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Date  
2<sup>nd</sup> May 2018  
Contact / Extension  
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Dear James

## **RIIO-2 Framework Consultation March 2018**

This response is from SP Energy Networks. SP Energy Networks holds three electricity network licences. We own and operate the electricity distribution networks in the Central Belt and South of Scotland (SP Distribution) which serves 2 million customers, and Merseyside and North Wales (SP Manweb) which serves 1.5 million customers. We also own and maintain the electricity transmission network in the Central Belt and South of Scotland (SP Transmission). We welcome the opportunity to respond to the above consultation and to reflect our views following the various Ofgem RIIO-2 stakeholder workshops.

Electricity networks are central to delivering the future energy system that mitigates the risk of climate change, and provides sustainable, affordable, reliable and resilient energy needed to power the GB economy on an enduring basis. Up to £48bn of investment in GB's electricity networks will be required to facilitate the Electric Vehicle roll-out alone; therefore, it is clear that we are dependent on investors whom we must continue to attract. Positively, this increased investment could partially be ameliorated by potential annual savings of £8bn from the application of flexible technologies<sup>1</sup>.

The decisions we make now are critical to achieving success for all future consumers. The RIIO Framework has to provide the right regulatory platform to ensure this is achieved. The focus of the framework consultation debate has been on price and cost but these factors must be balanced by proper consideration of reliability and sustainability that consumers want. We therefore highlight the significant areas that must be addressed going forward.

### **We must not lose sight of the significant benefits incentive based regulation has delivered for consumers**

Since incentive based price control models were introduced, network companies have demonstrated positive outcomes for GB consumers with a 17% real terms reduction in network prices<sup>2</sup>; 50% real terms increase in investment<sup>3</sup>; 30% reduction in the number and duration of power cuts<sup>4</sup>; consistent

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[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/505218/IC\\_Energy\\_Report\\_w\\_eb.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/505218/IC_Energy_Report_w_eb.pdf)

2 <https://www.ofgem.gov.uk/news-blog/our-blog/why-cost-capital-networks-likely-fall>

3 Ofgem (2008), SGBI speech

4 <https://www.ofgem.gov.uk/ofgem-publications/76425/rpix20-press-release-finalpdf>

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improvements in customer satisfaction scores which exceed those of John Lewis and Amazon<sup>5</sup>; supporting economic growth with increased jobs; and facilitating the decarbonisation of Great Britain. These improved customer and environmental outcomes have been delivered whilst achieving real cost reductions. Other regulators worldwide have adopted (or intend to adopt) many elements of Ofgem's regime. For example, The New York Public Service Commission indicated that it would consider adopting many elements of GB's existing price control regime, recognising that performance incentives will enhance its energy vision. There is strong evidence from the US that capping and limiting performance ultimately has adverse impacts on consumers.

We should collectively focus on the benefits which have been delivered by network companies and how to embed them and build on them further. In the RIIO-2 debate to date, there has been extensive focus on ensuring "Fair Returns" - though Ofgem has yet to provide stakeholders with a view of what constitutes a "Fair Return". Whilst we do believe it is Ofgem's role to scrutinise company returns, any resulting actions must be within the framework of the price control settlement and carefully balance the needs of present and future consumers and investors. Ofgem should not, therefore, focus on this one element of the price control to the detriment of other important areas such as increasing innovation through greater levels of investment and maximising consumer benefits through whole system solutions. Importantly, until Ofgem's proposed policy on "Fair Returns" is properly articulated, the appropriate cost of capital levels for a company subject to that policy cannot be fully assessed. This is due to the fact that there is a significant risk that companies will be exposed to various moving targets which could impact their credit ratings and more widely increase regulatory risk, which in turn would increase the cost of capital. Given that the cost of capital is a critical element of the RIIO model, SPEN cannot therefore adequately assess the acceptability of the RIIO-2 proposals until all elements of Ofgem's proposed fair returns policy are fully understood.

Ofgem will be conscious of the fact that a proper consultation exercise requires sufficient explanation of a proposal in order to permit intelligent consideration and response. At this stage, Ofgem has not provided enough details of its "Fair Returns" policy to allow such consideration and response.

Across RIIO T1 and RIIO ED1, SPEN is forecasting to deliver all of its Networks Outputs in accordance with our business plans, thereby establishing a justifiable reputation for accurate business plan submissions and solid delivery of investments. In ED1, SP Distribution and SP Manweb are forecasting to spend all their allowances. In T1, SP Transmission is forecasting a modest efficiency based outperformance that is transparent and auditable. In simple terms, SPEN needs the allowances it has requested under the RIIO process. While some companies have voluntarily refunded unspent allowances, SPEN is not in a position to do this for the reasons outlined above. However, in order to demonstrate its long term commitment, SPEN has established a £15m fund aimed at kick starting the way both transport and heating is powered in Scotland. SPEN will work with the Scottish Government, Ofgem and independent academic advisors to fund initiatives focussed on the decarbonisation of transport and heating in Scotland that can also boost local economic growth.

In line with the general approach to price controls adopted across the regulated sectors since privatisation, we would encourage Ofgem to continue to review output incentive targets in light of revealed performance in RIIO-1 and use the latest data for future targets for the benefit of consumers in RIIO-2. Due to the uncertainty associated with Brexit as well as the requirement for increased investment to facilitate the roll out of Electric Vehicles and other low carbon technologies, we

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<sup>5</sup> Ofgem (2017), 'RIIO ED1 Annual report 2015/16' and Ofgem (2015), 'Electricity Distribution Company 2010-2015'

believe that Ofgem should introduce controlled change in RIIO-2 rather than dramatic shifts in the framework. This will help to ensure that the UK can continue to attract the necessary investment in our energy system.

CEPA's report of the RIIO framework and RIIO-1 performance,<sup>6</sup> as commissioned by Ofgem, recognises that RIIO-1 has succeeded in incentivising output delivery and encouraging efficiency.

### **External Pressures**

There has been pressure from various parties in relation to network companies' returns. In the context of these pressures, it is important that Ofgem carefully and independently applies itself to its statutory duties to protect the interests of present and future consumers, ensuring that its decisions are evidence based and underpinned by robust analysis.

There is a risk that mechanisms which are viewed as beneficial to the present consumer, will ultimately be damaging to future consumers if companies' credit metrics are downgraded due to diminished regulatory certainty, or investors are no longer willing to invest in energy networks during a period of significant change as we make the transition into a low carbon future.

It is clear that the benefits of RIIO have not been adequately communicated. Network companies must redouble our efforts to inform the wider audience and ensure they are aware of the industry's achievements in delivering an extremely reliable service at relatively little cost. This was demonstrated during recent severe weather events where our networks continued to deliver a reliable service with little interruption, whereas, other services were adversely affected in a relatively short space of time<sup>7</sup>. This is just one example which highlights the increasingly healthy state of our energy networks as a result of the RIIO framework to date. Indeed, there is a strong case that the energy networks sector should be used as a model to help drive improvements in other sectors. We also believe that Ofgem, as an independent regulator, has a central role in ensuring that the benefits of RIIO are explained to the public, and that discussions take full account of the significant successes resulting from Ofgem's activities.

### **Financial Parameters and "Fair Returns" Mechanisms must be fair to consumers and investors**

Although we agree with the application of the CAPM framework, the proposed Ofgem range of 3% to 5% is significantly below that of 5.51% to 6.34% recommended in the Oxera report for ENA.

In Oxera's view, CEPA's estimate of the Total Market Return (TMR) derived from the Dividend Growth Model is understated as a result of undue reliance on UK GDP growth as a basis of dividend forecasts. Analysis by the Bank of England takes into account higher overseas growth, which accounts for a large part of listed companies' earnings. As recognised in Oxera's report, the TMR, is the most stable component of the cost of capital and is the most appropriate basis on which to derive the allowed cost of equity.

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<sup>6</sup> [https://www.ofgem.gov.uk/system/files/docs/2018/03/cepa\\_review\\_of\\_the\\_riio\\_framework\\_and\\_riio-1\\_performance.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/03/cepa_review_of_the_riio_framework_and_riio-1_performance.pdf)

<sup>7</sup> For example on the 27<sup>th</sup> February 2018, we experienced significant accumulations of snow, which resulted in significant disruptions to the transport network and to motorists on roads. SPEN continued to deliver a reliable supply to our customers.

We therefore consider that Oxera's estimates of TMR are more robust than CEPA's - and we believe there are strong reasons to select a point estimate at the upper end of the Oxera range to ensure there is adequate incentive on shareholders to invest. Ofgem's consultation sets out the drivers of increased future demand, additional generation across the network and a range of new challenges as a result of accommodating greater volume of intermittent renewable generation; all of which are likely to require increased network investment and innovation.

As little evidence has been provided, we cannot currently support the indexation of the cost of equity. Unlike the cost of debt; there is limited observable data that directly relates to network companies. Instead, greater reliance would have to be placed on suitable proxy stock market data, using an asset pricing model such as the CAPM. The only viable cost of equity index is one which fully reflects the relative stability of the TMR.

In the main, network company outperformance has been due to companies' TOTEX outperformance and the allowed cost of equity. Therefore, in relation to Ofgem's proposed "fair returns" mechanisms, we believe there should be a focus on developing a price control with appropriately calibrated licence mechanisms which have the ability to claw back material unspent TOTEX allowances<sup>8</sup>. This should remove any perceived need for a return-based claw-back mechanism. The proposed "Anchoring Returns" mechanism has very material downsides. It would introduce an ex-post regulatory mechanism which would rely on imperfect data to calculate adjustments to rates of return. Companies would be exposed to random and external factors and in the worst case, gaming. Ultimately, such a mechanism is likely to weaken the incentive on companies to submit well justified business plans and discourage the sharing of information and best practice amongst companies. Furthermore, as companies have regional differences and devolved Government targets, anchoring returns could have perverse outcomes as there will be many legitimate reasons for 'company A' performing differently to 'company B'. Ofgem in the past, by applying a 25% weighting on network owners forecasts<sup>9</sup> and 75% to their assessment, recognised the complexity of the process. The potential inequity of the price control, from unintended differences in allowances between companies, would be compounded under 'Anchoring Returns'.

Putting all these concerns aside, there is the practical problem of trying to apply a rebasing mechanism in transmission, where the level of rebasing would be largely driven by National Grid given its relative size - which does not appear to be consistent with the rationale for the mechanism.

There are several years before the RIIO-2 price controls take effect and a number of risks will evolve in the intervening period that need to be taken into account, therefore, it is too early to finalise the cost of capital. In addition, the transition timetable for Brexit and other political matters will add further uncertainty. Furthermore, no decision should be made on the cost of equity until Ofgem has finalised its proposals for 'fair returns', given their significant interdependence.

### **Listening to the Investor Community**

SPEN is part of the Iberdrola group, which is one of the largest utilities in the world. Our investors have advised that at this point in time, the US and Brazil are seen as more attractive places to invest than

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<sup>8</sup> For example, in the current price control, National Grid's unbuilt gas pipelines (which resulted in a voluntary return from National Grid).

<sup>9</sup> In the allowance setting process

the UK. The common view from the market is that investors are more cautious about investing in the UK. Our investors observe that the attractiveness of UK networks for them is lower than it was 10 years ago, and equity holders are concerned at the types of measures being proposed by Ofgem.

Stability and reasonable returns are required for investors; otherwise, there is a risk of capital leaving the UK, or, in fact, becoming more expensive, at a time where greater than ever investment is required in the UK to facilitate Great Britain's Low carbon agenda.

Ofgem has recently recognised in its Mid Period Review (MPR) decision<sup>10</sup>, that the costs associated with changes to regulatory confidence from an extension of the MPR scope are potentially significant, but also highly uncertain (potential range of 300m to £3.1 billion in present value terms across all RIIO-2 network price controls). It is our view that this value range would increase significantly should the proposed "Fair Returns" mechanisms be implemented, as this would undermine investor confidence.

**Providing our Stakeholders with an increased role and ensuring that the most vulnerable in society are protected**

Stakeholder engagement is very important to us. We believe that the establishment of the Customer Engagement Group and an informed TO User panel to provide challenge to the RIIO-T2 plan are welcome additions to the ongoing business as usual Stakeholder Engagement activities. However, we must be mindful of stakeholder fatigue and monitor stakeholders' views of this new method for assessing business plans throughout the process. For transmission companies, there is a real urgency for Panel Chairs and Members to be agreed as soon as possible as we are required to carry out stakeholder engagement activities to inform our plans which are due in Q4 of 2019.

We welcome the increased role for stakeholders in the development of our business plans; however, it is important that Ofgem has a process in place for ensuring this is managed appropriately so that stakeholders' reasonable requests are not unfairly benchmarked out of companies' business plans. With increased stakeholder engagement it is a reasonable conclusion Network Operators plans will become more company specific and unique as regional variances are reflected. Ofgem will need to focus more on company by company assessment rather than sector benchmarking.

The most vulnerable in our society must be protected and have a voice; therefore, we would encourage Ofgem to ensure that social obligations remain a priority for companies and that this stakeholder group is adequately represented on any panel.

