Debt to society: what the network companies should do with their windfall profits

A review of the RIIO-2 price controls.

citizens advice

Andy Manning and Sam Hughes
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Contents

Please note: all data in this report, unless otherwise stated, is presented on a notional company basis.

Executive Summary

The last few years have been a bruising time for households - skyrocketing energy prices and high inflation have driven a collapse in living standards for many. The cost of living crisis left many unable to heat their homes or put food on the table. For some companies though, this period of high inflation has handed them a windfall profit.

While energy suppliers operate in a competitive market, energy network companies are monopolies and therefore households rely on Ofgem to regulate them. This is done through setting economic regulations called price controls. All the running costs, investment costs and profits for these companies are ultimately recovered from consumer bills. Citizens Advice has historically called out the billions of pounds of excess profits made by these companies.[1] In response, Ofgem said it would get tougher in subsequent price controls.[2]

Despite improvements in many aspects of the price control, network companies are continuing to make significant profits in excess of what Ofgem believes is necessary[3], paid for by household energy bills. Our analysis shows that the vast majority of the excess returns to network companies since 2021 are **a windfall, with financial outperformance worth around £4 billion**. That is £4 billion of profit that is not associated with improved consumer outcomes or company performance.

This windfall has come about due to a flaw in the way the current price control accounts for inflation, meaning that the spike in inflation has allowed companies to recover costs for borrowing that significantly exceeded the actual cost of borrowing.

At the same time as high inflation has been handing network companies unearned profits, it has put many households into the red. Our advice services

[1] In Energy Consumers' Missing Billions (2017) and Monopoly Money (2019) we found that energy consumers were overpaying by billions of pounds.
[2] Ofgem press release, 2017
[3] Above the allowed cost of equity

have seen record levels of people who cannot afford their energy bills, and our research shows that 5 million people live in a household that is in energy debt.

Energy debt owed by households to their suppliers stands at £3.8 billion[4], similar to the unearned windfall that inflation has handed to the energy network companies. As network companies have been the inadvertent beneficiaries of the cost of living crisis, we believe they have an obligation to support those still suffering the worst effects of it.

As they are monopoly providers with no direct choice for, or accountability to, consumers, Ofgem must regulate these companies in a way that delivers value for money. Ofgem's regulation is not just a technical and economic agreement. It also establishes a social contract that regulatory arrangements will be legitimate and profits will be appropriate and fair.

Windfall profits, made during a cost of living crisis, jeopardise this. We have seen the risk to public trust when the public feels regulated monopoly companies fail to keep their end of the bargain. Public trust is especially important at a time when increased investment in energy networks is required to deliver net zero.

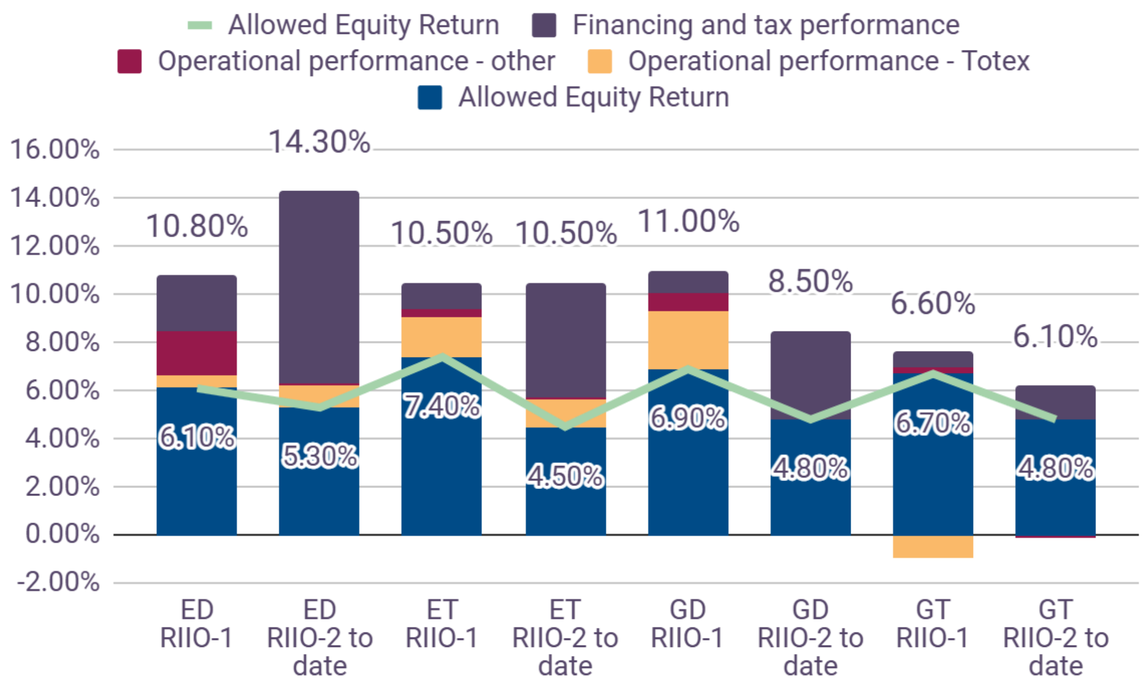
We believe network companies should explicitly demonstrate their commitment to the social contract by redistributing windfall gains to support consumers still reeling from the cost of living crisis.

[4] £3.82 billion, Ofgem debt and arrears indicators for Q3 2024

Key findings

Shareholder returns under current arrangements (known as RIIO[5]-2) remain at the excessive levels seen in RIIO-1, in contrast with Ofgem's aims to reduce them. These returns are driven by different factors in the price control in RIIO-2 as shown in figure 1.

Figure 1. Network companies RoRE[6] performance in RIIO-1 and RIIO-2 to date



Companies have been able to systematically outperform the level of return the regulator assessed as being appropriate (allowed equity return) as shown in Figure 2. Total outperformance (financial and operational) to date, with much of the price control left to run, is around £4.5 billion. This is made up of financing performance (performance due to companies' financing and tax arrangements)

[5] Ofgem's regulatory framework is known as RIIO (Revenue = Incentives + Innovation + Outputs)
[6] Return on Regulated Equity (RoRE) is Ofgem's measure of the financial return achieved by shareholders from a licensee during a price control period

and operational performance (performance due to operational actions by companies). The additional returns for operational performance reflect improved outcomes for consumers, whereas the returns due to the companies' financing arrangements can't be expected to bring any improvement in consumer outcomes. Mechanisms put in place to deal with systematic outperformance have failed.

