA payback cut-off of 2037 (i.e. 16 years from the beginning of RIIOGD2) to all asset management repex mains investments (and associated services interventions). This reflects uncertainty over the future of the gas network and the risk of asset stranding. "[26]

We refer to the updated Oxera report on cost of equity accompanying this submission.[27] Oxera concludes with an asset beta of 0.38 to 0.41 for energy networks, which we consider appropriate.

[25] See footnote 11.
[26] Ofgem (2020), 'RIIO-2 Draft Determinations – Gas Distribution Annex', 9 July, paras. 3.86 and 3.88
[27] See footnote 11.

FQ6. Is there evidence of a material difference in systematic risk between:
a) RIIO-1 and RIIO-2,
b) distribution and transmission networks,
c) gas transmission and electricity transmission,
d) gas and electricity?

With regard to a) above, we note Ofgem's contention that RIIO-2 would have "significantly less systemic risk" compared to RIIO-1 and reference is made to indexation of debt and equity, weaker incentives, and a narrower RORE range, as some contributors to this expectation.[28] However:

- Debt is already indexed in RIIO-1, so that is not a contributing factor.

- With regard to equity indexation, Ofgem has not presented robust evidence that the risk-free rate, adjusted for geared beta, and updated annually, would be a material contributing factor to systemic risk for a gas distribution network.

- Weaker incentive sharing from 63.2% to 49.6% does not have a significant impact on asset risk but should be factored into notional gearing assessment - for RIIO-1 Ofgem concluded likewise.[29]

- For RIIO-1, Ofgem stated: "We regard the scale of investment as the most significant differentiator of risk affecting both asset beta (and, therefore, the cost of equity) and the appropriate level of notional gearing".[30] It remains unclear to us how Ofgem judge the impact of net zero investment on systemic risk in light of that statement. Moreover, although Ofgem's representation of investment risk from RIIO-1 to RIIO-2 shows lower percentage rates in terms of Totex/RAV in table 19 of its Draft Determination. For the GDN sector, repex had a different capitalisation rate in GD1, and the table should be re-presented to neutralise that change. There is no evidence presented that changes in capitalisation rates from RIIO-1 to RIIO-2 should affect systemic risk.

- Finally, Ofgem's proposed asset beta for RIIO-2 is 0.375, slightly lower than the asset beta of 0.396 for RIIO-1 (assuming it applied a debt beta of 0.125 in RIIO-1). Ofgem has not justified such a reduction in the systematic risk of the GD sector.

[28] Para 5.59, Finance Annex, Ofgem Draft Determination July 2020
[29] RIIO-GD1: Final Proposals-Finance and Uncertainty Supporting Document, para 3.14, page14
[30] Ibid page 13.

Step 2 - Cross-checking the CAPM-implied cost of equity

FQ7. Do you have any views on how we should consider further the gearing impact on beta and cost of capital estimates?

We refer Ofgem to Appendix A2.6 of Appendix FQ7A - Cost of Equity Update (Oxera).[31] On page 75 of that report, Oxera concludes*:* "We observe that with the correct specifications the WACC is not very sensitive to gearing, while the equity betas have increased. This is consistent with the MM theorem that higher levels of gearing are translated into higher CoE but stable WACC. Although the MM cross-check is an important component of Ofgem's analysis, their analysis is based on incorrect inputs. The RfR rate and CoD assumed by Ofgem violate the mechanical relationship between the CoE and gearing. Given these fundamental problems, we consider that Ofgem's MM cross-checks cannot support the CoE proposed in its Draft Determinations". We ask Ofgem to consider Oxera's findings.

FQ8. Do you agree with our interpretation of cross-checks?

We do not agree. We refer to Appendix A2.7 of the updated Oxera report on cost of equity and agree to Oxera's conclusions on the robustness of Ofgem's cross checks.

Finally, Oxera's updated ARP-DRP report and cross check to Ke conservatively supports a Ke of 6.35% CPIH real at the 50th percentile on a notional leverage of 60%.[32] This updated report answers all of Ofgem's review points in the first report and we ask Ofgem to give this important cross check report very careful consideration.

Step 3 - Expected versus allowed returns

FQ9. What is your view on the overall in-the-round assessment of allowed returns to equity? Is our judgement of 3.95% at 60% notional gearing reflective of the combined analysis through Steps 1, 2, and 3?

The proposed rate of 3.95% would be too low. We ask Ofgem to review the updated Oxera report to the ENA, and which recommends a range of 6.00% to 7.08%. [33]

We adopted 6.1% for our Business Plan submission, as part of an overall revenue package to sustain an efficient network, financeability, and to avoid an increase to customer bills. We remain committed to that 6.1% and consider it to be a prudent rate, subject to all other allowances being set at appropriate levels. We note here that the proposed allowances in the Draft Determination for cost of debt and Totex are too low.

[31] See footnote 11
[32] Oxera report prepared for Energy Networks Association. Asset Risk Premium relative to Debt Risk Premium; September 2020, contained in Appendix FQ8A - ARP v DRP (Oxera)
[33] See footnote 11

FQ10. What is your view on the expected outperformance estimate of 0.25% at 60% notional gearing? Do you recommend alternative analysis techniques or do you have suggested improvements to the analytical files published alongside this consultation?
a) "AR-ER database.xlsx"
b) "Residual outperformance.xlsx"
c) "Simple MAR application model.xlsx"

We do not agree to this proposed adjustment.

We refer Ofgem to an updated report accompanying this submission from Frontier Economics which firmly rejects the basis of the outperformance wedge.[34]

We ask Ofgem to review the Frontier report and reconsider its proposed AR-ER adjustment to Ke.

We have no comments on the analytical files noted above.

FQ11. What is your view on an ex-post adjustment for baseline equity returns? Is there an alternative mechanism or implementation approach that you think could better meet our stated objectives? Do you have specific views on averaging, pooling or suggested simplifications?

We refer to our response in FQ10.

[34] Frontier Economics: A report prepared for ENA: Further analysis of Ofgem's proposal to adjust baseline allowed returns. September 2020. Contained in Appendix FQ10A - AR vs ER (Frontier) to this submission by WWU.

5. Financeability

Impact of COVID-19

FQ12. Do you agree with our approach to assessing financeability?

We have the following points:

1. There is a difference between Ofgem and WWU in terms of how Ofgem should apply its statutory finance duty in relation to licensees. One element of that difference is the degree of weight that should be given to each of the notional company and actual company financeability assessments. Ofgem has not materially changed its stance here in the Draft Determination. WWU's position, explained in its Business Plan submission and in prior responses to Ofgem Consultations, also remains unchanged. WWU remains willing to engage with Ofgem to determine if and how this difference could be resolved prior to the Final Determination. [35]

2. We note Ofgem's commitment to long term financeability, reinforced by regulatory commitment, in its RIIO Handbook published in October 2010.[36]

3. In the Draft Determination, Ofgem's assessment of long term financeability for its notional company is restricted to a projection of its bespoke economic form AICR, using market implied rates and certain interest rate scenarios around that. [37] We have concerns, including:

    a. At best, the approach by Ofgem seems a very simplified one, and given its statutory duty, we would have expected an in-depth evaluation more consistent with its own description of what a financeability assessment entails, which has a focus on cashflow. [38]

    b. Long term financeability assessment should at least include assessment of cashflows over a timeframe reflecting, at a minimum, RAV life.

    c. In particular, cash flow assessment should evaluate the impact of the significant acceleration of revenue and cash that will be caused by Ofgem's decision to make a full transition to CPIH on commencement of RIIO-2.

[35] See Ofgem comments in Appendix 5, page 211 of the Draft Determination Finance Annex; WWU Business Plan commentary in (i) Appendix 22A Finance Annex No.1 Sections 2.3,3.4,and Sections 7-9 and (ii) Appendix 22B Finance Annex No.1 Section 2.3, 4,5,7 and 8.
[36] RIIO Handbook published in October 2010: Box 10, page 105: "A longer term view of financeability – reinforced by regulatory commitment"
[37] Para 5.30-5.36, Draft Determination Finance annex
[38] Para 5.2, Draft Determination Finance Annex

d. Ofgem should project the impact on key rating agency metrics, rather than just its bespoke AICR, given the licence requirement to maintain a minimum BBB- rating and thus intrinsic requirement to meet actual rating credit metrics in that context. If the rating agencies do not adjust for the impact of the revenue acceleration into GD2 from the CPIH switch, they should not be expected to do so for the loss of revenue in subsequent controls. Further, should key rating levels be impacted then this may impair dividend flows and thus equity financeability.

e. Finally, and over the longer timeframe noted above, equity financeability should be assessed in terms of Ofgem's 3% dividend yield assumption, current market expectations of dividend yield on utility stocks and dividend cover.

FQ13. Do you agree with our approach to determining notional gearing for each notional company?

Our key comments are:

- Ofgem's assessment is based on its proposed allowances, which we do not agree to.
- Ratio analysis should reflect rating agency metrics.
- The cross check to market observable gearing levels is restrictive, and should be expanded to include gearing levels of unlisted networks.

FQ14. Do you have any evidence that would suggest we should consider adjusting our notional company financing assumptions due to the impact of COVID-19?

Costs incurred by licensees to manage COVID-19 impacts should be treated as a non-controllable pass through and allowed in revenue on a T+2 basis. Clearly, full assessment of key impacts will take more time.

7. Corporation tax

FQ15. Do you agree with our proposal to pursue Option A?

We agree with the proposal to pursue Option A subject to our comments on the additional protections outlined in FQ17 below.

FQ16. Do you agree with our proposals to roll forward capital allowance balances and to make allocation and allowance rates Variable Values in the RIIO-2 PCFM?

We agree with the above proposals.

FQ17. Do you agree with the proposed additional protections? In particular:
a) do you have any views on a materiality threshold for the tax reconciliation? Do you think that the "deadband" used in RIIO-1 is an appropriate threshold to use?
b) Do you have any views on our proposals to retain the Tax Trigger and Tax Clawback mechanisms from RIIO-1?
c) Do you have any views on the proposed process for the Tax Review?
d) Do you have any views on the proposed board assurance statement?

We agree with the proposal to submit CT600 returns annually to Ofgem, and reflecting the time limit for submission of those returns to HMRC.
In particular:

a) **do you have any views on a materiality threshold for the tax reconciliation? Do you think that the "deadband" used in RIIO-1 is an appropriate threshold to use?**

We agree with a materiality threshold in respect of allowing immaterial unexplained variances in the tax reconciliation and that the "deadband" used in RIIO-1 is an appropriate threshold to use. We would expect the tax reconciliation template, once developed, to calculate the threshold itself given the board assurance statement requirements as per d) below.

b) **do you have any views on our proposals to retain the Tax Trigger and Tax Clawback mechanisms from RIIO-1?**

The continuation of a Type A Tax Trigger mechanism for corporation tax rates would appear unnecessary given the added simplifications outlined in ss 7.24 and 7.25. In the same way that capital allowance rates are proposed to be included as Variable Values in the RIIO-2 PCFM including corporation tax rates as Variable Values would reduce the differences between the notional allowance and HMRC payments which licensees are required to reconcile annually.

We agree with the proposal to retain the Type B Trigger mechanism from RIIO-1.

We support the ENA recommendation that a review of tax clawback policy should be undertaken. Ofgem should justify : (i) why it is fair for investors to be exposed to tax clawback to the extent of 100% (i.e. no sharing of the impact), (ii) why it is appropriate to reduce revenues by excess interest @tax rate (i.e. a presumed tax benefit) rather than the actual tax benefit a licensee obtains as a result of any excess gearing (the stated objective of the mechanism per s7.27), and (iii) why, if any interest is disallowed by tax legislation, the related debt instrument or a portion thereof should still be included in the debt to RAV test?

c) do you have any views on the proposed process for the Tax Review?

Our view is that any adjustments to a licensee's tax allowance arising from a Tax Review should be limited to the period in the price control year that is under review and subsequent periods if necessary i.e. not retrospective.

d) **Do you have any views on the proposed board assurance statement?**

Given the extensive controls and consequences in tax legislation and HMRC audits governing accuracy of tax returns, we believe the scope of this statement should be focused on assuring the values of the reconciling items. We will continue to work with Ofgem through the ENA to develop an appropriate scope and drafting for the board assurance statement.

8. Return Adjustment Mechanisms (RAMs)

FQ18. Do you agree with our proposal to introduce a symmetrical RAMs mechanism as described above?

We have concerns.

1. It is not clear how RAMS and Uncertainty Mechanisms interact, in terms of downside shocks. In principle, RAMS should not be used as a mechanism to produce sharing of cost impacts where these are outside the control of the licensee. The appropriate mechanism for such impacts should be in Uncertainty Mechanisms which should not entail risk to eventual recovery. This is an important matter that directly affects financeability assessment. We ask Ofgem to consider this.

2. RAMS is company specific. Company specific actions on Totex and incentives would be captured. But company specific actions on cost of debt would not be. This seems inconsistent. We ask Ofgem to consider this.

3. We are not clear as to how the upper and lower limits would be affected by indexation through the control period. We ask Ofgem to consider this.

FQ19. Do you agree with our proposal to introduce a single threshold level of 300 basis points either side of the baseline allowed return on equity?

We are not convinced on the appropriateness of a symmetrical range, given our concerns noted above to FQ18 and the overall revenue package proposed, which would suggest a need for a much more limited downside exposure. We ask Ofgem to consider this.

FQ20. Do you have any other comments on our proposals for RAMs in RIIO-2?

We note Ofgem's proposals, stated to be in the interests of protecting consumers and investors, to adjust revenues on an ex post basis in GD3 where GD2 outturn RORE is below 0.95% or above 6.95%. We note RORE is to exclude finance, tax and BPI penalties and rewards and the adjustment would be 50% of the difference between the outturn RORE and the upper and lower limits.

We propose that any negative adjustment to revenues in GD3 be smoothed over GD3 to avoid unnecessary volatility to consumer bills and financial metrics which may concern investors, whilst any positive adjustment should be received in the first year of GD3 in support of its statutory finance duty to protect investors.

Finally, we note Ofgem has referred to its statutory finance duty in terms of protecting investors.[39]

[39] Para 8.7, Draft Determination Finance Annex: In developing our RAMs proposals, which include moderating the effect of returns being very low due to factors outside of companies' control, we have had regard to the need to secure that licence holders are able to finance their licensable activities.

9. Indexation of RAV and calculation of allowed return

FQ21. Do you agree with our proposal to implement CPIH inflation?

We raised concerns in our Business Plan submission and prior responses to RIIO-2 consultations about some specific consequences from the proposal to switch from RPI to CPIH from 1 April 2021. The switch to CPIH is one of the most significant measures by Ofgem, and therefore we request that it should demonstrate appropriate regard to these consequences.

First, Ofgem has responded to our request that it should consider the issue of the change in compensation from one of realised inflation to a mix of realised and expected inflation. It argues that there is no such change and that CPIH is a superior form of realised inflation. CPIH in its current form (but for the avoidance of doubt, in the context of real TMR for CAPM Ke determination, not any experimental backcast) is indeed considered a better measure of inflation. However, investors are asked to rely on an expectation created by Ofgem that the switch to CPIH will be NPV neutral without any reference to RPI outturn, because Ofgem has ruled this out. Ofwat did not take this stance - it will true up to outturn RPI for PR19. We also note that Ofgem's notional company has 30% of debt linked to CPIH for financeability assessment purposes, even though it notes that the GD&T sectors have 37% of debt RPI linked (before derivatives) and it proposes to include cross currency swaps, but not other debt associated derivatives. On this basis, we are not convinced by Ofgem's NPV neutrality proposition and ask it to review this matter again.

Second, in our Business Plan submission, we highlighted a concern to long term financeability directly arising from Ofgem's switch to CPIH. This has the effect of significantly accelerating revenue and cash flow into GD2, at the expense of revenues in subsequent controls. As noted in our response to FQ12, Ofgem should assess the long term financeability consequences of this significant change.

10. Regulatory depreciation and economic asset lives

FQ22. Do you agree with our proposals, including the policy alignment for GT and GD, and to recover backlog depreciation for GT RAV additions (2002 to 2021) over 20 years from the start of RIIO-2?

