

Appendix 1: Response to Cross-sector questions

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1 Overview

Electricity North West Limited (ENWL) is an electricity Distribution Network Operator (DNO). We recognise that Ofgem is “*not consulting on proposals for the next electricity distribution price control at this stage*” (paragraph 2.30). However, we are mindful that Ofgem has also indicated that measures with the current consultation “*may be capable, in principle, of application for ED2*” (paragraph 2.31). As Ofgem has not stated which measures may be applicable to a DNO, we have sought to focus our response on those areas where we foresee Ofgem might consider there may be potential applicability or where we, as stakeholders to other network licensees, are able to contribute to the development of the controls. Absence of comment in relation to a given area does not imply ENWL is in agreement with any given position or that we deem it suitable for applicability to electricity distribution.

Increasingly the controls for each sector need to be set mindful of the growing level of interactivity of solutions to meet consumers’ needs between sectors as whole system thinking develops. This response to the cross sector appendix should be read in conjunction with our RIIO-2 sector specific cover letter.

2 Introduction

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

As set out in our covering letter, we consider the wording in paragraph 2.20 to be inherently unclear. It appears that what Ofgem is suggesting is that it will develop a discretionary mechanism enabling further changes to be made to a licensees’ price control decision after having reached its final determination in circumstances where a licensee successfully appeals one or more aspects of that decision to the CMA. So, for example, if the CMA were to find that Ofgem had erroneously

disallowed £10m and made a consequential £10m increase to the licensee's allowed revenues to correct the error, the mechanism might be deployed to enable Ofgem to deduct £10 million elsewhere so as to 'maintain a coherent regulatory settlement'. If this is what is envisaged, it is entirely wrong for the following reasons:

- The appeals regime is not there to safeguard a 'settlement in the round'. Its purpose is to allow licensees to seek redress where Ofgem has made errors so as to allow for necessary corrections to be made. This is consistent with the EU Third Energy Package requirements that Member States "*ensure that suitable mechanisms exist at a national level under which a party affected by a decision of a regulatory authority has a suitable right of appeal to a body independent of the parties involved and of government.*"
- The CMA's powers in determining price control appeals are broad and include quashing the decision, remitting the decision back to the authority for reconsideration and determination in accordance with any directions and substituting its own decision for that of the authority and making any such directions as are necessary. It is therefore for the CMA to determine whether consequential amendments are required to the price control decision when correcting the error(s) and not for Ofgem, which must act in accordance with the CMA's determination including any directions.
- The fact that there may be a need to have regard to making adjustments to other aspects of the price control decision when correcting certain errors was expressly acknowledged by the CMA in the RIIO-ED1 appeal by Northern Powergrid. In its Final Determination, the CMA stated that it may, in some circumstances, be necessary to take care that overturning one aspect of a complex regulatory decision does not have knock-on consequences for other, unappealed aspects of the Decision (para 3.49). This is not about re-balancing a settlement but ensuring that appropriate corrections are made.

It would be very concerning if Ofgem considered it could deploy 'discretionary measures' to alter licensees' price control decisions post any successful CMA appeal in the manner which appears to be envisaged. We therefore cannot see any merit in Ofgem further pursuing this proposal. Alternatively, should Ofgem continue to pursue this proposal, it must provide further details to allow for meaningful engagement on the issue, including explaining the legal basis that Ofgem is relying on.

3 Giving consumer a stronger voice

We support giving our customers a stronger voice in developing business plans and holding us to account for delivering against these. To this end, we have proactively set up our Customer Engagement Group to critically advise us so that we ensure our customers appropriately influence our plans. This should result in Ofgem and our customers having full confidence in our proposals and promote and enhance the legitimacy of the RIIO price control framework.

4 Reflecting what consumers want and value from networks

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

No. It is not clear to us what extent North West energy consumers have been involved in considering the three new output categories. We do not think the output categories capture the full range of outputs consumers require.

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

We do not agree with the proposed output categories and wrote to Ofgem in November 2018 in response to the draft Business Plan Guidance setting out some thoughts in relation to these. We do see merit in consolidating the current output categories in terms of outcomes but think it will be challenging to map the activities, allowances and incentives we deliver against the categories as proposed by Ofgem. We propose our output categories for RIIO-ED2 should be informed by the detailed customer engagement we are undertaking to inform our plan.

As set out in our November 2018 letter, we believe that the following outcome categories would more accurately reflect the role of network companies in RIIO-2 and what our customers and stakeholders are looking for us to deliver during ED2:

1. Maintain a safe, reliable and efficient network, continuing to act in the public interest
2. Respond to our customers, including those consumers who find themselves experiencing a time of vulnerability
3. Adapt our network to meet the changing needs of our customers, recognising the importance of flexibility, capacity provision and access
4. Transition our network and our team, meeting the challenges facing our customers today and tomorrow
5. Ensure our financial foundations are sound, delivering at an efficient cost to our customers and maintaining our attractiveness to investors and lenders.

In particular, the role of network companies to act in and on behalf of the public interest is missing from the outcomes proposed in the consultation document.

The customer outcomes should include finances, both in terms of the cost to serve our customers and what that means in terms of regulatory finance. As a network operator, we are required to make trade-offs between all of these outcomes, including costs and financing, and we believe that according all of these the same status will increase the transparency regarding decision making, by Ofgem and the licensees, and increase understanding of the decisions made by licensees.

Should Ofgem continue with the three output categories it currently proposes then this should be reviewed ahead of applying Ofgem's proposed outputs to electricity distribution's RIIO-2 price control.

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

At a simplistic level, we do believe the distinction between licence obligations, price control deliverables (PCDs) and output delivery incentives (ODIs) is useful. We recognise that some areas may require a combination of obligations, PCDs and/or ODIs as noted in paragraph 4.25.

With electricity distribution not being considered at this time, we are unable to comment in detail as to the application of these categories to ED2. The division of mechanisms between the categories and the subsequent regulatory treatment is important to ensuring the intended behaviours materialise and a broad understanding of how Ofgem intends the framework to be applied is desirable before customers, stakeholders and companies develop their business plans.

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

Incentive mechanism benefits to companies should be based upon the consumer benefit derived from the incentivised outcome. If there is a dynamic approach to target setting where discovered improvements are more rapidly consolidated into tougher targets then the quantum or benefit available under an incentive over a 5 year price control will be lower. All else being equal, this is likely to reduce the amount of investment that can be funded by a given incentive mechanism as the payback period is shortened, leading to lower consumer benefit in the relevant price control period.

If having shortened the price control to 5 years and reaffirmed its intent to take the most recent benchmarks into account when setting targets at the start, Ofgem is more concerned by sustained performance under incentive mechanisms than there may be some potential merit in introducing dynamic approaches to incentives. In such an instance, dynamic incentives can only effectively work where the parameters that allow these incentives to be dynamic can be transparently set in advance and allow licensees to assess business cases for investment. As such, we see potential benefits in the use of dynamic-absolute incentives where changes within the incentive are based on a company's own performance and where the incentive is mechanistic in nature, allowing for a reliable estimation with regard to potential reward or penalty.

Whilst we can see potential benefits in using frontier performance to establish stretching targets at the start of price controls, we do not support the use of relative incentives within period. As previously stated, relative targets between licensees significantly increase the uncertainty associated with such incentives making it much more difficult to develop a business case to justify the necessary investment as one cannot predict the behaviour of others. Consequently, as a result of increased risk through an artificial state of competition being created overall customers may actually see an erosion in their benefit. In any event relative incentives may be very complex to effectively calibrate as companies may start at justified but potentially very different absolute incentivised positions due to for example their operating area characteristics. Similarly, they may face different levels of challenge making improvements going forward due to exogenous factors that would need to be corrected for.

Whilst Ofgem may consider price controls on a sectoral basis as this is less time consuming than reviewing licensees one at a time, licences are modified on an individual basis and we believe licences, once modified, should be able to 'stand alone' and not depend on variables from other parties.

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

We strongly agree that network operators should be able to develop and propose bespoke outputs to respond to the stated needs of their customers and stakeholders and that these should be subject to scrutiny from the Customer Engagement Group and RIIO-2 Challenge Panel. Even within outputs that are proposed for electricity distribution as a whole, we believe it is appropriate that the mechanisms should reflect the specific priorities of the customers whose needs they are responding to.

As previously set out, in order to ensure the legitimacy of the RIIO-2 controls and the role of customers and stakeholders in shaping these, it is essential that due regard is given by Ofgem to the regional sensitivities and the contributions of customers and stakeholders to licensees' plans. This is particularly important as Ofgem has rightly challenged companies to get customers and stakeholders more involved in shaping RIIO-2 so there is a need to allow this input to flow through ultimately to Ofgem's decision making.

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

The needs and requirements of customers and stakeholders should be the primary consideration when assessing proposals for bespoke financial ODIs. Whilst we understand Ofgem's comments in paragraph 4.43, we believe it is essential that neither Ofgem nor network companies attempt to limit the development of these where they can support the requirements of customers and stakeholders and result in additional consumer benefit.

5 Enabling whole system solutions

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

We do not see this as a problem as such rather an opportunity to be developed to deliver improved outcomes for customers as the energy system decarbonises and believe Ofgem have not articulated a significant problem within the consultation. The word problem implies something is not working adequately and needs to be changed, whereas the RIIO framework has a proven track record of delivering benefits for customers. The industry has been looking wider than sector specific for some time now, and for Ofgem to formally consider enablers and incentives to bring whole system solutions into the price control framework is the logical next step. We see the remainder of RIIO-1 as a preparation stage to allow companies to learn how we can develop systems, processes and engagement approaches in order to harness the benefits of collaboration, wider thinking and use of technology enablers as they become available. It is key that the RIIO-2 framework enables whole system to be taken forward with appropriate incentives, an investable regime and funding of new activities to make this happen for consumers.

Whilst we recognise that there is already good quality and effective coordination between electricity network parties which is increasing in prominence and maturity with the creation and ongoing work within the Open Networks project, we do agree with Ofgem on the four areas identified within section 5.10 as potential blockers to achieve greater levels of co-ordination.

There are three other areas that need to be considered as potential blockers, some of which may be more easily overcome than others.