Figure 2. RIIO-2 RoRE performance in excess of allowed return on equity

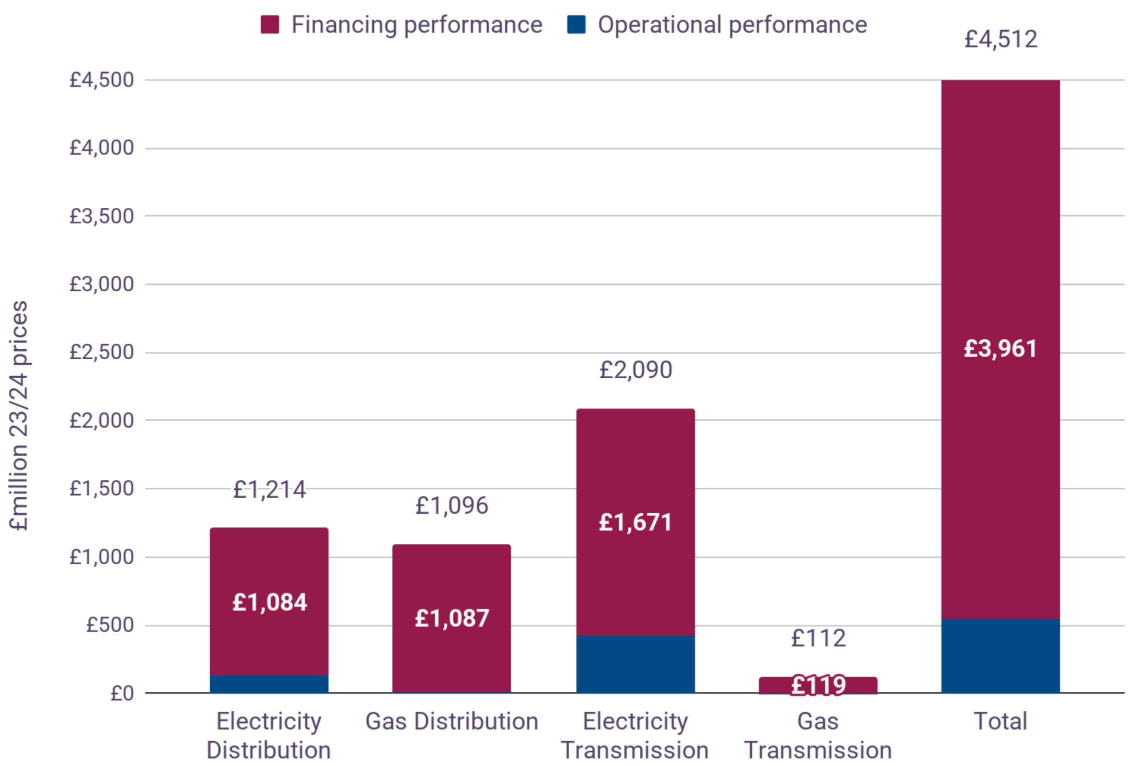


Figure 3. RIIO-2 Sector RoRE performance in excess of the allowed return on equity

£m 23/24	Operational performance	Finance performance	Total
Electricity Distribution	£129	£1,084	£1,214
Gas Distribution	£9	£1,087	£1,096
Electricity Transmission	£419	£1,671	£2,090
Gas Transmission	-£7	£119	£112
Total	£551	£3,961	£4,512

In this report we have looked at a number of performance measures in the RIIO-2 price controls and highlight a number of particular issues:

We find that of the **£4.5 billion total excess returns to date in RIIO-2, the vast majority of this benefit to network companies is a windfall, with a £3.9 billion financial outperformance** that largely results from a mismatch between the allowance for debt costs and actual debt costs. This is caused by inflation being higher than long-term expectations and is not linked to company performance or consumer outcomes. We expect this windfall to at least be maintained through the rest of RIIO-2, but it could increase further. The scale of this windfall is similar to the total amount of debt and arrears held by all GB domestic energy consumers[7].

Ofgem consulted on the impact of high inflation upon price control operation in 2023[8] and is taking action to prevent this reoccurring in future price controls. It considered[9], on balance, that regulatory intervention would not be in the interests of consumers due to any perceived worsening of regulatory stability negatively impacting future investment costs.

[7] £3.82 billion, Ofgem debt and arrears indicators for Q3 2024
[8] Ofgem Call For Input - Impact of high inflation on the network price control operation 2023
[9] Ofgem Call For Input - Impact of high inflation on the network price control operation – Conclusion and Next Steps

When the RIIO-2 control was being developed in 2020, Citizens Advice warned Ofgem of the risk of debt outperformance and called on the regulator to take action to ensure 'failsafe mechanisms' were designed to cope with this risk[10]. Failsafe mechanisms act to share systematic and significant outperformance benefits with consumers. We believe Ofgem should have done more to ensure failsafe mechanisms work in practice.

We also find that **Ofgem performance monitoring appears too weak** to give consumers confidence that that companies' performance is understood, explained, and challenged by the regulator.

[10] Citizens Advice, Response to Ofgem RIIO-ED2 Methodology consultation Annex 3 Finance Section, October 2020 and Response to Ofgem consultation on RIIO-2 Draft Determinations Finance Section, September 2020

Key Recommendations

Cost of debt windfall

Ofgem sets the detailed calculations to determine allowances for the cost of debt for companies[11]. In RIIO-2 these calculations have worked in such a way which means that high inflation has enabled allowances[12] for the cost of debt to increase. This has significantly exceeded the actual cost incurred by companies, because a proportion of the actual cost of debt held by these companies has been at fixed rates, rather than rates which vary with inflation. This has given some network companies a **significant windfall, with financial outperformance of over £3.9 billion**.

Network companies have effectively been beneficiaries of the cost-of-living crisis, and we believe they have an obligation to help those who are still suffering as a result of the crisis.

Network companies should demonstrate their commitment to a legitimate social contract with consumers. So we are calling upon the network companies to use their windfall to:

1. Make **voluntary contributions** to the funding required to provide **more extensive targeted bill support**. In our Fixing The Foundations report we estimated our proposal for targeted bill support would cost £1.8 billion annually. This could cover the total costs of providing enhanced bill support to a wider group of customers, who are struggling with affordability, in 2025/26 and 2026/27. This funding contribution could provide flexibility by ensuring there is an immediate and improved system of support in place while changes in the energy system and growth in the economy takes place to create space for longer term funding solutions.
2. Make **voluntary contributions** to the funding required to **provide debt relief for energy consumers**. Ofgem has recently consulted on the case for a debt relief scheme to write off up to £1.29 billion of debt. This

[11] Ofgem's approach is similar to that taken by other economic regulators
[12] Covering both the indexation of the RAV and the cash allowance

includes exploring an option for suppliers to make direct voluntary contributions to the scheme. This should be extended to network companies.

3. **Facilitate the financing** of any remaining funding requirements for **providing debt relief**. As the £3.9 billion is largely a windfall, it can clearly be used without causing any financeability issues for the network companies. Given the size of the windfall we believe the networks should waive any compensation and provide this as the equivalent of an interest-free loan.

Different companies will be affected differently, depending on the proportion of index-linked debt they hold.

Transparency and reporting

Ofgem must improve its performance monitoring activity. Since the start of RIIO-2 Ofgem has not published any annual performance reports. Without this there is a lack of visible transparency of company performance and Ofgem's activity to monitor it. For example, some companies who are underspending their total expenditure (totex) allowances are applying adjustments that reduce this reported underspend. The reasons for this are not sufficiently clear to assess whether this is in consumers' interests, such as through genuine efficiencies, or because of other delivery challenges.

Lastly, Ofgem has not published assessments of the drivers of company performance against the various outputs where performance is incentivised.

Ofgem should:

1. Publish **annual comparative performance monitoring** reports covering financial, outputs, incentives and metric performance, including clear league tables of performance.
2. The data should be accompanied by a **qualitative assessment** by Ofgem that explains good and poor performance of companies and how effectively the price control is delivering for consumers.
3. Require **company data submissions** to Ofgem to be **made public** by default (where possible) to aid further scrutiny.

Getting fairer in RIIO-3

Over RIIO-1 and RIIO-2 network companies have systematically outperformed the level of return assessed by Ofgem as being appropriate due, in part, to the design of its price controls. Outperformance in RIIO-2 so far is around £4.5 billion, most of which has not resulted from improvement in consumer outcomes. This undermines the legitimacy of regulatory arrangements and the social contract between customers, network companies and Ofgem.

'Failsafe mechanisms' are also currently systematically providing a greater level of protection to companies (who already benefit from significant protection) at the expense of consumers. As these mechanisms are intended to protect against unforeseen circumstances they must, by definition, be sufficiently broad in scope to prevent issues falling outside of their remit as we are seeing now with the cost of debt. We remain of the view that Ofgem should consider including debt *out*performance[13].

