RIIO-3 Sector Specific Methodology for the Gas Distribution, Gas Transmission and Electricity Transmission Sectors

A Citizens Advice consultation response

March 2024

Contents

Introduction

We can all face problems that seem complicated or intimidating. At Citizens Advice we believe no one should have to face these problems without good quality, independent advice. We give people the knowledge and the confidence they need to find their way forward - whoever they are, and whatever their problem.

We provide support in approximately 2,500 locations across England and Wales with over 18,000 volunteers and 8,650 staff.

Through our advocacy work we aim to improve the policies and practices that affect people's lives. No one else sees so many people with so many different kinds of problems, and that gives us a unique insight into the challenges people are facing today.

As the statutory consumer watchdog for the energy and post industries we have an important role to play in shining a spotlight on the problems consumers encounter, providing solutions to these problems and ensuring their voices are heard when important decisions are made about the future of these essential markets.

Executive Summary

Citizens Advice welcomes the opportunity to respond to Ofgem's RIIO-3 Sector Specific Methodology for the Gas Distribution (GD), Gas Transmission (GT) and Electricity Transmission (ET) Sectors. 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, questions left unanswered in the consultation, or topics where we may diverge from the positions of Ofgem or the networks.

The cost of capital will likely be set too high. In basing its approach on the UK Regulators Network (UKRN)'s guidance on the methodology for setting the cost of capital, Ofgem will set network returns at an unjustified level, benefiting company shareholders at the expense of consumers. This is due to UKRN's guidance bringing together existing methodologies and so consolidating the positions of regulated companies that have a commercial incentive to deliver high returns. Without attempts to remove the asymmetries between companies and consumer advocates, the trend of inflated network profits will likely continue into RIIO-3.

The incentive regime requires a lot of development to avoid over-rewarding companies.

- Financial incentives need to be reviewed and recalibrated following an assessment of RIIO-2 performance. Many incentives in RIIO-2 such as customer service and interruptions have rewarded networks. Without a qualitative assessment of whether incentives worked to drive performance improvements in RIIO-2, whilst also crucially delivering consumer value for money, it will be difficult to make informed decisions on whether they should be retained, modified or removed in RIIO-3.
- Ofgem should also ensure the principles of each financial incentive, including usable descriptions of performance that deserves rewards/penalties are set out clearly up front in SSMD to best enable subsequent discussion and decision making on calibration.

- Some electricity transmission incentives require significant changes. The Accelerated Strategic Transmission Investment (ASTI) mechanism is weighted in favour of improving the risk/reward ratio for Transmission Operators (TOs) rather than reducing costs for consumers. Additionally, incentives on TOs to manage constraint costs allowed them to earn over £8 million in rewards in one year compared to costs of £1 million.
- Ofgem should strongly consider setting sharing factors on a consistent basis across sectors and at a lower level than in previous price controls. At present, evidence does not indicate that high or low sharing factors materially alter company behaviour, but do clearly alter the value for money consumers experience. Ofgem must ensure sharing factors are set at a level which drives efficiencies but delivers maximum consumer value for money, particularly where investment is set to increase.

Gas decommissioning should not be funded through RIIO-3. The government has yet to make decisions on how and when the gas network will be decommissioned, and how it will be paid for. As all consumers will benefit from a decarbonised energy system, the fairest way to pay for decommissioning will be through general taxation. Ofgem should therefore not introduce any mechanisms or use RIIO-3 to fund these costs regressively amongst gas consumers.

Future Energy Scenarios should be selected carefully across different sectors. Though it is not necessarily essential for the chosen scenarios to remain consistent across GD and ET, the rationale for their selection should be consistently applied. In highlighting both Leading the Way and Falling Short for gas networks' planning pathways, Ofgem has provided two potential extremes of changes in gas demand. The System Transformation scenario should also be considered as it reflects the National Energy System Operator (NESO)'s 5 year forecast for a plausible decarbonisation pathway and seems a necessary additional data point to assess business plans against.

Getting this right matters beyond the direct impact on consumer bills. Unless these issues are addressed, the essential public support needed to achieve net zero could be undermined by perceived unfairness in the energy system.

Consultation response

1. Overview questions

Future of Gas

OVQ1. Do you agree with our proposal for how RIIO-3 should interact with the Hydrogen Transport Business Model?

Yes, we agree that the establishment of a hydrogen transport business model and hydrogen regulated asset base (RAB) means that the funding related to hydrogen network build, repurposing or preparation should be outside of the RIIO-3 process. This ensures there is a clear delineation between the funding and outcomes for activities relating to natural gas and hydrogen.

Without this there is a risk that the costs of any activities related to hydrogen could otherwise be recovered from natural gas consumers who may not necessarily benefit directly from that investment when its end uses are uncertain. We agree with the test that Ofgem suggests it will apply that there should be *'confidence in the need and clear benefits to natural gas consumers'*. Under this test it is unlikely that hydrogen-related spend would be justified in the absence of unambiguous policy decisions from government.

OVQ3. Do you agree with the proposal that network costs relating to hydrogen blending at both distribution and transmission level should be included in RIIO-3 net zero related UMs? If so, which mechanism do you think is most appropriate for these costs and why?

Yes, we agree. Whether blending will take place, and where it can take place, at the distribution level is not yet known and there is less certainty at this stage for transmission due to further anticipated consultations. We don't anticipate that these activities will be known in sufficient detail for business planning purposes in the short-term. Uncertainty mechanisms would therefore seem the most appropriate method.

However, government is explicit that the benefit of blending is primarily to support hydrogen production and not as a means of decarbonising gas. As with other hydrogen infrastructure investment, it is therefore not clear-cut that this is a benefit for natural gas consumers who would be funding these activities when compared to other RIIO-3 spending that is of benefit to current and future gas consumers.

Where hydrogen production is to support transport, industry or the electricity sector, Ofgem should set out if and how it sees this as directly beneficial to natural gas consumers. This should be mindful of:

- The context of the government's explicit rationale for its minded-to position on hydrogen blending at the distribution level
- That any future direct use by domestic and small business consumers is currently unknown and
- Ofgem's expectation that *"in all future scenarios a substantial amount of domestic heating will be electrified"*.

The principle of cost reflectivity is still relevant - i.e. that those who use more, or stand to benefit more, from infrastructure should face the proportionate costs of it.

OVQ5. What are your views on our proposal to not enable funding for further evidence relating to repurposing the existing network for hydrogen heating ahead of government's decision on hydrogen heating in 2026?

We agree that the evidence base for this decision is primarily a matter for government and we aren't aware of what specific evidence gaps would be required to be filled by networks ahead of 2026.

It is appropriate not to enable any further funding for evidence before the government's decision in 2026 due to the risk of customers funding activity from which they may not benefit.

OVQ6. Should RIIO-3 help to manage future gas network decommissioning costs? If so, do you have views on what these costs could be and what mechanisms should be used, including for anticipatory funding?

No, RIIO-3 shouldn't be used as the vehicle to manage future decommissioning costs.

We don't agree that the question of intergenerational fairness for decommissioning is similar to that for regulatory depreciation. The consultation states that the key principle for intergenerational fairness is that *'consumers pay network charges broadly in proportion to the value of network services they receive'.* This is a valid consideration for the building, maintenance and operation of the networks. However, there is no benefit to natural gas consumers associated with being charged for future decommissioning costs.

Therefore, it is clear that general taxation will be the most appropriate method of providing funding for decommissioning. The requirement to decommission is directly tied to the transition to net zero which is to the benefit of UK plc and all energy consumers. It is therefore the only progressive and fair way to fund decommissioning, if that is necessary.

We recognise that it has not yet been decided how decommissioning costs will be recovered. This reinforces that Ofgem should not pre-empt any decision by acting in an anticipatory manner, as this risks setting a direction of travel that is then harder to resile from. Cost recovery for decommissioning only from gas users does not reflect who will receive the associated value.

Role of Scenarios and Planning Pathways

OVQ7. Do you agree with the proposal to use the FES framework for selecting the RIIO-3 scenarios?

Overall, we agree that the Future Energy Scenarios are the most appropriate framework for selecting scenarios for RIIO-3. Given the transition of the electricity system operator (ESO) to the National Energy System Operator (NESO) which will be charged with carrying out central planning across all sectors it seems essential that price controls are informed by forecasts which will evolve from these. The annual iteration is also a significant benefit, ensuring that it is possible to use the most up to date information.

We agree that Ofgem should require business plans to be updated to reflect the updated FES due to be published in July 2024. We would also encourage Ofgem and the NESO to work together to explore whether publication dates can be better sequenced to reflect the need for network business plans and Ofgem decision making to be based on the most up to date and robust information available.

OVQ8. Do you agree with the proposal to use FES Leading the Way as the planning scenario for ET in RIIO-3?

In the context of needing to plan and build infrastructure ahead of need, we agree that it is appropriate for electricity transmission to use the Leading the Way scenario (or significant aspects of it) for RIIO-3, given it is the only scenario that meets the offshore wind target of 50GW by 2030 in the British Energy Security Strategy. Because of the important role of offshore wind it is necessary to ensure plans are on a trajectory to achieve this.

We agree with the views expressed by some network companies that it is logical that Ofgem ensures that the planning scenario used for ET also aligns with the transitional Centralised Strategic Network Plan (tCSNP2) and CSNP.

OVQ9. Do you agree with the proposal to use two FES planning pathways for the gas networks, ie Leading the Way and Falling Short as the additional common conservative scenario?

In principle we would prefer, overall, for common scenarios to be used across sectors for consistency, however the proposal to use 2 planning pathways for gas networks is a proportionate approach.

We anticipate that the risk of underinvesting in the electricity transmission sector will not be the same as underinvesting in the gas networks and, in particular, the gas distribution networks. The use of 2 (or more) scenarios should reveal the extent to which the investment need for gas networks differs between the 2 scenarios and in comparison to ET.

However, there are risks for Ofgem by using the 2 scenarios that sit at both extremes of changes in gas demand. This may make it more difficult to rationalise the most appropriate approach, depending on the extent to which the investment needs vary.

Ofgem should require the System Transformation scenario to also be used as a third scenario in gas given it reflects the NESO's 5 year forecast as a plausible decarbonisation scenario and seems to be an appropriate mid-range that Ofgem is likely to need to consider anyway if using two extremes.

OVQ10. Is Falling Short the most appropriate common conservative planning scenario to be used for the gas networks? Or is a common gas network developed scenario more appropriate?

While the FES Falling Short scenario is a useful conservative scenario we are concerned about how reliant Ofgem can be on its use given that it is premised on GB not meeting its net zero targets. The use of Falling Short as a data point would be more appropriate if a third scenario for gas (System Transformation) was also used.

We do not agree with developing an entirely separate bespoke scenario for gas networks. Consistency in the use of scenarios is important.

Outputs and Incentives

OVQ12. Do you agree with our proposed approach on the role, scope and format of PCDs?

Yes, we agree. PCDs remain an important part of price controls. At a time when speed of delivery is likely to be important and the scope of projects could change, we agree with the flexibility proposed by Ofgem and the focus on ensuring timely delivery of projects.

We note the concern expressed by a network company that imposing penalties from day 1 of a delay may not be in consumers' interests. Lessons should be learnt from ASTI timely delivery incentive, where the incentive was recalibrated to favour network companies at the expense of consumers.

Under the ASTI incentive, at best, TOs can earn a reward for delivering up to a year late and, at its worst, could earn a reward for delivering 2 years late[1]. Ofgem explicitly stated that they thought the ODI *"mitigates risk [that it is] asymmetric by design and systematically biassed towards penalties".* However, Ofgem doesn't acknowledge that with rewards still being earned for late delivery of up to 2 years it is clearly systematically biased towards rewards. It is essential that all timely delivery incentives strike a better balance than what is currently in place for ASTI to ensure the right balance between timely delivery and value for money is achieved and that outcomes do not undermine the legitimacy of the regulatory arrangements.

We agree that focussing PCDs on outcomes is a good principle. However, Ofgem and companies will need to be clear about how outcomes can be measured and assessed.

We welcome Ofgem's proposal for companies' business plans to include potential consequences of delays or failure to deliver PCDs to enable calibration by Ofgem. However, we would encourage Ofgem to consider whether there are preferred methodologies that network companies should use. Multiple impact methodologies used by companies across sectors could make calibration challenging.

Underspend

Where companies overspend allowances for PCDs but it delivers additional benefits for consumers we believe it is appropriate for the overspend to be subject to the totex incentive mechanism (TIM) sharing factors. We provide views in response to OVQ34 about the need for Ofgem to consider setting lower sharing factors to ensure they deliver the right balance between incentivising efficiency and delivering maximum value for money for consumers.

[1] Ofgem, Decision on accelerating onshore electricity transmission investment, Dec 2022

OVQ13. Do you agree with our proposed framework for setting financial incentives? Are there any additional considerations that we should take into account?

We generally agree with the proposed framework for financial incentives. However, despite acknowledging the RIIO-2 lessons learned feedback, we don't see any proposals which seek to address some of the issues identified, instead appearing to favour a status quo approach.

In particular, the consultation doesn't include any specific proposals which seek to address concerns about Ofgem's target setting approach and the use of relative or comparative targets.

The RIIO-3 proposals for financial incentives are fairly broad and, we think, miss the opportunity to set out what Ofgem views as the principles of financial incentives and further principles for each incentive. This would provide a much clearer starting point for further development of incentive calibration in working groups that can be tested against these principles.

As we set out during the ED2 process, in response to Ofgem's work on future regulation, and the reviews of economic regulation, we think Ofgem should also set out more detail on what justifies rewards and penalties.

Rewards - Ofgem states rewards will apply *"rewards where the overall cost of the incentive does not exceed the value of improvements to consumers, and where performance improvements are not already funded through the baseline"*. We agree with both of these however it should include that rewards shouldn't be provided for performance already achieved unless under a comparative metric. On an incentive level it must be clear what excellent performance looks like and where the threshold of baseline-funded performance sits.