The first being potential limitations that may exist due to electricity and gas being covered by different Acts of Parliament and whilst this is not an area we have explored to date, we would suggest that is an area to be further reviewed to ensure that this does not cause unintentional barriers.

The second is around the difference in time periods of network companies price control start dates, with electricity transmission, gas transmission, gas distribution and electricity system operator having an effective commencement date of April 2021, whilst electricity distribution is two years later commencing April 2023. When seeking to apply price control framework solutions to some of these issues, it is important that consideration is given to the fact that electricity distribution will be working to a different framework for 2 years of the 5 year RIIO-2 period, and therefore there will need to be transitional arrangements put into place to ensure that this sector is not left behind, and is adequately incentivised to contribute to whole system thinking in the way that other network companies will be. Uncertainty mechanisms will need to be flexible to accommodate this difference in timing and is covered more in our answer to questions CSQ11 though 18.

The third is the need for DSO defined responsibilities to be developed ahead of the T2 and ESO price control to ensure that network companies are clear on their responsibilities and accountabilities at the boundary of the distribution and transmission networks.

Finally, other than the necessary technology, data interfaces and other enablers, we see one key enabler missing in the plans at present, which is the existence of a whole system CBA. Without this, there is no ability to quantifiably conclude that the solution is the most efficient for the whole system. As part of taking a whole system view, consideration should be given to the carbon impact of decisions. With increasing levels of low carbon generation, reducing losses and promoting energy efficiency of customers' equipment has the potential to reduce the marginal generation plant requirements which is increasingly more carbon intensive than alternatives. To this end, we believe that network companies should be required to consider an end-to-end carbon reduction strategy as part of investment decision making.

We envisage this will result in changes to the CBA model currently used by DNOs (and we presume other network companies) to take account of potential whole system costs and benefits of the proposed options. Examples of areas that we believe should be included are

- impact on system losses;
- enhanced VoLL;
- holistic transmission benefits;
- beyond meter benefits, such as those seen in Smart Street; and
- public safety.

Care should also be taken when benchmarking companies' proposals, cheap for one company, may not equate to cheap for the whole system and different whole system solutions should be compared through the same assessment lens of a suite of costs and benefits.

Where a network operator can demonstrate a positive benefits case then we propose that funding is made available through appropriate allowances and/or uncertainty mechanisms to allow timely deployment of solutions.

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

As we stated in our response to the July 2018 framework consultation, we believe that the electricity distribution to electricity transmission interface (including the system operator) should be the focus for the RIIO-2 period ie a Whole Electricity System. This is in line with the proposed RIIO-ED1 and T1 definition which was recently consulted on and we feel is appropriate for the period up to 2026.

Similar conclusions can be drawn in the Gas sector, with benefits being mainly derived by closer co-ordination between the gas distribution and gas transmission companies.

As we explain further in CSQ10 whilst we believe the most appropriate focus for RIIO-2 is for electricity distribution to electricity transmission, we suggest that the price control should enable the ability to consider the extent to which closer working between electricity and gas is necessary and addressing any barriers which may exist.

We are actively exploring the extent of whole system gas issues as we have reached out to the monopoly gas distribution operators in our area to understand any interactivities between their customers needs reflected in their RIIO-GD2 plans and those of our customers when we come to develop our ED2 plan. Work through the ENA on common reference scenarios is also informing our thinking as to the extent of cross fuel whole system issues.

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

We agree that in the longer-term the interaction across vectors, particularly gas to electricity, and potentially wider still will become increasingly important. Two key drivers will be as government policy on heat reaches a conclusion, and the decarbonisation of transport continues in order to meet the UK's carbon objectives. Whilst we see the decarbonisation of transport being primarily an electricity impact at present for passenger cars and vans, the decarbonisation of heat and the decarbonisation of larger goods vehicles brings both gas and electricity into play together. We also recognise that there may be benefits for the future regulation of heat to ensure ongoing consumer protection.

There is no doubt that these external impacts need to be factored in to companies' plans, and cannot be treated in isolation. Naturally other vectors have an impact on electricity and gas in terms of demand, growth and potential time of usage. Building these into the common reference scenario is a way of factoring these other vectors into companies plans without broadening the definition too much in the early days and therefore allowing companies to more organically evolve through innovation and the learnings of network to network working.

Either way the RIIO-2 price control does need to be flexible enough to allow companies the flexibility to enable changes which may not be at the pace or scale originally expected in order to deliver customer and stakeholders wants and needs and it is good to see this need for flexibility being recognised by Ofgem including by considering uncertainty mechanisms potentially with volume drivers.

Whilst we would expect to see work developing during the RIIO-2 period to investigate and develop the coordination and engagement in readiness, we feel that broadening scope beyond our narrow focus of Whole Electricity System would be unlikely to generate significant consumer benefits until the RIIO-3 start period of 2026 onwards.

The Open Networks project has set up workstream 4 as "Whole Energy System" in early 2019. We suggest this is the vehicle to investigate and establish activity to focus on where such a broader

scope would provide benefits. The output of this workstream should help inform Ofgem's view of Whole System for the RIIO-2 period and consider which timelines/regulatory periods are most appropriate for broadening the definition wider.

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

We have responded to questions CSQ11 to CSQ18 together.

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

We have responded to questions CSQ11 to CSQ18 together.

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

We have responded to questions CSQ11 to CSQ18 together.

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

We have responded to questions CSQ11 to CSQ18 together.

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

We have responded to questions CSQ11 to CSQ18 together.

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

We have responded to questions CSQ11 to CSQ18 together.

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

We have responded to questions CSQ11 to CSQ18 together.

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

We have responded to questions CSQ11 to CSQ18 together.

Possible Mechanisms

We fully agree with the established principle of incentivising companies for the benefit of customers and that these incentives should be fair and proportionate. Incentive mechanisms need to be fully aligned to customer needs.

Business plan incentive

As we explain in our response to CSQ65 we believe there continues to be merit in incentivising ambitious and cost effective business plans as this should be in customers' interests. However, we see some challenges in introducing a business plan incentive/penalty based on the strength of whole system thinking in the business plan.

Timing – there are two timing aspects to consider. The first is the practical aspect of tranche one companies' ability to comprehensively include whole system thinking within their business plans which are due for submission in December 2019, given the expected decision on definition is likely to be May 2019. There is limited time for customer and stakeholder engagement of the quality that will truly inform companies' plans and allow them to build in evidence-based benefits other than those already in train through existing processes. These are likely to lie in the Transmission/System Operator and DNO sphere driven through Open Networks and the NOA process. The second is the timing difference of electricity distribution to other sectors going through RIIO-2. It is likely to be difficult for Ofgem to ensure it can assess the strength of whole system thinking in a business plan, and consumer benefit, when a key corresponding geographic or vector network submits their plans two years later.

Role appropriateness – at a point in time where the transition to DSO continues to evolve and the Future Worlds direction of travel is yet to be decided upon, there is a risk that companies include in their business plan activities that may yet change and be concluded as appropriate to another parties role. This may be seen as a company or sector being ambitious to get on and deliver against a need whereas in fact it may ultimately not be in consumers' best interests because better whole system solutions may emerge, such as from ED stakeholder and consumer engagement and associated business plan development.

Competition versus collaboration – Business plan incentives can be an effective information revealing device, encourage ambition; and lead to companies presenting their most efficient and innovative view. This is generally done at a company level and by its nature has a competitive element which can be effective in generating benefits for customers. The overarching ethos on whole system thinking is collaboration and stakeholder engagement for overall consumer benefit, and is at odds with a competitive pot proposed for good plans under the business plan incentive.

We also consider how a business plan incentive specifically looking at whole system ambition can interact with the totex incentive mechanism and resulting sharing factor and ensure that if established the two are clearly indicated by Ofgem how they interact and are designed to compliment rather than conflict with each other, i.e. an ambitious whole system based plan may appear less efficient in cost assessment than other plans which may generate a business plan incentive for ambition, but may result in a lower overall sharing factor based on cost assessment. This risk may cause companies to be more cautious in their ambition in order to secure a higher percentage sharing factor.

With the above challenges in mind, we support a more "traditional" business plan incentive mechanism that assesses the full company business plan on all aspects and is not focused on one specific area. Companies undertake a breadth of activities, and many, such as faults or maintenance will remain a sizeable portion of companies costs, and have limited, if any, crossover into whole systems. This business plan incentive should be supported by clear guidance and assessment criteria.

Innovation

We provide more detail on our views on Innovation within our response to the questions in Chapter 8 (CSQ 44 to 64) however in summary whilst we agree that more innovation should take place as a

BAU activity we do not believe that developments through BAU will be sufficient to deliver the transformation likely to be required to facilitate the transition to the low carbon economy that our customers and stakeholders are indicating is a priority for them. Given the indication by Ofgem of RIIO-2 being a “tighter price control” companies are likely to need more incentives and funding to allow them to invest in research and development for benefits coming from a broader definition of whole system that may not result in benefits directly to them or to consumers within the regulatory time period.

Therefore whilst it is appropriate and indeed necessary that the innovation stimulus package allows for innovation projects with a whole system focus to be eligible for funding, we do have concerns that the overall innovation package should not restrict projects to only those aligned with selected strategic challenges. This could have a negative result of restricting the breadth of work being considered and may stifle innovation in other areas as new customer needs and potential solutions emerge.

Such innovation focus would need to be considered within the framework of the broader innovation stimulus package to ensure that such focus is complementary and provides companies with sufficient clarity and flexibility.

At present we expect the whole system opportunities to be greatest between electricity transmission and electricity distribution activities. Therefore we consider separate gas and electricity innovation strategies continue to be appropriate at this time. However both these should include innovation to investigate potential whole system solutions between gas and electricity solutions.

Coordination and information sharing incentive

There are two funding elements associated with ensuring effective and beneficial coordination and information sharing.

The first is one-off set up costs which may be required to enable effective processes and systems. The benefits of establishing these could be substantial versus the potential loss of opportunity if not adequately funded. We suggest that companies incorporate any of these costs in their business plans and are funded under baseline allowances which we would expect to be incurred mainly in the early part of the price control period. This does leave a challenge for the electricity distribution sector who would not have the benefit of this until two years later than the other companies which in turn may cause misalignment and delays to benefits unlocking. Hence we propose a logging up mechanism is put into place for electricity distribution for 2021-2023 to ensure that the development of systems and processes needed to mirror ESO activities to deliver consumers benefits are not unnecessarily delayed by the difference in price control start dates. The logging up process can be incorporated into the setting of the next price control for ED2 and can inform the development of enduring ED2 allowances.