Ofgem must:

1. **Get tougher** on ensuring that the **returns earned by companies are fairer** and that reasonable levels of rewards and outperformance are better tied to improved outcomes for customers.
2. **Ensure failsafe mechanisms work well in reality** and are broad enough to capture all unforeseen circumstances.
3. **Ensure core price control components** like the totex incentive mechanism are **delivering outcomes consistent with consumer interests** across price controls.

[13] As part of its 'upside' Returns Adjustment Mechanism. Citizens Advice response to ED2 Sector Specific Methodology Consultation

Introduction

Great Britain has over 284,000km of gas pipes and 821,000km of electricity cables which transport energy to where it is consumed in our homes and businesses. These networks are privately owned. As it is highly inefficient and disruptive for parallel networks to exist in competition with one another, these network companies operate as monopolies instead.

In the absence of a competitive market, the prices that network companies can charge are set by Ofgem. It is Ofgem's job to ensure that:

- new network investment is in consumers interests,
- the costs of building, operating and maintaining these essential service providers are fair,
- the returns the companies earn are fair to both consumers and investors
- companies provide high levels of service, such as customer service and reliability
- companies' performance is monitored.

Ofgem does this through price controls, which are fixed for a period of 5 years. They specify how much money can be spent by companies, what is expected of companies in return for this spending (and what will happen if these expectations are not met), and how much consumers will be charged for this. These costs make up a fifth of the average domestic customer's dual fuel energy bill, and are expected to rise as more investment is required in networks during the transition to net zero.

Just as buying a home has a large up front cost spread over time by a mortgage with interest, energy networks are responsible for raising the initial capital required to invest in the networks and consumers repay this over time. Part of this repayment is profit earned by companies to pay out to shareholders in return for the upfront investment.

Therefore energy consumers ultimately pay for all costs incurred by energy network companies as well as all profits and rewards from incentive schemes that Ofgem allows companies to earn when they set price controls.

Network companies and their shareholders have an unambiguous commercial incentive to achieve profits that are as high as possible. The aim of network regulation, however, is to ensure network companies build the network capacity that will be needed by customers at the greatest value for money. Consumers would then fund this ‘efficient’ cost, plus the efficient costs for operating and maintaining the network and providing a good quality of service to customers.

The returns companies earn should also strike the right balance. It is important for consumers that returns are sufficient so that companies can attract the necessary investment, either through debt (borrowing) or equity (shareholder investment).

Consumers should be supportive of necessary increases in investment, including where this increases bills, for example to support the transition to net zero and to meet shorter term goals like Clean Power 2030. However, it is essential that increased investment is paired with fair returns which are no higher than they need to be. Unfairness and profits in excess of what has been assessed as appropriate, across all companies, could erode public trust. Excess profits will also mean less money in people’s pockets to spend how they wish to in the economy, something undoubtedly important to economic growth.

There are a range of ways that Ofgem tries to achieve this balance. This includes mechanisms which aim to protect both network companies and consumers if aspects of the price control diverge from what was expected at the time it was set - for example if supply chain costs are higher than expected or if companies earn returns in excess of what is expected. These do not necessarily protect consumers and network companies equally in practice as explored later.

In this report we review available evidence to explore how effective Ofgem has been, in practice, in trying to strike an appropriate and fair balance for energy consumers and whether value for money is being delivered in the current price controls called RIIO-2.

The RIIO-2 price controls started in April 2021 for the Electricity Transmission (ET), Gas Distribution (GD) and Gas Transmission (GT) sectors, and in April 2023 for the Electricity Distribution (ED) sector, with each lasting for five years.

As there is now data available for all companies, with three years of data available for the ET, GT and GD companies and one year of data available for ED, we believe now is an important time to conduct this work.

This can also inform the process of developing the next price controls (RIIO-3), which is underway for all sectors. In December 2024 the ET, GT and GD companies published their business plans with price controls starting next April (2026) following earlier consultations regarding the overall approach. Meanwhile Ofgem's first consultation on ED closed earlier this year with ED3 starting in April 2028.

Understanding what is and is not working well is vital for Ofgem to identify and tackle risks that could leave consumers out of pocket. At a time when energy prices remain high it's more important than ever that the money we spend on energy networks is as efficient as possible in driving the investment we need in the transition to net zero.

What we found last time

In 2019 our report Monopoly Money[14] found that energy consumers in Great Britain had overpaid by billions between 2004 and 2019. This work updated and extended Energy Consumers' Missing Billions[15], which was published in 2017.

In price-controlled sectors like energy, regulators make decisions about prices by estimating the cost of capital - the amount that lenders and investors need to earn to persuade them to make investments in the sector. We found that **regulators had systematically set prices too high by overestimating the cost of capital**.

This resulted in companies earning higher levels of return than needed and consumers overpaying unnecessarily. The **billions of pounds of overpayments are taken directly from consumers' pockets through higher bills**.

These inflated estimates of the cost of capital were due to a combination of mistakes, errors in judgement and poor forecasts. For example, regulators relied on forecasting rather than objective market data, and assumed that monopoly services were riskier than the evidence suggests. This led regulators to put the wrong values into their financial models, ultimately leading to unjustifiably high consumer bills. In an investment-intensive sector such as energy, even small calculation errors can lead to billions in extra costs for consumers.

The reports concluded that mistakes were not neutral: calculation decisions favoured companies and not consumers. For example, regulators have 'aimed up' when setting capital costs, choosing higher cost values than the evidence suggested.

We called for:

- **Energy network companies to return overcharged money to consumers** through a rebate on bills.
- **Regulators to improve future price control decisions to avoid consumers overpaying further**. This included asking regulators to track costs more accurately by using real market data where possible rather

[14] Citizens Advice, Monopoly Money, 2019
[15] Citizens Advice, Energy Consumers' Missing Billions, 2017

than forecasts, and to adjust their calculations of investment risk to reflect evidence that monopoly services are less risky.

- **A review of opportunities to use competition to deliver monopoly services**, reflecting evidence that companies bidding for delivery contracts reveal lower costs than monopoly providers.
- **Investigations into what went wrong** for consumers to be overcharged in this way.

In response to our findings, some network companies voluntarily paid back a small proportion of these profits we viewed as excessive[16]. Ofgem also tightened up its price control methodology, reducing the level of profits network companies could make by billions and delivering better value for money for consumers:

> *"Investors need to prepare for lower returns from 2021 with tougher price controls to maintain good value for customers"*[17]
>
> *"Ofgem confirms its approach to calculating the next round of network price controls, pointing to lower company returns and cutting £6 billion from the cost of capital passed on to consumers over the course of RIIO2"*[18]

[16] Citizens Advice press releases concerning SSEN and SGN's contributions
[17] Ofgem press release, 2017
[18] Ofgem press release, May 2019

Background to RIIO-2

The RIIO-1 price controls were set for 8-year periods. As we found in Monopoly Money[19]company returns were set too high and many network companies significantly enhanced their returns by underspending their expenditure allowances, and easily achieving their operational performance targets. Returns of 10%+ were reported by many of these businesses during the RIIO-1 period.

A key feature of the RIIO-1 price control was that significant electricity network reinforcement expenditure was expected to support renewable energy growth (load related expenditure), but this did not materialise at the expected scale. Ofgem had the opportunity to adjust the price control allowances at its midway point but decided not to. It judged that the benefits of regulatory certainty were greater than interventions to reduce costs and/or returns.