Penalties - At present Ofgem's statement on when penalties are due is *"where we consider that a minimum standard of performance is expected and non-delivery leads to consumer detriment; and/or where a financial incentive may support requirements included within licence conditions"*. In our view this is a very narrow view of the role of financial penalties in a price control and does not reflect either the current suite of penalty only incentives or the potential use of penalties in RIIO-3.

Principles

Our view is that incentives should emulate competitive market conditions as far as possible. This means incentive schemes should be designed to reward those companies that are performing well relative to other network companies (and penalise those performing poorly) rather than against targets set in advance. This drives continual performance improvement where it is economically efficient to do so and for performance to peak at the point where this is no longer the case. Comparative performance metrics is a principle the department for business and trade specifically proposed in their consultation on economic regulation[2]. We support this and encourage Ofgem to put these in place for RIIO-3 where possible.

Where this isn't possible it is important that rewards are for improving and/or excellent performance and penalties for declining and/or poor performance and where targets move dynamically to reflect improving performance.

We don't think that fixed targets that only change every 5 years are suitably dynamic to achieve this and leads to routine outperformance which doesn't deliver value for money for consumers. Instead, Ofgem should deploy dynamic targets. We don't believe that network companies require every detail of an incentive scheme, including a fixed target for a 5 year duration in order to plan and perform well. For business planning purposes, network companies need to know the marginal impact of an incentive i.e. if performance improves by X, then financial performance changes by Y. Whether this is to earn a bigger reward or reduce a penalty is irrelevant for decision makers. So, whilst we understand that network companies would like targets fixed in advance and have profited from this in the past, it is clearly not necessary.

Improvements

We welcome the proposal to ensure financial rewards don't apply for performance improvements which are already funded through the baseline allowances due to this leading to consumers paying twice unncessarily. We also

[2] DBT, Smarter regulation: strengthening the economic regulation of the energy, water and telecoms sectors

agree that incentives shouldn't provide rewards where the cost of doing so exceeds the value to consumers.

The principle of not providing rewards for activity already funded by baseline allowances should also apply to not rewarding performance which has already been rewarded. For example if a performance level has been rewarded in RIIO-2 Ofgem should consider how the calibration of targets (which are not relative performance targets) ensure that the same level of performance is not also rewarded in RIIO-3.

OVQ14. Do you agree with our approach to setting reputational incentives? Are there any additional considerations that we should take into account?

We agree with the approach to reputational incentives and agree they can motivate companies and ensure there is senior attention paid to them. However, in most cases, more could be done by Ofgem to create league tables and publish and publicise performance within these.

Wider and clearer scrutiny would drive greater reputational attention by companies. It would also maximise the value of reputational incentives and the value for money for consumers by ensuring companies are striving to deliver the best they can with the funding provided by customers.

At present, we are concerned that reputational incentives rely too heavily on an assumption that the energy stakeholder community will engage with what can be complex topics, will read multiple documents across different companies and then form conclusions about performance. Ofgem should play a greater role in filling the gap between large quantities of information and data and the ability for stakeholders to easily consume this information in order for reputational incentives to have transparency and the "bite" that is intended.

OVQ15. Do you agree with our proposals for bespoke outputs? Are there any additional considerations that we should take into account?

We agree bespoke outputs are useful in areas where activities are genuinely distinct or specific for a network company. We agree with Ofgem that in areas where there is no justification for regional differences and consistency of ambition is in consumers' interests that common outputs should be used.

We would, however, note that if bespoke outputs are proposed by companies where there may be a justification for this to be changed to a common output, it is important that there is enough time for the processes between Ofgem and network companies to allow this to happen.

OVQ16. Do you agree with our proposal to retain the EAPs and AERs in RIIO-3? Please provide reasonings for your position.

Yes, we agree. To meet net zero, network companies must make progress in reducing their emissions. Ensuring they have robust plans to tackle this and for progress to be tracked is important.

We also agree that minimum requirements, where appropriate, should be strengthened to ensure there is ambition and an achievable trajectory towards net zero. The use of companies' existing science-based targets should be beneficial in setting these out.

OVQ17. What are your views on the new proposed AER format with Commentary and KPIs?

We agree with Ofgem's proposal. Ensuring consistency and comparability in the reporting by network companies is fundamental to an effective reputational incentive.

In particular, the KPI proposals appear to lend themselves well to league tables which, as discussed in response to OVQ14, Ofgem should publish alongside any assessment or analysis it makes of the AER commentary provided to them. This would ensure there is clear visibility of the scrutiny Ofgem applies to AER and the KPIs.

OVQ18. Do you agree with our minded-to position of retaining the reputational incentive on TOs and GDNs for reducing their BCF?

Yes, we agree. In particular this is an area where consistency is needed both in the adoption and use of science-based targets but also the performance reporting associated with them.

We also note National Gas Transmission's exclusion from this reputational incentive even though many elements of its scope 1 emissions are being collected for the purpose of the environmental scorecard ODI-F. In its SSMD, Ofgem should explain clearly why this is and consider its inclusion in the reputational incentive for consistency.

OVQ19. Are there any other suggestions you would like to make regarding reporting standards?

Ofgem should bring together the data it's collecting and present it in an easily consumable way. How energy networks reduce their carbon footprint is important to the environment, the UK's legally binding net zero targets, consumers, and investors. It should therefore be presented by Ofgem more visibly in performance reporting.

OVQ22. Do you have any views on our proposals for the NARM framework?

We agree that ensuring there is consistency within sectors in the application of the Network Asset Risk Metric (NARM) methodology is important and agree that it is likely to be in consumers' interests for the NARM methodology and expenditure associated with it to be increasingly linked to outputs. This would mean funding is more ringfenced and, as highlighted by Ofgem, better holds companies to account for under delivery, while ensuring justified additional expenditure is provided.

We would welcome Ofgem's view in its SSMD of how data and digitalisation is intended to inform changes and development of the NARM, even if this is a longer term ambition rather than a shorter term matter for the start of RIIO-3. For example, we assume that the development of network digital twins, which is well underway through multiple innovation projects already[3], would reflect asset health and therefore integrate with NARM.

Truth Telling and Efficiency Incentives

OVQ28. Do you agree with our proposed key objectives for truth telling and efficiency incentives?

We believe the key objective of an efficiency incentive is to incentivise efficient delivery of outputs in period. We view the second stated objective, addressing information asymmetry, as desirable but not essential.

We agree that addressing information asymmetry itself is essential but this may be better achieved directly through the truth-telling incentive alone. We would anticipate that each incentive could be individually calibrated to deliver the right outcomes for consumers for what are 2 quite distinct activities.

Ofgem should review the additional value created by overlapping these 2 incentive properties and any potential risks from increased complexity.

OVQ29. What are your thoughts on our proposals relating to minimum requirements under an evolved BPI approach?

We agree with retaining a stage gate approach in the form of the BPI stage 1. It's essential Ofgem can come to informed decisions based on the information presented.

We believe it's reasonable to reduce the number of minimum requirements primarily to remove duplication. We understand the principle of removing areas from minimum requirements that don't help with the setting of the price control. However, it would be helpful in SSMD for Ofgem to set out examples of current minimum requirements where, if removed, don't change Ofgem's ability to set the price control.

[3] Eg. NGT - Collaborative Visual Data Twin - Phase 2; UKPN - Trinity; SGN - Gas System of the Future Digital Twin; ESO - Virtual Energy System – Common Framework Demonstrator; SPEN - EN-twin-e;

OVQ31. What are your thoughts on an 'in the round' assessment of business plan ambition as opposed to requiring and assessing CVPs?

CVP value and postcode lottery

We believe the use of Consumer Value Propositions (CVPs) in RIIO-2 hasn't necessarily driven the wide-scale positive outcomes that were intended by Ofgem. While we understand the view of some stakeholders that guidance could have been improved for companies we generally agreed with Ofgem's decision to accept or reject CVPs.

In most instances we agreed with Ofgem that many CVPs didn't represent substantially beyond BAU activity, or the benefits of the CVP were likely to be overstated or not based on a robust methodology. In instances where activities seemed genuinely new and beyond BAU we believe Ofgem appropriately recognised this.

As Ofgem acknowledges, 1 issue with CVPs was the postcode lottery risk for consumers where not all consumers would benefit from activities or services from the network in their area. However, we would like to highlight that we believe the CVP regime, on its own, wasn't responsible for this. Instead it was a lack of an additional mechanism to make proposals common among companies, which could have been implemented in RIIO-2. Unless explicitly addressed the same issue would occur under an 'in the round' assessment.

The value of CVPs is in incentivising and revealing these activities. Although relatively few CVPs were successful and eligible for rewards, more proposals were rejected for reward but required to be undertaken by companies, which still delivers a range of benefits to consumers.

However, the value to consumers is severely eroded if the benefits of accepted CVPs (or those CVPs rejected for reward but required to be undertaken) become siloed only to customers in the network who proposed them. In particular it creates a postcode lottery that likely takes a whole 5 year price control cycle to complete before such an activity even has an opportunity to become common.

We would argue that this is a significant weakness of the business planning process and incentive and must be addressed whether Ofgem chooses an evolution of the CVP process or a larger change to an in the round assessment.

We would strongly encourage Ofgem to ensure there is an effective process to make bespoke outputs or CVP 'ambitious activities' common across all companies where it's in consumers' interests across GB to receive these benefits. It's still appropriate to reward companies for developing genuinely novel and ambitious ideas and retaining this beneficial competitive force in the business planning process.

In the round

A benefit of an in the round assessment of ambition compared to CVP is that it better allows Ofgem to weigh the good with the bad. Under the CVP regime, Ofgem didn't have a process by which to consider a business plan, or aspect of a business plan, unambitious relative to its competitors. It was, in effect, an upside only assessment.

Being able to assess the ambitious and unambitious components within a plan would provide a more rounded, accurate and fairer picture, and could incentivise companies to give appropriate focus on ambition across the whole business plan. Under the CVP, it's possible that companies could choose to seek ambition only in some areas of the business plan.

However, there are risks that an in the round incentive could be less focussed and may also require suitable guidance, like CVPs, in order for it to be clear to companies how they will be assessed. We don't therefore think that simplicity is necessarily a key benefit of this method compared to CVPs, though it would have other benefits.

Assessing ambition

We recognise a desire for Ofgem to simplify, where possible, aspects of the price control. However, the area of baseline expectations and business plan minimum requirements is an area that Ofgem should ensure doesn't become oversimplified given its likely reliance on these in order to assess ambition against them. Simplifying in this area could make assessments far more difficult to judge and overall weaken any ambition incentive where expectations are not clear.

Compatibility

As there is a distinction between the ambition of costs and the ambition of outputs, we don't necessarily see the need for an in the round assessment to be consistent with both of these categories as suggested by Ofgem. We believe that as these can be distinct assessments Ofgem should have the flexibility to mix and match the best assessment methods available to it to build an overall process that best delivers for consumers.

OVQ34. What are your thoughts on the options for calculating the sharing factors and do you see strong reasons for changing the overall strength of the sharing factors relative to RIIO-2?

We agree with retaining the Totex Incentive Mechanism (TIM) in RIIO-3 as an incentive which can effectively encourage companies to be efficient in their delivery.

We recognise that both the CDIR-based approach and the IQI-type approach can be used to vary incentive rates from a central starting point if necessary and therefore both may have merits.

We believe the more important review that Ofgem should undertake is to look at what the right TIM sharing factor central rate is first which should also be the rate for any fixed sharing factors.

We don't agree that carrying over the current rates because they are already in use is a suitable justification given the sums of money involved and the extent to which sharing factors already vary between companies.

As of 2021/22, company outperformance in RIIO-1 was worth over £5.1 billion[4]. As network investment, particularly in electricity transmission, is set to be higher than in previous price controls, the value of totex performance to consumers is likely to increase and setting the sharing factor at the correct rate will be critical to ensuring RIIO-3 delivers value for money for consumers at a time of major investment.

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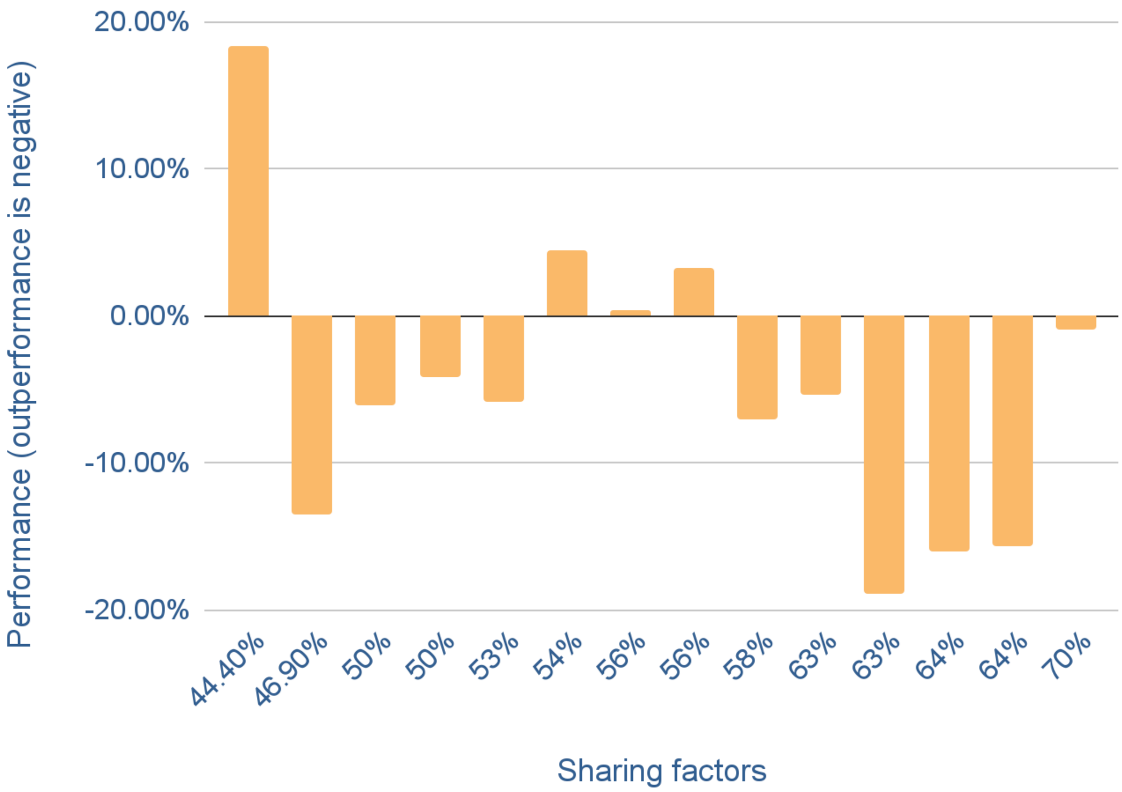
[4] (Total including enduring value adjustments), Ofgem, RIIO-1 Electricity Distribution Annual Report 2021-22 and Regulatory Financial Performance Annex to RIIO-1 Annual Reports

In our view, the key principle of sharing factors is that they should be set at the rate which provides consumers with the greatest value for money when underspends occur without eroding the company's *actual* incentive to be efficient. By *actual* incentive we mean whether the company would actively choose not to seek efficiencies because the revenue it could earn is lower than an alternative.

