Response to ED3 Framework Consultation

Citizens Advice

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Executive Summary

Citizens Advice welcomes the opportunity to respond to Ofgem's ED3 Framework Consultation. We are responding in our role as the consumer advocate for energy and have focused our response on questions where we can add most value.

We have highlighted key themes for the Executive Summary. These represent areas with the highest potential consumer impacts where we believe Ofgem needs to take action.

Company returns are still too high.

In ED2, Ofgem set its intention to bring down the high returns that investors made in the ED1 period. We believe Ofgem's methodology resulted in at least £1.5 billion in excess returns going to companies using Ofgem's own cross-check figures. So far, Ofgem's aims also appear to have failed within the price control as well with the sector RoRE for 2023/24 (14.1%) exceeding the average RoRE of ED1 (10.7%). To a large extent this is due to financing and tax benefits that have earned these companies £1 billion in additional returns in just the first year of ED2 (in 2023/24 prices).

Ofgem proposes a portfolio of potential actions, such as Plan and Deliver, which reduce risk for network companies in ED3, and in many cases will also transfer that risk to consumers. While we think these may be the correct decisions for consumers, this is reliant on whether these reductions in risk can be clearly tracked and identified when Ofgem is setting the cost of capital. Setting the cost of capital at a rate which ignores these changes would undermine legitimacy in the regulatory arrangements and guarantee that networks will earn excess profits in ED3.

The recent £7billion Rights Issue from National Grid and the transaction of ENWL at a 44% premium suggest that capital is plentiful to invest in these low risk companies, and that network companies are already seen as highly investable with confidence they can beat the regulatory arrangements comfortably to earn higher returns. Ofgem must concentrate on setting returns based on objective evidence and not place undue weight on narratives from parties with commercial interests.

We note that ED3 may have more public scrutiny than previous periods, due to the outcry at shareholder returns in the water sector and the recent climate of high energy bills. Ofgem is responsible for agreeing not just the regulatory licences but also the social contract between consumers and energy networks. Returns which are no higher than they need to be is a cornerstone of a legitimate regulatory arrangement which consumers can have confidence in. Consumer consent is essential for meeting our Net Zero targets, and it must not be undermined by price controls delivering outcomes that are generous to network companies at the expense of consumers.

Ofgem should review its approach to underspend.

We are concerned that companies underspending on their totex may create adverse effects for consumers. At present, some underspend is not reviewed by Ofgem.

Enduring value adjustments are working to bring down the value of reimbursements for consumers. In ED2, companies underspent their combined allowance by 15%, but after adjustments this was brought down to 4.6%, resulting in savings of £270 million that were not passed through to consumers.

We must also ensure that there are no perverse incentives that would allow for networks to receive funding in one price control for planned investment, only to defer the upgrades to the next price control in order to benefit from the underspend and then also receive additional funding in the next price control.

We also remain unconvinced that sharing factors in the Totex Incentive Mechanism (TIM), as currently set, have evidential merit or represent value for money for consumers.

Incentives should be assessed and recalibrated.

Before the ED3 period begins, Ofgem should assess how well incentives, both financial and reputational, are working to drive expected performance improvements. Incentives are one important way of driving up standards but in many areas they may need to change. It is essential that Ofgem embeds performance improvements and ratchets up its baseline expectations.

We strongly feel that incentives should be principles based, and designed to mirror a competitive environment. This would involve only the best companies receiving a reward, to recognise exceptional performance, rather than simply performing above a pre-determined baseline. Most networks would naturally fall within a deadband where no incentive or penalty is received, with the worst performer(s) incurring penalties - much as you would expect in a competitive market.

Some incentives, such as for reliability, may need to change under a 'plan and deliver' framework to ensure that investment required to be delivered, and subsequent performance improvements, cannot be double counted and rewarded as has been seen in the gas distribution sector under the shrinkage incentive in RIIO-1. Reliability incentives instead may need to consider actions over and above input-based network investment.

Ofgem should increase standards of performance monitoring and make more data available.

A scarcity of data in the price control period undermines the process. So far in RIIO-2 (ED, GD, ET and GT), Ofgem has not published any annual performance reports on any non-financial metrics.

This results in less effective stakeholder scrutiny, reducing the efficacy of reputational incentives, and minimising opportunities for lessons to be learned for future price controls.

We expect to see comparative company data published regularly by Ofgem, in accessible formats to allow for organisations and interested consumers to review how networks are performing against their obligations and incentives and to sharpen those incentives with visibility. We anticipate increased public scrutiny of value for money and company performance as investment increases and due to greater levels of customer interaction with networks and it is important that Ofgem facilitates this.

Drivers for change

Q1. Do you agree with our characterisation of the wider context for ED3? Are there any other areas of context that you consider material for ED3?

We agree that the selected priorities are all relevant factors to consider for the ED3 regulatory framework – and we address these later in our response. However, we consider it important that Ofgem also examines the performance of the current ED2 regulatory framework, drawing lessons for improvement.

Review of ED2 regulatory performance

We have conducted our own analysis of the performance of electricity distribution companies after the first year (2023/24) of RIIO-ED2, examining the areas of total expenditure (totex), output performance and returns. This is set out below. Data for 2023/24 has been extracted from published company regulatory reports. All figures are shown in 2023/24 prices.

ED2 Electricity Distribution totex

Baseline totex allowances - the ED2 regulatory framework was established in very similar circumstances to that outlined for ED3. The energy transition was expected to accelerate with significant demand growth. In December 2022, Ofgem approved the efficient ED2 baseline totex allowances. These 5-year allowances (from the February 2023 Ofgem price control model) are compared below with the latest allowances from the July 2024 financial model.

The July 2024 model includes subsequent changes to allowances made by Ofgem after the first year of the price control to address allowed adjustments and uncertainty mechanisms.

Figure 1: Change in 5-year electricity distribution totex allowances

	£m (23/24 prices)		
	Feb-23	Jul-24	% Change
ENWL	2087	2318	11%
NGED	7097	7404	4%
NPg	3373	3361	0%
SPEN	3552	3458	-3%
SSEN	4685	5393	15%
UKPN	6008	6012	0%
Total	**26803**	**27946**	**4%**

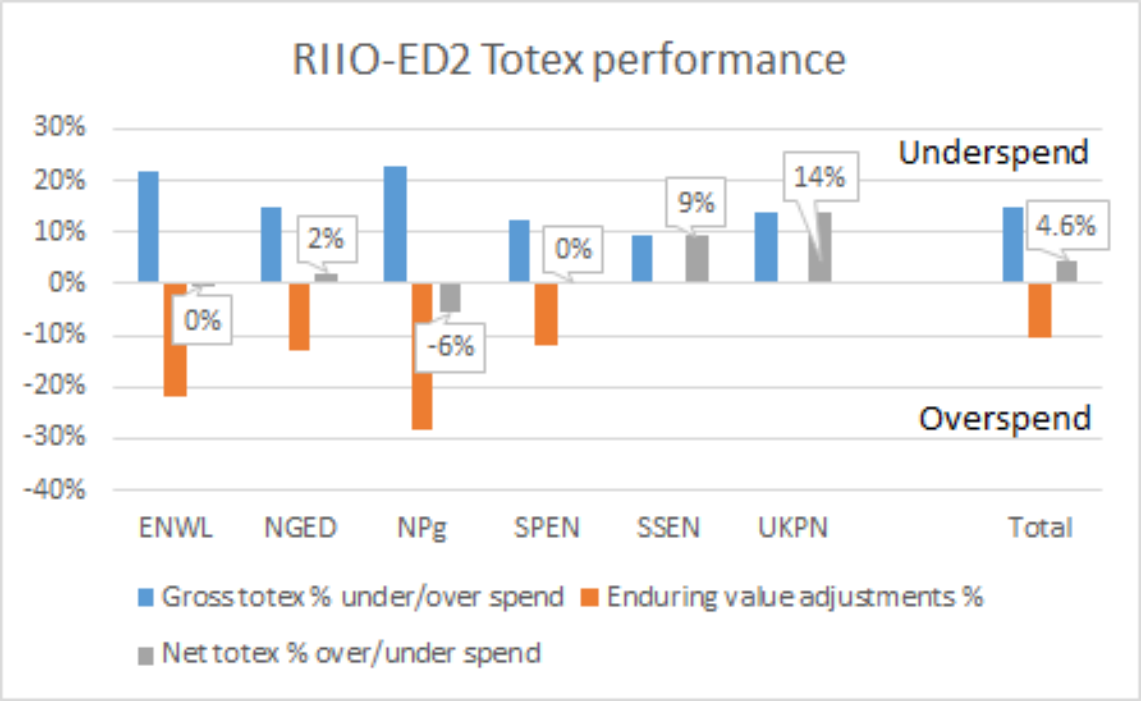
Since the price control decision, the overall totex allowance for electricity distribution companies has increased by £1.1 billion, or 4%. The main reasons for this appear to have been increased Load Related Expenditure (LRE) allowances for ENWL, NGED and SSEN.

Totex performance - A key element of the RIIO price control is a financial incentive for companies to deliver totex efficiencies by underspending their totex allowance. The design of the incentive includes a sharing factor where companies share around half of any underspend with customers. Similarly, any overspend is also shared between companies and customers.

The following chart illustrates the totex performance for 2023/24, the first year of RIIO-ED2. The chart shows underspend below allowance as a positive figure and overspend as a negative figure.

The chart shows gross and net totex under/overspend for each company as a percentage of annual totex allowance. The difference between these figures results from enduring value adjustments allowed by Ofgem - these are intended to reflect the financial impact of any decisions or future events that have yet to be included in revenue or RAV. Companies are required to explain these adjustments in their annual regulatory reports.

Figure 2: Electricity distribution totex performance against allowance



The chart shows that all companies underspent their totex allowance in 2023/24, ranging from above 20% for ENWL and NPg to 9% for SSEN. We calculate that, across all DNOs, the gross totex underspend was 15%[1], or £795m in 2024/25 prices. About half of this could have been returned to customers.

