Network Planning & Regulation

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Your ref

Our Ref

Date
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Contact / Extension
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Dear Akshay

RIIO-2 Sector Specific Methodology Consultation

This response is from SP Energy Networks. SP Energy Networks (SPEN) 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). Our Business and our staff live and work in the communities we serve and recognise the energy we deliver is a critical to life and the economy. Maintaining security of supply, as well as good quality of service, is essential to all of our customers. 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 the UK.

We welcome the opportunity to respond to the above consultation, and to reflect our views, following the various Ofgem RIIO-2 stakeholder workshops. Several policy developments have taken place since the RIIO-2 Framework Decision was reached in September 2018. It is important to us that we are able to provide constructive feedback on these developments, as there are still many RIIO-2 policy areas which have not yet been determined.

We are at a critical stage in the formulation of RIIO-2. Decisions made now will have implications for all stakeholders for many years to come. Predictability and fair returns are required at a time where, greater than ever, investment is required in the UK to facilitate GB's Low Carbon Agenda. As a UK based company, we are not only creating employment opportunities, but are also supporting our local economies as a responsible and transparent taxpayer. Against that background we would highlight the following:

Fair returns

We support Ofgem's policy intent to ensure that companies cannot excessively outperform. However, that objective has to be pursued with an acknowledgement that incentive regulation delivers benefits to consumers, and in a way, that ensures licence holders can finance their activities. Ofgem should also recognise that SPEN has delivered all of its outputs, forecast accurately and is meeting its TOTEX allowances in RIIO-1. It is important that Ofgem upholds well established regulatory principles and does not overreact to the perception that RIIO-1 price controls were set incorrectly. Under the

RIIO-1 baseline, returns were deemed to be fair on the basis of information available at the time. Shareholders accepted the risk associated with subsequent movements in cost of capital. Similarly, the scope for outperformance was made clear by Ofgem at the time. We are concerned that Ofgem is now rowing back every aspect of the price control to levels that will render the sector unattractive to the 'right type' of investors, investors with strong engineering and innovation capability, who we consider are needed to support the current energy transition. We appreciate this is Ofgem's response to the current macro-economic environment, however, Ofgem's approach risks undermining the incentives based framework RIIO is supposed to achieve. Given the important role of energy networks in the low carbon transition, our view is that this is not in consumers' interest.

Complexity

The latest RIIO-2 proposals are becoming overly complex and do not adhere to Ofgem's objective of simplifying the price controls. Not only are they overly complex, the various new policy proposals, such as 'blended sharing factors' or 'Allowed v expected' returns risk reducing investors' confidence in the energy network sector and its regulatory framework. Both mechanisms are trying to achieve the same outcome, and as a result, there is a risk of overlap. RIIO-2's impacts will be wider-reaching than energy alone; this price control is the cornerstone for GB's future economy. GB is reliant on network operators enabling future low carbon solutions, so we must look well beyond RIIO-2 to the impacts this price control can have on the wider economy.

Timescales

We are expected to submit a well-developed business plan by 1st July 2019, yet many of the principles around incentives, uncertainty mechanisms and cost assessment will not be finalised until the end of May. Indeed, we are aware that certain aspects of the policy for innovation will not be concluded until late in 2019. There are other practical aspects that should have been finalised by now but are not, such as the format of the business plan data tables (BPDTs), which contain the detailed numbers for the business plans. It is deeply concerning to us that something so fundamental to the business plan process is still outstanding. In general, for RIIO-T2, Ofgem is running late but companies will be expected to make up for the shortfalls in the process. We refer Ofgem to the specific examples of the difficulties these delays cause that we set out in our letter of 15 February 2019 responding to the Business Plan Guidance consultation. We provide further examples and information on the main body of our response to this consultation.

Below, we have provided an executive summary of our formal consultation responses, which are attached as appendices to this letter. This summary highlights the 10 most significant items which we have addressed within our detailed responses.

1. Ensuring Business Plan Assessment Effectiveness

Ofgem's proposal to have a business plan reward will ensure that stretching cost and output forecasts are submitted, promoting a RIIO-2 settlement that is good value for money for consumers. The RIIO-1 business plan incentive was an important catalyst that influenced the comprehensive nature of network operators' business plans, helping to drive meaningful improvements for customers. The SPEN companies have been shown to have made fair and reasonably accurate forecasts in their RIIO-1 business plans and have created customer value in delivering them. In other words, we have done exactly what we said we would do. However, we are concerned that Ofgem's proposed approach to the business plan reward will be complex to implement and less effective than the RIIO-1 incentive.

