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3<sup>rd</sup> September 2020

Dear Akshay

### **RIIO-2 Draft Determinations for Gas Distribution, Transmission and the ESO**

Electricity North West (ENWL) appreciates the opportunity to respond to this important consultation on the RIIO-2 Draft Determinations for those sectors whose price controls are due to commence in 2021. Our interest stems from the potential consequential impact on the framework development for ED2, commencing in 2023, as well as the impact the proposals will have on the energy sector as a whole and those consumers in our operating region. In summary of this letter our key points are:

- We would welcome more clarity being provided to stakeholders that decisions made as part of this Draft Determination process are not binding for ED2.
- Fuller proposals should be developed earlier in the ED2 process, giving a more complete framework that will enable stakeholders to see the overall price control and assess whether the combined effect of the individual proposals is in consumers' best interests.
- We continue to be supportive of the RIIO framework that Ofgem has pioneered and believe it can achieve the objectives of RIIO-2 through the retention and non-erosion of the RIIO cornerstones of 'Incentives' and 'Innovation', either by design or accident. We are therefore pleased to see that some incentives remain in key areas such as the sharing rates (TIM).
- Ofgem will need to challenge itself in a period of change to make agile and flexible decisions to ensure that no barriers to Net Zero delivery are created either accidentally or by design. Furthermore, Ofgem must assess whether it has the systematic approach, simple governance structures and capabilities required to make major decisions frequently, with less than six months total evaluation, consultation and decision-making each time. Ofgem should not underestimate the impact that the lack of certainty over future spend will have on the supply chain's willingness to invest, and therefore its ability to deliver in a timely manner.
- Issues remain on finance matters where we consider Ofgem is making some fundamental errors as we have already discussed with you. We do not consider that it is helpful waiting to the end of the process for the "correct forum" to decide on the legal position of the Financeability Duty. In particular, we are keen to ensure that Financeability is assessed on a licensee basis to ensure that whole regions are not left behind in the drive to zero carbon.
- If the objective of the RAMs is to protect customers and consumers from inappropriate returns, we urge that Ofgem includes finance and tax out/underperformance within RAMs as it would appear illogical to exclude them.



- A more balanced approach should be taken by Ofgem adopting positions more credibly within the ranges of evidence rather than towards particular ends of a spectrum. Ofgem should rebalance how it weights the needs to attract long term investment for future customers with short term bill reductions.
- Policy positions in RIIO-2 need to be made mindful of the CMA views and findings but should be independent of other sectors and should consider the evidence and unique circumstances both of RIIO-2 specifically and of each company.
- It is important for legitimacy that the framework for ED2 can be consulted on without prejudice. Therefore, the RIIO-ED2 framework needs to be considered on a standalone basis and proposed policy positions are established and justified for the ED sector specifically, distinct from GD2 and T2.
- Stakeholder input should be a strong underpinning of RIIO-2. From the proposed positions in the Draft Determinations we have some concerns that the weight Ofgem places on stakeholder requirements and the views of CEG's is below that which stakeholders expect.
- Continued focus should be applied to ensure Final Determinations progress in line with the existing timetable and proper processes, ensuring that there is no adverse impact on RIIO-ED2 framework development.

We have some concerns that the Draft Determinations refer to common sector-wide measures without qualification that these do not apply to ED. We note that in the Sector Specific Methodology consultation Ofgem states it is “clear that RIIO-ED2 is a separate process, however in the design of our proposals for RIIO-ED2, we have taken into account the lessons learnt and the feedback we have received from the other sectors.”<sup>1</sup> **We would welcome more clarity being provided to stakeholders that decisions made as part of this Draft Determination process are not binding for ED2.**

We note that the Draft Determinations are challenging with tough proposals being taken in all areas. The combined effect thus created could make some of the price control objectives undeliverable and risks creating adverse consequences for consumers at this crucial time in the journey to Net Zero and decarbonisation. Careful consideration should be given to this, as there is little or no margin for error for all stakeholders in facilitating and supporting national and regional Net Zero targets. We welcome novel and new policy approaches being raised, however, these are being included as part of Draft Determinations without earlier signalling leaving only limited time for all stakeholders, including companies, to examine, evaluate and understand these before Final Determinations. Therefore, we suggest a further observation relevant for ED2, **that fuller proposals are developed earlier in the ED2 process and we look forward to contributing to these. A more complete framework will enable stakeholders to see the price control overall and assess whether the combined effect of the individual draft proposal elements is in consumers best interests.**

The regulatory environment and framework should facilitate, support and deliver decarbonisation and the transition to a low carbon economy. **We have been supportive and continue to be supportive of the RIIO framework that Ofgem has pioneered and believe it can achieve these objectives. To achieve this the cornerstones of RIIO, ‘Incentives’ and ‘Innovation’ should be retained and not eroded either by design or accident.**

**We are pleased to see that incentives remain in key areas such as the sharing rates (TIM)** for Gas Distribution companies, although the combined proposed positions in the Draft Determinations do represent a notable shift in the RIIO framework toward less incentivisation. We believe that in ED1, Ofgem has been very successful in both aligning benefits for customers and incentive mechanisms. We are concerned to understand why reducing incentives and therefore customer benefits appear to be such an important policy direction, when our research indicates that customers value the improvements seen. Companies and Ofgem should always be looking to improve performance and efficiency for consumers and as improvements become harder to identify, strong incentives that can justify the costs of improvement investment must be maintained.

We recognise that the ESO is unique and therefore we support the creation of an alternative form of regulation for this entity. For GD/T, given the uncertainty faced by these sectors as a consequence of the

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<sup>1</sup> RIIO-ED2 Methodology Consultation: Overview, para 2.4, Ofgem  
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timing of their price control cycle, uncertainty of heat policy and their individual investment characteristics, we understand the extensive use of uncertainty mechanisms, reopeners and Price Control Deliverables (PCDs). This does create a more gated regulatory regime and will require Ofgem to take a more hands-on and central role in enabling and administering Net Zero, signing-off investments/company decisions and providing any funding in a timely manner thus increasing regulatory burden on both Ofgem and companies. **Ofgem will need to challenge itself in a period of change to make agile and flexible decisions to ensure no barriers to Net Zero delivery are created accidentally or by design.**

This approach has impacts on the numerous supply chains supporting the sector. Tariffs will need to be reset post any decisions from Ofgem. Current charge setting restrictions will create a timing delay of c.15 months before these reset tariffs affect cashflow reducing the ability for companies to pay supply chains until this takes effect. This is especially true in RIIO-2 where financial headroom could be limited. **Ofgem in its decision making should consider whether sufficient time and clarity are given so resource levels can be mobilised in the supply chains due to the use of uncertainty mechanisms and reopeners.** Also, **Ofgem must assess whether it has the systematic approach, simple governance structures and capabilities required to make such decisions at least twice a year, with less than six months total evaluation, consultation and decision-making each time.** This may also include bold decision making where evidence and certainty might not be at historical thresholds expected by Ofgem.

**Whilst we understand the reasons for this approach for GD/T this model may not be the optimal approach in sectors where frequent and incremental investment is required, such as ED.** Such a model will reduce flexibility as well as companies' abilities to react to unforeseen changes in a highly dynamic environment such as that expected for ED2.

**Issues remain on Finance where we consider Ofgem is making some fundamental errors. The Financing duty of Ofgem is to ensure that an efficient individual licensee can secure both debt and equity funding.** In RIIO-2 Ofgem is wrongly interpreting this duty as being to a notionally geared, artificially identified group of companies, creating circumstances of windfalls to some companies at the expense of financeability and/or reduced equity returns (and therefore investment incentives) for others. We continue to disagree with the proposed approach to debt allowances which fails to fund efficiently incurred debt costs and urge Ofgem ensures that licensees can secure both debt and equity finance consistent with its financing duty.

RIIO-2 provides almost no opportunity for individual companies to absorb these financing issues in the round and this problem is compounded by Return Adjustment Mechanisms (RAMs) being proposed to operate without considering financing and tax performance. The consequence is that companies like ourselves that perform strongly for our customers, set industry efficiency benchmarks at ED1, but have efficient debt taken out in the market ahead of the financial crisis, are less able to achieve fair returns by offsetting debt underfunding by incentivised strong performance for customers, as reflected in our RIIO-ED1 performance. **We would urge that Ofgem includes finance and tax within RAMs as this would better protect customers and consumers from inappropriate returns in RIIO-2.** Further, Ofgem's proposal not to take derivatives into account in assessing the cost of debt is illogical. Derivatives are an important way to manage risks for our customers as well as shareholders. Our views should be familiar to Ofgem through our ongoing dialogue and we have shared our views with the CMA as part of our submissions on PR19<sup>2</sup>.

We have worked to provide a substantial body of independent expert evidence to Ofgem's finance work stream through the ENA's RIIO-2 Finance Working Group. It is disappointing that Ofgem appears to have dismissed almost all the expert insight from these leading consultancies, and often based solely on Ofgem's own judgements justified with what appears to be weaker evidence. We are concerned that Ofgem's approach to financial matters is skewed and represents an unbalanced settlement where extreme positions are selected in all components. Applying the extreme-end of a plausible scale in all areas risks driving unintended consequences and behaviours and lead to inadequate investor appetite to drive forward decarbonisation in line with government policy worsening outcomes for consumers. **We urge Ofgem to take a more balanced approach, adopting positions more credibly within the ranges of**

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<sup>2</sup> Appendix 6: ENWL third-party representation letter to CMA review of PR19 appeals  
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**evidence rather than towards particular ends of a spectrum and to rebalance how Ofgem weights the need to attract long term investment for future customers with short term bill reductions.**

The ongoing PR19 referrals to the CMA should be a point of reference for Final Determinations and considered as part of the development of RIIO-ED2. Central proposed policy positions in Draft Determinations such as; issues of financing, ongoing productivity/efficiency assumptions, and the use of more stringent than upper quartile efficiency benchmarks are being reviewed as part of these appeals. **It is important that policy positions in RIIO-2 are made mindful of the CMA views and findings, but independent of other sectors and consider the evidence and unique circumstances of RIIO-2 specifically and of each company.** The decarbonisation challenges, as well as the transformative changes required are not inherently part of the water sector as they are in energy.

**We strongly believe the RIIO-ED2 framework needs to be considered on a standalone basis where proposed policy positions are established and justified for the ED sector specifically, distinct from GD2 and T2.** This will ensure that the framework is fit to enable a smarter more flexible energy system responsive to the drivers of decarbonisation, digitisation and decentralisation. Our stakeholders are asking us to take a leading role in delivering the Government's policy and the RIIO-ED2 framework and its application must therefore facilitate this.

For ED2 there is a real opportunity to reflect on the learnings of process and development of the T2/GD2/ESO Draft Determinations, and to ensure that these are enacted supporting the business planning process, including the role of stakeholder input. **Stakeholder input should be a strong underpinning of RIIO-2. From the proposed positions in the Draft Determinations we are concerned the weight Ofgem places on stakeholder requirements and the views of CEG's is below that which stakeholders expect.**

**We support continued focus to ensure Final Determinations progress in line with the existing timetable and proper processes, ensuring that there is no adverse impact on RIIO-ED2 framework development.** It is important that stakeholders, customers and companies can assess all the relevant information including the impact of the changes in a timely manner so that DNOs can engage, assimilate and reflect stakeholder responses to these policy changes in their business plans.

Process and appropriate engagement is important for all stakeholders and we note that Draft Determinations coming out just before the ED2 SSMC is a challenge especially where both have relatively short consultation periods and overlap in their timing. **It is important for legitimacy that the framework for ED can be consulted on without prejudice.**

We welcome the engagement we have had with Ofgem to date and look forward to this continuing at pace for ED2, working with Ofgem and other stakeholders. We remain confident that an overall framework including financing aspects for RIIO-ED2 that enables the delivery of key objectives, whilst ensuring fairness for all customers and shareholders could be achieved by Ofgem.

We have responded to the Draft Determinations by exception through six appendices to this letter. This response should also be read in light of our previous correspondence on RIIO-2. If you have any questions relating to our response, please don't hesitate to contact me or Paul Bircham ([paul.bircham@enwl.co.uk](mailto:paul.bircham@enwl.co.uk)).

Yours sincerely,



**Peter Emery**  
**Chief Executive Officer**

Encs: Appendix 1: response to RIIO-2 Draft Determination Core document questions; Appendix 2: Finance; Appendix 3: ESO; Appendix 4: Gas Distribution; Appendix 5: NARMS; Appendix 6: ENWL third-party representation letter to CMA review of PR19 appeals

# Appendix 1: response to RIIO-2 Draft Determinations Core Document questions

September 2020



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## 1 Overview

Electricity North West Limited (ENWL) is an electricity Distribution Network Operator (DNO). Our interest stems from the potential consequential impact on the framework development for ED2, commencing in 2023. The price controls for Gas and Electricity Transmission will impact our customers who benefit from these services as well as how those sectors work with us to decentralise and decarbonise the energy network.

We have some concerns that the Draft Determinations refer to common sector-wide measures without qualification that these do not apply to ED. We note that in the Sector Specific Methodology consultation Ofgem states it is “clear that RIIO-ED2 is a separate process, however in the design of our proposals for RIIO-ED2, we have taken into account the lessons learnt and the feedback we have received from the other sectors.”<sup>1</sup> We would welcome more clarity being provided to stakeholders that decisions made as part of this Draft Determination process are not binding for ED2.

We have answered selected questions although we would note that 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 ED. We strongly believe the RIIO-ED2 framework needs to be considered on a standalone basis where proposed policy positions are established and justified for the ED sector specifically, distinct from GD2 and T2. We will therefore provide more detailed response to relevant areas as part of our ED2 Sector Specific Methodology Consultation (SSMC) response which is due to close in early October of this year.

We note that the Draft Determinations are challenging with tough proposals being taken in all areas. In combination, this could make the price control overly stretching and risk adverse consequences for consumers at this crucial time in the journey to Net Zero and decarbonisation. Careful consideration should be given to this, as there is little or no margin for error for all stakeholders in facilitating and supporting national and regional Net Zero targets. We welcome novel and new policy approaches being raised, however, being included as part of Draft Determinations without earlier signalling leaves only limited time for all stakeholders, including companies, to work through these before Final Determinations. Therefore, we suggest a further observation relevant for ED2 that fuller proposals are developed earlier in the ED2 process and we look forward to contributing to these.

Ofgem acknowledged in its August 2019 Open Letter<sup>2</sup> on the ED2 price control that it is likely (though not certain) that ED will be the most dynamic of the regulated energy sectors, and Ofgem expect ED networks to see the greatest impact arising from the forces of decarbonisation, decentralisation and digitalisation. Setting the development of ED2 against this backdrop, it is important to recognise the differences between the regulated sectors. A different approach and mindset will be required from Ofgem to ensure that the ED framework developed does not result in the risk of electricity distribution networks being a blocker to decarbonisation. This is important in relation to connection of renewable generation and decarbonisation of transport as the uptake of electric vehicles increases significantly during the period as well as steps to decarbonise heat.

We recognise that there will be uncertainty within the ED sector, however this can be managed through well-defined targeted uncertainty mechanisms and volume drivers. This will ensure customers do not pay unnecessarily, reduce the regulatory burden associated with many time

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<sup>1</sup> RIIO-ED2 Methodology Consultation: Overview, para 2.4, Ofgem

<sup>2</sup>[https://www.ofgem.gov.uk/system/files/docs/2019/08/open\\_letter\\_consultation\\_on\\_the\\_riio-ed2\\_price\\_control.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/08/open_letter_consultation_on_the_riio-ed2_price_control.pdf)



consuming and lengthy re-openers as is described in the Draft Determinations, whilst providing the ability for DNOs to access funding where the need arises.

This response to Ofgem's RIIO-2 Draft Determinations - Core document should be read in conjunction with our covering letter and associated responses within our supporting annexes. We would also urge that our response is considered in light of our previous responses to the RIIO-2 framework consultations.

## 2 Embedding the consumer voice in RIIO-2

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

We believe there is value in the Groups having an ongoing role throughout RIIO-2, especially with respect to encouraging companies to deliver on their customer and stakeholder engagement strategies. However, Ofgem needs to give greater transparency of how it takes the views of these Groups into account and provide clearer and ongoing guidance if there is a particular aim or aims for these Groups to achieve.

It would be preferable to keep the existing model of one Group per company as opposed to a single sector Group. This is because, in our experience Groups have built up a detailed and in-depth understanding of individual companies' strategies and customer bases.

Some form of annual reporting to companies and Ofgem could be beneficial, but this should avoid duplication of existing reporting requirements e.g. business plan commitments reporting as in ED1 for DNOs and the proposed PCD reporting in RIIO-2. Consideration should be given to how the report from the Groups is utilised by the sector including Ofgem and how any additional reporting fits with Ofgem's own reporting too (e.g. the annual reports) to ensure benefit of the activity and efforts by the stakeholders involved.

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

We are not convinced that it is in the best interests of consumers and network users to ask Groups to scrutinise new investment proposals developed through uncertainty mechanisms. We would expect that the parameters for such mechanisms will be set out in the relevant Licences and Guidance and that any applications submitted under these mechanisms would be subject to close scrutiny by Ofgem as part of its assessment process. In the case of Net Zero re-openers this would presumably be duplicating the work of the Net Zero Advisory Group as well. Ofgem is likely to need to be much more agile going forward. Adding more layers of input could lengthen timescales for proposals to come to Ofgem, Ofgem's assessment of them might be more complicated for limited benefit so a role for Groups in new investment proposals may not serve consumers interests overall.

If Ofgem does proceed on the basis as proposed within DDs, then it is critical that the scope of any input is clear, and the conclusions drawn by the Groups are reflected in any decision made by Ofgem.



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

Based on our experience with the current framework for RIIO-ED1 we do not see the value in asking Groups to publish an external facing report. DNOs already produce an annual business plan commitments report, which is compiled with stakeholder input and further reporting by Groups would be a duplication of this work with little or no additional benefit to customers.

Within the DD documents there are a number of reporting requirements being proposed, including reporting on Price Control Deliverables (PCDs), outputs, Consumer Value Proposition (CVP), Annual Environment Report (AER) and Digitalisation Action Plan progress amongst others. How this suite of reporting should evolve, for what audience and what consumer benefit should be carefully considered alongside any proposal of a further Group generated report so that companies, stakeholders and Ofgem are clear on the purpose, location, timing and content of reports. It is important to ensure that all reporting obligations provide the necessary consumer benefit and company transparency as a trade off to the time, resource and cost of creating such reports. Rather than producing a separate report, benefit might come from the Groups reviewing the companies own reporting.

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

As indicated in our answer to Q1, we can see value in the providing for continuity of Groups in light of commencing preparations for RIIO-3. A decision should be taken once Final Determinations are made and based upon the sector by sector benefits the Groups have delivered.

Based on what we have seen in terms of how much Ofgem has intervened in business plans that were strongly supported by user and customer engagement groups (CEGs), further work is needed on the role of Groups looking at the next price control. Given that a significant amount of time and effort has been invested in both Groups and companies in building up a detailed knowledge of the companies and the price control, it would be sensible to ensure that that knowledge is retained by the Groups as companies move through RIIO-2 into RIIO-3, but this is only sensible if Ofgem places weight on these Groups views.