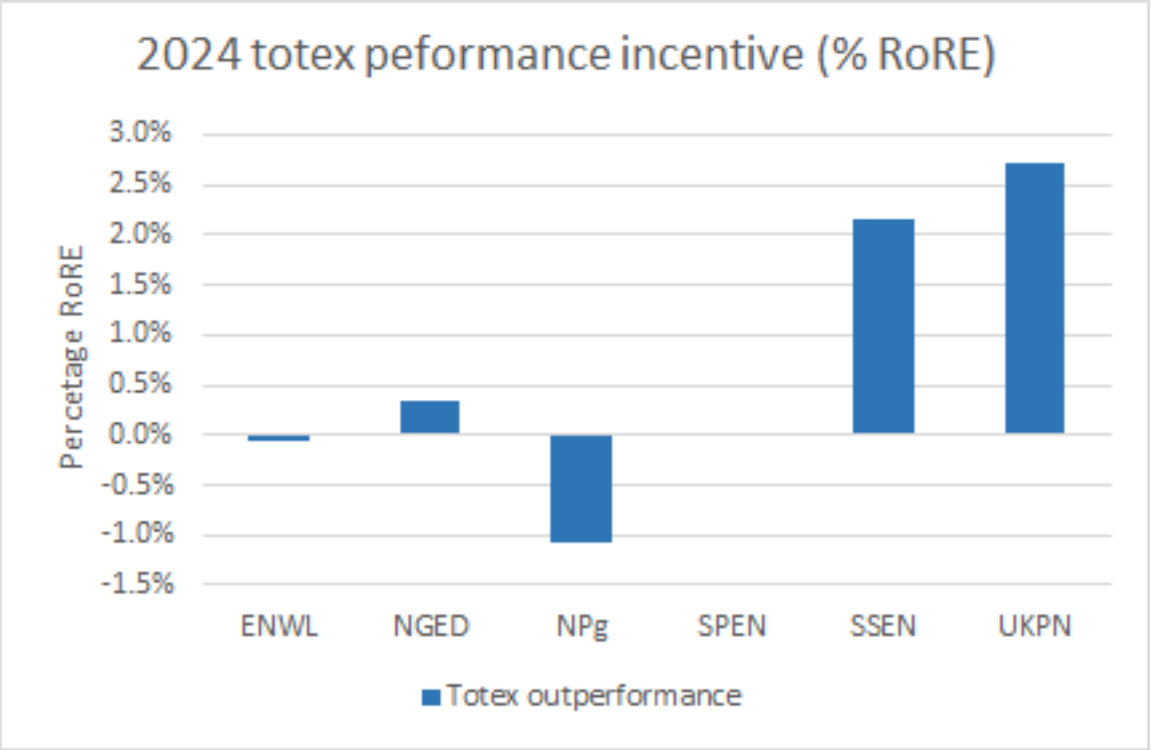
However, once the enduring value adjustments were applied, the net overall underspend fell to 4.6% or £240m in 2024/25 prices. Only four DNOs applied these adjustments, and each has reduced their totex underspend (and customer reward) significantly. ENWL, NPg and SPEN each had enduring value adjustments that fully eliminated their underspend. ENWL and NPg stated that these adjustments were due to phasing of expenditure within the price control period, and SPEN attributed the adjustment to emerging requirements.

It is difficult to ascertain whether the application of enduring value adjustments will offer benefits to customers over the course of the price control. The use of enduring value adjustments could simply delay the payment of totex incentives to themselves and to customers.

The following chart shows the resultant net totex performance incentive as a proportion of Return on Regulatory Equity (RoRE).

[1] Ofgem report this figure as 13% in their ED2 Framework Consultation.

Figure 3: Electricity distribution totex incentive performance



The chart shows totex incentive RoRE percentages are highest for SSEN and UKPN which did not apply any enduring value adjustments. Customers will also receive a benefit from these incentives.

ED2 Electricity Distribution Output performance

The RIIO-ED2 price control put in place a range of outputs and incentives including Licence Obligations, Price Control Deliverables and Output Delivery Incentives (ODIs) to drive improved performance. Of the ODIs, these are divided into reputational incentives (ODI-R) and financial (ODI-F) incentives.

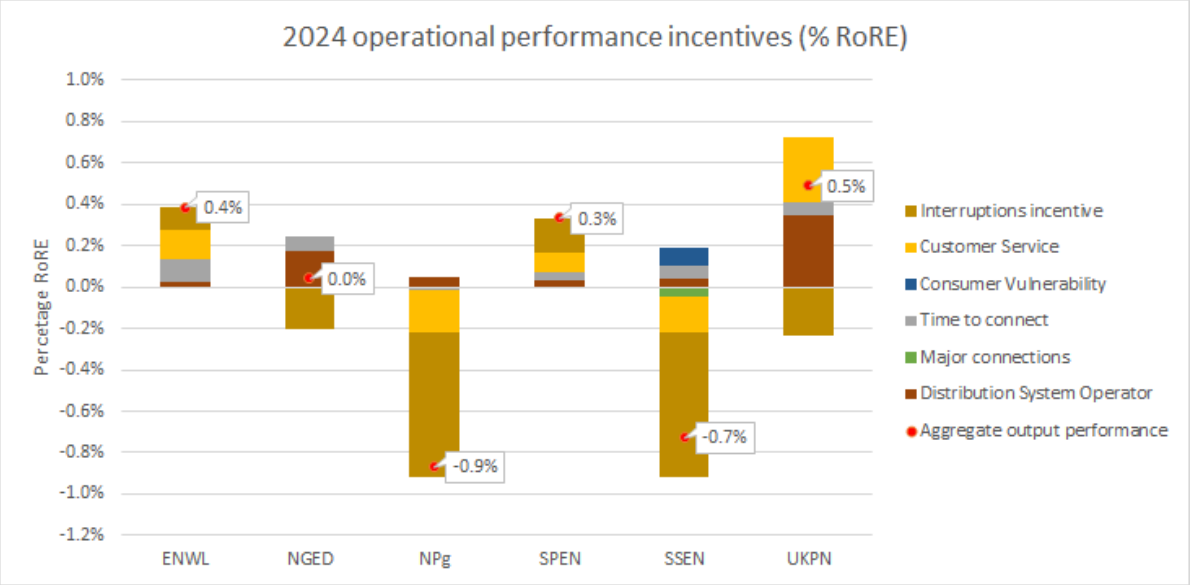
The common ODI-Fs for electricity distribution are:

- Interruptions Incentive Scheme – to improve network reliability and reduce outage times
- Customer service Incentive – to improve quality of customer service
- Consumer Vulnerability Incentive – to provide appropriate support services for customers in vulnerable situations
- Major Connections Incentive – to improve quality of service for major connection customers

- Time to Connect Incentive – to reduce time to connect small customers
- Distribution System Operator (DSO) Incentive – to incentivise more efficient network development and operation, considering smart and flexible alternatives to network reinforcement

The following chart shows the performance of each company against these metrics for 2024. It highlights the RoRE reward or penalty for each incentive together with the aggregate resultant figure for each company.

Figure 4: Electricity distribution operational incentive performance



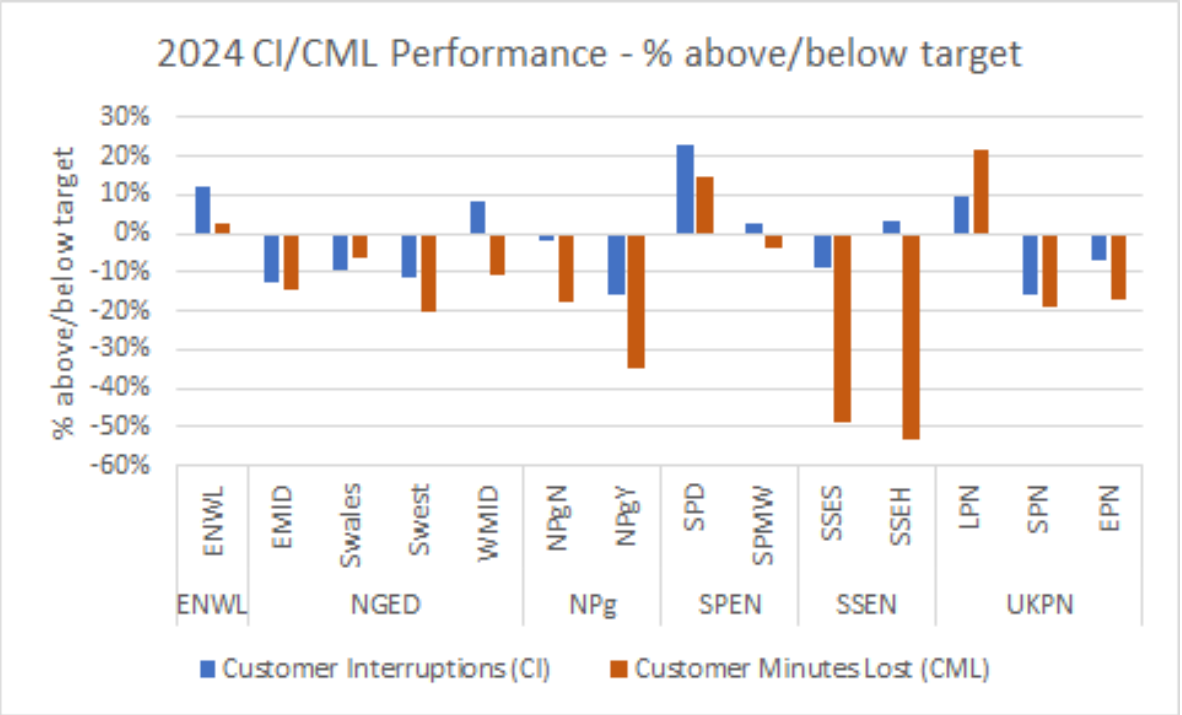
The chart shows the aggregate incentives range between plus 0.5% RoRE for UKPN, and minus 0.9% RoRE for NPg. This result only captures one year of ED2 performance and may not be representative of future performance. None of the companies are yet reaching the higher available levels of output performance incentive – this could indicate that performance is poor, that the targets are challenging, or are not a priority for companies to achieve.

The incentive with the greatest impact upon company performance is the Interruptions incentive which has resulted in penalties for several companies. This is discussed further below.

Interruptions incentive - the following chart shows performance of individual DNO's against loss of supply targets, both in numbers of incidents (CI) and average duration (CML). It shows the percentage deviation from CI/CML targets

Individual targets were set by Ofgem for each DNO area, and for each year of the price control. For most DNOs these targets were strengthened from ED1, targeting improved reliability performance for ED2.