With regard to Open Hearings, we are supportive of any mechanism that will encourage transparency and fairness and contribute to legitimacy. Ofgem will need to give careful thought to how the agenda is managed so that the hearings can be conducted briskly and efficiently, whilst affording a reasonable opportunity for opposing views to be aired.

**Competition models should only be taken forward where Ofgem can be confident that these will deliver value for GB consumers**

We support the introduction of competition where this delivers value to the consumer, and have advocated the "Early" CATO model as the best way to achieve the outcome from competition that

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<sup>10</sup> <https://www.ofgem.gov.uk/publications-and-updates/decision-mid-period-review-riio-ed1> Paragraph 3.21

ultimately benefits customers. The “Early” model, when applied to appropriate schemes, could introduce further innovation into the regime. As a result, this will more likely result in savings to the consumer than the “Late” CATO model.

In taking forward new models for competition, Ofgem will need to be confident that these can deliver incremental value for GB consumers, bearing in mind the level of competition that already exists. In addition to competition in connections and IDNOs in electricity distribution, c.95% of expenditure for transmission works is tendered on a competitive basis. Network operators have extensive experience of running this process and the benefit of introducing economies of scale to tendering. Network Operators use their experience to drive ongoing efficiencies and these are passed on to customers in future price controls.

An important consideration in the assessment of Competition Models is the Network Operators established processes, systems and resources to deliver large projects in a timeframe which minimises SO networks constraint costs.

We would also note that to date, experiences of “effective competition” in the electricity networks sector have been mixed. The IDNO regime in network distribution has added complexity for consumers. The OFTO regime has brought consumer benefit in terms of financing costs, but it has not delivered anything other than single-user radial connections (as opposed to the more complex requirements within interconnected networks). To date, there have been no OFTO-build schemes and instead OFTOs have only adopted commissioned assets which have been constructed and commissioned by the relevant offshore generator. These factors severely limit the read-across from OFTO arrangements to the construction and enduring operation of complex onshore networks, which also need to consider renewal and modernisation activities.

### **Retaining the Innovation stimulus to encourage environmental solutions and to reduce customer bills**

The innovation stimulus assists the growth of the supply chain where outcomes from innovative projects provide market and economic drivers to suppliers and solution providers. Without an innovation stimulus, the growth of the supply chain for innovative solutions will be hampered, and the realisation of benefits, through integration of such solutions in business as usual for network operators, the SO and GB consumers, will be delayed. The LCNF innovation stimulus was determined by Poyry on behalf of Ofgem to have delivered net benefits of £1bn and will deliver up to £7.8bn of benefits if projects are rolled out across GB.

We agree that innovation funding should encourage companies to focus more on challenges currently facing the energy sector such as accommodating the increasing use of electric vehicles, the decarbonisation of heat. Innovation funding should also encourage active knowledge sharing.

### **Assisting Governments achieve their ‘Low Carbon’ ambitions and assisting the wider energy transition**

Network investments – and the price control settlements which enable them -are fundamental to the delivery of the long term UK, Scottish and Welsh Government energy policy and low carbon ambitions. In order to deliver these ambitions, it will be necessary to look beyond single price control periods. For example, the future closure of thermal plant beyond RIIO-T2 will need to be considered as part of any review.

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Accommodating low carbon technologies in a timely and cost effective way should be a key feature of RIIO-2 and we are committed to playing our part in the transition to a low carbon economy. Given the variety of innovative solutions which may be proposed to address the future challenges, consideration should be given to assessment of whole life costs of solutions rather than simply the capital unit cost.

A study<sup>11</sup> carried out by the Energy Networks Association on the behalf of The Office for Low Emission Vehicles (OLEV), estimated the network reinforcement costs to facilitate 8 million Electric Vehicles (EVs) by 2030 and 30 million EVs by 2040 were sizeable, estimated at between £34bn and £48bn in total. The rate of EV growth remains uncertain, so there is a risk that networks could slow the growth of EVs if we are not prepared and investing adequately. We may draw upon the lessons learned in relation to adoption of solar PV technology in GB – which many network operators had underestimated and were ultimately unprepared for.

SPEN has also led the UK energy industry with our work on development of a Distribution System Operator vision and are committed to supporting these ongoing developments with a view to incorporating the necessary changes to roles and commercial frameworks into our RIIO-2 plans. It is our view that increasing costs associated with the ENA's Open Networks project and ongoing DSO developments should be considered as a separate allowance within the RIIO-2 price controls.

#### **Black Start focus in Sector Specific Strategies**

Ofgem has observed that the UK recorded its first working day without coal power since the Industrial Revolution. Whilst this is clearly an impressive statistic, the changing mix of generation in the UK also has material implications for the likelihood of a complete or widespread loss of power and the procedure for restoring power in the event that this happens. As a Transmission and Distribution network owner, we have a holistic view of the network, and believe it is crucial that Black Start capability forms a key output in RIIO-2. Over the next decade we expect further loss of thermal generation in the SPT network area which will create new challenges that RIIO-2 will need to address.

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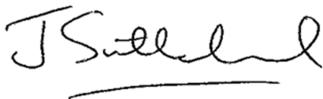
<sup>11</sup> ENA, 2016, The cost of charging infrastructure associated with uptake of electric vehicles in GB

**Process**

Ofgem's consultation policy document states that 12 weeks should be provided to respond to a consultation on "major issues of wide interest" whereas 8 weeks should be given in respect of a consultation focusing on issues with "narrower impact and of more specific interest". This consultation canvasses major issues of wide interest, however the timeframe for responses is 7 March to 2 May, 8 weeks. Our view is that 12 weeks should have been afforded to respondents. We therefore wish to highlight to Ofgem that it is our view that a 12 week consultation process should be followed for Sector specific consultations in the future.

Should you have any queries in relation to our response, please do not hesitate to contact me.

Yours sincerely,



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**RIIO-T2 Director**

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## Appendix 1 Response to Questions

**Q1. How can we enhance these models and strengthen the role of stakeholders in providing input and challenge to company plans? What are your views on the proposal to have Open Hearings on areas of contention that have been identified by the groups?**

**We are supportive of the plans to enhance consumer engagement within RIIO-2 in both Distribution and Transmission sectors as we believe that the proposals will bring the sector in line with the improvements that have been seen in both the water and the airline industries through enhanced engagement models. However, the detail needs to be worked on to ensure the model works as intended.**

**With regard to Open Hearings, we are supportive of any mechanism that will encourage transparency and fairness within a process, however, if staged in isolation the Open Hearing may become primarily an opportunity to present on any areas of contention in the presence of the Regulator. There is a risk that the Open Hearings lead to parties becoming more entrenched, rather than engaging in constructive dialogue and better understanding the underlying issues. This process will require a great deal of resource and input to prepare and support while the identity of the invited stakeholders would need to be carefully considered. So long as companies are transparent and consult with stakeholders, this should give them a chance to voice concerns which will not require an Open Hearing.**

We would like to take the opportunity to highlight a few points in relation to the proposals.

### Distribution

We believe that the establishment of the Customer Engagement Group to provide challenge to the RIIO ED2 plan is a welcome addition to the ongoing BAU Stakeholder Engagement activities currently operational within SPEN. It is our view that there is sufficient time to resource and build a comprehensive engagement plan around the Group and we are excited to see how stakeholders will further influence and shape our plans in RIIO ED2.

However, the establishment and resourcing of multiple Groups for all DNOs and GDNs will be difficult as there is a limited available pool of candidates and a limited number of Stakeholders. There could be an issue of limited representation for some DNOs, as there will be a scarce pool of candidates to choose from whom are willing to take on this role. This could lead to companies competing to offer higher salaries for the posts, the costs of which are ultimately borne by the end consumer.

### Transmission

We welcome the proposal for enhanced engagement in the transmission sector. We also support the recent report from the Ofgem Consumer First Panel, highlighting the difficulties faced by the end consumer when discussing transmission and price controls. For this reason, we believe that an informed TO User Panel is undoubtedly the way forward in transmission.

In relation to the Panel, we face the same issues in terms of stakeholder fatigue, availability and salaries as seen above in the distribution example. However the biggest risk to the proposed model in RIIO-T2 for Transmission is around the available time to carry out the required form of stakeholder engagement to be incorporated into a well justified business plan.

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Stakeholder engagement activity is expected to be undertaken in advance of our business plans which are due to be submitted in Q4 2019. This only leaves 6 quarters from now until submission – potentially 6 meetings going by the examples set in airports and water of quarterly meeting frequency. One suggestion to combat this issue is to prioritise a small number of specified areas to cover and provide explicit details as per other constructive engagement models. In Ofgem’s ‘Enhanced Stakeholder Engagement Guidance’ document, Ofgem accepts that this will be a “learning by doing” process. If we can ensure this process is focused on RIIO-T2, we can use the available timescales to develop the process and gain valuable experience before applying it to the RIIO-ED2 process.

By setting the transmission scope so wide with such a limited timescale, there is a risk that we end up with business plans that have not been given the level of scrutiny that the company, stakeholders, Ofgem or TO User Panel would accept. A wide remit to be covered in the time frame left does not afford companies the time to adequately respond to challenges from stakeholders and amend plans accordingly. The end result may be a final report featuring areas of contention and no areas of agreement which is not conclusive for stakeholders. It is important to note in this context that SPEN already engages with stakeholders extensively.

#### Existing Business as Usual Activities

Stakeholder Engagement Panels are not new to SP Energy Networks. We have been running established and embedded Panels for over three years. Our Strategic Stakeholder Panels are mature and provide significant value to our process. Our Stakeholders that sit on our Panels are informed and a vital part of our core business as usual stakeholder activities.

It is important to be mindful of the fact that the establishment of new Panels does not mean that we will cease our existing BAU activities. There is already a huge amount of time and resources invested not only from us, but also from our stakeholders and this will only increase with the creation of new Panels.

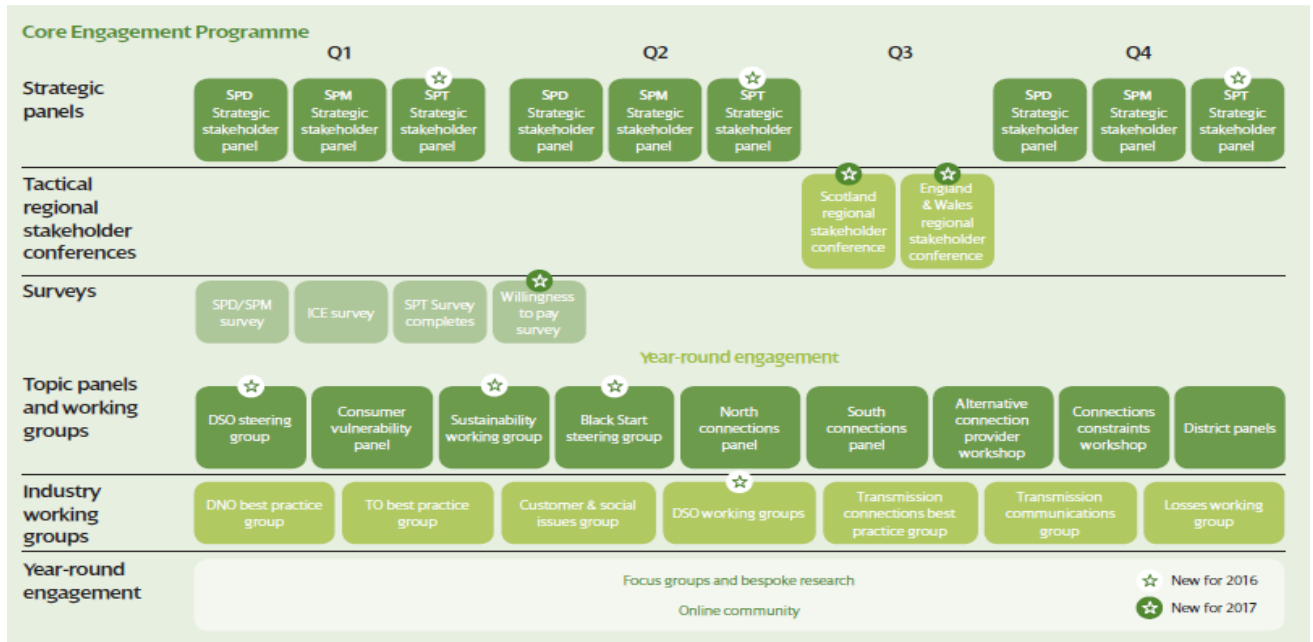
Please see an extract of our BAU Stakeholder activity as reported in our Stakeholder Submission. This highlights the breadth and level of activity in existing Panels, across our Distribution and Transmission businesses and also across our different regions. There is a huge volume of ongoing work in this area and we need to carefully manage the impact on our stakeholders and our available resources in terms of running new and existing Panels.

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Open Hearings

With regard to Open Hearings, we are supportive of any mechanism that will encourage transparency and fairness within a process. However, it is also our view that so long as companies are transparent and consult with stakeholders, this should give stakeholders a chance to voice concerns which would not require an Open Hearing.