In our view we don't believe there is overwhelming evidence that a company's behaviour is materially changed by either lower or higher sharing factors.

Our analysis of RIIO-1 totex performance indicates that there is not a strong correlation between lower sharing factors and companies performing less efficiently. Similarly the evidence doesn't point to higher sharing factors leading to a greater likelihood of being inefficient.

RIIO-1 Totex outperformance and sharing factors



It therefore seems logical to set sharing factors in RIIO-3 at a lower level than in RIIO-1 and RIIO-2. If, for example, a company can underspend with a sharing factor of 46.9%, it is not clear what the benefit is to consumers by setting a sharing factor at 50% or as high as 70%.

While lower sharing factors do expose consumers to a greater proportion of overspend, Ofgem should factor in the probability of this occurring - i.e. is the likelihood of overspend greater than the likelihood of underspend? Historically companies are significantly more likely to underspend their totex allowances than overspend.

We would also note that RIIO-3 will have many mechanisms to adjust allowances, to mitigate inflation and real price effects, if costs turn out to be unforeseeably different to what was predicted in business plans.

We expect that such mechanisms would prevent the likelihood of overspend and any further overspend may be reasonable and justified, and therefore cost exposure for consumers may overall be in consumers' interests provided that consumers have benefited properly from underspends elsewhere.

We recommend that Ofgem considers setting a lower sharing factor across all sectors in RIIO-3 in recognition that evidence does not suggest that different sharing factors influence behaviour, but do affect value for money for consumers.

Incentive aim

In the answer to OVQ28, we outlined that the key objective for the efficiency incentive is to incentivise efficient delivery of outputs and that the second stated objective, addressing information asymmetry, is desirable but not essential.

The appropriate design for the efficiency incentive will depend, at least in part, on whether addressing information asymmetry is viewed as a key objective. We don't believe that using CDIR to determine sharing factors will have any meaningful impact on information asymmetry. This is because the incentive to inflate forecasts remains regardless of the level of sharing factors and, as we have outlined above, there is no evidence the level of sharing factors affects behaviours.

So, if seeking to address information asymmetry alongside incentising efficient delivery, CDIR can be discounted and IQI should be further explored. We recognise that IQI relies upon having some degree of confidence in the accuracy of benchmark costs. Potentially IQI could be calibrated so that the risk to an individual network of inflating forecasts is sufficient to change behaviour (a 'steeper' IQI curve). It should also be possible for IQI calibration to take account of our general arguments above around a lower central sharing factor.

Managing Uncertainty

OVQ36. What are your views on our proposal, in principle, to retain the Net Zero and Reopener Development Fund UIOLI for RIIO-3? What are your views on the types of projects it could fund and how it would interact with other sector specific price control mechanisms?

We agree with retaining the UM and think that it should not be used for hydrogen-related costs due to the introduction of the hydrogen transport business model as the more appropriate funding route.

OVQ37. Do you think we should retain the NZASP for GD and GT? What should its scope be and what kind of projects would you expect to be funded through this reopener in RIIO-3?

It is noted by Ofgem that the context is changing for the Net Zero and Re-opener Development Fund UIOLI allowance. We would anticipate that the same consideration is needed for the Net Zero Pre-construction Works and Small Net Zero Projects (NZASP) Re-opener where there could be overlap with the hydrogen transport business model which would be a more appropriate funding vehicle.

OVQ43. Do you have any views on how we should effectively monitor the delivery of UMs?

We agree with Ofgem that as the number of uncertainty mechanisms increases, and the likelihood of them needing to be deployed also increases, it's important that information from companies enables Ofgem to make swift assessments which are as robust as would be expected ahead of a price control.

We believe it's proportionate for Ofgem to add in either additional governance arrangements or make allowance adjustments if companies are found to be providing inadequate submissions which prevent a swift and robust cost assessment analysis by Ofgem.

Innovation

OVQ47. Do you have any views on our proposal to retain a flexible allowance, providing evidence for why you think that it should, or should not be, retained?

We support retaining a flexible allowance for networks to deliver innovation projects. We recognise the benefits that can be realised for customers, such as through projects that address vulnerability or environmental sustainability. A guaranteed, predictable funding stream provided through the Network Innovation Allowance (NIA) offers opportunities for smaller projects, compared to the competitive Strategic Innovation Fund (SIF).

We would like to see increased oversight over the allowance in RIIO-3. All funding, including for smaller projects, should be scrutinised to ensure that they can't be undertaken as part of BAU, and that projects are truly innovative and don't duplicate existing work. Outputs should be clearly demonstrated to show the net gain from innovation funding.

Knowledge sharing between networks is also crucial to ensure that benefits can be widely realised. Ofgem could consider implementing annual events for networks, partners and stakeholders to reflect on successes, challenges and learnings, similar to the Vulnerability and Carbon Monoxide Allowance (VCMA) showcase event held by the GDNs.

OVQ48. Do you have any views on our proposal to retain a competitive network innovation funding pot, that continues to focus on key challenges facing the energy sector, with phases to de-risk the pot?

We agree that the competitive innovation fund should be retained. The SIF funding pot allows for riskier, larger-scale innovation projects, with competition working to drive ambition and allow for greater scrutiny of project proposals. We see the SIF as offering networks a place for work that wouldn't come under their BAU and would positively impact consumers, for example inclusive innovation projects that benefit people who could otherwise be left behind in the transition to net zero.

OVQ49. Do you have any views on how the structure of the price control innovation funding could be adapted to better focus on whole systems problems, and ensure strategic alignment with other public sector initiatives?

A review of price control innovation funding is needed to ensure that consumer interests are fully represented, especially marginalised consumers and those in vulnerable circumstances. Our report 'A flexible future' laid out how innovation funding can play a vital role in helping consumers who might otherwise be left behind in the energy transition to unlock the benefits of energy flexibility. If established with inclusivity in mind, innovation pots could support companies to design accessible products and services that reach a more diverse population. Dedicated funding could be set aside for projects that tackle participation barriers.[5]

OVQ50. Do you agree with our proposal to continue with a similar level of innovation funding, and if not, could you provide evidence for why a different amount is required, including consumer research you are aware of into their willingness to pay for network innovation?

Ofgem states that: *"reflecting the high level of innovation funding that would be provided if we continue with two funds of a similar scale, it is essential that these schemes are non-duplicative, high value, and work for networks and innovators alike"*. We therefore feel that to justify maintaining the same level of funding, Ofgem must demonstrate both the value of this approach (through positive consumer impacts and net financial benefits) and that its incentive regime and

[5] Citizens Advice, A flexible future: extending the benefits of energy flexibility to more people, August 2023

level of scrutiny would mitigate the chance of duplicative or low benefit projects. Should this prove too resource-intensive, Ofgem should consider reducing the amount of funding available before it compromises its monitoring processes.

We are supportive of Ofgem's plans to make the pot go further without necessarily needing to increase the amount of available funding. We would welcome reducing duplication in projects and encouraging collaboration between networks to pool their resources.

OVQ51. Do you agree there is a need to expand the scope of innovation funding to be more inclusive of third parties?

We agree that more third party involvement in innovation funding would be beneficial. The problem identified by Ofgem of networks blocking ideas that don't offer returns will need to be proactively addressed in order to allow full third party participation in both the NIA and SIF.

OVQ52. What are your views on us establishing an accelerator to support early-stage innovators?

Reserving a proportion of the total innovation fund as an accelerator for early-stage innovators would work to encourage higher quality applications and allow access into the SIF. This approach could be implemented initially on a trial basis, to ensure that reserving a proportion of the total pot offers good value for money for consumers. If it does create positive outcomes, it could then be implemented for the entire RIIO-3 period.

OVQ57. Do you have any feedback on the view that not enough network innovation funded projects have been rolled out, and can you share any evidence you have to support your position? OVQ58. What are your views on the design of potential new mechanisms to address this?

By its nature innovation funding involves a certain level of risk that some unsuccessful projects will never be rolled out. However, ensuring that successful projects are fully implemented should be the overarching goal, allowing networks to embed improvements and maximise the return consumers get on their investment and for shouldering the risk.

Rolling out innovation projects will take coordination and the sharing of responsibility between innovators, networks and Ofgem. Roll-out mechanisms may be necessary to avoid wasting consumers' money by successful projects being unnecessarily siloed to only those companies directly involved in them when other consumers could have benefitted.

However, where projects would provide networks with efficiencies, the use of these mechanisms would essentially give networks a triple reward: innovation funding, a roll-out mechanism to implement the project, and decreased operating costs. More work is needed to guarantee that a new mechanism to achieve roll out would deliver fairness, consumer benefits, and value for money.

Data and digitalisation

OVQ61. Are there areas of regulatory reporting that would be most beneficial to start with in the modernising project?

We agree that the digitalisation of data sharing can deliver significant benefits. As well as making the price control setting process easier and enabling Ofgem to have greater access to asset data for in period decisions, we are particularly interested in exploring its potential for monitoring company performance.

At present, Ofgem publishes a fraction of the data that it receives from network companies in their regulatory reporting packs (RRPs). In most cases this is aggregated data necessary for the metrics involved in incentives and outputs. However, it masks a great deal of underlying data, very little of which we anticipate would be deemed commercially sensitive.

As a principle, we believe Ofgem and network companies should consider performance data to be publicly available by default except where reasonable redactions are required. While we appreciate this could be a greater burden on Ofgem under a manual excel system, Ofgem should maximise digitalisation to reduce the resource burden.

We recommend that Ofgem maximises the potential reputational levers it should have at its disposal under greater digitalisation by publishing network performance data in league tables and other easy to engage with dashboards on its website wherever possible. This would make it easier to assess company performance and give greater confidence to consumers about how network performance data is being monitored. This will help hold companies to account and to further improve price controls.

In particular the following areas of performance should be prioritised:

- Customer service
- Complaints performance
- Complaints volumes per number of customers (as exists for retail)
- Interruptions performance
- Totex under/overspend
- Customer and company shares of totex under/overspend
- Overall earned returns
- Vulnerability incentives and metrics
- GSOPs performance
- Environmental metrics
- Timely delivery incentives
- Connections speed

While it's clear that digitalisation efforts for RIIO-3 are focussed on the GD, GT and ET sectors, it's less clear whether progress towards a minimum viable product will consider the ED sector. As a particularly key sector which will benefit from increased digitalisation, we would recommend development with ED to be at the same time as other sectors to minimise a lag in the benefits that could be realised ahead of setting the ED3 price control.

2. ET Annex Questions

Delivery of major new projects

ETQ2. What are your views on our proposed approach to setting PCF and ECF, the scope of PCF and ECF and continuing the 'operational aspects' introduced under ASTI?

We accept the benefits laid out by setting PCF and ECF, particularly early engagement with the supply chain and the opportunities for more timely delivery. At 2.5% of the total forecast totex for ASTI projects and 20% of forecast total expenditure respectively, the funding available is set at a high level, so if Ofgem intends to proceed with its re-opener allowing for additional PCF and ECF, it should be limited to specific circumstances and be subject to scrutiny from stakeholders.

ETQ3. What are your views on options for how the ITA could be implemented for major new ET3 investments, and what are your views on its role and scope?

The Independent Technical Advisor (ITA) would likely help to address the knowledge asymmetry between Ofgem and the TOs.

- **Organisational structure.** We have no strong preference on the organisational structure of the ITA.
- **Contract structure**. Contracting a new ITA on a project-by-project basis would likely be onerous and potentially slow down transmission build, however locking in one ITA for the entire RIIO-ET3 period may not offer opportunities to evaluate its effectiveness. Therefore ITAs should run for a set period of time with the opportunity to re-tender.
- **Scope/procurement**. We feel that Ofgem should have oversight of the ITA's scope, either through a high level directive with detail provided by TOs' procurement processes, or by defining the entire process.

- **Procurement/funding**. Our preference is for funding to be set by Ofgem and funded through the existing price control mechanism.
- **Duty of care.** We would like to see a duty of care either to Ofgem solely, to aid its role as an instrument of the regulator, or to act independently under an agreed set of principles. Having a joint duty of care between Ofgem and the TOs could compromise its role in ensuring that TO procurement represents the most efficient value for consumers.

ETQ4. What are your views on introducing a delivery incentive into RIIO-ET3 for major projects that is broadly similar to the ASTI ODI-F? Do you consider that delivery should be more strongly incentivised than under ASTI, and if so how?