In the RIIO-2 price controls, an early decision was taken to reduce the price control period to 5 years, aimed at offering greater value for money protection for consumers. RIIO-2 also faced an expected major increase in load related expenditure in the electricity networks. As well as enabling this investment, Ofgem sought to improve the value for money realised for customers in RIIO-2, addressing some of the concerns we raised. Ofgem did this by:

- Reducing the company equity returns and the cost of capital; also including a cap and floor on returns if they are excessively higher or lower than a target return on equity
- Ensuring efficient costs through a total expenditure (totex) allowance with an efficiency challenge and an efficiency incentive
- Introducing tougher operational performance targets encompassing customer service, resilience and sustainability
- Reducing the risk of over or underfunding companies by introducing uncertainty mechanisms and price control deliverables to allow for adjustments to be made and ensure critical investments were delivered
- Better embedding the consumer voice in business plan preparation and delivery

[19] Citizens Advice, Monopoly Money, 2019

Output performance

A key aspect of the RIIO-2 price control was delivering outputs that customers would value. These covered four main areas:

- **Quality of service:** meeting the needs of customers and network users e.g. minimising losses of supply, providing good customer service.
- **Reliability**: maintaining a safe and resilient network e.g. ensuring good asset health and delivering network reinforcement as needed.
- **Environmental:** deliver an environmentally sustainable network e.g. reduced greenhouse gas emissions, improved business carbon footprint.
- **Cost efficiency:** deliver efficient investment and operating costs.

The RIIO-2 price control included a wide range of Output Delivery Incentives (ODI), Licence Obligations (LO) and Price Control Deliverables (PCD). Two types of ODIs were defined – ones with a financial incentive (ODI-F), and those with a reputational incentive (ODI-R). Quantified output targets were set for the financial incentives, and performance to date is assessed in this report.

Early RIIO-2 concerns

In response to Ofgem's draft determinations for RIIO-2 for the gas sectors and electricity transmission, Citizens Advice believed Ofgem could have gone further in reducing allowed returns which we think could have saved customers £1.7 billion[20].

In 2020 we also warned Ofgem that there was a risk that companies may generate windfall gains in RIIO-2 as a result of debt outperformance. We highlighted that Ofgem's 'failsafe mechanism', the Return Adjustment Mechanism (RAM), would not be sufficient to adequately protect consumers as it did not include debt costs. This is despite Ofgem's intent that the RAM should:

[20] Citizens Advice press release, September 2020 and response to RIIO-2 draft determinations, September 2020

"act as a failsafe mechanism to protect 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".

The RAM was introduced as an additional measure to protect consumers and companies against significant deviations in performance from expectations when the price control was set. Later in this report we show how debt outperformance has led to windfall gains which the RAM has not been able to address.

In March 2023, Citizens Advice published views on the RIIO-ED2 final determinations. This highlighted that Ofgem's decisions were too generous to company shareholders and they could have gone further in reducing the cost of capital, which would have saved customers around £1.5 billion[21]. We also expressed concern that incentives could have been further strengthened to ensure companies have to work hard and deliver excellent outcomes to justify rewards. This included incentives on reliability and the service when connecting customers.

We also highlighted our view that Ofgem monitoring of company performance during the RIIO-1 price control was not stringent enough and did not do enough to explain companies' performance. We called on Ofgem to strengthen its visible performance monitoring in RIIO-2, making it easier to compare and assess performance and value for money, similar to the way Ofgem already does in the energy retail market's data portal and akin to the annual publications from Ofwat on performance in the water sector. We also address in this report how performance reporting has in fact gone backwards, rather than been improved for RIIO-2.

Recent developments

The RIIO-2 price controls are over halfway through for electricity transmission, gas transmission and gas distribution. Ofgem and companies have already

[21] Using Ofgem's own cross-check figures

commenced work on their RIIO-3 submissions, with business plans submitted to Ofgem in December 2024, for final determinations by December 2025.

Since the RIIO-2 price control commenced, there have been significant external events, namely:

- **2020 to 2022:** The COVID-19 Pandemic which caused an economic slump and reduction in energy demand.
- **2021 to 2024:** The energy price crisis caused by the post-Covid uptake in energy demand and the Russia-Ukraine war.
- **2021 to 2024:** Increased consumer inflation, peaking at 11% in 2022, and increased Bank of England interest rates which rose from 0.1% in December 2021 to 5.25% in August 2023.

Inflation impacts

Inflation has significantly increased the charges that network companies are able to recover. To keep financing costs low, the RIIO price controls are designed to protect network companies and their investors from the risk of inflation and interest rate increases. The company revenues will automatically change to reflect any increases or decreases of these indexes. In theory this is also intended to protect consumers should inflation be lower than expected or negative. The aim is to keep real equity returns stable over time to enable required investment and deliver an efficient cost of capital for consumers.

The sharp increases in inflation and interest rates have led to immediate increases in:

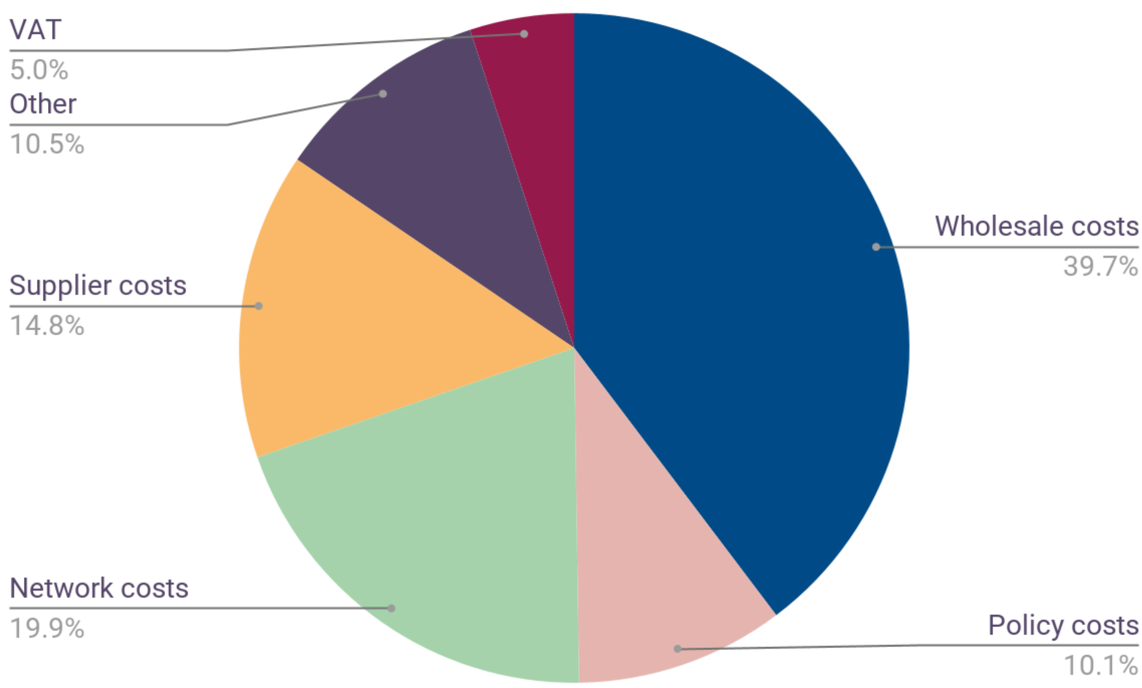
- **Totex allowances,** where companies will receive cost increases in line with economy-wide inflation and inflation of some specific costs.
- **Regulated asset value (RAV):** This is the value of a company's capital used in its regulated business. As this increases with inflation, it increases the base on which returns are generated.
- **Company returns** as the real cost of capital is adjusted to reflect interest rate increases. This particularly impacts the cost of debt, where returns are adjusted to reflect the latest trailing debt average.

During 2023, Ofgem consulted[22] on the impact of high inflation on network price controls and the associated increase in real equity returns. In the consultation Ofgem noted that, while these increases may be expected to balance out over time, the current inflationary environment challenged this view. It considered[23], on balance, that regulatory intervention would not be in the interests of consumers due to any perceived worsening of regulatory stability negatively impacting future investment costs. We explore this decision later and its impact on consumer value for money.