Open Hearings may result in even further proliferation of opinions and the timing of the hearings must be considered as companies will need to have published plans and time taken for stakeholders to review these before deciding if they wish to raise points at such an event. This may add weeks or months to the process to allow for these review periods and companies must be afforded the opportunity to address any points that are going to be raised before an open hearing.

Should Open Hearings be taken forward, we believe the process would need to be chaired and managed accordingly; otherwise we face the risk of no output from the Open Hearings, aside from a heated debate. The process needs to be designed to give the best chance of parties acquiring a better understanding of the underlying issues and their respective opinions. There is a risk that the hearings become adversarial and result in entrenchment.

This process will require a great deal of resource and input to prepare and support and the invited stakeholders would need to be carefully considered or there is a danger that the Open Hearing will become nothing more than an opportunity to present on any areas of contention in the presence of the regulator.

We must also be aware of potential unintended consequences that arise from Open Hearings. For example, the US has witnessed professional interveners trying to profit from such hearings. This is

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clearly not the direction that Ofgem wish for the Open Hearings to take, so these must be managed accordingly.

One suggestion would be to trial this on a current area of contention, for example, on Citizen's Advice "Consumers' Missing Billions" report, this might provide an insight into how an Open Hearing may work in practice.

### Governance

There is already extensive governance over the price control, including extensive scrutiny by the GEMA board. The new models introduce two potential levels of additional governance above and beyond the GEMA Board and existing GEMA governance:

1. TO / Customer Engagement Panel
2. RIIO-2 Challenge Group

By introducing new levels of governance and assurance, we risk overcomplicating the process and there may be significant areas of overlap between the groups. Furthermore, Ofgem's intention is to simplify price controls, which this may not lend itself to. No other sector has seen the engagement levels enhanced to what is proposed in RIIO-2 Consultation.

Should the engagement provide tangible outcomes for customers and stakeholders, it will have been a success. However, we do need to recognise that there may be some issues on which we may never reach agreement with stakeholder panels, and on which the ultimate decision will lie with the GEMA Board. It is therefore important that stakeholders' expectations are managed so they are aware that the final decision by GEMA on contentious areas may not align with their stated views.

It is our view that devolved Governments have a role to play in this process and should be considered as part of the approvals process. In addition, it is important that companies have the ability to exercise their right to speak directly to the GEMA Board in advance of any decisions being finalised.

### Challenge Group

The RIIO-2 Challenge Group must ensure that there is representation on devolved matters to ensure that there is a fair focus on all relevant topics GB wide. For example, the Scottish government has its own Energy Strategy which has differing energy targets to BEIS<sup>1</sup>. Similar considerations will apply to other regions, e.g. cities with powers devolved to mayors.

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## Length of price control

**Q2. Do you agree with our preferred position to set the price control for a five-year period, but with the flexibility to set some allowances over a longer period, if companies can present a compelling justification, such as on innovation or efficiency grounds?**

- *What type of cost categories should be set over a longer period?*
- *How could we mitigate the potential disruption this might cause to the rest of the framework?*
- *What additional measures might be required to support longer-term thinking among network companies?*
- *Do you instead support the option of retaining eight-year price controls with a more extensive Mid-Period Review (MPR)?*
- *What impact might the alternative option of an eight-year price control with a more extensive MPR have on how network companies plan and operate their businesses?*
- *What type of cost categories should be set over a longer period?*

**We acknowledge that a five year price control would have some merits, notably limiting the exposure of companies and consumers to any uncertainty or changes in the wider macroeconomic environment. However, in our experience, one of the material benefits of an eight year price control is the increased certainty over longer timescales, which we have been able to leverage to secure investment for larger scale projects and to negotiate better prices with our supply chains.**

**Should Ofgem move to a 5 year price control, it should not defer important decisions into later price controls and use the shorter price control period as an opportunity to avoid making longer term decisions. For example, we require to invest in our networks at this moment in time to facilitate EV's, we cannot wait until it is too late.**

For this reason we welcome the opportunity to allow network operators to propose packages or programmes that go beyond a price control period for example, projects which will extend from T2 into T3. It is important that Ofgem's cost assessment considers such expenditure and associated benefits in their entirety, taking into account the longer time horizons involved. For example, such expenditure may need to be assessed separately from the benchmarking of baseline expenditure in a single price control, to encourage optimal investment profiles. This is an approach which we believe should be applied across all licensees. The agreed efficient cost allowances could then be ring-fenced by introducing a revenue licence term to permit the continuation of RII0-2 projects into RII0-3.

If eight year price controls were to be retained, triggers could be included within the price control for re-openers. For example, if demand across our licence area changed by more than a certain percentage due to the uptake of EVs or electrification of heat, this could trigger a re-opener.

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## Whole system outcomes

**Q3. In what ways can the price control framework be an effective enabler or barrier to the delivery of whole system outcomes?**

- ***If there are barriers, how do you think these can be removed?***
- ***What elements of the price control should we prioritise to enable whole system outcomes?***

**In order to incentivise a whole system approach, economic evaluation techniques for appraising investments that have a whole system approach should be considered. The use of Cost Benefit Analysis (CBA) in ED1 was valuable in appraising different investment approaches and SPEN strongly support their use again in RIIO-2.**

**In the context of RIIO-2 we believe it is feasible to undertake whole systems assessment across electricity transmission and distribution. While it is possible in principle to extend the analysis to gas we believe the current legal framework does not permit electricity networks to undertake activities and investments that benefit gas consumers and vice versa, this could be problematic where the benefits case for an electricity network initiative is primarily driven by benefits to consumers in sectors outside electricity. Accordingly, we recommend a whole system assessment separately for electricity and gas is prioritised for RIIO-2 and we can look to combining these frameworks together with other sectors e.g. heat and transport in RIIO-3 allowing time to resolve any legislative constraints.**

More generally, the use of CBA allows network companies to evaluate and compare market based solutions, solutions from other parties, innovation or traditional approaches to assess which offers best value for money for customers. It is important that the results of the CBA are considered alongside assessment and benchmarking of baseline expenditure, as the best long term solution may not lend itself to benchmarking in the same way as each solution which is evaluated on its own merit.

For constraint market based solutions there will be an interaction with the SO, so a means of permitting the SO to fund investment to offset constraint costs is required. As part of the CBA process, TOs will also require access to a consistent value to evaluate constraints which should be provided by the SO.

The economic evaluation of projects must consider whole system costs and benefits, rather than only accruing such costs and benefits to customers who have a direct contractual relationship with the licensee undertaking the work. Previously analysis has only considered electricity customers for electricity investment, however, a whole systems approach would need to account for benefits accruing to other parties who are affected by such investment and may become future customers, for example, those who are currently 'off-grid' customers.

As there is an increasing focus on 'non-build' solutions<sup>12</sup>, a whole life analysis must take this into consideration as these may have a lower capital cost but a higher life time cost in comparison with the equivalent build solutions.

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<sup>12</sup> For example, a solution which delays or stops investment by encouraging customers to constrain their consumption or generation during peak times via a commercial contract.

Naturally, as Ofgem understands, taking a whole system approach will ultimately necessitate a review of the wider regulatory framework so that other potential hurdles are removed or mitigated.

**Q4. Do you agree with our minded-to position to retain the current start dates for the electricity transmission and electricity distribution price controls, and not align them?**

**We are in agreement with Ofgem’s minded to position not to align transmission and distribution price controls.**

We do not believe that it is a necessity to align the price control reviews between Distribution and Transmission to have a whole systems approach. As a ‘whole system’ approach also includes work across gas and electricity, the main focus should be on the mechanisms available to allow a whole system approach. We agree that the advantages and disadvantages Ofgem have identified are correct and that the disadvantages outweigh the advantages.

Whilst we don’t believe it is a necessity to align price controls, Ofgem may choose to extend the existing RIIO-T1 price controls by 2 years and align the price controls at the start of RIIO-ED2.

**Q5. In defining the term ‘whole system’, what should we focus on for the RIIO-2 period, and what other areas should we consider in the longer-term?**

- ***Are there any implementation limits to this definition?***

**Ofgem should focus on implementation mechanisms which permit the funding or incentive sharing between licensees where this would result in the best long term solution for the GB energy consumer to promote whole system solutions.**

If configured correctly, whole systems assessment will demonstrate where the cost of not investing in time will outweigh the initial investment especially to accommodate a rapid uptake of new technologies as was experienced with Solar PV. Such a whole system approach would therefore better enable network operators to facilitate the transition to a lower carbon economy. At present Ofgem does not have responsibility over other sectors such as transport and heat etc, so companies may need to demonstrate through stakeholder engagement and CBA how they deliver benefits across the different sectors. There will also be regional variations which will need to be taken into consideration due to different targets for the electrification of trains, EV targets and heating in devolved governments.

It is our view that a clear boundary of whole system is required. A whole system approach may involve individuals who are not existing or future customers. Therefore, there is a need to recognise this within the current licences. It is our understanding that our customers are not permitted to fund innovation associated principally with gas and other industries, therefore, a new licence condition and potentially amendments to the Electricity Act may be required to permit Ofgem to allow funding for licensees to consider innovation that is not just restricted to electricity, where this results in the best long term solution for the GB energy consumer. This is something that will require careful legal review. It is clear that there are material and growing cross overs between the gas, electricity, transport and heat sectors and therefore we encourage Ofgem to take a whole system view to the extent possible, and also address such matters via fora such as the UKRN.

The risk of not investing is likely to be a bigger barrier to the low carbon energy transition than the risk of overlap/duplication of effort. All of the current scenarios point to a rapid uptake of new technologies

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and it is important to avoid a lack of funding (as a result of price control decisions) to accommodate the changes.

Within the sector specific strategies, it may be appropriate to categorise projects which have a dependency on a whole system approach separately to other general load related projects. These projects may require a separate re-opener window as these are more likely to be subject to change than a less complex load project.

**Q6. Do you agree with our view that National Grid's electricity SO price control should be separated from its TO price control?**

**We agree that the SO should have its own separate price control to NGET TO. This is an entirely logical consequence of the SO/TO reforms.**

The legal separation that has been initiated between the NGET SO and TO businesses establishes a clear mandate, if not requirement, for a separate price control. This would reinforce the legal separation and ensure the SO and TO entities are better focussed on their obligations.

**Q7. Do you agree that we should be considering alternative remuneration models for the electricity SO?**

- *If so, do you have any proposals for the types of models we should be considering?*

**The incentive and price control framework for the SO should be able to appropriately ensure it can work with the TOs to identify the most efficient network solution across possible TO and SO initiatives.**

The independent SO has a much reduced asset base compared to its TO business as it is a service provider rather than an asset intensive organisation. Consideration of an alternative remuneration model is therefore appropriate. The role of the SO is evolving and is increasingly needed to support whole system and non-build solutions. Appropriate incentivisation linked to these new outputs should be developed.

**Q8. Should we consider alternative remuneration models for the gas SO?**

- *If so, why and what models?*

We do not have any comments on this point at this stage.

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## Network utilisation, stranding and investment risk

**Q9. What options, within the price control, should be considered further to help protect consumers against having to pay for costly assets that may not be needed in the future due to changing demand or technology, while ensuring companies meet the reasonable demands for network capacity in a changing energy system?**

**We agree that customers should be protected from asset stranding but this should not be assessed in isolation in particular taking into account delays of the electrification of other sectors in order to meet the government's carbon reduction targets. Ofgem should not consider the options to manage the risk of stranding without also taking fully into account the risk of delayed investment and uncertainty mechanisms which can accommodate both scenarios.**

Whilst we have seen a reduction in total demand for electricity as a result of embedded generation, we are now seeing greater fluctuations in peak requirements on the transmission system which need to be designed to accommodate the energy transition. Across the transmission network we have experienced swings in power flows across the transmission boundary with England of 5600MW in less than 48 hours as a result of the loss of base load generation in Scotland and intermittency of renewables. Investment in the transmission network is required to facilitate the increasing volume of renewables and ensure that the Great Britain energy market is underpinned by fit for purpose networks to secure resilience.

In terms of avoiding investment which may not be required, in the development of our RIIO-T1 plans, we were able to identify that the load related investment which was undertaken was forecast to be fully paid off by the constraint costs which it alleviated within the price control period. Constraint costs are a tangible metric which can be used to identify benefits from investments and should be used in a transmission CBA methodology to show the benefits which any given investment will offer and that the risk of stranding is minimal.

A common modelling approach could also be considered in RIIO-2 to evaluate the opportunity cost of delivering projects ahead of need compared to the economic impact of investment being made after the need has arisen. Such a model could demonstrate how the benefits investing ahead of need coupled with credible leading indicators in particular the avoided costs if such investments were deferred until the driver has become manifest on the network. For example proactive and strategic reinforcement in response to credible leading indicators of EV take up in a local area may prove more efficient than reinforcement after consumers have installed EV charging points.