Considering the success of the established business plan incentive in prompting good value for consumers, we propose that Ofgem should retain the option of awarding up to 2% of TOTEX, per company, when a plan demonstrates good quality and value. The current proposals significantly reduce the strength of the incentive, and potentially companies' ambitions, by diluting the prospective reward value by the number of companies also achieving a set criteria. Given that there is only one gas transmission company, it will be able to access the entire 2% reward, whilst in electricity distribution, this would be split amongst 14 licensees. The incentive will no longer have a strong enough signal to drive exceptionally ambitious business plans. In addition, we do not believe the RIIO-2 proposals meet the intention of simplifying business plan assessment whilst setting an effective TOTEX business plan incentive.

In our view, the 'blending' approach to the sharing factor has more inherent issues than the mechanism it is seeking to replace. The determination of costs to be considered baseline and the subsequent baseline categories introduces a new degree of complexity which will require consistency checks across price controls and sectors. Ensuring consistent and equitable application is an essential regulatory quality, however this will be very difficult to achieve across all network operators. Inconsistent application of the categories or costs, with similar properties, will create the possibility of endless cost boundary debates and through inconsistent application, unintentional inequality across companies and sectors.

To date the new business plan incentive lacks detail and guidance on what criteria Ofgem will apply in their business plans assessment. The clear communication of the detailed assessment criteria is a prerequisite to ensuring the network operators are informed and the process is equitable. We believe there would be benefit in reviewing Ofwat's approach to business plan guidance, which provided clarity well in advance of their submission date. In response to Ofgem's working groups, we tailored an approach based on Ofwat's for RIIO T2 and provided this to Ofgem for consideration.

2. Promoting Long Term Consumers Savings with Incentives and Innovation

The direction Ofgem set in establishing the RIIO framework has led to unprecedented levels of performance in the RIIO-T1 output incentive areas. This is delivering value for money for consumers and needs to be developed for the RIIO-2 period, and beyond, if the energy system transition is to be effectively supported by network companies. We estimate that our incentives have cost the average domestic customer 6p per annum, over the price control period. For this 6p, we have delivered performance levels that have increased levels of system reliability by 18%, improved our environmental impact and mitigated low carbon impacts, improved our customer and stakeholder satisfaction levels by 31% and increased efficiency in network planning. This constitutes incredible value for money for existing and future consumers.

As the level of returns available to companies in RIIO-2 is far less than those in RIIO-1, companies will not have the spare capability to take on any new, riskier innovations, which could potentially deliver significant new benefits to companies and consumers. Ofgem must recognise that innovation carries risk and so requires space and headroom. Without that space and extra support, new and true innovation, which has delivered up to £1.2bn of benefits to GB consumers over RIIO-1 for the LCNF alone, will not be possible.

The type of innovation we are able to deliver through business as usual, depends on the costs of each case, measured against the risks and benefits. Any technology or solution with unproven benefits and a lack of supplier base and/or lack of internal skill-set, to design and deliver such solutions, carries higher risk. Therefore, in order to be sure that we are controlling our costs effectively, we will not be able to deliver through business as usual processes, without at least a small scale trial. The need to test innovation must be reflected in Ofgem's assessments.

The approach to innovation must also recognise that networks are regulated monopolies. An innovation policy that assumes normal competitive market principles will not deliver value for consumers. One of the reasons for this is that it would eliminate collaboration. We believe the approach to innovation should provide incentives to innovate and share outcomes.

3. **<u>The Overall Financial Package must be fair to consumers and investors; ensuring the UK can attract the necessary investment and companies retain their 'Investment Grade' credit ratings</u>**

- <u>Return Adjustment Mechanisms & 'Allowed v Expected'</u>

Ofgem's Return Adjustment Mechanisms were created in isolation to the UKRN report's recommendation to introduce an 'expected-allowed return wedge'; Ofgem should only rely on one mechanism. We propose that the 'Allowed v Expected' mechanism is removed as this is a relatively arbitrary adjustment. As Ofgem has recognised, there must be scope for companies to share the benefit of increased efficiency with their customers. Currently, it is not at all clear that RIIO-2 will allow such an incentive in a meaningful way. Including a substantive 'allowed v expected return wedge' can only undermine what limited incentives for efficiency there may be, and so, work against consumers' interests.