We also support the principle that for business as usual coordination, this should be funded within baseline allowances, however recognise that new activities for DNOs as they evolve to DSOs and in turn create further opportunities for collaboration with transmission and the system operator as well as market flexibility procurement, that such systems and processes are adequately provided for within baseline allowances.

The second is as whole system solutions are considered more commonly during RIIO-2 there will be a necessary additional cost to companies for options assessment and feasibility studies that will lead to overall consumer benefit. At present it will be difficult to predict at what level and where the costs will fall for these activities and therefore an upfront allowance potentially combined with a mechanistic volume based funding driver for options analysis for a range of projects appear the two

most relevant options presented within the consultation. We consider the project specific revenue stream less relevant.

It is important that the costs and any incentive is proportionate to the benefit potential for customers to justify such payments to companies however in principle we are supportive of these options and look forward to seeing these develop further.

We note that Ofgem refer to a minimum level of performance required before a symmetrical penalty is applied. We are cautious of the impact of applying a penalty regime into a new business area, and propose that for new activities such as these with potential sizeable consumer benefits an incentive only regime is more likely to generate the behaviours required than the application of a symmetrical incentive/penalty regime.

Balancing financial incentives between traditional and whole systems behaviour

We agree that the totex incentive mechanism is a significant incentive to ensure networks run their systems efficiently. Electricity North West continue to develop systems, processes and new options in order to embed whole system thinking within our operations, however accept that there may be the risk that the totex incentive mechanism alone may not be sufficient in fully ensuring whole system solutions are embedded into companies businesses.

By companies having different TIM percentages (sharing factors) and dependant on whether outputs lie in their or others price control, mean that relying on TIM alone may not be an appropriate way of ensuring whole system behaviour in RIIO-2. It is therefore important that these particular range of options are assessed to ensure that the entire RIIO-2 framework acts in a way to ensure balance and that sharing factor differentials don't create a risk of distortions to consumer outcomes. Having a clear whole system CBA approach used by both distribution and transmission companies is a way of addressing this concern about differential sharing factors because the CBA approach would provide a layer of governance and assurance as to which solutions go forward.

The options presented all merit consideration and taking each in turn:

1 - Refining or formalising funding routes – whilst the use of directly remunerated services can be used as a tactical solution for RIIO-1, we do not see this as a long term solution on its own for RIIO-2. However refining and formalising the routes is a positive step so we propose this is further investigated. Clarity on the appropriate use of BSUoS, TNUoS and DUoS is also required as the funding routes currently pre-determine which customers pay for what element of the electricity system. Transferring these across licensees bring this question to the fore.

2 - Establishing mechanisms to redefine or transfer outputs between licensees – it seems logical to apply the principle that the accountable party (in terms of licence obligation or traditional output owner) holds the funding, the output and therefore the risk. Should the licensee identify or have proposed to them an alternative method of delivery that provides a whole system solution, then the licensee should enter into appropriate arrangements with the delivery party to realise these benefits for consumers.

Transferring of funding and outputs may bring an unnecessary layer of complexity, and therefore if this is to be considered for further development, it would need to be a more mechanistic process to allow discrete elements to be transferred, rather than a broader re-opening of aspects of the price control.

Equally, by transferring all the funding, there is no clear financial incentive for the transferring party, and the delivering party, whilst now bearing the risk, also bears the opportunity for efficiency via

TIM which will also then be shared with their customers. Should this be a transfer from the SO or TO to the DNO, then consideration also needs to be given to the customers who will pay/share the benefits, as the difference between DUoS, TNUoS, BSUoS customers to be considered.

3 - Ensure regulatory incentives support beneficial outcomes – we see one of the principles missing in this section is the sharing of any outperformance to the enabling parties in order to truly incentivise companies to not only share information and coordinate, but to actively engage in seeking alternatives to deliver a planned or forecast need.

The Transmission System Operator working with the emerging Distribution System Operator functions is ideally placed to oversee decision making along with a layer of independent scrutiny as we proposed in the case of DNO/DSO decision making on load related reinforcements.

On balance it may be more practically effective to take a hybrid approach which is a combination of the first and third proposals and is described below.

A combination of the utilisation of DRS (or a similar concept) for the delivering company to ringfence costs and revenues, in conjunction with a sharing of an element of the efficiency outperformance would be an appropriate incentive, and mean a more equitable share of benefit for both the instigator and facilitator.

Illustrative Example:

Company holding funding and output – sharing factor 55%

Whole system solution identified and delivered by another licensee

Customer receives benefit of outperformance 45%

Holding company and delivering company share 55% equally

The other models considered may result in either one or the other company benefiting from the out-performance despite both companies collaborating to seek the optimal outcome for consumers.

Ensuring the framework is able to flex to meet whole system needs

There is no doubt that the RIIO-2 period has a range of uncertainties and whole system solutions are one of these known uncertainties. It is therefore appropriate that the price control is designed with this in mind and is flexible enough to address these as they arise.

Electricity North West are also mindful of the regulatory burden that this may entail, particularly as the price controls for electricity distribution start at a different time to the other RIIO-2 companies, and the ESO is proposed to have a 2 year cycle with a 5 year planning horizon. There is a risk that both companies and Ofgem are in a perpetual round of reopeners and price control processes. Volume drivers may be an alternative solution in some cases, however a more permanent option to be explored for future price controls would be to consider alignment of electricity distribution to the other network companies in due course and particularly electricity transmission at the next opportunity.

We propose that flexibility is built into the price control where appropriate, and expenditure that may be facilitated elsewhere is not locked in so that customers can benefit from solutions available at the point of decision making. The proposals in balancing financial incentives does bring the risk that companies may forecast traditional solutions for all known projects, and when whole system solutions may be identified in period, companies gain the benefit, along with customers through TIM.

For projects not identified in companies business plans that arise in period, a coordinated reopener is appropriate. There are arguments for different windows due to companies price control start dates, however it is highly likely that whole system solutions will generally cross either the distribution or transmission boundary and therefore a reopener at the start of RIIO-ED2 and the start of RIIO-3 are the most appropriate times, ie 2023 and 2026. At the time of setting price controls, these solutions should be automatically incorporated into companies business plans. Materiality for reopeners whilst in place for good reason are sometimes a challenge, and may need to be considered in this specific case to be reduced in order to prevent deferral to the next business plan cycle due to the materiality and regulatory burden involved in submitting a reopener.

A more mechanistic funding mechanism could also be explored, for example where there is a known business need, but also a known potential alternative form of delivery so that this can be more mechanistically delivered without the need for a reopener. Eg reactors to manage voltage levels – we know we will need to deliver x, but x may be delivered by the DNO.

Whole system discretionary funding mechanism

The use of the words discretionary funding has caused a little confusion over the intention of this option, as the description implies discretionary funding as a reward, as opposed to how it is explained which is for delivery of projects which emerge during the price control which were not originally factored into companies plans.

It is unclear how this, reopeners, transfer of outputs and innovation funding all may interact with each other, or whether they are stand alone either/or options.

We consider that appropriately designed uncertainty mechanisms (including reopeners), together with balance of incentives should be adequate, and that no further discretionary funding mechanism is required.

6 Ensuring future resilience

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

We agree with this approach, although suggest that Ofgem need to be mindful of the relatively limited scope to which the monetised risk approach applies in some sectors. As noted in the document (section 6.22), asset management works outside the scope of NARMs will need to be subject to separate funding, assessment and output arrangements.

We also suggest that Ofgem should be cautious in making monetised risk comparisons across sectors as we are aware that the associated risk methodologies differ significantly in their detail.

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

Ofgem's proposals are not sufficiently clear to us as set out in this consultation. Drawing on wider discussion we are assuming that a 'relative' measure of risk refers to the amount of risk reduction

over the five years of the price control occurring as a direct result of qualifying interventions for a given funding level, then we agree with this proposal as it ties the quantified output (i.e. volume of risk reduction delivered in 5 years) more closely to the associated allowances.

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

We suggest this proposal needs careful consideration and is fraught with complexity. We agree that investment proposals need to be assessed in the context of their long-term benefit, and this is what the CBA model attempts to facilitate. However, there will need to be careful assessment on a sector-specific basis as to the extent that the monetised risk approach and CBA model are consistently calibrated against each other. We understand that this is not the case for the GD & T sectors, and that this will require further work for ED ahead of the ED2 control.

The implication of the proposal is that each component of the NARMs plan will effectively be subjected to a CBA. We would welcome further clarification from Ofgem as to the level at which they see the CBA approach being applied within RIIO2 as we have previously understood that Ofgem wish to simplify the CBA requirements.

Clear guidance will be required as to how to calculate the lifetime value, against what baseline assumption and over what period amongst other things. Benefits would also need to be measured at the point of intervention and not subjected to hindsight assessment. This guidance will need to be provided early in the process ahead of business plans being developed to avoid rework of investment planning and repeats of customer and stakeholder engagement.

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

We generally support the proposals, although we note that NARMs is a relatively narrow interpretation of asset 'resilience' and that appropriate consideration will also need to be made of resilience to extreme events such as flooding, storms, Black Start. We do not believe Ofgem has considered these aspects in its proposals to date.

We also note that willingness-to-pay is frequently difficult to ascertain with regard to a relatively abstract non-service measure such as monetised risk.

Any benchmarking across licensees in this area will be dependent on 1) a consistent application of NARMs scope, 2) appropriate consideration of qualifying expenditure and 3) consideration of risk factors outside of the NARMs methodology. These will all need to be reviewed ahead of ED2.

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

We are concerned that this could become a very complex area, in the face of Ofgem's drive for simplicity. We need to see more detailed specific options though we already consider the existing High Value Project (HVP) mechanism covers off much of this risk adequately for ED2 and should be retained, subject to a discussion on appropriate qualifying thresholds and confirmation of the proposed ED1 Closeout arrangements in this regard.