We have no comments on GT RAV backlog depreciation.

11. Other finance issues

Capitalisation rates

FQ23. Do you agree with our proposed assumptions for capitalisation rates?

We agree with the stated principle of aligning regulatory capitalisation rates to accounting treatment, thereby respecting such treatment and maintaining some basic alignment with audited financial statements, which contain relevant information to investors and other stakeholders.

However, should a licensee be required, under financial reporting standards, to impair or write down the accounting carrying value of an asset previously capitalised into RAV, then the residual RAV for that asset should be released as allowed revenue in the year of impairment or write down. This would be consistent with the principle stated.

This proposal would be a consistent and reasonable extension of Ofgem's commitment to RAV, in that any investment previously made and funded by licensees but required to be impaired or written down in future should be recoverable immediately. To protect intergenerational equity, we would propose a limit of such RAV releases to a total of 5% of average RAV in GD2, i.e. 1% of RAV per year on average over GD2.

This proposal could be treated as an uncertainty mechanism, on the basis that future impairments and write downs cannot be predicted reliably over a forthcoming control period.

FQ24. For one or more of the aggregations of Totex we display in Table 40, should we update rates ex-post to reflect reported outturn proportions for capex and Opex?

If Totex recognition would be aligned with financial reporting standards in accordance with Ofgem's stated principle, we do not see a need to update.

However, we ask Ofgem to consider the 45-year sum of digit depreciation profile for RAV additions during RIIO-2 and to reflect if it would be a fair weighted representation of different asset categories between very long life assets such as repex and connections, to short to medium term life assets such as fleet and IT.

RAV opening balances

FQ25. Do you agree with our proposal to use the closing RIIO-1 RAV balances as opening balances for RIIO-2?

We agree.

FQ26. Do you agree with our proposal to use estimated opening RIIO-2 balances until we have finalised the closing RIIO-1 RAV balances?

We note Ofgem's comment: *"Until we know the final closing balances for RIIO-1, we propose to provisionally use the opening RIIO-2 RAV balances as submitted by the companies in their Business Plans."*

We now have updated Totex actual and forecast figures for RIIO-1 which will be submitted through RRP and a forecast closing RIIO-1 RAV balance per RFPR R9 – RAV. This may be a more appropriate forecast RIIO-GD1 RAV closing balance. We note however that tab R9 in the RFPR includes enduring value adjustments. Given that there may be some inconsistency in the approach to Enduring value adjustments adopted by different licensees, it would be appropriate to remove these adjustments from the closing balance if this were to be used as an opening RIIO-GD2 balance.

RIIO-1 Close-out

FQ27. Do you agree with the three categories of adjustments outlined below?

We agree with the categories of adjustment highlighted. We note that RIIO-GD1 close out workshops have not yet taken place so a more extensive view can be provided once all of the relevant details are known and have been discussed.

We note Ofgem's comment: "*As well as this, we will also make adjustments for areas that will impact RIIO-2 allowed revenues, such as incentives that operate on a two-year lagged basis*". The RIIO-GD1 licence – Special Conditions Applicable to the Licensee (DN) Part E refers to post period adjustments relating to shrinkage and environmental emissions incentive revenue, PRGSAS and PRGAS. Per the RIIO-GD1 licence these adjustments will take effect in formula year 2023/24. We ask Ofgem if these adjustments will be included in the RIIO-GD1 close out process?

FQ28. Do you agree with our approach in using estimated values for closeout adjustments until we are able to close out the RIIO-1 price controls?

We agree.

Amounts recovered from the disposal of assets

FQ29. Do you agree that proceeds from the disposal of assets during RIIO-2 should be netted-off against Totex from the year in which the proceeds occur?

Should Ofgem agree to our proposal to release remaining RAV into allowed revenue for any asset that would be impaired under financial reporting standards, such disposal proceeds should be deducted from allowed revenue, not from RAV. Otherwise we recommend that disposal proceeds be deducted from RAV, not Totex, in the year in which the proceeds are received.

FQ30. Do you agree that we should carry out a review where an asset is transferred to a holding company and then subsequently sold to a third party?

We agree.

Annual Iteration Process

FQ31. Do you agree with our proposal to apply one interest rate to revisions to PCFM inputs and charging errors, based on a short-term cost of debt?

We do not agree. We refer Ofgem to a report from First Economics on this area. [40]

- Prior year adjustments relating to expenditure items should generally roll forward at the allowed cost of capital.
- Under- and over-recoveries against the revenue cap, and ODI penalties and rewards should roll forward at a benchmark interest rate plus a margin.

FQ32. Do you agree with the margin-based approach, and the methodology used to calculate a margin of 110bps?

Please refer to our response to FQ 31. A margin of 110 bps seems reasonable.

FQ33. Do you have any reason why the marginal cost of capital for revisions to PCFM inputs and charging errors should remain distinct from each other, or why WACC may remain a more appropriate time value of money for a particular subset of prior year adjustments?

See responses to FQ31 and FQ32.

FQ34. Do you agree with our proposal to include forecasts for most PCFM variable values for the purposes of the AIP?

We agree with the proposal to include forecasts for most PCFM variable values for the AIP (that encompasses adjustments to both base revenue and allowed revenue), which should reflect updates more quickly, reduce the magnitude of true-ups, and streamline reporting. As per ongoing discussions this should be on the basis of Totex forecasts submitted to Ofgem as part of the RRP process, with specified allowable updates. However, consideration should be made for late adjustments to allowed revenue such as those relating to Supplier of Last Resort Claims, which in the last two years have been directed by Ofgem in late January before charges are set on 31 January for the regulatory year beginning on the following 1 April. Under the new regime these would be received too late to process through the AIP which would be finalised in the previous December.

[40] Appendix FQ34A - RIIO-2 prior year adjustments (First Economics) accompanying this submission by WWU

FQ35. Considering re-openers as set out in these Draft Determinations, do you agree with our proposal to exclude them from any forecasting? If not, please submit specific examples or analysis of the potential materiality of actual spend versus initial allowances.

Discussions to date regarding the reopener windows have considered the timing of the AIP. If the reopener windows are set so that the process is complete and direction from Ofgem can be made in time for the adjustment to that year's PCFM then we agree with the proposal to exclude them from any forecasting.

FQ36. Do you agree that additional reporting on executive pay/remuneration and dividend policies will help to improve the legitimacy and transparency of a company's performance under the price control?

We do not believe there is a legitimacy issue in this area. There are already requirements to disclose executive pay/remuneration under the Companies Act in the UK and dividend policy is typically included within statutory accounts. Careful consideration needs to be given to what, if any, additional disclosure is appropriate. We are available to continue working with Ofgem in this area, if required.

Base Revenue, setting ODI caps and collars

FQ37. Do you agree with the proposed definition of Base Revenue?

We agree.

FQ38. Do you agree with the proposal to fix the values used for ODI caps and collars at final determinations?

We agree.

Wales & West Utilities

RIIO-2 Draft Determinations Gas Distribution Annex

WALES&WEST UTILITIES

2. Quality of service - setting outputs for RIIO-GD2

Summary Response

Meeting the needs of consumers and network users

- We had serious concerns about the disallowance of our £4m vulnerability spend - which we now understand was an Ofgem error. It is imperative that the required allowances are provided otherwise we will be unable to deliver our commitments which customers have asked us to deliver.
- WWU are pleased to see many of the bespoke output proposals put forward in our Business Plan adopted into the revised GSoP across the GDNs.
- The level of Customer satisfaction scores (CSAT) expected in GD2 exceeds the level of service our customers requested. Additionally, we are concerned regarding the asymmetric deadband being proposed.
- We support the WWU interruptions target however we are keen that this is a national target to ensure all customers receive the same level of service cross the UK.

Deliver an environmentally sustainable network

- GDNs have an important role to play in reducing carbon and this is an area that benefits from incentivisation and we are keen to ensure the right behaviours are incentivised.
- However, the proposed approach to the GD2 Shrinkage Incentive limits incentivisation and needs careful consideration.
- Our concern is the incentive based on system pressure and MEG alone would be too narrow and only incentivises performance in these areas and not the bigger picture of total emissions.
- We are committed to improving our environmental performance however we are unable to increase our ambition within the allowances currently proposed.

Maintain a safe and resilient network

- We support the driver for an Allowance Adjustment Mechanism on Repex PCD however think the 2% and 10% restrictions on allowances for mains and services respectively are too small with little flexibility to manage changes to the risk profile of pipes and changing stakeholder requirements.
- NARMs was a metric designed to give the Networks the flexibility to respond to changing requirements and we are concerned that the use of PCDs for Capital projects prevents the correct asset management decisions being made at the correct time.

Introduction

GDQ1. Do you have any views on our common outputs that haven't been covered through any of the specific consultation questions set out elsewhere in this chapter? If so, please set them out, making clear which output you are referring to.

CSAT

We are pleased to see the outcome of the six-month trial of telephone surveys of connections and emergency work, plus the revised questionnaires has been used as the basis of the incentive scores for GD1. This reached a wider demographic and added clarity to the questions, but resulted in lower scores than have been seen under the current GD1 methodology.

However, the use of dead band creating an asymmetric reward / penalty mechanism is one that will dis-incentivise companies to invest in continuing to drive up customer satisfaction scores. We would urge Ofgem to amend this in the FDs

Our stakeholders have told us that a score of 9/10 is an acceptable level of performance and that further investment to continually outperform this score is not justified. UK benchmarking reports from the Institute of Customer Service (ICS) and TTi both show that a score of 9/10 is not just sector leading for utilities; but is leading in all UK sectors.

This mechanism will see GDNs penalised for scores which would have represented the maximum reward in GD1. GDNs would be penalised for a score below 9.37 for emergency work which is not justifiable.

We therefore ask Ofgem to review the use and application of the dead band, and to review the emergency incentive to ensure companies are incentivised to perform well, but not penalised for UK leading customer service levels.

Unplanned interruptions

The application of GDN specific unplanned interruption targets does create a postcode lottery of performance across the UK for customers e.g. 11 hours vs 28 hours. A headline that an average interruption time of 28 hours in one network is acceptable does not give a good message to customers. As we discussed at early sessions of the Ofgem interruptions working group, a better methodology would be to have a common GDN target for 'routine interruptions' and bespoke GDN targets for large incidents and Multi Occupancy Buildings (MOBs) which were reflective of the network and the MOB population in that GDN. We would urge Ofgem to revisit this to ensure customers across the UK receive consistent levels of service.

If this is not addressed, then at the very least there should be a reward available for WWU and NGN who put forward ambitious interruptions targets in the business plan when compared against SGN and Cadent and are now expected to achieve them when others have significantly less stringent targets to achieve.

Use it or lose it allowance Vulnerable customers and CO:

The Draft Determinations provide little information on the operation and funding of the Use It or Lose It allowance (less than one page). WWU put forward £750k per annum based upon a 1/8th split of the £30m fund for WWU and collaborative projects which has been moved into uncertainty mechanisms.

Ofgem have confirmed that the Use It or Lose It allowance for GDN work and collaborative work will be in base allowances. We are working with Ofgem to develop the guidance document for the allowance ensuring it has enough detail to give confidence that money spent will be allowed, and to clarify the boundary between this allowance and the innovation funding for vulnerable customers.

There has been discussion at the Ofgem Customer working groups about GDNs being required to log projects on a portal, and what type of projects would be eligible for the funding, but Ofgem confirmed they were not looking to approve individual projects. We agree this is a proportionate approach.

Meeting the needs of consumers and network users

GDQ2. What are your views on the reporting metrics we have proposed for the consumer vulnerability ODI-R?

The metrics detailed are all obtainable and reportable, however, they need further clarification through the Ofgem Customer working group. It is also imperative that the required allowances are provided otherwise we will be unable to deliver our commitments.

Priority Service Register (PSR): In the trial of the Customer satisfaction scores we collated the satisfaction scores for PSR customers alongside the overall returns. We are unclear if you will require the overall satisfaction to be reported by work type or as an overall score. We reported to you through the Customer working groups that PSR volumes for connections work would be very low as customers do not appear on the gas suppliers PSR until after the gas connection has been made.

Fuel Poor Network Extension Scheme (FPNES): The number of FPNES connections made is reportable every year via the RRP. We seek clarity on if networks would we be reporting against the baseline levels we put in our plans or the maximum number of connections allowed via the volume driver. This metric would need to be removed if the FPNES scheme is stopped before the end of GD2.

Carbon Monoxide (CO): The average CO awareness score does not drive getting the CO awareness message to large numbers of people and could drive a behaviour to just getting a good score from a small select group.

Stakeholders want us to get the CO message to a wide range of people including supporting non-gas issues more linked to festivals, other fuels. We believe a better metric is the number of people reached through CO awareness sessions with the questionnaire providing proof of the engagement and learning.

We are also unclear how these metrics will be used. Is there a benchmark level you expect networks to reach or is this a case of creating league tables? Context from the annual RRP reporting will need to be included in Ofgem annual reports to avoid giving a false impression of the effort and initiatives taking place in the networks and through collaborative working.

GDQ3. What are your views on the design of the annual showcase events, including whether they should be held at a national or regional level?

WWU believe that the work done by WWU should be showcased in the WWU region through local showcase events or WWU webinars.

We would consider holding these alongside our annual programme of stakeholder consultation events to minimise the cost to consumers of attending the events. This then allows local partners and organisations to attend and provide feedback at a local level leading to continued development of services. Alongside the WWU events, we are in discussion with Welsh Water to deliver some joint vulnerable customer events (trial event in Rhyl March 2020 postponed due to COVID-19).

The GDN collaborative work is more appropriate to be showcased on a national stage. However, to minimise costs to the GDNs customers, and to organisations who wish to attend, we propose to use events such as the National Energy Action Annual Conference, or the Utility Week Vulnerable Customer Conference to have GDN stand and a place on the agenda. We will also take the learning from the online webinar style approach used in many organisations during Covid-19 to consider if this is a potentially effective route to share best practice.

GDQ4. Do you agree with our position to change the FPNES from a PCD to a capped volume driver?

WWU welcome this decision and believe it is the right one to manage the uncertainty around the future of domestic heat.

Our stakeholders and CEG were concerned that a low PCD target may restrict our ability to fund additional work if opportunities arise through revisions to the Energy Company Obligation scheme, Welsh Government schemes, a new funding in England. The volume driver will address these concerns.

We have highlighted that the base workload used in the costs is incorrect in using 5,000 connections rather than 2,500 and Ofgem have confirmed this will be corrected.

WWU will work with Ofgem to agree the unit allowance for each FPNES connection which must include funding for the mains on community schemes as well as the service cost and the fees paid to the Ofgem approved fuel poor partners required under the FPNES.

A reasonable timeline to complete work in progress must also be agreed to protect customers in the event Ofgem close the FPNES scheme before the end of GD2. We propose a period like the 180 days used before the Index of Multiple Deprivation eligibility criteria was removed in GD1.

GDQ5. For GSOP3, is a 48-hour exclusion period for the provision of access to hot water and food in the event of a major incident appropriate? Should this be extended to cover interruptions that are not a major incident?

Yes, a 48-hour exclusion period is appropriate. We have worked with Ofgem on the expansion of GSoP3 over the last two years. During stakeholder research, vulnerable customers and carers have raised the issue of hot water for medically dependant bathing, and access to hot food where the person is unable to use alternative appliances.

The wording of the standard needs to clearly reflect the offer of hot water is only to those registered as requiring hot water for medical needs.

We have always taken care of PSR customers and anyone identified as vulnerable impacted by our works who is not on the PSR. The GSoP should act as a minimum standard and we would rather be trusted to engage with the household and offer the appropriate service rather than having to comply with a strict GSoP that requires high effort and cost to measure and report. For example, we might offer hotel accommodation, or pay for a take away, or offer transport to community centre for showering or other bespoke support.

The large incidents do provide a scale to formally mobilise hot food provision for the area but this takes time to plan and set up which is driving the 48-hour timescales - we will respond more quickly where needed and practical to do so.

GDQ6. In relation to our proposal to extend quotation GSOPs on entry and exit connections, is it sufficient – in regard to green gas entry enquiries – for these GSOPs to apply to the provision of initial and full capacity studies? Are there other parts of the green gas entry process we need to consider to ensure an improved service provision?