We believe strategic investment, with appropriate regulatory treatment, is in consumers' best interests, but there are elements of the ASTI decisions that are likely to be detrimental to consumers. Ofgem needs to adjust the delivery incentive to better balance the interests of consumers and companies.

We believe the ASTI Accelerated delivery ODI is a clear example of where an outcome has skewed to the detriment of consumers, arising from the asymmetries in the regulatory process we have previously outlined. The incentive was put in place to incentivise timely delivery by rewarding or penalising early or late delivery against the target date in order to protect consumers. Despite the incentive having exemptions which protect TOs from experiencing penalties for delays due to circumstances outside their reasonable control, TOs put forward arguments that the balance of risk wasn't appropriate in the original proposal.

The ASTI decision reflected changes that made the incentive scheme much softer:

- The target delivery date is now the end of the year in which the project is required to be delivered. This is acknowledged by Ofgem as providing "additional headroom".
- The 'neutral date', before which delivery earns a reward and after which will be penalised, is now a year later than the target date.

In practice this means that, at best, TOs can earn a reward for delivering up to a year late and, at its worst, could earn a reward for delivering 2 years late.

Ofgem stated that it considers *"these changes, along with the other adjustments set out in this Chapter, sufficiently mitigates the risk that the ASTI ODI is asymmetric by design and systematically biased towards penalties"*. It does not, however, consider the risk of systematic bias towards rewards. This is despite the evidence of network companies outperforming targets consistently.

Future delivery incentives need to also avoid bias towards rewards. In practice, this will mean choosing more sensible target delivery dates and neutral dates. We would also note that beyond the direct impact on consumer bills, outcomes like these undermine the legitimacy of the regulatory arrangements. Without public confidence, long-term certainty over the regulatory regime is damaged, impacting the investment climate. This means the potential impact on consumers of issues like these going unaddressed is potentially much greater than the direct impact.

ETQ5. What are our views on our proposed cost assessment approach for major new RIIO-ET3 projects?

With the introduction of the ITA providing more scrutiny to major project procurement, it seems reasonable that Ofgem will streamline its assessment process to avoid delays to projects. ASTI projects currently undergoing this cost assessment approach should be audited to ensure that they have provided consumers with value for money.

ETQ6. What are your views on our proposed treatment of sub-£100m schemes identified by the CSNP?

We would support sub-£100m projects being treated under the regulatory regime for major projects where the need has been identified by the CSNP.

Load related expenditure outside of the CSNP

ETQ7. What are your views on our proposal for load-related expenditure outside of the CSNP, how these mechanisms can be improved and streamlined, and the appropriate thresholds for the mechanisms?

We feel that Ofgem's framework for load-related expenditure is appropriate, considering an established need ahead of the price control and well-justified costs to be eligible for baseline funding.

Minimising networks' impact on the environment

ETQ11. What are your views on retaining funding to support mitigation projects that reduce the visual impacts of existing infrastructure in designated areas?

Where consumer willingness to pay and effective community engagement can be proven, we support retaining funding for mitigation of the visual impacts of existing infrastructure. We recognise that the perceived environmental and visual impacts of transmission projects can be a detriment to consumer support for net zero. There should however be a cap on expenditure, and new projects should be prioritised where there is a scarcity of resources.

ETQ12. Do you agree with our assessment of the bespoke outputs described in Table 7?

We are broadly supportive of the bespoke outputs. National Grid Electricity Transmission (NGET)'s specific outputs should be reviewed against delivery in RIIO-ET2, and if successful should be rolled out to other TOs, or otherwise removed.

Compliance with safety legislation

ETQ13. Do you agree that we should retain the RIIO-ET2 approach to safety, or do you consider there is anything more we could do?

Retaining the approach to safety appears to be the best option. An ODI-F wouldn't be appropriate considering the need for TOs to comply with HSE legislation.

Network Access Policy (NAP) LO

ETQ14. Do you agree with our proposal to retain the NAP for RIIO-ET3, and do you have any views on if and how it should be updated?

We support retaining the NAP as a Licence Obligation to ensure effective coordination between TOs and the ESO to reduce constraint costs. We feel that any risks to TOs will be mitigated when the NESO is established and greater oversight and coordination will be baked into the system.

Energy Not Supplied (ENS) ODI-F

ETQ15. Should we retain the ENS incentive as an ODI-F and strengthen performance targets, or transition to a minimum obligation standard?

Our preference is for a penalty only incentive for Energy Not Supplied. TOs have embedded improved performance and are therefore continuing to receive rewards for performance that can no longer be seen as outstanding.

ETQ16. Are either a rolling baseline target or the addition of an improvement factor appropriate changes to the incentive target calculation methodology given the increases in target outperformance?

Adding an improvement factor appears to be the best way to embed improvements and raise targets over time in a fair and manageable way.

ETQ19. Should Ofgem add a materiality threshold for exceptional events?

Yes, this would mitigate circumstances where the cost of assessing an event exceeds the value of individual exceptional events.

ETQ20. What are your views on our proposed change to the ENS reporting requirements?

We welcome the proposed change to capture the full picture of grid weaknesses beyond solely disruptions resulting in the loss of supply.

Connections incentives

ETQ22. What are your views on the extent to which fundamental reform of the ET connections incentives is required, and how would you approach that reform?

Reform should be led and informed by the NESO through its long-term connections reform. Although the programme of work does not begin until 2025, decisions made through its Connections Process Advisory Group will be available throughout 2024 and can help to inform the approach to connections incentives under ET3.

ETQ23. Do you have views on how the Timely Connections incentive can be reformed, or replaced, to better capture the efficient coordination of network offers?

A review of the current incentive will need to be taken to assess its effectiveness and data made available to stakeholders so that informed views can be sought on how to improve the incentive.

ETQ24. Do you have views on how the QoCS incentive can be reformed, or replaced, to better capture the service that connections customers receive?

The risk of bias due to a lack of understanding of the connection process should be mitigated in RIIO-ET3. Surveys should be scrutinised by Ofgem to ensure that they contain adequate information for respondents to offer their views, and provide the best way for respondents to participate. Responding opportunities could be reduced to avoid high drop-off rates in the final surveys.

As TOs are generally outperforming this incentive, the targets should be recalibrated to consolidate performance improvements.

ETQ26. What are your views on our proposal to retain the blended constraint cost savings, the 90:10 sharing factor, and the current windfall gain protection mechanism?

Whilst we believe that the TOs having an incentive to help the system operator to manage constraint costs is in the interests of consumers, it's clear from the evidence provided regarding the performance of the incentive scheme in the second year of RIIO-T2 that the scheme doesn't represent good value for money.

In year 2, the TOs were able to earn over £8 million in incentive rewards compared to costs of £1 million[6]. This is an extraordinary rate of return. Beyond the direct impact on consumer bills, outcomes like these undermine the legitimacy of the regulatory arrangements. Without public confidence, long-term certainty over the regulatory regime is damaged, impacting the investment climate. This means the potential impact on consumers of issues like these going unaddressed is potentially much greater than the direct impact.

It is clear the sharing factor could be adjusted to 95:5 without impacting incentive properties. A 95:5 sharing factor would have meant TOs still earning over £4 million in incentive rewards in year 2. It is not credible that the TOs wouldn't have acted to earn this reward. Ofgem should take the 95:5 sharing

[6] Table 1 RIIO-2 System Operator: Transmission Owner Optimisation output delivery incentive

factor as a starting point and explore how much further the TO share can be reduced whilst maintaining the incentive.

New Infrastructure Stakeholder Engagement Survey ODI-R

ETQ28. What are your views on whether and how TO customer service performance should be incentivised or enforced during RIIO-ET3, over and above the incentives and obligations described elsewhere in this chapter?

Customer service performance should be enforced throughout RIIO-ET3. Customer and stakeholder surveys could be coordinated between TOs, potentially with Ofgem oversight, to ensure consistency and comparability. Insights should capture overall satisfaction along with areas for improvement for the TOs.

CSNP Coordination

ETQ30. Do you agree that there should be a licence obligation on the TOs to engage and collaborate effectively with the FSO to ensure the delivery of the CSNP?

Yes, due to the importance of the CSNP in coordinating network build to reduce long-term costs to consumers. Ofgem should consider how effective engagement and collaboration between TOs and the FSO is monitored and assessed.

Evolving the RIIO-ET2 approach to cost assessment for RIIO-ET3

ETQ31. Do you have any views on how the cost assessment methods used in RIIO-ET2 for load and non-load capex could be improved and/or simplified for RIIO-ET3? Do you think we should consider alternative and/or supplementary approaches to the assessment? If so, which?

We support the continued toolkit approach to cost assessment and retaining the principles used in ET2 f]or what makes a good cost driver. Leading with a needs case approach to load and non-load related capex will ensure that TOs are funded for work in line with current and future consumer demand.

The inconsistency of cost reporting across TOs will need to be addressed in ET3 to enable robust cost assessment.

ETQ39. Do you have any views on our initial thinking around the role and potential evolution in RIIO-ET3 of the UMs listed in Table 9?

We agree with Ofgem's proposals on evolving or closing the majority of uncertainty mechanisms used in ET2 due to the removal of uncertainties that initially justified their implementation in the ET3 period. Where retained, we expect to see a robust evidence base for their inclusion.

3. GD Annex Questions

Proposed RIIO-GD3 specific outputs and uncertainty mechanisms

GDQ1. What are your views on our proposal to remove the shrinkage ODI-R as a separate output?

We agree that it's beneficial to remove duplication between reporting in the ODI-R and in the AER as long as data is reported in the RRPs. As RRPs are a key area of improvement as part of the digitalisation of performance reporting it's essential that RRPs contain the necessary information to enable Ofgem to increase and improve its digital cross-company performance reporting and monitoring as we have covered in response to OVQ61.

GDQ2. What are your thoughts on the options we have set out for the shrinkage ODI-F and on the design of this incentive?

We recognise that a penalty only ODI-F would minimise the risks to consumers that rewards are funded for performance which may result from BAU activities while also providing a clear incentive to ensure ambitious shrinkage targets are met.

We aren't opposed to the introduction of a UIOLI allowance provided that there is clear evidence of the type of activities that could be delivered which gas networks are currently unable to fund in any other way, for example through bespoke outputs.

We would also expect the introduction of robust governance around the type of projects funded, the cost benefit analysis required for any spending, particularly in the context of uncertainty about the need for gas assets in the future. We would also expect Ofgem to be closely involved in approving or denying funding for projects to ensure consumers are protected.

If the funding is to be used for potentially novel shrinkage reduction activities, we would also expect there to be clear processes by which novel ideas are deployed more widely, even if they aren't projects funded through innovation mechanisms.

Lastly, if Ofgem provides mechanisms for the wider rollout for activities initially funded by innovation funding, there would need to be clarity to prevent overlaps with a shrinkage UIOLI allowance.

We don't have a view on Option 1 which would retain the shrinkage ODI-F in its current form. It's not clear from the consultation, or evidence presented in the working groups, to what extent the incentive is successful in driving non-repex activities in RIIO-2 so far. We also note that incentive performance reporting, as opposed to financial performance reporting, doesn't appear to have been published yet for the first 2 years of GD2, impacting our ability to assess the incentive.

GDQ6. What are your views on the options we have laid out for the heat policy re-opener, including whether this should be combined with other RIIO-3 net zero mechanisms?

We agree with removing the energy efficiency element of the heat policy re-opener.

An additional area we would recommend Ofgem considers is the disconnection process. Government heat policy could materially impact if and how fast disconnections from gas networks occur and allowances that relate to this.

We welcome the attention Ofgem is paying to the current RIIO-2 policies on the different costs and routes that customers can choose to use in order to disconnect from the gas distribution network. However, subsequent government policy in RIIO-3 could also impact the rate that this happens at and, where applicable, the allowances for this. It may be useful to also include this in the re-opener.

Proposed RIIO-GD3 specific outputs and uncertainty mechanisms

GDQ22. What are your thoughts on our proposal to continue the emergency response time LO and whether the target should be set monthly, quarterly or annually?

We agree that setting a more frequent target ensures there is actual consistency in meeting the licence obligation, rather than a performance level on average across a whole year. On an issue of public safety we agree that setting a clearer and higher standard is justified. The principle of ensuring consistency can and should be deployed in other areas of the price control where there is likely to be seasonality to performance but where performance metrics are currently assessed on an averaged annual basis.

RIIO-GD2 outputs and uncertainty mechanisms proposed for removal

GDQ27. What are your views on our proposal to remove NGN's bespoke job completion lead-time including re-instatement ODI-R in RIIO-GD3?

We agree with the removal of this bespoke output. However, Ofgem should be clear about whether the standard delivered by this bespoke output is a standard that is expected by all GDNs.

For example, this output was introduced to improve connections performance despite NGN's customer satisfaction performance on connections being typically among the top 3 of licensees in RIIO-1 overall and specifically for connections[7]. This indicates that the customer satisfaction metric for connections in RIIO-1 didn't necessarily reveal the range of performance that sat underneath the headline average score if a separate reputational incentive was required in RIIO-2.

If Ofgem is satisfied that performance has improved by NGN to a suitable level, it's right to remove the bespoke output. However, it's unclear if there is evidence

[7] Ofgem, RIIO-GD1 Annual Report 2020-21

that similar improvements need to be made by other GDNs in the area of connections, beyond what is in the GSOPs, based on the aggregated data that was reported under the CSAT incentive in RIIO-1 and with no data yet published for RIIO-2.

Proposed RIIO-GD3 specific outputs and uncertainty mechanisms

GDQ28. What are your views on our proposed position on the role of GDNs in relation to vulnerability, and how can they support a just transition to net zero?