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

We are concerned that under-delivery is assumed to be punitive, unless a company can prove to the otherwise. Whilst we agree that the risk targets should be set on a relative basis, their achievement should be reviewed cognisant of changes in the overall risk position (e.g. through the impact of other investment, changes in data), otherwise a licensee may be incentivised to deliver outputs no longer required due to the potential consequences of punitive action.

Similarly, we suggest that over-delivery should not be unfairly penalised, particularly if considered in the context of overall allowance outperformance.

In both cases, an appropriate dead band will be required to ensure that complex closeout processes are not required for minor variations against target. These closeout processes also must be defined from the outset of the price controls.

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

We believe that these arrangements may work adequately in the current ED context, however this relies on robust definitions of qualifying and non-qualifying expenditure. Further work will be needed to develop any ED approach as part of that price control development.

We propose adjusting the current expenditure categorisation to more clearly differentiate that expenditure incurred on assets qualifying under NARMs, and also to more clearly credit interventions primarily aimed at mitigating the consequence of failure, as opposed to the probability (i.e. replacement and refurbishment). This should build on any work in this regard completed as part of the RIIO-ED1 Closeout process.

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

The ring-fencing of qualifying activity and expenditure for NARMs appears to work well in ED1. There is a well-established practice through the RIGs of reporting all risk movements and only crediting the appropriate qualifying ones towards achievement of the NARMs target.

The High Value Project (HVP) mechanism is an appropriate way of ring-fencing large projects and removing their potentially distorting effect from an overall NARMs measure. This mechanism also allows for the definition of an appropriate Price Control Deliverable for the project.

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

We recognise the benefits of companies including a sustainable workforce strategy within the Business Plans, although think further clarity is required in terms of what this should include as it is currently not defined either within the Consultation document or in the Business Plan Guidance that has recently been consulted upon.

We are sharing some initial thoughts on what a sustainable workforce strategy for ENWL as a DNO will need to reflect. These factors such as the changing demands on the business as it facilitates the transition to a low carbon economy, including the requirements that emerge from the development of the DSO model and factors like changes in attrition rates as colleagues seek to move more within and beyond the sector may be relevant for transmission and gas distribution.

Based on our knowledge, it is difficult to specify a range of measures at this time that could be used to hold companies to account. We therefore suggest that a requirement to report on progress against the strategy as part of consolidated annual reporting to Ofgem and to our customers and stakeholders seems to be the most appropriate approach, whilst recognising that this will evolve during the ED2 period. Given Ofgem's proposals to reduce the number of incentives, we are unsure what is envisaged by the reference to an incentive is within para 6.64.

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

We agree with this proposal.

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

We agree with this proposal, as these costs should be reasonably foreseeable for those qualifying sites known at the time of submission.

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

We agree with this proposal as our experience is that these requirements have changed a number of times previously and could potentially expose licensees to significant additional costs within period, particularly if the associated compliance dates also fall within the period. In line with the approach adopted for ED1, we would expect there to be a low, if not zero, materiality threshold applied to a reopener of this nature as it is outside the scope of control for network companies.

Conversely, we would expect that any sites for which funding has been secured that are subsequently removed by government would be subject to a return of allowances under a reopener.

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

We suggest that there is a combined window for all licensees around the middle of the combined RIIO-2 period (i.e. 2021-2028), in 2025. This would allow for a single re-opener across all sectors which would be particularly useful in the context of sites shared between TOs and DNOs.

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

This is a reasonable starting proposal but further work will be needed on the associated definitions which must be workable. We wish to continue working with Ofgem to understand the implications for ENWL and our customers.

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

This appears appropriate but suggest that more clarity is needed about what would / would not be included within the scope of the allowances.

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

We agree with this approach which should cover big ticket items or where costs are sufficiently uncertain. We suggest that the current materiality threshold is probably too high and should be reviewed for this area. A mid-point reassessment may be useful as technology is moving at a rapid pace in this area.

7 Managing uncertainty

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

We have responded to questions CSQ35, CSQ36, CSQ37 and CSQ38 together.

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

We have responded to questions CSQ35, CSQ36, CSQ37 and CSQ38 together.

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

We have responded to questions CSQ35, CSQ36, CSQ37 and CSQ38 together.

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

We have responded to questions CSQ35, CSQ36, CSQ37 and CSQ38 together.

There appears to be some logic in Ofgem's current proposal. However, given the scope for potential changes in this area over the coming years, we anticipate more detailed consideration being given to the treatment for real price effects and similar measures as part of the ED discussion.

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

The current use of operating demands in electricity distribution networks is based on the principle that an asset operates at its peak capability for a period of time whilst the majority of times the asset is operating below its maximum operating capability. The cycle of heating and cooling of assets is a recognised characteristic and means that the maximum operating capability is higher than a continuous rating due to latency of the asset. There are very few assets in the distribution network where the utilisation is 100% i.e. it is used at its capability continuous through time. Where this occurs, the peak demand that an asset is capable of operating at is limited as the thermal latency of an asset can be used in defining its operating regime. In most cases, the operating demands on our distribution network assets are utilised at around 50% to 60% (of its capability) and therefore there is significant available distribution network capacity for customers to use. Our Capacity to Customers project showed the potential for much of this capacity to be used by customers willing to enter into flexible contracts. This has now become the normal operating regime for much of the network where assets are operating close to capacity.

Where additional capacity is needed, we consider a capacity uncertainty mechanism would be more appropriate than a utilisation incentive. For example, whilst DNOs can aim to maximise the use of assets, ultimately customers choose where to connect and under what terms. Addressing the inherent uncertainty is more material than a notional asset usage metric. Such a mechanism could require the network operator to publish available capacity metrics, persuade customers, through tariffs, to make use of this available capacity and to publish utilisation metrics for key assets. However once capacity is used, efficient creation of additional capacity is essential. This type of mechanism complements the totex incentive mechanism as, instead of proposing to develop the network or fund flexible services to mitigate bespoke reinforcement needs, it drives the network operator to shift demand and/or generation to use the network when there is available capacity. It does not drive opposite behaviours for asset health indices, but close monitoring of operating regimes and asset health indices would be required to ensure that the quality of service standards to customers are maintained, not reduced. We trust these insights from a distribution perspective are useful.

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

We are supportive of your proposals to require additional evidence to be gathered for any anticipatory investments. In RIIO-ED1, we have introduced into business as usual an evaluation process for all investments; this process, defined as our Real Options Costs and Benefit Analysis

(ROCBA) approach, was developed under a NIA project and it evaluates traditional and alternative solutions, including market solutions like demand side response or flexible services, against a backdrop of our five demand scenarios (also developed as part of a NIA project, called ATLAS). Our journey to develop this into a probabilistic CBA will involve creating the necessary functionality in preparation for RIIO2. We do believe that robust planning coupled with such a probabilistic real options evaluation approach can ensure efficient delivery of capacity (via DSR or assets) just in time for customer needs.

When considering proposals for anticipatory investment, we expect Ofgem to consider the extent to which such proposals have been shaped and challenged by customers, as well as local and regional stakeholders, and views from the Customer Engagement Group or User Group on these proposals. This approach will ensure that network companies are well placed to facilitate growth aspirations at a regional level, whilst ensuring plans are within the bounds of that which customers are prepared to support.

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

When developed and utilised properly, a probabilistic CBA may reduce the need for all but the most highly anticipatory investments because the probabilistic CBA will assess the uncertainty risk and give a proposed investment decision. There are strong drivers in the RIIO framework, through the various incentive mechanisms, that limit the opportunity for truly anticipatory investments. Where an investment is highly uncertain the CBA should propose the option of delaying or taking the first least regrets step. The issue of timing is the key determinant – there are two examples that highlight this timing issue; a large network development takes several years to deliver and so we have to start work prior to the uncertainty reducing to an acceptable level so it is delivered in time; and the second case is where a widespread change, through lots of small interventions, is anticipated over multiple years and in multiple locations which could not be delivered when required if all work was left until the need was certain. In both cases this can be managed through a least regrets approach within a CBA. Therefore Electricity North West is not convinced there is a need for developing a risk sharing approach for anticipatory investments.

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

We have answered questions CSQ42 and CSQ43 together.

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

We have answered questions CSQ42 and CSQ43 together.

In the event that a high-value anticipatory investment was being developed, we expect Ofgem to have a significant level of oversight of such a project through a mechanism like Strategic Wider Works or companies regulatory reporting mechanisms as to the approaches being developed to compete projects of a high-value or similar. As such, we believe it is likely to be appropriate for any variation to the standard risk-sharing approach to be developed as part of this interaction and specific to the project in question, rather than as part of the RIIO-2 Framework.

8 Driving innovation and efficiency through competition

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

Electricity North West agrees that more innovation should take place as a BAU activity. An appropriately set totex incentive mechanism should drive network operators to seek opportunities for incremental innovative improvements that streamline existing approaches, delivering benefits for customers, stakeholders and shareholders. This is particularly true for developments with high Technology Readiness Levels (TRLs). We consider that if network companies are certain that a project will work then it cannot really be regarded as innovation.

However, we do not believe that developments through BAU will be sufficient to deliver the transformation likely to be required to facilitate the transition to the low carbon economy that our customers and stakeholders are indicating is a priority for them. The level of change required for electricity distribution carries with it a level of risk that contrasts with the low risk framework Ofgem has indicated that it is seeking to implement for RIIO-2. As such, mechanisms will continue to be required to enable DNOs to trial solutions to respond to these challenges as they arise.

RIIO-1 innovation stimulus recognises that not all innovation will be successful, indeed the recent history of projects funded through this framework demonstrate that important lessons can be learned from these failures. We are concerned that the proposed changes will result in projects, particularly those anticipated to deliver operational and maintenance improvements, might not be funded, especially where there is a high level of uncertainty of success.

There is also a further risk in pushing innovation to BAU that the current dissemination requirements would then not apply. The current approach means that all customers have the potential to benefit from innovative improvements. However, a more limited regime has the potential for improvements which could benefit all customers being retained by individual network operators for commercial advantage, especially in the event of intensified competition through relative and/or reputational incentives being introduced.