WWU are pleased to see many of the bespoke output proposals put forward in our Business Plan adopted into the revised GSoP across the GDNs.

This satisfies our stakeholders, ensures customers get the same compensation for poor services across the GDNs and index linking to take account of inflation will be welcomed but needs to be centrally controlled to ensure consistency in its application across the GDNs. However, further work is required to align the new work types to the existing standards in the drafting of the Statutory Instrument.

The GSoP table on page 161 of the GDN annex does not take account of the isolations, diversions, larger developments or (green) gas entry. The GDNs implemented voluntary standards for gas entry with initial enquires (15 days) or capacity studies (30 days).

We would like to note that WWU did not suggest that gas entry should be incorporated into the GSoPs, but it should be more visible in reporting.

The volume of gas entry requests in very low compared to other work types. The requests from customers can also be quote bespoke and relate to multiple sites and options. Connections to the LTS (>7bar network) may be one of the options. As a result, a high proportion of entry requests would be classified as Sufficiently Complex Jobs and with the low volumes the 90% performance level applied to connections GSoPs would not be appropriate.

If it is to be incorporated into GSoP, WWU suggest that a new standard is created (GSoP 8A) to document these standards. However, the Statutory Instrument currently only deals with connections direct to gas consumers. Third parties are covered under the voluntary GSoP scheme and this may be more appropriate for the green gas standards.

Regarding the provision of a quotation for the GDN to make the connection of a green gas infrastructure to its network, this can be aligned to GSoP 6 for the quotations, GSoP10 for the planning and GSOP11 for the substantial completion.

In the case of a third-party Utility Infrastructure Provider making the connection, the existing GSoP8 covers approval of the design.

The GDNs will work with Ofgem though the Customer working group to develop the detail of the wording.

GDQ7. What are your views on our consultation position to monitor the provision of and adherence to appointment timeslots for purge and relight activity through an ODI-R? Are our suggested reporting measurements reasonable?

The wording of the appointment timeslot reputational output is unclear and needs to be clarified.

Joint GDN stakeholder research showed customers wanted to be kept informed of the progress of an interruption and to minimise the period but did not believe a formal standard would be beneficial. Our complaints data shows that time left off gas is an issue to customers.

The intention of the GDN Business plan proposals was that appointments will not be offered during the working day as engineers will be on site to put customers back on gas as soon as gas is available at the Emergency Control Valve (ECV). They would be offered where the customer is not home and we leave a card. When the customer subsequently contacts us, they will be provided with an appointment slot either that evening, the following day or a future time of their choice. We will measure and report our adherence to these appointments.

We will work with Ofgem through the Customer working group to ensure the requirement scope and wording is clarified so that it is clear it applies to unplanned and planned interruptions.

GDQ8. Do you agree with our proposed option to provide Cadent and SGN with consumer funding through Totex baseline or a financial ODI reward for collaborative street works activities?

We are happy with the options proposed for the reasonable base allowance or a financial incentive to undertake collaborative work in greater London with the council and other utilities on the understanding that there is proper evaluation of sharing of the learning with gas networks and other utilities. However, this must be subject to a claw back mechanism of that collaborative work does not take place.

Deliver an environmentally sustainable network

GDQ9. How should we set targets for the shrinkage financial incentive?

Incentivisation is a key component of the RIIO framework, existing to drive performance in areas that consumers and wider stakeholders' value, and penalise for failure to deliver. Shrinkage and leakage incentives have been successful in GD1 with all GDNs surpassing targets resulting in a significant reduction to environmental emissions and benefit to the environment, significantly contributing to the UK carbon reduction goals.

The UK's focus on the environment and reducing carbon has increased significantly in recent years with the introduction of the Net Zero requirements; and it is clear the GDNs have an important role in this. It is an area that benefits from incentivisation and we are keen to ensure the right behaviours are incentivised.

For this reason, we welcome the opportunity to comment on the proposed approach to a GD2 Shrinkage Incentive which would limit incentivisation to average system pressure and mono-ethylene glycol (MEG) level actions.

Our stakeholders have told us they see emissions as a key area of focus. Whilst system pressure and MEG are key influencers to emissions, there are many other factors. Our concern is the incentive based on these factors alone would be too narrow and only incentivises performance in these areas and not the bigger picture of total emissions.

1. An incentive to reduce Average System Pressures can have unintended consequences.

Average System pressures can vary year on year for the benefit of stakeholders and indeed, may need to increase to facilitate wider environmental benefits. Factors that influence system pressure include mains insertion and connection of biomethane plants. Our stakeholders support biomethane connections and the South West is a hotspot for these. Stakeholders also want us to keep the cost of repex down and mains insertion is a key component in this. Both these things have the impact of increasing pressures. All GDNs are forecasting pressures to increase in GD2 for these reasons. There is a real risk that the proposed shrinkage incentive based on average system pressures will drive behaviour that is in conflict with other stakeholder requirements.

2. Using the last year of GD1 as a baseline of Average System pressure is not appropriate

There are risks in using the last year of GD1 average system pressure as the baseline. Annual average system pressure is heavily impacted by the severity of a winter. There is risk to both consumers and networks from this approach.

If the 2020/21 winter is very harsh, this will result in high average pressures that could leave an easy target to outperform in GD2. If it's a mild winter this could set a target that can only be failed in GD2.

We would therefore prefer a target using an average of the 3-year period 2017/19 – 2019/20.

We challenge the Ofgem assumption that year on year lowering of pressures should be rewarded. As stated earlier, system pressure is forecast to go up to enable live mains insertion and connection of green gas sites. These are both key stakeholder requirements and the current approach to the financial shrinkage incentive is at odds to both these requirements.

3. Inclusion of other factors will better incentivise Environmental Emissions reductions

To better facilitate environmental emissions, we should not take focus away from emissions from pressure reduction stations. Whilst these only contribute to 15% of emissions currently, by 2030 they will contribute to nearer 50% as the repex programme reduces the contribution from iron and steel mains. We believe GDNs should be incentivised to innovate in this area to reduce total emissions.

4. A Shrinkage incentive is not a double count of benefit linked to Iron Mains Replacement.

We appreciate and support the concern from Ofgem that GDNs should not receive financial reward through the shrinkage incentive for delivering the funded Mains and service replacement programme. That said, we believe there are ways of incentivising total shrinkage without rewarding for repex delivery, see our response to GD10 below.

GDQ10. Do you have any views on what clarifications are needed to ensure a consistent method of calculating the benchmark shrinkage volumes?

We agree it must be ensured that all GDNs are consistent in using the same method to calculate the shrinkage baseline volumes, however, as we stated above, we disagree that baselines should be based on changes in pressure and conditioning levels from the final year of GD1. As explained above, the reason for this is if a network experiences a severe winter during the final year of GD1, they will benefit from less ambitious targets. The converse to this applies, where a mild winter results in unachievable targets.

WWU proposals are outlined below to promote incentivisation of Environmental Emissions through a GD2 Shrinkage Incentive.

Principles to support development of an incentive methodology should:

- Ensure all GDNs are calculating baseline volumes on the same basis as each other using a clear methodology that could not be interpreted in different ways.
- Encourage GDNs to make decisions which lead to the best consumer outcome.
- Ensure targets are easily understood and challenging but do not result in GDNs being heavily rewarded or penalised for factors outside of our control.
- Encourage GDNs to innovate and manage their networks to minimise carbon emissions.

The benefits of Ofgem's proposal is it distinguishes between performance in GD1 and GD2 by using the most up to date and relevant data based on the final year of GD1 to compare with outcomes in GD2. This means that target pressures are based on real data that networks have shown to be achievable and is specific to that network. The method is relatively easy to apply using the methodology on which we currently assess shrinkage. However, a drawback of the Ofgem proposal is the process of differentiating pipes laid before the end of GD1 and the pipes laid after the start of GD2 using different average system pressures which would be a very cumbersome and complex activity that could result in inconsistencies and errors. The method also does not define what happens to pipes decommissioned and not replaced after the end of GD1.

WWU would propose the following methodology for discussion with Ofgem:

1. Take the GWh shrinkage/leakage as at close out of GD1.
2. This could be the reported number in 2020/21 RRP or to normalise out things such as winter severity, this could be an adjusted number using the actual leakage model for 20/21 RRP but updated with an average of 3 years average system pressures and MEG saturations.
3. Using this number as the baseline, run the 5-year (as per GD2 business plan) repex programme through the LRMM (leakage reduction management tool) to get a GWh reduction each year and therefore based purely on mains and service replacement.
4. Taking the GD1 close out GWh levels and netting off the impact of repex each year sets the annual target for GD2 in total GWh which if met, has no penalty or reward – therefore GDNs are not being rewarded through the shrinkage incentive for delivering the funded repex programme.
5. Each year GDNs report actual total GWh and the variance from the baseline target is either penalised or rewarded.

The benefits are:

- Focuses us on what really matters to stakeholders – total emissions to atmosphere.
- Meets Ofgem's objective of not rewarding networks for allowed repex through the shrinkage incentive.
- Is simple to apply and easy for consumers to understand.
- Would penalise companies who are behind on repex programmes.
- Prevents scenarios where networks could be rewarded for good pressure management but penalised for poor MEG management in the same year.
- Encourages innovation – e.g. Above Ground Installation venting and leakage - the Ofgem proposal would not incentivise us to look at this but if GDNs are incentivised on our total GWh then they are more likely to innovate in these areas.

GDQ11. Do you think a deadband should apply to the financial incentive? If so, please provide evidence as to how this could be quantified.

The severity of a winter is a key factor in emissions. We believe a deadband is appropriate so as not to reward or penalise consumers and networks as a result of winter severity. A deadband could be calculated using a statistically valid assessment of the impact of severe and mild winters on system pressures.

GDQ12. What are your views on our consultation position for the four GDNs' EAP proposals in RIIO-2 as set out in this document?

We recognise the growing importance of environmental protection to our consumers and believe that the implementation of the EAP proposals will significantly increase the environmental performance of the GDNs.

Open and transparent reporting against targets is important to build and maintain trust with stakeholders. However, we would recommend caution when setting out reporting parameters to ensure that they do not discriminate against business models, intensity of workload and reginal factors. In addition, it must be recognised that improvement in one environmental focus area may be detrimental in another and a balance must always be achieved.

GDQ13. Do you agree with our consultation position to include progress on biomethane in GDN's AERs, alongside standard connections data?

We agree that it would be appropriate to include progress on biomethane in GDN's AERs alongside standard connections data as a way of reviewing performance and ensuring knowledge and best practice sharing between GDNs.

GDQ14. Do you have any other comments in relation to this section?

Please see below, a summary response to the areas listed in the draft determination. Our full response is provided separately as Appendix GDQ14A - Addendum to Environmental Action Plan and should be read in conjunction with our EAP submitted alongside our December 2019 Business Plan.

We are committed to improving our environmental performance. Our business plan was supported by our customers and whilst we understand there are areas Ofgem assessed our plan as being less ambitious than other GDNs, we are unable to increase our ambition within the allowances currently proposed. For example, the reduction of the mains replacement workload will mean that we are unable to even deliver our Business Plan emissions reduction target.

The four key areas we have reviewed can be summarised as follows:

Science based targets (SBTs) - We have amended our ambition to meet an SBT for Scope 1 & 2 carbon emissions (excluding shrinkage) as requested.

Embodied Carbon - We are committed to understanding and reducing the embodied carbon on projects throughout GD2. However, this is a new initiative and to ensure that any targets are SMART and stretching we are working internally and with key stakeholders to ensure robust and reliable processes are in place. As such, we will not be committing to a reduction target across all projects for GD2, at this point, but to defining bespoke targets for individual projects and reporting on them within the AER.

Recycled Aggregate - We understand that our aggregate targets are lower than those proposed by other GDNs, however, we are limited by economic and geographic factors within a number of our regions. Increasing our targets would negatively impact upon other environmental focus areas and the efficiency of the business. We are committed to proactively seeking solutions within this area that will improve our performance and simultaneously meet stakeholder expectations on efficiency, and carbon reduction.

Vehicles - We have committed to ensuring that our commercial fleet represents the best value for money for our customers whilst ensuring our ability to deliver a safe and reliable gas network and limiting our environmental impact. Our December 2019 EAP did not account for the early “greening” of the commercial fleet because, currently, vehicle duty cycles, existing technologies and infrastructure do not support sweeping change to our commercial fleet.

However, in light of the proposed PCD for the commercial fleet and expectations for technological acceleration within this sector, we propose to increase the number of electric vehicles (EV) or ultra-low emission vehicles (ULEV) within the fleet by 2026. This supplementary target will only be achieved should the additional funding requested be made available and suitable vehicles reach the market place.

Maintain a safe and resilient network

GDQ15. What are your views on the proposed set of Workload Activities for the Tier 1 mains replacement PCD?

We understand the driver for a Tier 1 PCD and we are supportive of the proposed workload activities:

- Decommissioned and replaced - Cast & Spun Iron LP & MP
- Decommissioned and replaced - Ductile Iron LP

There is very little opportunity for 'decommissioned and not replaced' mains remaining on our network. Most decommissioned without lay will be short lengths at the end of cul-de-sacs or lengths decommissioned as a result of new links installed elsewhere. This would be hugely data intensive to report and if this category is included we would also need to include 'lay without abandon' to capture new links.

GDQ16. What are your views on our proposal to adjust allowances for the Tier 1 mains replacement PCD on the basis of mains decommissioned?

We understand the driver to adjust allowances to reflect work delivered. We also generally support funding adjustments for mains abandonment in preference to mains laid as this incentivises networks to innovate and look for opportunities to abandon at lowest cost, sharing any benefit with consumers. Our concern is the significant assumptions made by all GDNs to convert lay costs to abandon costs and how valid and comparable they are. We also have concerns due to the timing of this and that the first view would be in FPs with little opportunity for engagement and review.

We have significant concerns about allowances being set from top down analysis (subject to reduction from regression analysis and a further year on year efficiency challenge) and truing up using a bottom up approach without efficiencies applied. The current methodology Ofgem are proposing in setting the unit costs does not reflect the different mix of technique and specific regional factors not addressed in the current regional factor adjustment. We are concerned setting the unit costs at an industry level could impact the amount of money adjusted. For example, the unit cost could be greater than was allowed in the first place. In reality, other work would be done in its place so there is no case for penalising the GDNs.

GDQ17. What are your views on our proposed approach to setting unit costs for the Tier 1 mains replacement PCD?

As mentioned above, we are concerned with the unit costs being based on a bottom up approach, this is inconsistent with the allowance setting process which is based on a top down regression.

GDQ18. What are your views on our proposed Allowance Adjustment Mechanism and Allowance Adjustment Restrictions for the Tier 1 mains replacement PCD?

We support the driver for an Allowance Adjustment Mechanism. We do however think the 2% restriction on allowance adjustment is very small and does not leave enough flexibility to manage changes to the risk profile of pipes and changing stakeholder requirements, both of which will result in changes to the repex programme. 5-10% would be an acceptable range to protect consumers but also to manage change that history has shown is inevitable.

There is also a scenario where we get ahead of our programme. The current 2% cap is circa one month's work at GD1 productivity levels. We would want to avoid a situation where we stood down resource if we got a few months ahead of target. The mains are part of the mandatory HSE programme so we will be replacing them in GD3 anyway.

GDQ19. What are your views on our proposed Workload Activities for the Tier 1 services PCD?

The proposed workload activities (service relays and service transfers – domestic and non-domestic) capture the key workload areas and disaggregate based on cost to deliver so we support these workload activities as the basis for the PCD.

GDQ20. What are your views on our proposed approach to setting unit costs for the Tier 1 services PCD?

This is the same view as the mains Tier 1 PCD – Please see question GDQ16.

GDQ21. What are your views on our proposed Allowance Adjustment Mechanism and Allowance Adjustment Restrictions for the Tier 1 services PCD?

We support the driver for an Allowance Adjustment Mechanism. We do however think the 10% restriction on allowance adjustment is very small and does not leave enough flexibility to manage changes as the result of the risk profile of pipes and also changing stakeholder requirements, both of which will result in changes to the repex programme and associated services. 10-20% would be an acceptable range to protect consumers but also to manage change that history has shown is inevitable.