### 3 Quality of service – setting outputs for RIIO-2

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

Licence obligations on a Digitalisation Strategy, Action Plan and adoption of best practice are expected to bring benefits in line with Energy Data Task Force findings. More work needs to be done on how energy data is used by stakeholders to say how and to what extent this will flow through to consumer benefits. Where data results in benefits to network businesses themselves and the benefit outweighs the cost, Ofgem can expect companies to get on with digitalisation.

We are aligned to the principles of best practice guidance and the principle of presumed open data, triaging such data and building this into governance structures will be the next steps we take.

We would caution however that some aspects of the guidance will bring significant challenges and costs involved in compliance and this needs to be considered when allowances are set in this area. Uncertainty over the standard approach to be taken means that companies may not be able to fully estimate the work involved in transitioning to a standard specified model.

The subject of data which networks do not routinely collect but may be requested by stakeholders also needs to be considered, with guidance and expectations to be shared so that companies and stakeholders are clear on areas of responsibility.

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

We agree with the frequency of publication of updates to the digitalisation strategies but feel the publication of digitalisation action plan updates every 6 months is too frequent and will place a significant burden on companies in terms of preparation and approval for external publication and will result in engagement fatigue quite quickly.

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

We will continue to work internally, and across industry towards the principles set out by the Energy Data Task Force, that data is presumed open, and is 'discoverable, searchable, understandable', with common 'structures, interfaces and standards' and is 'secure and resilient' and where appropriate will feed into the best practice guidance and other industry initiatives as they are developed.

As we continue our work in this area, we will become more informed as to which data should comply with the guidance.

We are a proactive contributor in the industry wide 'Data working group', recently established by the Energy Networks Association (ENA). This group focuses on the digitalisation of the networks across electricity and gas, including provision of network data in line with the recommendations of the Energy data taskforce. We are working with other members to identify new data fields, or value from existing datasets to maximise benefits for consumers. We consulted on our draft digitalisation strategy in December 2019 and are now looking to revise this taking into account stakeholder responses and Ofgem feedback. We have also recently published our Grid Digitalisation & Data Strategy as we continue to seek to better understand stakeholders' views on our steps to maximise the value of data.

We would like Ofgem to publish responses to this question as soon as possible as this data will assist us in understanding stakeholder and customer wants and needs. In addition, Ofgem clearly stating what level of data provision and digitisation network customers should fund is key as there are a range of approaches companies can take with more or less risk for consumers as to the cost/benefit trade off.

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

Yes, as set out in our response to Q4 we believe there is value in the Groups having an ongoing role throughout the price control though greater transparency of how Ofgem uses the insights from the Groups and what, if any, weight Ofgem places on Groups views needs to be provided to the Groups and other stakeholders. Our CEG is challenging us as we develop our business plan. A key issue is that the extent of the benefit of the Groups continuing is linked to the extent the business plan Ofgem takes forward is recognisable to the independent Group involved in its development. If a completely different plan and approach is taken the case for the Groups reviewing progress weakens. We are awaiting more insight as to what the stakeholder engagement incentive will be in RIIO-ED2 and the role of the Groups should be complementary to this. We do see an ongoing role for them in ensuring that customer and stakeholder engagement remains at the forefront of companies' business operations as we hope Ofgem allows our CEGs insights to shape business plans that are delivered.

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

We do think that areas of EAP are appropriate for a financial ODI (ODI-F) and note with interest the varied bespoke company proposals presented within company' business plans. The option of a financial ODI should also be considered on its own merits for RIIO-ED2.

Where "we summarise our consultation position on the minimum requirements for the RIIO-2 EAPs across all sectors"<sup>3</sup> this obviously would lend itself to a reputational ODI (ODI-R), however, where companies are able to demonstrate that they have gone beyond these minimum standards "and enhance the natural environment for current and future consumers"<sup>4</sup> there should be a mechanism to incentivise and reward companies to do this beyond a reputational consideration. It would then be for companies, considering the potential enduring role of Groups and through stakeholder and customer research to demonstrate that enhanced outcomes in this area are valued by customers and they are willing to pay for this. This is evidenced by Ofgem where it is stated that "Looking across the companies, we found that the ambition to deliver environmental improvements varied considerably."<sup>5</sup>

The purpose set out in the section of the core document "To ensure transparent and comparable reporting on the environmental performance of gas and transmission networks"<sup>6</sup> is right, although currently there are challenges regarding the scope, consistency and methodology of reporting between companies and also across the sectors. We would support the aim to "provide guidance to the companies on the scope and form of the AER... to hold a working group in autumn to work with the companies to develop the guidance."<sup>7</sup> Ideally, this type of workshop should have been held before draft determinations and it is important that process lessons of this nature can be learned for RIIO-ED2.

We agree with the requirement for the Annual Environment Report (AER) to ensure that companies are transparent in the reporting of the environmental impact of their network as well as demonstrating progress against their EAP, however, we would add that this reporting should be considered in conjunction with other reporting requirements on environmental matters in order to avoid duplication such as environmental reporting in the RIGS.

## 4 Ensuring efficient cost of service

We note the positions set out in this section of the DDs and that the process and assessment of efficient cost of service is bespoke to each sector. Given the unique characteristics of ED it is important that all parameters, methods and elements of ensuring efficient costs are developed appropriately for that sector. Where proposals made as part of this DD are considered appropriate to apply to ED then Ofgem should clearly state why this is appropriate and this should be consulted on as part of the ED2 SSMC.

As such, to the questions contained in this section of the document we would like to offer some macro comments but note these are principle points rather than a comment on the process that should apply to GD/T2. We also note that Real Price Effects (RPEs) allowances and ongoing efficiency assumptions

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<sup>3</sup> Core document, paragraph 4.48, Ofgem

<sup>4</sup> Core document, table below paragraph 4.48, Ofgem

<sup>5</sup> Core document, paragraph 4.52 Ofgem

<sup>6</sup> Core document, table below paragraph 4.48, Ofgem

<sup>7</sup> Core document, paragraph 4.63, Ofgem

form part of the referrals of the final determinations in PR19 to the CMA and as such it is important that robust and well evidenced conclusions and allowances are made with respect to these two items.

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

We welcome that the approach to cost assessment and application to ED is being consulted on as part of the SSMC.

We agree with the question that the *proposed cost structures, assessment of materiality, and choice of indices* are crucial to ensuring a fair assessment and allowance for RPEs. As with the process run for GD/T2 this assessment and proposal needs to be done on a sector specific basis as can be evidenced by the use of notional company cost structures for GDNs and company specific cost structures for transmission companies.

Ofgem should consider very carefully the impact of COVID-19 and the impact this will have on the indexation used in the ongoing annual true-up of RPE and allowances. Consideration should be given to whether the index used will reflect the legitimate cost pressures faced by the sector if it is couched in the experience of the wider economy. Ofgem indicates its view that the impact of COVID-19 on the energy sector is different to the wider or more general economy, and this should be considered very carefully with respect to RPE allowances and ongoing true-up mechanisms.

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

We note that the proposals on ongoing efficiency are at the top end of the plausible scale as assessed by CEPA. We also note that this aiming up is partly justified by the impact of innovation funding, structure and characteristics of the monopoly industry we operate in. Where the benefit of part of the existing framework is cited as evidence to support stronger measures as part of RIIO-2 this should be noted and collated to a central table to ensure evidence that these benefits are not being double counted.

Innovation investment has been primarily focused on meeting future challenges and supporting customers. The resulting efficiencies are visible in company submissions to the regulator. Innovation funding hasn't been focussed on reducing the costs of ongoing operations and existing requirements which companies are incentivised to do through other levers in the RIIO framework such as the TIM. Careful consideration of the calibration of ongoing efficiency and what this is aimed at achieving, as well as the consideration of catch-up efficiency and what that covers, needs to be given when justifying regulatory positions. It's important that being innovative doesn't become a zero-sum game to companies who need to balance a range of priorities. The regulatory framework needs to have real rewards for innovation, not unmerited additional discounts to future costs for past success in addressing future long-term challenges facing consumers, stakeholders and companies.

We have concerns that Ofgem are confusing and mis-applying the various levers in the RIIO toolkit and what they are designed to cover based on the justification for the proposed positions in Draft Determinations (e.g. ongoing efficiency and catch-up efficiency).

We also have concerns that the impact of COVID-19 is being underplayed and underassessed in these DDs. A global event with the impact that COVID-19 has had is unprecedented. Particularly given the timing of Gas and Electricity business plan submissions in December 2019 meaning that these plans won't have been able to reflect COVID-19 impacts.

In operating our ED business, at the time of this response in September 2020, we are still assessing the medium and longer-term implications of COVID-19. Any ongoing productivity assumption needs to be cognisant of this unknown impact and be calibrated in a way that isn't bullish in its assumption without quantification of all the facts.

## 5 Ensuring efficient financing

Please refer to annex 1 which provides our detailed comments on the financial issues raised within DDs.

## 6 Managing uncertainty

In general, to effectively manage uncertainty within the RIIO-2 framework, ENWL support a limited number of targeted uncertainty mechanisms that are well defined and are clear to what risk or uncertainty they address in the period. We do not support macro or broad measures such as the mid-period review reopener deployed in ED1, as the broadness of the mechanism leads to a lack of clarity for companies and Ofgem about how, why and when these should be applied and assessed. With ED2 starting two years after that of GD/T2 we believe that the level of uncertainty required to be managed should be less and therefore the approach taken for GD/T2 should not directly apply to ED2 for the reasons explained in our Overview section.

Indeed, we have concerns where the Draft Determination refers to "Cross-sector uncertainty mechanisms" without qualification that these should or shouldn't apply to ED. We are pleased to see uncertainty mechanisms and wider methods for managing uncertainty for ED are being consulted on separately and independently of the DDs through the ED2 SSMC. We note this should consider the impact on the level of uncertainty but not be limited to; the later start date for ED2, the differences of the challenges in ED compared to GD/T, and the lessons learned from the responses to the proposed package for managing uncertainty from this DD consultation.

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

As discussed above any mechanisms for managing uncertainty, including re-openers, should be clearly defined and targeted.

The most critical process consideration for re-openers is that Ofgem will need to be able to make material decisions much more rapidly than today's processes and based, relatively speaking, on incomplete information in a faster changing world compared to Ofgem's normal requirements for certainty including complete evidence of the highest standard. Greater transparency from Ofgem, laying out the basis on which it intends to take decisions will enable companies to react quickly to emerging needs and challenges as set out in the framework re-openers. The ability for Ofgem to act quickly is crucial to ensure Ofgem itself doesn't inadvertently become a blocker to decarbonisation and decentralisation of the energy system.

A common approach has a benefit of being clear and easy to understand where this is to apply in most of cases. We have concerns with the proposed approach for each of the parameters set out in the DD as shown in the extract table and related comments below.

Re-opener parameters	Consultation position
Re-opener application windows	Bring forward re-opener application windows from May to January. Reduce re-opener application window from one month to one week (ie last week of January).
Application requirements	Provide additional detail and guidance where possible in licence conditions and guidance.
Authority triggered re-opener	Authority can trigger a re-opener at any time during price control.
Materiality threshold	For each individual re-opener application, set a materiality threshold such that we will only adjust allowances if the changes to allowances resulting from our assessment, multiplied by the TIM incentive rate applicable to that licensee, exceeds a threshold of 1% of annual average base revenues (as set out in Final Determinations). Allow for aggregation of some re-openers subject to specific criteria.]

Taking each of the elements in turn:

- Re-opener application window:** The greater reliance on UMs and re-openers as proposed in the DDs will result in increased regulatory burden and this should be considered when making any changes to application windows or timescales. By bringing forward the application window from May to January, it is clear the only benefit is a longer assessment time for Ofgem, however, this isn't consistent with the need for agile and timely decision making as the speed of decarbonisation and the pathway to Net Zero becomes clearer. Consumers and the industry need a quicker and more appropriate approach to re-opener decisions given the large number of decisions Ofgem has positioned itself to need to make. It is unlikely to be sustainable without an overhaul to decision making processes that could impact many stakeholder's roles.

- **Application requirements:** We support the clarification and proposal to provide additional guidance to companies and all stakeholders. We also agree with the proposal to consult on the guidance and any subsequent amendments, before it comes into effect, but this must be done before price control starts and ideally should be done before Final Determinations. We would urge that this guidance and requirements on companies are proportionate and cognisant of the impact on the regulatory burden placed on companies and Ofgem. Its aim should be to support key objectives and not slow down the process and thus the regulatory requirements become a barrier to the industry in delivering essential activities under decarbonisation, Net Zero, or other considerations. Guidance should be clear and set out the requirements to ensure companies are aware of the criteria to which the authority “may reject any re-opener application that does not contain all the information necessary for us to make an informed decision on the contents of the application”<sup>8</sup> as set out in 7.21. As much as possible the company and stakeholders need to understand the basis and approach of Ofgem’s decision making so that the presented proposal from the companies align with Ofgem’s expectations and views.
- **Authority triggered re-openers:** We think that this parameter should apply to a small number of re-openers with defined windows, where consumer benefit can be demonstrated and not be applicable to any or all re-openers by default. We have concerns that this will increase uncertainty on companies.

The process for triggering re-openers should be the same for both Ofgem and companies in terms of certainty and clarity as to what might be triggered when. This isn’t the case as it stands in proposals where the Ofgem can trigger at any point. Certainty and clarity underpins good regulatory practise and an open-ended asymmetrical process does not provide this to companies and stakeholders alike.

- **Materiality threshold:** We support the flexibility to aggregate re-openers where there are items that don’t meet materiality on their own. It is unclear on reading the DD documentation precisely which re-openers are and are not eligible for aggregation and transparency is key. We would urge that a clear table is produced showing each re-opener and the associated parameters. It is also not clear why a higher or even a different materiality threshold should apply to aggregated items<sup>9</sup>. By the Ofgem definition a materiality threshold “provides a balance to ensure network companies and consumers are protected from significant variations in expenditure over the price control”<sup>10</sup> where significant variations should be based on the same definition, i.e. no difference between a single item materiality threshold and an aggregated claim where appropriately evidenced and justified against the relevant criteria. Also applying the company specific sharing factor (TIM) has the same effect of changing the level of significance between companies as well as the effect of a lower TIM than in RIIO-1 having the result of increasing materiality from RIIO-1 levels, which is inconsistent with a lower risk price control. Under a lower risk, lower returns price control it would be a surprise if materiality thresholds increased. A flat percentage of allowances, reviewed in the round to ensure risks are not increasing for companies with lower returns, would be simpler and not create differences in what is or is not significant between companies.

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<sup>8</sup> Core document, paragraph 7.21, Ofgem

<sup>9</sup>Core document, paragraph 7.34, Draft determinations give the example of 3% compared to 1% for single item re-openers.

<sup>10</sup> Core document, paragraph 7.32, Ofgem



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

We believe that it is essential that whole systems outcomes are, as a minimum, not precluded by regulatory arrangements and, where appropriate, should be enabled and incentivised to ensure that all network companies are focussed on delivering the most optimal outcome for all relevant consumers.

From discussions with Ofgem, we are anticipating that the Co-ordinated Adjustment Mechanism (CAM) is designed as a back-stop solution to be used in rare circumstances (especially in a shorter price control period) rather than one expected to be used commonly as fully formed plans should be developed by companies including consideration between all stakeholders as to which outputs and allowances should be set.

The approach Ofgem has taken in GD/T Draft Determinations by excluding any uncertain investment, instead preferring the use of uncertainty mechanisms means that the CAM is even less likely to be used as only those certain costs and projects are allowed in baseline expenditure. This results in the likelihood of another network being able to offer a whole system solution to the overall benefit of customers being even lower. **In light of this, and the potential complexity of the CAM and its timings, we believe it is worth Ofgem considering whether there is sufficient justification for the inclusion of this mechanism within RIIO-2.** If Ofgem does decide that the mechanism is required, we believe it should be developed bilaterally with companies. This is contingent upon Ofgem retaining the view that CAM is a mutual company consented mechanism where this is triggered by a single company.

Consideration needs to be given to projects identified within company plans, or that emerge within period where a whole system solution is identified, but due to the wider use of UMs no licensee has the ex-ante allowances/output obligation to be able to transfer it. The company triggering the UM to receive the funding adjustment to then transfer to another licensee appears impractical, and therefore there is a need for some method of the company delivering the solution to be able to have their revenues and outputs adjusted to take into account the new obligation. As it is currently designed the CAM is not able to do this with its prime purpose transferring from one licensed entity to another. The Net Zero re-opener could be one potential solution but would need to be adjusted to allow companies as well as Ofgem to be able to trigger this re-opener.

We make further comment on the CAM below:

- We consider the CAM only being applicable to asset-based solution as, flexibility-based solutions, or other such services will be managed on potentially shorter-term timescales through commercial arrangements.
- We agree with there being no materiality threshold, instead with a focus on ensuring customer benefit and we also agree with the logic that companies would not progress with an application where benefits are speculative or hard to demonstrate.
- Whilst we acknowledge that there will be a licence obligation (LO) on whole system co-operation and collaboration within RIIO-2, incentivisation within this area will further support the drive of focus towards whole system solutions and ensure that companies see the broader benefit of a CAM application. We support the intent of companies agreeing compensatory value associated to risk of any transfer and a share of any intended benefits are agreed within the commercial terms between companies when undertaking the CAM proposal and would strongly urge that guidance associated with the CAM is shared ahead of the price control

commencing so that there is clarity over expectations and what sort of levels of commercial benefit Ofgem sees as appropriate. We also believe that greater clarity is still required on what Ofgem will consider customer benefits and treatment of a proposal where material benefit falls outside of the sector enabling the solution.

- We agree there is no requirement for the “foreseeable” criteria.
- We agree with the proposal of application from one licensee, with a statement of agreement with the other licensee. We also agree that this should be network triggered only as a collaboration and not required or initiated by Ofgem on one or both licensee.

We have previously stated that one of the key enablers for whole system decision making is the existence of a whole system cost benefit analysis (CBA) and so are pleased to see this being covered within the Open Networks work, as well as sector specific CBA work. It is important that Ofgem are involved in this work and consider its use within CAM assessment as companies need to have clarity and clear guidance as to what the criteria they must consider when making their operational and investment decisions. Without this clarity in place and a supportive whole system CBA there is no ability to quantifiably conclude that the solution selected is the most efficient given whole system consideration.

We would add that companies have previously raised the subject of costs associated with exploring whole system solutions, preliminary studies and other preparatory work that would need to be undertaken on a routine basis ahead of any CAM application being considered necessary. We understand that the costs for any applications which go ahead would be included in the CAM, but there are also likely to be a range of costs associated with exploration of options that do not go ahead and therefore sit as aborted costs. These will be incurred by all companies as they seek to embed whole system exploration in their BAU approach however these are not costs that would have routinely been incurred in RIIO-1 and need to be considered within company’s overall totex allowances. Guidance over expectations on whole system collaboration and where costs are borne by for example DNOs to support TO exploration or vice versa is required to ensure fair and equitable arrangements are put in place.

We believe the next step in development and assessment of the CAM will be for Ofgem to stress test the CAM under a range of scenarios/case studies to see whether the issues raised in our response can be appropriately managed.

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

Careful thought needs to be given to this question given the timing difference of the RIIO-2 period with the other sectors. The DD currently considers years 2 and 4 as potential windows. This would mean submissions in May 2022 and May 2024 (or possibly January in line with Ofgem’s proposed common position on re-openers).