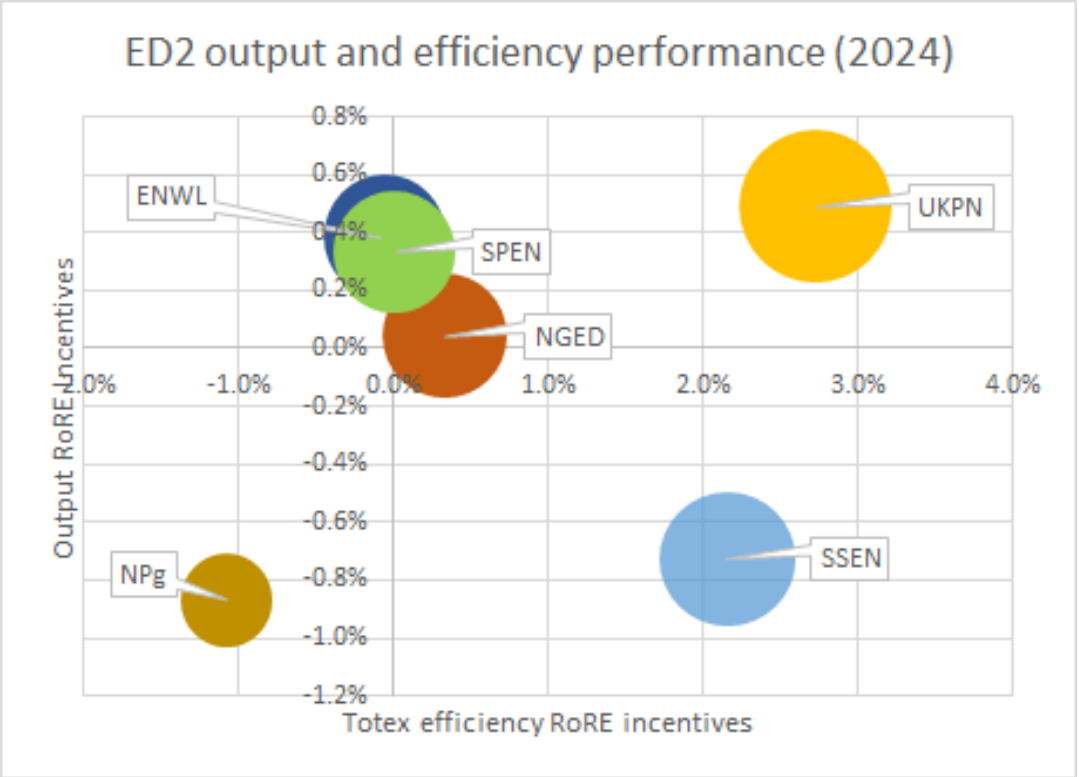
Figure 5: Electricity Distribution CI/CML performance against target



The chart illustrates that most DNOs are underperforming against their 2023/24 CI/CML targets. SPEN and ENWL are the best performers, with SSEN and NPg being the weakest, which they attribute to extreme weather events during the year.

Overall output performance - the following chart illustrates the performance of individual companies against both totex and output incentive regimes. The size of the company 'bubbles' below represents the total Operational RoRE reported by each company for 2023/24.

Figure 6: Electricity distribution Operational RoRE performance



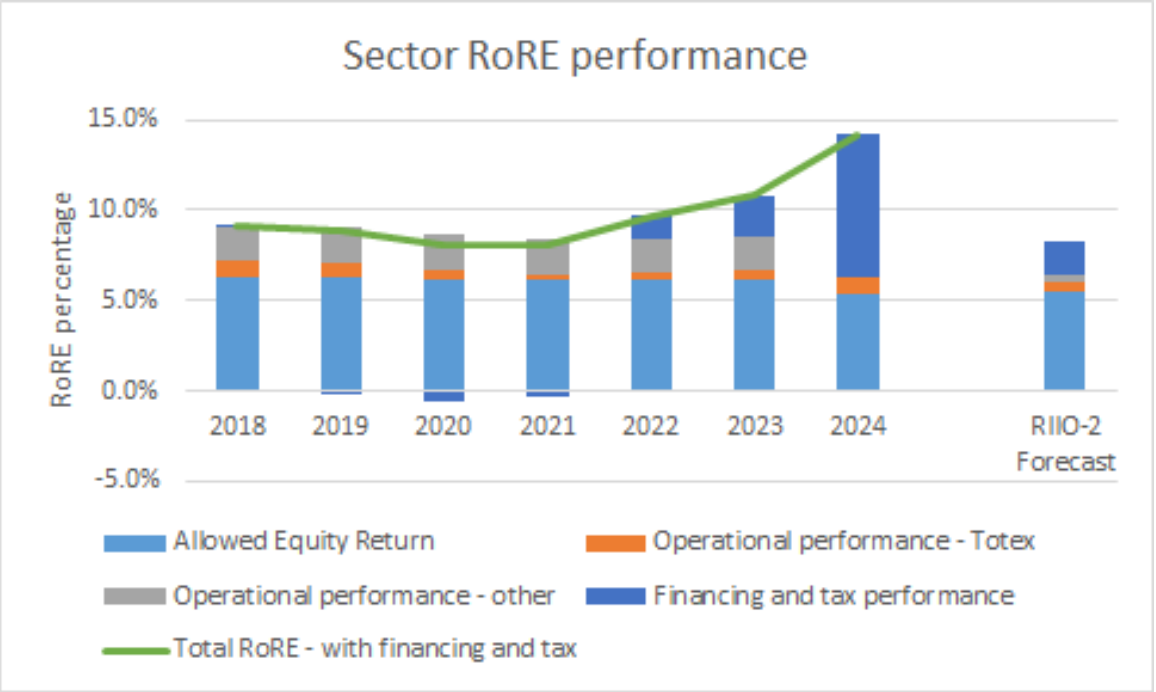
The chart illustrates that UKPN has achieved the highest output incentive and the greatest efficiency saving, whereas NPg has penalties for both. SSEN also shows low output performance.

ED2 Electricity Distribution RoRE

Ofgem's RIIO-ED2 final determinations sought to reduce excessive investor returns evident in RIIO-1 and reduced the allowed cost of equity.

The following chart shows the actual electricity distribution sector returns from 2017/18 to 2023/24. It shows the total RoRE earned by investors based on notional gearing. This includes the allowed equity return plus totex/operational incentives, and financing/tax incentives.

Figure 7: Electricity Distribution RoRE performance 2018-2024



The sector RoRE for 2023/24 is 14.1%. This is higher than the average RoRE of 10.7% for the electricity distribution sector for RIIO-ED1.

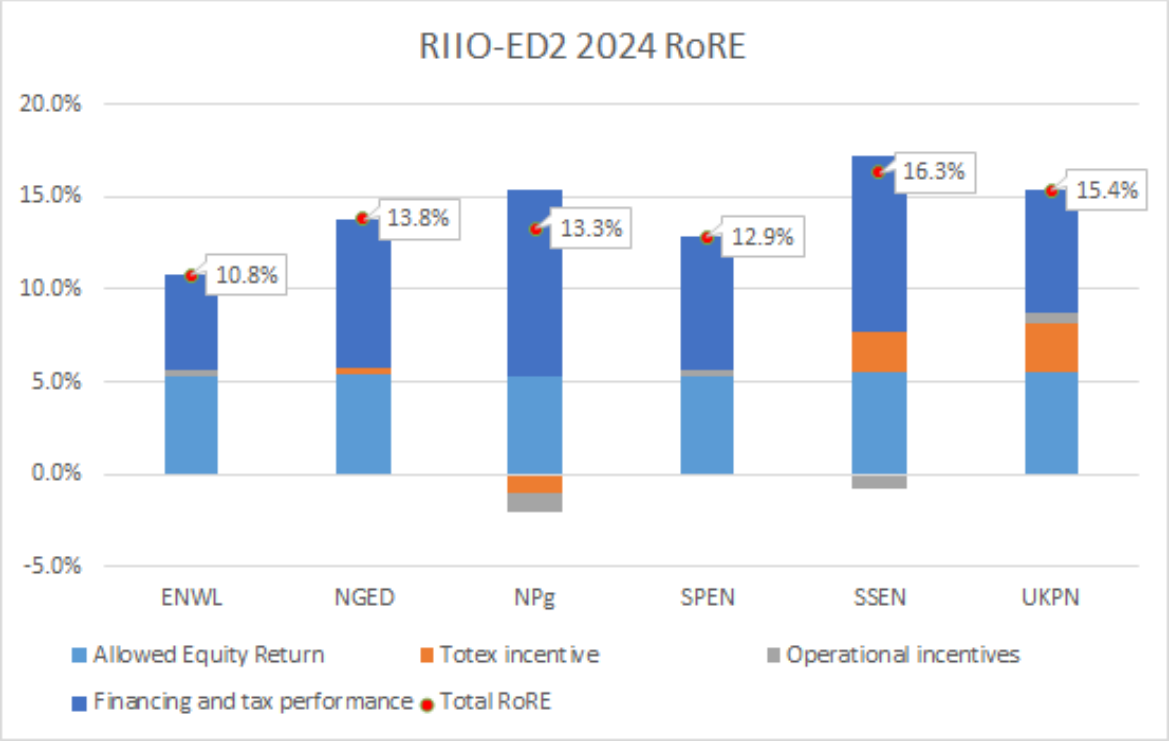
The 2023/24 increase is driven by financing and tax benefits, totalling 7.9%. In cash terms, we estimate that this financing/tax benefit over the first year of ED2 represents a £1 billion additional benefit for companies (in 2023/24 prices).

Compared to ED1, the returns from operational performance incentives have fallen significantly in 2023/24. This may either indicate that these incentives are more difficult to achieve (as demonstrated by the Interruptions incentive analysis above), or that companies may be prioritising other performance areas.

The chart also shows the forecast average RoRE of 8.3% for the RIIO-ED2 period overall, mainly due to an expected decrease in financing and tax benefits. However, this will be dependent on economic assumptions and is likely to be higher as inflation has remained above long-term expectations.

The following chart shows the actual RoRE for the individual electricity distribution companies for the first year of RIIO-ED2.

Figure 8: Electricity Distribution RoRE performance 2023-2024



The chart shows individual company RoRE (including financing and tax benefits) ranges between 10.8% (ENWL) to 16.3% (SSEN). NPg has the greatest benefit from financing/tax (10%), but this is offset by operational and totex penalties.

ED2 regulatory framework performance – key observations

This section has reviewed the performance of electricity distribution companies after the first year of RIIO-ED2. Key highlights are:

- Totex allowance - Ofgem has increased Totex allowances for the 5-year price control by £1 billion, or 4%, reaching £28 billion.
- Totex performance – companies underspent their combined allowance by 15%, but the underspend is reduced to 4.6% after adjustments were allowed. This meant savings of around £270m were not passed through to customers.
- Output performance – this ranges between +0.5% to -1%, not demonstrating particularly strong or weak performance overall. Reliability is the weakest area of performance with SSEN and NPg demonstrating poorest performance.

- Total RoRE – returns ranged from 10% to 16% which is even higher than the excessive ED1 levels. Companies have received windfall gains from Ofgem's decision not to adjust financing arrangements. We calculate that this additional return totals £1 billion (in 2023/24 prices) for the first year of ED2.

In March 2023, Citizens Advice published views on the ED2 final determinations, highlighting that Ofgem could have gone further in reducing cost of capital saving customers around £1.5billion, using Ofgem's own cross-check figures, to provide customers with better value for money and strengthened incentives to provide customers with better services.

We also highlighted our view that Ofgem monitoring of company performance during the ED2 price control is not coherent or stringent enough. As we highlight throughout this response it is not clear what monitoring activity and performance assessment is being made in all of RIIO-2, not just ED2, to identify comparative company performance and explain why some companies appear to offer better performance than others.

The above analysis, which we recognise only reflects the first year of ED2, indicates that the price control framework may be falling short. There is evidence of totex underspend, underspend not being shared with customers, weak incentive performance, and high returns to companies. We urge Ofgem to improve their performance monitoring and learn lessons from ED2 for the ED3 price control.

ED3 objective and consumer outcomes

Q2. What are your views on our overarching objective and proposed consumer outcomes?

Ofgem's overarching objective for ED3 is that the price control should ensure that current and future consumers' interests are met by electricity distribution networks providing the necessary network capacity, to enable decarbonisation goals, at least cost, based on whole system value.