Bill increases

Ofgem in its two most recent updates announced a 10%[24] and 1.2%[25] increase in consumer energy bills under its retail price regulatory framework, with electricity and gas network charges representing a fifth of the bill.

Figure 4. Dual fuel energy cost breakdown - retail price cap 1 January to 31 March 2025



[22] Ofgem, Call For Input - Impact of high inflation on the network price control operation, 2023
[23] Ofgem Call For Input - Impact of high inflation on the network price control operation – Conclusion and Next Steps
[24] Ofgem, Changes to energy price cap between 1 October - 31 December 2024
[25] Ofgem, Energy Price cap

Between 2021 and 2024, the network charge in average customer bills has increased from £324[26] to £370 (both in 2024 prices), an increase of 15% above inflation. This £46 increase across 27 million customers accounts for some £1.2 billion of additional expenditure per annum.

Further above-inflation increases in network charges are expected over the remainder of the price control period to fund additional network investment to enable the transition to net zero.

Given this upward cost pressure for consumers, it is important to assess whether the RIIO-2 price control represents good value for money.

[26] Ofgem energy bill network component = £268 in 2021, increased by 21% CPIH inflation = £324 Ofgem, Default tariff cap update from 1 October 2021

Obtaining data

This assessment of network company performance is based on publicly available information.

Each company is required to report its financial and operational performance to Ofgem annually and to publish the results. This information is normally published by September each year on individual company websites. Reports include:

- Regulatory financial accounts for each regulated company
- Customer performance reports
- A regulatory reporting pack, contained detailed financial and operational updates and calculation of performance incentives and/or penalties.

An Ofgem summary of price control financial performance is published annually in a spreadsheet, with the latest version[27] published in February 2025, covering the period up to and including the year 23/24. From these sources[28], this report seeks to assess company performance up until 31st March 2024, the end of RIIO-2 year 3 for electricity and gas transmission, and gas distribution, and the end of RIIO-2 year 1 for electricity distribution[29].

In a change from RIIO-1, Ofgem has not yet published additional analysis and commentary on company performance during RIIO-2, despite receiving the data from companies. This makes it more difficult for stakeholders to understand changes that have been agreed between Ofgem and network companies, and to assess the comparative performance of companies. There is further commentary on this issue later in this report when we consider transparency of performance in RIIO-2.

In the analysis section of this report, RIIO-2 performance for each of the sectors is examined, firstly considering the sector, followed by the individual companies. Each section considers the following key factors:

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[27] Ofgem, RIIO-2 regulatory performance data file 2023-24
[28] Excluding the latest Ofgem data file, which was published after analysis was completed
[29] Ofgem, RIIO-1 Electricity Distribution Regulatory Performance Data Files 2022-23

- **Totex performance**, showing changes to allowances and over/under spend against allowance.
- **Output performance**, showing performance of key financial output delivery incentives (ODI-F) against targets.
- **Shareholder returns**, showing Return on Regulatory Equity (RoRE) including financing benefits.

Summary of findings - debt outperformance

The biggest area of outperformance by companies to date during RIIO-2 relates to **debt costs**. These are the allowances provided to companies to enable them to repay their costs of borrowing. We have found that the allowances provided to cover the cost of debt have exceeded the actual cost of debt incurred **by over £3.9 billion**.

The intent when setting allowances for debt is to broadly match incurred debt costs at a sectoral level[30]. Hence, it is clear that this outperformance represents a policy failure.

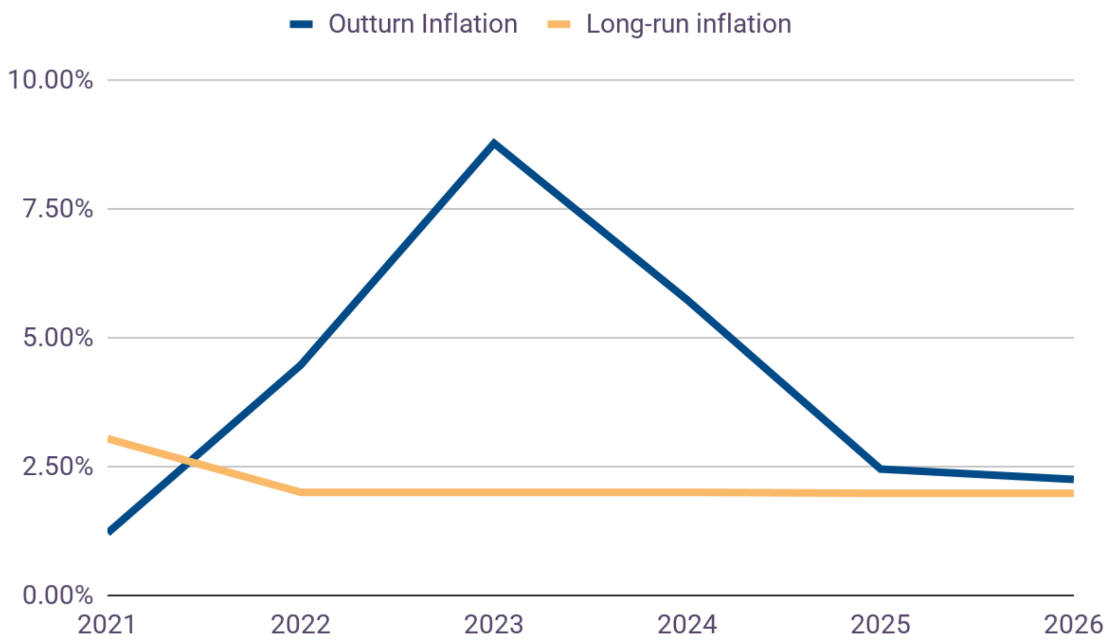
The debt outperformance results from the detailed calculations which determine the allowances network companies are given to cover debt costs. In RIIO-2, allowances are linked to inflation. However, in reality a proportion of actual debt is at a fixed rate rather than being indexed-linked (and so costs do not move with inflation). This means high inflation has caused allowances to significantly exceed costs. This also means different companies will be affected differently, depending on the proportion of index-linked debt they hold.

More technically, the cost of debt allowance is based on a trailing average of market interest rates. This is deflated using a long-run inflation assumption (typically 2%) to convert from nominal terms to real terms. The costs incurred by companies related to fixed rate debt do not vary with inflation once issued, and so as outturn inflation rises above the long-run assumption the real cost of fixed rate debt rate falls and a mismatch occurs between debt costs and debt allowance.

As actual inflation has been well above the long-run assumption, this drives additional returns and profits above those reasonably expected.

[30] Ofgem aims '...to broadly match debt allowances with expected efficient debt costs for RIIO-2 through the calibration of the index'. Ofgem: RIIO2 Final Determinations para2.2

Figure 5. Outturn inflation and long-run inflation



The intent of the regulatory regime is to protect both consumers and network companies against inflation. However, the impact of inflation on debt allowances has provided an additional return on top of the adjustment intended to provide that protection.

Ofgem has stated that this additional return *"...is a result of an economic sensitivity inherent within the price control and is not associated with business performance or outcomes for the consumer"*[31]. **This is a windfall.**

In practice, this outperformance results in additional Regulated Asset Value (RAV) growth. This is paid for by consumers to companies through depreciation allowances over the regulated asset life. However, companies are able to leverage the additional RAV to raise money, meaning the benefit to companies is immediate.

[31] Ofgem, Call For Input - Impact of high inflation on the network price control operation, 2023

Ofgem has proposed prospective changes to the next set of price controls (RIIO-3) which mean that the outperformance we have seen in RIIO-2 would not reoccur if the inflation conditions were repeated. This represents an acceptance that the increased profits driven by the outperformance are not justified and should be prevented from happening again.