Historic outperformance cannot be a guide to future outperformance within a newly calibrated and significantly modified incentive regime. This proposal goes against the past stability and predictability of the WACC-setting process, which is fundamental in the UK regulatory model and has aimed to maintain investor confidence.

Whilst we do not support all of the proposed Return Adjustment Mechanisms, we support Ofgem's policy intent to ensure that companies cannot excessively outperform. As we have detailed in our financial section, we fully support any mechanism which will ensure companies cannot outperform due to any TOTEX underspends, which are not due to efficiency.

- Cost of Equity

It is imperative that we accurately set the Cost of Equity to avoid a similar situation to 1999, where water companies were trading at a large discount to their RAV, due to a market perception of a tough regulatory settlement. It is not in consumers' interests to damage companies' financeability.

Although we agree with the application of the CAPM framework, we do not support Ofgem's methodology for estimating the CAPM's individual parameters. Ofgem has not properly addressed the issues raised by stakeholders, in relation to their evidence base in the Consultation. For example, CEPA's Dividend Growth Model, a key component of Ofgem's cross-checks, understates the expected TMR, due to implausibly low assumptions around dividend growth. It is also clear that the level of returns indicated by Ofgem's proposals do not reflect the risks faced by network companies.

In many ways, water companies are less risky than electricity networks, yet Ofwat has proposed a Cost of Equity for PR19 that is 100bps higher than Ofgem's current proposal. Looking forward 10 years, we see more uncertainty for energy than for water companies.

Ofgem have committed to departing from the well-understood and longstanding regulatory practice of selecting the upper end of a cost of equity range. This has been supported in a number of ways, including academic research, which has found that aiming up, well above the central estimate, is likely to minimise the expected losses to society from underestimating the regulated business's true cost of capital.

- CPIH Transition

We would support a move to CPIH indexation of the price control settlement as long as it can be demonstrated, in practice, that the process would result in a price control settlement that would be NPV neutral for consumers and investors. Further clarity is required on all aspects of the CPIH assumptions that Ofgem intend to use for RIIO-2, before the aim of value neutrality can be fully satisfied.

- Cash Flow Floor

As you will be aware, network companies are required by their Licence to use reasonable endeavours to retain an investment grade credit rating. Therefore, the notional price controls revenues should achieve ratios at a level that are comfortably above the minimum prescribed ratios, for a particular rating, and robust to appropriate stress testing. The Cash Flow Floor (CFF) proposals, which Ofgem are consulting on, are closely related to financeability. To date the CFF has not been a feature of established price control regulation. We understand that the CFF has been developed to try to ensure the creditworthiness of the licensees in the current low cost of equity environment.

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SP Distribution plc, Registered Office: Ochil House, Technology Avenue, Blantyre, G72 0HT Registered in Scotland No. 189125 Vat No. GB 659 3720 08

Credit Rating agencies are already interpreting this approach as Ofgem being willing to allow the credit worthiness of the industry to decline[1]. Even if it could be practically implemented, the CFF proposals would only represent short term relief and would not correct the underlying issue regarding insufficient liquidity through calibration of the price control. We believe financeability can be achieved with readily available alternatives at Ofgem's disposal which are less intrusive and costly to implement than Ofgem's CFF proposal. We also have a number of outstanding questions about how the CFF proposals could be made to work practically and legally.

4. Enhancing Resilience

We are pleased to note the inclusion of Workforce Resilience in the Sector Methodology Papers for consultation. We fully support the requirement to explicitly set out our proposals to maintain a resilient and diverse workforce in RIIO-2. We are experiencing a change in the traditional skills required by employees working with a Transmission business, due to technology changes. For example, series compensation, active load management schemes, substation digitalisation and protection and control developments, have changed the skills mix required. As a result, we propose that in addition to workforce renewal plans, companies are incentivized to provide the relevant training associated with the facilitation of a low carbon future and encourage collaboration with local supply chains, in order to further support our local economies.