For RIIO T2, SPT are proposing to use 2018 FES scenarios which have been tailored to the SPT customer demographics to consider a range of uncertainty. A best view of the future energy profile for SPT stakeholders and customers will also be created which will be informed by stakeholders' plans and views. This 'best view' will then be used to define the proposed load related investments for T2. This approach allows us to ensure the plans are reflective of stakeholders' requirements and equally stakeholders are aware of the cost of delivering this.

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## End-use energy efficiency

**Q10. In light of future challenges such as the decarbonisation of heat, what should be the role of network companies, including SOs, in encouraging a reduction in energy use by consumers in order to reduce future investment in energy networks?**

- ***What could the potential scale of this impact be?***

**The greatest efficiencies in delivering a secure, low-carbon sustainable energy system will be best realised through the adoption of a 'Whole-System' approach, including energy efficiency. Transport and heating sectors require to use more electricity also, so there is an increasing role for electricity networks. DNOs are not best placed to roll out energy efficiency initiatives, which we have experienced via our Flexible Networks LCNF project.**

Transport and heating sectors requires to utilise more low carbon electricity, not less, therefore there is an increasing role for electricity networks in the future.

We do recognise the importance of energy efficiency in driving down cost for customers in our area and, as such, we have partnered with organisations that provide energy efficiency advice, support and practical solutions for consumers free of charge. This advice is open to any customers in our licence areas, through these partnership agreements. We have therefore, been actively promoting energy efficiency in our awareness campaigns.

As part of our Flexible Networks LCNF project, which was part of a project to investigate energy efficiency to avoid or defer reinforcement costs, we found that it was difficult to convince customers to install energy efficiency measures.

It is our view that DNOs are not best placed to rollout energy efficiency initiatives (such as increased insulation) in a cost effective manner as we do not have the experience to roll out energy efficiency programmes and would be relying on third party delivery. The focus for network companies should be on delivering the greatest efficiencies though whole system approaches.

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## Innovation

**Q11. Do you agree with our proposal to retain dedicated innovation funding, limited to innovation projects which might not otherwise be delivered under the core RIIO-2 framework?**

**We agree with the proposal to retain dedicated funding for innovation incentives under the core RIIO-2 framework. We base our opinion on our experience with the RIIO-1 innovation framework and a comprehensive review of the innovation projects undertaken by network owners and operators under RIIO-1 innovation mechanisms. It is our view that innovation must be retained to encourage companies to invest in solutions which will facilitate the low carbon future. The rationale for introducing the present funding mechanisms was a recognition that innovation expenditure was vulnerable to being unduly reduced within a baseline price control allowance. We believe that this rationale remains, and supports some form of ring-fencing of innovation expenditure in future price controls. Knowledge sharing should be encouraged further.**

We agree with the proposal to retain dedicated funding for innovation incentives under the core RIIO-2 framework. We base our opinion on our experience with the RIIO-1 innovation framework and a comprehensive review of the innovation projects undertaken by network owners and operators under RIIO-1 innovation mechanisms.

Many innovation projects only deliver direct benefits to the funding licensee and other network operators through knowledge dissemination in future price control periods which can be lost in comparative efficiency assessments. The innovation mechanisms in RIIO-1 also encouraged licensees to initiate and deliver innovation projects where in some cases the majority of the benefits accrued to other network operators, the GB System Operator (SO) and third parties (e.g. SPT's VISOR and Phoenix NIC projects, and projects related to ANM schemes). Such projects will have a weak business case for network operators directly and in the absence of an innovation stimulus it will be challenging for network operators to undertake such innovation projects. Networks innovation funding is set up to give companies resources to innovate as we are subject to price controls and benchmarked so we do not have the discretion that a non-price controlled company has with regards to raising funds to invest in R&D and then profit from the benefit.

Projects undertaken under the NIA and NIC regimes in particular carry a degree of technical, commercial, operational and/or regulatory risk that warrants a separate innovation stimulus. The need for additional innovation incentives is to better manage these risks and to enable the smaller scale trials that are necessary to identify the requirements for larger scale roll-out. Innovation projects greatly aid in de-risking such technologies, processes and methods and best manage the process of integration into business as usual. Additionally, roll-out of innovative technologies, processes and methods often require new skillsets, infrastructure and application requirements which are developed through different phases of innovation projects.

The innovation framework's requirements for knowledge dissemination and shared Intellectual Property Rights (IPR) generated from projects encourage strong collaboration among network operators, SO, third parties and with other global utilities for the ultimate benefit to consumers. This also delivers efficiencies through single pilot trials where the supplier and/or solution provider is aware that the foreground IPR and relevant background IPR will be accessible to all network operators and the SO. The well-developed IPR guidelines of current innovation stimulus provide the funding licensee

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with the ability to encourage vendors to participate in innovation in the right spirit and a transparent way.

The innovation stimulus assists the growth of supply chain where outcomes from innovative projects provide market and economic drivers to suppliers and solution providers. Suppliers and solution providers have engaged with network licensees through the innovation stimulus to create specific solutions for emerging challenges in the GB network which at the same time has provided them direction to adapt their future product and solutions. Without an innovation stimulus, lower returns on capital will hamper the growth of the supply chain and investment in innovative solutions, subsequently delaying realisation of benefits through integration of such solutions in business as usual for network operators, the SO and GB consumers.

**Q12. Do you agree with our three broad areas of reform: i) increased alignment of funds to support critical issues associated with the energy transition challenges ii) greater coordination with wider public sector innovation funding and support and iii) increased third party engagement (including potentially exploring direct access to RIIO innovation funding)?**

**We are broadly supportive of all three broad areas of reform and we would support increased third party engagement. However, to date, there has been limited stakeholder appetite for direct third party access to funding. This is more applicable to smaller companies who do not have the resources to risk losing on tendering exercises which they may not win.**

- (i) In principle, we support this reform. We propose guidelines, clusters and themes to be set at the outset of the RIIO-2 period for the innovation framework to allow the innovation funding to be best utilised across all sectors in a balanced and transparent way. One of the areas for improvement of the RIIO-1 innovation framework is lack of clearly defined areas for innovation within the framework itself, thus providing no clear direction for utilisation of innovation funding to address specific challenges. This can be concluded from a review of RIIO-1 innovation projects which show stronger focus on some areas and less or no focus on other critical challenges. Cross-sector innovation themes can be included using a similar overview analysis of challenges in different sectors and identifying similarities in challenges and overlaps where more alignment of innovation efforts is required.
- (ii) We agree in principle that there could be value generated through greater coordination with wider public sector innovation funding and support. The nature of this co-ordination could be purely on identification of innovation themes and wider stakeholder engagement through dedicated knowledge dissemination events. For example, innovation topics in the GB telecoms industry are of great interest to network operators and the SO, currently in the process of evolving their own telecommunication infrastructure to support emerging applications such as those required by the DSO transition and the challenges presented by EV charging infrastructure. We would welcome further detail on how this mechanism may operate in practice.
- (iii) There are potential benefits with increased third party engagement in the RIIO-2 innovation mechanism. The Ofgem Network Innovation Review published in March 2017 proposed network operators and the SO to call for ideas from third parties as a part of the NIC bid process. This has aided in adding more transparency to the innovation mechanism where third parties can submit proposals and work in partnership with network operators and SO. We agree this process should be further developed and continued in RIIO-2. RIIO-2 innovation framework should set up a call for ideas from third parties for well-defined innovation areas and further develop a set of guidelines and governance process for assessing eligibility of third

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parties to participate in innovation process. We recommend this process should be managed by network operators and the SO who should continue acting as funding licensees.

Ofgem came to the clear conclusion that stakeholder support for allowing third party direct access to funding is limited<sup>13</sup>, and that there was no strong rationale for consumers to directly fund innovation by non-network companies and that this could undermine the value for money of funded projects. We do not believe that there has been any change in the operating environment that would change this position.

**Q13. What are the key issues we will need to consider in exploring these options for reform at the sector-specific methodology stage, including:**

*(i) What the critical issues may be in each sector and how we can mitigate the bias towards certain types of innovation through focusing on these issues?*

*(ii) How we can better coordinate any dedicated RIIO innovation funding with wider public sector funding and support (including Ofgem initiatives such as the Innovation Link and the Regulatory Sandbox)?*

*(iii) How we can enable increased third-party engagement and what could be the potential additional benefits and challenges of providing direct access to third parties in light of the future sources of transformative and disruptive innovation?*

**The critical issue we face on our networks is the forecast rapid growth of EV's and smart devices on our networks, in addition to the threat of cyber security (which is increased by these developments). We propose the creation of an innovation governing and review board (IGRB) run by Ofgem which will take a holistic view of whole system challenges and define innovation clusters and themes focused on all areas that require innovation in RIIO-2. In a RIIO-2 innovation funding mechanism, clear guidelines and governance processes should be defined for assessing the eligibility of third parties to participate, ensuring third parties' participation in innovation results in benefits that accrue largely to wider energy sector.**

The critical issues which currently affect energy sector are related to:

- Digitalisation and Artificial intelligence
- Peer to peer trading impacting forecasts of demand
- Higher dependency on electricity across the economy (IT, EVs, transport, heating, telecoms; social; banking)
- Enabling more distributed energy resources and enhancing system visibility to make the best use of available resources for providing system services,
- Development of new commercial frameworks,
- Making provisions for rapid growth of EVs and roll-out of smart devices,
- Development of economic and efficient Black Start processes,
- Creating awareness among GB consumers and encouraging participation from consumers to meet energy challenges,
- Accelerated development of communications infrastructure; and

<sup>13</sup> [https://www.ofgem.gov.uk/system/files/docs/2017/03/the\\_network\\_innovation\\_review\\_our\\_policy\\_decision.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/03/the_network_innovation_review_our_policy_decision.pdf)

- Cyber security. Please note that the some of the above developments increase risk in this regard

We propose the creation of an innovation governing and review board (IGRB) run by Ofgem which will take a holistic view of whole system challenges and define innovation clusters and themes focussed on all areas that require innovation in RIIO-2. We also propose publication of an annual innovation roadmap by the IGRB which would inform wider stakeholders regarding innovation projects initiated under each cluster and the balanced use of innovation funding to meet challenges across all identified themes. The specific clusters where innovation can deliver benefits across energy sectors could potentially also be given higher precedence and provide a potential for co-ordination with wider public sector funding.

The Ofgem consultation lists a range of public sector funding available in GB. We agree it will be beneficial to co-ordinate innovation activities between dedicated RIIO innovation funding and other public sector funding mechanisms and that this is best applied to stakeholder engagement and knowledge sharing. The creation of the Energy Innovation Board (EIB) will greatly aid in this co-ordination. The aforementioned innovation governing board could potentially also have representatives in the EIB, and facilitate sharing of information regarding projects initiated and findings from successfully completed innovation activities. Our view is Ofgem's innovation link and regulatory sandbox is complementary to RIIO innovation funding and should be further encouraged to fast track innovations which currently do not fit the regulatory framework and facilitate evolution of frameworks to support the wider roll-out of such innovative proposals.

We propose that the call for ideas from third parties in the RIIO-1 innovation framework should be further developed and continued in RIIO-2. In a RIIO-2 innovation funding mechanism, clear guidelines and governance processes should be defined for assessing the eligibility of third parties to participate, ensuring third parties' participation in innovation results in benefits that accrue largely to wider energy sector. We recommend this process should be managed by network operators and SO who should continue acting as funding licensees to mitigate the complications of imposing license obligations on third parties which may deter their participation in innovation funding mechanism, as highlighted in the Network Innovation Review. SPEN proposes that third parties could engage more through the innovation link and regulatory sandbox which allow potentially disruptive innovation to be undertaken in a more managed way with support from Ofgem and network operators and SO complementing transformative innovation undertaken by a dedicated innovation funding mechanism in RIIO-2. Our proposed innovation governing board could also have representation from third parties to support the definition of clusters and themes and participate in the review of innovation projects.

#### **Q14. What form could the innovation funding take.**

- ***What would be the advantages and disadvantages of various approaches?***

**We believe that innovation should be based on clearly identified clusters and themes with a continuous review mechanism in place to ensure balanced funding across clusters and avoidance of repetition of themes. There should be a stage review of innovation incentives and projects to ensure projects are aligned to their original objectives and are on track to deliver benefits. We also support the removal of multiple publications of close down and project progress reports which are resource intensive and do not provide a whole picture of all innovation activities.**

We agree in principle that the current innovation funding mechanisms would benefit from a review for RIIO-2. We have conducted a comprehensive review of all NIA, NIC and IRM projects in the RIIO-1

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period. The review highlights the key strengths of these mechanisms and at the same time presents opportunities for improvement and reform for RIIO-2 period. Our response to Q.11 highlighted the strengths of the RIIO-1 and the positive outcomes of dedicated innovation funding. The following are some of the areas where current innovation framework could be improved:

- Avoid repetition in innovation themes (technologies may be different but address recurring themes).
- Definition of a unified/defined benefits tracking mechanism.
- Improvements and streamlining of innovation governance processes.
- Improvement in the quality of publications and reports generated from various innovation processes.
- Provision for more incentives to drive the integration of innovation with business as usual processes.