Ofgem previously suggested it is possible that the mis-match between outturn and long-run inflation assumptions could even out over time i.e. periods where outturn inflation is higher than long-run inflation assumptions (and so windfall outperformance is achieved) will be balanced out by periods where outturn inflation is lower than long-run assumptions (and so networks receive lower allowances).

The changes proposed by Ofgem to tackle the risk of outperformance will also prevent the inverse from occurring. By choosing to change arrangements directly after a period where inflation has been high and substantially exceeded long-run assumptions, Ofgem has crystallised the detriment to consumers with no opportunity for it to even out over time.

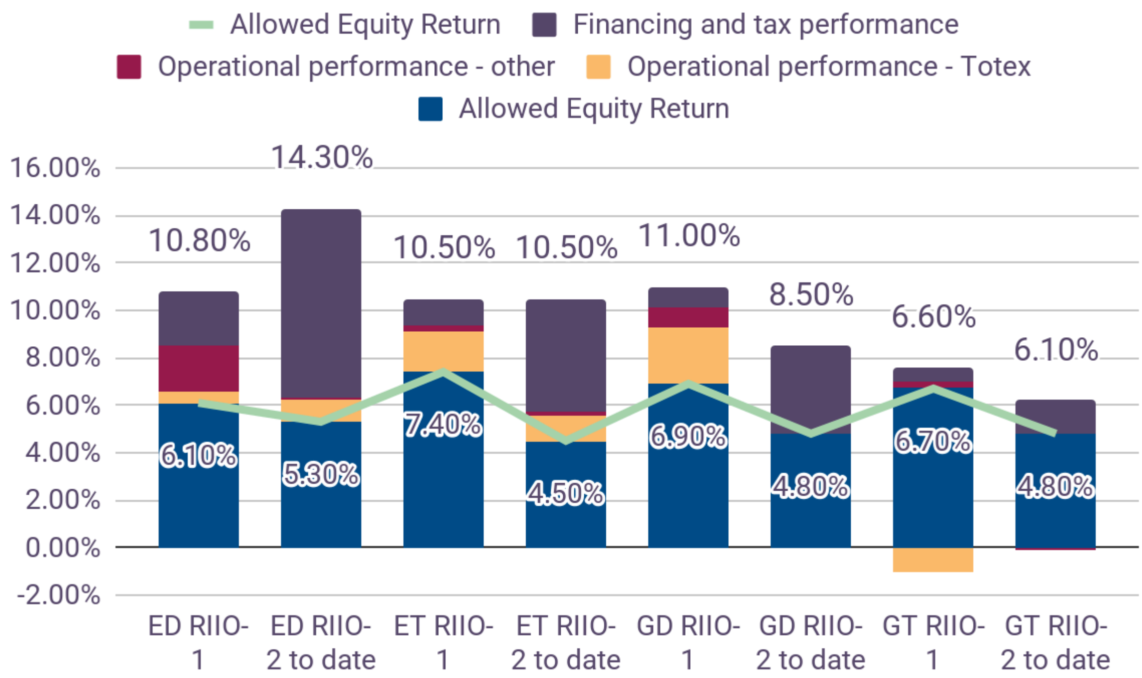
Nevertheless, we are supportive of the prospective changes as outperformance remains more likely than underperformance. But, as it can now not be argued that the price control could naturally redress this windfall return to companies over time, we believe other actions need to be taken to ensure consumer confidence in the legitimacy of the regulatory arrangements is not undermined.

These options are explored in the recommendations section.

Summary of findings - network company returns

Using Ofgem's measure of financial performance, known as Return of Regulatory Equity (RoRE), we have found that performance is at a similar level to the previous set of price controls in contrast to Ofgem's intent that RIIO-2 would be a tougher price control than RIIO-2.

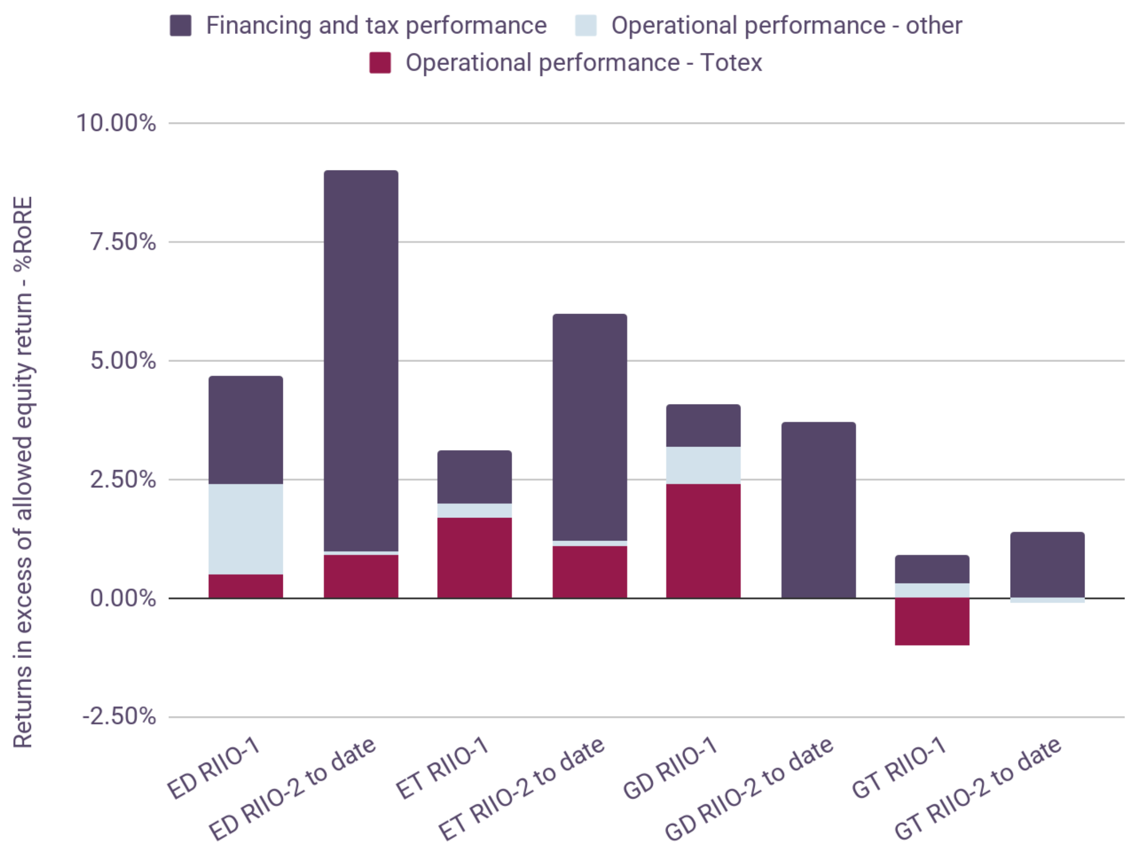
Figure 6. Network companies RoRE performance in RIIO-1 and RIIO-2 to date



When we compare the total returns of companies to the level that Ofgem assesses as being efficient (allowed equity return), we see that the difference between the two is actually greater in RIIO-2 to date compared to RIIO-1.

However, the main drivers of this outperformance have changed and are now overwhelmingly being driven by financing benefits rather than operational factors. Unlike operational factors where benefit is delivered to customers through efficiency or rewards for excellent performance, this financial outperformance has no link with any improved customer outcomes.

Figure 7. Network company outperformance compared to efficient allowed returns



Under incentive regulation, companies that perform better than others should be able to earn additional rewards. However, what we observe is systematic overall outperformance with *all* companies outperforming their allowed returns and earning additional rewards in RIIO-2. Again, we do not see these returns associated with improved outcomes for customers, but because of financing and tax benefits.