There is also a scenario where we get ahead of our programme. We would want to avoid a situation where we stood down resource if we got a few months ahead of target. The mains and associated services are part of the mandatory HSE programme so we will be replacing them in GD3 anyway.

The introduction of a cap also creates a link between this PCD and the NARMs methodology, the 'overflow' of service work would be managed by a different mechanism and a 'average mix of work' calculated to define the interaction. This adds significant complexity, in addition to the existing interactions of the services PCD with the mains PCD. Removal of the cap removes the need to develop an interface with NARMs, containing management of services volumes in a single PCD. This is much simpler to design and operate, providing a transparent and proportionate response.

GDQ22. What are your views on our proposal for a common PCD for capital investments?

We understand the driver to protect consumers in relation to funding of capital investments. We have concerns that the proposals are very restrictive in allowing the Networks to respond to changing risk profiles and changing stakeholder requirements. NARMs (formerly NOMs) was a metric designed to give the Networks the flexibility to respond to changing requirements and we are concerned that the use of PCDs for Capital projects prevents the correct asset management decisions being made at the correct time.

GDQ23. What are your views on our proposals for delivery, clawback and deliverables for the capital projects PCD?

Please see our response to GDQ22. In addition, we have concerns that any non-completed projects are subject to 100% claw back if the project is not completed within the GD2 period. There are many factors that may accelerate or push back investment. For example, WWU have proposed a 13km pipeline replacement. These crosses mountains in Wales and there are many environmental consents to enable this project. There could be things outside of our control that delay the project and disallowing all spend incurred is not appropriate where there is significant justification for any delays where the Network is not at fault.

GDQ24. Do you agree with our approach for funding physical security for the GD sector? And do you agree that in light of the proposed baseline Totex that the physical security PCD is no longer required for the GD sector?

We are in agreement with Ofgem's proposal.

GDQ25. Do you consider that the enhanced obligations framework for exit capacity and the additional information being sought are appropriate?

The enhanced obligations framework as described in the draft determinations formalise the general processes we undertake in order to determine the NTS Flat and Flex capacity and pressure requirements at each of our Offtakes and the discussions we have with NGGT and other networks.

We agree that a whole systems approach with obligations on both GDNs and NGGT should achieve more efficient operation of the Total System and welcome the balance of inputs being required by both parties.

However, the current Uniform Network Code (UNC) and NGGT Methodology process for capacity booking and allocation do not, in our view, offer the most efficient framework for bookings to take place. In addition, there are no means of raising modifications for the NGGT methodology statements and the current drafting of special conditions 9A and 9B do not recognise the Enhanced Capacity Obligations or the benefits for whole system efficiency that could be delivered through due discrimination for GDNs.

We have previously raised a number of concerns around capacity booking arrangements and the impact they have on efficiency of the Total System. For example, we raised concerns and offered some alternative approaches for some aspects of User Commitment via UNC Mod 0671 and before that we responded to the consultation on the Exit Capacity Methodology statement in May 2017; however nothing of substance has resulted from these discussions.

User Commitment in its current form may sterilise NTS capacity unnecessarily where Users are obligated to retain capacity bookings for 4 years which they would otherwise release.

In the case of GDN offtakes, the costs associated with User Commitment are passed to downstream customers which may result in one set of consumers within the GDNs subsidising consumers who are connected directly to the NTS and are able to have more choice in how NTS Capacity is booked.

We withdrew UNC Mod 0671 on the basis that these issues would be covered via the NTS Access Capacity Review group UNC 0705R which we welcomed and have fully supported.

We hope that the Enhanced Capacity Obligations and a clear steer in NTS' licence conditions to develop frameworks that promote Total System efficiency including for Flat, Flex and AOP products would encourage progress of UNC 705R in a manner which sees significant improvements in arrangements for coordinated and efficient use of network capacity across GDN and NTS systems. When making bookings for capacity we must consider our current and future 1:20 requirements and any risks associated with releasing capacity (flat, flex or pressure) which we may not be able to recover. Flat capacity may be subject to substitution to meet requirements at other NTS offtakes and we are not guaranteed to be able to recover Flex Capacity or Assured Offtake Pressures at a later date, because these are made available at NTS' discretion. These restrictions will inhibit some of the intentions of the enhanced capacity obligations as we currently understand them.

Following our bilateral discussions with OFGEM on the 10 August we now understand that the intended scope of the Exit Capacity Enhanced Obligations may necessitate revisions to the UNC and Capacity methodologies referenced above and delivered under NTS' licence conditions in order to encourage more efficient booking processes for networks whilst ensuring our 1:20 obligations are protected. We don't think this is clear from the current drafting of the enhanced obligations and propose specific licence obligations are placed on NTS to ensure the frameworks are updated to deliver more efficient booking processes for GDNs that delivers economic and efficient operation of the Total System not just the NTS.

We welcome the opportunity to discuss the draft determination proposals at future workshops and will provide further feedback at that time.

3. Cost of service - setting baseline allowances

Summary Response

- A reduction of 16% in Totex allowances presents a serious concern and puts the long-term viability of the network at risk.
- There is £194m of essential expenditure currently missing from our Totex allowances across GD2 (£38.8m pa) which is required to deliver a safe and reliable network for our customers and other stakeholders, including HSE, summarised as follows: -

Shortfall	Area	Consequence
£54m	Repex & Multi Occupancy Buildings (MOBs)	• Unable to comply with our HSE approved safety case risking our Licence to Operate • Fails to protect the safety of customers with 1000+ pa increase in high volume gas escapes by 2030 • Increases emissions and prevents us transitioning our network to hydrogen ready, in conflict with government net zero policy and ambition • Under-investment in high rise buildings which Grenfell has shown is unacceptable to society
£35m	IT & Cyber security	• Seriously impacts the integrity & security of our network • Move to Net Zero target will not happen without sufficient investment in Systems and telecoms • Removes the ability to deliver digitalisation priorities in GD2
£24m	Loss of metering & Smart metering	• Deterioration of emergency service levels • Inability to support Smart meter roll out
£30m	Regional Factors	• Deterioration of service levels • Reduces the ability to keep customers safe with less resources
£3m	Net Zero Pathfinder model	• Excellent opportunity for UK to benefit from whole system modelling to deliver the Green Recovery
£4m	Vulnerability	• Support for customers living in vulnerable situations will stop • No investment to keep customers safe from CO
£22m	Efficiency challenge	• Deterioration of service levels • Inability to deliver customer priorities • 1.2-1.4% is unjustified & unachievable • Very top of CEPA stated range
£22m	Benchmark position	• Deterioration of service levels • Inability to deliver customer priorities • Lack of justification for the move to 85th percentile • Reliance on single model not statistically robust • Built upon modelling riddled with errors
£194m	**Totex**	• Does not deliver our current and future customer requirements • Risks the long-term viability and sustainability of our network

- It is imperative that we work with you to ensure the risks and consequences of this missing allowances are fully understood and why this level of Totex must be allowed in the Final Determinations.

We have major concerns about the allowance setting process and can be summarised as follows: -

- The Ofgem modelling is excessively more complex than GD1, with limited time to understand, analyse and respond in the DDs;
- We have identified a number of errors which raises concerns on how the Ofgem work has been assured in advance of DDs;
- The reliance on one single Totex model is not robust with R^2 deterioration between price controls from 0.93 to 0.87;
- Inconsistency in cost treatment between GDNs when similar evidence provided; creating a postcode lottery across the UK;
- Surprised benchmark set at 85th percentile – this is inappropriate;
- Further ongoing efficiency challenge – circa 1.2~1.4% is unachievable; and
- Mains replacement allowances do not adequately cover the most recent market tender evidence.

Incentives

- The DD represents a significant move away from the incentivisation framework introduced in RIIO1, to the extent there is no realistic incentive for companies to deliver enhanced performance in GD2.
- The upside on incentives has halved and the downside has more than doubled compared with GD1 - and is dramatically skewed towards the downside.
- The RIIO1 incentive package led to c.£6m earned by WWU whereas at best, the forecast incentive RIIO2 package will be a max £1m and potentially even ended up in penalty; which for a high performing networks illustrates the move aware from incentive regulation which is not in the interests of customers or investors.
- Further analysis by KMPG on the DD incentive package and a comparison to PR19 is contained in Appendix Analysis of the RIIO-GD2 Draft Determinations (Incentives)

Approach to GD cost assessment

GDQ26. Do you agree with our proposal of using a top-down regression model?

In principle yes, but not as the only regression model, it must be used in conjunction with middle up/bottom up regressions to validate its resultant Totex allowances – also the resultant R^2 from the regression models needs to robust. For the Totex regression model it is less than 0.9 in GD2, whereas in GD1 it was greater than 0.9. There has been concern at CMA in the past on the use of a single model, we explore this and detail our preferences in Appendix GDQ26A - Cost assessment of Ofgem's RIIO-GD2 Draft Determinations (Oxera)

GDQ27. Do you agree with our proposed approach to benchmarking modelled costs at the 85th percentile?

No – we are surprised to see this set as the benchmark. This percentile has moved through the last three price controls from 67th in GDPCR1, to 75th in GD1 and now to 85th in GD2. This is extremely challenging and, coupled with the ambitious ongoing efficiency challenge, is unachievable.

We have reduced Totex expenditure through efficiency and initiatives throughout the last few price controls but are at the point where we have exhausted cost savings. Our cost base is reflective of the costs required to operate the network which achieving all required outcomes for customers. We also believe Ofgem's reasoning is unjustified and incomplete. We discuss further below.

The statement Ofgem make in regard to using the 85th percentile relates to collecting more extensive data through business plans, more work to normalise GDNs data and use of regional factors, so therefore comparability has been improved across GDNS. There is no further evidence to support his statement. We discuss concerns below:

- More data has been collected but has not been validated against annual RRP data; leading to concerns over the accuracy of this data which is demonstrated by the volume of errors that have been identified in the Ofgem modelling to date.

- The regional factor analysis has been rolled forward from GD1 with no further sophistication applied.

- Ofgem's GD2 modelling approach is a 'cherry picked' version of GD1, taking same regional factors adjustments and Totex model with the same drivers and discarding other models without justification or explanation.

- The number and type of normalisations is the same as GD1.

We do not believe Ofgem's statement is justified given our observations above and on this basis we do not support the move to the 85% as the benchmark.

We discuss quantitative evidence in regards to the choice of benchmark in more detail in chapter 5 of Appendix GDQ26A - Cost assessment of Ofgem's RIIO-GD2 Draft Determinations (Oxera)

GDQ28. Do you agree with our proposed approach to estimating embedded ongoing efficiency and values calculated?

No, we believe this to be excessive, please see Q11 for a detailed response and Appendices Q11A - RIIO-GD2 ongoing efficiency (Oxera) and Q11B - Frontier Productivity Growth (First Economics)

We have also noted a calculation error in the models relating to the compounding of ongoing efficiency included in the BPDT submissions. Again, we have observed a lack of assurance and review of BPDT data as part of the cost assessment process. We detail this error in our error log, found in Appendix GDQ26A - Cost assessment of Ofgem's RIIO-GD2 Draft Determinations (Oxera) relating to circa £11m over GD2 for WWU alone.

Normalisations

GDQ29. Do you agree with our proposed pre-modelling normalisations?

We agree with the majority of the pre-modelling normalisations. However, we are specifically concerned with Loss of meter work treatment and the number of overall adjustments.

Loss of meter work has been incorrectly treated based on precedent set in previous price controls, most recently GDPCR1. Historically the costs have been included in pre-modelling normalisation and treated as a separately assessed item. Our Loss of meter work appendix submitted as part of our December 2019 BP explains our issues with stranded 'efficient time' and how it is not possible to remove this when having licence obligations for standards of service.

Including this within the regression highlights the inefficiency of the emergency service and the inability of networks to reduce in the historical regression time series. In previous price controls this has been treated as a post modelling adjustment and recognised that a glide path is needed to get to a non-formula supported emergency service.

Customers have benefitted from the utilisation of this otherwise necessary, but unproductive regulatory cost, as a saving in GD1 and previous price controls and we should not be penalised as inefficient in subsequent controls, this has been circa £2m per annum benefit for consumers. We propose this is treated as a post modelling adjustment consistent with previous Ofgem precedents in GDPCR1.

The overall modelling adjustments which cover normalisations, excluded and technically assessed costs vary significantly across the networks, WWU have had 3% of costs removed pre regression and Cadent 24%.

Running the regression on the full cost basis is a relevant cross-check because it ensures that all trade-off between cost areas are fully taken into account (in line with the idea of a totex model). If there are interactions between regressed costs and those that are excluded from the regression, then running separate assessments (as Ofgem does) could be problematic.

In the model where all costs are included WWU is by far the leading company (8% better than the upper quartile and 5% better than the 85th percentile—i.e. the second-ranked company). Given the large differences across GDNs in the costs removed by Ofgem prior to modelling and the operational trade-offs discussed above, the outcome from Ofgem's totex modelling could be erroneous. That is, the outcome that WWU is currently assessed as being 5% inefficient in modelled totex may simply be due to inappropriate asymmetric cost exclusions. This is likely to disproportionately affect WWU given that it has the smallest proportion of cost exclusions.

Regression Analysis

GDQ30. Do you agree with the selected aggregation level, estimation technique and time period for our econometric modelling?

No, we disagree with a single Totex model being used. This places huge reliance on a single model, with a single cost driver, using a single estimation approach providing an accurate estimate of GDNs' efficiency. Given the issues around the CSV cost driver, the limited amount of cross sectional data available, the use of forecast data for modelling, the significant cost adjustments that are made prior to modelling, the high level of aggregation for modelling, and the fact that all models suffer from modelling error, **there is a significant risk that this approach will result in inappropriate efficiency predictions**.

As such, it is likely to be more robust to combine results from different models. The view that results from different models should be combined has also been expressed by other regulators and in CMA appeals. For instance, at PR19, Ofwat noted the following:[41]

> We recognise that there are practical limitations to the use of statistical modelling in cost assessment. All models are subject to error and a degree of bias. In many instances, it is not possible to identify a single "preferred" econometric model that clearly prevails over all others. To mitigate risks of error and bias we do not rely on a single model. Rather, we use a diverse set of models, with different drivers and different levels of aggregation, in triangulation

We urge Ofgem to work on further developing the middle-up and bottom-up models that were used to set allowances at GD1 and finding appropriate cost drivers for these, rather than simply ignoring them because the 'turn-the-handle' approach did not give statistically robust results. If these more disaggregated models are less robust then Ofgem should still give them weight but set a lower benchmark to account for this uncertainty.

The 85th percentile benchmark is based on the reliance of the single model, this is not appropriate having only one cost driver. In fact, we show that the model is less robust than the models used at GD1 when an UQ benchmark was chosen.

We discuss our issues with the aggregation level, time series and techniques for estimation in Appendix GDQ26A - Cost assessment of Ofgem's RIIO-GD2 Draft Determinations (Oxera)

[41] Ofwat (2019), 'Supplementary technical appendix: Econometric approach', January, p. 5.

GDQ31. Do you believe we should take into consideration revised cost information for the remainder of GD1 including 2019-20 (actuals) and 2020-21 (forecast)?

Yes, if we are including GD2 forecast data and historical GD1 data then there is no justification for excluding 2019/20 actuals or 2020/21 forecast cost data. This further inclusion provides a more complete dataset. It is worth noting this excludes any impact for COVID-19 in the cost base for GD1 or GD2.

GDQ32. Do you agree with our selected cost drivers for Opex?

The cost driver used for Opex is a CSV consisting of a number of components and weights. he current CSV has a number of issues in its construction and use;

- The CSV is not constructed on economic principles;
- The individual components measure different things and are in different units;
- Many of the components are subsets of each other; and
- Ofgem has chosen the same components as at GD1 in the bottom up analysis yet chooses not to use the bottom up models.

Our main concern is on the reliance of MEAV within this CSV, with the number of errors found in the modelling and the significant impact adding MOBs into the CSV has on allowances we believe it is disproportionately impacting the CSV.