We would suggest that only one window is practical, and this should apply in year 3 (2023). The usefulness of the second window as being proposed in year 4 will not allow sufficient time for any solution to be delivered within the regulatory period and will overlap with the price control development for RIIO-3.

Consideration of the windows in ED2 is critical to ensure the CAM can be workable as envisaged, we set this out in more detail in our response to the SSMC for ED2 which is due for submission in October.

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

We were disappointed to see this proposal, not only in the context of RIIO-ED2, but as proposal for in-period licence changes to a sector's regulatory requirements not covered at all by this consultation. We consider this an error in process.

As such we do not expect that any decision will be made on the RIIO-ED1 regime through this consultation and decision. We will respond in more detail through an appropriate Ofgem consultation on RIIO-ED1 arrangements we expect Ofgem to conduct.

Therefore, we do not support proposals made through this consultation to make changes to ED1.

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

We agree with the two re-opener opportunities but question whether the first re-opener should be mandatory if the landscape since submission has remained stable.

We recognise that the scope of cyber resilience is uncertain in terms of the threats we may face and the fact that they can change rapidly based on external influences such as geopolitical scenarios, economic scenarios and the deployment of new technology.

OT cyber resilience is inherently bound to Cyber Assessment Framework (CAF) outcomes. As and when Ofgem publish an enhanced profile, company plans may have to be adjusted accordingly.

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

We understand that cyber security and resilience improvements would result in reduced risk and increased maturity and would therefore be demonstrated as a matter of course in any benefits analysis of project outcomes.

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

As set out previously to effectively manage uncertainty within the RIIO-2 framework, ENWL support a limited number of targeted uncertainty mechanisms that are well defined and are clear to what risk or uncertainty they are to address in the period. We do not support macro or broad measures such as the mid-period review re-opener deployed in ED1 as the broadness of the mechanism leads to a lack of clarity for companies and Ofgem about how, why and when these should be applied and assessed. As such, customers are best served by appropriate ex-ante allowances to companies.

That said a re-opener for non-operational IT and Telecoms capex where a defined external driver can be established is worth consideration on a sector by sector basis.

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

We support the retention of a re-opener to cover Critical National Infrastructure (CNI) to adjust revenues following government mandated changes to network site security requirements. This is exactly what re-openers and uncertainty mechanisms should be used for to cover changes in requirements that are externally driven and outside of companies control with respect to the

requirement to comply with mandated changes. To that end we disagree that a materiality threshold should apply to this re-opener and believe the approach on materiality should be consistent with the Cyber and IT re-openers. Applying any materiality threshold to a mandated and or legislative requirement wholly outside of companies control places all risk on companies which is inconsistent with a lower risk aspiration as set out by Ofgem for RIIO-2.

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

We note Ofgem's position that at DDs Ofgem do not currently propose to include any additional re-opener mechanisms relating to changes in legislation, policy, or technical standards. This is on the basis that Ofgem view they have insufficient information to justify the need for or scope of any such mechanisms in any sector currently.

Specific uncertainties relating to the ED sector will be covered within the RIIO-2 ED2 Sector Specific Methodology Consultation, however we would add that some of the issues raised within 7.88 are also relatable to the ED sector.

We don't think for our ED sector that additional reopeners for legislation, policy or technical standards are required, based on what we are currently aware of, especially with shorter price controls. However, of general applicability in principle to these Gas Distribution and Transmission controls, Ofgem cannot assume that no changes will occur in legislation, policy, or technical standards during the price control period and Ofgem should acknowledge that companies manage these pressures for consumers, by Ofgem ensuring they provide funding and reward for doing so. Also, particularly, where Ofgem is driving or influencing the legislation (e.g. Clean Energy Package), policy (e.g. Connection charging) or technical standards (e.g. cyber standards) then it is vital Ofgem has in mind when making any changes, especially as to their timing, the impact on the price controls Ofgem also set.

In general, Ofgem can assist all stakeholders and reduce costs for consumers by ensuring Ofgem driven or influenced changes are well signalled and timed to inform any changes to customer needs and the setting of price controls at the start of a period or fit into the programmes of UM's put in place. Once a price control has been set, managing the changes and risks during the price control is a source of value for customers driven by companies which needs to be appropriately rewarded and funded as part of the regulatory package in the round.

## 7 Net Zero and innovation

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

As these DDs are for the early RIIO-2 sectors, and ED is subject to a separate process we will comment in further detail within our response to the RIIO-ED2 SSMC. We would add that with DNOs due to submit business plans to the Ofgem challenge group in May 2021, covering the period 2023-2028, it is essential that, when assessing plans, Ofgem considers the future decarbonisation requirements and ambitions of both the UK and regions, such as Greater Manchester, that are targeting carbon neutrality at earlier deadlines than 2050. We expect Ofgem to be much clearer on what it expects to see in baselines and what will be rewarded or penalised under the BPI and how it will be assessed.

It is essential that the right environment is created to encourage continued investment for the future. Network investment is essential to realising clean growth and a green recovery by enabling the mass adoption of low carbon technologies such as electric vehicles and solar and providing a

reliable network for all. When Ofgem seeks to ensure Net Zero at lowest cost to consumers, it's important Ofgem outlines how this is assessed as low-cost solutions may be available in the short term but could result in higher overall costs to consumers to meet Net Zero

In principle Ofgem's approach is an option, but it does seem in its implementation to be a significant departure from how regulation has historically worked with much more decision-making reverting back to Ofgem even within the context of shorter price controls where we'd expect to have more predictability.

A major lesson in these price controls is that Ofgem might seek to be more transparent in the criteria it intends to apply to what is known and justified and how Ofgem defines known and justified. Ofgem is likely to face a major challenge in administering the Net Zero transition as the scale of requests for funding could be large (Ofgem has quoted double digit billions) and the need for speedy decisions moving at a pace inconsistent with normal regulatory decision-making practises with only partial information available.

We are surprised that a better balance to include more of the Net Zero proposals into baselines couldn't be reached through these price controls as Net Zero commitments are now enshrined in law, so the strength of need is likely increased leaving timing the more material consideration. We have not seen outlined how Ofgem balances between current and future consumers, as we'd expect many of the Net Zero investments needed to be of real benefit especially to future customers, particularly and possibly more efficiently delivered now rather than through multiple interventions over multiple price controls.

A better solution for customers and all stakeholders would be improved use of volume drivers and a convergence if possible on the level of certainty and criteria for progressing consumer funded investment in Net Zero between all stakeholders. This would mean that the Ofgem led removal of much of the Net Zero supporting investment wouldn't have been a major surprise and there would be better understanding as to how this decision by Ofgem benefitted consumers by not supporting so much decarbonisation driven action now through baseline funding.

It is therefore crucial that Ofgem create a framework and price control determination with the flexibility required to support Net Zero innovation and help companies meet increased consumer demand for low carbon energy sources.

It is appropriate to ensure that baseline funding is granted for known and justified investment needs, whilst investments with high degrees of uncertainty are subject to well defined uncertainty mechanisms (UM). It is important for Ofgem and companies to both be clear on the degree of uncertainty and what constitutes the need for funding to be considered as best served through an UM rather than baseline funding. Given the reaction to DDs we perceive that Ofgem has set the criteria on what goes in a baseline at a different place to that other stakeholders were expecting.

UMs in the form of re-openers, come with a natural degree of regulatory burden, take time and resource for both companies and Ofgem and therefore should only be used when they are considered to be in consumers best interest. Where UMs are to be used to facilitate network investment when a need becomes clearer, there should be an accelerated and transparent process to enable agile decision making and avoid Ofgem becoming a blocker on the country's pathway to decarbonisation. Volume drivers are an attractive option where the unit rate can be set, and the funding adjusts with the volume of an output or outcome as it is required. We provide more detailed comments on UM process within our response to question 12.

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

See response to question 21 above, however we have some concerns that the DDs refer to common sector-wide measures without qualification that these do not apply to ED (though they may be capable of being considered in due course) and that the decisions on the ED2 price control are not being made now, we would welcome more clarity being provided by Ofgem on this matter.

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

Our view is consistent with our response to the Net Zero Open Letter in May 2020, extracts of which are shared below. We would add that in the interest of transparency, it would be helpful if Ofgem published the Open Letter and the responses received (subject to respondent agreement) so that stakeholders can see respondent views and how this input has shaped Ofgem's thinking. We support transparency ourselves and have published our response on our website<sup>11</sup>.

We note the many references to the Net Zero Advisory Board both with reference to the Net Zero re-opener and also the Strategic Innovation Fund (SIF). It would be helpful for Ofgem to provide more information on the composition and work schedule for this group as there is limited information available at present and therefore it is unclear as to how this will be used to inform any decision by Ofgem to trigger the Net Zero re-opener.

We also recognise that Electricity Distribution has the benefit of time (i.e. Final Determinations in 2022) where policy and pathways may be clearer compared to Gas Distribution or Transmission which are to be settled much earlier. We therefore consider that this reopener proposal is possibly more needed and with greater likelihood of being triggered for the earlier RIIO-2 price controls than for ED2.

#### Scope

ENWL support a limited number of targeted uncertainty mechanisms that are well defined and are clear to what risk or uncertainty they are to address in the period. We do not believe the proposed broad scope of the Net Zero re-opener meets our criteria and therefore our position is that it should be reconsidered.

Our response to the Net Zero open letter proposed that the scope be linked only to those elements driven by change in government policy (either central or devolved), unforeseen breakthroughs in technology driving changes in consumer requirements or significant market driven changes leading to unforeseen lower LCT costs.

The broadness of the mechanism risks leading to a lack of clarity for all stakeholders including companies and Ofgem about how and why these should be applied and assessed. In our response in May we cautioned against setting any Net Zero mechanism with insufficiently defined parameters; these should be tightly set, targeted and linked only to those driven by change in government policy (either central or devolved), unforeseen breakthroughs in technology driving changes in consumer requirements or significant market driven changes leading to unforeseen lower low carbon technology costs.

The wording in the consultation position of "changes connected to the achievement of the Net Zero carbon target not otherwise captured by any other RIIO-2 mechanism"<sup>12</sup>, combined with the proposal

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<sup>11</sup> <https://www.enwl.co.uk/about-us/regulatory-information/riio2/>

<sup>12</sup> Core document, table below paragraph 8.20, Ofgem

that the re-opener can be used by Ofgem at any time in the price control brings a significant degree of uncertainty and risk to companies that changes to outputs and allowances can be made at any point in time for a variety of unknown reasons.

We are also unclear why there is a need for both the Net Zero re-opener and the Heat Policy re-opener for GD as the Net Zero re-opener appears to have the same trigger as Heat Policy would and this may be an opportunity to remove one UM option.

### Process

Whilst it was pleasing to see the recognition of licensees as providing valuable input to ensure the mechanism can work effectively, it is still unclear within the consultation document what timescales are anticipated for the duration of the process described.

As with the other re-openers or UMs within the DD proposals, the most critical process consideration for the Net Zero re-opener is that Ofgem will need to be able to make material decisions much more rapidly than today's processes and based, relatively speaking on incomplete information compared to Ofgem's normal requirements for a complete and high standard of evidence. This will enable companies to react quickly to an emerging Net Zero need.

Ofgem is clear that it considers a lower returns and lower risk price control to be the aim for RIIO-2, hence any Net Zero re-opener will be reserved for actions that a company will not be able to commit to absent regulatory agreement, as to do so would be higher risk. During RIIO-2 it looks likely that companies will have less financial flexibility to respond quickly to emergent needs and ahead of Ofgem providing funding, therefore cashflow considerations will be more important in RIIO-2 and could result in shovel ready projects needing to wait for revenue to start actually being collected, which in distribution could mean a two year pause until revenues can be set to fund the cash costs of investments. Then supply chains would need to be activated and then commence delivery, likely taking further time. It is therefore critical that any Net Zero re-opener process can be decided quickly and that there is timely positive impact on the cash position of the company if further expenditure is required.

The target should be for Ofgem to make any decision and enable the company to appropriately adjust its revenues to meet any new cash expenditure needs within three months of the start of the process. These kinds of timescales might be what's needed to avoid regulation becoming a blocker to meeting customer needs. Ofgem may want to also consider whether an approach where some initial funding could be rapidly released on a no-regrets/no-hindsight risk basis to allow companies to mobilise to meet urgent customer and stakeholder needs where these arise with a short lead time if Ofgem needs more time to make any decision(s).

### Materiality

In setting the materiality threshold and how the re-opener might work, the RIIO-2 package in the round needs to be reviewed and Ofgem's common approach to materiality should not necessarily be adopted by default. In a lower return price control with potential for more reliance on UMs or specific PCDs there is naturally much less flexibility for companies to respond as they have in RIIO-1 to changing environments without rapid decision making by Ofgem to determine allowances and direct that companies can immediately update their tariffs to fund the obligations agreed.

### Interlinkages

How any Return Adjustment Mechanisms (RAMs) are implemented is also key. Any re-opener funding for Net Zero would need to be adjusted for how any RAM works. This broad point of re-openers and the function of RAMs is a general one, but since a Net Zero reopener might be highly material, the concerns we have about how the mechanism works if RAMs are in place is important.



We strongly suggest that a detailed assessment of the interlinkages between different re-openers in place be carried out and shared and consulted on with companies and stakeholders.

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

We broadly welcome the introduction of the Strategic Innovation Fund (SIF) as it appears to widen the innovation focus beyond the electricity networks, including other energy vectors such as heat. This would appear to have the potential to allow for the qualification for funding of projects not currently allowable under NIC, such as those beyond the electricity meter, which are of net benefit to consumers.

It is important however to obtain a suitable balance between complexity and deliverability, and to avoid the SIF becoming overly expansive and as a result increasingly hard to prepare and, ultimately, deliver projects.

We would also be particularly keen to ensure that projects such as CLASS and Smart Street, which are considered highly innovative in nature, remain viable for funding through SIF as these have significantly positive consumer benefit cases. Both these projects include highly technical, network centric deliverables, not necessitating or requiring the element of co-ordination and collaboration perhaps envisaged within the SIF, but that, owing to their being beyond the scope of NIA, wouldn't have been possible to progress without NIC. In introducing SIF as a replacement to NIC, Ofgem should seek to ensure that projects such as CLASS and Smart Street don't inadvertently fall between the gap in innovation funding (i.e. between NIA and SIF).

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

We look forward to learning more about SIF and having further opportunity to comment on its practical application in due course, especially for RIIO-ED2. We note the SIF is ambitious, and there will be lots of work needed to ensure the processes are well understood, practical and ultimately fit for purpose. Similarly, it is our view that ongoing support and regular review will be required to ensure SIF delivers its aims throughout the period of RIIO-2. Ofgem need to be cognisant that this might attract a considerable overhead dependant on the requirements.

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

We agree in principle with this approach though it needs to be looked at on a sector specific basis. The benchmarking method used ought to suitably consider the changes in innovation challenge in the period between RIIO-1 and RIIO-2 and, if necessary, as evidenced by a network operator through its business plan, make appropriate adjustments. As such, it's important that the benchmarking process is suitably flexible to allow the network operator to present evidence to support a more ambitious innovation proposal for RIIO-2.

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

We agree there are opportunities for improved reporting of innovation-funded activities. We are working with gas and electricity colleagues through the ENA on a range of improvements for RIIO-2 and look forward to continuing discussions with Ofgem on their applicability.

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

We believe the proposals to strengthen the RIIO-2 NIA framework are sensible and the direction of travel for NIA is consistent with the broader aims of stakeholders. To appropriately satisfy these aims, the drafting of all associated changes to the NIA governance document will be crucial, ensuring that the strengthening is effective and as intended. We believe the ENA and its member companies can add considerable value to this process, and we are pleased to note the intention of Ofgem to hold workshops on drafting updates to the governance.

We are comfortable with proposals that eligible projects should focus on issues associated with the energy system transition (EST) or they seek to address a particular consumer vulnerability. We consider this narrowing of the focus from that of ED1 to offer potential for better alignment across networks, thereby increasing the opportunity for collaboration between companies. However, as with any change to the eligibility criteria, there is a danger that a project such as transformer oil regeneration, which sought to introduce a viable method of extending the safe operating lifespan of transformers and which is now BAU, would not meet the proposed qualifying criteria for NIA, nor, owing to its being a high-risk, long-term project, would it meet the expected threshold for BAU innovation. Given this, we believe that careful consideration of the appropriate definition of EST and, for similar reasons, customer vulnerability, should be given to avoid potential for innovations such as oil regeneration being considered ineligible for funding thus risking not being done at all. Clearly, such an outcome would not be in the best interests of vulnerable customers and customers more generally who might otherwise have benefited from the increased efficiencies.

We are broadly supportive of the proposal to require all NIA projects to develop solutions that deliver net benefits to customers in the relevant sector as it is these customers that pay for the projects in the first place.

We are pleased to see inclusion for consideration of the impact of innovation upon vulnerable consumers. This is an important development and one we aim to address in part through our Smart Street project, which through its reductions in energy consumed, is expected to deliver significant savings to over 20k vulnerable consumers during ED1 continuing into ED2.

We fully support the aim to increase third-party involvement in NIA. It's crucially important that all network operators continue to engage fully and effectively with third-parties as appropriate on network innovation.

On proposals for the development of a collective guidance document for third-parties covering IP, we are not convinced that this will address the issues of inconsistency between DNOs as is its stated aim. Matters of consistency in application of the governance document are perhaps best addressed through the collaborative working between organisations, most probably via the ENA, to agree, for example, a set of common legal terms covering IP, which can be understood and adopted across all parties seeking to draw upon NIA. Perhaps this work ought to form part of planned future work on redrafting of the NIA governance document.

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

Whilst needing to avoid costly post-project completion reviews which would appear to offer only limited value, particularly given the high volume of NIA projects, we broadly welcome the addition of quality assurance measures in respect of the robustness of NIA projects in RIIO-2. To add most value this ought to happen at the start of the process during project registration and continue through its delivery.

We consider quality assurance is most effectively and efficiently achieved through self-auditing of projects including for this within all aspects of NIA project reporting (i.e. project registration as well as annual and final reports). Further, we believe the ENA can play a key role in this, perhaps through its facilitating an 'annual audit report' of the portfolio (or a section of based on theme) of NIA projects.

Furthermore, individual network operators ought to consider establishing 'innovation links' with a network of relevant stakeholders (perhaps including Local Authorities, Universities and technology providers) whom could be approached to provide the necessary quality assurances being sought.

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

We agree with the proposal to carry forward any unspent NIA funds from RIIO-1. We also support the proposal to provide the allowance as a package to be expended by the networks within the five years of the price control period as opposed to fixed amounts in each of the five years. This allows considerably greater flexibility in project delivery and potentially for the inclusion of slightly larger projects within the NIA portfolio.

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

In principle this seems reasonable although it should be considered whether it is proportional and shouldn't have the consequence of slowing the process down or rejecting projects that are of clear benefit to consumers and stakeholders.

#### Increasing competition

As this consultation relates specifically to the Gas Distribution and Transmission sectors, and ED is subject to its own ongoing RIIO-2 framework development, we will respond in greater detail to the SSMC rather than specifically to questions 32 and 33 set out in the DD consultation.