#### Proposed Mechanism

We propose the following reforms for the RIIO-2 innovation mechanism to adequately address the weaknesses and build upon the strengths of the current mechanisms:

- Innovation based on clearly identified clusters and themes with a continuous review mechanism in place to ensure balanced funding across clusters and avoidance of repetition of projects to address particular themes.
- A stage gated review and gap analysis of innovation incentives and projects to ensure projects are aligned to their original objectives and are on track to deliver benefits. If deemed necessary, re-evaluation of project deliverables and gap analysis to ensure alignment of project themes.
- A unified review and benefits tracking mechanism.
- Avoidance of multiple publications of close down and project progress reports which are resource intensive and do not provide a whole picture of all innovation activities.
- Introduction of a benefits sharing mechanism to incentivise innovation within licence areas and deliver tangible benefits to GB customers.
- Introduction of Innovation Governing and Review Board (IGRB).
- The IGRB will streamline the reporting mechanism to Ofgem and will be responsible for the overall management of the innovation activities.

The following are potential advantages of the proposed reforms:

- Harmonised approach to innovation with clear identification of areas warranting innovation
- Avoidance of repetition of themes and channelling innovation funding to focus areas.
- Publication of overview reports that provide insight into roadmap, implementation plan and benefits generated through innovation
- Regular review process and benefits tracking
- Transparent mechanism with more aligned efforts towards innovation

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**Q15. How can we further encourage the transition of innovation to BAU in the RIIO-2 period? How can we develop our approach to the monitoring and reporting of benefits arising from innovation?**

**We propose that in RIIO-2 innovation projects will be subject to regular review and gap analysis. This will highlight any barriers to successful completion or roll-out throughout the duration of the project.**

Innovation projects undertaken in RIIO-1 have been to an extent integrated in network operators and the SO's business as usual processes and practices. However, we do acknowledge that the success rate of innovation projects' transition to business as usual could be improved. This aspect would benefit from a review for the RIIO-2 innovation funding mechanism.

Our review of innovation projects indicates that the following are the main barriers to successful integration of successful innovation projects to business as usual:

- Difficulties in developing skillsets upon completion of an innovation project to facilitate transition to business as usual.
- Complications in integration with legacy systems.
- Lack of competition in the supplier base to drive down costs for innovative solutions resulting in the innovative solutions being too expensive.
- Timing of innovation projects where certain innovation projects are only suitable for roll-out in future price control periods.

We propose that in RIIO-2 innovation projects will be subject to regular review and gap analysis. This will highlight any barriers to successful completion or roll-out throughout the duration of the project. The projects can then be modified to bring them back on track to deliver. Innovation projects should have an application plan right from the outset of the project as this will be continuously improved throughout project delivery to ensure the necessary skill-sets, infrastructure and supplier base exists.

Our proposed unified impact assessment and benefits tracking mechanism will ensure that all innovation projects are benchmarked under well-defined criteria and are transparent to all stakeholders. Innovation projects that score well in this mechanism will be given higher priority and their roll-out will be incentivised with the benefits sharing mechanisms. Network operators and the SO who can demonstrate quantitative and qualitative benefits could be rewarded through the following options for benefits sharing thus accelerating integration with business as usual.

#### Benefits generated in current price control period

In this case, the network licensee should be allowed to recover the innovation share initially contributed for pursuing the incentive. In the instance that direct benefits are generated which can be monetised, the licensee could share these benefits with consumers in accordance its TOTEX incentive mechanism ratio.

If the benefits generated are not direct benefits but still score high in an impact assessment and deliver benefits to the wider network or wider societal benefits, these can be incentivised by a discretionary reward.

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Benefits generated in future price control periods

The same principle as above can be applied and licensees can be rewarded in future price control periods if companies demonstrate efficiencies and customer benefits delivered through roll-out of innovative solutions.

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## Competition

**Q16. Do you agree with our proposal to extend the role of competition across the sectors (electricity and gas, transmission and distribution)?**

- ***What are the trade-offs that will need to be considered in designing the most efficient competitions?***

**Ofgem should not lose sight of the level of competition that already exists in electricity distribution from competition in connections and IDNOs. In addition to this, c.95% of expenditure for transmission works is tendered on a competitive basis. Network operators have extensive experience of running this process and the benefit of introducing economies of scale to tendering. The OFTO regime cannot be compared to the construction and operation of onshore transmission as it has not delivered anything other than adoption and operation of simple single-user radial connections, rather than being embedded within complex interconnected networks; and (ii) it is financed by highly geared structures.**

The consultation document states that '*system operators are required to enable or implement competition models*' (paragraph 5.41). However, in our view, the role of the SO should be reviewed carefully in this context. We believe the scope for the SO is appropriately limited to identifying the optimal network solution in collaboration with network companies. Where a network solution has been selected as optimal, it would then be down to the TOs and Ofgem to discuss any implications in terms of competitive tendering, as presently handled through the strategic wider works (SWW) process.

It is appropriate to implement competition where it is demonstrably of benefit to consumers on the basis of sound evidence. It is now timely to review these experiences so that any further introduction of competition is only introduced if we can all be entirely confident that it will benefit present and future consumers. To date, experiences of competition in the electricity networks sector has been mixed. The experience of the IDNO regime in distribution networks has added complexity for consumers. The OFTO regime has brought consumer benefit in terms of cost savings predominantly due to factors such as the low cost of debt available in highly geared structures. To date, the OFTO regime has resulted in generators constructing, commissioning and testing assets which are then adopted by an OFTO. Those asset have generally been single-user radial connections, rather than new transmission assets being embedded within complex interconnected networks. Under the OFTO regime, the OFTOs take on commissioned and tested assets. These factors undermine the costs and perceived benefits of OFTO arrangements from being reliably applied to the construction and enduring operation of onshore networks, which also need to consider renewal and modernisation activities. From a transparency perspective, we would welcome the publishing of OFTO returns in respect of OFTOs.

The proposals for the CATO regime, although still lacking in key areas, have been developed over time with significant consultation and stakeholder input. However, it is untried and untested and the necessary legislative changes have been held up in the parliamentary process. Ofgem should focus on an "Early" CATO regime and ensure that robust cost benefit analysis has been carried out to ensure that this will result in a net benefit for the GB consumer. As delays are likely to be associated with a lesser co-ordinated approach, competition may result in a net cost to the consumer and for the wider economy, as we are concerned with critical national infrastructure projects. It follows that Ofgem must ensure it is confident that the introduction of competition in such projects will deliver significant savings to consumers over the lifetime of the project with an acceptable level of risk, before it initiates any tender process.

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Any proposal to disaggregate the ownership and operation of network assets to a wider number of participants must consider the costs of tender exercises, the potential for delays and the associated impact on security of supply and the needs of stakeholders. Additionally, multiple parties providing essential network services with the necessary level of resilience will inevitably lead to unnecessary duplication of control and management centre facilities which, along with the critical telecommunications and data services essential to smarter networks, will incur costs which must be factored into necessary detailed impact assessments. Finally, the operational risks arising from the disaggregation of operation must also be carefully identified and considered.

It is therefore not axiomatic that competition is appropriate in all sectors and scenarios. Ofgem need to identify and justify where competition is needed and can bring benefits, with an acceptable risk profile, bearing in mind that the RIIO framework is in itself a proxy for competition that is delivering benefits for consumers through effective regulation that has played an important role in reducing costs and increasing efficiency. Detailed cost and risk based analysis must be carried out before implementing any new competitive regime to ensure that this does not result in a net cost to the GB consumer.

We have advocated the "Early" CATO model as the best way to achieve the outcome from competition that ultimately benefits customers yet raised concerns over the potential timing impact that any new tendering process could add to critical national infrastructure projects as indicated above. A major consideration in designing the most appropriate competition model is therefore the risk of delay to such projects and associated generator connections.

**Q17. Do you consider there are any reasons why our new, separable and high value criteria might not be applicable across all four sectors?**

- *If so, what alternative criteria might be suitable?*

**Detailed Impact Assessments and CBA would need to be undertaken for any sector where competition is envisaged as being of benefit to consumers.**

These criteria cannot automatically be assumed to apply to any other sector, however, are a good starting point for any initial discussions.

**Q18. What could the potential models be for early stage competitions (for design or technical solutions)?**

- *What are the key challenges in the implementation of such models, and how might we overcome them?*

**There are potential benefits from earlier competitions for ideas or solutions to deliver network needs. A trade-off in this case is the challenge to test and comparatively assess the quality of solutions and their capability to deliver consumer benefit over the longer term.**

The SO is being incentivised to facilitate the number of alternative solutions it can introduce but it is unclear how the process for DNOs or other parties to propose these solutions in the NOA process will be achieved. This is also being considered as part of the Open Networks Industry workstream and the ESO plan should align with the outcome of this work.

A key challenge to overcome is the additional work and time to assess ideas and solutions in a competition will be costly and risk delaying decisions on the appropriate solutions.

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## Our approach to setting outputs

**Q19. What views do you have on our proposed approach to specifying outputs and setting incentives?**

- **When might relative or absolute targets for output delivery incentives be appropriate?**
- **What impact would automatically resetting targets for output delivery incentives during a price control have? Which outputs might best suit this approach?**

**Ofgem's arguments for the removal of fast-tracking for electricity transmission are relevant in the consideration of relative targets. If Ofgem believes cross-company comparators will not lead to robust outcomes for fast-tracking then it follows that it will be similarly difficult to accurately implement relative targets.**

Automatically resetting targets, as a principle, undermines the intent of providing freedom to find ways of reducing costs for consumers and of rewarding companies that deliver service improvements (paragraph 6.18). It is our view that peer comparisons can be considered to be problematic in all sectors, as performance may not always be directly comparable and long term planning is undermined when there is lack of clarity on the required outcomes that a target represents.

We are supportive of the proposal to further enhance the consumer facing outputs and price control deliverables. We would expect both our Customer Engagement Group and TO User Panel to be fully involved in this process and help determine the acceptable levels for stakeholder and consumers they wish the company to deliver.

We note the proposals at 6.13 regarding potential licence modifications. A range of issues need to be explored here if these proposals are to be developed. The proposals, if we understand them correctly, materially increase the risks faced by licence holders. Licence holders would face enforcement action for the same incident by multiple regulatory bodies, for example Ofgem and the Health and Safety Executive or SEPA. There is a significant risk of double jeopardy and therefore mitigation mechanisms would be needed to deal with this. It is important to note that the issues such as safety and environmental matters are, entirely properly, extensively regulated, subject to very robust oversight by expert regulators and subject to significant penalties, including criminal sanctions.

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## Our approach to setting cost allowances

### Q20. What views do you have on our general approach to setting cost allowances?

**We agree with the general principle of reassessing the various elements of a network company's cost base to ensure risk allocation remains appropriate. In principle, we think one of the most powerful incentives of the RIIO framework is the potential upfront reward for a "well justified business plan" notably through fast-tracking and IQI, and we welcome Ofgem's commitment to retain some form of financial incentive for companies submitting plans that clearly demonstrate improved service levels and cost efficiency, thereby pushing companies to stretch themselves that bit further and maximise consumer benefits. However, any potential reward(s) must be proportionate and transparent to stakeholders.**

We understand the potential concerns raised, that for certain costs where risk has been allocated to network companies to manage within ex-ante allowances, companies may be perceived to have benefited from the upside risk of actual costs being well below the forecast setting the allowance. While we understand such concerns will motivate Ofgem to make greater use of uncertainty mechanisms such as indexation and cost pass-through, we believe there are some factors to consider before Ofgem makes any changes:

#### Interaction with safeguard mechanisms

Where Ofgem is considering mechanisms that may limit overall returns then the impact of forecasting risk and the need to address it through cost allowances, is diminished. Equally, were Ofgem to consider options to share returns earned during the price control, it is important to ensure the intended incentives on networks are not blunted by a reduction in efficiency incentives inherent in the treatment of certain costs.

#### Assessment of cost risk

Whilst certain costs may have remained lower than forecast in the present price control period, this may not remain the case going forward. Taking the example of real price effects (RPEs), the prolonged suppression of RPEs in the current economic cycle is not fully understood and has confounded experienced and well informed forecasters.

#### Scope for cost efficiency

It is also important to consider the extent to which companies can influence costs. Where costs are controllable, a move away from ex-ante allowances to, for example, a continual re-basing of allowances, may not be in consumers' interests. For example, it may inhibit the achievement of greater cost efficiencies that could have been shared with consumers, under the existing RIIO mechanisms offsetting any potential forecasting errors.

Robustly designed volume drivers can be an effective way of managing areas of uncertain volumes of work, particularly where these are not under the control of the network company. These require careful calibration to ensure fair and accurate outcomes, so should be developed as part of the sector specific consultation and working groups' process.

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Paragraph 6.29 references the expectation of demonstration of efficiency between RIIO-1 and RIIO-2 for similar activities and similar outputs. Caution is required in the assessment of both the similarity and the source of costs. The cost allowances and reporting for electricity transmission capital works are primarily on a 'named scheme' basis to reflect the uniqueness of the activities and their associated costs. In order to determine whether works are comparable for this purpose, it is necessary to examine the scopes in detail to identify the specific elements which are common.