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

It is finely balanced whether or not it is appropriate to remove the IRM for RIIO-2. In a shorter period, we see reduced requirement for a mechanism of this nature and we recognise the relatively limited use made of the mechanism during the longer RIIO-1 period. However, given the transformative change facing the electricity distribution sector, it is possible that unanticipated disruptive technologies may become available during the period that cannot be funded through other mechanisms. Maintaining some flexibility to allow network companies to respond to such developments could be beneficial to avoid the need to delay adoption until RIIO-3. Especially as including the IRM in RIIO-2 is relatively low regulatory burden since it has been developed and already implemented in RIIO-1 therefore both companies and Ofgem have experience of it. Even though it hasn't been used that often in RIIO-1 to date, we believe IRM has generated substantial consumer benefit against the cost of operating it though this would be something relevant for Ofgem to assess before taking a decision on the future of this mechanism.

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

Electricity North West has concerns restricting projects to those aligned with selected strategic challenges may stifle innovation and restrict the breadth of work being progressed that may limit potential responses to the complex and rapidly evolving transition. The proposed narrow, more focussed approach has the potential to increase coordination but will ultimately prevent groundbreaking innovation from receiving funding. This concern is supported by our experience from the latest joint call for NIC ideas, which has highlighted a diverse number of projects worthy of funding, and there is a risk that this approach could be lost in RIIO-2. Whilst we recognise that the strategic challenge will be reviewed on a regular basis, this may not be sufficient to outweigh the potential consumer detriment.

We believe NIC projects already demonstrate a high level of collaboration with third parties and Electricity North West is currently actively engaged with a number of DNOs delivering on these projects. Whilst we recognise the wider benefits of the collaborative approach advocated by Ofgem, there are challenges at present for multi licensee projects, principally that current governance requires one network company to lead a project, which effectively relegates any others to project support.

We support splitting projects by stage gating them to enable early-stage research and development (limited deployment, prior to later-stage demonstration and deployment trials) but are concerned that this could result in a large amount of early stage research, paid for by our customers with little resultant customer benefit.

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

The proposals for raising innovation funds for transmission and gas distribution seem appropriate.

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

We believe that there is still a need for the NIA to allow Research & Development of higher risk ideas on a smaller scale/size. In our experience, lots of solutions have been developed using this funding and its predecessor (IFI), that would not have otherwise been developed as the potential to deliver shareholder value was insufficient or unclear at the onset of the work. However, we recognise that there is potential to further enhance the NIA approach going forward.

ENWL has a proven track record of transitioning NIA projects into BAU, when solutions have been proven and there is a customer or network need for them. Withdrawing this funding may have a number of unintended consequences which are not in customers' interests such as network operators only progressing innovation projects where they are (almost) guaranteed to succeed and a BAU need currently exists. This short-term focus is unlikely to support the transition to a low carbon economy that we anticipate being required in the longer-term.

At present, NIA funding is allowing us to build a portfolio of options to resolve expected challenges, driven by emerging customer need and the low carbon agenda (e.g. high uptake and clustering of

LCTs). We strongly believe that it is a substantially more expensive path and materially higher risk to reactively investigate emerging issues and network constraints as they appear. In electricity distribution, the current framework is facilitating the development of a range of tools that the DNOs can utilise, as an alternative to traditional reinforcement, as and when network and customer need dictates. The deployment of new technical and commercial initiatives, based on the learning outcomes of NIA / IFI / LCNF demonstrates the success of the current framework. We anticipate BAU transition will increase over the next 5-10 years driving even more benefit for consumers.

The value of NIA funding needs further consideration. Currently, it is a small percentage of totex which, for larger groups, can create significant potential funds. However, unlike deployment of new technologies, forecast totex spend is not necessarily the most appropriate measure for innovativeness. We suggest it may be more appropriate to equalise NIA between groups within a sector, rather than on a licensee basis. As the benefits of this innovation should be shared through effective knowledge dissemination, we suggest that it may be appropriate to also share the costs. Additionally, in a low risk and low return regime the 10% compulsory network company cost contribution should not be increased, and there may be a case to lower it in a tougher regime if innovation is to continue at current or greater intensity.

Based on our experience, a significant proportion of the current NIA funding goes to small to medium enterprises (SMEs) to help develop solutions for network companies. This funding has resulted in the development of a number of truly innovative new products, which have now been embedded as proven technology into BAU, and are delivering significant network and customer benefits. Some of these products were developed as a direct result of a specific problem identified by the network companies. The success of initiatives developed under this funding mechanism is demonstrated by technologies that have been adopted by DNOs across GB. One such example is the Kelvatek Bidoyng or 'smart fuse' for managing transient faults, which was developed further in Smart Street to provide remote LV interconnectivity for voltage management. These devices have transformed the experience of customers during transient faults. This funding is also vital for engaging effectively with SMEs who are driven by external market conditions. As NIA has a lower level of governance than the NIC and is not subject to bid costs, which can prove prohibitive for technology developers, the funding provides an effective mechanism for enabling third party involvement. However, we do think it is important that the NIA governance is clarified so that BAU deployment of solutions previously tested using NIC or equivalent funding is not then funded as part of NIA projects.

The issue of potential unnecessary duplication of projects has been resolved by the ENA process that enables all network operators to review, comment and challenge pre-registered NIA projects. The multi-DNO process also enables learning from other projects to be highlighted and incorporated in new projects to build on learning. We believe that the involvement of third parties in NIA projects is already very strong so we are surprised that it is felt that this needs to be strengthened further. We believe that our role is to act as a 'gatekeeper' to make sure that customer funding is spent wisely but to also to act as an enabler.

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

We believe that all closed NIA projects should be reviewed in the annual NIA report for a period of three years following closedown to highlight transition into BAU or NIC research. This approach would provide a suitable mechanism to disseminate cost savings delivered by the project and the longer term benefits derived from the research.

It should be noted that some research projects do not deliver totex benefits but deliver benefits such as reduced connection cost, quicker connection times, environmental and carbon benefits as well as improving forecasting and investment plans. These benefits can be more difficult to track but are valid and improve the customer experience. To allow tracking of benefits such as connection costs and times would mean the Network Operators have to quantify the counterfactual which can be time consuming and could mean maintaining old systems which could negate the benefit accrued by the customer. These benefits would be better tracked through direct engagement with Ofgem on a yearly basis to present the NIA portfolio to highlight the progress, strategy and benefits of the entire portfolio.

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

We agree with the proposals for the electricity distribution companies prior to the commencement of RIIO-ED2 subject to our comments above.

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

As set out in previous responses, Electricity North West supports the use of competition where it can be shown to be in the best interests of our customers. To date, we have demonstrated our commitment to competition through our approach to opening up the greatest number of connections market segments to competition, introducing tenders for the provision of flexibility services and work to develop a platform to enable market participants to trade network capacity. We have also proactively engaged with Ofgem on its development of the CATO approach, even though not directly applicable to electricity distribution.

The models set out provide for a range of situations where it may be appropriate to consider the use of competition. We recommend that these should not be seen as a definitive set of models as the development of new approaches may allow alternatives to be brought forward that may be more effective in delivering benefits for customers.

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

As set out in our previous responses, the criteria of 'new', 'separable' and 'high value' continue to be appropriate, although we note that these have been developed in relation to electricity transmission and suggest further work may be appropriate to consider the opportunities, and then associated benefits and costs of applying the same approach to other sectors.

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

We note that the benefits being drawn on within the draft impact assessment are drawn from transmission and may not be appropriate for other sectors, especially electricity distribution where, for

slow-track companies, there is already a lower cost of capital than other sectors. The counterfactual, including the expected cost of capital, will need updating in assessing the benefits and costs of late competition given the emerging shape of RIIO-2 proposals and some of Ofgem's "working assumptions" on financial parameters. Similarly, in sectors like electricity distribution where contestability of connections is well established, there may be less scope to derive benefits than in other sectors.

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

We are not aware of any for transmission or gas distribution.

We note that Ofgem intends to develop the framework for electricity distribution at a later date. We suggest that, given other work that is currently ongoing in electricity distribution to introduce additional forms of competition such as the opening of flexibility markets as an alternative to building network assets and work being undertaken as part of the Open Networks projects, considerations for electricity distribution may differ significantly from other sectors.

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

We have answered questions CSQ55, 56, 57 and 58 together.

CSQ56. Are there other potential drawbacks of early competition?

We have answered questions CSQ55, 56, 57 and 58 together.

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

We have answered questions CSQ55, 56, 57 and 58 together.

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

We have answered questions CSQ55, 56, 57 and 58 together.

We agree with the challenges identified in Appendix 2 in relation to early competition, namely Deliverability, Access to land and Change in circumstances. When considering opportunities for early competition, the challenge will be in streamlining the process to avoid every competition being 'bespoke' like the work on the Shetland New Energy Solution, and thereby minimising the costs associated with running the competition and awarding to the successful participant.

However, the emerging use of flexibility tenders within electricity distribution demonstrates that there are opportunities to introduce early competition in a cost effective way that deliver value to end customers and also open up new opportunities for participation by both new and existing market participants. It is important that these tenders are given time to evolve organically to meet the needs of the all involved.

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

We believe the criteria of 'new' and 'separable' and 'high value' are likely to be appropriate for identifying early competition projects that require the involvement of the system operator or Ofgem to establish them. In these instances, we believe experienced network operators will have a view of whether the counterfactual investment to respond to a given need is likely to trigger these criteria and therefore whether it may be appropriate to apply an early competition approach.

We note that network operators, including DSOs, may identify other opportunities for competition and opportunity should be given for such opportunities to evolve organically as needs and solutions prevail where these can be shown to deliver value for customers.

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

The ability to understand the identified need and proposed solutions to it is, we believe, the most important criteria for who is best placed to run competitions. For very large projects such as Strategic Wider Works, there is merit in Ofgem assessing potential bids with the support of technical consultants. However, for smaller projects, we do not believe this is the most efficient approach.

In our opinion, network companies are best placed to understand the needs arising within their area and scrutinise proposed solutions. However, we do recognise that there is the potential for a perceived conflict of risk with this approach. For this reason, we advocate the role of an independent body, such as a Customer Engagement Group, to challenge and scrutinise the decision-making process to be able to reassure all parties that any potential bias, perceived or otherwise, is effectively and appropriately managed to deliver cost-efficient and effective solutions for customers.