We do note with interest the proposals to introduce both early and late competition to all eligible projects which are funded via uncertainty mechanisms. We also note that it appears to be Ofgem's intention to approve company's proposed design which appears to be a greater involvement beyond Ofgem's traditional role as economic regulator especially when we note the diverse and complex broad range of options and decisions that might be brought to Ofgem to review.

In the case of the ESO's Early Competition Plan (ECP), due February 2021, we believe it is too early to be able to provide any detailed or sufficiently informed views at this time, however we will closely follow the process and await further visibility on views of how any ECP could be applied to ED. Given the ECP is due at a time where DNOs will be close to finalising their RIIO-ED2 business plans it is important that this interdependency is clearly recognised and late changes to Business Plan Guidance are avoided.

## 8 Approach to the Totex and Business Plan Incentive Mechanisms

We have not answered questions 34, 35 and 36 as we seek not to influence the decisions that are made for individual companies, our comments are limited to high-level policy points where these apply to individual sectors or the energy sector as a whole.

It has been clear that there has been a lack of understanding and clarity surrounding the BPI and the process of its assessment. This is not limited to the timing and depth of guidance provided to companies. Ofgem should seek to avoid the BPI becoming a skewed incentive where companies only aim to avoid significant downside penalties where the observable and achievable upside is much smaller. This will reduce companies ambition where compliance with the guidance is the goal thereby reducing the potential overall outcome for consumers.

We also have reservations that the interaction between stages 3 and 4 of the BPI as well as the calibration of the TIM and the materiality threshold for re-openers has been full considered. We welcome that the TIM for GDNs has retained some of its incentive strength, but consider the TIM set for the transmission companies, if applied to other sectors, would risk less delivery of improved outcomes for consumers in RIIO-2 and beyond due to low sharing factors.

We welcome that more clarity and guidance as to the approach to BPI and CVP for ED2 is being consulted on as part of the SSMC and urge that lessons are learned from these DDs to improve the outcome for all stakeholders as part of that process.

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

It has been clear through industry discussions and workshops that there has been uncertainty over the CVP element of the business plan guidance and this has manifested itself in the outcome of the DD proposals.

It is now clear from the DD proposals that this disconnect between Ofgem's expectation, many stakeholders, customer engagement groups and companies understanding which has resulted in a larger than expected number of CVP proposals presented, yet a very small number assessed as meeting criteria, and an even lower number considered worthy of a reward. This will not have been helped by the iterative approach to Ofgem producing business plan guidance.

We expect lessons to be learned for the ED process from this experience so that both DNOs, stakeholders and Ofgem can have a more positive experience, underpinned by clearer guidance on expectations and method of assessment. DNOs are working together collaboratively on a convergence project on how Social Return on Investment or SROI can be standardised. We urge that Ofgem consider the output and progress of this project and how this can enhance CVP assessment for RIIO-ED2.

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

It is appropriate that companies are held to account for delivery against the proposals in which they received a reward for and in the case of non-delivery a clawback to be in place, but this needs to be clearly defined and developed in consultation with companies and stakeholders. It is positive to see Ofgem noting that alternative methods of delivering the same outcome will be considered as part of this and also accepting that circumstances do change, and companies may identify better ways of delivering outcomes for customers.

We would add that it is important (as in the case of all items which are subject to assessment at closeout) that the closeout report requirement must be scoped up in conjunction with companies and stakeholders ahead of the price control commencing, ideally before business plan submissions and certainly before Final Determinations. It is crucial that Ofgem avoid the temptation of leaving closeout mechanisms to be drafted during the price control as this brings risk to both companies and customers and also risks external factors further delaying completion of work, as is evidenced by recent need to defer the RIIO-1 closeout methodology for GD/T due to the COVID-19 pandemic<sup>13</sup>.

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

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

We would make two points as to the interlinkages described in the chapter.

First, the DDs cover TO's, ESO, GT and GDNs and do not relate to the price controls for ED (RIIO-ED2). This means Ofgem must identify any specific interlinkages for ED and consult on its approach during the RIIO-ED2 process. We will then take the opportunity to comment on interlinkages in more detail as part of that process.

Second, while we are encouraged by Ofgem's transparent approach in setting out its views on interlinkages, we are concerned that Ofgem is influenced by the possibility of CMA appeals and is seeking to preserve additional flexibility as a means to protect its position in such appeals. For that reason, we think it is helpful to be clear as to how interlinkages should play into an appeals process.

The most helpful source on this is the view expressed by the CMA in its letter to Ofgem of 30 October 2019. The CMA explained:

- in accordance with previous appeal determinations, the CMA will take interlinkages into account;
- regulators should explain these interlinkages, and the reasons for them, in their decision documentation;
- an appellant cannot "cherry pick" just one specific unfavourable component of a regulatory decision where that is not in practice a separable decision; and
- the overall price control is the combination of a number of individual decisions, and it is not beyond the CMA's powers to review these individual decisions, on the basis that they need to be considered "in the round" with decisions that are otherwise unconnected parts of the regulatory settlement.

We think this position is clear. Where there are interlinkages, Ofgem needs to specify them and do so clearly, and not just refer in general terms to "in the round interlinkages" at a very high level. To the extent interlinkages inform decision making, we would expect Ofgem to state clearly the interlinkages and the effect that they have had. Where Ofgem does so, and there is an appeal, the CMA is well able to consider those interlinkages, including those which need to be considered "in the round". Altogether, this ensures that any appeal focuses on the right issues, and all the right issues, and does

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<sup>13</sup> Covid-19: Amendments to RIIO-1 Network Price Control Processes for 2020, page 5, Ofgem, May 2020

not result in any party considering that matters remain “unresolved” at the conclusion of any appeal process.

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

We have nothing to add in response to this question.

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

We understand that Ofgem’s position is that “in appropriate circumstances, we will consider whether to review wider aspects of the price control settlement following the conclusion of a successful appeal to the CMA. The aim of such a review would be to ensure a coherent regulatory settlement is maintained in the event the CMA’s decision has material knock on consequences for the wider price control settlement.”<sup>14</sup>

Ofgem gives two examples of where it envisages a post appeals review may be carried out. These are:

- “The CMA quashes the decision(s) appealed and remits to Ofgem for reconsideration with a direction that Ofgem reconsider the decision and consider interlinkages; or
- The CMA quashes the decision(s) appealed, retakes the decision itself but directs Ofgem to consider interlinkages.”<sup>15</sup>

Ofgem suggests this is not an exhaustive list, as it is difficult to set out possible future scenarios. The key issue from our perspective is whether Ofgem is intending to leave open the possibility of post appeals reviews in circumstances where it has not been specifically directed to (re)consider a matter by the CMA.

If Ofgem is clarifying that it will do as directed, then we do not consider that any policy statement needs to be made. A policy statement setting out that Ofgem would comply with the binding directions of the CMA is otiose.

If Ofgem is intending to leave open the possibility of further post appeals reviews, Ofgem should be explicit about its intentions, to allow parties to engage meaningfully. That said, if this is Ofgem’s intention, the comments provided by ENWL in its March 2019 response to Ofgem’s Cross-sector questions would continue to apply. We elaborate on those points below.

- 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

<sup>14</sup> Core document, table below paragraph 11.30, Ofgem

<sup>15</sup> Core document, paragraph 11.32, Ofgem

and making any such directions as are necessary. As set out in response to Question 39, the CMA is able to consider interlinkages in the appeals process. 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.

- In circumstances where, further to a decision on appeal by the CMA, Ofgem reopened and reconsidered an aspect that it was not directed to by the CMA, it is highly likely that the parties subject to any further changes would appeal this decision. It cannot be in anyone's interests – least of all consumers – for repeated adjustments to be made to price control settlements. Ofgem would also, in that scenario, need to be aware of the deleterious effect on regulatory certainty, which would increase the risk associated with investing in regulated companies (and so increase licensees' cost of equity).

In practical terms, the perceived threat (that matters will be reopened after an appeal) will mean that the consideration of interlinkages in any appeal process will be vital. As set out in response to Question 39 above, this process rightly begins with the regulator explaining interlinkages in its decision. Ofgem should not seek to reserve to itself the possibility of considering interlinkages other than those raised in its decision or considered in the appeals process. The threat to coherence of a regulatory settlement would only arise if Ofgem does not properly document relevant interlinkages and/or fails to raise them in an appeals processes.

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

Ofgem's position is that it "expect[s] any prospective appellant to send pre-action correspondence at a sufficiently early stage after the publication of Final Determinations and ahead of the deadline for making an application for permission to appeal."<sup>16</sup> Ofgem makes reference to the view of the CMA, which we consider is a helpful starting point. The CMA stated:

*"We wish to encourage this pre-appeal conduct [of early, active engagement] as good practice. Where it appears that appellants have acted in a way which, without good reason, makes case management more difficult, for example appellants who fail to engage with the appropriate regulators and notify us and update us about their potential intentions to appeal, this could be reflected in our assessment of their conduct when allocating costs at the end of the appeal, even when such appeals are successful. Ideally, we would prefer such pre-notification to include the potential scope of any appeal, rather than be limited to notification of the potential existence of an appeal."*<sup>17</sup>

While we appreciate that early and positive engagement with the regulator about appeals is a practice to be encouraged, we would be surprised if Ofgem was unaware of the likely grounds of dispute given the degree of engagement during the price control process. Moreover, there are practical reasons why it may be difficult or inappropriate to engage early. In particular, Ofgem will appreciate that deciding to bring an appeal to the CMA is often a finely-balanced decision and companies will want to see the final outcome of the price control process before deciding whether to appeal or not. Ofgem's position, that such pre-action correspondence is "expected" is not clear as to the legal effect envisaged, and it would be helpful if Ofgem clarified its position.

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<sup>16</sup> Core document, table below paragraph 11.30, Ofgem

<sup>17</sup> CMA Response: Clarification of our position on potential Energy Licence Modification Appeals, paragraph 12, CMA



To the extent Ofgem is seeking to make pre-action correspondence compulsory, we would note that the process for appeals to the CMA is well-established, and laid down in legislation, supplemented by the CMA's rules on energy licence modification appeals (CMA70). Companies should adhere to the requirements of the appeal process. This process has been designed to be fair and workable to both appellants and the regulator. Prospective appellants can decide what, if any, further information they share with Ofgem beyond that which is legally required. It is not for Ofgem to add to or amend the CMA's rules or the statutory process.

To the extent Ofgem is seeking to position the lack of pre-action correspondence as a matter that the CMA should take account of in allocating costs at the end of an appeal, we would note that this too is a matter for the CMA. It cannot be for one party to an appeal to determine the terms on which costs are allocated between parties. In contrast, the CMA's view appears not to place an "expectation" of pre-action correspondence on appellants.

It follows from the above that we have nothing to add on the proposed timing for "encouraged", voluntary pre-action correspondence.

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

A global event with the impact that COVID-19 has had is unprecedented. The timing of Gas and Transmission business plan submissions in December 2019 means that these plans won't have been able to reflect COVID-19 impacts.

In operating our ED business, at the time of this response in September 2020, we are still assessing the medium and longer-term implications of COVID-19. In the short term, through the COVID-19 restrictions, we have found our agility, the commitment of our workforce and supply chain and by listening to stakeholders and customers that we have been able to continue to provide a high standard of service, throughout the period to date. We also continued, in response to customer and stakeholder needs to provide new connections where safe to do so as well as sustaining the delivery of our maintenance and resilience programmes of work. We took the view from the start of the COVID-19 restrictions that safety of employees and the public is paramount, but also our vital services would be even more critical, especially if COVID-19 impacts on our customers continued into the winter months.

Inevitably, whilst focussing on customer needs, the rapid changes we made to our business to ensure that vital services continued as seamlessly as possible have led costs to increase. For example, simple changes we've made, like we now use both our existing company vehicles and staff's own cars paid company mileage so that staff going to fix power cuts don't travel together for extended periods. We've also been doing different mixes of maintenance work as certain jobs we need to do offer better ability to protect the public and our workforce social distancing compared to the most efficient, optimised programmes we'd normally undertake. Under the ED1 Totex Incentive Mechanism the increased costs are shared with customers and shareholders. At the scale these costs to date have been incurred to date, we don't currently think action is needed by Ofgem in our current price control to address any shortfalls in allowances. It's too early to say even now what the enduring impacts might be on our costs and service levels. For example, it is unclear to what extent we will return to the, "old pre COVID-19 normal". **Therefore, we expect Ofgem will want to be able to take into account new evidence from GD/T companies on COVID-19 impacts and take these into account when setting final determinations.** In our case, as an ED company, our separate process is running about 2 years later. So, we expect to be able to more effectively assess and evidence the medium and longer-term impacts of COVID-19, if material enough on our business and reflect these into our final business plan in December 2021. A decision on in period mechanisms may still need to be made based on the circumstances.

More widely, the working between Ofgem and network companies in response to the pandemic outbreak and subsequently towards supporting customers has been an exemplar of how regulation can work under the RIIO-1 framework. It is important that the overall package in RIIO-2 is mindful of the successes of RIIO-1 for customers and does not impede the decisive and customer focussed actions companies took to protect delivery of vital services, at additional cost, without recourse to Ofgem in advance. RIIO-2 might include no flexibility in the settlement for companies and is much more focussed on companies making cases to Ofgem for new customer and stakeholder requirements and if new risks come to pass. This could be a problematical way to work in the event of similar or repeat COVID-19 type situations in RIIO-2, as Ofgem may be required to take rapid and decisive action directly to enable companies to respond as they have in RIIO-1.

Ofgem should consider the 2020/21 fiscal year carefully as this was affected due to COVID-19 when Ofgem undertakes cost assessment and benchmarking. Additionally, Ofgem should ensure that appropriate indices for changes to costs during the price control are reflective of network company cost changes. The energy networks sector provides essential services and has largely continued through the pandemic. Reference indices for costs might place too much weight on other sectors that have responded differently and have latent capacity in them due to COVID-19. We request Ofgem does not use an unrepresentative index influenced by sectors that have had a down turn and probably therefore won't have the same cost pressures as energy networks. Additionally, ways of working might be altered that affect productivity levels now and the scope to drive future productivity improvements might be impacted. Indeed, the energy sector will likely see relatively more price pressures than much of the rest of the economy as the energy sector offers the opportunity to build back better, investing in infrastructure for long term societal and consumer benefit that commences work to address the decarbonisation challenge. Hence general indexes and measures of cost are likely to diverge from energy sector costs due to the COVID-19 shock's different impact to each sector. To the extent that Ofgem agrees costs through uncertainty mechanisms during GD/T2, these cost submissions can take COVID-19 impacts into account as they are made, meaning it's the base costs most susceptible to COVID-19 change that Ofgem and companies need to consider how best to do any necessary adjustments.

# Appendix 2: response to RII0-2 Draft Determinations Finance Annex questions

September 2020



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## 1 Overview

Electricity North West Limited (ENWL) is an Electricity Distribution Network Operator (DNO). Our interest stems from the potential consequential impact on the framework development for RIIO-ED2, commencing in 2023, as well as the impact the proposals will have on the energy sector as a whole and those consumers in our operating region. We urge that Ofgem consider the requirements for ED specifically and reflect this in the proposals made as part of that framework development for RIIO-ED2.

We have reviewed the Draft Determination proposals and would comment that issues remain on Finance where we consider Ofgem is making errors. We set these out in our response to the financing annex through our responses to question posed in the consultation.

The financing duty of Ofgem is to ensure that an efficient individual licensee can secure both debt and equity funding. In RIIO-2 Ofgem is wrongly interpreting this duty as being to a notionally geared, artificially identified group of companies, creating circumstances of windfalls to some companies at the expense of financeability and/or reduced equity returns (and therefore investment incentives) for others. We continue to disagree with the proposed approach to debt allowances which fails to fund efficiently incurred debt costs and urge that Ofgem ensures that licensees can secure both debt and equity finance consistent with its financing duty.

Further, RIIO-2 provides almost no opportunity for individual companies to absorb adverse effects of these financing issues in the round and this is compounded by the introduction of a Return Adjustment Mechanisms (RAMs) proposed to operate without considering financing and tax performance. The consequence is that companies like ourselves that perform strongly for our customers, set industry efficiency benchmarks at ED1, but have efficient debt taken out in the market ahead of the financial crisis are less able to achieve fair returns by offsetting debt underfunding by incentivised strong performance for customers. We do this in RIIO-ED1. We would urge that Ofgem includes finance and tax within RAMs as this would better protect customers and consumers from inappropriate returns resulting in RIIO-2. Further, Ofgem's proposal not to take derivatives into account in assessing the cost of debt is illogical. Derivatives are an important way to manage risks for our customers as well as shareholders. Our views should be familiar to Ofgem through our ongoing dialogue and we have shared our views with the CMA as part of our submissions on PR19<sup>1</sup>.

We have worked to provide a substantial body of independent expert evidence to Ofgem's finance work stream through the ENA's RIIO-2 Finance Working Group. The independent consultant reports referenced within our response are being provided alongside through the Energy Networks Association's (ENA) response to this consultation and are therefore not appended to our individual response. A considerable body of evidence has been provided by the ENA which merits thorough consideration by Ofgem, including reviewing evidence that has already been considered as Ofgem is reaching incorrect conclusions, often based solely on Ofgem's own judgements justified with what appears to be weaker evidence.

We are concerned that Ofgem's approach to financial matters is skewed and represents an unbalanced settlement where extreme positions are selected in all components. Applying the extreme-end of a plausible scale in all areas risks driving unintended consequences and behaviours and leads to inadequate investor appetite to drive forward decarbonisation in line with government policy, worsening outcomes for consumers. We urge Ofgem to take a more balanced approach, adopting positions more credibly within the ranges of evidence rather than towards particular ends of

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<sup>1</sup> [https://assets.publishing.service.gov.uk/media/5ebeb46e90e071e33ce88a4/Electricity\\_North\\_West\\_Ltd\\_Redacted.pdf](https://assets.publishing.service.gov.uk/media/5ebeb46e90e071e33ce88a4/Electricity_North_West_Ltd_Redacted.pdf)

a spectrum and to rebalance how Ofgem weights the needs to attract long term investment for future customers with short term bill reductions.

Here after is our response to specific questions posed in the Finance annex of the RII0-2 Draft Determination consultation.

## 2 Allowed return on debt questions

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

As a general point of principle, we continue to have concerns over a one-size fits no one approach to setting the debt allowance. A full indexation methodology, calibrated to the expected sector debt costs, will provide cross-generational outperformance to those 'lucky and large' networks, while perpetuating financeability headwinds for others.

We understand the Ofgem desire to incentivise the networks to outperform the debt allowance, but do not believe that this outperformance should benefit the networks for decades after the end of a regulatory period.

We believe that the suitability of any approach is best measured with respect to its outcomes. Ensuring the financeability of individual networks, through the re-distribution of the sector debt allowances towards those networks with higher embedded debt costs, would provide significant benefits over the current approach without additional costs for UK consumers.

We recognise the concerns raised previously in respect of any straight pass-through of debt costs, and although we continue to believe it is more appropriate than the full indexation approach, we believe a modified approach that provides individual networks with pass-through of embedded costs only, can deliver incentivisation for new financing, while also protecting consumers interests through debt efficiency tests in Business Plan submissions.