In RIIO-GD2, GDNs have been expected to support consumers in vulnerable situations within their existing areas of competence, activity and consumer interaction. We believe that this should continue in RIIO-GD3, and support the included examples such as proactively addressing vulnerability in emergency situations, assisting customers in vulnerable circumstances during outages, taking account of vulnerability in customer service functions and offering additional assistance free of charge. GDNs shouldn't expand their remit to include activities such as installing energy efficiency measures for fuel poor households, which should instead continue through schemes such as ECO.

However, we believe that Ofgem should consider whether GDNs leveraging large amounts of funding for energy advice and charity partnerships, as they have done through the VCMA in GD2, does represent their existing competencies, activities and consumer interaction. Even before the uplift in available VCMA funding, GDNs had £12 million available each year through GD2 to spend primarily in the advice sector, compared with the approximately £5.3 million given to Citizens Advice through the energy levy in 2021/22[8]. Using GDNs as a proxy for leveraging money could be seen as inefficient, and in the absence of a clear advice strategy or oversight on how money is being spent in the sector, we could end up with duplication of work, gaps in provision or suboptimal outcomes for consumers. This isn't a problem for Ofgem alone to solve through

[8] Citizens Advice, Tackling gaps and overlaps: a discussion paper addressing the energy advice challenge, April 2022

its RIIO-GD2 determinations, but it should be aware of the wider picture of energy advice and its implications for the administration of the VCMA.

More scrutiny is needed over whether GDNs are best placed to leverage these advice partnerships, as opposed to other organisations, and where they themselves add value to the partnerships. Ofgem should consider how well resourced gas networks are to spend this funding effectively. For example, SGN reported spending £1,246,570 of its VCMA allowance on administrative costs in in 2022[9], which shows that managing its pot requires significant financial resources.

More examples of best practice should be shared between the GDNs and with external stakeholders to ensure that their organisations are adding value to the advice and charity sector.

GDQ29. What are your views on our proposal for GDNs to develop individual and joint-GDN vulnerability strategies?

We support the initiative GDNs have taken in RIIO-GD2 to publish a collaborative vulnerability strategy, and would like to see it kept up to date, informed through effective stakeholder engagement and customer insight. Given the Department of Business and Trade's intention to move towards a universal Priority Services Register (PSR), any knowledge sharing and collaborative work on vulnerability could help to achieve better outcomes for customers in vulnerable circumstances. The joint strategy could be useful in setting overarching aims for the collaborative VCMA pot, and we hope that it would also provide more opportunities for GDNs to collaborate on cross-regional projects, and encourage the networks to spend more than the mandatory minimum of 25% on joint endeavours.

We would like to see individual strategies published regularly too. With updated VCMA guidelines providing a template for vulnerability strategies, we will find it easier to scrutinise GDNs' plans and compare them against each other. We expect to see insights from customer research laid out in individual strategies,

[9] SGN, VCMA Annual Report, 2022

justifying the needs case for ring-fencing 75% of the total VCMA spend for individual networks to provide tailored projects to their specific customer base.

GDQ30. Do you agree with our proposal to retain the RIIO-GD2 vulnerability minimum standards is sufficient to ensure customers in vulnerable situations are protected and treated fairly?

We support retaining the vulnerability minimum standards. However, these should be reviewed to ensure that consumers in vulnerable situations aren't left behind as customer service standards for all customers improve.

GDQ31. What are your views on our proposal to retain the use of the VCMA UIOLI allowance, on the alternative option to incentivise vulnerability through an ODI-F, and on which activities to support vulnerability could be funded through baseline allowances?

Though there would be benefits to moving to an ODI-F over a UIOLI allowance, we feel that on balance retaining the UIOLI mechanism would result in better outcomes for consumers. UIOLI has the benefit of returning unspent money to customers, and by removing the competitive element of the incentive it encourages GDNs to pool resources to increase the impact of their projects.

We recognise that a financial incentive may lead to higher quality projects, but this could be achieved by using the common SROI model to drive standards. Once adopted by all networks, Ofgem should consider updating the VCMA guidance to require a set minimum SROI, rather than just a positive figure, to future VCMA projects.

GDQ32. At what level should VCMA funding be set to ensure its effectiveness and sustainability, and what percentage should be ringfenced for collaborative projects?

RIIO-GD2 saw the amount of funding available in the VCMA pot increase by almost 3 times, reaching a total of £171 million, which we believe is much too high. Ofgem used the maximum volume driver to allow 'flexibility in over-delivery', though GDNs had previously struggled to over-deliver on even their previous, much-lower targets. Our main concerns were that the additional money set unachievable targets for GDNs, that they would need to scale up too quickly, and the time pressure could lead to money being spent inefficiently.

We would support the level of funding returning to a lower amount, taking into account GDNs' actual, rather than projected, delivery figures and the effect that cliff edges of funding could have on third sector partnerships.

Funding should be set at a sustainable level that would be replicable in future price controls. This will give VCMA partner organisations more certainty, and prevent poor outcomes for consumers in vulnerable circumstances when projects are phased out due to sudden funding drop-offs. In RIIO-ED2, the total available in vulnerability funding (approximately £70 million) was decided at Final Determinations based on extensive business planning and stakeholder engagement. Ofgem should consider aligning GDN vulnerability funding with this approach to reach a number that represents a realistic and achievable total pot.

We recognise the benefits of ring-fencing spending for collaborative projects within the VCMA. Pooling funding for collaborative projects ensures that GDNs and their partners can take advantage of economies of scale, and reduces the risk of creating postcode lotteries where gas customers cannot benefit from projects that would improve their circumstances due to living outside of the relevant GDN's licence area.

However, mandating any more than the current 25% of total spending on collaborative projects would come at the expense of the funding allocated based on customer numbers. While a blunt instrument, we do believe that dividing the pot based on the size of the customer base is the fairest way to distribute the total funding between the GDNs. Ofgem could therefore consider how best to encourage, without mandating, more collaborative projects funded through the VCMA, such as using the annual showcase event as an opportunity to assess the feasibility of scaling up and expanding regionally the individual GDN projects with the highest SROIs. If there are barriers to more collaborative spending, these should be further explored and mitigated.

GDQ33. How should VCMA funding be allocated to ensure maximum impact for consumers in vulnerable situations?

If the FPNES is wound down and the funding redistributed to the VCMA, Ofgem should consider explicitly ring-fencing a proportion of money for fuel poverty projects within the VCMA guidance.

GDQ35. What are your views on the options we've set out to incentivise customer satisfaction during RIIO-GD2?

Customer satisfaction incentives for RIIO-GD2 were too generous, consistently rewarding GDNs for their performance. In the second year of GD2 (2020/21), all 8 licence areas exceeded their targets on planned interruptions, unplanned interruptions and connections.

In light of this, tighter incentives need to be set to ensure that performance is consolidated and that consumers don't over-reward the networks. Should Ofgem choose to maintain the current RIIO-2 incentive design, it should carefully set targets to avoid outperformance seen in GD1 and the first years of GD2. We recommend no longer using GD1 data as a benchmark as it's fast becoming out of date, and dynamic targets should be used to best keep up with real-time performance improvements.

The proposed option for a penalty only incentive fits into Ofgem's intention to maintain customer service performance rather than to continue to strive for ever-better scores. However, there is an argument that incentivising exceptional customer service is still relevant, due to the likelihood of increasing customer interactions through disconnections as people decarbonise their home heating.

Our preferred option for a customer service incentive would be to move to relative targets, rewarding the best performing GDNs and penalising the worst, with a fixed minimum standard set as a backstop. This aligns with DBT's intention in its Smarter Regulation proposals to introduce more relative performance targets for regulated industries. It also creates incentives for GDNs to both consolidate their improved performance and strive for exceptional performance without overpaying on an incentive at the expense of consumers.

If collaboration and best practice sharing between GDNs is a barrier to this approach, it would be useful to see evidence of how this has contributed to network performance improvements seen in GD2.

GDQ36. What are your views on how the complaints metric can ensure customers' complaints are resolved quickly and effectively?

We support the proposal to retain the penalty-only complaints incentive in GD3.

Our preference is for the complaints metric to use dynamic targets over static. This should avoid issues of outperformance and will best reflect an overall industry standard throughout the GD3 period.

It makes sense to retain the repeat complaints metric as the largest proportion of the incentive, as this should encourage effective complaints resolution. However, the metrics for timely resolution may create adverse effects, with there potentially not being an incentive for GDNs to deal with complaints quickly once passed over the 1 and 31 day mark. It’s also unclear why these timeframes have been chosen.

We would like to see the volume of complaints as a proportion of all customers and PSR customers. It doesn’t necessarily need to feed into the penalty, but it would be useful as a stakeholder to have comparable data available that may give early insight into customer service issues, particularly as this is already commonplace in the energy retail market.

GDQ37. What changes, if any, are required to the GSOPs?

We will soon be publishing an update to our prior Standard Issue[10] report on network performance on GSOPs. We will share the new Standard Issue Update report as soon as it's ready, however, we have found the following:

- Gas networks performed less well when compared to electricity networks. On average, electricity networks meet performance standards for GSOPs for the period 2018/19 to 2021/22 of over 98% whereas only 2 of the gas licence areas achieved an average above 95%. There was also a higher degree of variability between gas network companies and their licence areas.
- There was also a higher degree of variability between years including in making required payments and doing so on time. Not all of the variability can be attributed to Covid-19 and multiple causes were provided by companies to explain drops in performance.

Our recommendations for Ofgem on GSOPs are:

- Ofgem should consider introducing negative incentive mechanisms for all guaranteed standards. The mechanism would penalise network companies for not paying out due compensation to their customers. Currently, this incentive only applies to 6 of the electricity standards.
- In gas, annual targets are only set for gas connection standards and responding to telephone calls and gas emergencies. Ofgem should consider introducing a target performance (pass rate) for all gas guaranteed standards.
- The Regulatory Reporting Pack should be periodically reviewed, making it easier for stakeholders and the general public to understand. The critical concern of the current pack is the lack of information on the number and the value of missed compensation. The data is needed to hold distribution companies accountable for their performance against GSOPs, ensuring all missed payments are returned to customers. Stakeholders such as Citizens Advice should be included in the review process to ensure that the Reporting Pack is accessible.

[10] Citizens Advice, Standard Issue, May 2019

- Ofgem must ensure consistency among network companies regarding interpreting and completing reporting forms as our research found that network companies interpreted the reporting package and filled in the fields differently (particularly in the GD1 period). Ofgem should perform data quality checks to ensure all GSOPs' data submitted by distribution companies are accurate. Network companies should be encouraged to invest time and resources in quality assurance for GSOPs' reporting.

GDQ38. What are your views on our proposed options for the unplanned interruption ODI-F?

We agree with retaining this ODI-F as an essential way to ensure customers receive good levels of reliability across GB and GDNs have suitable plans, procedures and resources to deal with unplanned interruptions when they do occur.

Ofgem should consider the benefits of using average restoration time targets on a monthly or quarterly basis, as Ofgem has proposed for the emergency response time LO which we support in response to GDQ22. It's important that any underlying variation in performance across seasons is understood to ensure that an annual average does not risk masking undue differences. This is particularly the case given unplanned interruptions during winter months will have a disproportionately greater impact on consumers compared to summer months.

We agree with Ofgem in its preference for option 3 to introduce separate performance measures for MOBs for Cadent and SGN. However, we don't think this should be on a company basis but on a licensed network basis. For example, Cadent North West has more comparable performance to NGN and WWU than it does to the rest of Cadent's networks so it's unclear whether it justifies inclusion.

We would also question the inclusion of SGN Scotland when the number of unplanned interruptions is also more in line with other low-MOB networks. We recognise the poor performance on the duration metric in 2022/23 but it's not clear from the evidence presented whether this single year performance justifies inclusion.

Target setting

Targets are being set in such a way that recognises performance that varies significantly. There is therefore a question of the postcode lottery this creates whereby a network licensee can have 17 times the number of unplanned interruptions and 32 times the average duration of unplanned interruptions of another network area (comparing Cadent London MOB performance with NGN MOB performance in 2022/23[11]).

While target setting based on average historical performance may be reflective of the service that *has* been delivered, it doesn't deal with the issue of whether this is an *acceptable* level of performance. Ofgem in its SSMD and draft determinations should explicitly consider the acceptability of performance levels and the extent to which it's appropriate for them to differ to this extent across GB.

We would also encourage Ofgem to review the level of the major incident threshold for incidents which are excluded from the performance measure to ensure it remains appropriate. 250 customers may mean very different things in a densely populated area compared to a sparsely populated area. It's not necessarily clear why 250 customers is the right threshold to apply to all companies across GB. We would also ask Ofgem to clarify whether this exception removes any MOBs from performance measures due to the number of customers contained within an MOB.

Ofgem should be clear about whether the purpose of the incentive is *only* to prevent its decline or whether it's reasonable to expect GDNs to make marginal performance improvements where they can and to embed this performance in future years. The merits of the different target setting options suggested by Ofgem are largely dependent on this incentive purpose.

In particular, basing performance on the highest (i.e. worst) performance in a 6 year or 4 year period doesn't seem to embed any performance improvements that can or have been made. Instead it would logically embed declines in performance, which is contrary to the aim of preventing decline as a minimum.

[11] Based on the data in Figure 9 and Figure 10 in Ofgem's GD annex

GDQ39. What are your views on the options we have set out for the Collaborative Streetworks ODI-F?

This incentive would benefit from greater clarity from Ofgem about what it's intended to deliver and to what extent the projects undertaken are influenced by the GLA or other utilities - i.e. to what extent is the incentive working in isolation or not.

Where the GLA and other utilities, as external drivers, have a combined influence on the projects that are most needed and which deliver benefits to consumers then we would anticipate the value of option 2 with a dynamic incentive rate and additional complexity may offer little additional value to consumers over and above option 1 with a flat incentive rate.

RIIO-GD2 outputs and uncertainty mechanisms proposed for removal

GDQ42. What are your views on our proposal to remove the Fuel Poor Network Extension Scheme in RIIO-GD3?