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

We believe native competition should be defined as 'competitions that are run by a network licensee'. We do not believe it is appropriate to limit these to being a response to the totex incentive as there may be a wide range of reasons which result in a similar outcome, i.e. a network company running a competitive process to deliver an effective and efficient outcome. We believe that such native competition is in the best interests of customers and should therefore be welcomed and encouraged.

Network companies are experienced in running competitive processes as part of procurement activity so are well placed to run such competitions and the broadening out of this thinking to seeking solutions to identified needs is a logical development of this expertise. It also reflects the changing needs of network companies as focus shifts to making flexible capacity available to support the transition to a low carbon economy.

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

We believe that totex continues to be the most appropriate approach to incentivising network companies to consider a wide range of potential solutions to the challenges they face. We believe this does create a level playing field for network and non-network solutions.

Ofgem needs to be mindful that its proposals with regard to blended sharing factors do not inadvertently dampen this incentive.

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

We are unconvinced that this approach is needed for the RIIO-2 period and that network companies should instead be encouraged to expand the approach currently being utilised in ED1 to run competitions for flexibility contracts and alternative solutions to building assets.

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

We are unconvinced that there is a role for the ESO to facilitate competition in the gas sectors and suggest further work is required to consider whether or not such a role is required and whether the ESO is best placed to discharge this.

9 Simplifying business plan assessment

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

We believe there continues to be merit in incentivising ambitious and cost effective business plans as this should be in customers' interests. However, we do have some concerns with the proposals as included in the consultation document.

1. Compliance check – in order for this to be appropriate, the Business Plan Guidance needs to clearly set out what companies need to do to be able to pass this hurdle. At present, the Guidance is still not finalised and subjective in areas, making it very difficult for companies to be able to satisfy themselves that they have acted in accordance with it. As not passing this stage could trigger an upfront penalty, we do not believe this is appropriate.
2. Evaluation of quality – similar to the comments on the compliance check, we do not believe the Business Plan Guidance is sufficiently clear to allow companies to understand Ofgem's expectations with regard to what constitutes quality. A considerable amount of work goes in to compiling a price control business plan and we certainly seek to ensure our plans are challenging and of a high quality. Lack of clarity regarding expectations increases the level of risk associated with compiling these plans which we do not believe is in customers' interests.
3. Competitive element to the reward – we do not support this. We have no way of knowing the approach adopted by other parties and do not think this is helpful. It is likely to deter companies sharing thinking on aspects of plans that would benefit from collaboration. We

also do not see that there is detriment in a high number of companies submitting plans deemed to be Good Value and being rewarded for this as this should ultimately drive benefits for the customers of the respective plans, particularly in sectors like electricity distribution where costs are not socialised so the customers funding any reward would be those directly benefitting from the more stretching plans. Plans should also not be forced into a ranking for a reward but should be assessed and rewarded independently of each other.

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

We do not believe it is necessary to distinguish between cost categories for the cost assessment element of a Business Plan Incentive. Companies will need to justify their costs and to determine the most appropriate mechanism to fund these. Where costs are uncertain, it may be appropriate that some form of uncertainty mechanism is used, either to allow these to be considered within or after the period (for high levels of cost uncertainty) or by some form of volume driver (for high levels of volume uncertainty). The approach taken to determining costs and how these should be funded should be evaluated, rather than just focusing on the actual costs themselves. Consideration just of the costs themselves may miss the bigger picture of the approach being taken by a company.

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

At a high level, the method seems appropriate but we believe this needs to be reviewed for electricity distribution as the policy for this sector develops. Much more detail needs to be developed and provided including Ofgem sharing more on how its proposed boundaries were set.

CSQ68. What should be the range for the business plan reward/penalty? Is the range of $\pm 2\%$ of totex equivalent appropriate for incentivising high quality and ambitious business plan submissions (eg Value or Good Value)?

In line with Ofgem's statements elsewhere in the consultation document, namely to "apply financial rewards mainly where the overall cost of the incentive does not exceed the value of improvements to consumers, and where performance improvements are not already funded through the baseline" (para 4.24). The costs of compiling business plans is significant and most companies will have only included a fraction of the costs for developing RIIO-2 plans within their RIIO-1 Business Plan, as a consequence of expectations being less developed when these plans were submitted. Accordingly, the incentive should be calibrated against the potential additional costs licensees will incur to deliver plans of the level of quality and ambition expected.

The consultation is unclear as to what the $\pm 2\%$ of totex equivalent equates to. We assume based on previous controls that this is total totex across the whole price control but note that Ofgem has mooted the possibility of it being related to only a single year's allowance. There is obviously a big difference between these two. Clarity on this point is needed.

We are also unclear whether this should be a percentage of totex by licensee, a fixed level per Group or a hybrid of these. For ED1, Groups of licensees within the same ownership were able to submit combined plans for their multiple licensees. The incremental costs per additional licensee is significantly reduced if this approach is adopted, whilst there is a significant level of fixed costs that are applicable whether the submission covers one or four licensees. As such, we believe that, in the event, Ofgem permits Groups to submit combined plans then either an absolute cap on the potential reward for Groups should be applied or an uplift made available for licensees who are not part of such Groups.

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

In our previous responses, we have expressed our concerns with the IQI, which are not necessarily the same as Ofgem's. As previously stated, we are concerned that the IQI matrix did not adequately reward companies for efficient business plans in ED1 and the application in RIIO-1 was with errors. As such, we do support the proposal to remove the IQI.

In developing its successor, we believe it is important that licensees should be rewarded for developing challenging and realistic plans that also demonstrate the characteristics of being stakeholder-led and based on a long-term view and that these rewards should be strengthened. We have previously referred to this as retaining an evolved IQI but are open to an alternative mechanism where this can be demonstrated to deliver for customers. It is key that any business plan incentive mechanism is set out in advance of business plans being developed with customers and stakeholders so all parties can respond appropriately.

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

We have responded to questions CSQ70, CSQ71, CSQ72 and CSQ73 together.

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

We have responded to questions CSQ70, CSQ71, CSQ72 and CSQ73 together.

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

We have responded to questions CSQ70, CSQ71, CSQ72 and CSQ73 together.

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

We have responded to questions CSQ70, CSQ71, CSQ72 and CSQ73 together.

Introducing blended sharing factors could give a systematic way to determine how sharing factors will be set in RIIO-2 that links the sharing factor to a more detailed view of the scope for companies

to manage these costs. However, as Ofgem identifies, there will be significant complexity and potential implementation challenges associated with this new approach.

At this stage, we do not believe there is sufficient detail to fully understand Ofgem's proposals and increased clarity would be beneficial to allow us to fully assess the intended approach.

In the event Ofgem adopts blended sharing factors, it is essential that these are carefully implemented to ensure that there are no adverse or unintended consequences from the proposed approach.

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

If correctly calibrated and subject to the comments provided in response to this section and the business plan incentive section, we believe a blended sharing factor may drive the intended behaviours. More work is needed on how these two mechanisms interact because there are clearly potential issues about the relative incentive strengths between the level of reward for an initial lower cost plan compared with a less stretching initial plan and the scope of reward to outperform it in regulatory period at the prevailing sharing factor. However, at this stage, there remain too few details to be able to form a firm view.

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

We have responded to questions CSQ75 and CSQ76 together.

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

We have responded to questions CSQ75 and CSQ76 together.

Based on our experience, sharing factors do impact on decision-making and where effort is focussed to identify savings. However, they are not the sole factor that determines companies' approach as factors such as time taken to develop and prove a new way of working along with length of price control will also be relevant. With the shorter five year price control, having strong sharing factors to incentivise companies should be in consumers' long term interests as this will maximise the extent of benefits that companies are incentivised to deliver and consumers will benefit sooner in successive periods.

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

We suggest that for RII0-2 and beyond, productivity improvements are just one aspect of what is likely to drive outperformance. Likely to be more important as we support the transition to a low carbon economy is a company's willingness and ability to respond to new challenges and evolve its approach to meet differing customers' wants and needs. We therefore suggest that the scale of the challenge facing a sector should be given at least equal consideration to any scope for productivity

improvements and such responsiveness and willingness to change could also be a justification for an increased sharing factor.

In sectors where there are a number of companies and as a result there is competition already between these companies then these sectors will have potentially delivered more productivity improvements as a result of competitive pressure and diversity of approaches followed by best practice sharing.

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

We have responded to questions CSQ78, CSQ79 and CSQ80 together.

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

We have responded to questions CSQ78, CSQ79 and CSQ80 together.

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

We have responded to questions CSQ78, CSQ79 and CSQ80 together.

In a five year price control, we do not believe it is desirable or necessary to adjust the sharing factor level after the price control is set and believe that the potential for such adjustments is likely to lead to negatively impact on decision making with potential consequential impacts. Changing sharing factors within the five years does not fit well with Ofgem's goal of a simpler regime.

In the event there is a material change to a licensee's allowances, such as the approval of a Strategic Wider Works project, then it may be appropriate to revisit the sharing factor. However, in order to avoid any adverse consequences of such a change, it is essential that Ofgem sets out in which circumstances and how it would treat any case prior to the commencement of the price control period.

10 Fair returns and financeability

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

As previously set out, we appreciate the challenges facing Ofgem in light of calls from some stakeholders with regard to returns in the sector. However, we are unconvinced that the proposed Return Adjustment Mechanisms (RAMs) are necessarily needed to address these, particularly in light of other measures being adopted by Ofgem that will distinguish RIIO-2 from the current price controls. These wider changes that Ofgem is proposing are important to note when attempting to assess the proposed RAMs for RIIO-2 to ensure that the mechanisms developed for this set of controls reflects the issues that may arise from 2021 onwards, rather than seeking to address issues in a preceding control period that can be avoided by developing the existing RIIO approach without adding additional risk, complexity and uncertainty or distorting incentives that essentially work well for consumers in principle.

It is also vital that Ofgem gives due consideration to potential unintended consequences. Proposals that push towards a consolidation of licensees will undermine the credibility of comparative regulation and also reduce benefits for customers. Therefore RAMs need to be based on a licensee basis, rather than Group basis, and Ofgem should ensure that cross subsidisation is eliminated to ensure a fair application across licensees. Ofgem needs to satisfy itself that in developing these proposals they do not narrow the range of viable ownership structures, unless such structures can be demonstrably be shown not to be in customers' interests.