With respect to estimating debt costs, either under the proposed or any alternate approach to setting the debt allowance, we raise the following points of principle:

- The cost of derivatives should be included in any estimation. A key function of derivatives is risk management. To the extent that the efficiency of derivatives cannot be understood simply, networks should be asked to provide additional information in a form that Ofgem can use to better understand even those who have complex derivatives arrangements.
- We support the inclusion of all areas of financing – including transaction costs, liquidity management and pre-financing.
- To the extent that networks are exposed to RPI basis risk on financing following Ofgem's decision to move to CPI or CPIH, the efficient cost of hedging this risk should be included in the estimation of debt costs.
- We recognise that intercompany loans need to be considered individually and should be considered for inclusion on a case-by-case basis.
- If it can be demonstrated that some networks suffer structurally higher financing costs, such as from being an infrequent issuer in capital markets, then the additional costs should be included for that network. We look forward to providing you with our evidence during the development of proposals for ED2 as to the levels required.
- Incorporating additional sectors into any calibrated average will accentuate the issues noted above, while providing minimal benefits to consumers.

- Debt allowance outperformance or underperformance should be seen as much of an incentive mechanism as any other incentive mechanism. If there is to be a Returns Adjustment Mechanism (RAM), this should include all returns to Equity, and therefore be struck after debt allowance performance which should also be included in the RAM.

We look forward to working with Ofgem in formulating an improved approach for setting RIIO-ED2 debt allowances and will provide additional detail in our response to FQ1 of the SSMC.

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

We note our existing concerns regarding Ofgem's approach in our response above to FQ1.

Providing that the primary objective holds - being to reimburse the estimated sector debt costs - the choice of reference index is of reduced importance, as any resulting allowance can be structured to be largely equivalent through the use of a wedge or a deduction. While such adjustments can be justified by reference to transaction costs, the halo effect, or similar, this process of justification is less critical than that of delivering on the primary objective and reimbursing networks with the appropriate allowance. We consider the appropriate allowance is set on a company specific basis.

We do not have a view at this stage on whether the Utilities index is ultimately more appropriate, but we look forward to working with Ofgem as part of the ENA Finance Working Group to understand the relative benefits and weaknesses of the proposal.

We note that the period covered by any index, and whether a constant timeframe or tromboning structure is adopted, is of arguably more importance than selection of the base index. If this structure is inappropriate, the allowance will not accurately match the refinancing profile of networks and would also expose those networks to significant underperformance in the event of any rate reversion.

This risk could be reduced through the adoption of a modified pass-through approach as discussed in FQ1.

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

As noted in our response to FQ1, we do not support a one-size fits all approach to setting the debt allowance.

We support bespoke mechanisms in principle, particularly when this delivers additional wider benefits, such as ensuring the financeability of networks.

Ofgem should set allowances for debt costs as they do for other allowances, i.e. taking the individual circumstances of the licensee into account, including such as infrequent issuers in capital markets or the timing of efficiently incurred issuances.

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

The mechanical attempt to introduce indexation into the equity allowance has pitfalls. Equity investors into UK infrastructure provide patient capital and seek long-term stable returns.



While indexation may seem attractive to regulators, adjusting CAPM for short term fluctuations for risk-free rate in isolation is an error and provides a false sense of precision in the output, while also being disjointed from the expectations of investors, which are forward looking and long-term.

Following the revision to five-year price controls, we do not believe equity indexation is either necessary or a positive development for networks or consumers.

### 3 Equity beta questions

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

We firmly support the conclusions drawn in Oxera's Cost of Equity for RIIO-2 Q4 2019 update where they find that it would be inappropriate to place a high weight on water network betas.

Systematic risk refers to the risk inherent in the entire market and beta is a measure of the systematic risk of the security (or sector) relative to the entire market.

We view that achievement of net-zero carbon, as prescribed by Government, affects the market as a whole and is not just single company or sector related. Further, some sectors, notably energy are affected more by this than others. We therefore do not agree with CEPA's assertion that such risk is idiosyncratic, but we do agree that there will be greater change in energy networks than water.

CEPA state that:

*"While the scope for change may be greater in energy networks, some of the risks and opportunities resulting from energy network transitions are likely to be idiosyncratic rather than systematic in nature. Based on current regulatory arrangements heightened uncertainty does not necessarily translate into heightened systematic risk exposure and, therefore, the risk premium that might be demanded by investors."*

It is clear that substantial investment in energy networks will be required to reach Government's Net Zero carbon challenges, and that energy networks will be expected to take the lead in achieving these unprecedented goals. These challenges deliver significant risk and uncertainty but are expected to happen in the energy sector. In contrast, CEPA reference that water also face infrastructure challenges (and therefore risk) and cite the potential need for investment to improve resilience against drought situations. It is clear that the first is a requirement and brings with it significant delivery risk; the second is uncertain.

It is also clear that the Electricity Distribution companies face far more technological and delivery challenges in delivering and spear-heading the move to net zero and should not be compared on a relative risk basis to water.

As outlined above, we do not believe the use of water companies, particularly for Electricity Distribution companies, is appropriate. Notwithstanding this, a further concern in their use is how equity returns are measured. If Ofgem include quoted water companies as the basis of investor expectations for equity returns, then they should ensure that debt outperformance included in quoted company results is stripped out before equity returns are measured.

*FQ6. Is there evidence of a material difference in systematic risk between:*

- a) RIIO-1 and RIIO-2,*
- b) distribution and transmission networks,*
- c) gas transmission and electricity transmission,*
- d) gas and electricity?*

There are clearly different risk delivery challenges between the sectors to achieve Government targets of Net Zero. Electricity Distribution networks face substantial delivery and technological challenges in not only meeting internal company-specific Net Zero targets but also acting as the leader and enabler to allow thousands of businesses and millions of customers to meet their own ambitions and targets. Given this diversity in our customer base and in the network circumstances, ED faces unique infrastructure challenges in meeting what will likely be an enormous variety of low-carbon challenges on the distribution network.

## 4 Step-2 implied cost of equity consultation questions

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

It appears Ofgem's current stance on this matter is born out of the NERL CMA challenge. Specifically, Ofgem state:

*"...that given our combined assumptions for risk-free and TMR, common approaches to re-gearing asset betas have the effect of increasing the overall WACC estimate. The result holds, even when using high estimates of debt beta, after accounting for the impact of tax, and when using various re-gearing formulae options. The overall effect can imply that the cost of capital is approximately 10bps higher for each five percentage point increase in gearing. We also note that lower levels of debt beta exacerbate this effect, as anticipated in the SSMD,<sup>97</sup> making us further doubt arguments that we should assume a low debt beta."<sup>2</sup>*

As part of the PR19 CMA appeal Oxera have looked in to this issue and it appears that the assumptions Ofgem are using, particularly regarding the RfR, are the primary cause of this effect. We believe that use of an appropriate RfR (see Annex 1 of ENA submission to CMA review of Ofwat Price Determinations for PR19<sup>3</sup>) alongside reasonable CAPM assumptions can overcome this issue. We also believe that using this argument to justify a higher debt beta is misplaced.

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

ENA has provided evidence to caution on the interpretation of cross-checks Ofgem use such as MARs, OFTO's and investment management forecasts. As we have previously set out, we believe there is a great deal of subjectivity which gives rise to a range of answers and thereby significantly impact their ability to provide objective support to conclusions drawn from the CAPM.

Regarding MARs, Ofgem's proposals rely heavily on water companies. We are concerned about such significant use of water companies in the overall analysis (see response to FQ5 for example), and in particular the use in this instance to justify MARs based arguments on a false premise that they are in any way good proxies for energy companies, let alone Electricity Distribution companies.

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<sup>2</sup> RIIO-2 Draft Determinations – Finance Annex, para 3.70, Ofgem

<sup>3</sup> ENA representation to CMA Annex 1, 'Are sovereign yields the risk-free rate for the CAPM?', Oxera, May 2020

Regarding OFTOs, we maintain this is not a valid cross-check due to the significant risk and structural differences between networks and OFTOs.

For ED2, we believe that calibration of cross-checks should be better targeted and more appropriate.

## 5 Step-3 allowed return on equity consultation questions

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

Our view remains consistent with the Oxera's November 2019 update paper on the cost of equity.

The ENA has provided a substantive body of evidence to support the component parts of CAPM. Ofgem has routinely disregarded this evidence in favour of results that instead deliver lower CAPM equity returns, while providing only cursory explanation or evaluation.

The evidence disregarded is not simply a matter of judgement that can be dismissed. All data should be considered, with the weight of evidence then providing direction within the distribution of outcomes.

We are concerned that once again alleged evidence has been sought to justify the Stage 1 downside positions at stage 2, and that the evidence provided by the ENA through its consultants has been largely ignored.

The stage 3 adjustment (allowed v expected returns) should never be necessary in a well calibrated incentive-based regulatory regime – especially one that is now likely to include RAMs as an overall check to ensure returns remain within ranges Ofgem sets. Again though, evidence has seemingly been sought to attempt to substantiate yet another downside adjustment.

In each case Ofgem have erred on the downside resulting in a cherry-picked theoretical composite that is difficult to rationalise and not credible in a real-world situation. The overall approach is simply not balanced.

Ofgem state that a key aim is to support achievement of Government targets on net-zero carbon. This will require significant investment, particularly from Electricity Distribution companies, and due to the inherent uncertainty in how this will be achieved, could lead to further risk in the paths chosen to fulfil this ambition. This investment requirement is incompatible with the current calibration of the cost of equity.

*FQ10. What is your view on the expected outperformance estimate of 0.25% at 60% notional gearing? Do you recommend alternative analysis techniques or do you have suggested improvements to the analytical files published alongside this consultation?*

- a) "AR-ER database.xlsx"
- b) "Residual outperformance.xlsx"
- c) "Simple MAR application model.xlsx"

As mentioned in FQ9 above, the stage 3 adjustment (allowed v expected returns) should never be necessary in a well calibrated incentive-based regulatory regime - it is curious that Ofgem appear to be the only regulator to feel the need to employ such a catch-all adjustment. Its inherent current and future uncertainty will result in erosion of investor confidence and increase the risk they face, as well

as tempering their view of a stable and predictable regulator for future regulatory determinations. It is also likely to have adverse impacts on the incentive regime.

The behavioural impacts of such an adjustment were clearly explained in the Frontier paper prepared for the ENA “ADJUSTING BASELINE RETURNS FOR ANTICIPATED OUTPERFORMANCE – An assessment of Ofgem’s proposals (March 2019)”.

As for alternatives (a) to (c) above, the basis is all historical. There is a fundamental disconnect here in so much as RIIO2 is presenting a far tougher incentive regime, which contains substantial changes that tighten it, exposing companies to more downside risk than anything gone before, so basing an adjustment on historical evidence in attempting to adjust for future expected outperformance is conceptually wrong. An example is the selection of such a high efficiency bar for setting cost allowances at tougher than upper quartile.

Notwithstanding our concerns with the use of such an adjustment, an alternative approach to assess the balance of the whole package would be to assess the overall incentive/opportunity of outperformance against overall penalty/risk of underperformance. This should include all elements of the RIIO-2 package, including financing. Without this assessment it is impossible to justify a lowering of equity return rates against investor expectations.

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

Given our view of the initial adjustment as expressed in answers to questions FQ9 and FQ10 above, we don’t think this is necessary and adds more uncertainty into the mix for investors, distorts incentives and other adverse impacts thereby adding to consumers long term costs and likely reducing the future benefits the regime to date has achieved.

That said, and specifically in answer to this question, the Draft Determination does not provide sufficient detail on the specifics of such a mechanism giving rise to a number of questions:

- What does performance mean?
- How will it be measured? Does it include financing and tax (it should)?
- Why apply a sector average? Will this be weighted? What are the consequences for individual company decision-making?
- Has any impact assessment been conducted?
- If in the event that Ofgem find that the sector underperforms due say to insufficient totex allowances being provided to cover the investment needed, will Ofgem provide a positive uplift adjustment?
- How will the impact of Ofgem’s own within period decisions be treated on the substantial range of in period adjustment mechanism?
- What are the likely impacts for future price controls?
- Will future processes be consistent?
- Will this lead to a systemic position of winners and losers within sectors?
- What is the economic impact on a region of having a systemic loser or winner in the region?

There are probably many more questions to be considered on this proposal, especially at a sector level basis, which is likely to lead to differing conclusions. The uncertainty surrounding this proposal and its future implications seem to add to the confusion and risk of the price control outcome rather than alleviate it. This proposal was flawed from the start in principle, has been insufficiently developed, and

is now being shaped with late evidence that should have been provided earlier and as developed has major changes far too late in the process.

With future Ofgem clarification, we expect to provide an answer to these questions during the ED process as our understanding of the process develops. We remain particularly convinced that there is no evidential basis for an adjustment downwards in returns in ED and that this would have detriment to customers as the energy system decentralises and decarbonises.

## 6 Financeability Questions

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

We do not agree with Ofgem's approach to assessing financeability.

As a fundamental principle, we consider that Ofgem's legislative duty is to ensure the financeability of individual networks and not the notional company. As such, it follows that the regulator needs to have due regard to individual company circumstances to successfully discharge this duty.

We equally accept that this cannot represent carte-blanche for networks and there should be a requirement to identify any inefficient costs to avoid customers funding these. However, this financing duty is established to ensure that the long-term interests of consumers in each licence area are met.

It also cannot be appropriate to set equity returns independently and then expect equity to simply subsidise under funding associated with efficiently raised debt with no implications.

We look forward to working with Ofgem on the financeability assessment for the RIIO-ED2 price control.

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

The results of the financeability assessment should not be used to justify the choice of notional gearing.

Notional company gearing is a determining factor in the long-term financing structure of networks. Regulatory consistency is critically important here and any decision to move from previous price controls needs to be carefully considered and well-justified.

The actual gearing levels of networks is an important consideration. If it can be demonstrated that these are consistently below the current notional gearing level and any change can also be justified with regard to customers interests then a well-signalled change, with transitional arrangements may be appropriate.

The financeability assessment at the existing notional gearing level should be sense-checked as to whether the equity return, and debt allowance proposals are viable. The notional gearing level should not be used as a lever to make the assessment workable.

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

The COVID-19 pandemic has highlighted three particular areas:

- The short-term volume risk that networks are exposed to.
- The requirement to maintain stress-test levels of liquidity and committed facilities.
- The value of structuring facilities with covenant headroom.

We have provided evidence to Ofgem on the impact of the pandemic as part of the Covid-19 Financial Monitoring.

We have not reviewed the notional company financing assumptions in detail but will provide feedback as part of the RIIO-ED2 process.

The areas highlighted above, to our minds, are important considerations when setting the debt allowance and equity returns.

The cost of maintaining appropriate levels of liquidity and committed facilities should be factored into the estimation of debt costs. While the related variability, and therefore risk, in equity returns arising from the pandemic should be an important cross-check for the CAPM derived equity return.

## 7 Corporation Tax questions

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

Out of the options put forward for consideration, we would agree that Option A is the most suitable.

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

Although we agree in principle to making allocation and allowance rates Variable Values so that they are more aligned to actual results, we would like to see further guidance on how this will work in practice. In particular, for the change in allocation percentages, could the allocations be different for individual years and would the onus be on the company to calculate and revise the allocations on an annual basis? Would it be a requirement for companies to perform this calculation annually, even if they are not expecting the outcome to be materially different to the previous allocation? What methodology would be put in place to ensure a consistent approach is taken across the network operators? Furthermore, we would like to ensure that the simplification does not result in unintended consequences which have a detrimental effect on the calculation of the tax allowance.

*FQ17. Do you agree with the proposed additional protections? In particular:*

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

We agree that there should be a level of materiality in place. The current RIIO deadband affects allowances, rather than being a tool to make an assessment of materiality for a tax reconciliation. Therefore, at this stage, we would need to undertake further analysis to determine what would be an appropriate materiality threshold, which we anticipate performing for the RIIO ED2 process.

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

We are mindful of certain instances where the clawback mechanism might have the following unintended consequences, for example:

- The impact of Ofgem changing notional gearing
- Where interest costs are disallowed for tax
- If there is a timing difference, i.e. where the associated tax benefit was not received for the period in question.

We believe these consequences should be taken into consideration when ascertaining whether the tax clawback should be applied.

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

We have concerns about the structure and balance of the proposed wording, especially when considered alongside the drafting for other such re-opener mechanisms. This has been underlined by Ofgem's response where they have stated that they do not necessarily expect this tax review mechanism to result in positive adjustments to the tax allowance (albeit they have stated that the drafting will remain silent on this). We believe there should be safeguards put in place that are in line with other re-opener mechanisms. We would like to see further guidance and clarification on the process that stakeholders must follow to notify Ofgem of a concern.

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

The Board Assurance Statement as drafted appears to have two key objectives.

The first is to provide assurance to Ofgem that that information provided by networks in the tax reconciliation is accurate and reflects a true and fair view of the network's position. We do not feel a separate assurance statement is warranted in this area. The tax reconciliation will form part of the expanded RIG submission and it will be subject to the collective DAG control procedures with Director sign-off.

The second objective appears to be a request for Directors to confirm that "the notional tax allowance as calculated by the PCFM represents a fair reflection of the Licensee's actual tax liability". This can only ever be provided subject to the items included in the CT600 reconciliation, as such we do not understand this requirement. We do however understand that the wording is being reconsidered by Ofgem. This statement also needs to be qualified to take account of tax deductions and/or timings for which Ofgem has not given allowances within the current period. For instance, the licensees may have derivatives. To the extent that these are not taken into account by Ofgem in setting allowances, the tax effect should also be allowed as a reconciling adjustment.

Separately, we highlight the additional existing documentation and processes that support the legitimacy of a network's tax affairs, including the SAO certification, Fair Tax Mark and published Tax Strategy.

## 8 Return adjustment mechanism questions

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

We do not support the inclusion of RAMs within the RIIO-2 framework as these are not required if Ofgem sets an appropriate price control at the outset. RAMs distort the working of incentives, whose property has been one of the cornerstones of the success for consumers of Ofgem's regulatory regime.

The justification for the introduction of the Return Adjustment Mechanisms (RAMs) appears to be two-fold. Firstly, as a failsafe to cap any perceived excess returns generated by strongly performing networks and secondly, to protect the cash flows and financeability of underperforming networks.

While a symmetrical RAMs mechanism is attractive from a simplicity perspective, it does not accurately reflect the weight of consequences at each boundary. The shape of the RAM ought to be informed by the package in the round of the regulatory mechanisms, and what scope Ofgem wants to allow for company performance to drive the level of returns achieved. The design of the RAM might need to be company specific, and the elements included and not included in how the RAMs work might impact how it is designed symmetrically or otherwise.

We believe that Ofgem needs to give greater consideration to setting an appropriate floor level for the RAMs, ensuring that it is triggered at a level, and in a manner, that limits distress of the affected networks in a way that is proportional to those networks impacted at the RAMs ceiling. This will be an important factor both in assessing downside financeability and in discussions with ratings agencies.

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

A single threshold level benefits simplicity, but noting our response to FQ18, we do not necessarily support a symmetrical threshold either side of the baseline allowed return on equity.

Any RAM should be structured so that does not disincentivise networks from continuing to strive for innovation and further efficiency. The threshold level should be set in this context.