Ofgem's four proposed consumer outcomes for ED3 are as follows:

- Networks for net zero – strategically planned network investment, providing capacity and access for users when it is needed at least cost based on whole system value for current and future users.
- Responsible businesses – delivering a high-quality service befitting of essential infrastructure, focusing on social, environmental and economic outcomes, including robust consumer protections, long-term value for money, financial resilience and supporting sustainable economic growth.
- Resilient and sustainable networks – networks are safe and managed in a way that promotes long-term asset health and resilience and considers risks in the delivery of new and upgraded assets.
- Smarter networks – leveraging data, digitalisation and innovative solutions to optimise networks and their role in the overall system, increasing the transparency and value of network data to stakeholders.

We note that Ofgem's prior objectives for the current ED2 price control were:

- delivering the local energy distribution networks needed for net zero, enabling the connection of electric vehicles and heat pumps
- supporting a smarter, more flexible, and digitally enabled energy system, which should improve network efficiency
- ensuring network reliability, reducing the frequency and duration of power cuts
- delivering high quality services to customers and network users
- ensuring no one is left behind in the energy transition
- delivering at lowest cost to consumers

We note that these objectives are broadly consistent, particularly the emphasis on network capacity for net zero, network reliability and least cost to customers appears consistent, albeit that ED3 now has a greater focus on strategically planned network capacity.

However, Ofgem appears to be more focussed on the long-term value for money. We agree with the importance of long term value for money and so it

remains critical that Ofgem's focus is on ensuring the ED3 price controls deliver excellent value for money for consumers. Getting decisions wrong in the short term will create and compound additional costs for consumers over a longer time period due to regulatory depreciation.

We suggest that an additional objective for Ofgem should be to learn lessons from ED2 and improve the design of the ED3 price control to secure a fairer deal for consumers. In particular, Ofgem should ensure that the social licence between energy consumers and energy networks is strong and that consumers can have confidence in its legitimacy and in Ofgem's regulation.

Regulatory framework

Q3. Do you agree that the network investment elements of the framework should be more input based?

Yes we agree. The creation of RESPs and their value in network planning, in our view, relies on the price controls utilising them to drive more specific expectations from DNOs. We believe the plan and deliver model for network investment provides clarity on what is needed and the delivery timescales expected of network companies, enabling DNOs to focus on delivery.

It remains unclear whether Ofgem believes that the current framework that relies on the totex incentive mechanism (TIM) is delivering the best outcomes for consumers. While underspends are shared with consumers, we firstly do not believe the levels of the sharing factors are well justified and are likely to allow returns to companies that are unnecessarily high. Secondly, it is unclear whether all underspends represent the right outcomes for consumers, and whether Ofgem has made an assessment of this. For example, ex-post reviews of LRE underspends for primary reinforcement only occur if DNOs spend less than 80% of their ex ante allowance in ED2. This means underspends of up to 20% are not explored by Ofgem. It is unclear that this is a fair approach and may not adequately protect consumers. Thirdly, enduring value adjustments require more attention to understand whether they are delivering the right outcomes.

We agree that moving to more input based regulation for network investment is likely to be a positive step forward. However, we believe it would be beneficial if

Ofgem assessed the extent to which the current framework is, in practice, working well for consumers or is falling short.

Q5. Do you agree that the incentives on DNOs will need to adapt from RIIO-ED2 and if so, how?

Yes we agree. A move to plan and deliver will rely to a great extent on protecting against under delivery for network investment to ensure that what is planned and needed is delivered on time. However, rather than thinking of these as incentives, we believe Ofgem should think of these as controls.

Licence obligations are a powerful tool to ensure that companies deliver what is expected from them and we do not believe that all controls should necessarily be financial incentives.

Some incentives, such as for reliability, may need to change under a plan and deliver framework to ensure that investment required to be delivered, and subsequent performance improvements, cannot be double counted and rewarded as has been seen in the gas distribution sector under the shrinkage incentive in RIIO-1 which led to unjustified rewards. Reliability incentives, instead, may need to consider actions over and above input-based network investment.

Some other quality of service incentives may also need to take a different approach in ED3 in cases where sector performance is generally good and the benefits of further improvements may not justify the additional investment. In some cases Ofgem may wish to focus on ensuring performance does not drop or that it becomes more consistent across all companies. We believe customer service may be such an incentive where this change could be needed.

Zero sum incentives should be explored in such cases. This provides the right incentive that companies should perform well relative to their peers and much more closely reflects a competitive market environment. Such incentives also minimise the risk that consumers over-reward companies if targets have been set too low by Ofgem. Protections can also be calibrated to ensure that minimum service levels are provided to prevent performance slipping.

As we have recommended in all recent price controls, it is important that Ofgem firstly sets out what each incentive intends to deliver and what good

performance (i.e. deserving of a reward) would look like in terms of quality of service and value for money. Calibrating incentives against a clearly defined aim then becomes an easier and clearer task.

Q6. Do you agree that there is still a role for re-openers in ED3, particularly given the timing of the future full RESP output and how should these be triggered?

Yes we agree that re-openers will likely remain a key part of the price control and could be needed in relation to RESP inputs, depending on timings. However, it is key that these are subject to robust scrutiny, particularly given the very high additional allowances permitted so far in RIIO-2.

Provided the timing of RESP plans and their input is sequenced early in ED3, it is possible that reopeners could play a smaller role in the latter stages of ED3.

We recommend that Ofgem produces high, medium and low scenarios for the additional cost allowances that may result from reopeners.
Reopeners should be symmetrical and equitable, meaning that DNOs and Ofgem can both trigger them and they should allow for both increased and decreased allowances as necessary. It is not clear that there are any merits in limiting who can trigger reopeners.

Q7. Using RIIO-ED2 as the counterfactual, what alternative regulatory models or characteristics are needed in ED3 to ensure the DNOs deliver the above consumer outcomes? What are the trade-offs we should consider?

As noted above, we believe Ofgem should assess the effectiveness of the RIIO-ED2 counterfactual in practice, rather than in theory, to better aid development of an alternative regulatory model.

In particular Ofgem should assess whether the totex incentive mechanism, as a key cornerstone of incentive regulation, is delivering the right outcomes for consumers.

We agree that greater use of PCDs throughout the price control may support delivery of particular projects, and their timely delivery.

While we recognise that aggregating DNO delivery against plans is one method which simplifies monitoring, Ofgem needs to ensure that aggregation does not allow for the masking of the non-delivery or under delivery of projects.

Average and aggregated performance is not uncommon in price controls and there is a growing risk that these methods of measuring do not reflect the whole picture. Where possible Ofgem should have clear outputs specified and measure against these. The increased focus on data and digitalisation should enable more granular data without increasing resource burdens.

Q8. Do you agree that the regulatory framework for ED3 should have features of the Plan and Deliver model for network investment and Incentive Regulation model for other elements?

We agree that Plan and Deliver should feature for network investment in ED3 in order to benefit from the introduction of RESP. It will be critical that Ofgem has sufficient confidence in the demand forecasts and strategic plans to adopt the 'Plan and Deliver' approach. Ofgem must also deploy adequate monitoring and uncertainty mechanisms to be put in place to prevent any gaming of the proposed regime.

Q9. Do you think that there is a greater role for elements of ex post regulation or of cost pass through in ED3, either specifically in assessing cost changes resulting from changes to investment requirements during the period, or more broadly to reflect the changing context?

We think these approaches to regulation should be considered by Ofgem.

As mentioned earlier, we think the TIM and enduring value adjustments should be reviewed. We believe there is a risk they may be leading to excess returns to companies with underspends not necessarily reflecting the best outcomes for consumers.

With potential further complexities, this situation could worsen so it is right to consider whether alternatives may better deliver the legitimacy of regulation and value for money that consumer and public confidence requires.

Networks for net zero

Q12. Do you agree that the risk and downside for consumers of network underinvestment in network reinforcement would be greater than the downside of overinvestment?

On balance, yes. We believe the risks of underinvestment (ie a lack of network capacity) would likely amount to a larger bill for consumers, with delays in electrifying homes and buildings preventing the whole system benefits of cheap renewable power from being realised.

However, the risks of overinvestment should not be understated. In a time of high energy bills it is crucial to secure the right investment at the right price, so that today's consumers are not overly burdened with costs for a transition that benefits future generations.

Q13. What are the benefits and risks to deliverability if network reinforcement is deferred to future periods?

There are risks for consumers' value for money if network reinforcement is deferred. Consumers may end up funding networks for deferred work that is partially reimbursed at the end of the price control, only for it to be funded again in the following period.

Q14. What do you see as the role of distributed flexibility, both in the short and longer term, to manage distribution network constraints?

We agree that network flexibility within ED3 should not be used to continually defer reinforcement if it has been identified as needed. As mentioned above, however, ED3 should consider where flexibility could serve to mitigate higher costs where supply chains are constrained if this is sufficient to deliver lower overall costs to consumers. Its applicability will largely depend on when and where supply chain constraints would occur, the availability of flexibility, and the extent to which there is a cost saving potential.

However, we believe it is plausible that as network reinforcement and demand profiles become clearer through ED3 and into ED4 and beyond, that distributed flexibility may become a beneficial tool that prevents network reinforcement, where the value of reinforcement may become more marginal, particularly if the levels of flexibility required for Clean Power 2030 materialise.

Q17. Do you agree that the tRESP output outlined for early 2026 will help create a level playing field for DNOs' business planning and support the ED3 objective and consumer outcomes?

The NESO is required to develop RESPs to set out an independent, cross-vector view of the spatial development of energy supply and demand within a region that is consistent with local net zero strategies, the national level FES pathways and the NESO's special plan (SSEP). Ofgem expects DNOs to use the RESP to develop longer-term strategies for facilitating net zero on their networks including distribution-level strategic and anticipatory network investment.

Ofgem's ambition is for the first full suite of RESP outputs to be available in 2028, too late for ED3. As such, Ofgem is considering the timing and scope of a tRESP output in early 2026 to align timelines and provide input for the DNOs to prepare their detailed network plans for ED3.

The RESP process should add valuable independent coordination and inputs to cross vector network planning, prioritising local network investment where it is really needed to benefit network users and consumers. We agree these plans need to have consistent methods and assumptions to derive network need, and coordination of wider stakeholder engagement and cross vector input on local priorities.

We agree that the tRESP should provide a valuable contribution to network investment plans for ED3, potentially acting as a challenge to DNO ED3 plan assumptions.

However, one key area where clarification is needed is on the relative expectations and responsibilities of both RESP and network companies on local stakeholder and customer engagement. At present there is a clear risk of overlap which could lead to duplication of effort and confusion among stakeholders on where to prioritise their engagement.

Network companies are already familiar with operating their own engagement and likely to operate this way by default without any further clarity. The RESP is an entirely new function so identifying where responsibilities start and end for each early on will be critical to getting ED3 engagement and the tRESP contribution to ED3 right for all parties concerned.

Q18. Can anticipatory network reinforcement be used to smooth the long-term build profile to avoid creating pinch points for the supply chain and workforce? What are the risks and trade-offs?