We support the proposal to remove the Fuel Poor Network Extension Scheme (FPNES) in RIIO-GD3. Whilst new gas connections have historically helped to bring down energy bills for households in fuel poverty, as the customer base declines, gas may end up more expensive as costs are recovered from a smaller customer pool, increasing bills for those least able to pay. This scheme also increasingly conflicts with the uncertain future of the gas grid and the government's legal obligation to meet net zero by 2050 - which Ofgem is explicitly tied to supporting through its new net zero duty. We also note that declining demand and an increased administrative burden for GDNs indicate that resources are best spent elsewhere.

As the FPNES is wound down through the last years of RIIO-GD2 and closed for RIIO-GD3, Ofgem should ensure that its original purpose - to help people in fuel poverty - is continued through the Vulnerability and Carbon Monoxide Allowance (VCMA), where the funding will be reallocated. This could be achieved through updating the VCMA guidance to specify a minimum proportion of total funding to be spent on fuel poverty projects.

GDQ43. What are your views on our proposal to remove the consumer vulnerability ODI-R in RIIO-GD3?

We support the proposals to remove or redistribute the metrics of the consumer vulnerability ODI-R. In particular, it makes sense to move customer satisfaction for PSR customers into the customer satisfaction ODI-F.

Should a reputational incentive still exist for customer vulnerability, standardisation is needed to ensure the best data is available, for example on GDN annual reporting, PEAs and SROI (once the common tool is adopted).

GDQ44. How can the annual VCMA event be improved?

In its current form, the VCMA showcase event works best as a space to share and reflect on successful project outcomes. We would like to see more focus on GDNs assessing the feasibility of scaling up successful individual projects, with opportunities for other networks to pool their funding.

We feel it's worthwhile to have this positive, collaborative approach, though sharing challenges and learnings should also be integral to the VCMA. This might be more effectively discussed in a closed forum and a slimmed-down selection of stakeholders compared to the current event.

GDQ45. What are your views on our proposal to remove the DLCA, and do you see any challenges that might arise if it were to be removed?

We agree with DESNZ that the DLCA is a subsidy for extensions to the gas network which is in conflict with government ambitions to phase out fossil fuel subsidies and meet net zero and so should be removed.

GDQ46. What are your views on our proposal to remove the domestic connections volume driver? If you think it should be retained, what changes do you recommend for its design?

Although Ofgem has assumed a low materiality of costs arising from domestic connections, as we don't know which FES scenario Ofgem will use to assess and scale costs, we believe the SSMC stage is too early to be able to support the removal of this volume driver.

At this stage we believe it's important to retain a clear method of clawing back costs for connection volumes that could vary significantly depending on business planning, the scenarios assumed, and the speed of decarbonisation away from fossil fuels.

Should GDNs assume a level of connections that differs from Ofgem's assumptions and from the outturn connection levels, then there are risks that baseline allowances provided for connections may be higher or lower than required (if the volume driver has been removed). Under a volume driver we can be reasonably confident that automatic processes will ensure Ofgem claws back allowances not required.

GDQ48. Should personalising welfare services continue to be supported under RIIO-3 and, if so, how should it be funded?

We would support the continuation of welfare services under RIIO-3, though Ofgem needs to assess whether it has achieved good outcomes in GD2 to justify its cost. If the assessment is favourable, then Ofgem should consider how it intends to roll out this programme of work to other GDNs.

If this work is considered a core expectation for the GDNs, then it should be funded through baseline allowances. However, as an additional element of the package of support for customers in vulnerable circumstances, it could sit in the VCMA's UIOLI allowance.

GDQ49. What are your views on our proposal to remove Cadent's bespoke Highrise building plans ODI-R from RIIO-GD3?

We agree with removing the ODI-R if Ofgem is confident that the activity has become part of BAU processes. However, Ofgem is considering widening the MOB element of the unplanned interruption ODI-F to other companies. It may therefore be necessary to ensure that such planning processes also become part of BAU processes among companies whose performance in MOBs warrants inclusion in the incentive.

Options for evolving our cost assessment approach for RIIO-GD3

GDQ60. What are your views on alternative technical assessment approaches for RIIO-GD3?

Ofgem cites in the consultation a proposal from a GDN to 'streamline' the approach to technical assessment by using the Demonstrably Inefficient and Wasteful Expenditure (DIWE) framework.

We don't agree that a price control framework that seeks to deliver value for money for consumers and drives companies to deliver as efficiently as possible would benefit from such a framework. We don't think it's in consumers' interests to introduce processes where the burden for disallowing costs may be raised to the extent that may be required for such a framework.

We recommend Ofgem rules out this approach in its SSMD due to the additional risks it places on consumers.

GDQ63. What are your views on retaining the RIIO-GD2 pass-through cost items for RIIO-GD3?

We generally agree with retaining the pass-through cost items in GD3. However, Ofgem should explain why it remains satisfied that companies still have limited control over the costs subject to each pass-through mechanism, and confirm obligations which require economically efficient behaviour or procurement where possible.

Efficiency is particularly important in procuring shrinkage as these costs to consumers are significant at between £30 million and £70 million annually in the last decade and up to £130 million in 2021 under recent high gas prices. Efficient procurement is therefore essential in achieving value for money by minimising these costs to consumers.

We would also argue that as the funding providers, ensuring ongoing efficiency is also important in funding the central data service provider (CDSP). However, some gas stakeholders have expressed ongoing dissatisfaction in recent years with the CDSP's demonstration of efficiency and transparency in business planning, prompting a UNC modification[12] to be proposed as a necessary tool to introduce the concept of efficiency into this process.

We recommend Ofgem provides explicit statements about each pass-through mechanism to demonstrate why it remains confident that GDNs have limited control.

[12] 0841 - Introduction of cost efficiency and transparency requirements for the CDSP Budget

4. GT Annex Questions

Infrastructure fit for a low-cost transition to net zero

GTQ1. Do you agree with our proposal to include a re-opener to manage the impact of introduction of the CSNP and gas strategic planning processes, with annual windows starting from the first year of the price control?

Yes. It will be essential that RIIO-3 is able to adapt to reflect the work of the NESO when it produces the relevant energy system plans at the transmission and distribution level. We also agree that the flexibility provided by annual windows and from the first year is likely to be necessary.

GTQ2. Are there any other areas of our proposed RIIO-3 framework (e.g. outputs or UMs) that you think may need to adapt to accommodate the future role of the FSO in strategic network planning?

It will be necessary to ensure that the NESO is captured as a stakeholder or customer in any relevant engagement surveys contained in outputs. Effective collaboration between NGT and the NESO will be essential to successful and timely network planning and delivery. We note the proposal to remove the stakeholder satisfaction survey, where the NESO's views would currently be captured. It's important the scope of the customer satisfaction survey is therefore broad enough to encompass NESO.

Given Ofgem's expectation that NGT will work with NESO in the business planning process, we recommend that Ofgem ensures business plan guidance reflects this to require NGT to demonstrate where business plan proposals have been informed by this engagement process, even if there remains some uncertainty. This would provide transparency to Ofgem that this engagement is taking place effectively and that business plans have been informed by NESO as far as is possible at this early stage. Given its importance we believe such evidence would be justified as a minimum requirement under the BPI.

GTQ3. What are your views on what the overall focus of the RIIO-GT3 environmental package should be, and should any additional areas be incentivised?

As noted in our response to the Overview document, we are satisfied that removing the environmental scorecard is appropriate, but encourage Ofgem to make better use of the reputational incentive potential of the information contained in the AERs.

Ofgem receives a wealth of data from NGT (and other networks) on environmental performance. To maximise the benefit of the data Ofgem should publish easy to understand league tables, and visualisations of how NGT and all networks are performing in their efforts to reduce their environmental impact against their own targets and commitments, including science-based targets.

Overall, the focus of the GT3 environmental package should do 2 things:

1. Reveal the environmental impact of the network, even in areas where it has no or limited control
2. Incentivise the reduction of emissions where NGT can take reasonable and economically efficient steps to reduce them. In many cases reputational incentives will be appropriate. Where financial incentives are considered or used it is essential that:
    a. There is high confidence in the metrics and that they reflect changes which are genuinely attributable to the behaviour of the company
    b. It's clear what performance level results from interventions already funded by customers or which represent a BAU pathway for science-based targets. Where financial rewards are considered it must be clear what additional value is being delivered over and above what would otherwise happen.

GTQ4. What are your views on each of the current individual environmental outputs presented in this section and the Overview Document?

It's not possible to provide views on each of the current environmental outputs as Ofgem hasn't provided data or analysis in the consultation on NGT's performance or the success or otherwise of the outputs.

GTQ5. What are your views on the above two options for the GHG emissions incentive?

We don't have views or information about the extent to which NGT has direct control over strategies to minimise venting and therefore the extent to which either a symmetrical, asymmetrical or penalty only incentive are appropriate.

However, we would note that as a principle, companies shouldn't earn rewards for performance that improves as a result of actions already funded by customers as Ofgem highlights noting the recompression machines funded by the RIIO-GT2 Net Zero Pre-construction and Small Projects re-opener.

It is right that companies are incentivised to think and act innovatively but there must be a clear threshold whereby the performance which customers should already expect due to the funding provided should not warrant financial rewards. It needs to be clear what additional value is being added that warrants rewards which we don't believe is currently clear.

It also appears clear that the target will require recalibration under any changes. The targets in the first years of RIIO-2 are broadly similar to targets set in RIIO-1. However, rewards have been earned in RIIO-2 despite NGT experiencing *"increased volatility of the network and changing flow patterns over the past two years… [which has] increased the need to run compressors"*. Our assumption is that running compressors more would lead to higher levels of venting and yet venting levels are instead lower. If improved performance is as a result of technical upgrades funded by customers then targets should be amended to reflect this new baseline not just in RIIO-3 but within RIIO-2 as well to ensure it delivers value for money for consumers.

GTQ7. What are your views on the above three options for the NTS Shrinkage incentive?

We don't agree with Option 2 as it suggests collars and caps that are *proportionate* to the annual shrinkage costs. This wouldn't be appropriate as if shrinkage costs are high then rewards and penalties would be greater. This doesn't reflect the fact that shrinkage is currently on pass through terms for NGT and we don't believe the actual financial exposure faced by NGT of shrinkage costs being higher or lower than expected justifies penalties and rewards which are proportionate to the price of electricity and gas.

If shrinkage is informed significantly by flows which NGT doesn't have control over then we would have concerns about the ability to set a robust financial incentive on this aspect of NTS shrinkage.

By contrast, procuring efficiently is an area under more direct control of NGT.

If considering an incentive for procurement, it's important Ofgem is clear about the extent to which NGT's licence already requires them to procure shrinkage efficiently to ensure it's clear what additional value a financial incentive, rather than reputational incentive, would deliver for consumers. It may also be useful for Ofgem to gather views of shippers and other stakeholders to understand NGT's procurement performance based on the annual shrinkage procurement reports produced by NGT and the scope for improvement. We note Ofgem committed in GT2 Final Determinations to conduct a *"review of the performance of shrinkage after two years, and to assess how well NGGT is managing shrinkage costs"*[13]. It's not clear to whether this review has been conducted and, if so, what conclusions have been reached about NGT's performance and any learnings that would inform the options under consideration for RIIO-3.

We don't believe it would be possible to set a fixed or dynamic single target ex-ante in a market as volatile as the gas and electricity markets.

We anticipate that robust targets could only be set if they are in relation to a particular gas price - i.e. x% above or below a price point determined by Ofgem

[13]Ofgem, RIIO-2 Final Determinations - NGGT Annex (REVISED)

(though this could also be asymmetric or downside only). The price point could be an average price or a lower quartile price to ensure that procurement strategies are securing shrinkage gas and electricity as economically as possible.

It's concerning that meter error may account for the majority of unidentified gas at the NTS level. If this can be addressed via the bilateral contracts with meter owners in an economically efficient way this may justify a reputational incentive to deliver reduced meter error or correct meter bias.

GTQ9. What are your views on including NTS Shrinkage costs within NGT's baseline totex allowance?

We understand the logic of exposing NGT to the risk of shrinkage cost as well as the incentive to reduce costs. However, we are concerned about the risks to consumers of baseline allowances being set incorrectly up front if, as highlighted by Ofgem, forecasting GSO costs is already challenging due to volatile gas prices. It's unclear how Ofgem would conduct a cost assessment for such a cost if it was included in baseline totex allowances and may rely too heavily on GSO forecasts.

GTQ10. Do you have any views on the future of this PCD?

As noted in response to OVQ6 we don't think that RIIO-3 is an appropriate vehicle for funding the decommissioning of gas assets.

We don't agree that the question of intergenerational fairness for decommissioning is similar to that for regulatory depreciation. The consultation states that the key principle for intergenerational fairness is that *'consumers pay network charges broadly in proportion to the value of network services they receive'.* This is a valid consideration for the building, maintenance and operation of the networks. However, there is no benefit to natural gas consumers associated with being charged for future decommissioning costs.

Therefore, it's clear that general taxation will be the most appropriate method of providing funding for decommissioning. The requirement to decommission is directly tied to the transition to net zero which is to the benefit of UK plc and all energy consumers. It's therefore the only progressive and fair way to fund decommissioning, if that is necessary.

We recognise that it hasn't yet been decided how decommissioning costs will be recovered. This reinforces that Ofgem shouldn't pre-empt any decision by acting in an anticipatory manner, as this risks setting a direction of travel that is then harder to resile from. Cost recovery for decommissioning only from gas users does not reflect who will receive the associated value.

High quality of service from regulated firms

GTQ17. Do you have any views on our options for the Customer Satisfaction Survey Incentive? In particular, do you see merit in recalibrating target performance to NGT's most recent performance?

We don't believe option 3, which would remove the financial incentive and set a reputational incentive, has merit. Customer satisfaction is an essential component of the price control to ensure companies deliver high quality services and it's not clear that a reputational incentive would improve or maintain performance.