This Draft Determination is not in respect of Electricity Distribution; therefore, we do not feel it appropriate to opine on whether the 300 basis points is appropriate, but we look forward to considering any RAMs proposals in more detail as part of RIIO-ED2 process.

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

We have a fundamental issue with the current RAMs proposal which is that it is not in consumers interests to introduce this measure as it merely represents a fail-safe mechanism to give Ofgem confidence returns will be within certain bounds, moving us more towards rate of return regulation.

The RAMs proposal is clearly structured around equity returns, with adjustments triggered as those returns deviate materially from the baseline.

We do not see how it can be justified to base the RAMs assessment on an incomplete view of equity returns, which excludes financing and tax performance.

It is not unfeasible for a network that is poorly performing operationally to be granted additional effective subsidisation from customers, while also being overfunded in respect of its debt costs. This cannot be in the interests of customers.



It is essential for the technical integrity of the mechanism that RAMs include financing and tax performance – i.e. include all net returns to equity and not some. Whilst RAMs are not in consumers interest, improperly implementing the policy measure will worsen this measures impact on consumers.

The price control mechanism already includes various existing measures to control the levels of out and under performance in specific areas. The rationale to include another measure in respect of certain specific items only is limited, while it is misleading to present it as a solution to perceived excess returns while it remains an incomplete view of excess returns itself (i.e. excludes tax and financing as currently proposed).

As a final point, in the context of a price control including RAMs, we do not see the justification for also including an adjustment to equity returns for allowed versus expected returns. Ofgem is introducing layers of complexity into the price control in areas such uncertainty mechanisms, while refusing to consider alternate approaches elsewhere on the grounds of regulatory consistency and simplicity.

Should Ofgem continue with both RAMs and an adjustment to equity returns, the baseline equity return must be set at the expected return level and the RAM should be set around the baseline equity return pre-any adjustment. The logic of this is clear if one considers a situation with a larger allowed versus expected adjustment was proposed – say 200bps. In this scenario, Ofgem would be setting allowed returns 200bps below the return level required by investors on the basis that they will outperform. However, if the current RAM proposal was also adopted with baseline returns set at the allowed return level, returns would then start to be adjusted when they were only 100bps higher the expected level (or indeed 500bps below). This is clearly an undesirable outcome.

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

The problems inherent in the Retail Price Index are well understood. While so, as highlighted in 9.5, steps are underway to reform the index, with changes potentially introduced from 2025, two years into RIIO-ED2.

Any move away from RPI is problematic for networks. Adopting RPI-linked financing, either directly as index linked bonds or through the use of derivatives, has helped manage inflation risk in networks for many years. Much of this RPI-linked financing is structural and long-term, it cannot be restructured easily without cost. If CPI or CPIH is adopted, then this could not have been foreseen by networks and debt allowances should be adjusted to include the cost of removing any resulting basis risk.

While there was a strong rationale to implement an alternate measure of inflation in RIIO-2, we believe this rationale has diminished following the reform proposals. Noting the negative impact associated with the change, we do not believe the ‘ends’ justify the ‘means’ and we request that Ofgem reconsiders this strategy for RIIO-ED2.

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

As a general principle we would support the adjustment of capitalisation rates to limit the intergenerational mismatch of asset usage and charges, as well as any perceived RAV stranding risk. We are not close enough to the detail on the respective sectors to opine on any adjustment mechanism.

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

As a starting reference point, we would agree with estimating capitalisation rates from accounting distinctions. However, if deviations can be justified and agreed by networks and Ofgem, we also support moderate deviations from this natural rate if in the wider interests of consumers. However, excessive deviation will become an issue if the ratings agencies view it as an artificial construct.

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

There are number of approximations in the assessment of capitalisation rates and it will never be perfectly accurate. Neither does it need to be. The benefits of predictability and certainty over capitalisation rates are significant and, in this area, they should not be disregarded in the pursuit of greater alignment with historic accounting distinctions.

The scope for a material restatement of RAV following an ex-post adjustment is a real concern and this could inadvertently lead to breach of financial covenants and financial distress.

For these reasons, we do not support the use of ex-post adjustments for capitalisation rates.

To the extent that additional totex awarded through uncertainty mechanisms has a materially different natural capitalisation rate, the specific capitalisation rate for this spend should be agreed ex-ante as part of the award, if the individual or cumulative amount is significant.

## 9 RAV opening balance questions

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

We are comfortable with Ofgem's proposal to use closing RIIO-1 RAV balances as opening balances for RIIO-2. This maintains regulatory consistency and underpins long-term financial planning.

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

We are comfortable with using estimated opening RIIO-2 balances on an interim basis subject to:

1. There being a clear audit trail as to how opening balances are derived, and therefore a clear path to truing them up and;
2. The close-out process being determined in advance of RIIO-1 closing and being implemented in as short a time period as possible to avoid unnecessary and prolonged uncertainty.

## 10 RIIO-1 close-out questions

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

We are comfortable with the proposed high-level process.

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

Yes, we are happy that estimates are used. An absence of estimates could lead to unnecessary lumpy revenue profiles, and fair estimates ensure companies are appropriately compensated at the right time.

## 11 Disposal of assets questions

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

We are happy with this. It is consistent with the ED1 approach.

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

We agree that Ofgem should have some oversight in this regard. In such circumstances it might be preferable to have an independent review to assure any adjustment to totex. However, the process should be quick and only apply to an onward disposal taking place within a reasonable period of time after the initial transfer, reasonable being a function of the value involved.

## 12 Time value of money questions

*FQ31. Do you agree with our proposal to apply one interest rate to revisions to PCFM*

We do not believe the proposal of applying one interest rate to all revisions is appropriate.

We do recognise that a bank rate plus a margin can be suitable for those instances where it is purely a short-term timing difference and a network can reasonably be expected to accommodate through existing cash or short-term bank facilities.

However, we believe the WACC remains the correct discount rate when adjustments reflect permanent corrections to the price control, or a more substantial timing adjustment that impacts shareholder dividends, thereby being effectively financed through a mix of capital.

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

In broad terms, we agree with a margin-based approach for certain PCFM revisions. The methodology used to calculate the margin of 110bps also appears reasonable but should be calibrated against short-term funding costs of the networks.

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

As outlined in our response to FQ31, we consider that a bank rate plus a margin can be suitable in those instances where it is purely a timing difference and a network can reasonably be expected to accommodate this timing difference through existing cash or short-term bank facilities.

However, we believe the WACC remains the correct discount rate when adjustments reflect permanent corrections, or a more substantial timing adjustment that impacts shareholder dividends, thereby being effectively financed through a mix of equity and debt capital.

## 13 Revenue forecasting questions

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

At this very early stage, it is difficult to either agree or disagree with the proposal given the insufficient detail on both licence drafting and modelling to fully understand the impacts. This needs careful consideration, particularly regarding any impact on the licence, to ensure any new process is fully understood and doesn't have unintended consequences. We prefer to comment on this when the proposal is more fully developed, and therefore anticipate providing a response for the ED2 process.

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

It is too early for us to provide an answer to this. We will consider this during the ED2 process.

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

We do not agree that additional reporting on executive pay/remuneration and dividend policies will help to improve the legitimacy and transparency of a company's performance under the price control. We believe that current reporting requirements, under various statutory provisions, provide a level of disclosure that is both sufficient and consistent. We believe that there will be insufficient consistency and context available in the public domain (due to commercial sensitivity, data protection, etc) to enable fair comparison and assessment of such disclosure. It should be noted that disclosure of executive pay creates a barrier to promotion and recruitment/ retention of talent which the industry needs to be able to attract. Regarding reporting of dividend policies, having set an expected rate of return and an incentive/penalty regime around this, coupled with a gearing limitation, we fail to see the purpose of publishing dividend policies. If the purpose is to restrict dividends, then this represents a restriction on equity earnings and needs to be factored into the overall equity return allowance.

## 14 Base Revenue definition and ODI cap/collar questions

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

Please refer to FQ34 response.

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

Please refer to FQ34 response.

# Appendix 3: response to RII0-2 Draft Determinations Electricity System Operator Annex questions

September 2020



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## 1 Overview

As the Distribution Network Operator (DNO) for the North West of England, Electricity North West (ENWL) works closely with National Grid as the System Operator (ESO). As DNOs are actively evolving to the new role and responsibilities of a Distribution System Operator (DSO) this interaction with other parts of the energy system becomes ever more crucial.

Following the recent legal separation, and collaborative role the ESO will need to play in transforming the energy system, the time is right for the ESO to have its first standalone price control which is specifically designed to consider the unique nature of its business and the need for it to work more closely with others as the energy system decentralises.

We have been engaged in the RIIO-2 process to ensure that an appropriate price control is built which will enable the ESO to deliver its key functions in collaboration with others and is flexible enough to adapt to the rapidly changing energy system and its role within it. The DDs is a significant milestone in this journey and we share our views in this annex where appropriate.

We would like to draw out the increasing need for formal collaboration between DNOs, the ESO, and industry (including Ofgem). Whilst the ESO has some insights and experience in managing markets and network planning, it is unwise to try to develop wider plans in isolation or to consider the ESO is naturally positioned to take industry leadership. The industry has embarked on a long-term transition to DSO, collaborating through the Open Networks ENA project and elsewhere. It is critical that the ESO and DNOs work together collaboratively over the coming years to maximise benefits for consumers and take learning from each other. This is demonstrated through the aspects of role three which have proved hard to measure, and Ofgem's grading and comments on the delivery schedule. There are several references to integration and seamless interface/planning with distribution and this must be planned together rather than specified within one company's plans which effectively beholden the other party.

As well as collaborating to enable decarbonisation where there is much emphasis on future needs, the ESO still needs to focus on more every day matters such as carefully defining products and effectively operating markets including for example timely market information and managing code changes. These are areas the ESO must not lose sight of.

We appreciate the scale of complex work Ofgem has done on these ESO proposals. Though we've had limited time for detailed analysis of ESO DD content due to the amount of policy being shared simultaneously over the summer, plus a relatively time-compressed eight-week consultation, (rather than the standard 12 week we were originally anticipating for such a wide interest consultation and a new type of price control). Therefore, our comments are limited to regulatory principles and approach and we have not responded in detail within some areas.

We will continue to engage with Ofgem and the ESO throughout the price control process and will share our views on the updated delivery schedule as well as the forthcoming guidance document.

## 2 Incentives framework

We have not answered question 1 or 2 as we are not involved with the Electricity Market Reform (EMR) function, and therefore are not able to constructively comment on this area of operations.

*ESOQ3. Do you agree we should regulate system restoration costs in a consistent manner to other external balancing costs?*

The proposals appear to ensure that performance on Black Start is appropriately monitored which we support given it is important that the ESO and Ofgem do not lose any emphasis on what is a critical element of the ESO's role by moving away from the standalone Black Start assessment process.

We would add that it is important that costs do not escalate in this area following the removal of the disallowance mechanism. Therefore, scrutiny via the overall external balancing cost assessment should continue to ensure value for customers.

Whilst we acknowledge Ofgem's reference that the ESO has the ability to unlock substantial benefits for consumers, this does not mean that costs should be unchecked. Removing a disallowance mechanism, in an area where costs were noted as high in prior years, should not be undertaken without an appropriate and robust alternative in place.

We agree with the logic of having one overall incentive package in place for the ESO and therefore bringing in the Black Start performance and EMR elements simplify the framework.

*ESOQ4. Do you agree with our approach to setting up-front performance expectations?*

An evaluative approach to incentives is always challenging and therefore setting up-front performance expectations is key. It is critical that the ESO is clear on the expectations ahead of the period and also on how the assessment process will be undertaken, including the criteria and evidence required. Stakeholder input is also critical to ensure that the work programme and performance metrics are well supported and widely understood.

We note that the DDs show Ofgem's grading on the submitted Delivery Schedule, however given the requirement for an updated Delivery Schedule to be provided by the ESO by 9 October 2020 it is important that this final grading is completed and shared as soon as is practicable. This is to ensure that both the ESO and stakeholders have clarity on clear expectations and how delivery and incentive performance are linked.

*ESOQ5. Do you agree that a financial reward or penalty should be determined every two-years, to align with the period over which we set expectations, costs and outputs?*

We agree with the incentive period covering the two-year business plan cycle, therefore removing the need for a separate forward plan. This reduces regulatory burden and provides stakeholders with earlier visibility of programme of work and outcomes. At present the forward work plan is published too close to the start of the year for stakeholder views to influence plans in any meaningful way. By using Business Plans and running Delivery Schedules as an alternative this will allow stakeholders to actively input at an earlier stage than seen in RIIO-1. This also better reflects the nature of many of the ESOs actions which do not always naturally lend themselves to neat one-year segments.

We agree with Ofgem that to "bank" incentive earnings or penalties in six monthly increments will not be reflective of the ESO's performance over the full two-year period. This will bring more complexity into the process and puts the ESO at risk of changes that will undo what was previously granted.



Based on observations to date we haven't seen particularly material rewards. This might simply be reflective of lack lustre performance, although we would expect that Ofgem would be in regular discussions with the ESO if this was the case. Instead this may represent the challenges of an evaluative regime and therefore clearer up-front expectations and explicit assessment criteria will help to manage this hence we want to see strong performance from the ESO in a regime which allows them to be able to earn and receive incentive rewards that will be sufficiently motivating.

*ESOQ6. Do you agree with our proposed approach to within-scheme feedback, including the timings and approach to performance panel sessions?*

We agree with Ofgem's proposals on in-period feedback, we consider this essential to ensure that the ESO has regular feedback from the performance panel. We also agree that the six-monthly intervals, with a full evaluation at the 12-month period and end of scheme point, strikes the right balance between administration burden and ensuring that the ESO is clear on expectations and the panels view on performance. It is important that there is timely and clear feedback that is transparently given and might be responded to by the ESO, again transparently if necessary.

We note that there are no proposals for a call for evidence or formal event at each six-month interval. However, it is not clear whether it is the intention that these are still held at the 12-month and two-year points. It is critical that stakeholder views are not lost in this new process as they are invaluable to support the panel in forming their views. we strongly suggest that these are maintained and held at the 12-month and two-year points.

*ESOQ7. Do you agree with our proposed evaluation criteria for RIIO-2?*

We agree in principle to the elements of assessment as laid out in the consultation position set out in table 9. We note that there is limited detail to be able to fully comment on the incentive regime and so intend to respond to the more detailed implementation and guidance document when it is consulted upon later this year as indicated in paragraph 2.56.

*ESOQ8. Do you agree with our proposals on the incentive scheme value?*

We have stated in previous consultation responses that the incentive strength for the ESO should be sufficient to drive the desired behaviours, however, at the same time not so great as it causes financeability issues for the new standalone ESO.

We agree with the preservation of a downside penalty, whilst maintaining an attractive enough upside value to drive performance. To some extent there needs to be strong performance from the ESO to benefit customers, therefore creating a virtuous circle; if the price control regime is clear on what good performance looks like that will earn an incentive, the incentive is paid and new clear and stretching targets are met. Experience to date of only modest incentive payments might be a reflection of the process in practice, as well as potentially ESO delivery capabilities. We also support equal emphasis on each of the three roles but recognise that there are limited performance metrics and measures on role three compared to the others which may need further consideration when coming to evaluate performance.

### 3 Outputs

*ESOQ9. Do you think that our proposals will capture the full scope of minimum obligations/standards associated with the ESO's Business Plan activities?*

We agree with the principle of ensuring that obligations on whole system outcomes should be consistent across DNOs, TOs and the ESO and welcome this clarification. We would caution that this work must be done mindful of the timing of and separate processes (e.g. ED2) for other consultations on any changes to the other sectors licence so that policy or licence conditions for one sector are not set as default by another sectors consultation process. This is particularly important for ED which is two years behind the ESO in terms of the RIIO-2 price control process and framework development.

It is also important that any new licence conditions referenced in paragraph 3.6 do not place new obligations on the ESO over and above their existing role and it is clear that the ESO should collaborate with DSO's as the energy system decentralises. It is key to enable DSO's who are closer to regional customers and operate more complex networks with millions of nodes and customers in increasingly dynamic and complex ways. The complexity of DSO is arguably much more complex than ESO and will require a different mix of capabilities to the ESO.

We are interested to better understand the intent behind the proposal to place obligations on the ESO to set strategic direction in code functions and welcome greater clarification on what this means in practice and how this fits with the BEIS and Ofgem significant code review of energy codes. Feedback on the ESO's performance in code management has been historically poor compared to other code managers.

*ESOQ10. Do you agree with our proposed changes to the ESO Roles Framework guidance?*

As we explain in our answer to question 4, we understand the challenges that exist with an evaluative incentive regime and therefore are supportive of the intent to update the roles framework guidance to provide greater clarity on the expectations as well as what "exceeding baseline" looks like.

We are less certain on the Ofgem guidance prescribing expectations from the ESO's second business plan period (2023-2025) as this should come from the ESO and its stakeholders building on the progress towards the longer-term vision, rather than specified by an economic regulator.

We note the reference that there is the possibility that the guidance may be updated within the two-year business plan period and we would suggest that this should remain static in order to ensure the ESO has clear and unchanged guidance in terms of expectations to ensure regulatory certainty. Ofgem might find it useful to give clear forward signals of what is intended for the next regulatory period in plenty of time to allow all to consider and prepare for the next phase.

#### Delivery Schedule and Performance Metrics

We have not responded to questions 11-15 on the detail within the Delivery Schedule, Performance Metrics or Ofgem's grading due to the time-compressed nature of the consultation, however, we would draw your attention to those elements of the Delivery Schedule which require DNO action.

Given the timing difference between the start of RIIO-2 for DNOs compared to other sectors, BP1 for the ESO takes place during the remaining two years of RIIO-ED1 for DNOs. As a result, the deliverables which require action from DNOs will need to be considered alongside their existing ED1 commitments

and allowances. One example may be category '(c)' whereby Ofgem's expectations are stated as an ESO-DNO data exchange into the data platform. Depending on how this is designed this could impose significant costs on DNOs whereby ESO has funding within its price control but DNOs do not. Decisions on how this is progressed needs to be jointly taken by the affected parties.

We will of course continue to engage with both Ofgem and the ESO as the updated Delivery Schedule is generated for the October deadline.

*ESOQ16. Do you agree with our proposals for measuring stakeholder satisfaction?*

We are supportive of the proposal for a stakeholder satisfaction survey and agree with the proposal for independent provision and benchmarks. We do not see any proposals for eligibility criteria which would be helpful to see to be able to fully comment on whether the proposals will adequately measure stakeholder satisfaction. The ESO has a large number of stakeholders and it is important to ensure that there is sufficient reach for the survey to fairly reflect the full range of stakeholder views. Particularly DNO's are a key community to feedback on ESO performance and vice versa the ESO should provide views on working with DNO's as they transition to DSO.

We are unsure whether this is intended to replace the existing stakeholder input into the incentive performance as it currently works for RIIO-1 and it would be helpful for Ofgem to clarify this before Final Determinations (FDs).

*ESOQ17. Do you agree with proposed approach to tracking plan benefits?*

We agree it is appropriate for the ESO to report regularly on the achievement of benefits, and that six-monthly reporting is a reasonable frequency. Because of the scale of activities and changes the ESO is involved in we would not expect continuous updates of all aspects.