Additionally, the CSV does not consider the condition of assets. All networks in 2005 were in different conditions due to replacement cycles within regions, this means we all have differing condition of different asset types. The MEAV accounts for scale but does not take into account condition, which is a big driver of repair and maintenance costs. We have discussed this in CAWG sessions over the last 18 months and have provided solutions for including condition - through the use of monetised risk. We discuss this in further detail in Appendix GDQ26A - Cost assessment of Ofgem's RIIO-GD2 Draft Determinations (Oxera) along with our suggestions for cost driver alternatives.

GDQ33. What are your views on our proposed approach to the synthetic cost driver for repex?

We believe the repex synthetic cost approach is fair but needs to consider the technique in the unit costs, Ofgem already consider material as a separate unit cost but do not recognise technique. As we have mentioned in our Business Plan mains replacement appendix the volume of open cut is increasing from 8% in GD1 to 20% in GD2 and costs circa 30% more. Through the analysis CEPA has carried out for mains replacement PCD it has been noted you quote the significant cost differentials between the two techniques but still do not include it in the synthetic unit costs.

We have also noted the error in missing certain diameter bands in the analysis and have provided a DDQ response for you to update your modelling error.

We currently believe the Repex allowances are inadequate to deliver the mains replacement. We have carried out a competitive market tender process and the unit rates are significantly above those of the draft determinations. We discuss this and share relevant tender evidence in GDQ33A - Repex Cost justification paper. We have also written a paper to demonstrate the robust nature of our tender process, we are happy to share this during the cost assessment discussions in September. It is worth noting the procurement process is still ongoing so this is an early indication of the indicative costs we will incur.

GDQ34. What are you views on our proposed repex workload adjustments?

We are struggling to understand the rationale to disallow all investment for some mains (and associated services) categories. We also note inconsistencies across GDNs in this assessment. In the case of WWU, Tier 2B and iron > 30m has been disallowed, whereas other GDNs had steel and Tier 3 workload categories disallowed and Tier 2B and/or iron > 30 allowed. In reality, these are the same pipes manufactured in the same foundries and laid to the same standards in the same time periods across the UK. It is difficult to understand why a T2b pipe in a neighbouring network would attract investment when one in our geography would not qualify.

This leaves us with some significant challenges:

- Unable to meet our stakeholder requirements for general consumers and local Authorities;
- Significant risk in complying with the duty to maintain our pipes under the Pipeline Safety Regulations; the HSE will not sign off the WWU safety case on this basis;
- Unable to deliver our environmental commitments in terms of emission reductions and leaving us unable to deliver a hydrogen ready network. This is at odds with government policy and ambition on net zero. Its also conflicts with Ofgem's own support for networks meeting the challenge of net zero;
- Significant risk in complying with the duty to maintain our pipes under the Pipeline Safety Regulations and compliance with our own Safety Case;
- Inconsistent approach across different networks; creating a 'postcode lottery';
- If Tier 2 Repex is disallowed in FDs we must be given an increased Opex allowance to manage the increased leakage from these aging and decaying pipes remaining in service;; and
- Keen to understand the 2037 (16yr) payback period; there are no scenarios where Repex fails to payback; including our T2b which Ofgem has disallowed? Analysis shows the cost to consumer over time is higher with T2b and iron >30m disallowed. This is due to the increased opex cost of leakage and the fact this is funded today rather than repex costs which are recovered over 45 years.

Stakeholders
Our stakeholders were unanimous in support of our planned mains replacement programme. Consumers supported the safety and environmental benefits delivered by our proposed programme. Consumers and Local Authorities have been vocal in us only disrupting an area once. i.e. when we go into an area to carry out mains replacement, we replace all iron and steel mains in that area meaning we don't repeatedly disrupt the public by returning to fix leaks on mains left in the ground and not replaced with PE.

HSE also expect us to have a balanced investment portfolio that gives attention to maintaining health and risk of all asset groups and not leave particular groups unmanaged. The concept of zero investment in certain asset groups would not enable us to meet this objective and the HSE would therefore be unable to sign off our updated Safety Case.

We have held a bilateral with HSE (12 Aug) to discuss the issue of disallowances and they confirmed we need to comply with the Pipeline Safety Regulations regardless of Ofgem's final determinations.

Environment
We are committed to delivering a Net Zero ready network by 2035. Significantly reducing network emissions is a key component of this strategy and one that is supported by our consumers. We had some feedback that our plan to reduce emissions by 10% was not ambitious enough. We balanced this with feedback on costs of reducing emissions. We believe our plan was a balanced approach, considering all feedback to limit costs to consumers whilst having a positive impact on the environment.

Tier 2B and iron >30m pipes are key components of our plan to deliver our 10% emissions reduction and if workload in these asset groups is not allowed then we cannot meet our environmental commitments.

In addition, iron mains are not fit to transport hydrogen. Not replacing these mains prevents us delivering the hydrogen ready network required by stakeholders. This is at odds with Ofgem's commitment to Net Zero and their view on the role GDNs need to plan in helping the UK achieve this.

Pipeline Safety Regulations and compliance with our own Safety Case
Whilst there is no equivalent mandated programme for replacement for Tier 2B and iron>30m as there is for Tier 1 and Tier 2A, there remains a duty on networks to maintain all buried pipes under the PSR. Our Safety Case sets out our management plan for each asset group and how it delivers compliance with legislations such as the Pipeline Safety Regulations.

Disallowing all workload in these groups leaves us at risk with compliance with the Pipeline Safety Regulations and unable to comply with our Safety Case in its current form. Removal of any management plan from the Safety Case would likely result in its rejection when re-submitted to HSE for approval.

The disallowance of work will result in an additional 1,453 gas escapes in the GD2 period and 6,653 in the period up to 2030. Due to Tier2 being the larger diameter mains this will likely result in 590 "gas-in-building" events, which is a significant safety risk.

Inconsistent approach across different networks
Table 25 of the Gas Distribution annex shows that Ofgem have applied an inconsistent approach across the GDNs in disallowing repex expenditure. Taking Tier 2B as an example, four Networks have had workloads allowed in full whilst four have had them disallowed in full. It is not credible that Tier 2B pipes constructed of the same material and laid in similar periods are performing significantly differently in different regions. We have discussed with all GDNs who have similar concerns.

We have appended updated Cost Benefit Analysis (CBA) and further engineering and stakeholder evidence to this response – see Appendix GDQ34A - Updated CBA Analysis

The 2037 (16yr) payback period
One of the key factors in Ofgem allowing investment is the 16-year CBA payback period introduced in GD2 (the balance of the 24-year payback period allowed when Ofgem assessed investment for GD1). We appreciate there is uncertainty around the future use of the gas network and we need to avoid stranded investment. To ensure our asset investment plan was robust and future proof, we assessed it against the FES. These 4 scenarios illustrate the extremes of future energy solutions for the UK. There is no scenario in which the gas network is mothballed by 2037. In a number of scenarios, annual gas demand reduces as a result of general efficiency of appliances and insulation. Peak demand however is forecast to increase due to domestic heat load and small gas fired power plants connecting.

There is a reality that the gas network will still be transporting gas under pressure in 2037 and the Tier 2B and iron >30m pipes will still be required even if there is a reduced demand. Reduced demand has zero impact on reducing leaks or emissions to atmosphere, so we would challenge the logic that we should stop assessing the impact of leakage beyond 2037.

To bring this to life, Newport, the home of our head office, has circa 65,000 domestic properties with 60,000 on gas. To convert these properties from gas to alternative heating would cost in the region of £3,000 per property. This is a cost of £190m and to take Newport off the gas grid. Homes would have to be converted at the rate of 11 a day from 2021 to achieve this. The cost and labour needed is not credible without even considering the willingness of consumers to allow such conversions to their homes.
For these reasons the impact of not investing needs to be considered over a longer period to ensure the optimum investment decisions are made.

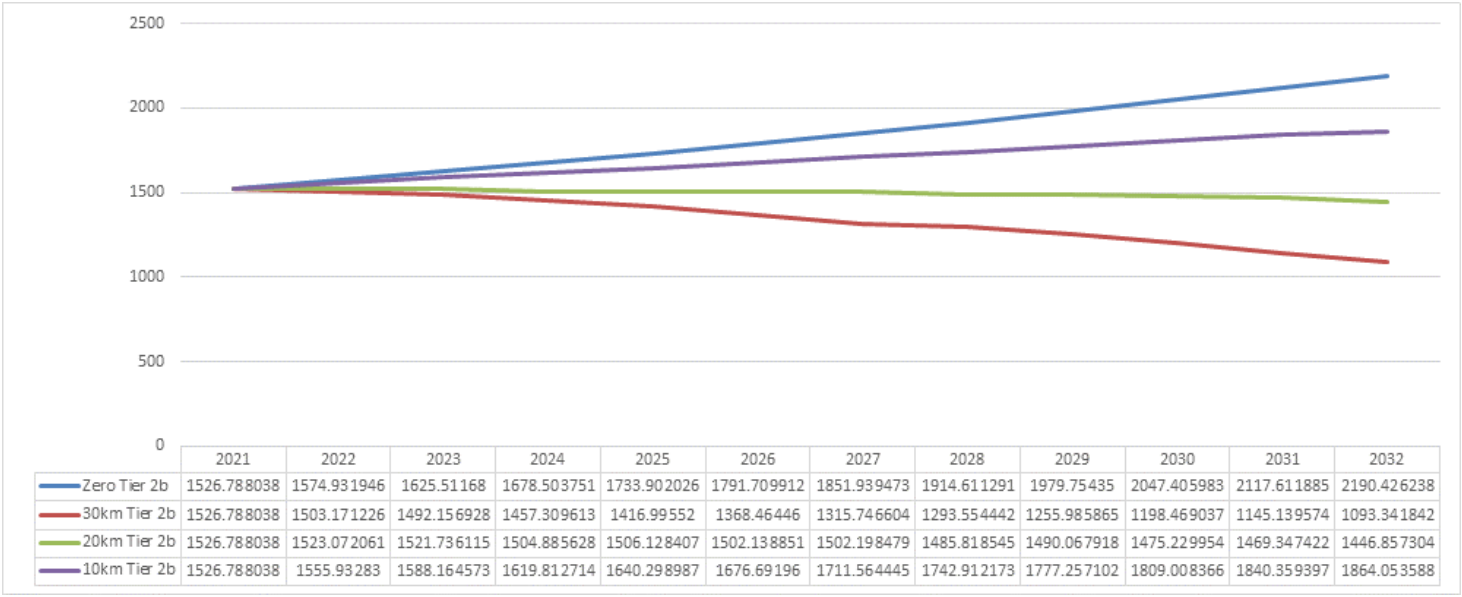
For these reasons highlighted above we are unable to accept a position where these categories are not funded as we will be in breach of the Pipeline Safety Regulations and the HSE will not accept a safety case where no work is undertaken on these categories of pipe.

GDQ35. Where we have disallowed workloads, should we consider making corresponding adjustments to Opex costs? If so, how do you think this could be done?

Disallowing Repex has a direct impact on future Opex costs. There is a clear link proven and we have modelling to demonstrate the impact of our current disallowed Tier 2B and iron >30m workloads on repairs and associated costs. Any disallowance of Repex requires the Opex to be funded.

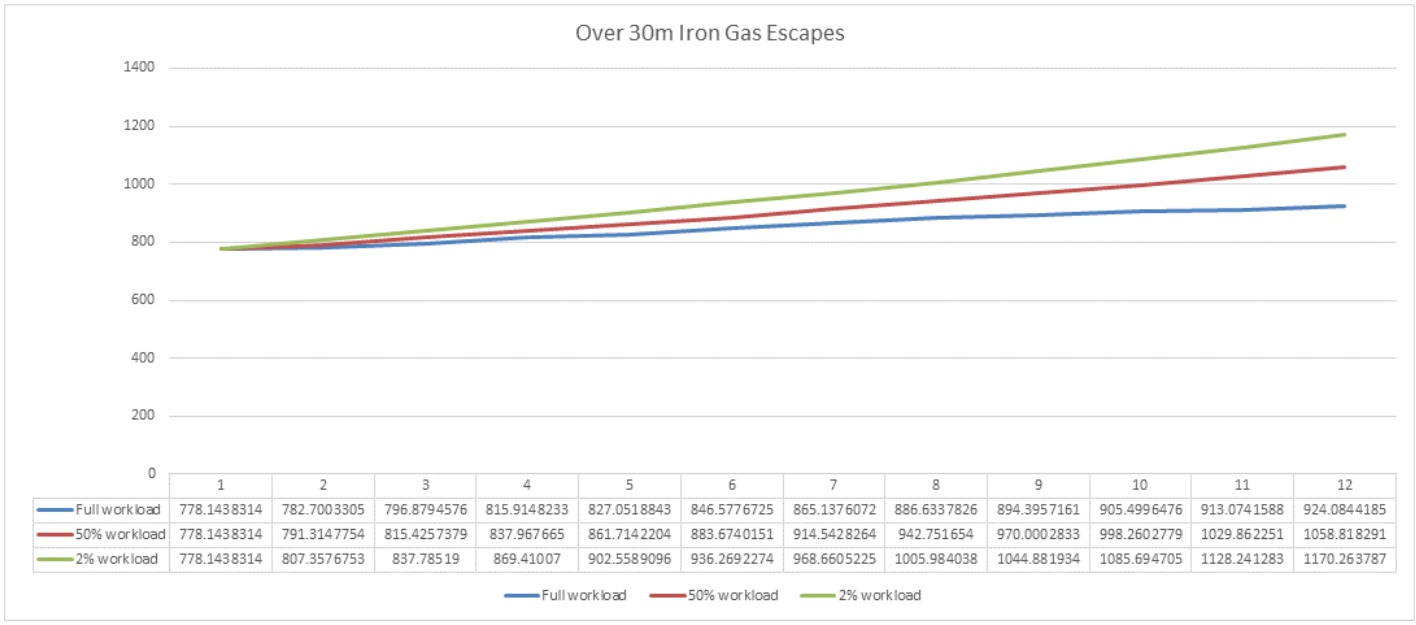
The following graphs show the impact of varying Repex annual programme lengths on repairs for Tier 2B and iron >30m.

Tier 2B



	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Zero Tier 2b	1526.788038	1574.931946	1625.51168	1678.503751	1733.902026	1791.709912	1851.939473	1914.611291	1979.75435	2047.405983	2117.611885	2190.426238
30km Tier 2b	1526.788038	1503.171226	1492.156928	1457.309613	1416.99552	1368.46446	1315.746604	1293.554442	1255.985865	1198.469037	1145.139574	1093.341842
20km Tier 2b	1526.788038	1523.072061	1521.736115	1504.885628	1506.128407	1502.138851	1502.198479	1485.818545	1490.067918	1475.229954	1469.347422	1446.857304
10km Tier 2b	1526.788038	1555.93283	1588.164573	1619.812714	1640.298987	1676.69196	1711.564445	1742.912173	1777.257102	1809.008366	1840.359397	1864.053588

Iron >30m



	1	2	3	4	5	6	7	8	9	10	11	12
Full workload	778.1438314	782.7003305	796.8794576	815.9148233	827.0518843	846.5776725	865.1376072	886.6337826	894.3957161	905.4996476	913.0741588	924.0844185
50% workload	778.1438314	791.3147754	815.4257379	837.967665	861.7142204	883.6740151	914.5428264	942.751654	970.0002833	998.2602779	1029.862251	1058.818291
2% workload	778.1438314	807.3576753	837.78519	869.41007	902.5589096	936.2692274	968.6605225	1005.984038	1044.881934	1085.694705	1128.241283	1170.263787

This analysis shows that the disallowed workload results in 1,340 additional repairs per annum by the end of the mandatory programme (2032). This causes significant disruption, Opex costs and emissions to atmosphere that prevent us from achieving Net Zero.

We have analysed the cost to consumer. Our planned repex programme for tier 2B and iron >30 would cost consumers circa £1.25 over GD2. The cost of repairs with no programme would cost consumer £5 over GD2. It is clear that the best outcome for customer bills is the allowance of our planned programme.

GDQ36. What are your views on our proposed approach to the synthetic cost driver for capex?

The connections and mains reinforcement synthetic unit costs are a reasonable approach and have not changed since GDPCR1. Providing the rest of Capex is removed for separate assessment then the costs are reflective of the driver.