We don't believe option 1 or option 2 are mutually exclusive. Under a penalty only incentive it's still important to ensure that the targets, maximum reward and/or penalty, touchpoints and survey channels are all reviewed.

We believe the following improvements should be made irrespective of choices about asymmetry and penalty-only.

Process - Ofgem should review whether it's appropriate for NGT staff to make the decision of whether a touchpoint was significant enough to warrant a survey. This approach is unique among customer satisfaction surveys from other sectors. We would recommend all customer contacts relevant to a touchpoint should be eligible for surveying to remove this process and increase the sample potential. We recognise the issue of survey fatigue but also recognise the risk that potential survey respondents could be missed.

Methods - Survey methods should be updated to include non-telephone methods. In particular they should include online surveys to increase the potential response rate. This is a common method of conducting surveys for customer service in many competitive markets and many of the services provided to NGT's customers are also likely to be digital.

We think telephone surveys shouldn't be the only channel in RIIO-2 and we think it will be significantly further outdated for RIIO-3 given it will end in 2031. We believe Ofgem should take the opportunity to update the channels for RIIO-3 and use the later years of RIIO-2 to prepare for the change.

Data robustness - Ensure that data is suitably robust and representative to be subject to financial rewards and penalties. We note from a working group that it's not uncommon for 5 out of the 8 touchpoint areas to receive less than 10 responses in a year and in one category to be based on a single response. We don't have information on the number of customers who could have been surveyed, however we are concerned about how representative samples may be.

By comparison the major connections incentive for ED2 also has relatively low samples but has a sample robustness process to prevent the financial incentive operating in instances where error rates are too high. In a recent consultation Ofgem has proposed not to change targets due to the lack of robust data[14]. The approach between these 2 incentives does not appear consistent.

Weighting - With 8 survey touchpoints and an averaging approach it's highly likely that averaged scores can mask underlying underperformance in certain areas, provided other areas overperform. However, in reality this provides customers with a touchpoint lottery, much like consumers can face a postcode lottery.

We believe there is likely to be value in applying a weighting methodology with separate targets to each or grouped sections which reflects the performance Ofgem and NGT's stakeholders want to see from it.

This can also be designed with different weightings to reflect areas where the value of preventing deterioration of performance may be disproportionately high relative to the value of further improving performance in some of the

[14] Ofgem, Consultation on amendments to the Major Connections Governance Document, Feb 24

touchpoints of the survey. For others there may need to be greater focus on improving performance.

GTQ18. Do you have any ideas how the strength of the incentive and the range between capped and collared outcomes should be set?

The strength of the incentive, particularly where rewards are considered, should be mindful that providing customer service is a baseline allowance activity and that customers should expect NGT, like other network companies, to provide great customer service with the funding that is already provided for staff, IT systems and other operational costs. Ofgem should be explicit in what additional value it expects to be driven over and above the service that can be delivered with that funding which justifies rewards funded by customers.

GTQ19. Which new touchpoint areas could be added to the incentive, and which new engagement and survey channels could be introduced to help NGT improve in the delivery of its services to customers?

Survey methods should be updated to include non-telephone methods. In particular they should include online surveys to increase the potential response rate. This is a common method of conducting surveys for customer service in many competitive markets and many of the services provided to NGT's customers are also likely to be digital.

We think telephone surveys shouldn't be the only channel in RIIO-2 and we think it will be significantly further outdated for RIIO-3 given it will end in 2031. We believe Ofgem should take the opportunity to update the channels for RIIO-3 and use the later years of RIIO-2 to prepare for the change.

Ofgem should also ensure that engagement with the NESO is covered by this incentive if it's not explicitly covered elsewhere. Collaboration with NESO will be important in planning the energy system and NESO will rely to some extent on information sharing by NGT. Ofgem has an opportunity to capture this in the customer satisfaction survey, particularly with the removal of the stakeholder survey where NESO may otherwise have been captured.

GTQ20. Do you have any views related to the transparency of the customer survey results?

It's essential that output and incentive performance is transparent to stakeholders in any sector and believe this should already be BAU.

As we have highlighted throughout this response, we also recommend that Ofgem makes significantly greater use of the data that it has at its disposal to apply reputational pressure on outputs and incentives by collating and publishing performance in easy to understand formats on its website.

GTQ21. Do you have any views on how positive changes in NGT's behaviour and customer service could be incentivised?

We believe that financial incentives whether symmetric, asymmetric or penalty only can, if calibrated correctly, be equally successful in driving excellent customer service and to emulate competitive market pressures where they otherwise cannot exist.

GTQ22. What are your views on our proposal to remove the Stakeholder Satisfaction Survey reputational incentive?

We are satisfied that if there is undue overlap between the stakeholder satisfaction survey and the customer satisfaction survey that it's right to remove the stakeholder reputational incentive. However, this is assuming that the NESO will be deemed a 'customer' and therefore included in the customer satisfaction survey given the importance of this collaboration.

GTQ23. What are your views on our minded-to proposal to retain D-1 Quality of Demand Forecasting incentive as a financial incentive with a tighter target?

We agree that the importance of the D-1 forecasting to small shippers and its consequential impact on the costs that consumers face justifies the retention of the incentive in some form to ensure it delivers for the market.

GTQ24. What are your views on the options presented for the D-2 to D-5 Quality of Demand Forecasting incentive?

We believe both options have merit but again, are not mutually exclusive. Retaining the incentive on a reputational basis under option 1 should still include a review to ensure that new targets remain appropriate and stretching, particularly if they relate to improvements achievable under baseline allowances.

We don't have views on the value of the incentive as the value will be experienced directly by gas shippers or other potential gas market participants, such as potential gas DSR aggregators. However, we recognise the value to consumers of forecasting being as accurate as possible and that incentives, whether reputational or financial (symmetrical, asymmetrical or downside only), are appropriate provided there is clarity about where thresholds sit between baseline funded improvements and improvements beyond this BAU level.

GTQ25. What improvements to the D-1 and D-2 to D-5 incentive could be considered?

We agree that consideration should be given to the seasonality of forecasting when volumes can vary so significantly. Averaged metrics can mask underperformance in areas which are important. Forecasting accuracy at times of higher volumes will have a disproportionately high impact on the costs that consumers face through the gas market compared to times of low volumes.

Ensuring the incentive reflects this is an appropriate evolution of the incentive to ensure there is suitable consistency throughout the year.

We note Ofgem is considering seasonal or even monthly metrics for the emergency response time LO in the GD sector which we support in response to GDQ22 for the same reasons as why it would be beneficial for D-1.

We recommend that in setting targets Ofgem should seek to understand the accuracy of forecasting from confidential submissions from gas shippers to understand the forecasting accuracy potential. If the incentive is intended to drive forecasting that is as accurate as possible, it's important that Ofgem doesn't look only at historical NGT performance but also what can be reasonably achieved or is deemed ambitious. This would enable the incentive to be carefully calibrated to achieve those aims as far as is economically efficient.

Ofgem should be clear whether improvements to forecasting by making investments are also a baseline funded activity or not. As in other incentives, if customers are funding investment to make improvements, incentives should ensure those improvements are delivered and not reward that performance. If there is a level of performance over and above that, then rewards may be appropriate but it should be clear where the threshold is.

GTQ30. Do you agree with our minded-to option (option 1) for the CCM incentive? Please provide reasons for your position.

Yes, we agree that conducting a thorough review of the incentive is required due to the complexity of the incentive and to ensure the target, caps and collars remain relevant for RIIO-3. Part of the review should also consider whether there is overlap with the totex incentive mechanism to ensure there isn't a risk of double rewarding.

Cost of service

GTQ34. What are your views on setting allowances for internal costs and SO rewards and penalties from the ODIs?

As noted in response to a number of questions, Ofgem should ensure that setting baseline allowances for a level of performance customers are already paying for is captured within the ODIs to ensure customers aren't paying twice and that ODIs clearly reflect these thresholds.

GTQ37. Do you have any views on the UMs needed for RIIO-GT3?

As noted in response to GDQ63, we would argue that as the funding providers, ensuring ongoing efficiency is important in funding the central data service provider (CDSP). However, some gas stakeholders have expressed ongoing dissatisfaction in recent years with the CDSP's demonstration of efficiency and transparency in business planning, prompting a UNC modification[15] to be proposed as a necessary tool to introduce the concept of efficiency into this process.

For this pass-through mechanism, Ofgem should consider whether NGT could and should influence the efficiency of costs incurred by the CDSP given that it's a major customer of the CDSP. Under a pass-through mechanism there may be limited incentive to ensure costs that are ultimately funded by customers are appropriate.

[15] 0841 - Introduction of cost efficiency and transparency requirements for the CDSP Budget

5. Finance Annex Questions

Allowed return on debt

FQ5. Do stakeholders have any additional evidence for us to consider in our review of the additional borrowing allowances or infrequent issuer premium?

At the most recent price control (RIIO-ED2) Ofgem noted that the 25bps additional cost of borrowing estimate was *'higher than the 10bps included in the Competition and Market Authority's (CMA) PR19 Final Decision on its redetermination for four water companies.'*[16] This implies that Ofgem believes their estimate to be generous. Ofgem should fully consider whether the PR19 approach is more appropriate.

Allowed return on equity

FQ6. Do stakeholders agree with our interpretation and proposed application of UKRN Recommendations 2-7?

We don't agree that Ofgem's approach should be based upon the UKRN guidance on the methodology for setting the cost of capital.

In our view the current UKRN guidance on the methodology for setting the cost of capital will likely mean a potentially substantial upward bias in the allowed cost of capital. This will be to the benefit of company shareholders and at the cost of consumers.

In response[17] to UKRN's consultation we were clear that we didn't believe that the outputs of the UKRN guidance were compatible with the government's call for the UKRN Cost of capital taskforce: *"to ensure that the setting of the periodic cost of capital must ensure value for money and provide a fair deal for all consumers, and accordingly, to ensure the general affordability of consumers' essential bills"*.

[16] RIIO-ED2 Final Determinations Finance Annex Para 2.24

[17] Citizens Advice response to UK Regulators Network (UKRN) guidance for regulators on the methodology for setting the cost of capital, November 2022

With rising interest rates and infrastructure investment on an upward trajectory to meet net zero, it has become more important than ever that the approach to cost of capital provides a fair deal for consumers and seeks every opportunity to ensure consumers' bills are affordable. However, we don't believe the UKRN exercise has determined a methodology which finds the right cost of capital - i.e. one that is likely to provide returns which are neither too big nor too small. Indeed, the UKRN has not attempted to do so, rather stating that the guidance *"brings together and consolidates existing methodologies used for setting the allowed return in regulated sectors"*[18]

The guidance therefore accepts the established positions of the regulated companies. It doesn't acknowledge or reflect that there are also alternative positions from consumer bodies - i.e. Citizens Advice - that deserve meaningful scrutiny and attention.

This is particularly disappointing as there is a clear commercial asymmetry. While companies and their shareholders have an unambiguous commercial incentive to ensure returns are as high as possible, our views are aligned with public interest and the government that returns should be neither too high nor too low.

We believe that the current methodology will likely lead 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-checks.

In our previous work, we also found regulators allowed networks across essential markets to overcharge consumers by £24.1 billion over the past 15 years. We recommended, again, that UKRN should revise its methodology for calculating cost of capital.

The government's consultation regarding economic regulation also identified these issues citing the NAO's 2020 report on Electricity Networks, which highlights that, based on available data, energy network companies forecast

[18] UKRN, Guidance for regulators on the methodology for setting the cost of capital, March 2023

9.2% returns on average, in comparison with average FTSE returns of 5.25-5.75%[19].

Simply hard-coding the approaches that have led to this generosity, through the UKRN guidance, isn't in the interests of consumers. While consistency is beneficial in principle, the approach must be able to evolve to reflect future evidence, rather than risk precluding this.

This is an important distinction between regulatory stability and regulatory predictability. Stability risks the wrong approaches becoming further embedded while predictability accepts the need for change and evolution but with confidence of regulatory rigour and transparency.

Citizens Advice still recommends that UKRN should commission an update to their 2018 cost of capital study under a new process, including further research on areas where UKRN agreed it's needed. The process should also better address the inherent and structural asymmetries and enable a diversity of perspectives to be independently considered, in particular taking into account the views of those who represent consumer and public interest.

In the meantime, for this price control, Ofgem shouldn't be relying upon the UKRN guidance.

FQ7. Do stakeholders consider there to be good reasons to deviate from the respective approaches set out under UKRN Recommendations 2-7?

There are good reasons to deviate from the respective approaches set out under UKPN Recommendations 4, 5, 6 and 7. As set out above, the UKRN review was fundamentally flawed in that it wasn't seeking to identify good practice for establishing the appropriate rate of return on investment. So the UKRN Recommendations shouldn't be generally relied upon. There are also a number of additional concerns related to specific recommendations.

UKRN Recommendation 4

[19] National Audit Office, Electricity Networks, 2020

Citizens Advice has consistently argued that Total Market Returns (TMR) should represent all assets in the economy, rather than just UK equities. This includes within our submissions to the CMA RIIO-2 Price Control appeal, which also provided evidence that indicated that long run (real) returns on all assets in the economy are likely to be appreciably lower than the corresponding long-run returns for equities. This is also unsurprising given that equities generally exhibit much greater systematic risk (i.e. correlation with macro-economic events) than all assets generally.

This argument was accepted by the CMA[20]: '*we agree with Citizens Advice's argument that, theoretically, the TMR should reflect the return on all assets in the economy, and that there is some evidence suggesting that total returns across all asset classes are lower than those on equities alone, and potentially materially lower.*'

However, the UKRN (and so, by extension, Ofgem) dismisses this on practicality grounds. The CMA also acknowledges potential practical implementation issues, but says that regulators should give '*careful consideration*'. We see no evidence that any consideration has been given. It is unacceptable to permanently consign known issues to the 'too hard' pile. It's especially worrying to ignore a potential source of generosity where there's such compelling evidence that returns are too high[21]. Even if, after careful consideration, Ofgem remains of the view that using all assets isn't practical to implement, analysis should be performed to establish the potential level of generosity this compromise is providing. This can then inform other decisions, such as when choosing spot estimates from a range.