Potential disadvantages are that front-loading investment could exacerbate rather than mitigate supply chain pressures which could increase costs. Consumers would pay for extra costs in the ED3 price control period and beyond.

Ofgem highlights that there is currently 44% average headroom on the primary distribution network and 60% headroom on the secondary network. Ofgem states that this is predicted to decline by 2035 such that ED3 is a critical period to make network interventions to increase capacity.

For ED3, Ofgem considers that the potential risk and consumer impact of delayed network build could be much greater than investing earlier than needed. As such Ofgem proposes to take a more proactive stance in delivering network capacity in ED3 on the basis it is in consumers' interests to avert the risk that distribution networks become a blocker to Net Zero.

Overall, we agree that a 'Plan and Deliver' approach for LRE is more appropriate for ED2, but this must be effectively designed to incentivise value for money and delivery. Ofgem should also consider the impact of the consumer-led flexibility needs set out in the Clean Power 2030 plan.

Q19. Do you agree that investment optioneering should aim to reduce the lifetime costs by sizing elements of works for long-term need, including considering the impact of thermal losses?

Yes. If network companies can demonstrate that optioneering can reduce overall costs, for example through upgrades with lower marginal cost due to other civil work taking place, or in relation to asset health investment, then this is a positive outcome for consumers. However, this is an area where there must be effective monitoring. Assumed benefits to consumers from optioneering may be marginal and any change in outturn costs or delays to delivery may erode the net benefit to consumers.

Ofgem's performance monitoring approach in ED3 will need to be suitably granular and robust to ensure that approaches which may be assessed as

providing net benefits to consumers ahead of the price control actually provide them in practice and can be demonstrated.

Q21. To what extent should the price control be more directive on specific anticipatory and strategic investments to achieve the 'networks for net zero' consumer outcome?

We anticipate that ED3 will contain more directive anticipatory investment, particularly where the future needs case is strong and the risk for consumers is low.

Ofgem should also consider how price controls being more directive alters the risk profile for DNOs and may bring further benefits to consumers. We believe that more actions which move large amounts of discretion from network companies to Ofgem must further reduce the risk for these companies, but represent a transfer of risk to consumers.

As this is a general principle that Ofgem may be applying throughout the price control framework it is essential that Ofgem carefully stacks all of these changes when assessing the equity beta and that their effect is clearly demonstrated in the cost of capital assessment.

Ofgem cannot make changes which alter and move actual risk, and the perception of risk, for companies without then also reflecting this in the cost of capital. To do so would guarantee that returns do not reflect the changed nature of price controls.

Ofgem considers that the 'flex-first' approach to investment is no longer appropriate and proposes a 'Plan and Deliver' model for LRE for ED3 to ensure that DNOs are delivering investments consistent with the longer-term needs of the network and aligned with wider strategic energy system plans. As such, DNOs would be accountable for the delivery of an agreed LRE investment plan.

A 'Plan and Deliver' model means that consumers may be paying again for LRE they should already have received in ED1 or ED2, where Ofgem forecasts and allowances for LRE appear higher than necessary. We don't think customers should pay twice or three times for the same investment. In setting LRE delivery targets and allowances for ED3, we suggest Ofgem should deduct any expenditure that customers have already paid for.

Overall, we agree that more 'Plan and Deliver' is appropriate. This approach to LRE should ensure that customers get 'something for their money' and reduces the risk that companies simply do not undertake the agreed investment. But effective ongoing monitoring of network utilisation and capacity availability will be required by Ofgem to ensure that existing and future customer benefits are realised.

Q24. Should we consider how we might bring all network capex investment together within the framework, irrespective of driver (eg load, asset health, resilience), to ensure a common approach to future proofing and delivery?

An efficient 'touch the network once' approach that delivers overall lower costs may mean that a common approach to capex investment that arises from multiple drivers could be beneficial. In particular, if it is likely that price control mechanisms could work in tension with each other or that commercial incentives do not align with the outcomes which are sought for consumers.

Responsible business

Q25. How can we better strengthen accountability for consumer outcomes?

At a time when many consumers are struggling with high energy costs, it is imperative that the ED3 price control must reflect consumer interests, especially those of vulnerable consumers.

In licencing network companies, Ofgem is also providing a social licence between network companies and consumers that the regulatory regime is legitimate; that it will deliver what consumers need, and that the outcomes for consumers and network companies will be fair. As network investment is set to increase, ensuring there is legitimacy in this social contract is fundamental and accountability of network companies, and of Ofgem's own performance, is a key part of this.

A crucial part of ensuring accountability is the accessibility of information and evidence that performance monitoring is effective. Without this, it is not possible for consumers to have confidence that there is legitimacy in the regulatory regime, and that the fairness that Ofgem aims to achieve is being

delivered in practice. As outlined elsewhere in this response, we are concerned by the lack of visible reporting on network performance.

In RIIO-1 Ofgem published both annual financial performance data as well as annual reports on companies' performance, including against a range of metrics including incentives. While this was welcome, we argued that this should be improved upon in RIIO-2. Instead in RIIO-2 we have so far seen no annual reports published by Ofgem at all.

This represents an enormous step backwards in transparency of the performance of companies and of the price controls themselves.

While companies publish data themselves and huge quantities of data is submitted to Ofgem annually, there is little demonstrated accountability in RIIO-2 that shows whether Ofgem is satisfied or otherwise in the performance of network companies and whether the price controls themselves are delivering what was intended.

We want to see Ofgem commit to publishing annual comparative performance monitoring, demonstrating how companies are performing financially, against their targets and metrics, and in comparison to each other.

We also want to see Ofgem publish key data and metrics in easy and accessible formats in the same way it publicises information in the retail market to give visibility to customers. This should take the form of league tables where it is appropriate to do so as this provides additional incentive to companies over and above the financial incentives in place. For reputational incentives, this publicity of information is essential and we would question the extent to which companies have reputational risk without this.

By default we believe all data in companies' annual regulatory reporting packs should be published except for data which is genuinely commercially sensitive.

Ofgem should also publish its own qualitative assessments of annual company performance and of the operation of its price controls. At present it is unclear what monitoring activity is taking place and to what extent Ofgem is satisfied that its RIIO-2 price controls are delivering the outcomes as intended. While the end of price controls is an opportunity to reflect, we believe this needs to become a more visible and embedded activity, particularly when the scale of investment is set to increase significantly.

Q26. What are your views on ED company reporting and the overall transparency of performance and compliance?

We agree that it is very important that DNOs maintain strong consumer and public trust, and that this should be a focus of ED3. We further agree that transparency is key to driving greater accountability and note that Ofgem have sought to achieve this through modification to their reporting guidance.

The regulatory reporting regime requires companies to annually publish their reporting data together with commentary reports. While transparency reporting obligations appear to be being met by companies, we consider that Ofgem itself is falling short in this area and that ongoing performance monitoring is not stringent enough as described in response to Q25.

Ofgem does not currently publish annual comparative analysis of individual DNO or licensee performance. As such, it is very difficult for third parties to accurately compare and assess the vast amounts of information produced by companies. It is also unclear to what extent Ofgem is applying detailed scrutiny to company performance and the performance of the price control, and can therefore assess why some companies may be performing better than others, and whether rewards and penalties are justified or proportionate.

In our response to Q1 above, we have included the results of our analysis of the first year of ED2, which highlights some emerging performance issues. We would repeat our recommendation made above which are consistent with the views we expressed in our March 2023 response on ED2 Final Determinations[2].

> *"Ofgem needs to establish a formal and rigorous comparative performance monitoring framework including qualitative assessment. This monitoring should identify why some companies succeed and others don't. Feedback to companies needs to be rigorous to ensure that laggards use best practice to bring them up to standard. Annual league tables using a RAG rating would be useful to highlight progress."*

[2] Citizens Advice, Our views on Ofgem Final Determinations RIIO-ED2, March 2023

Q27. Do you consider that ISGs alone are sufficient to ensure high quality and effective consumer and stakeholder engagement throughout the ED3 price control? What alternative or complementary approaches should we consider?

There are two different roles ISGs can and do play. Firstly, they hold companies to account for consumer and stakeholder engagement in building their business plans and secondly, they can hold companies to account within the price control period. This question only references one aspect of the ISG work but our response will refer to both.

On the first role relating to business plans, we have not yet formulated a view on the success ISGs have had in this process. An independent and comparative assessment would be beneficial to better understand this, particularly given some aspects of the operation of ISGs are subject to confidentiality requirements by the companies.

On the second role we believe there is an important role for ISGs in holding networks to account during the price control period against their commitments. However, ISGs should not be the only source of scrutiny and should not seek to replicate the effective monitoring and scrutiny role that we believe is central to Ofgem's duty, as the regulator, on behalf of consumers.

ISGs are variable in how they carry out their remit, unless Ofgem sets a more prescriptive framework. Critically, they do not have an explicit remit on any comparative performance scrutiny either and therefore may not be evaluating performance against both best and worst practice. This must still be the role of Ofgem and is an area we believe needs improvement.

In addition to data provision as we have described above, other scrutiny options may be beneficial. Ofgem may wish to consider using the model of independent national performance panels that are currently deployed to advise Ofgem on NESO and DSO performance. Such a panel could be established in advance of ED3 and contribute to the regulatory framework decisions. The principles of open hearings used in RIIO-2 to hold companies to account on business plans could also be deployed much more widely to ensure that scrutiny is applied in a visible way and companies are answerable to questions.

It is also important that Ofgem's decisions on both ED3 price controls and the RESP framework, are clear about where the responsibilities for engagement among network companies and RESPs start and end respectively to ensure there is clarity. There is currently a risk that both parties could seek to engage with the same stakeholders on relatively similar topics and issues at a time when stakeholder fatigue is a real risk.

Q28. Do you agree that Ofgem should adopt research approaches, such as deliberative techniques to ensure that the consumer voice is heard and considered throughout the ED3 and company Business Plan process?

We strongly agree that Ofgem should consider how research approaches, such as deliberative techniques, can help to embed the consumer voice into the whole ED3 period, including company business plans.

To avoid duplication of effort and a patchwork approach to consumer engagement, Ofgem should consider centralising research, particularly for areas of the price controls where Ofgem is seeking to drive consistency rather than variation in approach and outcomes. Variation in outcomes can easily result from engagement and research undertaken differently and may not reflect genuine variation. This can lead to postcode lotteries.

In other areas where variation may be the right outcome, guidelines should be set for companies on what methods are acceptable and can be deemed suitably robust to inform plans and Ofgem decision making. The networks should also be encouraged to work collaboratively on research design, sharing best practice.

ED3 will likely contain many significant trade-offs and we believe Ofgem must be at the heart of understanding views on those trade-offs, rather than being recipients of that evidence.

Citizens Advice would welcome further discussions with Ofgem on how Ofgem-driven research can deliver new insights for price controls.

Q29. How should our approach to enhanced stakeholder engagement be adapted to better include the perspectives of all vulnerable customers, including those that are seldom heard, digitally disengaged/excluded and those that are worst served?