Currently some of the other capex is represented by MEAV but these areas like property and tooling spend is not representative of the scale of assets in the network. These should be removed and separately assessed. We provided an appendix on the efficiency of our facilities and property costs as part of our December 2019 business plan.

GDQ37. What are you views on our proposed capex adjustments?

There are very few capex adjustments for WWU with the exception of IT which is a serious concern and is addressed as part of Appendices GDQ37A – Multiple IT project papers. Ofgem removed over 80% of our capital allowances for IT Capex based on a 'lack of evidence' from WWU. However, there was very little communication between BPs in December 2019 and DDs in July 2020 on this matter. We have been working with Ofgem to provide all relevant information to get the full allowance reinstated.

LTS pipelines has now been assessed separately and is subject to a PCD, given the large non- routine spend we agree this should be separately assessed.

Non-regression Analysis

GDQ38. Do you agree with our assessment of non-regression costs and our proposed adjustments?

We agree a number of areas should be separately assessed as part of the BP process where regression is not appropriate.

Of the separately assessed areas we disagree on the proposed adjustment for MOBs, we populated and provided evidence on our MOB investment but have had our allowances based on Cadent's rates. This is wholly inappropriate based on Cadent not completing the BPDT templates in full or their costs being representative of our cost base. We have produced a further evidence paper disclaiming these assumptions in Appendix GDQ38A - MOB Cost & Workload Justification Paper

Technically Assessed Costs

GDQ39. Do you agree with areas selected for technical assessment?

Yes, we agree with the non-routine and technical nature of the mainly engineering cost areas that are technically assessed. One area we believe should be technically assessed is IT Opex, currently IT Capex is technically assessed but this doesn't consider the Opex/Capex trade-offs in IT Opex relating to SAAS and more efficient whole life costs.

GDQ40. Do you agree with our proposed approach?

We agree specialist consultants should be assessing these costs however we would like more discussion on the impact of not allowing the work/costs and the implication on other cost areas in a timely manner between BPs and DDs. The short window for this DD response has meant we have not had sufficient time to produce a detailed review of all the technically assessed areas, considering this we will be providing further information for Smart metering for discussion in the next CAWG.

Disaggregation of allowances

GDQ41. Do you agree with our proposed disaggregation methodology?

The disaggregation is currently proportionate across all areas of Totex, the one issue with this is the level of efficiency is different for different cost areas. Currently Ofgem are only using the one Top down model, there are limits on how you do this disaggregation. If bottom up and Middle up models were used there would be a further detailed level to disaggregate on a more accurate basis.

We discuss this in detail in chapter 4 of Appendix GDQ26A - Cost assessment of Ofgem's RIIO-GD2 Draft Determinations (Oxera)

Inadequate Totex

In order to understand our rationale for the inadequate Totex we have added relevant references and comments. Some of these will need further discussion as part of the CAWG and we are happy to provide the evidential working files where relevant.

Shortfall	Area	Detail	DD Question Reference/appendix
£54m	Repex & Multi Occupancy Buildings (MOBs)	• Workload disallowed • MOB costs based on Cadent – further evidence to justify WWU cost base	• GDQ34 • Appendix GDQ34A – Mains Replacement justification paper • Appendix GDQ38A - MOB Cost & Workload Justification Paper
£35m	IT & Cyber security	• Further project detail and project by project plan • Detailed Cyber plans including risk appetite	• Appendices GDQ37A – Multiple IT project papers • Cyber Appendices • Q16A - Draft Determination Cyber OT Allowance Justification
£24m	Loss of metering & Smart metering	• Loss of metering not recognised as a separately assessed area • Smart metering to now be included in base	• GDQ40 • Smart metering uptake assumptions and calculation of allowances to be addressed in CAWG
£30m	Regional Factors	• Further evidence on the regional factors impacting Repex	• Appendix GDQ26A - Cost assessment of Ofgem's RIIO-GD2 Draft Determinations (Oxera) • Appendix GDQ33A - Repex Cost justification paper
£3m	Net Zero Pathfinder model	• Detail costings to enable us to roll out the pathfinder model to over 40 organisations	• Appendices Q37A - Whole system data and pathfinder CVP & Q37B - CVP Whole system data and pathfinder CVP model
£4m	Vulnerability	• Removed from Totex in error, to be added back in for FDs	• GDQ1
£22m	Efficiency challenge	• 1.2-1.4% is unjustified & unachievable	• Q11 • Appendix Q11A - RIIO-GD2 ongoing efficiency (Oxera) • Appendix Q11B - Frontier Productivity Growth (First Economics)
£22m	Benchmark position	• 85th Percentile not achievable	• GDQ27 • Appendix GDQ26A - Cost assessment of Ofgem's RIIO-GD2 Draft Determinations (Oxera)
£194m	**Totex**		

We have provided a walkdown of the additional costs discussed in this chapter versus the BP submission as Appendix Updated Totex summary.

4. Adjusting baseline allowances to allow for uncertainty

Response Summary

Please also refer to the summary to Section 4 of the Core Document.

- We support the reopener proposed on Tier 1 stubs, MOBs.
- The reopener on <7bar diversions should be extended to include >7bar.
- We are very concerned that Ofgem have rejected WWU's reopener proposal which poses an increased risk for distribution vs transmission (who have this included in their licence already).
- We support the volume driver PCD for connections.
- We propose that the costs of the Joint Office of Gas Transporters should be treated as 'pass through' in a similar way to the Xoserve costs.
- We support the continuation of the large loads re-opener subject to it being available for multiple projects that have unfunded reinforcement that collectively meet the threshold.

Introduction

GDQ42. Do you have any views on our common UMs that haven't been covered through any of the specific consultation questions set out elsewhere in this chapter? If so, please set them out, making clear which output you are referring to.

Please see our response to Section 4 of the Core Document.

GDQ43. What are your views on the proposed re-opener for Tier 1 stubs?

We are currently in negotiation with the HSE on treatment of stubs. Until these negotiations reach a conclusion, we do not believe it is appropriate to plan investment to remove these stubs. We therefore support a re-opener approach.

GDQ44. What are your views on our proposal to introduce a <7bar diversions re-opener?

We support the introduction of the proposed Repex Diversions re-opener which is to cover rechargeable diversions where some element has to be funded by networks due to statutory provisions for example Highway works under the New Roads and Streetworks Act; however, we propose that it is extended to include above 7Bar as well as these are typically the more expensive, although less numerous, rechargeable diversions. If this was done it would be consistent with the approach taken with Gas Transmission that also has an equivalent Pipelines Diversion re-opener in both GT1 and GT2.

The best approach is to combine the Repex Diversion re-opener and our proposed Quarry and Development Loss re-opener. Diversions due to development and development loss claims are two aspects of the same issue. Under standard easement terms WWU is usually obliged to pay compensation for the impact on the development, or any sterilisation of part of it and usually under those terms it can opt to limit compensation by choosing to divert a pipeline, WWU would normally choose the cheapest, or the most expedient option if available under an easement or through agreement with a landowner. Therefore, depending on the circumstances a claim could be brought under one re-opener or the other, this would also apply in the case of 'Lift & Shift' clauses. It is therefore more sensible to combine the two re-openers into one that combines the diversion / loss of development claims aspect as well as those diversions that cannot be charged to the requestor for various reasons.

GDQ45. What are your views on the triggers and windows for the MOBs safety re-opener?

We support Ofgem's proposals for the MOB safety re-opener.

GDQ46. What are your views on our consultation position to address bespoke decarbonisation of heat re-openers through our proposed innovation stimulus, Net Zero and Heat Policy re-opener mechanisms?

The support for WWUs NIA proposals is welcome which will ensure seed low-cost innovation projects is maintained. There would appear to be a gap between NIA funding average project value in GD1 of £0.1m and the SIF threshold of £5.0m.

The Net Zero and Heat Policy re-opener mechanisms also leave a gap for low cost, high value investment in the early 2020s - a critical time for UK decarbonisation of heat, power and transport. WWU response to Q.21 of the core document provides further detail.

GDQ47. What are your views on the questions set out in paragraph 4.57 of this document in relation to large hydrogen projects?

Significant progress is being made related to the case for hydrogen – being the lowest cost and least disruptive pathway for heat, power and heavy transport decarbonisation (ENA Pathways report; BEIS Hydrogen Programme Development Group [HPDG] reports).

The pathway for hydrogen is not one of silos – industry; heat; power generation; heavy transport, but one of an integrated whole energy system approach. The industrial clusters are increasingly being seen as the seed to kick start the hydrogen economy, providing demand for the government projects aimed at producing zero or near zero hydrogen. This will provide the opportunity to millions of buildings to decarbonise and provide flexible generation to back up renewable generation. Alongside this, the decarbonisation of heavy goods vehicles (HGVs), buses and train can begin.

The BEIS HPDG is delivering an integrated approach – linking with upstream production and storage and with the development of hydrogen appliances. The network development is essential to ensure these government supported elements can come to fruition and develop the hydrogen economy that many other countries are pursuing.

Hence, we believe that a coordinated approach to funding the innovation needed, followed by the engineering design should be funded via GD2. In addition, the construction of hydrogen infrastructure for the first areas for hydrogen roll out needs to be funded to achieve the demanding timescales set by the Committee on Climate Change. Five years is too long to lose without progress in this important area.

In the recently published National Grid ESO FES 2020, hydrogen is seen as a requirement in all three Net Zero pathways, and the HPDG is set to deliver this.

The current funding proposals do not support the government ambition to decarbonise the UK economy. For hydrogen projects the following is a broad outline of funding suggestions, using variations to the funding mechanisms proposed:

1. **Early stage conceptual work and feasibility studies**
   The Network Innovation Allowance would be a useful tool to kick start the process, learning from studies elsewhere in the country to avoid duplication.
2. **Research and development projects detailed by BEIS HPDG**
   The SIF mechanism would be most appropriate to progress the projects identified by the hydrogen programme development group.
3. **Engineering design of hydrogen projects**
   A modified Heat or Net Zero reopener would be best suited to propose network funding, socialised across consumers as this would be a whole system design, not just an industrial consumer solution.
4. **Construct and operate hydrogen systems**
   Bespoke funding depending on the initial scenario – short pipelines dedicated to a single/small cluster of local industry could arguably be funded solely by the customer, but risk being sized and operated in a way that would render them inefficient for other uses such as wider heat decarbonisation or flexible power generation.

More widely, the development, construction and operation could be through base allowances or through the late competition model, as long as the long-term view of whole system decarbonisation was met.

GDQ48. Do you have any other comments in relation to this section?

For our general response to the common design parameter of the Uncertainty Mechanisms please see our answer to Core Document Q12.

We also have a proposal regarding the treatment of the costs of the Joint Office of Gas Transporters.

Proposed pass-through of Joint Office costs
Standard Special Condition A12 of the GT Licence collectively requires the GDNs and National Grid Gas to provide joint administration arrangements to facilitate operation of the Uniform Network Code (UNC). The Joint Office provides this service and is resourced, funded and managed by Gas Transporters on behalf of all UNC Parties through Totex at a current cost of approximately £1.3m for 2020/21.

The cost of this service has risen steadily through the GD1 period and is now more than double the cost in 2012/13. This increase has been caused by increased demand on the Joint Office and has been funded by the Gas Transporters but we cannot support further increases in GD2 unless they are funded. We propose that the costs of the Joint Office of Gas Transporters should be pass through as is proposed for Xoserve costs. There are two reasons for this.

First, Joint Office costs are largely driven by the number of modifications raised and their complexity as this directly affects the number of meetings required and hence the resource required to support them; this is only partly controlled by the Transporters as Shippers raise approximately 50% of modifications (24 out of 45 in the year to June 2020). Some of the modifications raised by Transporters are driven by regulatory change such as faster switching that is also out of Transporter direct control.

Second, the BEIS / Ofgem Code Governance Review Consultation issued in summer 2019 contained some questions related to current operation of industry codes. We expected Ofgem's response to the consultation responses in to be published in January 2020 and to contain proposals related to moving Code Administrators such as the Joint Office to Code Managers. We therefore did not put this pass-through proposal into our business plan as we were awaiting Ofgem's decision.

We now understand that Ofgem do not see this review as impacting on current arrangements and that they would like to see Gas Transporters moving the Joint Office from its current Code Administrator role towards a Code Manager role without a regulatory decision. We are willing to facilitate this move to deliver customer benefit and better industry governance that parties to the UNC may agree to be beneficial as long as we are not exposed to the unfunded additional costs that we would incur if these changes were made under existing arrangements. One example of significant and uncertain costs that could materialise relates the possible move to bring the code of the Independent Gas Transporters (IGT) into the UNC. The benefit of this change will accrue to Shippers on IGT networks and IGTs themselves and will need to be driven by the IGTs but will result in costs for the Joint Office.

This has led us to propose pass-through for the Joint Office costs. Although this proposal is new, we believe that it is reasonable given what we see as a change of emphasis by Ofgem in this area of work.

We are keen to work with Ofgem to enable this to be included in the final determinations and together with the other Gas Transporters have already had some engagement with the Ofgem licensing team regarding future development of the Joint Office.

GDQ49. What are your views on our proposal to introduce a new domestic connections volume driver?

WWU support the need for a volume driver given the uncertainty around the future of domestic heat, especially given the proposal to not allow gas grid connections to new homes from 2025. We still await to see the full detail of this from BEIS.

Our stakeholders did not raise this issue with us but it does mean they will only fund the allowances for the workload we deliver in GD2 which is a positive outcome for bill payers. The volume driver allowance needs to be set for each GDN as each will have different methodologies to calculate the costs of the Domestic Load Connection Allowance (connections and first 10m in public highway as required under SSC4B Gas Transporters Licence). This cost will vary not only due to connecting mains diameter as suggested by Ofgem, but location of the main and 10m of pipe, reinstatement costs, traffic management / permit costs etc. A fixed allowance based upon our business plan workloads and costs would be simpler to administer and apply.

GDQ50. What are your views on our proposal to continue with the large loads re-opener?

The large loads re-opener proposed in the Draft Determinations would be more sensibly described as a “Unfunded reinforcement re-opener”. We support the continuation of this re-opener subject to it being available for a number of projects that have unfunded reinforcement that collectively meet the materiality threshold. We propose this for the following reasons.

We expect that most of the connections to our network will be for flexible generation to support de-carbonisation of the electricity system. All gas customers are also electricity customers.
Since submitting our business plan, it is clear that the likelihood of a single large power generation connection to our above7 Bar network is much lower than previously thought and it is much more likely that there will be multiple smaller connections to the below 7 Bar network. It is important we can aggregate multiple large loads connections which will then qualify in aggregate for this reopener mechanism.

In July 2020 Calon Energy called in Administrators, Calon Energy operates two Combined Cycle Gas Turbines (CCGT) in South Wales. The failure of Calon Energy indicates that the market for large CCGT electricity generation is difficult. If these generators do not re-open then the capacity is likely to be replaced by smaller flexible generation that is most likely to connect to WWU’s below 7 Bar network.

WWU has already connected 41 flexible generation sites to our network so most of the locations that do not require reinforcement have been used.

Under the proposal in the Draft Determinations the re-opener is in January 2022. A claim made in January 2022 will need to be prepared in 2021 which is the first year of the price control. This is too early, if as we expect, most connections are to the below 7 Bar network then these have shorter lead times than above 7 Bar connections and therefore we may need to make connections that have unfunded reinforcement after the date of this re-opener but well before the end of the price control.

We therefore propose that re-openers should be annual or every other year consistent with our response to Core Question 12. In line with our response to Core Question 12 we propose that the materiality threshold should be set at zero for this re-opener. Expenditure under this re-opener is driven by customer connection requests under Gas Act section 9. Where these are economical and efficient WWU has to connect them and if Economic Test results in network funded reinforcement WWU has to incur this expenditure. It is therefore unreasonable not to allow networks to recover all expenditure incurred and therefore the threshold should be set at zero.

Reinforcement spend is typically committed at least a year in advance and in some cases more than that and annual application window are particularly appropriate in this case to ensure that the network can recover its investment in timely manner. The proposed design only has one re-opener window in January 2022 and with this and investment committed to but not delivered by that date would not be recoverable until the end of the price control period.