Figure 8. Number of network companies outperforming and underperforming

	RIIO-1		RIIO-2	
Number of companies	Outperforming	Underperforming	Outperforming	Underperforming
Electricity Distribution	6	0	6	0
Gas Distribution	4	0	4	0
Electricity Transmission	3	0	3	0
Gas Transmission	0	1	1	0
Total	13	1	14	0

Ofgem introduced a failsafe mechanism in price controls called the Return Adjustment Mechanism (RAM). This is described as *"a mechanism for ensuring that energy consumers do not pay in full for levels of return that are only achievable by companies due to errors or information asymmetry"*[32].

The purpose of the RAM is to tackle situations where returns are unexpectedly high, such as having come from unexpected sources, and to address situations where returns may be unexpectedly too low. However, when Ofgem introduced this mechanism they chose not to include financial outperformance as a trigger for this mechanism.

Therefore we see the sources of outperformance in RIIO-2 fall outside of this mechanism because of its design. This is despite warnings by Citizens advice on several occasions in 2020, before the RIIO-2 price control started, *"that companies may generate windfall gains as a result of debt outperformance"* and

[32] Ofgem, RIIO-2 Final Determinations: FInance Annex, 2021

that Ofgem should consider including outperformance on financing costs[33], as part of the 'upside' Returns Adjustment Mechanism.

[33] Citizens Advice, Response to Ofgem RIIO-ED2 Methodology consultation Annex 3 Finance Section, October 2020 and Response to Ofgem consultation on RIIO-2 Draft Determinations Finance Section, September 2020

Summary of Findings - Performance monitoring and transparency

This report analyses information produced by companies in their annual regulatory reports and financial data submissions to Ofgem, together with Ofgem annual spreadsheet updates of key financial performance data. This information is spread across many documents and is difficult to consolidate in a common form across sectors and companies. We also find that gaining a picture of financial performance is extremely complex and challenging. Delays between company publications and Ofgem publications also create temporary inconsistencies between data.

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

Citizens Advice is concerned by the lack of visible reporting on network performance.

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

We are not aware of any decision taken by Ofgem to reduce its monitoring and reporting activity and since 2022 there has been a placeholder on the Ofgem website where this data would be published:

> *"We will publish performance reports on this page from 2022 onwards".*[34]

Had the reporting framework from RIIO-1 been in place as a minimum, Ofgem should already have published 3 years worth of data from the 8 companies in the ET, GT and GD sectors and 1 year of data covering the 6 ED companies.

[34] Ofgem, Network price controls 2021-2028 (RIIO-2), captured 11/1/25

However, Ofgem has not collated and published this data with associated assessment or commentary.

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

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

Given the vast amount of customer money required to fund RIIO-2, we consider that Ofgem should undertake more comprehensive monitoring of ongoing performance, with regular update publications to provide transparency and aid external scrutiny.

Furthermore, RIIO-2 has a range of reputational incentives in place. By definition reputational incentives can only work effectively where companies' performance, both good and poor, is being widely highlighted, displayed and scrutinised in order to drive the right behaviour in companies.

We believe Ofgem's role is central to this and much more needs to be done.

We recommend:

1. Ofgem commits to publishing annual comparative performance monitoring, demonstrating how companies are performing financially against their targets and metrics, and in comparison to each other. Ofgem already does this in the energy retail sector and we note that Ofwat publishes annual reports on water company performance.[35]
2. Ofgem publishes key data and metrics in easy and accessible formats in the same way it publicises information in the retail market to give visibility to customers. This should take the form of league tables where it is appropriate to do so as this provides additional incentive to companies over and above the financial incentives in place. For reputational

[35] Ofwat, Water Company Performance Report 2023-24

incentives, this publicity of information is essential and we would question the extent to which companies incur reputational risk without this.

3. By default all data in companies' annual regulatory reporting packs should be published except for data which is genuinely commercially sensitive.
4. Ofgem should also publish its own qualitative assessments of annual company performance and of the operation of its price controls. At present it is unclear what monitoring activity is taking place and to what extent Ofgem is satisfied that its RIIO-2 price controls are delivering the outcomes as intended. While the end of price controls is an opportunity to reflect, we believe this needs to become a more visible and embedded activity, particularly when the scale of investment is set to increase significantly.

Analysis

Electricity transmission sector

The electricity transmission price control covers the 5 year period between 1st April 2021 and 31st March 2026. Ofgem's objectives for RIIO-2 were to prepare the network companies to deliver net zero at lowest cost to consumers, while maintaining world-class levels of system reliability and customer service, and ensuring no consumer is left behind.

The RIIO-ET2 price control provided increased funding for load related transmission investment, together with uncertainty mechanisms that could release additional funding if required. Ofgem also introduced measures like Price Control Deliverables (PCDs) to monitor and ensure that investments were delivered. As for returns, the allowed cost of equity was reduced from RIIO-1.

This section examines the performance of electricity transmission companies after the first three years of RIIO-ET2. It examines the areas of total expenditure (totex), output performance and returns.

a) Total sector expenditure (Totex)

Baseline totex allowances

In December 2022, Ofgem approved the efficient baseline totex allowances for each electricity transmission company in the RIIO-ET2 Final Determinations. These 5-year allowances (from the February 2021 Ofgem price control financial model) are compared below with the latest totex allowances from the July 2024 Ofgem financial model.

The July 2024 model includes subsequent changes to allowances made by Ofgem after the first year of the price control to address allowed adjustments and uncertainty mechanisms. All figures are shown in 2023/24 prices.

Figure 9. RIIO-2 Change in 5 year Electricity Transmission Totex Allowances

£m (23/24 prices)	Feb-21	Jul-24	% Change
NGET	7,763	12,899	66%
SHET	3,444	7,101	106%
SPT	1,662	2,782	67%
Total	12,869	22,782	77%

Since the price control decision, the overall totex allowances for electricity transmission have increased by £10 billion or 77%. All the transmission companies have seen a significant increase. Load related capex allowances have increased by £6 billion and asset replacement capex allowances have increased by £3 billion.

A key driver for this increase was the December 2022 Decision by Ofgem to accelerate transmission investment needed for net zero. This is described below.

Accelerating strategic electricity transmission investment (ASTI)[36]

In response to previous Government targets for up to 50GW of offshore wind generation by 2030, the National Energy System Operator (NESO) was charged with developing a transmission network design to deliver these targets. This network plan was published in July 2022 and recommended urgent investment in many new transmission projects.

In December 2022, Ofgem introduced the new ASTI funding and approval framework for 26 new onshore projects, with a forecast capex of £20 billion across all onshore transmission companies. The regime was designed to accelerate project delivery, with the Ofgem cost scrutiny being reduced to prevent delays.

The ASTI regime was justified by Ofgem in 2022 because they estimated it would deliver a benefit to consumers of £2.1 billion (at the time) from reduced constraint costs. In Ofgem's ASTI cost benefit assessment, individual project costs were not provided but a package of eight projects including the two Eastern Green Link projects had an estimated cost of £4.6 billion.

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

Ofgem has subsequently (during 2024) proposed the funding for these two projects from that package of eight (Eastern Green Link 1[37] and 2[38]). These latest costs for the two Eastern Green Link projects alone are £5.5 billion, £0.9 billion above the estimate for eight projects three years ago.

Ofgem's cost assessments for these projects noted challenges arising from commodity price inflation and limited capacity in the supply chain due to high global demand. As such, no reductions were proposed to direct costs claimed by the Transmission Operators (TOs).

Where costs have increased materially the potential net benefits to consumers may have also increased, however it is also possible that higher costs through ASTI could be eroding the net benefits intended. Ofgem has not provided updated cost benefit assessments across the ASTI programme which means that consumers and stakeholders do not have assurance that progressing these projects through the ASTI programme still represents value for money.