Effectiveness: All of the proposed mechanisms have the potential to adjust returns within the sector. We note Ofgem's statements that the Class 2 options would "*ensure that a sector average cannot exceed or fall below a predetermined level*". However, the examples provided only show situations where a licensee is performing at or above the base cost of equity.

Whilst Class 2 options may allow Ofgem to limit sectoral performance, it does this with potential consequences for the level of performance of individual licence holders. We believe it is more appropriate to focus on licensee levels of returns, rather than company specific, as this aligns with Ofgem's statutory duty to ensure licence holders can finance their activities.

Impact on incentives: We believe all of the proposed options would have a negative impact on incentives as they would, by their very nature, dampen the potential impact of incentives on licence holders' revenue. Of these, Ofgem consider Class 1 sculpted sharing to have the most pronounced effect as companies "*would need to share more of their outperformance*" beyond the threshold. We agree that this could impact on licence holders' decision making. However, unlike the other options, the licence holders are able to understand and forecast the potential impact as part of their decision-making. This will allow informed decisions to be made, for example to curtail investment if returns are likely to reach the threshold.

The Class 2 options may have a different impact on incentives as the sectoral-wide aspects mean that licence holders will only have limited information to make decisions with as they will be unable to factor in the performance of their peers. This inability to forecast potential return on investment could act as a deterrent to investment as shareholders will be unable to be certain what level of return they may achieve. We do not believe this to be in customers' interests as a new and exogenous risk source has been created and is now faced by the company which it cannot manage. Ofgem should clarify how it intends to factor in this increased risk of performance into its assessment of equity risk and beta for RIIO-2.

RAMs will create additional uncertainty for investors in respect of equity returns, further strengthening the case against any expected vs. allowed return adjustment.

Effect on companies' risk profiles: Contrary to Ofgem's assessment, all of these mechanisms have an adverse impact on companies' risk profiles as they all increase the level of uncertainty associated with the returns that might be achievable. Of the proposed options, the Class 1 sculpted sharing has the lowest level of adverse impact as companies are able to forecast when and to what extent it would be applied. The Class 2 mechanisms are significantly more unpredictable as licence holders could not forecast the sectoral average returns and the extent to which the RAM might be triggered. In some cases a company might also be exposed to errors in Ofgem setting the price control for other companies leading to a triggering of the Class 2 mechanism.

Impact on collaboration: We agree that the Class 1 sculpted sharing is neutral in terms of impact on collaboration. We do not believe the alternative approaches are neutral in terms of impact and believe there could be a negative impact on collaboration both within and across sectors from these approaches. We acknowledge Ofgem's observations as to the current levels of collaboration within

and across the sectors but we expect consumer value from collaboration to increase, rather than to decrease, as we move through ED1 and into ED2 with the move to DSO. The assessment therefore understates the potential impact as we transition into a phase of more rapid change and whole system thinking.

Reliance on Ofgem: Any sector based adjustment mechanism relies upon Ofgem setting fair determinations. Returns for other licensees should not be influenced by mistakes in this respect.

Level of complexity & challenges in implementation: We agree that of the proposed approaches, Class 1 sculpted sharing is the most straightforward and transparent approach. It would allow licensees and stakeholders to be able to monitor performance during the period (assuming the proposal to adjust as part of closeout is implemented), avoids the need to take multiple decisions on parameters and is in line with Ofgem's stated desire to simplify mechanisms wherever appropriate. However, any RAMs mechanism should be applied on a licensee by licensee basis to prevent disproportionate impacts on single licensees.

In the event that a RAM other than the Class 1 approach is to be implemented, Ofgem should publish timely annual forecasts of its impact to enable licensees to make appropriate decisions, for example, to defer investment decisions when a negative RAM adjustment is expected to be triggered through over-delivery.

In our response to the Framework consultation, we made a number of suggestions as to the approach Ofgem should adopt if it pursued the use of RAMs. We have refined these thoughts below:

- a licensee specific rather than sector average approach, so the other elements of the RIIO Framework are not diminished;
- it should operate on a licensee by licensee basis. Groups that operate more than one licence are able to transfer performance between licensees, through cost allocations. Ofgem needs to ensure that Groups do not value shift between licensees to evade the potential impact of any RAMs.
- appropriate cap/collar that is at a fail safe level still high enough to incentivise desired outcomes and with a lower level low enough to protect against financeability issues;
- clear criteria that can be applied with a minimum degree of subjectivity, with timely publication by Ofgem of comparative performance, so companies are able to forecast likely outcomes and apply to decision making processes;
- the mechanism should be assessed on a regulatory period basis using the company's performance across the entire period, taking in to consideration the impact of the closeout mechanisms to assess performance against outputs across the period; and
- aspects of a company's performance, including financing and tax should be considered, to understand if the level of return is justifiable based on the service and outcomes being experienced by customers.

We believe these continue to form the suitable basis for evaluating the appropriateness of the design of a RAM and believe that, when assessed against the above, the Class 1 sculpted sharing approach is the least worst RAM Ofgem is considering. This must be supported by a review of the adjustment calculation to ensure that it gives due consideration to the level of justifiable return based on the actual service and outcomes delivered by the licensee.

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

We generally support the removal of discretionary measures as they create uncertainty for investors and company decision-making processes thereby hampering companies delivering benefits to consumers.

However, we note one of the reasons for this is that Ofgem is concerned that it may struggle to distinguish “*between genuine and non-genuine outperformance*”. We recognise this potential challenge but do wonder whether an element of discretion should be built into any proposed RAM to reduce the negative impact of a mechanistic adjustment, factoring in the benefit to consumers of performance. Ofgem is then able to review the calculated adjustment and to then consider, including with consultation, whether or not it is appropriate to apply the calculated adjustment.

CSQ83. Do you agree with our proposal to introduce an individual performance-based adjustment approach (Class 1) for the transmission sectors?

In the event that Ofgem do introduce an adjustment mechanism, based on the information consulted upon, an individual performance-based adjustment approach is the most suitable. Investment decisions are made on an individual company/licensee basis and the RAMs should follow this approach. Comparative mechanisms such as the sector-based approaches fundamentally undermine the ability of management to make informed decisions as they are unable to assess the potential impact of a business case for a discrete project or business change. This creates unnecessary uncertainty, particularly for sectors like electricity distribution where significant investment is likely to be required during the ED2 period to ensure we can successfully support our customers and stakeholders through the low carbon transition.

In the specific case of the transmission sectors, we question how the dominance of one licensee in each of ET and GT can be managed to ensure fair adjustments and look forward to seeing Ofgem’s proposals in this regard.

It should be noted that even an individual performance adjustment has the potential to disincentivise optimal performance, as the opportunity to drive performance is effectively constrained for well performing companies. Ofgem needs to consider whether this is likely to result in the desired management focus for the RIIO-2 period, the objective of greater simplicity and to maximising benefits to consumers.

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

In the event that Ofgem do introduce an adjustment mechanism, we do believe that an individual performance-based adjustment approach to be the most suitable so we do not agree with a sector average based approach. Investment decisions are made on an individual company/licensee basis. Comparative mechanisms such as the sector-based approaches fundamentally undermine the ability of management to make informed decisions as they are unable to assess the potential impact of a business case for a discrete project or business change. This creates unnecessary uncertainty, particularly for sectors like electricity distribution where significant investment is likely to be required during the ED2 period to ensure we can successfully support our customers and stakeholders through the low carbon transition.

Network companies should not be able to hold each other ‘hostage’. Proposals for cross-sector averages put licensees at the mercy of other players, without the information to be able to make informed decisions. A GDN cannot know how ambitious (or not) other plans are, yet the current proposals tie their ultimate returns to how ambitious or not the plans of others are and then how other management teams deliver against them. We do not believe this to be in customers’ best interests, nor to be a simplification of the regime.

Again, we iterate that the adjustment should not unfairly increase the predictability of returns for a single licensee compared to multiple licensee groups.

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

For the reasons set out in response to question CSQ84, we do not believe the Class 2 approach is appropriate. However, of the proposed alternatives set out in paragraph 10.79, we do believe this is the least worst approach for consumers. We think this mitigates some of the potential external risk to companies that the Class 2 approaches introduce.

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

The consultation document provides no explanation to support the proposed adjustment threshold of ± 300 bps RoRE. This makes it difficult to be able to have a view as to whether or not this is an appropriate band for the adjustments to operate around.

As the current consultation is not considering electricity distribution, we cannot consider the proposed range against the backdrop of proposed incentive mechanisms. Calibration against these needs to take place in order to be able to form an opinion on the appropriate range for electricity distribution.

In particular, it is not feasible to assess 300bps without knowledge of the investment and its risk required to achieve incentive income, at any given particular level.

We generally support the use of symmetrical mechanisms. However, consideration does need to be given as to how the potential downside of RAMs interacts with Ofgem’s financeability duty and cash flow floor proposal, especially if a sector average approach is adopted. It does not seem appropriate that the actions of other players could result in a company triggering the cash flow floor nor how these mechanisms would interact as the RAM is likely to be triggered at the end of the period whilst the cash flow floor is within period. It is difficult to understand how sign offs on availability of resources, as mooted under cash flow floor proposals can be made, absent a full picture of RAMs impacts.

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

As previously set out, RoRE may be a suitable metric if it is correctly calculated and includes all factors that affect returns for the specific company, including financing and tax. We are pleased that Ofgem is now publishing this full picture of returns.

We consider it appropriate that RoRE based on actual gearing is used, rather than RoRE based on notional gearing, as this more closely reflects actual returns earned by equity holders.

We note that RoRE on an actual basis could be impacted by strategically adopting a gearing structure materially below notional level, thereby triggering RAMs. To the extent that deviations from notional gearing levels reflect financing strategy, rather than prudent risk management, Ofgem should consider restricting the differential between RoRE on a notional basis and RoRE on an actual basis to prevent gaming and thereby protecting consumers.