GDQ51. Do you agree with our definition of a 'large load' to use for this re-opener?

We propose a slight change to the definition shown below.

"A connection to the network that has passed the Economic Test and requires Specific reinforcement expenditure upstream of the Connection Charging Point not rechargeable to the new loads of at least £100,000".

This enables the re-opener to be triggered by more than one connection that collectively require network funded reinforcement that sum to the threshold rather than requiring one large one to trigger the re-opener on its own. We believe that this is more appropriate given that we are likely to see a continued growth of smaller flexible gas fired generation to support de-carbonisation of electricity generation and the move to Net Zero. We believe the threshold suggested in our definition meets the intent of the re-opener and means that small value network funded reinforcement is not included.

GDQ52. Do you agree with our proposal to continue with a smart meter rollout re-opener?

We agree with the continuation of the smart meter roll out re-opener mechanism, given as GDNs we do not control the roll out or have any influence in these costs. Our main concern is the re-opener window, given the unknown nature of the meter roll out and customer uptake it would be unfair to only have one re-opener window one year into the price control. There should be a mid and end review window, or potentially an annual window, which would then capture any changes in timing and rate of roll out for energy suppliers.

GDQ53. Do you agree with our proposal to continue with a common streetworks re-opener?

We agree with the continuation of the streetworks re-opener; however, we disagree with the re-opener window being only one year into the price control. Given the nature of the new requirements, the legislation changes and the uncertainty of their impact we would propose a mid and end review window or potentially an annual window.

Wales & West Utilities

RIIO-2 Draft Determinations – Wales & West Utilities Annex

WALES&WEST UTILITIES

2. Setting outputs

Response Summary

Common Outputs

- We support the FPNES volume driver.
- We support the WWU interruptions target however we are keen that this is a national target to ensure all customers receive the same level of service.
- We support the driver for an Allowance Adjustment Mechanism on Repex PCD however think the 2% and 10% restrictions on allowances for mains and services respectively are too small with little flexibility to manage changes to the risk profile of pipes and changing stakeholder requirements.

Bespoke Outputs

- Whilst the WWU bespoke outputs where rejected, we were pleased to see that our GSoP proposals into revised common outputs for the GDNs, and the voluntary interruptions output will be measured by a reputational reporting across the GDNs.

CVP

- We are disappointed we did not receive a reward for our CVP.
- We are concerned that future commitments of some networks have not been checked against the current performance of other companies; an inconsistency of approach that could result in additional allowances for some and no allowance for others where the performance is already being achieved.
- We note the positive comments about our Pathfinder model - albeit no allowance or CVP reward was provided by Ofgem. Further evidence is attached to this response to demonstrate the benefit and achieve a reward/allowance.

Common Outputs

WWUQ1. What are your views on the values for the common output parameters we have set out in the WWU Annex?
Comments on the majority of these outputs are included in the Gas Distribution Annex questions above. Here is a summary plus any specific comments on our metrics for completeness.

FPNES - we are pleased to see a volume driver for the FPNES above our baseline target of 2,500 connections. This will allow us to fund connection for up to 7,870 homes. This will satisfy our stakeholders who had concerns about our ability to fund connections if schemes exist for funding the heating system through GD2.

Unplanned Interruptions - we are satisfied with our target of 14 hours. However, the application of GDN specific targets does create a postcode lottery of performance across the UK for customers. As discussed at early sessions of the interruptions working group, the right methodology would be to have a common GDN target for 'routine interruptions' and bespoke GDN targets for large incidents and MOBs which were reflective of the network and the MOB population in that GDN. If this is not changed, a reward should be applied for NGN and WWU for their commitment to delivering ambitious targets.

NARMS - We are broadly ok with the target set for NARMs. We do believe that following FPs we should run the allowed workloads through the official NARMs models to derive the final target for RIIO-GD2.

Repex: Tier 1 mains replacement - We are comfortable with the workloads allowed subject HSE allowing us to push dynamic growth into GD3. However the dead band of 2% is restrictive and we would suggest 5-10% as more appropriate. Current assessment of allowed costs indicate we have been allowed unit costs that we have never achieved. All indicators point to costs increasing. This is evidenced in our Business Plan chapter 16 'Distribution Network' and appendices 16A and 16B of the December submission. We have provided further justification on the inadequacy of the allowances for Repex in appendix GDQ33A – Repex Cost justification paper.

Repex: Tier 1 services - We are comfortable with the workloads allowed subject HSE allowing us to push services with dynamic growth into GD3. We do however believe the dead band of 10% is restrictive and we would suggest 10-20% as more appropriate. Current assessment of allowed costs indicate we have been allowed unit costs that we have never achieved. All indicators point to costs increasing. This is evidenced in our Business Plan chapter 16 'Distribution Network' and appendices 16A and 16B of the December submission. We have provided further justification on the inadequacy of the allowances for Repex in appendix GDQ33A – Repex Cost justification paper.

Capital projects – we support the proposed PCD for replacement of Pipeline HN039.

Bespoke Output Proposals

WWUQ2. Do you agree with our proposals on the bespoke ODIs? If not, please outline why.

Whilst all the WWU bespoke outputs were rejected, it was pleasing to see that the GSoP related ones fed into revised common outputs for the GDNs, and the voluntary interruptions output will be measured by a reputational reporting across the GDNs. This will ensure all GDNs are focused on the issue of minimising time off gas for customers and will pay the same level of compensation for poor service. We will work as part of the Ofgem Customer working group to refine these proposals and add the detail that is absent from the Draft Determination document.

The theft of gas bespoke output we proposed has been incorporated into the Totex Incentive mechanism in a simplified form that will encourage us to continue to do more to tackle theft of gas, noting that part of the benefit to customers will be spread over a longer period via slow money, but is disappointing that the additional costs we requested to embed full time resources to maximise the number of proactive investigations into our BaU was disallowed. We will continue to commit to the ICS service mark and BS 18477 Inclusive Service provision. This will help us to continually benchmark and improve our services to customers during GD2.

WWUQ3. Do you agree with our proposal on the bespoke PCD? If not, please outline why.

We are pleased to see the costs of the land remediation programme are provided in base allowances. This will satisfy our stakeholders and bringing contaminated land sites back into beneficial use for consumers and stakeholders.

Consumer Value Propositions

WWUQ4. Do you agree with our proposals on CVPs? If not, please outline why.

We are disappointed that having followed the late guidance on CVPs laid out by Ofgem in the Business Plan guidance that all our proposals were rejected. We believe that our models for the proactive work on theft of gas and the outcomes for customers for tackling fuel poverty and raising CO awareness were well justified and showed a large net benefit to customers of the investment we would make.

Additionally, Ofgem have not compared or checked the rewarded CVP commitments against the existing performance of other companies. NGN were given a CVP reward based on their commitment to improve response to repairs by the end of GD2; the level of their commitment is broadly aligned to what we've already achieved in 2019, the last full year's data available; yet no reward has been given to WWU for our BaU performance which is already exemplar.

When we questioned Ofgem through the Draft Determination Queries (DDQ) process as to whether we can now update our CVP to achieve the same reward as NGN, Ofgem told us this opportunity was no longer available. They pointed out they needed "to be fair and non-discriminatory, treating licences in an equivalent manner". However, not rewarding WWU is neither fair nor representative of consistent treatment.

Additionally, Transmission companies have been rewarded for maintaining and enhancing ecological diversify whereas our CVP was not rewarded.

Our CVPs were supported by our CEG, and the model and justifications were supported by Sia partners, the company Ofgem used to justify the continuation of the FPNES.

We welcome the feedback that with further evidence, a reward under the CVP and a base allowance could be available for the roll out of Pathfinder. Please note the Pathfinder was actually not consumer funded via NIA; this is wrongly referenced in the WWU annex by Ofgem; this project was predominately funded by WWU (90%).

We attach further evidence (see Appendix Q37A - Whole system data and pathfinder CVP) to support additional base costs and reconsideration of the CVP for the Pathfinder model and whole systems data sharing. In addition to improving the Pathfinder model and process to meet the minimum standards set out in Ofgem RIIO ED2 publication for Local Area Energy Planning. Our CVP Appendix Q37A - Whole system data and pathfinder CVP has been updated from December 2019 BP Appendix 2C19 following further work on stakeholder engagement on the Pathfinder model in RIIO GD2 to justify a base allowance of £3m and consideration for a CVP reward.

4. Adjusting baseline allowances to allow for uncertainty

Summary Response

- We do not agree with the rejection of our bespoke UM on the loss of land development claims; this increased risk for distribution vs transmission and presents an adverse impact on financeability assessment in GD2 without an uncertainty mechanism.
- We were grateful to the Ofgem team for a bilateral meeting to discuss this further.
- We have now provided significant supporting information and evidence to support the need for a reopener – see Appendices WWUQ6A -– WWUQ6C

Bespoke UM Proposals

WWUQ5. What are your views on the baseline values for the Tier 2A iron mains volume driver?

These values are not material for WWU, we are happy for this to be consistent with GD1 approach.

WWUQ6. Do you agree with our proposals on the bespoke UMs? If no, please outline why.

UM for Loss of Land Development Claims

WWU do not agree the rejection of our bespoke UM on loss of land development claims. WWU is seeking only to recover the cost of valid and efficiently incurred claims for compensation, or of the costs of diversion where land development claims are made by landowners. As these claims are uncertain both in terms of the volume of claims and the timing and value, WWU consider that a re-opener is the most appropriate mechanism to recover costs incurred by WWU. WWU are not looking for Totex baseline funding nor for any funding based on within period forecasts of claims.

Background

WWU has noted the response in the Draft Determinations and has provided the requested evidence that the level of and the materiality of claims is likely to rise in GD2. Like National Grid Gas Transmission, WWU has significant pipeline distances over rural areas and is therefore exposed to the same type of risks particularly claims for loss of development due to a number of ongoing and proposed developments that WWU expect to occur in GD2 on land crossed by our pipelines. WWU therefore think that the same re-opener should be available to WWU.

Local Plans and areas allocated for development in WWU area

WWU has over 35,000kms of pipe network, including over 2,300kms of high-pressure pipes and has the second longest LTS network length amongst all GDN's.

The table below shows Gas network LTS Pipeline lengths recorded in the UKOPA database. WWU assume that Company A is NTS and Company F is Cadent. This shows that WWU has the largest length of LTS out of four single network companies (the others being Scotland Gas Networks, Southern Gas Networks and NGN). This assumes that Company F is Cadent and that the average length of LTS length across each of Cadent's four networks is1330km.

Company A (km)	WWU (km)	Company C (km)	Company D (km)	Company E (km)	Company F (km)
7629.23	2359.275	1190.139	1358.334	1712.775	5320.359

Due to government policies aimed at increasing the number of new residential dwellings built each year (to meet a continuing rising demand and a historic shortfall in meeting that demand) throughout England and Wales, large areas of land have been allocated for development. As a consequence, WWU has significant exposure across a large area relating to thousands of easements for gas pipes in private land that have a variation of 'lift and shift' clauses ("Lift and Shift") or loss of development clauses ("Development Clauses").

The Local Plan process, is ongoing in each local planning authority area. Some areas will have current adopted Local Plans and some will be out of date and the new Local Plans will still be at the "draft" or "emerging" stage. However, in most local authority areas, it is possible for WWU to make an approximate assessment of the extent of new development land that has been identified within the area served by WWU and which might result in planning permission being granted and claims being made against WWU during GD2. There are 46 Local Planning Authorities in Wales and South West of England which has requirements for circa. 600,000 new houses within the Local Plan periods (see Appendix WWUQ6A - Provisional Housing Numbers - data analysed from 2018 however note that some Local Authorities have not provided any data and therefore the requirement is likely to be in excess of this). As well as housing, many of the larger developments will allow for community facilities such as schools, hospitals and medical centres, leisure and sports buildings and land, and will provide areas of retail, office and business uses. WWU also experience private landowners who wish to develop on their land.

Loss of Development Land Claims and Mitigation

Claims against WWU in this context will arise where a landowner is likely to obtain, or has obtained planning permission (either in accordance with, or notwithstanding the policies in the relevant Local Plan), but the permitted development cannot be implemented (or fully implemented) due to the presence of a gas pipeline. As a consequence, the value of the development land is normally reduced, or the viability or profitability of a development will be negatively impacted (which again is likely to reduce the land value). Such claims normally arise because of the terms of a Deed, which specifies the rights and restrictions associated with pipeline assets.

As explained in more detail in Appendix WWUQ6C - WWU Loss of Development Process, when the pipelines in WWU's network were laid, normally they were laid under the threat of compulsory acquisition, but in most cases, rather than going through the protracted process of compulsory purchase, rights to lay the pipeline were negotiated with the relevant landowners and Deeds of Grant were entered into. Normally, in order to defer (and avoid if the land never achieved development potential) having to pay a higher consideration for those Deeds of Grant and to avoid paying the "hope value" of the land with the benefit of a potential future planning permission, WWU or its predecessors paid a lower value consideration, but agreed either to include within a Deed of Grant a Lift and Shift, or a Development Clause.

Once planning permission is obtained, WWU's deferred liability for the loss of development value can no longer be deferred and depending on whether the Deed of Grant contains a Lift and Shift, or a Development Clause, WWU will need to establish whether a claim is valid and whether it will have to divert a pipeline, or pay compensation under a Development Clause.

In either circumstance, WWU can normally either limit compensation by choosing to divert a pipeline or, to avoid diverting under a Lift and Shift, by paying compensation. WWU would normally choose the cheapest, or most expedient, option if available under a Deed or through agreement with a landowner.

Compensation takes into consideration the loss of development value due to the presence of the gas pipe and restrictions relating to the easement, building proximity distances or HSE Land Use Planning zones (PADHI). The landowner is required to mitigate their loss and WWU actively enters into dialogue and work with the landowner to reconsider their design and layout to allocate permitted areas such as roads and open space to the areas close to or over gas pipes.

In terms of quantum of the compensation payable under a Deed, this varies depending on the type of pipe e.g. high pressure, the area of land sterilised by the pipe, the length of pipe affected, the value of the land with the proposed development the date the Deed was entered into and the specific wording of the Deed. For example, whether the Deed refers to the date of Deed or the date of planning permission being granted as the valuation date can be a significant factor in determining the level of compensation which is payable.

Known Development Clause Claims

WWU has a number of known claims which it will have to manage in GD2 where there is a potential material quantum element involved, either in terms of compensation or the cost of diversion (if that option is available) or the cost of diversion arising from a Lift and Shift scenario. WWU anticipate that any liability arising for these known claims and potential future unknown claims will fall within GD2 and possibly GD3.

An anonymised summary of the known potential claims which WWU is monitoring and/or managing and is currently in the region of 20, claims presented as being over £50,000. The anticipated quantum for those being presented in respect of those claims together with the potential diversion costs are set out in Appendix WWUQ6B - Loss of Development Claims currently being monitored.

The following factors set out below have increased the expected impact of loss of development claims on WWU in GD2 compared to GD1. Uncertainty is inherent in the wording in the Deeds covering pipes in our network. The reasons for the uncertainty, WWU believe, are generally the same as those experienced by NG NTS:

- Between 2005 and 2012, WWU experienced some development claims though they were limited in number due to the property recession. However, with a return to increasing values and due to central government pressure on local authorities to increase housebuilding, the pressure on brown and greenfield sites has increased which has led to a number of development claims recently being raised against WWU;

- The size of average developments is also rising, and with larger developments, often on the edge of existing urban areas, the chances of interactions with existing utility infrastructure meant to supply those urban areas, increase;

- The cases generally progress slowly, and this has been the case for GD1 however, there are a number of claims which WWU expect to be presented and/or resolved in GD2;

- More former coal sites industrial sites are being redeveloped, traditionally these have a Lift and Shift clause. This is a particular issue in South Wales. In addition, across the whole of the WWU area sites are being developed which were in the previous ownership of Network Rail, the Canal and River Trust, the Duchy of Cornwall and Crown Estates which traditionally required Lift and Shift clauses when they entered into Deeds;

- Government and Local Authorities continue to pursue a national house building initiative with recent Government announcements of large areas of housing earmarked for development with changes being made to the planning system to make applications quicker and more straightforward;

- There is pressure of development in green belt agricultural areas where WWU's pipes are located. Many areas selected for pipeline development were historically safer areas for utilities and development was considered unlikely for the foreseeable future. However, as Local Authorities revise Local Plans and Governments change strategy (see above), the risk profile changes for these areas over time with higher chances of planning being granted for development;

- Mitigation and re-design of scheme by landowners to accommodate the pipeline asset and easement strip/restricted zone is always the focus but in some instances, it is just not possible to re-design a scheme to avoid any loss of development value. If a re-designed scheme is not of equivalent value to the permitted development, then Development Clauses are normally triggered; and

- Landowners are generally more aware of the potential claims available to them under a Deed and are more inclined to pursue such claims with specialist land agents increasing their focus on this area.