*ESOQ18. Do you agree with our suggested areas for regularly reported evidence?*

We have no comments on the regularly reported evidence for roles one and two, however, as we mention in our response to question 8 given that role three has limited metrics and deliverables associated with it, it is important that regulatory reported evidence is clear on the ESOs performance on role three to support assessment of performance.

## 4 Internal costs

The assessment for the ESO is unique to the ESO and as such we offer no comment on the process undertaken and the questions posed by questions 19-23.

*ESOQ24. Do our proposed changes to the reporting of changes to the ESO's shared services costs offer a sufficient level of consumer protection?*

Where there are shared service costs we believe it is appropriate for methodologies to be scrutinised with any changes made in a clear and transparent manner.

## 5 Finance

We have provided our detailed comments on finance arrangements within our response to the Finance annex contained in this document and therefore have not provided further comment within this section specific to the ESO.

## 6 Innovation

*ESOQ30. Do you agree with the level of proposed NIA funding for ESO? If not please outline why.*

We have no comments on the level of funding proposed but do note Ofgem comment in paragraph 6.8 that the ESO RIIO-2 request is relatively larger as a percentage of totex than other network companies.

We recognise the ESO ability to impact balancing services costs using innovation funding and consider this to be strongly in the interests of customers.

We will follow with interest the NIA projects undertaken and their outcomes in line with our standard business processes.

*ESOQ31. Do you agree that ESO's NIA funding should be subject to the condition that all projects must involve partnership with other network companies, third party innovators and/or academics?*

We have mixed views on the proposal of mandatory partnerships on all NIA funded projects. On the one hand collaboration can bring benefits and can provide Ofgem and stakeholders with comfort that the ESO work is aligned with the wider industry challenges, however, on the other hand it does bring an added level of complexity and also will incur time to develop and research appropriate partnerships for the specific issues identified together with stakeholder calls for input and suggested work areas. This additional burden may have the unintended consequence of slowing down innovation and reducing the ESO ability to be agile and respond to emerging needs. So, in general we think ESO projects should involve one or more other partners but it's important that the number of partners doesn't become an aim in itself.

We also hold the view that time-bounding NIA projects to the two-year BP periods may limit what can be achieved, particularly in BP1, given the time needed to mobilise and develop partnership proposals in the period between FDs and the start of the price control period. We suggest Ofgem consider extending the period in which NIA projects are able to run so that it does not have the result of limiting projects to those which can be delivered within the two-year parameter or alternatively provides a clear signal that NIA funding won't be turned off for in-flight projects mid-way through up to a certain value. We think the ESO could likely plan for multi-year projects beyond the two years as it would not seem to be in consumers interests for Ofgem to not fund multi-year projects, especially those part way through. However, in a low risk regime, Ofgem should consider greater clarity for the ESO and the stakeholders they work with that projects with benefits with customers would continue to be funded by NIA.

The ESO is an active participant in the innovation effort across industry and anything which places this at risk would be retrograde to the overall Net Zero ambition.

## 7 Uncertainty

*ESQ32. Do you believe our price control design is sufficiently flexible to account for uncertainty? Are there any relevant foreseeable future uncertainties which we have not identified here?*

We do not think specific uncertainty mechanisms or re-openers are necessary for a two-year business planning cycle where the next business plan can capture and adapt as uncertainties arise.

*ESQ33. Do you have any views on whether we should introduce a different funding approach or uncertainty mechanism to account for the risk of material changes to the ESO's revenue collection role? Do you have any views on how this should be designed?*

We provide no response to this question.

## 8 Other cross-cutting issues

### **Governance of ESO IT**

*ESQ34. Do you agree with our assessment that the current approach, with the ESO's IT provided by National Grid Group is not appropriate for the future? Have we identified the correct concerns with the current model?*

We agree that if the ESO is to be held to account for delivery and performance against its business plan, then it is essential that it has control of the key dependencies within the plan, of which many of the IT projects are considered integral. A strong enough regime will ensure that the ESO is able to secure the IT services it needs when it needs them. A shared services model might give benefits such as lower costs and rapid access to a very broad range of capabilities. The ESO business management itself is best placed to determine what IT support model to follow and it should be clear that this decision is taken by the ESO.

*ESQ35. Do you agree that the ESO needs full control of its IT provision? Are there other options that you think are preferable?*

We do agree that the aim should be for the ESO to have full accountability and control of its IT provision, particularly given the level of expenditure stated within the plan and the reliance on IT projects to deliver the outcomes and customer benefits stated.

*ESQ36. Do you have a view on the proposed timing of implementing IT autonomy?*

We agree that having a desired aim of autonomy which aligns to the start of a business plan cycle is attractive in its simplicity, however, setting an arbitrary target linked to the timing of price controls may not be the best solution.

The separation of IT systems and full autonomy will be a significant programme, in terms of resource, time and cost. A cost benefit assessment of options including other mechanisms than separation should be considered. Also, when considering work of such complexity an enforced delivery within two years could lead to inefficiencies or sub-optimal delivery, certainly in the short term. We would therefore suggest that the ESO is given the opportunity within its IT separation plan to propose a date which is deliverable and affordable whilst being no longer than necessary.

### **Cost Recovery**

We do not have any views on the ESO's cost recovery and therefore have not answered question 37 or 38.

### **Regulatory Reporting**

We do not have any views on ESO reporting requirements and therefore have not answered question 39.

### **Timings for the future Business Plans**

*ESOQ40. Do the proposed timings for the BP2 process provide sufficient time for the ESO to develop and refine a robust plan, stakeholders to contribute to this and Ofgem to undertake the necessary assessment and decision making?*

We agree that there does not need to be such a prolonged process for BP2 in terms of the submissions to determinations due to the framework parameters being established for BP1.

We would however suggest that the gap between DD in November 2022 and FD in March 2023 gives stakeholders limited time to respond to DDs and influence changes ahead of FDs. Consideration should also be given to the timeline for ED2 to ensure that stakeholders are given appropriate time to consider and input into both processes.

# Appendix 4: response to RIIO-2 Draft Determinations Gas Distribution Annex questions

September 2020



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## 1 Overview

Electricity North West Limited (ENWL) serves part of the same customer base as two gas distribution companies, Cadent and Northern Gas Networks that operate in Electricity North West's distribution services area. We also interface with the Gas Distribution Networks (GDNs) via a number of industry fora, particularly those convened via the Energy Networks Association. Through these channels we share best practice regarding interfacing with consumers and how we deliver services. We have also reached out to the GDN's in our area as part of understanding if there are any whole system opportunities arising from their plans and to identify if there are any ED related requirements (e.g. electricity connections for local gas fuelled generators).

In addition to this business plan engagement activity, we have also undertaken a significant development in collaboration with Cadent to create decarbonisation pathways which effectively provide energy blueprints for our three key areas of Greater Manchester, Lancashire and Cumbria. These provide near to mid-term certainties around the future of energy supply and demand in order to inform decision-making and investment planning for the adoption of low carbon technologies (including solar PV and electric vehicles) as the North West transitions to a Net Zero future.

Our response to this annex focuses on those aspects where there is a potential consequential impact on the framework development for ED2, commencing in 2023.

Our comments relate to each of the sections of the consultation document, and specific questions have been answered by exception. We trust this response will assist Ofgem as it develops its thinking further.

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

### Meeting the needs of consumers and network users

We have not answered questions 1-7.

*GDQ8. Do you agree with our proposed option to provide Cadent and SGN with consumer funding through totex baseline or a financial ODI reward for collaborative streetworks activities*

Through our customer engagement as part of our business plan development for RIIO-ED2 we have found that the duration of street works, and street works in general are an area of priority for both customers and stakeholders. Therefore, the consideration of a financial incentive (ODI-F) to improve services to customers or baseline funding to deliver this is merited and we would support either approach in general.

That said, for clarity we seek not to influence the decisions that are made for individual companies, so our comments are limited to high-level policy points where these apply to individual sectors or the energy sector as a whole based on what the same customers and stakeholders are telling us as part of our ED2 engagement.

## Deliver an environmentally sustainable network

We offer no comment to the bespoke EAP and AER proposals for GDNs as set out in the sector specific annex, our comments to the general approach to outputs can be found in section 3 of our response to the core document. We have some concerns that the DDs refer to common sector-wide measures without qualification that these do not apply to ED (though they may be considered) and that the decisions on the ED2 price control are not being made now, we would welcome more clarity being provided by Ofgem on this matter. It is likely also that all sectors will require bespoke items and considerations with regards to outputs.

## Maintain a safe and resilient network

We offer no comment to output proposals for GDNs as set out in the sector specific annex as these are specific to that sector and unlikely to be applicable to ED, our comments to the general approach can be found in Q9 of our response to the core document. All sectors will likely require bespoke items and considerations as the energy sector develops and commits to how it will deliver and lead decarbonisation and Net Zero.

## 3 Cost of service- setting baseline allowances

Cost assessment and the setting of baseline allowances is key and an important aspect of the regulatory framework. The consequences of process or assessment failings will risk the key objectives and outcomes required of the short and long term including decarbonisation and Net Zero considering where the industry is on this pathway. Justification and evidence supporting positions and methods needs to be robust and we would urge that Ofgem errs on the side of caution rather than stretching what can be justified through the evidence it has gathered and established.

The ongoing PR19 referrals to the CMA should be a point of reference for Final Determinations and considered as part of the development of RIIO-ED2. Central proposed policy positions in Draft Determinations such as; issues of financing, ongoing productivity/efficiency assumptions, and the use of more stringent than upper quartile efficiency benchmarks are being reviewed as part of these appeals. It is important that policy positions as part of RIIO-2 are made mindful of the CMA views and findings, but independently of other sectors and considering the evidence and unique circumstances for RIIO-2 specifically and each company. The decarbonisation challenges as well as the transformative changes required are not inherently part of the water sector as they are in energy.

## Approach to Cost Assessment

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

We support the use of both top-down and bottom up regression models as well as non-regression or disaggregated modelling where appropriate. The targeted use of disaggregated modelling techniques could include unit cost modelling where there are distinct costs and activities where cost trade-offs do not exist and where legitimate differences between companies occur and can't be explained or appropriately accounted for through cost drivers in econometric regression models.

We offer no comment on the appropriateness of the modelling method for GD other than the use of a single top-down totex regression model to establish the majority of the cost baseline (c.84%) for the industry is out of step with regulatory practice in PR19 and that utilised in RIIO-ED1.

We understand that a number of alternative models have been tested but not used in the proposed assessment of costs for GD. It is generally accepted that there is no single perfect econometric model, and Ofwat concluded as part of the PR19 framework that:

“All models are subject to error and a degree of bias. In many instances, it is not possible to identify a single “preferred” econometric model that clearly prevails over all others. To mitigate risks of error and bias we do not rely on a single model. Rather, we use a diverse set of models, with different drivers and different levels of aggregation, in triangulation.”<sup>1</sup>

In essence, multiple models which are aggregated or triangulated aims to account for this imperfect assessment process and individual model imperfections. Therefore, a single model covering 84% of the cost base would seem incoherent with this limitation, and when coupled with a more stringent benchmark, would suggest an increased level of accuracy or confidence of the assessment process that may not be justified. Modelling accuracy shouldn’t be determined by statistical diagnostic tests alone such as the ‘R<sup>2</sup>’ or the fit of the model. Models should make sense on both an economic and engineering basis or logic and both are as important when developing models that establish baselines for companies where trade-offs and cost substitutions exist.

A more stringent benchmark of the 85<sup>th</sup> percentile as compared to the upper quartile threshold that has been traditionally used would exacerbate any weakness of the single top-down regression model used for GD. Our experience is that a suite of models considering both top-down, bottom-up and disaggregated models (where appropriate) should be utilised in the assessment and establishment of baselines for companies and that this would represent good regulatory practice.

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

We have provided our thoughts on the use of more stringent benchmarks in GDQ26, but we do not think that the use of 85th percentile should be the starting point. The use of a more stringent benchmark suggests a level of modelling accuracy that is unlikely to be supported by a single top-down totex regression model that covers the majority of the cost baseline. Further evidence of this is that in the CMAs redetermination of PR14 with regard to the Bristol Water review it used an average benchmark as the use of upper quartile benchmark may overstate inefficiency. This is particularly important where modelling is solely reliant on single methods and models and where these can’t distinguish between modelling ‘noise’ and inefficiency.

The sector specific annex for GD also suggests that “it is reasonable to expect that all networks should be able to continue delivering efficiency improvements and achieve efficient performance over RIIO-GD2”<sup>2</sup> because “Overall for the GDNs, actual totex over the period 2013-14 to 2018-19 is on average 14% lower than RIIO-GD1 allowed costs”<sup>3</sup> as part of the justification for using an 85<sup>th</sup> percentile benchmark. Care should be taken in using such analysis to support the use of a more stringent benchmark. Efficiency delivery in the period of RIIO-1 will be due to a mixture of reasons and not because the benchmark used wasn’t stringent enough. Interlinkages with other regulatory mechanisms such as the lowering of the totex incentive mechanism (TIM) will also change the dynamics and incentives for companies in RIIO-2. Any inferences on efficiency could only potentially be made by looking at unit costs, rather than just reductions on allowed GD1 costs and would need to reflect future work types too.

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<sup>1</sup> Supplementary technical appendix: Econometric approach, pg.5, Ofwat, January 2019

<sup>2</sup> RIIO-2 Draft Determinations - Gas Distribution Annex, para.3.27, Ofgem

<sup>3</sup> Ibid.

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

We note that the proposals on ongoing efficiency are at the very top end of the plausible scale as assessed by CEPA. We also note that this aiming up is partly justified by the estimated impact of innovation funding, structure and characteristics of the monopoly industry companies operate in. Where the benefit of part of the existing framework is cited as evidence to support stronger measures as part of RIIO-2 this should be noted and collated to a central table to ensure and evidence that these benefits are not being double counted or assessed and built into other Ofgem evidence for mechanisms (e.g. allowed vs expected returns calculations).

## Normalisation

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

We strongly believe the RIIO-ED2 framework needs to be considered on a standalone basis where proposed policy positions are established and justified for the ED sector specifically, distinct from GD/T2 therefore we comment that pre-modelling normalisations should be assessed and justified based on the sector being assessed and should not apply as a standard process by default.

## Regression Analysis

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

This should be read in conjunction with our answer to GDQ26. We support the use of both top-down and bottom up regression models as well as non-regression or disaggregated modelling where appropriate. The targeted use of disaggregated modelling techniques could include unit cost modelling where there are distinct costs and activities where cost trade-offs don't exist and where legitimate differences between companies occur and can't be explained or appropriately accounted for through cost drivers in econometric regression models.

We offer no comment on the estimation technique or time period other than these should be assessed and justified based on the sector being assessed and the characteristics of that sector such as the number of comparator points and observations. The process and methods for GD2 cost assessment shouldn't apply as a standard process by default to other sectors.

## Non-regression costs

We have no comments on the process for GD2, treatment of non-regression costs should be sector specific and expect this to be consulted on separately for ED.

## Technically assessed costs

We have no comments on the process for GD2, technically assessed costs should be sector specific and expect this to be consulted on separately for ED.

## Disaggregation of allowances

*GDQ41. Do you agree with our proposed disaggregation methodology?*

The method for allocating costs through a disaggregation methodology should be developed in conjunction with companies as part of their sector specific consultation or RIIO-2 working groups. If such a method is needed for ED, we would urge that this is developed with the sectors and its stakeholders independently of the process established for GD and T.

## BPI calculations

Our comments to the general approach for the BPI can be found in section 9 of our response to the core document. There should be substantial learning for Ofgem, companies, and stakeholders from the Draft Determinations process with regards to the assessment, application and process for the BPI. We urge that these are considered and implemented as part of a revised BPI for RIIO-ED2.

We have no comments on the process for GD2, so our comments are limited to high-level policy points where these apply to individual sectors or might be applied to the energy sector as a whole.

## 4 Uncertainty mechanism consultation questions

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

In general, to effectively manage uncertainty within the RIIO-2 framework, ENWL support a limited number of targeted uncertainty mechanisms that are well defined and are clear to what risk or uncertainty they are to address in the period. We do not support macro or broad measures such as the mid-period review reopener deployed in ED1 as the broadness of the mechanism leads to a lack of clarity for companies and Ofgem about how, why and when these should be applied and assessed.

With ED2 starting 2 years after that of GD/T2 we believe that the level of uncertainty required to be managed should be less and therefore the approach taken for GD/T2 should not directly apply to ED2. Indeed, we have concerns where the DD refers to "Cross-sector uncertainty mechanisms" without qualification that these should or shouldn't apply to ED. We urge that uncertainty mechanisms and wider methods for managing uncertainty for ED be consulted on separately and independently of the DD through the ED2 SSMC. This should consider the impact on the level of uncertainty but not be limited to; the later start date for ED2, the differences of the challenges in ED compared to GD/T, and the lessons learned from the responses to the proposed package for managing uncertainty from this DD consultation.

# Appendix 5: response to RII0-2 Draft Determinations NARM Annex questions

September 2020



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## 1 Overview

ENWL has been part of the work sponsored by Ofgem to look at the Network Asset Resilience Measure (NARM) for the RIIO-2 period under the Cross-Sector Working Group. Within this group Ofgem have promoted the concept of commonality across the energy sector in applying the NARM framework. As a result of this aspiration, the concepts in the DD of Transmission (Gas and Electricity) and Gas Distribution has the potential to impact on the outcome of the RIIO-ED2 review to be carried out after the end of the current GD/T reviews.

Whilst there are similarities between all operators within the energy sector in GB, the fact that there isn't a single common methodology that is applied by all actors in the sector means that there is potential that decisions made for GD/T could set precedence for ED which may not be appropriate or deliverable and this should not be the case.

Additionally, the manner in which the other sectors calculate their monetised risk values can be complex, and when compared to the DNO's Common Network Asset Indices Methodology (CNAIM) outputs, may require significant additional activities in ED2 at a cost to customers which we do not feel is justified or warranted compared to the perceived benefits. We look forward to ongoing dialogue to share our evidence as part of the ED2 process.

Whilst we welcome the continuation of the principles established in measuring asset risk and developed over the period from 2010 to date we believe that any requirements should be simple and transparent to all interested parties. These principles should also apply to the Closeout principles for the RIIO-ED2 period. We therefore welcome the fact that the DD contains proposals as to the RIIO-2 closeout process for the incentive which is a significant improvement from the position the sector has found itself in for the start of RIIO-1. The Closeout proposals should be clear and transparent to aid understanding by all interested stakeholders.

## 2 Monetised risk calculation and setting outputs

We welcome the fact that the principles that are set out in the recently published ED2 SSMC to be applied to the NARM methodology for the RIIO-ED2 period are built upon those in place for RIIO-ED1 and draw less obviously from GD2/T2 equivalents. We consider that the development of risk-based approaches is considerably more advanced in the ED sector and that we now have a number of years of experience of implementation of CNAIM within the Network Asset Secondary Deliverables (NASD) framework which gives an excellent grounding for the development and implementation of NARM in RIIO-ED2.

Our comments below relate to the specifics proposed for GD/T in the context of the above statement.