In relation to ensuring asset resilience, asset management decisions must be optimal and not disincentivised, as a result of the unintended consequences of Ofgem's NARMS proposals. As raised in different NARMS working groups, the current proposed approach introduces a perverse incentive to avoid the delivery of justified additional interventions, when this represents the best outcome for customers. We strongly believe that well justified over-delivery should be funded on the same basis as the mechanism for the business plan. This is to ensure companies are consistently incentivised to carry out effective asset management and to adapt to changing network risk. Experience shows that there are occasions when non-delivery of agreed works is either in consumer interests or is prevented by circumstances outside the control of the network owner. In these circumstances, under-delivery is justified and should not be penalised.

5. Encouraging Continued Collaboration

In order to ensure that network companies collaborate and share best practice in order to introduce new efficiencies for consumer, 'relative' incentives or Return Adjustment Mechanisms must be avoided. Each network operator is responsible for its own licence area which can vary greatly in terms of size, geography, customer numbers, technical challenges and economies. Therefore, each licensee is unique in the way it operates and is managed. It is important for Ofgem to recognise that, in specific circumstances, collaboration between companies allows learning from best practice and sharing of innovation which works to consumers' benefits. Furthermore, no company is ever truly 'like' for 'like', so any relative incentive or adjustment mechanism may not be carried out on a 'level playing field'. We

[1] Statements made by Moody's on 14th February 2019 & S&P on 20th February 2019

look forward to working further with Ofgem to help ensure effective collaboration can be pursued wherever appropriate and in consumers' interests.

6. Delivering an Environmentally Sustainable Network

We fully support Ofgem's proposal to introduce a new Environmental Framework, whereby we should include the environmental costs as part of our baseline funding. However, we do believe that a smaller environmental or low carbon incentive is still required, in order to encourage further improvements in this area. We welcome the removal of the Environmental Discretionary Reward Incentive, whilst supporting the retention of the other existing environmental incentives, given the evidenced benefits from RIIO-ET1. We will consult with our stakeholders on our environmental ambition in March 2019.

We would also support an amendment to the existing RIIO-ET1 policies for mitigating the impacts of transmission infrastructure on visual amenity. Currently, the allowance can only be used in National Parks and National Scenic Areas (Scotland) and does not adequately reflect the full range of nationally important landscape receptors across the country. The current limited scope does not represent the interests of our stakeholders or consumers in Central and Southern Scotland.

In addition, the scope does not adequately reflect the statutory obligations which exist within the Electricity Act 1989 (Schedule 9), in relation to visual amenity. Should this mechanism be maintained, we would like to see it enhanced to cater for a full range of nationally or internationally designations, which relate to the potential impact of existing infrastructure. A number of our stakeholders observed that there is a difference in approach to the use of landscape and amenity designations north and south of the border. Ultimately this has led to a lack of opportunities to address landscape impacts from existing transmission infrastructure under the current scheme.

7. Becoming a "Whole-System" Enabler; The Solution Lies with Network Companies

Ofgem describes Whole-System from a starting point of increasing interaction across network companies, which is important from a solutions perspective. However, the context of the need for Whole-System solutions should be considered as well. The drive to achieve climate change targets, by decarbonising the energy system, is at the root of the need for whole system approach. The changing use of electricity for transport and heat, and the increase in decentralised and non-synchronous generation, is changing the way network companies need to operate. Whole-System solutions lie with network companies. Incentive mechanisms need to be designed to unlock the opportunities. Investment decisions, taken now, have the potential to achieve large-scale benefits for consumers in the future. These decisions must focus on the impact on the network over an appropriate period of time, in order to capture the broader economic and social risks and benefits. Whole-System trials should be encouraged as we will only 'learn by doing' given that this policy area is still so uncertain. We propose that the scope and application of Whole-System is kept under review for RIIO-3 in light of experience and any ongoing legal constraints.

The proposal to allow the use of innovation funding to address Whole-System approaches is positive as it provides a funding route for costs, which would not be considered at the time the business plans are developed, and allows companies to flex their approach. We are already taking a Whole-System approach across both our transmission and distribution businesses.