It is also essential that closeout mechanisms are developed prior to the commencement of controls to allow for an accurate calculation of RoRE so returns are stated after enduring value adjustments recognising future adjustments that may be applicable, especially through uncertainty mechanisms and the Totex Incentive Mechanism.

As a DNO, our consideration of whether or not RoRE may be suitable as a metric under RAM's is based on our experience in electricity distribution.

Any returns adjustment mechanism should be applied fairly across licensees. Groups that operate more than one licence are able to transfer performance between licensees, for example through central cost allocation. To be fair, any mechanism would have to operate on a licensee by licensee basis, and Ofgem would need to assure that other licensees performance within Groups has been fairly presented, otherwise its application would disproportionately impact on smaller licensees.

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

Firstly, we reiterate our concerns with Ofgem's proposal for full indexation of the debt allowance, calibrated based on sector average performance. We believe this methodology unfairly benefits large companies that can raise funds each year at above benchmark issuance size; and companies that are fortunate in the timing of issuance. We also highlight that out/under performance on financing would be largely set at the time of calibration, leaving companies with little opportunity to rectify.

We strongly believe that the debt allowance should be based on individual licensee's (not Groups') debt positions in accordance with Ofgem's financeability duty.

Notwithstanding these concerns, we believe that it is appropriate for return adjustments to be based on a post financing and tax RoRE. To exclude financing and tax performance from this or other mechanisms to consider returns within the sector is misleading and does not provide an accurate view of under- or over-performance within the sectors.

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

We believe that adjustments should be made as part of the closeout process, subject to the mechanism for closing out the price control being clearly established prior to the commencement of the price control. Whilst this does not remove the requirement to ensure closeout mechanisms are properly developed prior to the commencement of price control periods, it does allow all relevant parties to understand the impact of these mechanisms and to ensure that there are no unintended consequences from its application. However the evolving potential impact on licensees through the price control period should be provided by Ofgem annually, in order to ensure predictability of returns.

A single adjustment should also minimise charging volatility and assist other parties to be able to accurately forecast their costs.

11 Achieving a reasonable balance in RIIO-2

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

We have answered questions CSQ90, 91 and 92 together.

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

We have answered questions CSQ90, 91 and 92 together.

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

We have answered questions CSQ90, 91 and 92 together.

We are unclear what Ofgem means when it refers to *'the accuracy of the price control'*. Assuming this relates to a very close match between allowances and expenditure then the very nature of price controls means it is almost impossible to establish an 'accurate' control as there will always be deviations from the plan as these are based on forecasts, unless significant ex post adjustments are introduced. We do not believe such adjustments would be in line with the RIIO framework or with incentive-based regulation more generally.

We therefore advocate that Ofgem should be seeking a control that is 'appropriate', that recognises that there will be aspects that deviate from plan (and the use of uncertainty mechanisms is a sensible response to this) and that incentive regulation is complex but can be made more accessible through transparency and engagement.

Given the reduction in returns, risk reductions should be made, including concluding on all licence conditions (including the detail of close out mechanisms) prior to the commencement of the price control period.

Several of the potential new mechanisms, for example RAMs and the Cash Flow Floor are not necessary in any event, but also run counter to the intent of simplifying the price control, especially when the effect of these novel mechanisms are compounded together.

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

Ofgem has stated it wanted to develop a lower risk, lower return package for network companies in RIIO-2. Our observation on the developments for RIIO-2 to date is that risk (such as complexity and uncertainty due to the framework) is actually increasing whilst returns are proposed to be substantially reduced.

Ofgem's consideration of the types of risk facing network companies assumes that the risks facing networks companies are uniform irrespective of the sector. We do not believe this is correct. Electricity distribution faces a systematic risk that it is often the primary facilitator for Government policy to deliver the transition to a low carbon economy. As a consequence, we have seen significant change through ED1, with the DNOs being asked to take on additional roles and responsibilities within the pre-determined allowances. Whilst we believe that some of the potential scope creep can be addressed for ED2 through appropriately set uncertainty mechanisms, this does not fully mitigate the risk to DNOs. In the event that Ofgem decides to lower the allowed cost of capital for electricity distribution, there will be less headroom for DNOs to absorb such additional scope. We do not believe that risks such as this have been appropriately factored into Ofgem's consideration of the appropriate level of return.

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

We do not agree return adjustment mechanisms are appropriate as these increase framework complexity and uncertainty and are new sources of risk. Ofgem should focus on and have confidence in learning from price control setting experience and set appropriate allowances and incentives in the first place. In our response to the Framework consultation, we set out our concerns that proposals for the development of return adjustment mechanisms were being driven by concerns with the calibration and implementation of the RIIO Framework, rather than from the structure of the regime itself. We continue to believe this remains the root cause of the concerns Ofgem has sought to mitigate through the development of RAMs. As described in response to question CSQ100-102, we believe Ofgem should be seeking a control that is 'appropriate', that recognises that there will be aspects that deviate from plan and that incentive regulation is complex but can be made more accessible through transparency and engagement.

As the proposals currently being consulted upon are not directly applicable to electricity distribution, we are unable to assess whether they are accurate or appropriate. However, it is our view that RAMs should not be needed where an appropriate control is set and are too broad a brush to ever be used as anything beyond a fail-safe mechanism which really should not be required in the first place as instigating RAMs may distort risk profiles and incentives from those that best serve consumers.

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

We do not believe that there is a balance between the proposed RAMs and the proposed expected-allowed return wedge. The proposed expected-allowed return wedge has not been adequately justified and comes with a number of fundamental issues that mean it should not be taken forward as a negative adjustment. The purpose of both of these mechanisms is to drive down the achievable return, although they seek to achieve this objective through different means. There is a risk that the use of both mechanisms undermines broader investor confidence within the energy networks, resulting in investors seeking alternative investment options. At a time when significant investment is likely to be required in GB networks, and particularly electricity distribution to facilitate the low carbon transition, deterring investment is unlikely to be desirable and may have unintended adverse consequences.

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

Our stakeholders have told us that they believe the areas of highest priority for Electricity North West at present are: transitioning to the low carbon economy; keeping their lives running; delivering energy efficiency; providing support for vulnerable customers; addressing fuel poverty; improving network resilience; and investing in the North West. We will continue to test and confirm this with our customers and stakeholders as we progress the development of our Business Plan for ED2.

As the current consultation focuses on the other sectors, we cannot confirm whether or not Ofgem has achieved the right focus to enable us to deliver the areas of most value to our customers in ED2. However, we expect to work with Ofgem as it develops its thinking for ED2 and will seek to represent the needs and wants of our customers through this process.

As Ofgem continues to refine its thinking, we believe it is important that the current pressure on Ofgem to reduce returns as a consequence of distortions in the RIIO-1 controls, particularly for transmission and gas distribution, do not create a barrier to investment in ED2 as this would be detrimental to our customers.

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

Based upon our stakeholder research, we believe it may be “*appropriate to fund targeted company action to support consumers in vulnerable situations.*” As an industry going through significant change, it is important that we are mindful of those customers who may struggle to participate in this change, whatever the vulnerability, and it seems appropriate that licence holders are able to ensure customers less able to engage are supported to an appropriate extent through this transition to minimise the risk of different groups of customers being disproportionately disadvantaged or even left behind.

However, both the assumption that this is supported by customers and the extent to which it is supported require further testing. Ofgem’s approach also assumes that there is a general acceptance that energy costs, rather than taxation or other measures, are the most appropriate means to fund this redistribution of wealth which would also benefit from validation.

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

We recognise that Ofgem is seeking to balance the interests of existing and future consumers. However, as the majority of proposals within the consultation documents lack qualitative assessment, such as cost benefit analysis or discounted net present value analysis, it is difficult to understand how this balance has been struck. We are aware that Ofgem does face significant pressure to reduce costs to existing consumers. Measures such as reducing the allowed returns and down aiming an allowed vs expected wedge do appear to be focussed on addressing these near-term concerns but could have significant long-term and detrimental impacts on future consumers. Undertaking a full impact assessment on the costs and benefits of proposals, both separately and combined as a package, would demonstrate the balance Ofgem has sought to achieve through this process and also ensure that future decision-making can be informed by any changes to the underlying assumptions.

12 Preliminary impact assessment questions

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

We have answered questions CSQ99, 100, 101 and 102 together.

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

We have answered questions CSQ99, 100, 101 and 102 together.

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

We have answered questions CSQ99, 100, 101 and 102 together.

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

We have answered questions CSQ99, 100, 101 and 102 together.

We do not believe the approach to assessing the impact of Ofgem's RIIO-2 proposals is appropriate. The approach also does not appear to be in line with Ofgem's guidance on how to undertake Impact Assessments¹, particularly the expectations for how an Impact Assessment will be undertaken in accordance with s5A of the Utilities Act.

We recognise that Ofgem has sought to assess the costs and benefits of its proposals in terms of Consumer Bill Impact, Enabling the energy system transition, Impact on quality of service and Other Impacts. We also acknowledge Ofgem's statement that some of the proposals "*can only be assessed qualitatively*". However, there is a lack of substantive, quantitative analysis to underpin the Impact

¹ Ofgem, 'Impact Assessment Guidance', October 2016, https://www.ofgem.gov.uk/system/files/docs/2016/10/impact_assessment_guidance_0.pdf

Assessment and the Appendix does not seem to be objectively set out considering a full range of factors, so a much more robust assessment is required for proposals of this significance.

Ofgem's Guidance recognises that Impact Assessments will need to evolve as policy develops and we would expect the level of detail to increase as Ofgem works through the price control process. However, as decisions will be made on key aspects of the methodologies for transmission and gas distribution, and potentially on proposals that may be capable in principle of application to electricity distribution, we do not believe it is acceptable for Ofgem to base its decisions on the potential cumulative impact of its proposals on the limited information provided in Appendix 5.

We expect Ofgem, in accordance with its Guidance, to outline the Option appraisal process it has undertaken, considering monetised CBA, distributional effects and hard to monetise impacts, for its new proposals, particularly where those proposals substantially depart from the approach adopted for RIIO-1, including slow-track ED1 proposals, or introduce a new approach. These impacts should be assessed both on an individual policy basis and a cumulative basis, and should consider the impacts on actual, as well as notional, companies particularly where Ofgem is aware of material differences between companies.