UKRN Recommendation 5

We continue to believe that weighting shouldn't be given to shorter-term betas. This is primarily because index-investing has an upward bias on short-term betas. We explored this in our response to the UKRN consultation regarding cost

[20] CMA, Final Determination: Cost of equity
[21] For example, see evidence from transactions in the response to FQ14

of capital. The UKRN decision with regards to our position is particularly unsatisfactory.

The UKRN decision states '*that more research is needed to quantify the size of this distortion'.* Whilst it's useful for the UKRN to acknowledge the distortion, we believe that UKRN should then have outlined how the required research was going to be conducted. It's clearly not safe to simply leave a known distortion unquantified and unaddressed. Similarly, it's not acceptable for Ofgem to leave a known distortion unquantified and unaddressed. Ofgem should consider what research is required to quantify the distortion.

Similarly to the reasoning for rejecting using total assets for estimating TMR, the use of World betas is rejected on ground of practicality. So, this is also not a sufficient answer. Analysis should be performed to establish the potential level of generosity this compromise is providing. This can then inform other decisions, such as choosing spot estimates from a range.

UKRN Recommendation 6

As described above, the compromises made regarding TMR and equity betas mean the range for the cost of equity is structurally biased in favour of the companies and against the interests of consumers. It sits within a price control process which is subject to the same structural asymmetries: regarding information, resources and commercial incentives. This is also supported by the real world evidence of the premiums being paid for network companies (see FQ14).

Hence, using the midpoint of the range for the spot estimate, whilst making sense in theory, doesn't hold in reality. In the real world, it represents 'aiming up'.

This was recognised by the National Infrastructure Commission (NIC) that has recommended setting the cost of equity (and expenditure allowances) with the expectation that network companies will outperform targets and earn rewards -

known as 'aiming off'[22]. Ofgem itself has also recognised this when noting in its final RIIO-2 determinations that *'...we have been suitably cautious across all elements of the evidence and that a baseline allowed return of 4.30% is arguably consistent with a degree of aiming up, given evidence from cross-checks.'* It's worth noting that the approach taken since this determination, including what is proposed here, has been *more* generous than RIIO-2 due to the removal of the outperformance wedge.

The recommendation of the NIC does not appear to have been considered by the UKRN review. The instruction from the CMA[23] that Ofgem needs to consider how to address outperformance does not appear to have been considered either. Although we believe UKRN Recommendation 6 has limited use in any case due to it not being grounded in real world circumstances, the failure to address the views of both the NIC and CMA make it especially difficult for Ofgem to rely upon. Ofgem should instead consider 'aiming off' as a method of addressing both the CMA's concerns regarding outperformance and the structural asymmetries that exist across the price control process.

UKRN Recommendation 7

We agree with much of this recommendation but believe the results of cross-checks can be put to greater use.

Firstly, cross-checks need to be used fairly and symmetrically. At RIIO-ED2 Ofgem chose not to act on its own cross-checks that showed the cost of equity it was setting was too high, preferring instead to use these as evidence that the cost of equity was instead not too low[24]. No arguments were put forward as to how Ofgem had confidence that the cost of equity was not too high. That Ofgem chose to focus on whether the cost was too low, when cross-checks indicated

[22] National Infrastructure Commission, Strategic Investment and Public Confidence, Recommendation 5

[23] CMA, Final determination: Outperformance wedge, Ongoing efficiency, Licence modification process Para 6.178

[24] For example: *'In our view, the cross-check evidence does not support the DNOs' view that our CAPM mid-point is too low. If anything, the cross-check evidence is more consistent with the view that our CAPM mid-point is higher than the true cost of equity'* RIIO-ED2 Final Determinations

that it may be too high, makes it difficult to have confidence the use of cross-checks will be consistent regardless of what cross-checks show.

Cross-check evidence should be a trigger to review the approach taken to setting the cost of equity. Given the systematic reasons why the CAPM approach is likely to overestimate the cost of equity, it shouldn't be a surprise that cross-checks indicate that it's too high. This is further supported by the real world evidence of the premiums being paid for network companies (see FQ14). Whilst we agree that cross-check evidence can't simply replace the spot estimate, it does provide evidence of the suitability of the methods employed to derive that estimate.

At the very least, known and stated areas of generosity or 'caution' should be removed. At RIIO-ED2, there were a number of areas that Ofgem explicitly indicated were generous. These should have been corrected as cross-check evidence clearly showed there was no need for caution.

Finance examples	**Draft Determination - Ofgem commentary**
Halo effect	'The size of that halo effect is slightly larger than assessed for the GD&T sectors (7bps using a weighted average, 11bps using an unweighted average). ...we continue to consider that the iBoxx GBP Utilities 10yr+ index is appropriate as the basis for the allowed cost of debt, and **do not propose an explicit adjustment for any halo effect**.'
Infrequent issuer premium of 6bps	'We note that use of a 15bps premium on new debt, as per the NGN proposals at RIIO-GD&T2, would lead to a **3bps infrequent issuer premium** for RIIO-ED2, given the proportion of new debt expected to be raised in RIIO-ED2'
Cost of borrowing additional 25bps	'The 25bps additional cost of borrowing estimate is equivalent to the allowance provided in the RIIO-GD&T2 Final Determinations. We note this is **higher than the 10bps** included in the Competition and Market Authority's (CMA) PR19 Final Decision on its redetermination for four water companies.'

Cost of carry 10bps	'The point estimate we propose to adopt is from the **upper bound** of a plausible range (2-10bps).'
Cost of raising new equity 5%	'We said in the RIIO-2 GD&T Final Determinations that 5% was likely to be a **high estimate** of the cost of raising new equity.'
Revenue forecasting penalty mechanism	"Given that the average change even in year five is only 3.17%, a 6% threshold ought to be **more than sufficient**"

FQ8. Do stakeholders agree with our proposed methodologies where not specifically covered by the UKRN Guidance recommendations or our approach in previous price controls, such as the proposed approach to converting the RPI-real yields to CPIH-real inputs in the RFR calculation?

Ofgem should present Return on Regulated Equity (RoRE) ranges on a probability weighted basis.

For RIIO-ED2, the range presented included many elements that weren't credible. For example, the maximum rewards and penalties for incentives schemes were included which were simply part of the scheme design and not representative of any expectation of performance. Also, efficiency incentives were assumed to be +/-10% where 10% overspends would be unprecedented. This, in turn, leads to an implausible downside performance scenario of up to 200bps. It can also create a false impression of the price control package that is generally unhelpful.

Ofgem should present RoRE ranges based on P10 or P90 outcomes (i.e. '1-in-10' scenarios), using historical incentive performance data.

Financeability

FQ13. What, if any, improvements should Ofgem make to the assessment of financeability in the next price control?

As explained in the answer to FQ8, Ofgem should present Return on Regulated Equity (RoRE) ranges on a probability weighted basis. This should be used to provide a more plausible range for financeability checks

FQ14. What evidence, if any, should Ofgem consider in relation to expanding its assessment of financeability to account for 'investability'?

We are unsure what is meant by 'investability'. If companies are able to finance their activities (i.e. are financeable) then, by definition, they should be able to deliver what consumers require. This means 'investability' risks being a construct designed to justify additional returns for companies. We believe this would be a risk to the delivery of the infrastructure that is required to deliver net zero. We recognise that public trust in regulated companies and regulators is low as noted in the government's consultation on economic regulation[25]. This shouldn't be further jeopardised through the net zero transition by setting returns at a level that isn't fair and isn't reflective of significant structural changes to the way that infrastructure is planned and risk is apportioned. The move to greater centralised planning and networks becoming delivery bodies materially moves risk from network companies to consumers and should be explicitly recognised. Without public confidence, long-term certainty over the regulatory regime is damaged, impacting the investment climate. This grid investment is necessary for consumers to benefit from cheaper renewables, lowering overall energy bills, and is good for economic growth. Damaging public confidence may also affect the changes that consumers need to make which government will be reliant on to meet net zero.

This means that Ofgem should be asking whether returns are set at the correct level. The available evidence is that returns are too high. The most recent transactions in the energy network sector have all had significant premiums to the regulated asset value. In 2023, National Grid completed the sale of a majority equity interest in its UK gas transmission and metering business at a premium of around 45% for the gas transmission business. In late 2022, SSE

[25] DBT, Smarter regulation: strengthening the economic regulation of the energy, water and telecoms sectors

agreed a sale for a 25% stake in its transmission business at a 70% premium to the regulated asset base.

This evidence is consistent with the known compromises within how the allowed return is calculated and the evidence from the cross-checks. This should be leading Ofgem to consider how it addresses the areas where price controls are too generous, not methods for justifying additional returns.

It should also be noted that the discretion network companies have over whether to invest is limited. The price control sets clear deliverables and the licence sets clear obligations. So, whilst Ofgem asserts that the need to raise fresh equity during RIIO-3 presents a risk it does explain how this works in practice. We believe these assets will remain attractive due to their low-risk nature. Although we have seen no evidence of this, even if rates of returns are not attractive to current investors, it's highly likely there will be investors for whom they are attractive. This means raising new equity is a risk to companies' share prices and not to consumers. In extremis, if companies are genuinely unable to raise capital, Ofgem has already been clear that it has the tools to manage this scenario[26]. Providing extra funding to manage a theoretical risk that doesn't appear to exist in the real world, and for which the ultimate consequences are limited, isn't in consumers' interests.

Regulatory depreciation and economic asset lives

FQ21. GD & GT: assuming re-openers are available and there is no adjustment to the allowed WACC, how should regulatory depreciation be used to address the uncertainty around the future path for gas and perceived asset stranding risk?

We agree that it's not appropriate or necessary to increase allowed returns on capital in compensation for this perception of increased risk to the long-term value of the RAV. The CMA has also been clear in this area, noting that this is a diversifiable risk and that it's '*unpersuaded that the ability to recover the value of*

[26] Ofgem, GEMA response on Finance Issues and TNUoS, Para 257.5

any stranded gas assets is likely to be materially related to the broader economic cycle'[27]. This should be ruled out in the SSMD.

We believe that the future path for gas and the perceived asset stranding risk, although inter-related, should be considered separately.

Firstly, we agree that it's a *perceived* asset stranding risk. We also don't believe that an actual asset stranding risk exists for investors. The uncertainty is simply over what route will be taken to ensure investors receive the return for which they had legitimate expectations. However, all of the solutions proposed seek to directly address the asset stranding risk, as if it exists, rather than the perception. Ofgem should explore with government what assurances can be provided to negate arguments over asset stranding risk.

Secondly, regardless of the perceived asset stranding risk, the spike to gas networks costs (on a per customer basis) will require addressing. We agree this is unlikely to be a fair and appropriate way to distribute costs between consumers. We believe that smoothing depreciation to broadly deliver a flat depreciation charge per consumer is worth further consideration. We note that this results in higher bills in the shorter term. This needs to be taken into account when solutions to address affordability are being designed and implemented. We aren't convinced that the RAV needs to be fully depreciated by a certain date. We believe that other solutions can be developed, including funding through taxation. These can be signalled clearly to avoid the perception of asset stranding risk.

FQ22. GD & GT: what long-term path should regulatory depreciation aim to follow between 2026 and the assumed de-energisation point to promote fairness for current and future consumers? What unit metrics should this be based on? Is this resilient to the various scenarios under FES 2023?

The primary aim of profiling depreciation of the RAV should be to manage the distributional impact of the potential dramatic increase in gas unit charges caused by reduced use of the network.

[27] CMA, Final Determination: Cost of equity, Para 5.452

FQ24. GD & GT: what considerations are raised by asset repurposing and how might these affect the decisions to be made on regulatory depreciation policy? What guidance is sought for the SSMD so that licensees have sufficient clarity for their business plans?

We disagree with the premise underpinning the assertion that network companies would stand to benefit from any subsequent asset transfers if the RAV were to be fully depreciated to zero before repurposing. When the RAV is fully depreciated, investors have been fully remunerated by consumers and so these should be considered consumer assets. Any benefits from asset transfers should accrue to consumers.

This would be consistent with using the purchase of assets for repurposing to pay off the residual RAV if the asset value was close to the residual RAV. However, the idea that the value of such assets would be close to the residual RAV appears far-fetched. Purchases would be of the assets, not the RAV, and consumers should receive the benefit for the value over and above the residual RAV. We recognise the neatness of a straight exchange but that isn't sufficient. Potentially, some incentive could be placed on network companies to dispose of these assets at a good price, but the vast majority of the benefit should accrue to consumers.

Return Adjustment Mechanisms (RAMs)

FQ27. Do stakeholders have views or evidence as to why RAMs should or should not continue?

We believe that RAMs should be continued. RAMs limit the exposure of both consumers and companies to a poorly calibrated price control. Both of these effects should be of benefit to consumers. However, we note that Ofgem failed to take into account the impact of the RAMs on risk. As the RAM changes the risk structure of the companies for shareholders it can be expected to, at some level at least, reduce the equity beta of the companies.

This needs to be either taken into account explicitly in determining beta or as further support for adopting value towards the bottom of ranges when assessing cost of equity (aiming off).

FQ28. Do stakeholders have views or evidence as to whether the RAMs methodology should be amended, such as recalibrating the threshold or rates or including financial performance?

RAMs should include financial performance. The purpose of RAMs is to provide protection to consumers and investors in the event that network company returns are significantly higher or lower than anticipated at the time of setting the price control. It simply doesn't fulfil this purpose if financial performance is excluded.

Company performance across the RIIO-2 price controls should be reviewed. This will inform whether recalibration is required.

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