Actions taken by WWU to minimise impact of claims
As part of our internal governance procedures, WWU seeks to be proactive and will consider potential developments which may be highlighted to members of the Estates, Asset or Plant Protection teams through developer contact or local planning development knowledge. WWU also review the status of Local Plans from Local Planning Authorities to identify areas of land allocated for future development including large housing developments and commercial developments to be developed in the future. Our internal process for dealing with loss of development claims is set out at Appendix WWUQ6C - WWU Loss of Development Process including a flowchart process in Table 1. WWU will continue to follow this process during the GD2 period.

As set out in Appendix WWUQ6C - WWU Loss of Development a cross team group expend significant resource on dealing with this type of claim and external experts are retained when necessary at an early stage with the key aim of minimising the impact, the costs and resolving the claim. On a monthly basis, representatives from Legal, Asset and Finance meet to discuss any progress in respect of all development claims.

Design of re-opener
In the light of the evidence provided which supplements the summary and evidence WWU included in Chapter 12 of our Business Plan (page 107-109) (Dealing with uncertainty) WWU request a Quarry and Development Loss re-opener using the wording in National Grid Gas' Special Condition 5E that is proposed to continue in GT2. Although in GT2 this will not include crop loss and drainage claims as these will be included in NTS baseline funding in GT2, it will cover our main risk arising from successful loss of Development Clause claims. To facilitate the easy implementation of this re-opener WWU is willing to accept the parameters of the NTS re-opener though WWU draw attention to our proposals on re-openers in general in our answer to Core Question 12.

Summary
Due to the large areas of land allocated and being considered for development WWU anticipates a significant increase in the number of Lift and Shift and Development Clause claims that it will need to deal with in the next 5 years and further into the future. Based on the current claims, WWU has good knowledge of what it will face in GD2 and the level of probability and exposure to these claims is high with no mechanism of covering the risks which are inherent within Deeds. In addition, WWU has the added risk of uncertainty with claims which are not on its radar being received with little or no advance warning.

5. Innovation

WWUQ7. Do you agree with the level of proposed NIA funding for WWU? If not, please outline why.

We agree with the level of funding proposed for WWU based on the evidence we provided, i.e. at a similar level to GD1. However, it should be noted that the NIA process for GD2 Net Zero projects will be highly collaborative and other GDNs have hydrogen innovation projects that are closer to fruition than in WWU. Therefore, WWUs proposals were based on the use of the shared learning acquired from those projects. It will clearly be important that the earlier stage hydrogen proposals are funded in line with the BEIS hydrogen programme development group.

Wales & West Utilities

RIIO-2 Draft Determinations – NARMs Annex

WALES&WEST UTILITIES

3. Baseline Network Risk Outputs and Baseline Funding

Response Summary

We have been working alongside Ofgem and the other GDNs for many years to develop NARMs (previously known as NOMs) which is a sophisticated tool for asset health and risk management. However, the planned usage for GD2 is no longer appropriate and there are some fundamental changes to the sharing mechanism being introduced which have not been previously discussed or consulted upon which seriously restrict our ability to respond to customers and stakeholders throughout GD2.

Our views in summary are as follows:

- NARMs is a well-developed 'risk management' tool; however, it's not fit for purpose as a 'delivery' tool. Its complexity restricts our ability to consult with consumers on the benefits.
- The new NARMs sharing mechanism introduced without consultation (5%:95% to consumers); removes any stimulus to innovate and restricts our ability to adapt to stakeholder requirements.
- NARMs models were re-issued multiple times; we are therefore concerned around the quality of these models and question the level of assurance sought by Ofgem.
- NARMS is now incredibly complicated; we need to ensure the effort is proportional to the value which don't believe is currently the case.

Costs Associated with Baseline Network Risk Outputs

NARMQ1. Do you agree with our proposals on the scope of work within each of the NARM Funding Categories and on the associated funding arrangements?

NARMs (Formerly NOMs) was developed by network companies under the direction and support of Ofgem, as a tool to assess the health and associated risk of our asset portfolio and to enable the evaluation of the benefit of asset investment on health and risk. This enabled us to:

- share with consumers the benefit of investment and the value of the spend
- risk trade to respond to changes in stakeholder requirements, changing risk profiles across asset groups and innovate to deliver risk targets in a more effective and efficient way

This has served consumers, Ofgem and the networks well in GD1, improving Asset Management, CBAs and as a medium to share knowledge across the gas and electricity networks.

We have concerns that we have moved significantly away from the original aims of NARMs and the metric will no longer deliver against the original objective. NARMs is no longer a 'risk management' tool; it's now a workload delivery tracking tool which is not fit for this purpose as it was never developed with this aim in mind. Its complexity restricts our ability to consult with consumers on the benefits of investment.

Ofgem's proposal to take some assets and some asset investments outside of the NARMs assessment seriously reduces the ability to use NARMs as a tool to assess total asset risk across asset populations and respond to changing requirements. It makes risk trading a negative concept where in reality it is a key component for successful asset management.

We do however agree that load driven investment should be outside of NARMs as it is customer driven and outside of the control of the networks.

4. NARM Funding Adjustment and Penalty Mechanism

Calculating NARM Funding Adjustments and Penalties

NARMQ2. Do you agree the funding adjustment principles and our proposals for applying funding adjustments?

We agree with the principle that both consumers and Network companies should not benefit or be penalised from factors that impact NARMs outside of asset interventions.

The new NARMs sharing mechanism introduced in DDs (5%:95% to consumers) with no prior discussion or awareness causes us concerns. We are concerned that this new mechanism does not feature in any of the core documents and first visibility is in the NARMs annex. This significantly reduces the likelihood of stakeholders picking up on this mechanism and subsequently providing their feedback through the DD consultation process.

The adjustments to TIM, from a sharing factor that favours Networks to one that is nearer 50:50 is a significant change that ensures networks and consumers equally benefit from networks delivering outcomes and outputs at lower cost. We do not understand the driver for an additional bespoke sharing mechanism for spend associated with NARMs. This removes any stimulus to innovate and restricts our ability to adapt to stakeholder requirements. This also introduces significant data submissions and analysis that are not proportionate to the relatively low levels of spend that are now associated with the asset investment monitored under NARMs – circa £20m per annum for WWU.

We also understand that this was introduced following analysis of electricity transmission data and we are concerned this is not reflective of an equivalent analysis of GDN data if it was to be carried out. Ofgem's concern that networks will move away from our business plans to an investment plan of only low cost interventions is unfounded. This goes completely against asset management principles, safety legislation and executive oversight from the HSE.

NARMQ3. Do you agree with our proposed approaches to calculating funding adjustments and to application of penalties?

We are supportive that networks should be penalised for failure to deliver NARMs commitments. The balance of penalty and reward, and likely outturn on penalty or reward, has now majorly skewed towards penalty - yet Ofgem acknowledges in its Draft Determinations Overview document that customer satisfaction is at a 'record high' and 'GB has one of the world's most reliable and safest energy systems'.

It seems that the effect on networks for all the effort to deliver these positive outcomes is that now they are more likely to be penalised than rewarded.

In GD1, the mechanism is symmetrical between the GDN and customers, i.e. we keep 63% of underspend and pay 63% of overspend. Under the new proposals, we keep 2.5% of underspend and pay 50% of overspend which seems very disproportionate.

A major concern is that Ofgem reserves the right to decide investment was either justified or unjustified at the end of GD2 under a criterion that is not clearly defined. Asset Managers could make decisions throughout GD2 with Ofgem overriding those decision in a close out process. This introduces significant risk to network companies and introduces Ofgem as the asset managers in the investment process. Clarity is therefore required upfront on the criteria Ofgem will use to assess investment.

NARMQ4. Do you agree with our proposals in regard to requirements for justification cases?

We are supportive of the requirement for networks to provide a commentary of our investment delivery and to provide further justification where NARMs is over or under delivered. Our concern is there is little visibility or working examples of the process and criteria Ofgem will apply to evaluate the justifications. We would like to work examples through with Ofgem prior to FDs to ensure we have a robust process for assessing asset investments decisions.

Wales & West Utilities

RIIO-2 Draft Determinations - Gas Transmission Annex

WALES&WEST UTILITIES

GTQ1. Do you agree with the outputs package that we are proposing for the GT sector?

Response Summary

- We agree the efficiency of the total (distribution and transmission) system could be improved to an extent by enhanced obligations.
- The current frameworks (UNC and NGGT Methodologies) will need to be updated to remove some of the current inefficiencies in the booking processes e.g. User Commitment.
- We propose a licence obligation on NGGT to develop frameworks that promote Total System efficiency including for Flat, Flex and AOP.

The enhanced obligations framework as described in the draft determinations formalise the general processes we undertake in order to determine the NTS Flat and Flex capacity and pressure requirements at each of our Offtakes and the discussions we have with NGGT and other networks.

We agree that a whole systems approach with obligations on both GDNs and NGGT should achieve more efficient operation of the Total System and welcome the balance of inputs being required by both parties.

However, the current UNC and NGGT Methodology process for capacity booking and allocation do not, in our view, offer the most efficient framework for bookings to take place. In addition there are no means of raising modifications for the NGGT methodology statements and the current drafting of special conditions 9A and 9B do not recognise the Enhanced Capacity Obligations or the benefits for whole system efficiency that could be delivered through due discrimination for GDNs.

We have previously raised a number of concerns around capacity booking arrangements and the impact they have on efficiency of the Total System. For example, we raised concerns and offered some alternative approaches for some aspects of User Commitment via UNC Mod 0671 and before that we responded to the consultation on the Exit Capacity Methodology statement in May 2017; however, nothing of substance has resulted from these discussions.

User Commitment in its current form may sterilise NTS capacity unnecessarily where Users are obligated to retain capacity bookings for 4 years which they would otherwise release.

In the case of GDN offtakes, the costs associated with User Commitment are passed to downstream customers which may result in one set of consumers within the GDNs subsidising consumers who are connected directly to the NTS and are able to have more choice in how NTS Capacity is booked.

We withdrew UNC Mod 0671 on the basis that these issues would be covered via the NTS Access Capacity Review group UNC 0705R which we welcomed and have fully supported.

We hope that the Enhanced Capacity Obligations and a clear steer in NTS' licence conditions to develop frameworks that promote Total System efficiency including for Flat, Flex and AOP products would encourage progress of UNC 705R in a manner which sees significant improvements in arrangements for coordinated and efficient use of network capacity across GDN and NTS systems.

When making bookings for capacity we must consider our current and future 1:20 requirements and any risks associated with releasing capacity (flat, flex or pressure) which we may not be able to recover. Flat capacity may be subject to substitution to meet requirements at other NTS offtakes and we are not guaranteed to be able to recover Flex Capacity or Assured Offtake Pressures at a later date, because these are made available at NTS' discretion. These restrictions will inhibit some of the intentions of the enhanced capacity obligations as we currently understand them.

Following our bilateral discussions with OFGEM on the 10 August we now understand that the intended scope of the Exit Capacity Enhanced Obligations may necessitate revisions to the UNC and Capacity methodologies referenced above and delivered under NTS' licence conditions in order to encourage more efficient booking processes for networks whilst ensuring our 1:20 obligations are protected. We don't think this is clear from the current drafting of the enhanced obligations and propose specific licence obligations are placed on NTS to ensure the frameworks are updated to deliver more efficient booking processes for GDNs that delivers economic and efficient operation of the Total System not just the NTS.

We welcome the opportunity to discuss the draft determination proposals at future workshops and will provide further feedback at that time.

List of Appendices

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Summary	Analysis of the RIIO-GD2 Draft Determinations (Incentives)
Summary	Analysis of the RIIO-GD2 Draft Determinations (Uncertainty Mechanisms)
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Gas Distribution	Appendices GDQ37A – Multiple IT project papers
Finance Annex	FQ10A - AR vs ER (Frontier)
Finance Annex	FQ1A - Review of Ofgem's DD additional costs of borrowing, and deflating nominal iboxx (NERA)
Finance Annex	FQ34A - RIIO-2 prior year adjustments (First Economics)
Finance Annex	FQ7A - Cost of Equity Update (Oxera)
Finance Annex	FQ7B - Oxera (2020), 'Response to the CMA on estimating RPI-adjusted equity market returns'15 April
Finance Annex	FQ7C - Oxera (2020), 'Is aiming up on the WACC beneficial to customers', prepared for Heathrow Airport, 7 April
Finance Annex	FQ7D - Oxera (2020), 'What explains the equity market valuations of listed water companies' 20 May
Finance Annex	FQ7E - Oxera (2020), 'Estimating debt beta for regulated utilities', 4 June.
Finance Annex	FQ7F - Oxera (2020), 'Are sovereign yields the risk-free rate for the CAPM'20 May
Finance Annex	FQ7G - Oxera (2019), 'Review of RIIO-2 finance issues Rates of return used by investment managers', 6 March
Finance Annex	FQ7H - Oxera (2019), 'Risk premium on assets relative to debt', 25 March.
Finance Annex	FQ7I - Oxera (2019), 'Review of RIIO-2 finance issues The estimation of beta and gearing', March
Finance Annex	FQ7J - Oxera (2019), 'Estimating RPI-adjusted equity market returns', 2 August
Finance Annex	FQ7K - Oxera (2019), 'Assessment of political and regulatory risk', prepared for National Grid Group, 4 March
Finance Annex	FQ8A - ARP v DRP (Oxera)
Gas Distribution	GDQ14A - Addendum to Environmental Action Plan
Gas Distribution	GDQ26A - Cost assessment of Ofgem's RIIO-GD2 Draft Determinations (Oxera) (CONFIDENTIAL)

Gas Distribution	GDQ33A - Repex Cost justification paper (CONFIDENTIAL)
Gas Distribution	GDQ33B - WWU_SQ_CA_10 Attachment
Gas Distribution	GDQ33C - Mains Replacement Cost Model Overview
Gas Distribution	GDQ34A - Mains Replacement justification paper
Gas Distribution	GDQ34B - Updated CBA Analysis - Tier2 B
Gas Distribution	GDQ34C - Updated CBA Analysis - Irons & >30 metres mains"
Gas Distribution	GDQ37A - GDQ37 XXXX multiple project papers
Gas Distribution	GDQ38A - MOB Cost & Workload Justification Paper
Gas Distribution	GDQ38B - MOB Scope of Works - Upavon Court Penhill Drive Swindon. SN2 5HD
Gas Distribution	GDQ38C - TSP-IGEM-20-138 G5 Ed3 6th Working Draft after Comment
Gas Distribution	GDQ38D - Note to IGEM TCC re TCO.EFV End of Network 2020.06.29(JO)
Gas Distribution	GDQ38E - Note to GTDC - Building Regs & External Risers
Gas Distribution	GDQ38F - Draft_Building_Safety_Bill_PART_2
Core document	Q11A - RIIO-GD2 ongoing efficiency (Oxera)
Core document	Q11B - Frontier Productivity Growth (First Economics)
Core document	Q16A - Draft Determination Cyber OT Allowance Justification
Core document	Q21A - Support for Net Zero related investment in RIIO-2 (Ernst & Young)
Core document	Q37A - Whole system data and pathfinder CVP
Core document	Q37B - CVP Whole system data and pathfinder CVP model"
Summary	RIIO2 Process Concerns
Wales & West Annex	WWUQ6A - Provisional Housing Numbers
Wales & West Annex	WWUQ6B - Loss of Development Claims currently being monitored (CONFIDENTIAL)
Wales & West Annex	WWUQ6C - WWU Loss of Development Process (CONFIDENTIAL)