**NARM Model Structure:** The Model structure detailed in Appendix 3 to set the Total Monetised Risk Reduction Target potentially has problems which depends upon the way the submissions have been made. For very large projects on specific plant types or circuits/pipelines where funding is requested specifically within the RIIO-2 period, then the process is logical as delivery should occur in the period. For high volume asset interventions however, there is a risk that at the time of the submission then the exact mix of work to be delivered will not be clear. This is because of the flexibility required to define and negotiate delivery (such as wayleaves etc.). This therefore may introduce errors in the determination of the Total Monetised Risk Reduction Target.

The process Ofgem has used derived unit costs and allowed volumes has precedent from previous regulatory reviews and it seems appropriate to use this again for the RIIO-2 period.



As the assessment of Total Monetised Risk Reduction Target has been carried out prior to the end of the RIIO-1 period it is possible that the planned interventions for the rest of RIIO-1 (especially for the GD sector) may vary significantly from those in the submitted business plans. The impact of COVID-19 is clearly a factor that could cause this, therefore the stated target should be promptly restated post the closure of the RIIO-1 period for the benefit of both customers and the companies involved.

**Output Setting:** We are concerned that the output required for RIIO-2 has been set prior to the end of that period with no proposal to review this once the end of RIIO-1 period has occurred. Whilst this may not be as appropriate for the transmission sector, it is appropriate (for the reasons already stated) for GD and later the ED companies.

For these reasons we believe the targets should be indicative and subject to potential revision post - negotiations which will take place between the DD and Final Determinations and the end of the RIIO-1 period, thus permitting the initial baseline to represent the actual position, and not a predicted activity.

We welcome the clarity as to the assumption that all interventions are treated as occurring in the last year of the period.

**Whole Life Risk versus End of Period Targets:** We note the proposal to exempt the GD companies from a Whole Life risk approach for the RIIO-2 period, due to uncertainties in that part of the sector. We welcome this acknowledgement of sector-specific considerations and assume that this will also be the case for RIIO-ED2 NARM treatment.

### 3 Baseline network risk outputs and baseline funding

*NARMQ1. Do you agree with our proposals on the scope of work within each of the NARM Funding Categories and on the associated funding arrangements?*

In general, the proposal seems to be logical and we welcome the clarity that this level of detail has brought. However, the development of the mechanism associated with NARMs to be implemented in RIIO-2 has resulted in the creation of a series of mechanisms which overcomplicates the way in which the period will be governed. Further comments are provided below:

#### Scope of work within Table 2

Category A1 – This category relates to the core activities associated with assets within the NARMs methodology and aligns to the practices allowed in RIIO-1. We welcome the ability to continue to risk trade between the asset types within this area of the allowances as this is a fundamental feature of the risk framework.

Category A2 – This category relates to areas of consequential risk reduction because of drivers other than those in Category 1. We note that within table 2 there is no specific reference to risk trading, but this is alluded to later in the same section. We support the view that the risk reduction target should be considered in the context of the overall network risk and that changes in the latter from forecast may legitimately support changes in the former.

Category A3 – Where it is not possible to carry out risk trading within the mechanism we believe it is right to implement a different mechanism to those associated with Categories A1 and A2. We support the exclusion of these projects from the NARM Risk Management assessments in RIIO-2.

Category B – We agree that as part of further potential cross-sector alignment that more asset types should be included in future NARM iterations. We also welcome Ofgem’s commitment not to revise the RIIO-1 NARM targets because of the potential to introduce these in RIIO-2.

There is insufficient data in this appendix to comment on the reason for the specific treatment of certain projects as detailed in sections 3.5 to 3.17.

We note the intention to align the Baseline Network Risk output costs to include both Direct and Indirect costs and the timescale to publish the proposals (with the Final Determination). This may have issues for the RIIO-ED2 review and believe that the DNOs should be kept apprised of the proposals in this area.

## 4 NARM funding adjustment and penalty mechanism

*NARMQ2. Do you agree the funding adjustment principles and our proposals for applying funding adjustments?*

The principles of the funding adjustments methodology are in line with the principles outlined in the RIIO-2 Decision document but are overly complex in their execution. In addition, there is still a lack of detail in some areas of the methodology as proposed, which we would have like to have seen at this stage in the process. We welcome the following aspects of the proposed methodology:

- NARM Methodology Changes: The Company targets will be held neutral should these occur.
- Consequence of Failure (CoF) changes due to organic growth: The Company targets will be held neutral. We note that changes not associated with organic growth will potentially incur an adjustment in the targets.
- Reduction of CoF by indirect investment: That this will be treated as neutral thus permitting projects to specifically target a CoF risk reduction will be allowed.
- Data Cleansing: Reasonable levels will be permitted and will not impact the targets.
- Cost savings will only be allowed in TIM if proven to be genuine efficiencies.

We however note that several expressions in the DD are undefined currently making further analysis of the potential consequences for the sector difficult.

*NARMQ3. Do you agree with our proposed approaches to calculating funding adjustments and to application of penalties?*

We agree that any adjustments should occur at the end of the period as part of the closeout mechanism. Closeout mechanisms need to be defined ideally before the period commences.

We are concerned that the level of complexity that appears to be being proposed for the mechanisms that will enact these principles is so high as it effectively eliminates the principles of the risk-based approach in the first place. The conditions for assessing changes to the forecast programme look to virtually eliminate risk trading and revert to an assessment of input volumes masquerading as a risk output. The rationale appears to be to prevent excessive windfalls which suggests to us that the fundamental underlying methodology is not fit-for-purpose and its application needs to be reviewed ahead of Final Determinations.

That notwithstanding, we do not believe it sets a precedent for RIIO-ED2 where the approach is far more mature and the risk consequently lower.

*NARMQ4. Do you agree with our proposals in regards to requirements for justification cases?*

We support the need for companies to provide robust justification where delivery is either over or under the target rate, however suggest a degree of pragmatism is required both in terms of the assessment of targets (e.g. introduction of a materiality deadband) and also clear and concise evidence requirements.

## Appendix 6

# ENWL third-party representation letter to CMA review of PR19 appeals



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Competition and Markets Authority  
By email to: [waterdetermination2020@cma.gov.uk](mailto:waterdetermination2020@cma.gov.uk)

11 May 2020

Dear Sarah,

## Ofwat PR19 Price Determinations

Electricity North West Limited (**ENWL**) appreciates the opportunity to provide comments to the CMA on the issues raised in Ofwat's references and the main party submissions in the above matters and some initial observations on Ofwat's response. ENWL is one of six companies managing an electricity distribution network in the UK regulated by Ofgem, and we are proud to serve communities in the North West of England. Our particular interest in the Ofwat PR19 Price Determinations stems from the clear read-across on key issues to the forthcoming RIIO-2 price controls in the energy sector which, as an electricity distribution network operator, will affect us directly.

ENWL is a member of the Energy Networks Association (**ENA**) and fully supports any submission made by ENA to the CMA on this matter. However, ENWL has some additional comments, on areas not covered by ENA, which it wishes to bring to the CMA's attention. These relate to regulators' financing duties (and how they meet it in practice) and company specific debt costs.

## 1 Financeability

- 1.1 We note that all of the appellant companies have raised the issue of financeability in their Statements of Case, which in turn forms a key part of Ofwat's response.
- 1.2 Three key points we would like to make in this regard are as follows:
  - (a) Contrary to the suggestion made by one of the appellant companies, there is no material difference between the financing duty in the water sector and that in the electricity sector;
  - (b) When developing price controls, regulators look to ensure that the price control is set at a level which would allow an efficient notionally geared company in the sector to finance its licensed activities through recovery of its efficiently incurred costs and an allowed cost of capital. However, while establishing that an efficient notionally geared company is financeable under the price control is an important exercise, this alone is not sufficient to discharge the financing duty

- (c) To satisfy the financing duty, a regulator must conduct financeability tests and make appropriate adjustments to take into account company-specific characteristics. Size is an important characteristic. A small company can be expected to face higher costs than the sector's notionally geared company, even where both operate efficiently. Regulators must take this into account when taking steps to assess and secure financeability.

1.3 We address each of these points in more detail below.

#### The financing duty

1.4 Under section 2(2A) of the Water Industry Act 1991, Ofwat has a primary duty to act in the manner which it considers is best calculated to (among other things) "*secure*" that companies "*are able (in particular by securing reasonable returns on their capital) to finance the proper carrying out*" of their functions. This is variously referred to as the "**finance duty**", the "**financeability duty**" and the "**financing duty**". We use the latter in this submission.

1.5 Northumbrian Water Limited suggests that Ofwat's financing duty is "*materially different*" from the financing duty of other sector regulators. Specifically, it states<sup>1</sup>:

*"The duty to regulate in a manner best calculated to achieve a result is clearly a higher standard to that, for example, in the electricity sector which is only to 'have regard to'."*

1.6 In our view, there is no material difference between the financing duties imposed on the regulators<sup>2</sup>. There are of course differences in the drafting of the relevant statutes. Section 3A(2) of the Electricity Act 1989 provides that, when carrying out its functions, Ofgem "*shall have regard to ... the need to secure that licence holders are able to finance [their] activities*". This is wrapped up in the principal objective to protect the interests of consumers. "Financeability", in the context of the Electricity Act 1989, is therefore neither a subsidiary nor primary obligation, but one of two specified ways in which consumers interests are protected (the other being the securing that all reasonable demands for electricity are met). This is entirely consistent with the fundamental idea behind the financing duty: that it is in the long term interests of consumers to ensure efficient companies are financeable.

1.7 Ofgem does not simply have to have regard to "financeability", but to the "*need to secure*" the financeability of licence holders when making its decisions. Regulators have some discretion as to the means by which they discharge this duty, in that they must do so in the manner in which they consider is best calculated to secure financeability.<sup>3</sup> But the overriding obligation on the regulator is to ensure efficient companies can finance their licensed activities. If an efficient company was unable to do so Ofgem would be in breach of its principal objective in 3A of the Electricity Act 1989.

1.8 We do not think that the CMA, in this determination process, need consider in detail whether Ofwat's financing duty is materially different from the financing duty of any other regulator. However, should it engage in any such exercise, it would be appropriate to seek views from other regulators and regulated businesses.

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<sup>1</sup> Northumbrian Water Limited, Statement of Case dated 2 April 2020 (paragraph 983).

<sup>2</sup> We note Ofwat supports this view. See Ofwat response – Introduction, overall stretch on costs and outcomes', at footnote 70 where Ofwat describes the financing duty under the Electricity Act 1989 and states "*Read fully and in context, it is not a diluted version of the duty on Ofwat*".

<sup>3</sup> We consider that Ofwat take the point on discretion too far in its response. There are always limits on regulators' discretion – the obligation to secure financeability being just one. The suggestion that a regulator's discretion could be so exhaustive as to virtually preclude any challenge to a price control settlement on the grounds of breach of the financing duty is plainly wrong.



#### Efficient, notionally geared company

- 1.9 In practical terms, across sectors, the financing duty means that it is incumbent upon the regulator to ensure that individual licence holders are able to finance their activities and that companies can secure both debt and equity finance. Regulators tend to start this assessment by reference to a 'notionally efficient company' in the first instance.
- 1.10 However, it follows from the nature of the financing duty that while this is a useful starting point, it is not enough for a regulator to find that an efficient notionally geared company is financeable under the price control,<sup>4</sup> as it appears is Ofwat's view. A small company can be expected to face higher costs than the sector average by virtue of its size. Regulators need to take this into account in discharging their financing duty.
- 1.11 We note that this view is consistent with that expressed by the CMA, for example in *Bristol Water plc: A reference under section 12(3)(a) of the WIA91 – Report (2015)*<sup>5</sup>, where it stated:

*"Ofwat's approach will result in some companies, in particular very small companies, being in a position where their notional cost of efficient finance, is higher than Ofwat's assumption. If the notional company is based on a total industry average, the resulting cost of debt could be perceived as too low for these very small companies, which could be perceived as being potentially inconsistent with its finance duty."*

#### The financeability of each company

- 1.12 To satisfy its financing duty, the regulator must therefore assure itself that each company with efficiently incurred costs is financeable. So it should consider the financeability of each company individually, taking into account company-specific information and characteristics. Financeability tests are the means by which a regulator can transparently demonstrate that it has discharged the financeability duty.
- 1.13 Financeability is secured by allowing recovery of efficiently incurred costs and a reasonable return. This principle, and the need for such financeability assessment to be company-specific was clearly recognised in *Firmus Energy (Distribution) Limited v Northern Ireland Authority for Utility Regulation: Final Determination (2017)*<sup>6</sup>, in which the CMA stated:
- "Financeability is a term used by regulators to decide if a firm has the ability to pay off its providers of debt and equity finance. In price controls, ... it is generally assumed that financeability is achieved when the rate of return (or WACC) has been set at a high enough rate, such that the revenues and therefore cash flows made by the firm are sufficient to pay investors and lenders."*
- 1.14 The regulator therefore cannot assume financeability based on simply on the notionally geared company: a price control should ensure financeability of efficient companies. As such, the regulator must make appropriate cross-checks. If regulators expect companies to be able to achieve investment grade credit ratings, they must test to ensure companies proposed settlements meet appropriate ratios. These ratios need to include returns to equity, appropriately

<sup>4</sup> Of course the efficient notional geared company should be financeable without any material adjustments, before attention is turned to individual circumstances. If the efficient notionally geared company is not financeable under the proposed regulatory settlement – without mitigation – the regulator has failed to satisfy the financing duty at the first hurdle.

<sup>5</sup> See [https://assets.publishing.service.gov.uk/media/56279924ed915d194b000001/Bristol\\_Water\\_plc\\_final\\_determination.pdf](https://assets.publishing.service.gov.uk/media/56279924ed915d194b000001/Bristol_Water_plc_final_determination.pdf) (paragraph 11.75).

<sup>6</sup> See <https://assets.publishing.service.gov.uk/media/5953bfd8e5274a0a69000079/firmus-final-determination.pdf> (paragraphs 7.98 and 7.99). We note Ofwat relies on this case as evidence that it need only establish that the notional company is financeable. We do not support this reading of the case. See 'Ofwat Response – Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case' – Financeability at para 3.84 onwards.

measured, including expected tax and debt performance. Such cross-checks should not be dismissed as merely "a sequence of binary pass or fail tests".<sup>7</sup> They form a necessary part of the regulator's overall assessment to ensure that the price control settlement is financeable. Failure on one or more of the tests would be a strong indicator that there is a financeability concern which needs to be addressed.

- 1.15 Regulators must also allow sufficient headroom to allow companies to respond to plausible downside financial shocks within regulatory periods and take into account the level of challenge on the companies (e.g. low inflation scenarios or interest rate reversion). It is not in consumers long term interests to see periods of significant underperformance. In that scenario, investors and potential investors would be inclined to "demand" higher long term returns, and, where those are not available, avoid investing.
- 1.16 Finally, we are concerned by the volume of last-minute adjustments and mitigations evident in the PR19 regulatory settlement - and which we note are becoming increasingly common in regulatory settlements more generally. As a point of principle, it would be helpful if regulators focused on meeting the financing duty in relation to each company throughout the determination process, to avoid the uncertainty inherent in a suite of adjustments at its end.

## 2 Company specific debt cost

- 2.1 We also wished to comment on a specific point relating to cost of debt. As a starting point, we consider that setting of the cost of debt allowances flows from the financeability duty, and regulators must ensure that each company is financeable, based on its particular circumstances (subject to an efficiency test.). It is not appropriate to rely upon equity returns to cross subsidise underfunded debt returns.

- 2.2 In its Cross-Cutting Issues paper, Ofwat noted that:<sup>8</sup>

*"there is some evidence that the smallest water-only companies have tended to have a higher cost of debt than larger companies. We said this was not sufficient to justify an uplift however, as customers should not be expected to fund higher costs that arise due to factors that are under company control (for instance timing or tenor). This is due to the poor efficiency incentives that such a policy would imply."*

- 2.3 To the extent that smaller companies faced higher debt costs for reasons other than timing or tenor, Ofwat's view is that small companies "cannot expect to pass higher size-related financing costs on to their customers."<sup>9</sup>
- 2.4 We support the principle of adjustments made by Ofwat at PR14 and PR19 (company specific adjustments or small company premiums) which show that an additional allowance for the size of company is appropriate. However, it appears that these have been applied in a restrictive way.
- 2.5 In our view, it is important that regulators do not penalise companies for past management decisions where these were efficient when taken and which cannot be ameliorated by refinancing. If regulators, succumbing to hindsight bias, do not make allowances for such efficiently incurred debt, then the financeability of the company is not secured. Ensuring financeability in this way

<sup>7</sup> See Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case, paragraph 3.83.

<sup>8</sup> See <https://www.ofwat.gov.uk/wp-content/uploads/2020/03/Reference-of-the-PR19-final-determinations-Cross-cutting-issues.pdf> at paragraph 5.67.

<sup>9</sup> See <https://www.ofwat.gov.uk/wp-content/uploads/2020/03/Reference-of-the-PR19-final-determinations-Cross-cutting-issues.pdf> at paragraph 5.68



does not threaten to "greatly dilute incentives to issue debt efficiently"<sup>10</sup>: only efficiently incurred debt costs would be recoverable.

- 2.6 In a similar vein, is the treatment of derivatives. In our view, it is unreasonable to review underlying financing structures without also taking into account the cost or benefit of derivatives, where these have been entered into primarily for risk management purposes. By way of example, it would be illogical to exclude derivatives where these are used to hedge against inflation risk where index-linked debt was not available. In such circumstances, they should (alongside the underlying nominal debt) be treated consistently with index-linked debt. Similarly, we agree with the position taken by Anglian that *"It is inconsistent for Ofwat to exclude swaps from the analysis whilst including inflation-linked bonds."*<sup>11</sup>
- 2.7 Ofwat does not agree that the costs of financial risk management should be borne by customers. Effective financial risk management limits the sensitivity of a company's financial performance to systematic, macro-economic risks relating to (for example) currency, inflation and interest-rates. This is supportive not only of a company's credit metrics and overall financeability, but also of the equity betas typically observed in the utility sector, which then translate into a reduced cost of capital for consumers. Providing the risk management costs are efficiently incurred it is appropriate for these costs to be recovered through the price control. We note that Ofwat points to a number of examples where there may be difficulties in including swaps (e.g., assessing whether a given swap was efficiently incurred, and in comparing their cost to ordinary debt instruments) but this does not justify a blanket exclusion.

We have provided these initial views by 11 May deadline in order to assist the CMA, but may of course wish to make further comments and submissions during the process (particularly as we further digest Ofwat's Response, published on 5 May 2020). We are also happy to confirm that nothing contained within this submission is confidential, and we are content for it to be published in full on the CMA's website.

If you have any questions, please do not hesitate to contact me or Paul Bircham

[REDACTED]). Should you wish to hear from us in person (or by videoconference given the current restrictions), we will seek to make ourselves available where possible.

Yours sincerely



David Brocksom

Chief Financial Officer

<sup>10</sup> Reference of the PR19 final determinations: Risk and return – response to common issues in companies' statements of case, paragraph 3.94.

<sup>11</sup>[https://assets.publishing.service.gov.uk/media/5e8dc457e90e07077abf9a4c/Anglian\\_Water\\_PR19\\_CMA\\_Redetermination\\_Statement\\_of\\_Case\\_Corrected.pdf](https://assets.publishing.service.gov.uk/media/5e8dc457e90e07077abf9a4c/Anglian_Water_PR19_CMA_Redetermination_Statement_of_Case_Corrected.pdf) at paragraph 142 (iii).