We would suggest the use of deliberative research to be key to ensuring all perspectives can be reflected in network company business plans and Ofgem decision making in a more meaningful way. This would widen the scope of topics and issues that a broader range of consumers could contribute to and better enabling trade-offs to be understood.

In the past we have not been convinced that some consumer research and engagement activities provide useful or meaningful evidence as it is unclear what existing knowledge consumers might have on the topics to make informed decisions and choices. Deliberative techniques significantly improve the quality of research, particular with groups who may have more limited existing knowledge of network companies and their activities.

Worst served customers, in particular, would benefit from consistent engagement approaches. We know that worst served customers in terms of electricity reliability seem to typically have a base level expectation of interruptions, often due to living rurally. As reliance on electricity is only set to grow, and particularly in rural areas where there are few alternative options for decarbonising homes, ED3 presents a new opportunity to ensure the needs and experiences of worst served customers are properly understood.

Q30. What alternative or additional approaches might we use to ensure that the consumer voice remains central to our policy setting process?

As we have highlighted on many occasions, price controls remain asymmetric in commercial incentives, information and resources.

Network companies have an unambiguous commercial incentive to achieve price control arrangements which, overall, provide them with the best chance to earn returns which are as high as possible. They also have informational and resource advantages.

However, those representing consumers' interests, including Citizens Advice as the statutory consumer advocate, are aligned with public interest and

government ie. that price controls should deliver networks that consumers and network users require at the lowest cost and provide good quality services.

These aims are also broadly the same outcomes for consumers that Ofgem seeks to drive.

Yet decisions routinely lead to outcomes within price control periods which do not appear to deliver this at lowest cost to consumers with returns set higher than necessary.

For example, we believe that the current methodology for setting the cost of capital leads to returns which are too high. In response to Ofgem's final determinations for ED2 we stated that the methodology resulted in at least £1.5 billion in excess returns going to companies using Ofgem's own cross-check figures[3]. In our previous work Monopoly Money[4], we also found regulators allowed networks across essential markets to overcharge consumers by £24.1 billion over the past 15 years.

The government's consultation on strengthening economic regulation in energy, water and telecoms sectors[5] also identified the issue of high returns citing the NAO's 2020 report on Electricity Networks, which highlights that, based on available data, energy network companies forecasted 9.2% returns on average, in comparison with average FTSE returns of 5.25-5.75%"[6].

In response to a question asked by the previous government on how economic regulators can better deliver their remit, we provided the following response on the need to rebalance these asymmetries. We believe these issues still need to be addressed and are key to ensuring that the consumer voice remains central to our policy setting process.

Rebalancing asymmetries

It is important that economic regulators' remit includes explicit requirements to actively recognise and rebalance the inherent asymmetries between industry parties and those representing consumers interests. For economic regulators to

[3] Citizens Advice, Our views on Ofgem Final Determinations RIIO-ED2, March 2023
[4] Citizens Advice, Monopoly Money: How consumers overpaid by billions, 29 May 2019
[5] Department for Business and Trade, Smarter regulation: strengthening the economic regulation of the energy, water and telecoms sectors, November 2023
[6] National Audit Office, 'Electricity Networks', 2020,

protect consumers interests, consumer voices must be heard throughout the regulatory processes.

It is then essential that economic regulators recognise and seek to address the resource and process asymmetries that exist. Currently there is an imbalance between the strength of the industry voice versus the consumer voice:

1. **Commercial interest.** Government and consumer bodies have a common public interest in ensuring networks are able to support GB to meet net zero targets in an efficient way and with the right returns for investors (i.e. neither too high nor too low). In contrast, investors (and companies) have an unambiguous interest in the allowed cost of capital being as high as possible and overall price control arrangements being as favourable as possible to maximise returns.

2. **Resource asymmetry**. Companies have a considerable commercial incentive to invest resources (time, personnel, consultancy fees) into the regulatory process and have the financial ability to do so. Consumer advocates, on the other hand, are at a disadvantage with fewer financial and personnel resources to contribute to the process. For example, in developing ED2, there were 78 working group meetings in one year, each lasting 2-3 hours, to determine key elements of price controls. Citizens Advice managed to attend around a third of these whereas industry could afford to have voices at all of them. Such processes worsen asymmetries rather than addressing them.

3. **Process asymmetry**. The process also needs to better recognise these asymmetries throughout the whole regulatory process and take actions to redress the balance.

   Ofgem, for example, has acknowledged these issues, stating that the network price control process results overall with a balance of risk which favours the networks[7]. This therefore comes at increased cost and risk to consumers.

   This must include appeals to the CMA where only the regulated companies have effective appeal rights meaning the appeals regime serves to worsen the situation, which is already skewed against the

[7] Ofgem, Open Letter: Future Systems and Network Regulation, September 2022

interests of consumers. In practice this would need other interested parties, such as statutory advocates, to have effective appeal rights which can be used without undue barriers and recognise the asymmetries in resources.

It is essential that economic regulators proactively rebalance these processes by giving appropriate weight to the submissions of consumers bodies versus investors and the companies. Namely, regulators should give special weight and consideration to the submissions of consumer bodies throughout price control processes, in reflection of their common interest with the public interest, in their limited resources, and in their (currently) limited regulatory appeal rights.

In contrast, regulators should treat the submissions of investors – via the companies and their advisers – with considerable caution, in reflection of investors' very substantial vested interest in the outcome of such regulatory decisions.

In addition, processes should also be amended to better enable the consumer voice to be heard. We welcome some improvements made by Ofgem recently to assist consumer representation in price control development processes, however, we think more needs to be done to ensure views aligned with consumer interest are reflected in Ofgem's decision making.

For clarity, regulatory processes should not be changed in a way that comes at the cost of robustness as this would be a false economy.

Q31. Has the BMCS incentive served its purpose in driving performance improvements and how can we adapt the metrics to better incentivise performance across a wider range of interactions between DNOs and their customers, particularly relating to connections?

The BCMS incentive (comprising a Customer Satisfaction Survey and Complaints Metric) has been an important means of driving improved customer service across DNOs.

However, as noted, service levels have improved and there is a question about whether the benefit of levels exceeding 9/10 produces diminishing returns relative to the cost of doing so. We believe that Ofgem should consider different types of incentives where the aim is to maintain performance in the sector or to

ensure a levelling up of service to consistent levels between companies if necessary. Zero sum incentives with minimum level requirements are one option to achieve this.

If the BMCS is to expand to potentially better capture the interactions networks have with customers then we think a zero sum incentive could still be applicable.

One aspect of connections that may need consideration is the extent to which householders and installers are primarily receiving a direct or indirect service from DNOs. Advice from government[8] indicates that in many instances householders may not need to make direct contact with DNOs, whereas installers of low carbon technology will do where necessary. While satisfaction of householders will of course be key, Ofgem should explore whether the BMCS suitably captures and reports the nature of these interactions.

The BMCS is a good example of an incentive which has led to the service levels intended. However, it is also an example of an incentive where network companies receive baseline allowances in order to perform these services. It is therefore essential that any targets and baselines reflect what should be realistically expected to be achievable with the baseline allowances already provided to companies.

Q32. How should the CVI be adapted for ED3 and should we consider greater alignment with the GD sector?

We believe the PSR reach aspect of the CVI will likely need altering in ED3. We remain highly supportive of a multi-sector PSR being implemented and believe this should be achieved without any further delay. Improving the journey for consumers to provide and maintain their data across energy networks and beyond, would significantly shift how PSR reach is achieved and the incentive may no longer be needed to drive this outcome.

We agree that electrification of cooking and heating appliances means that guaranteed standards protections in place for the gas distribution sector

[8] UK Government, Guidance: How to register energy devices in homes or small businesses: guidance for device owners and installation contractors

should be explored for electricity distribution to ensure customers in vulnerable circumstances do not experience harm during interruptions.

Q33. Should DNOs have a role in delivering energy efficiency measures to homes and businesses? What might the scope of these services be and how should they be funded?

It is important that consumers should be able to access energy efficiency benefits. However, it is not evident that DNOs have the capability or incentive to deliver such benefits and funding of DNOs to deliver energy efficiency measures may simply add additional costs to consumer bills.

As existing schemes may be best placed for delivery, DNOs should ensure that they have strong referral pathways in place, both for government schemes (such as ECO4) and localised initiatives. Referring customers onto advice or delivery providers can enable DNOs to maximise the value of their contact with their customers.

There may be some low regrets activities such as DNOs providing data to support the targeting of energy efficiency schemes if, for example, energy efficiency deployment through existing schemes, and in particular areas, could resolve temporary network capacity issues. However, this would need further exploration on how effective this would be.

Furthermore, we believe there would be a high risk that funding such activities through network charges could result in a transfer of value from poorer households to wealthier households without significant protections and targeting.

Q34. How can we drive further service improvements under the TTC incentive?

We note that the Time To Connect (TTC) incentive has been effective in reducing the time taken to make connections at lower voltages, though we still believe the targets set by Ofgem for ED2 were not ambitious enough. Ogem should ensure that any improvements are consolidated by re-calibrating the incentive towards more stretching targets. If a natural floor exists for how short the TTC timeframes can be, we would recommend that Ofgem calibrates the incentive in consideration of this.

Q35. Should the TTC also apply to domestic connection upgrades ie fuse/cutout/service cable upgrades, including unlooping?

Yes. With the predicted uptake of LCT in ED3 we agree that the scope of incentives related to enabling LCTs in domestic and small business properties needs to be examined to ensure they capture the way customers and/or installers will be interacting with DNOs.

We would expect the end to end connections review published by Ofgem to also reveal the services that customers and installers experience which may be appropriate to be within scope of an evolved TTC/TTQ incentive.

Q36. What is the best approach towards incentivising services to major connections customers and how should the MCI be adapted for ED3?

Both the TTC and MCI incentives should incorporate improvements identified from Ofgem's end-to-end review of the incentives, obligations and standards relating to electricity connections.

Q38. In the context of greater electrification, is our current approach towards regulating reliability appropriate for ED3?

We agree with Ofgem that the ED3 price control framework should drive reliability to levels which are acceptable and desired by customers.

We agree with Ofgem conducting a study on the value of lost load (VoLL) to understand how the value consumers place on avoiding interruptions may have changed and how this could keep up to date. We know from worst served customers that while reliability is desired, there are also levels of interruption which may also be deemed acceptable. The aim of any reforms to the reliability incentive will be to drive the right balance to be met in an efficient way and reflecting customers' changing use of electricity networks.

We consider that reliability, even where it is regional, may be an area where centralised Ofgem insights, such as through VoLL, are particularly beneficial due to high historical costs involved in reliability, such as the £1billion of rewards received by network companies in ED1 which we believe were clearly excessive.

We believe that incentives, of some kind may be required, whether to drive further and continual improvements to a level desired by customers, or to ensure performance is maintained and does not decline.

Q39. What role should bespoke outputs and CVPs have in ED3?