In the case of electricity transmission, there are a number of factors which also affect the practicality of implementing automatic reset of allowances. Referencing paragraph 6.61, determining robust unit costs where there are a small number of companies, of very different scales with very different asset bases is not trivial. This is compounded by relatively low volumes of activities which are normally bespoke leading to high levels of variation in unit costs. As an alternative mitigation of the risks outlined in paragraph 6.32, we propose that greater transparency in cost setting is included in the RIIO-T2 process. Examining the proposals in greater detail (a 'bottom-up' approach) will result in higher confidence in the derivation of the costs and we believe that it is manageable for the case of electricity transmission. This type of approach would be best suited to areas where there is relative certainty over the scope of investments such as non-load related Capex.

In our responses to the questions regarding whole systems approach we have advocated using a cost benefit analysis (CBA) framework that can identify the most efficient solution across sectors and vectors. It is important to ensure that the conclusions of such an assessment is considered alongside any cost benchmarking which may not in itself capture the wider benefits of such expenditure. Similar considerations apply where Ofgem is assessing proposed expenditure that spans more than one price control. For example an individual project that has a positive net benefit but covers RIIO-T2 and T3 may need to be excluded from benchmarking of T2 or T3 expenditure done in isolation.

#### **Q21. What views do you have on our intention to index RPEs?**

**We wish to work with Ofgem to understand the impact of moving to an indexation method for RPE's. This would require the energy network sector and statistical experts to develop more appropriate indices, which could then be used to index base year expenditure allowances. However, it must be acknowledged that there is a symmetrical risk to companies and consumers of moving to any potential index. In addition, if the potential move to CPI is confirmed the basis of RPEs would need to reflect this inflation measure.**

As the price control expenditure allowances are set in base year prices, these need to be adjusted by appropriate measures of input costs and prices for each category of expenditure. In general, a measure of consumer prices will not appropriately reflect the patterns of expenditure and price changes experienced by energy network companies. For example, network companies are more exposed to changes in the price of metals such as copper and specialised steel, which are more volatile, but less exposed to those of personal services.

Historically, Ofgem has adopted an ex ante adjustment to allowances based on projections of input price trends, which have proved difficult to forecast accurately. Our experience is that annual changes in our own costs, such as those of transformers, do not closely match those of proprietary cost indices that are published for the electrical sector. We wish to work with Ofgem, the energy network sector and statistical experts to develop more appropriate indices, which could potentially be used to index base year expenditure allowances.

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It would be more transparent to apply the relevant indices of input cost and prices to the corresponding categories of expenditure allowance (set in base year prices). This would avoid the indirect approach of indexing allowances by the change in consumer prices and then, separately, making a further adjustment for Real Price Effects. The more direct approach would help stakeholders understand the reasons for the changes in allowances, especially where these differ from consumer price inflation.

Although there is scope to improve the input price and cost indices, we stress that Real Price Effects cannot be assessed independently of changes in productivity. Historically, productivity improvements have been assumed broadly to offset Real Price Effects. The counterpart of lower Real Price Effects, since the Great Recession, has been lower productivity growth. Although the cost of some inputs may not have, so far, risen as rapidly as assumed, this has largely been offset by a need to procure more inputs, as these have been less productive than assumed when the price control was set.

**Q22. What impact would resetting cost allowances based on actual cost performance (eg benchmarked to the average, upper quartile or best performer) during a price control have? Which cost categories might best suit this approach?**

**We are not supportive of the re-setting of cost allowances. Such an approach is likely to significantly reduce companies' incentives to seek and maintain cost efficiencies during a price control, thereby reducing the benefits to consumers of sharing these cost savings. Such an approach would not provide any certainty to our shareholders and is a step away from the principles of good regulation.**

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## Information-revealing devices

### Q23. Do you agree with our assessment of IQI?

**We agree with Ofgem’s assessment of the IQI and believe that learnings from RIIO-1 will positively flow through into the RIIO-2 mechanism to provide Ofgem with more accurate information. Ofgem should share its assessment guidance with stakeholders as soon as possible to ensure that companies have this information when developing their business plans.**

The discussion here largely focuses on the information asymmetry mitigation element of the IQI, namely the incentives on companies’ business plan submissions in response to the choice of upfront reward/penalty and enduring sharing factor. Incentives in this respect are better focused through the rewards for the “well justified business plan” whether these take the form of fast-tracking or other financial incentives.

The other important aspect of the IQI is the enduring sharing factor on cost under and over spend. It is important this aspect is not lost in any proposals regarding the IQI. The enduring sharing factors were introduced to address the problems of “periodicity” where in the absence of defined sharing factors companies had skewed incentives to achieve cost efficiencies in the early years of a price control period - and defer efficiencies identified towards the end of a period until the start of the next. Enduring sharing factors benefit consumers by maintaining a continuous incentive on companies to implement cost saving initiatives and to mitigate cost overruns.

Ofgem claims that companies systematically over-forecasted costs and would have been £100m better off if they had submitted more accurate forecasts (paragraph 6.47). It must be taken into consideration that this statement is not reflective of all companies’ performance and both our transmission and distribution companies are performing broadly in line with our forecasts. Furthermore, it is our view that any value will naturally diminish as companies will have made significant learnings from RIIO-1 which can be applied in RIIO-2.

### Q24. Do you agree with our assessment of fast-tracking?

**In principle, we agree with Ofgem’s Fast Tracking assessment in RIIO-T1, however, believe that there are lessons to be learned from RIIO-ED1. Any fast tracked company’s licence must not be modified in advance of slow track companies. Any rewards must be proportionate and transparent.**

We understand why stakeholders may have concerns about the fast-tracking experience in RIIO-ED1, and whether the financial rewards gained by the fast-tracked companies were proportionate. SPEN shares those concerns. In our view, it is the rewards and dynamics on companies to submit “well justified business plans” that drive many of the benefits quantified by CEPA – rather than early settlement for the fast-tracked company. A further weakness of the ED1 fast track process was the early conclusion of licence modifications for the fast tracked company, which meant that stakeholders did not have all the information they needed to make a fully informed assessment of the ED1 fast-track settlement. Specifically stakeholders had to consider whether or not to appeal the licence modifications of the fast-tracked companies when the basis for the fast-track settlement and the total awards accruing to the fast-tracked companies could not be critically assessed against the information revealed during the slow-track process completed 8 months later. In contrast, the licence modifications

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for the fast and slow tracked companies in RIIO-T1 were implemented together at the end of the slow-track process.

With regard to fast tracking of transmission companies, we agree the competitive dynamic between the three companies is lessened in part due to disparities in their scale, but we believe there is still sufficient scope to incentivise the TOs to submit plans that maximise the benefits to consumers through improved service. Accordingly we believe Ofgem should continue to make some form of incentive or reward available to TOs in respect of business plan quality.

**Q25. What are your views on the options we have described?**

- *How might these apply in the different sectors?*
- *Should we retain the IQI, amend it or replace it entirely?*

**We believe that Ofgem should retain the two core components of the IQI mechanism, namely efficiency sharing factors and an incentive around submitting well justified business plans for both distribution and transmission.**

In order to maintain the incentive strength from RIIO-1, there should be similar transparency as in the current IQI, over how Ofgem's view of companies' business plans translate into the upfront reward/penalty and efficiency sharing factor. This must be published well in advance of company submissions, and preferably alongside the sector specific consultation due to be published later this year.

While we understand why Ofgem may wish to remove fast-tracking for transmission due to limited benchmarks, we consider that there is scope for a calibrated package of incentives to have some form of incentive/reward on TO RIIO-T2 business plan submissions. In particular, if the TOs can be incentivised to develop business plans, informed by stakeholder engagement, that maximise consumer benefits further in RIIO-T2 from T1, this will lessen the burden on Ofgem to take its own view on company forecast performance.

As we have noted, it is important to retain the efficiency sharing factors either in an amended IQI or an alternative incentive. In addition, we support the retention of a form of reward or incentive on all network companies including transmission to submit well justified business plans. Again, this need not be achieved by means of the current IQI mechanism.

**Q26. What factors should we take into account when assessing plans for example, under fast-tracking (option 2) or a single business plan incentive (option 3)?**

**We believe Ofgem should be using a similar range of criteria to those outlined in the RIIO Handbook<sup>14</sup> for "well justified business plans" Ofgem may wish to consider whether the criteria could be simplified to reduce the resource and time pressure of assessing the submissions.**

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<sup>14</sup> <https://www.ofgem.gov.uk/ofgem-publications/51871/riiohandbookpdf>

In relation to distribution, assuming comparative benchmarking is to be used, it is important that a decision on the “best plan(s)” is made after all companies have been fully assessed or after the slow-track assessment is completed.

**Q27. Do you have any views on the factors we should take into account when deciding how to differentiate efficiency incentives for companies if we do not use the IQI?**

**Feedback from panels in enhanced engagement arrangements should be a key consideration. The process of socialising and building trust in business plans will enable stakeholders to formulate an opinion on the quality and accuracy of information revealed in business plans. It is our view that efficiency incentives for companies could be differentiated by drawing on final reports from the various panels. In addition, the quality of Cost Benefit Analysis underpinning investment plans should be taken into account. We also believe that the quality of information presented in the business plan data tables and lessons learned from RIIO1 could be relevant factors.**

We would welcome early clarity from Ofgem on how it intends to differentiate efficiency incentives as we are already underway with our transmission business plan development.

**Q28. Is an explicit upfront financial reward required to incentivise companies to submit high quality business plans, in addition to differential incentive rates or sharing factors?**

**Yes. An upfront incentive is required to break down ‘silos’ of traditional approaches to business plan development.**

It is our view that this is a significant regulatory lever to drive well-justified business plans and could provide a catalyst for industry-wide collaboration needed during the energy transition. Whilst incentive rates do drive the targeted behaviours during a price control, an upfront incentive is able to set the direction a business plan takes eg demonstrating more joined up investment across licenced areas and sectors.

**Q29. Do you have any views on our proposal to remove fast-tracking for transmission?**

**Fast tracking benefits consumers because it allows companies to progress their work plans without delay, resulting in a head start to our delivery programmes, which benefits consumers. This was our experience when we were fast tracked in RIIO-T1.**

We believe there is merit in retaining some form of upfront financial incentive for well-justified business plans in transmission. The lack of conditions to allow for meaningful benchmarking in Transmission should not necessarily stop the use of fast tracking if, for instance, the focus of the fast tracking incentive is widened to achieve better overarching co-ordination between neighbouring networks and the ESO or the inclusion of disruptive service providers.

**Q30. Do you have any views on how we propose to incentivise better business plans from transmission companies, including removing the prospect of an upfront financial or procedural reward and placing greater reliance on user and consumer engagement and scrutiny?**

**We do not support the removal of an upfront financial reward to incentivise better business plans in transmission for reasons we have set out above.**

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However, in the absence of such an incentive, a set of KPI's could be agreed with companies as to how Ofgem will assess their business plans as part of a balanced scorecard. Ofgem correctly observes that there is less comparability between electricity transmission companies so a combination of generic and company-specific factors should feature in how the scorecard is assessed.

The KPI's could be arranged in terms of the key RIIO output areas. It is our view that there may also be a limited reliance on company past performance. Should a scorecard be taken forward, this must be developed imminently as we are already creating our transmission business plan and will require foresight of what we will be scored against.

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## Annual reports/reporting

**Q31. How can we best improve the suite of annual reporting requirements to be as efficient and useful as possible?**

**Where synergies exist with existing regulatory reporting requirements, these submissions should be merged.**

Currently SPEN submits over 400 regulatory submissions to Ofgem, including regulatory reporting tables and various reports. Whilst we agree that we must report on our performance to ensure that Ofgem have the ability to challenge us, it is our view that this has gone beyond what is useful to Ofgem or stakeholders. This is also a huge drain on our resources which could be focussed on more customer facing tasks.

To simplify the reporting process, it would be helpful if Ofgem, potentially with the assistance from network companies, complete an exercise where all regulatory submissions are listed and the purpose of the output of the submission determined. The goal should be to ensure that Ofgem only requests data which is eventually used and helps Ofgem. Where synergies exist, these submissions should be merged. It will also likely become apparent that some reporting requirements are now redundant and can be removed from the network companies' licences. The statutory consultation on RIIO-2 licence obligations could be used to sweep up removal of redundant reporting requirements.

**Q32. How can we make the annual reports easier for stakeholders to understand and more meaningful to use?**

**Ofgem's annual reports cater for a range of stakeholders. Stakeholders should be consulted to understand their requirements from the RIIO Annual Reports and the findings used to develop a format and content that is ultimately useful for all.**

Recent feedback from our stakeholder panels has highlighted that stakeholders feel annual reports are a regulatory requirement and they tend not to read them – not restricted to the energy industry. Our stakeholders indicate a preference for short visual summaries over long documents with relatively impenetrable information. An option would be to create a high level annual report targeting consumers and a technical annex for audiences with a deeper interest in company performance.