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8. Co-Developing our Business Plans with our Stakeholders

We welcome the increased role for stakeholders in the development of our business plans. To date, we have held three TO User Group sessions, which have been helpful in co-creating our business plans. We have also presented to Ofgem's Challenge Group on one occasion and, as requested by them, we will shortly be making a submission on historic cost and network data. Whilst we support both groups, we do believe that it is important these groups are provided with sufficient resources and support, in order to make fair assessments of company performance. Therefore, we would suggest that the relevant experts should present to Ofgem's Challenge Group, to bring members up to speed with the current price control regime and company performance. The ENA's Finance Working Group has recently written to Ofgem's Challenge Group to offer to provide a general cost of capital overview, given that the Challenge Group has a financial remit with its ToR.

We are continuing to engage with our stakeholders, via bilaterals and consultations. During March, we will launch our Incentives, Environmental and Innovation stakeholder consultations. It is very important that Ofgem has a process in place for ensuring that our stakeholders' reasonable requests, are not unfairly 'benchmarked out', as part of the business plans assessment process.

9. Ofgem's 'Early' CATO Model is the only competition model which may deliver value for GB consumers

We fully support the implementation of competition where this is of benefit to consumers and done in a way which respects the statutory framework. Currently c.95% of our transmission expenditure is tendered on a competitive basis. However, we do not consider that the most recent competition models, that Ofgem has proposed, are likely to deliver wider benefits to consumers than the existing framework. The vast majority of work across our transmission and distribution businesses is already subject to market tendering and significant problems remain with the additional late competition models Ofgem is proposing.

We consider that the early competition models proposed within the consultation document are unclear, as to how they will work in practice, and if they are to apply to the transmission or distribution networks, or both. In particular, we are unconvinced that the proposals put forward in the consultation document for early competition are appropriate for the transmission network. Should Ofgem decide to implement early competition models, we are of the opinion that different early competition models are required for transmission and distribution networks, particularly as DSO flexibility solutions will have a strong role to play across the distribution network. We would also strongly encourage Ofgem to develop a comprehensive policy detailing its proposed early competition models, for both the transmission and distribution networks, with particular emphasis on ensuring that the early competition models continue to offer network operators as much flexibility as possible. Therefore, if circumstances change or if new, more effective solutions arise, these can be adopted, delivering system security and the most cost effective outcome for consumers

Given that the late competition models are still in development by Ofgem, we question whether the late competition models, can be finalised and embedded, in sufficient time, to coincide with the start of RIIO-2. This is a particular concern to us, given that (i) there are substantive differences between the land and planning regimes in England and Scotland. In effect those differences mean that late

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competition, as currently imagined by Ofgem, particularly in relation to the transfer of planning consents, would not be possible in Scotland; (ii) the suggestion that TOs should set out in their Business Plans how, and to what expenditure, competition will apply, during the RIIO-2 framework. We would urge further details from Ofgem on this, as a matter of priority, given the deadline for our Business Plan submission.

We welcome further details from Ofgem as to what 'native' competition entails as this is not entirely clear in the current document and may simply be a description of the extensive market tendering, which we already do.

10. Potential CMA Appeals

Ofgem proposes that it is able to make further licence modifications (to both appealing and non-appealing licensees) after an appeal to the Competition and Markets Authority (CMA). It is not clear to us what exactly Ofgem's proposals are. We would therefore ask Ofgem to explain its proposals in more detail, including the nature and legal basis of the discretionary mechanism, and an explanation of the problem Ofgem is trying to address through the introduction of the measure. We consider that the statutory appeals process already presents the flexibility that would permit Ofgem and the CMA to consider any relevant links between challenged parts of the price control decision and unchallenged parts, in the context of any appeal. In the British Gas Trading and Northern Powergrid price control appeals, the CMA confirmed in its final determination reports that if evidence was presented that suggested that overturning one part of the price control decision would have knock-on consequences for other unappealed aspects of the decision, the CMA would consider any such links on a case-by-case basis. We therefore believe that an appropriate channel already exists, through the statutory appeal process, for Ofgem to propose and evidence any necessary changes to other components of the price control which are affected by the appeal.

We will continue to review the full RIIO-2 methodology as this develops and would be happy to discuss any parts of our response with you or your teams. Please do not hesitate to contact us should you have any queries.

We have attached the following documents which provide our detailed responses:

I. RIIO-2 (Cross Sector) Sector Specific Methodology – SPEN Response
II. RIIO-ET2 Sector Specific Methodology – SPEN Response
III. RIIO-2 Electricity System Operator Annex – SPEN Response

Yours sincerely,

Frank Mitchell
SP Energy Networks CEO