Ofgem notes the ED2 experience of bespoke outputs was that disproportionate regulatory burden was experienced relative to the proposed benefits that would be delivered. Also, there was a 'postcode-lottery' of benefits as we have highlighted on many occasions. The postcode lotteries are particularly acute when other companies are not compelled to follow the best practice of a successful CVP proposition and the potential for further rollout may be delayed by the entire length of the price control (5 years in the case of ED2).

We support the suggested approach of narrowing the eligibility criteria for bespoke outputs and raising the bar for applications. It is important that DNOs have an opportunity to advance ideas for added consumer benefit, but these should try and focus on delivering initiatives where many consumers may benefit rather than solely within one DNO.

We would encourage Ofgem to identify a process as part of business planning that allows any CVPs, if continued, to be revealed, assessed, and widened to all relevant DNOs before the start of the price control. Only with broad scope and wide applicability can CVPs deliver the maximum consumer value. Under the current arrangement we believe consumer value is being wasted.

Q40. How can we optimise late and early competition models for application in electricity distribution?

We support the use of early and late competition in the ED sector as in the ET sector.

Particularly where supply chain constraints are a concern, innovative options and providers must be considered where this can deliver faster or more effective solutions and potentially provide price competition for DNOs.

Q41. How should our approach to cost assessment evolve, to enable us to better manage increasingly pronounced trade-offs between consumer protection, efficiency and investment in the distribution network?

For ED3, Ofgem considers that the cost assessment methodology will need to be adapted to ensure it delivers value for consumers by considering the whole energy system, especially the need for increased LRE investment. Ofgem is considering simplifying the ED2 cost assessment approach and relying more on bespoke ex-ante cost assessments or expanding ex-post cost assessments. Ofgem also note that the potential output of RESPs in defining network investment needs will have an impact on the scope of cost assessment needed.

The determination of efficient ED3 totex allowances is a critical part of Ofgem's role in delivering value for money for consumers. The majority of DNO expenditure is applied to asset replacement and operational expenditure, and it will be important to retain a rigorous efficiency assessment and performance improvement regime. This should not be diluted for ED3.

Q42. How should our guidance for cost benefit analysis evolve to better enable optioneering between different interventions, taking relevant long-term risks and benefits into consideration?

For LRE and other expenditure areas where there may be considerable uncertainty about volumes and timing, it will be important for uncertainty mechanisms to be effectively defined together with associated measures to ensure expenditure is both needed and is delivered efficiently. We agree that RESPs may have an important role to play in defining need but would question whether there can be sufficient maturity or consistency in these plans for ED3.

Q44. Do you agree that the current approach to setting the ongoing efficiency challenge is a suitable starting point for ED3?

Yes, we agree this approach is appropriate for ED3.

Q45. Do you see any reason why we should not implement the proposed changes to the calculation allowed returns, consideration of investability and assessment of financeability that we set out in RIIO-3 Sector Specific Methodology Decision – Finance Annex for ET, GT and GD?

We note that Ofgem's approach to setting the allowed return on capital and the assessment of financeability will be substantially in line with the approach taken in ED2. Ofgem plans to continue improvements already announced for the RIIO-3 price controls for ET, GT and GD. These methodological improvements are proposed to include:

- updates to best practice when calculating the cost of capital using the Capital Asset Pricing Model (CAPM), building on the 2023 UKRN Guidance;
- the payment of an element of the debt allowance in nominal terms to address the inflation leverage effect;
- implementing a RAV-weighted approach to setting the cost of debt allowance for the ED sector;
- the consideration of 'investability' to better understand whether the allowed return on equity from our methodologies continues to meet the needs of the energy network sectors; and
- investigating broadening the toolkit used when assessing financeability.

As set out in our response to Q1 above and in response to Ofgem's draft[9] and final[10] determinations for ED2, we consider that the design of the ED2 price control financial parameters is, as for ED1, still unduly generous to investors and does not represent value for money for consumers.

While we recognise that the proposed RIIO-3 regime seeks to address these design failings, we remain concerned that the Ofgem approach to ED3 financial parameters will continue to be unduly generous to network companies. Ofgem's proposal to consider 'investability' is vague and seems structurally biased towards accepting arguments of investors that higher equity returns are needed.

[9] Citizens Advice, Response to ED2 draft determinations, August 2022
[10] Citizens Advice, Our views on Ofgem Final Determinations RIIO-ED2, March 2023

It is essential that Ofgem looks beyond subjective narratives and focuses on objective evidence and that equity returns are better aligned to equity costs.

National Grid Rights Issue

In May 2024 National Grid (NG) who own both Transmission and Distribution network companies in GB announced a £7billion Rights Issue (RI)[11]. They offered a 34.7% discount to the theoretical ex-rights price[12], within the average interval for UK companies[13]. The offer had a 91% acceptance rate[14], within the average range for the UK[15]. The RI was the largest one registered in the UK since 2009[16] and the issue was a part of NG's proposed investment strategy for the financial years of 2025 - 2029[17].

This was a remarkably successful RI with investors purchasing additional shares despite not being associated with clear investments, timings or returns as well as taking place ahead of Ofgem's RIIO-3 methodology decision in July 2024.

This strongly indicates that Ofgem' existing cost of equity methodology is already providing exceptional attractiveness to investors and that rather than being higher, cost of equity returns could be lower than RIIO-2 without impacting the ability for NG to attract and retain capital.

Raising £7billion of equity in one day without warning suggests capital is available, plentiful and financeable.

ENWL acquisition

In June 2022, Ofgem published a MAR inference model within its electricity distribution price control draft determination (ED2)[18]. Ofgem used this MAR model to infer a CoE from recent transactions involving monopoly network companies. Ofgem found that the transactions are consistent with a CoE range of 3.2% to 3.9%[19].

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[11] "Results of Rights Issue" London Stock Exchange, 7 April 2024.
[12] "NG Announces Fully Underwritten £7bn Rights Issue", NG, 7 April 2024.
[13] "Encouraging Equity Investment", Association of British Insurers, July 2013, page 36.
[14] "Top News: NG Gets 90% Acceptances for GBP 7 Billion Raise", Morningstar, 11 April 2024.
[15] "RPC's Response to the UK Secondary Capital Raising Review Call for Evidence", November 2021, page 6.
[16] "Further Issues Summary", London Stock Exchange, 31 July 2024, accessed September 2024.
[17] "National Grid's Investment Proposition", NG, May 2024.
[18] "RIIO-ED2 Draft Determinations – Finance Annex", Ofgem, June 2022. Page 181
[19] "RIIO-ED2 Draft Determinations – Finance Annex", Ofgem, June 2022. Page 44

Analysis below has applied Ofgem's MAR inference model to the recent transaction of ENWL[20] in August 2024 in a table alongside the calculations Ofgem presented in its ED2 draft determinations.

Figure 9: Ofgem's Market to Asset Ratio inference model and ENWL transaction

Component	WPD	Bristol	SGN	NGGT	ENWL	ENWL	ENWL	Formula
Baseline allowed ROE	4.65%	4.09%	4.55%	4.55%	5.43%[21]	5.43%	5.43%	A
Expected Outperformance	2.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	B
Real ROE	6.65%	5.09%	5.55%	5.55%	6.43%	6.43%	6.43%	C = A + B
CPIH	2.00%	2.00%	2.00%	2.00%	2.00%[22]	2.00%	2.00%	D
Nominal ROE	8.65%	7.09%	7.55%	7.55%	8.43%	8.43%	8.43%	E = C+D
RAV Growth (Real)	2.00%	2.00%	2.00%	0.00%	0.00%	1.00%	2.00%	F
RAV Growth (Nominal)	4.00%	4.00%	4.00%	2.00%	2.00%	3.00%	4.00%	G = D + F
Dividend pay-out ratio	70%	61%	64%	100%	100%	84.45%	68.90%	H = 1 - F/C
Dividends paid	4.65%	3.09%	3.55%	5.55%	6.43%	5.43%	4.43%	I = H * C
Market to Asset Ratio (MAR)	1.61	1.44	1.35	1.3	1.44[23]	1.44	1.44	J
Notional Gearing	60%	60%	60%	60%	60%[24]	60%	60%	K
Equity Multiple	2.53	2.10	1.88	1.75	2.10	2.10	2.10	L = (J-K)/(1-K)
Real Cost of Equity	3.80%	3.50%	3.90%	3.20%	3.06%	3.59%	4.11%	M = I/L + C-I

The ENWL transaction based on Ofgem's model suggests a potential real cost of equity between 3.06% and 4.11% depending on real RAV growth suggesting that returns in this sector are already too high and the difference between baseline

[20] Iberdrola, Acquisition of Electricity North West, August 2024
[21] Ofgem, RIIO-3 SSMD Allowed Return on Equity Early View Summary Calculations
[22] Ofgem, RIIO-3 SSMD Finance Annex
[23] Iberdrola, Acquisition of Electricity North West, August 2024
[24] Ofgem, RIIO-3 SSMD Allowed Return on Equity Early View Summary Calculations

allowed return on equity and real cost of equity has grown since Ofgem produced this analysis for ED2.

Iberdrola have also said they paid a 44% premium for ENWL[25] demonstrating that these companies are already highly attractive investments.

Several elements of the proposed Ofgem ED3 price control framework e.g. use of uncertainty mechanisms, anticipatory LRE allowances, dilution of NARM incentives, digital investment allowances, less-onerous totex assessments, etc., appear to further reduce the risks faced by companies. This would argue for a lower equity return being necessary.

We would stress the importance of focussing on objective evidence when determining financial parameters. This should include the premium investors are already willing to pay for these companies, the apparent availability of capital, the historic likelihood of regulatory outperformance, and the many ways that Ofgem may further reduce the risk of these companies. Customers deserve a fairer deal.

Q46. Do you see any reason why we should not implement the proposed updates to financial resilience requirements that we set out in RIIO-3 Sector Specific Methodology Decision – Finance Annex for ET, GT and GD?

No, we strongly support further financial resilience requirements and can see no reason why requirements relating to financial resilience should differ across different sectors. Citizens Advice responded to Ofgem's ringfence review[26] and believe this should be a high priority for Ofgem. Securing the financial resilience of network companies minimises risks to consumers, but Ofgem's expectation is that making network companies even more resilient to wider economic environments should also improve their credit rating. This in turn makes them an even safer investment for current, and any other potential, investors. This should lead to savings in the cost of capital.

As mentioned throughout this response, it is essential that Ofgem recognises the many ways in which its decisions will be further reducing the risk of network companies that are already significantly safer than typical markets. The

[25] Iberdrola, Acquisition of Electricity North West, August 2024
[26] Citizens Advice, Response to Ofgem's call for input on the energy networks ring fence review, December 2024

compounding effect of these decisions in reducing risk for companies (and in some cases transferring that risk to consumers) must be reflected in the cost of capital calculations. Otherwise those calculations will be inaccurate and fail to reflect the decisions Ofgem has taken itself. In a period of increased investment, getting the cost of capital wrong will likely cost consumers £billions more than is necessary.