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## Chapter 7 – Fair returns and financeability

### Cost of debt

**Q33. What are your views on the policy objectives that we have defined with respect to the cost of debt?**

**We broadly agree with these policy objectives, which are customer focused. Naturally, Ofgem must also continue to comply with its duty to have regard to the need to secure that licence holders are able to finance their licensed activities.**

Furthermore, network companies have a licence obligation to maintain an investment grade credit rating, which is dependent on the credit rating agencies assessment of key financial parameters such as the allowed cost of debt.

**Q34. Which option might help to ensure that the approach to updating the cost of debt methodology delivers best value to consumers and why?**

**We would support the adoption of a pass-through allowance for debt. This would remove any incentive to adopt short-term financing decisions simply to match or outperform the cost of debt index. Furthermore, pass-through would ensure that customers pay no more than the licensees' actual interest costs.**

During previous Price Controls we have supported indexation of the cost of debt allowance. The Trombone mechanism introduced in RIIO ED-1 was an enhancement on the approaches in RIIO T-1. However the recent history of the index does not reflect the longer term nature of network companies embedded debt. Networks Companies RAV additions are amortised over long period (T2 will be 45 years) therefore long term debt is raised with varying maturities to avoid refinancing risk. We believe it would be in customers' interests to replace the current indexation approaches in RIIO1 with a pass-through allowance in RIIO2 which will ensure low risk long term debt management strategies and appropriately recognise network companies embedded debt portfolios. In addition the pass through of interest payments is common in "cost of service" regulation, as widely implemented in the United States.

We would support the adoption of such pass through in GB for energy network licensees. This would remove any incentive to adopt short-term financing decisions simply to match or outperform the cost of debt index, for example, by raising debt with a shorter maturity than would be optimal for long-lived assets or using complex financial engineering or ownership structures that may introduce greater risk to customers and pricing in the longer term.

We support the view expressed in the consultation that setting a pass-through allowance that matches the cost of debt to each company would eradicate debt outperformance or underperformance from price controls. It would be a simplification of arrangements which offers protection to both consumers and companies from forecasting risks and promotes the adoption of debt policies that promote stability and are in the best longer term interest of the sector.

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We agree there are some challenges in quantifying the actual cost of debt to network companies and/or whether it has been efficiently incurred. We currently provide evidence on the basis of the cost of internal debt as part of Licence Condition Cross Subsidy reporting.

Ofgem should place the onus on companies to demonstrate that debt costs are accurate and efficient through regulatory reporting. There are existing mechanisms that ensure that pass through costs are efficiently incurred. Currently companies are required to submit evidence that Business Rates have been challenged adequately before Ofgem will allow a pass through for such costs. It is our view that a proportionate approach should be developed to ensure that all debt costs are efficient.

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## Cost of equity

**Q35. Do you agree with our proposed methodology to estimate the cost of equity?**

- *Do you agree it would be desirable to index the cost of equity?*
- *Do you have views on our proposal for indexation?*

Although we agree with the application of the CAPM framework, the proposed range of 3% to 5% is significantly below that of 5.51% to 6.34% recommended in the Oxera report for ENA<sup>15</sup>. The Total Market Return is the most stable component of the cost of capital and is the most appropriate basis on which to derive the allowed cost of equity. CEPA's report contains various flaws which must be assessed and addressed (see further below). We do not support the indexation of the Cost of Equity as, unlike the cost of debt; it cannot directly be observed but has to be estimated from stock market data, using an asset pricing model such as the CAPM. Furthermore, potential annual adjustments resulting from indexation of the cost of equity would add to the volatility of network charges and make them less predictable.

Ofgem has stated that its proposed cost of equity of 3% to 5% would result in savings for household customers of around £15 - £25 per year.<sup>16</sup> Should this value be quoted in future, it should be caveated to ensure that it is clear that this does not take into account Ofgem's proposals to potentially move to CPI(H) inflation or introduce nominal returns which would increase customer bills and offset this saving.

It appears that the main factors leading to Ofgem's underestimate include:

- Total Market Return
- Risk Free rate
- Equity Risk Premium
- Asset beta
- Equity beta

CEPA's estimate of the Total Market Return derived from the Dividend Growth Model (DGM) is understated due to incorrect reliance on UK GDP growth as a basis of dividend forecasts. Analysis by the Bank of England takes into account higher overseas growth, which accounts for a large part of listed companies' earnings<sup>17</sup>.

The Total Market Return is the most stable component of the cost of capital and is the most appropriate basis on which to derive the allowed cost of equity. By contrast, estimates of the Equity Risk Premium are more variable and more recent theoretical developments no longer support the assumption of a constant Equity Risk Premium, which was used in some early studies.

The risk free rate continues to be artificially suppressed by UK quantitative easing, which is expected to be reversed before or during RIIO-2 price control periods. Predicting how the risk free rate may change over the duration of the price control is not a case of "aiming up" but rather a prudent

<sup>15</sup>[http://www.energynetworks.org/assets/files/info/Oxera%20research%20on%20the%20cost%20of%20equity\\_2018-02-28.pdf](http://www.energynetworks.org/assets/files/info/Oxera%20research%20on%20the%20cost%20of%20equity_2018-02-28.pdf)

<sup>16</sup> <https://www.ofgem.gov.uk/news-blog/our-blog/tougher-price-controls-energy-networks>

<sup>17</sup> We have sought expert advice from NERA on this matter

consideration of the uncertainty around the pace and timing of changes to quantitative easing. Regulatory precedent is for reversion to a positive value for the Risk Free Rate in cost of capital calculations.

The lower end of CEPA's range for asset beta is exceptionally low and is not consistent with the observed cost of debt, as equity, which only has a residual claim, is inherently more risky than debt. Spreads on A and BBB rated corporate bonds (used as a proxy for the bonds issued by the energy companies) are around 150bps, which should be less than the product of the asset beta and the Equity Risk Premium. CEPA's estimates of asset betas appear to have been biased downwards by the inclusion of water companies, which are lower than those for UK and international energy network companies. Oxera presents evidence for an asset beta range of 0.38–0.42 for energy network companies.

The equity beta must be re-gearing to be consistent with the notional gearing assumed for each price control. Empirically estimated betas will reflect actual gearing, which may be below the notional gearing that is assumed for the price control.

Moreover, there are strong reasons to select a point estimate towards the upper end of the range. From a societal perspective, the costs of underinvestment, for example, in terms of energy not supplied, higher constraint costs and the greater volumes of green-house gas emissions, resulting from a slower transition to a low carbon economy, are much greater than the costs associated with slightly higher than economically optimal level of investment.

As there are several years before the RIIO-2 price controls take effect, it is too early to finalise the cost of capital parameters, as financial market and wider economical and political conditions will continue to change, in ways which cannot be currently accurately forecast.

In principle, we do not support Ofgem's proposal to introduce a cost of equity indexation mechanism in RIIO2. Unlike the cost of debt, the cost of equity cannot be directly observed and has to be estimated using an asset pricing model such as the CAPM. Any cost of equity indexation approach would therefore inherently involve greater levels of complexity in comparison to the equivalent cost of debt indexation mechanism.

Furthermore, the weight of evidence supports the relative stability of the Total Market Return (TMR), whereas the Risk Free Rate (RFR) is more variable. Consequently, the only potentially viable cost of equity index is one which fully reflects the relative stability of the TMR. The contribution of changes in the RFR is a minor component of the cost of equity, largely offset by the corresponding change in the Equity Risk Premium (ERP) as the TMR dominates the calculation, as shown by Ofgem's illustration of a potential cost of equity index.

Nevertheless, potential annual adjustments resulting from indexation of the cost of equity would add to the volatility of network charges and make them less predictable.

We agree that the TMR dominates the calculation of the cost of equity, with only a minor contribution from changes in the RFR.

We also agree that short term empirical estimates of beta tend to move more than the underlying non-diversifiable risk of energy network companies, which is difficult to explain, and probably overestimates the underlying change in risk.

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Until Ofgem's policy on fair returns policy is properly articulated, the appropriate cost of capital levels for a company subject to a fair returns policy cannot be fully assessed. This is due to the fact that there is a significant risk that companies will be exposed to various moving targets which would result in a risk to their credit ratings and more widely increase regulatory risk, (which – in turn – increases that company's cost of capital). Given that cost of capital is a critical element of the RIIO model, SPEN cannot therefore adequately assess the acceptability of the RIIO-2 proposals until all elements of Ofgem's fair returns policy are fully understood.

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## Financeability

**Q37. Do you consider there is merit in removing the indexation of the RAV and adopting a nominal return model in RIIO-2?**

- ***What would be the benefits and drawbacks?***

**We do not express a firm view on this proposal at this stage of the process as further analysis is required to be carried out on this option against other potential financial parameter changes on adoption.**

Care would need to be taken under this proposal as any move away for inflation indexing is likely to have a profound effect on a portion of the current investor base that require or rely on the indexation to cover exposure to inflation. This cover would be eliminated by a nominal returns methodology. Also a move to a nominal methodology would lose the major advantage of the indexed RAV that in real terms regulatory depreciation is constant each year. Today's and tomorrow's customers pay the same amount.

It would also change the risk profiles within each company as, once again, the indexing for inflation provides a natural hedge of some of the company's underlying pension and other cost exposures. A nominal return would however provide a greater degree of certainty about future returns which would appeal to a different set of investors but with a different profile and outlook to the existing investors. Existing RPI linked debt would, unless its costs were specifically allowed for under the price control, introduce basis risk under a nominal return model (which would not change with inflation). Given the significant levels and maturity of inflation linked debt in some companies this would need to be carefully managed in the context of any proposals to remove indexation of RAV. We advocate a pass-through of the cost of debt in Q34. A nominal return regime would however more closely align with the issuance of standard fixed rate debt instruments which could potentially appeal to a more varied and sizeable investor base. It would also reduce the current basis risks that exist on the fixed rate debt issuance of each company.

**Q38. Should the onus for ensuring financeability lie with the network operating companies in whole, or in part?**

**Whilst companies should act responsibly at all times in relation to financeability, this responsibility should ultimately lie with Ofgem. It is in the longer term interests of consumers and the sector for network companies to comfortably and consistently achieve cash flows which maintain investment grade credit ratings. This greatly facilitates access to debt markets and issuance of debt on the most efficient terms. Retention of this established fundamental feature of the price control process is greatly valued by investors and is of very material benefit to consumers.**

An overarching expectation from a regulatory settlement is to ensure financeability of investment plans. This is clearly consistent with present and future consumers' interests. Allowing network companies greater flexibility to finance themselves may lead to significant variations in the capital structures. This could present a risk of financial distress in the sector if companies pursue ill-judged aggressive financial engineering to improve returns. However, safeguards could be introduced to limit the use of financial engineering to improve returns. If the onus to ensure financeability is shifted to network companies, Ofgem would need to set out what, if any, boundaries to place around financial engineering and levels of risk. The option of shifting more of the responsibility for financeability to the

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network companies, but with Ofgem retaining appropriate regulatory oversight, could encourage better management of those entities and potentially lead to more dynamic funding initiatives.

**Q39. Do you consider the introduction of a revenue floor, to protect the ability of companies to service debt, to have merit?**

**We believe the introduction of a revenue floor could have merit if it is in line with investors' and debt holders' expectations and does not harm a network company credit ratings.**

The introduction of a revenue floor should provide some security to both existing and future debt providers by establishing a minimum level of revenue to support the servicing of debt. It should also be at a level which is capable of sustaining the normal operations of the company. The challenge would be in determining the exact level of the floor. If the floor level was set too low in the eyes of the debt holders it would not provide any additional security and would potentially prove detrimental to their assessment of the risks. Conversely, if set too high, it would potentially create perverse incentives to take abnormal financial risks or relax management scrutiny of financial performance.

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## Corporation tax

**Q40. Do you agree that Ofgem should review the causes of any variances between tax allowances and taxes actually paid to HMRC (including the treatment of group tax relief)?**

- ***Which of the options described in this consultation may be worth investigating further to address any material variances?***

**We are supportive of a notional tax allowance with added protections.**

We agree with greater transparency of any variances between tax allowances and taxes actually paid to HMRC. However, this should not solely be based on the review of one pricing control period, but should cover the total tax allowances obtained for the cost of network assets over their life. Option A (Notional allowance with added protections) would seem to be the most appropriate option.

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## Other finance issues

**Q41. Do you agree that we should move away from RPI for RIIO-2 (including for the indexation of the RAV if retained as a feature)?**

- *If yes, which of the two potential indices – CPI or CPIH – might be most suitable?*
- *Is a phased transition between RPI and the chosen successor index necessary or desirable?*

**We can see the merits in moving away from RPI in RIIO-2 as this is the common view held by the Office for National Statistics and many statisticians. However, we do not offer a view on whether the alternative index should be CPI or CPI(H). In any event, it must be remembered that the licensee's own costs are not impacted by the choice of inflation index and its costs will still need to be financed adequately. We note that initial analysis indicates that moving to CPI(H) would result in higher bills for customers, for many years, above the level that would result from continued RPI indexation.**

We recognise that CPI(H) is the measure of consumer price inflation preferred by some parties, although the RPI remains in wide-spread use, including, importantly, for UK index-linked gilts issued by the Debt Management Office.