Q47. What are the key factors (including benefits and costs to consumers) that Ofgem should take into consideration when conducting its review of the appropriate approach to regulatory depreciation in ED3 and beyond?

It's essential that reviewing regulatory depreciation considers the actual size of potential bill changes and when these will occur for consumers. The proportion of energy bills covering network costs is already likely to increase and understanding bill impact over the depreciation period will need to be understood.

Ofgem should also consider how much the total cost and total returns paid to companies could be under different scenarios.

This may be an area where, again, centralised research by Ofgem on intergenerational fairness should be beneficial.

Smarter networks

Q49. What should the role of the DSOs be in identifying and delivering whole system benefits?

In ED2, Ofgem focus was on a 'flex-first' approach where flexibility was used to manage localised network constraints and defer the need for costly infrastructure upgrades. However, Ofgem now considers that system-wide benefits (and consumer value) of distribution-based flexibility may be larger than the savings from deferring distribution investment. Ofgem notes that the 'flex-first' approach may be a false economy if it overlooks the system-wide benefit of distribution network reinforcement.

We consider that consumers will benefit from a regime where both:

a) distributed flexible resources (generation, storage, demand response) can respond to national market price signals, and

b) the capacity of distribution networks is visible and efficiently uses flexibility resources in both the short and long-term.

These factors are inter-related in that flexible demand/generation outputs will impact distribution network peak capacity needs. But currently price signals for distribution network congestion are not coordinated and so risks the deferral of investment and loss of national system-wide benefits. We suggest that further consideration be given to how these price signals can be better coordinated and realise flexibility benefits for both national energy markets and local network investment.

We note that the Government's Clean Power Plan 2030 has consumer-led flexibility as a major contributor to the delivery of 2030 targets with a potential 10 GW of additional flexibility being introduced. This could make a significant difference to distribution network investment needs. Ofgem's proposed approach to favour network investment over flexibility may add additional costs in some cases.

For ED3, Ofgem considers that DSOs should continue to focus on improving network visibility and digitalisation to support the development of smart grids. The latter is key to enabling demand-side response, storage, and distributed generation to respond to market signals or direct load control. We agree that network visibility for DNOs and third parties is a critical issue.

We agree there is a strong ongoing need for robust DSO functions in ED3 to deliver network visibility, efficient network capacity and use flexibility for the benefit of existing and future consumers based on whole system value. DSO monitoring and performance incentivisation should continue and be enhanced to ensure that performance is improved for ED3. In particular there will be a need in any incentives and monitoring to ensure that the net benefits to consumers are clearly quantified, which has been identified already as an area for improvement in ED2.

Q50. Our historic approach to publishing and sharing datasets has been stakeholder led and focused on establishing good digital foundations in the DNOs. With the rapid pace needed for enhanced data and digitalisation, should we instead be considering incentives around strategic priorities, such as network planning, flexibility, and connections?

We do not think that incentives should replace a collaborative approach between stakeholders, Ofgem, and networks to publishing datasets. If Ofgem intends to use incentives in this area, it should be clear on how these will go above and beyond the existing Smart Optimisation Output (SOO) licence obligations.

We would also note that, anecdotally, network companies have concerns about getting the right balance between making suitable data available and concerns about cyber security and potential threats to the network. We do not see the publishing of data to be an area where there is benefit to networks progressing this with their own discretion and with the risk of inconsistency across licence areas.

Those wishing to engage with this data may be more regionally focussed or nationally focussed. It is therefore beneficial to ensure that there is consistency across GB in what data is available and how it is accessed and interacted with to minimise barriers to connection customers, flexibility providers, aggregators and many other interested parties.

Ofgem's intention to determine the scope of a modern reporting process during ED2 is a positive step. However, we are concerned that slow progress on initiating this project has led to a lack of data for stakeholders to assess during the ED2 period. We are keen to see the project progressed quickly so that a fully digitised reporting suite is available for the beginning of the ED3 period.

We strongly urge Ofgem to ensure that use of digitalisation improves performance reporting and monitoring. We believe Ofgem should apply a principal of open data - ie that network company performance data should be open by default and only information that is commercially sensitive should be redacted.

We believe this is a significant but important change from the current arrangements whereby significant volumes of data are collected and submitted

to Ofgem by companies, but very little is published by Ofgem. In the absence of visible Ofgem assessments, it is unclear what monitoring and compliance activity is taking place and whether Ofgem deems performance of companies and of the price control to be positive or not.

In our view, digitalisation provides an opportunity to achieve this without very significant additional resource burdens. It is also a key component of price controls which we believe is currently missing.

Q53. Our aim is for the ED3 framework to be structured to deliver high impact, transformative innovation – do you think that further changes, alongside those proposed for the other sectors in our RIIO-3 SSMD, are required to deliver this?

We support the ambition of the ED3 framework to deliver high-impact, transformative innovation that benefits both the energy network and its consumers. However, we observe an imbalance in the current approach to innovation incentives. Specifically, the existing incentives primarily encourage the deployment of innovations that achieve network efficiency and cost savings, but place less emphasis on innovations that deliver direct benefits to consumers or the wider energy system.

To address this, we believe targeted adjustments to the incentive structure are necessary to ensure a more balanced approach. Incentives should actively promote innovation projects that focus on consumer-centric or whole-system outcomes, such as enhanced reliability, and better accessibility of energy services. This rebalancing would align innovation more closely with the ED3 framework's overarching aim of delivering improved outcomes for consumers.

A framework designed to deliver high-impact, transformative innovation must also prioritise transparency and accountability. However, significant shortcomings in the current framework undermine the effective monitoring and evaluation of innovation projects.

Reports submitted to the Smarter Networks Portal often lack standardised and detailed information regarding project deployment, outcomes, and long-term application.

Our forthcoming research highlights that fewer than half of Network Innovation Allowance (NIA) projects specify how their results will be applied following

completion. This lack of clarity makes it difficult to determine what innovations are being delivered, the tangible benefits achieved, and how these outcomes are integrated into the network or scaled to provide broader system and consumer benefits.

Given that, currently, 90% of innovation funding is ultimately contributed by consumers, the absence of clear and accessible information makes it challenging to hold network operators accountable for the use of these funds.

To address these issues, we recommend establishing a robust monitoring and evaluation system to track project progress and assess outcomes against predefined metrics, such as cost savings, emissions reductions, and improvements to reliability. Transparency should be embedded as a regulatory requirement under the RIIO-ED3 framework, supported by standardised and publicly accessible reporting. These reports should provide clear information on project objectives, outcomes, lessons learned, and plans for scaling results to maximise long-term value for consumers and the wider energy system.

Q54. Are there any factors particular to DNOs that facilitate or challenge deployment of innovation on their own and across networks?

One significant challenge in deploying innovation is the cost associated with implementation, such as investing in new network equipment and additional staff resources. These financial barriers often discourage network companies from rolling out proven innovations, even when the long-term benefits to consumers and the wider energy system are clear. To address this, we propose introducing a reopener mechanism that allows network companies to apply for additional totex allowances specifically to cover the costs of deploying innovative solutions. For this mechanism to function effectively under RIIO-ED3, we recommend allowing network companies to submit applications to Ofgem throughout the price control period, rather than limiting applications to fixed windows. This flexibility would encourage the quicker deployment of proven innovations.

Another key challenge is the lack of sufficient incentives for network companies to adopt innovations, particularly if they do not deliver an immediate financial benefit to the companies themselves.

We welcome the work underway by Ofgem to consider how innovation that may be beneficial to consumers in a range of ways can secure better, more consistent and faster deployment rates. We are open to options about how to achieve this and welcome Ofgem's approach in not only considering financial incentives. We believe there is the potential for Ofgem to play a greater role in both monitoring the progress and success of projects, as well as potentially the identification of solutions which warrant widescale deployment.

We believe there is merit in considering whether a company's track record in delivering past innovation projects should be a key factor in determining future funding eligibility. Companies with a proven ability to successfully deliver innovation, rapid deployment, and achieve measurable outcomes could be prioritised. This may be a way of further applying incentives.

Resilient and sustainable networks

Q55. Do you agree that we should retain the Network Asset Risk Metric (NARM)? How should it further evolve in ED3?

We agree that NARM is an important output measure in the price control to hold companies accountable for their investment decisions and to ensure they are effectively managing their assets. The full scope of consumer value should be reflected in the weighting, and risk should be considered on an individual basis, for example where an asset risk would disproportionately impact consumers in vulnerable circumstances, either now or in the future.

Q56. Do you agree that we should consider a more integrated approach to managing asset health, together with load-driven expenditure, given the need to future proof for resilience (climate, cyber and physical security) and future demand? What might the risks and benefits of this approach be?

We note that, based on the Ofgem's analysis of Year 1 RRP submissions for RIIO-ED2, DNOs have delivered on average 14.70% of their Baseline Network Risk Outputs established for RIIO-ED2. This is below the 20% annual average that might be expected in a 5 year price control if the output is delivered equally across all years. To highlight performance, it would be helpful if Ofgem

could produce detailed annual analysis of NARM performance by individual DNO.

We note that Ofgem are considering changes to the NARM regime to make it more input based but no evidence is presented to support this, nor explain why it is more beneficial for consumers. Additional complexity may make this measure increasingly opaque to external observers.

A key risk of input-based measures is that Ofgem does not have sufficient information to set the inputs accurately, potentially making the regime unduly benign for DNOs.

Q59. Do you have any comments on the suitability of current incentives to ensure that consumers continue to receive a reliable service in the face of climate hazards?

We agree that it is in the interests of consumers to maintain network reliability by addressing climate resilience in price control decisions. We welcome that Ofgem is engaging with key stakeholders to build a collective understanding of the need for and challenges of climate resilience for ED3.

An input-based (and monitoring) approach appears appropriate to ensure that the necessary climate resilience measures are delivered. The existing reliability metrics appear appropriate for measuring reliability performance though, as noted above, it will be increasingly important to better understand what levels of reliability are needed among consumers increasingly reliant on electrified technologies, those already worst served, and what whether improvements are needed to address short interruptions.

Q60. Do stakeholders agree with retaining and strengthening the main components of the environmental framework from RIIO-ED2?

We agree with retaining and strengthening the framework from ED2 as proposed. We also agree that Ofgem should develop the price control approach to better and more consistently consider network losses in network interventions as proposed.

Q65. What would the benefits be of a geographical approach to delivering new and upgraded assets in terms of supply chain and workforce constraints?

Ofgem wants to help alleviate these pressures through a regulatory framework that stimulates confidence and growth of energy sector supply chain and workforce capacity. Ofgem state this is consistent with their Growth Duty.

Ofgem note that ED2 already includes provision for operational training and requires companies to address workforce and supply chain resilience. An option to allow advanced procurement may be considered for ED3.

We agree it is in consumers interests to ensure that they are not faced with higher costs due to the regulatory regime not allowing these pressures to be mitigated. But the inclusion of such regulatory actions will reduce risk and cost for DNOs and this must also be recognised in the regulatory regime and particularly in setting the cost of capital.

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