Although, in theory, it may be possible to hedge this risk, at least to some degree, it would not be costless. Swap providers charge a credit spread and inflation swaps create a contingent liability, with the potential for significant breakage costs in the event that the swap needs to be cancelled. Ultimately, these costs would be borne by the consumer. Moreover, inflation related instruments and derivatives, such as index-linked gilts and inflation swaps are based on the RPI.

In principle, the choice between CPI and CPIH should take into account:

- The impact on the volatility and predictability of network charges
- The degree of correlation of changes in the consumer price index with changes in network companies' costs. Correlation with industry cost and price indices is higher for RPI than CPI.
- The prospects for the issuance and liquidity of gilts and corporate bonds linked to the consumer price index
- The availability of independent forecasts of the consumer price index

However, there is little back history available for CPIH, so there is little evidence on its volatility or its correlation with network companies' costs. Furthermore, few forecasts are made directly of CPIH, as opposed to making adjustments to CPI forecasts to derive a projection for CPIH. Moreover, there is no indication that the Debt Management Office intends to issue CPI or CPIH indexed-linked gilts. Consequently, we consider a decision to move to CPIH, at this stage, would not be based on evidence.

In any event, a transition to CPI(H) must be present value neutral. This will require:

- The nominal cost of capital to be maintained at the same value, whatever inflation indexation is used
- The relationship between the single nominal cost of capital and separately stated real returns, in RPI and CPI or CPIH terms, must be clear and transparent to mitigate the perceived risk that the effective return has somehow been lowered

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- The impact on financing of the existing RAV, which was financed under RPI based price controls, should be minimised
- Existing RPI index-linked debt is fully financed for its duration
- The avoidance of “credit-negative misjudgments which could undermine companies' returns”<sup>18</sup>
- The treatment of pensions adequately allows for the liabilities of the pension schemes which have RPI linked benefits.

In any event, it must be remembered that the licensee's own costs are not impacted by the choice of inflation index and its costs will still need to be financed adequately.

Moreover, stakeholders need to be aware that initial analysis indicates that moving to CPI(H) would, counter-intuitively, result in higher bills for customers, for many years, above the level that would result from continued RPI indexation. At the very least, affordability concerns of customers will limit the speed of adjustment to alternative inflation indexation.

**Q42. In the light of our proposal not to amend, at a price control framework level, our policies for depreciation and asset lives set in RIIO-1 do you have any views or suggestions that you wish to put forward?**

**We agree in principle with this proposal, however, it will not be clear until Ofgem has determined its cost of capital, fair returns and other financeability proposals until a clear determination can be made.**

**Q43. We propose to review the fast/slow money split at the business plan submission stage, do you have views that you wish to put forward at this stage?**

**It is too early in the process to determine what would be an appropriate split as this will be entirely dependent on the other outcomes above, such as whether there will be a move to CPI(H) or a nominal return.**

**Q44. Do you think existing mechanisms for providing allowed revenue to compensate for the raising of notional equity are appropriate in principle and in practice?**

**In principle we agree that existing mechanisms for providing allowed revenue to compensate for the raising of notional equity are appropriate.**

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<sup>18</sup> Moody's: Adoption of CPI will impact UK water and energy networks, reshape index-linked debt market, 14 January 2016

## Ensuring fair returns

**Q45. What are your views on each of the options to ensure fair returns we have described in this consultation?**

**We are not in a position to provide a definitive view on the five options set out in the consultation paper, as Ofgem has not provided sufficient detail on how the proposed mechanisms would work in practice. It is essential that Ofgem provides more detail before taking any firm decisions.**

**Subject to that caveat, we observe that in the main, evidence in relation to “excessive” company returns is due to companies’ TOTEX outperformance and allowed cost of equity. Therefore, in relation to Ofgem’s proposed “Fair Returns” mechanisms, we believe the focus should be on developing a price control with appropriately calibrated licence mechanisms which have the ability to claw back unspent TOTEX allowances. This should remove the perceived need for a return-based claw-back mechanism which would introduce degrees of revenue volatility which would not be in Investor or Customers interest. We would expect energy retailers to reflect the consequential risk of increased volatility to charges in their fixed term price setting process. The result could be higher bills for consumers..**

At each price control it is normal to review and, where appropriate, reset targets for incentive mechanisms and update other parameters, for example, the Value of Lost Load (VoLL) and the shadow price of carbon dioxide emissions, to take account of more recent research and estimates. Customers and wider society then continue to benefit from improvements in quality of service and environmental improvements, such as reduced green-house gas emissions. Incentives should be appropriately calibrated and aligned to stakeholder benefits on an ex ante basis and not subject to fair returns mechanisms. Boards need to have certainty over incentive incomes to appraise investment decisions with confidence. Uncertainty over incentive income will undermine investment associated with outcomes which are incentivised as they align to outcomes in stakeholders’ interests.

Also the proposed claw-back, of what are deemed to be excess returns, by “anchoring” returns, would over-ride and greatly weaken the effectiveness of more precisely targeted individual incentives. Additionally, the sector average RoRE may be distorted by outlying observations, which would then result in inappropriate adjustments to the majority of licensees for whom the price control is operating as expected. There are also significant risks of unintended consequences resulting from an untested and inappropriately designed adjustment mechanism.

Moreover, future customers would be materially disadvantaged, as efficiency gains that would otherwise have been driven by higher powered incentives, which would reduce future costs and improve future service, would be foregone and discouraged.

By introducing additional uncertainty around the potential reward for incurring expenditure to deliver improvements, the balance is swung against undertaking discretionary expenditure, because the return becomes much less predictable.

Furthermore, the proposed claw-back would introduce asymmetry into the regulatory regime, which is inconsistent with the CAPM framework proposed for setting the allowed cost of equity. The resulting skewing of returns to the downside and the increased uncertainty around outcomes for individual licensees would increase the expected return required by investors. Investment Analysts have

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highlighted this reduction in return has the potential to undermine Networks Owners investment grade credit ratings. Such a development would substantially increase the cost of debt finance which would increase charges in the long run to customers,

The fair returns mechanisms introduce revenue volatility and risk which would likely lead to a detrimental reassessment of the stability of UK Network Owners regulatory environments. This is an important input in the assessment criteria applied by credit rating agencies.

Incentive-based regulation, as previously developed by Ofgem, is recognised world-wide as the leading approach to improving the outcomes that are delivered by regulated networks and superior to rate of return based regulation and profit sharing.

In so far as Ofgem perceive the need to modify the regulatory regime, we suggest that individual returns are sculpted, ex ante, so as to avoid the risk of perceived excess returns. For example, this could be implemented by varying the sharing factor with the degree of outperformance. Nevertheless, this would distort the allocation of resources across the range of incentive mechanisms, which would lead to a suboptimal outcome for customers and society, as benefits which could be delivered at lower cost would become less attractive for companies to focus on.

Moreover, limiting returns in the way proposed would greatly inhibit collaboration and sharing of best practice, deter innovation and encourage companies to become more risk averse, focusing on lower risk projects. Again, this would be suboptimal for customers and society.

Much of the political pressure Ofgem faces can be resolved by appropriately communicating the benefits of RIIO and publishing appropriate returns metrics which are easy for all stakeholders to understand.

**Q46. Is RoRE a suitable metric to base return adjustments on?**

- ***Are there other metrics that we should consider, and if so why?***

**We do believe RoRE has its merits for industry experts and to inform Ofgem’s analysis, however, this is not an appropriate measure for communicating with wider stakeholders. RoRE is misunderstood by many individuals, therefore, we propose that Ofgem publishes companies’ ‘Return on Assets’ as this provides stakeholders with a more accurate view, reflecting the fact that asset intensive companies must be compensated for the significant amount of investment they plough into their networks.**

It is important that Ofgem encourages transparency and simplicity when engaging stakeholders. We do not believe that the Return on Regulated Equity (RoRE) measure is the best measure for communicating with stakeholders as it cannot be compared across sectors and it provides stakeholders with a misleading view as it does not take into account that companies also service debt which reduces the overall Weighted Average Cost of Capital (WACC). We suggest that Ofgem develops a standard metric on “Return on Assets”<sup>19</sup> for the industry, as this will provide stakeholders with a more accurate view on network profitability.

RoRE has significant limitations as a measure of return:

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<sup>19</sup> Profit before interest expenses and taxes / Total Assets



- 1) Especially for multiple years, as it depends on the way in which the average return is calculated.
- 2) It is extremely volatile for individual years, as the totex allowances remain fixed but the actual expenditure profile varies over the price control period.
- 3) It does not adequately take into account delivery of outputs.
- 4) Projected RoRE relies on subjective forecasts of future performance.
- 5) Currently, there is no agreed set of components which should be included (e.g. whether and, if so, how the cost of debt and tax effects are included).
- 6) The calculation changes over time.
- 7) The RoRE value is potentially subject to revision arising from, for example, revised forecasts and subsequent adjustments for output delivery, logged-up items and close-out of the price control.
- 8) It is not comparable across sectors.
- 9) It is not auditable as no firm will agree to audit this value as it does not form part of the relevant financial standards.

Adjusting returns based on annual RoRE would create a feedback loop, where year to year fluctuations are amplified and network charges become less predictable.

The implementation of audited RIIO Accounts, from which an agreed RoRE could be calculated, would be an essential precondition for basing adjustments on RoRE figures, although significant shortcomings would remain.

We suggest that Ofgem retain RoRE for internal reporting and assessment, as it does have its merits. However, a more appropriate metric for stakeholders would be the use of a “Return on Assets”.

**Q47. Do you have any views on the interlinkages and interactions outlined in this consultation and those that we will need to consider as we develop our sector-specific proposals?**

**The various financial parameters and ‘fair returns’ mechanisms are interlinked. If a change is made to one, this could significantly impact the others. Therefore, Ofgem will require to make a decision on ‘fair returns’ and other significant price control parameters before any cost of capital or financial metrics can seriously be considered. However, we do not believe that Ofgem’s ‘fair returns’ or financeability proposals are sufficiently detailed to enable SPEN to provide detailed comments at this stage.**

**Q48. Do you have any views on the issues highlighted that we will consider as we develop our sector-specific proposals?**

**It is our view that the various mechanisms Ofgem have proposed for ‘fair returns’ are not required if incentives are re-calibrated to reflect actual RIIO-T1 performance. A focus should be on trying to re-calibrate existing incentives and implement enhanced totex forecasting or clawback techniques.**

**Q49. Are there any sector-specific issues or policy areas that we should ensure we review and consider as we develop our sector-specific proposals?**

**Ofgem and companies should place a greater focus on Cost Benefit Analysis in RIIO-2 to ensure companies are taking into considering longer term solutions with whole system**

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**benefits, which will benefit the consumer in the long run. We also believe that it is crucial that 'Black Start' forms a key output in RIIO-2.**

**Our customers are very important to us, therefore we must ensure that our vulnerable customers in particular are protected and form a crucial part of company business plans.**

**A greater emphasis must be placed on Environmental and sustainability factors in RIIO-2. This must form a key part of our thinking in RIIO-2 as we strive to meet Government low carbon targets and create a cleaner, safer environment for our current and future customers.**

It would be helpful for Ofgem to consider the appropriate time period which companies can determine whether a project has a viable positive NPV. It is our view that we should measure the NPV over the asset life of the project as many projects may have a negative NPV over, for example, a 15 years period; yet deliver 10 fold benefits over the asset life.

Ofgem has also observed that the UK recorded its first working day without coal power since the Industrial Revolution. Whilst this is clearly an impressive statistic, this is also concerning from a Black Start perspective due to the loss of thermal generation and the inertia which it brings to provide stability to the GB system. As a transmission and distribution system owner, we have a holistic view of the network, and believe it is crucial that Black Start forms a key output in RIIO-2.

**Q50. Do you have any views on our high-level proposals for timing of RIIO-2 implementation, and on our proposals for engagement going forward?**

**We feel we have adequate time to implement the enhanced engagement in Distribution but face serious resource and time pressure to setup the Transmission model. This should be taken into consideration in determining the scope for the TO User Panel and ring fencing of topics to be considered by the Panel. We anticipate 6 Panel meetings in the time available before RIIO-T2 Business Plan submission.**

We would request monthly granularity in Ofgem's plan of key milestones to aid planning in compressed timescales.

We would also ask that consideration is given for the time between the sector specific strategy decision and submission of the business plans. Currently the indicative dates show a best case scenario of 9 months and a worst case of 3 months. Experience from previous price controls shows that a minimum of 4 months is required to review an update the business plan in light of the sector specific strategy decision and the subsequent required internal governance. The 4 months' timeline is a tight turnaround and we would encourage Ofgem to maximise the timeframe between these key milestones.

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