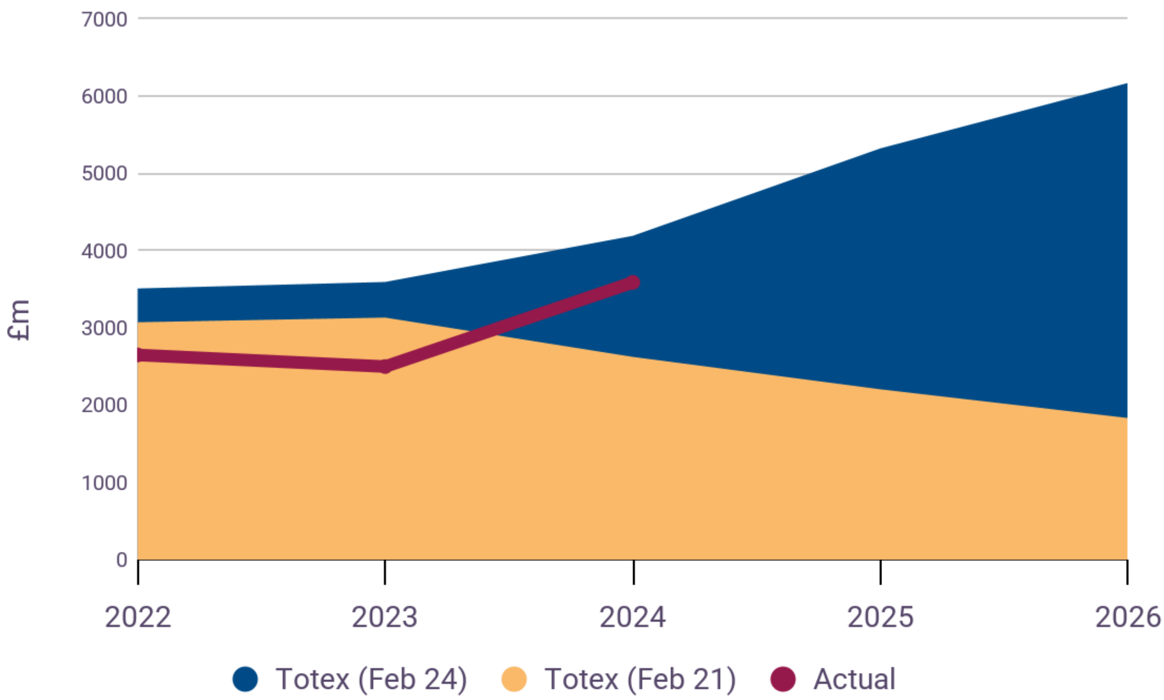
Totex allowance profiles

As described above, the original totex allowance profile for RIIO-ET2 has changed significantly, almost doubling from original forecasts.

The following chart (Figure 10) illustrates the change that has taken place in annual allowances across the 5-year RIIO-ET2 period. The original totex profile is compared with the latest profile (all in 2023/24 prices). The actual expenditure is also included for the first three years of the price control.

[37] Ofgem, Eastern Green Link 1 (EGL1) – Project Assessment Consultation, 2024
[38] Ofgem, Eastern Green Link 2 (EGL2) project assessment decision, 2024

Figure 10. RIIO-2 Electricity Transmission Totex Allowances and Actual Spend for 5-year period (23/24 prices)



The chart shows that actual totex is running around 20% below the latest allowance. There is also a major increase in the allowed expenditure forecast to the end of the price control period. With the time remaining in RIIO-2 it appears potentially very challenging for this target expenditure (and current deficit) to be addressed by the end of the price control period, and continuing underspend appears likely.

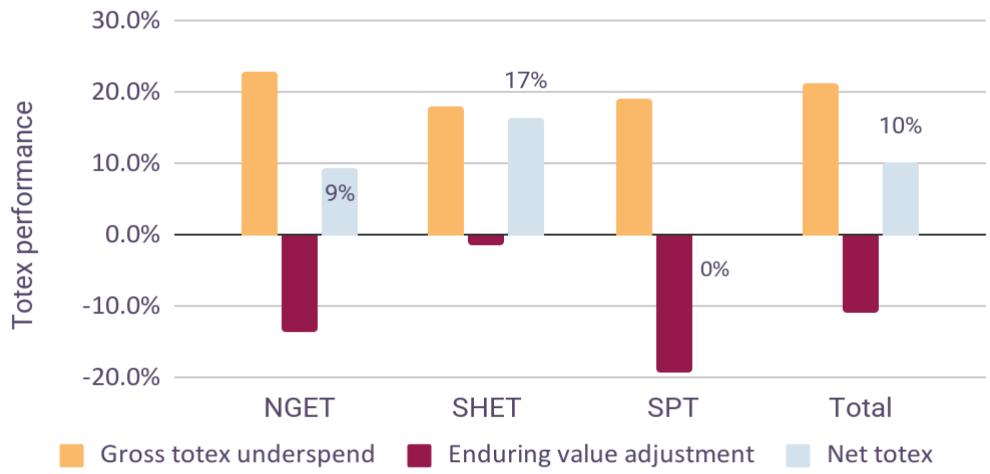
Totex outperformance

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

Figure 11 illustrates the totex performance for the first three years of RIIO-ET2. It shows gross and net totex under/overspend for each company as a percentage of annual totex allowance. The chart shows underspend below allowance as a positive figure and overspend as a negative figure.

The difference between net and gross figures results from enduring value adjustments[39] - these are intended to reflect the financial impact of any decisions or future events that have yet to be included in revenue or RAV. Companies are required to explain these adjustments and report them as accurately as possible in their annual regulatory reports.

Figure 11. RIIO-2 Electricity Transmission Totex performance against allowance



The chart shows that the gross underspend for the sector was 21% for the first three years of RIIO-ET2. However, once the enduring value adjustments were applied, the net overall underspend fell to 10%. This equates to an underspend of £1.13 billion in 2023/24 prices.

NGET and SPT were primarily responsible for these enduring value adjustments, which were mainly shown as attributable to expenditure phasing adjustments.

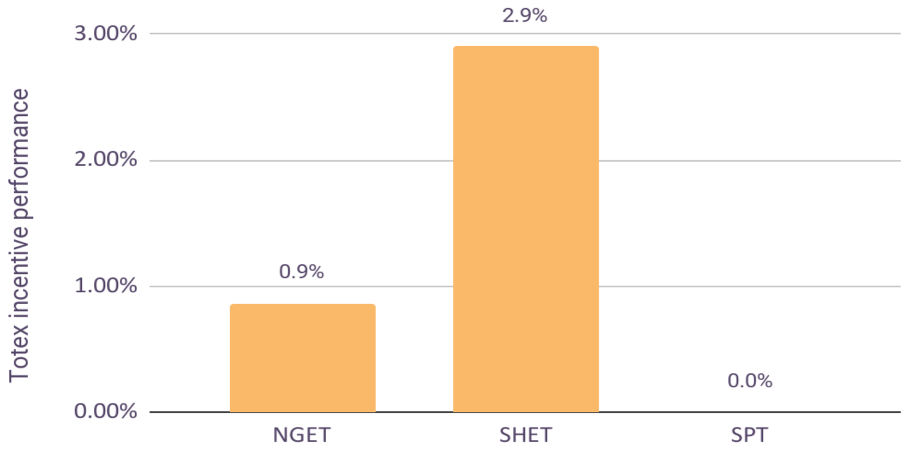
It is difficult to ascertain whether the application of enduring value adjustments will offer benefits to customers over the course of the price control. If their application is not tracked effectively from one price control to the next, there is a

[39] "Adjustments made to a licensee's financial or operational performance. These adjustments include the impact on the companies' return and RAV. Examples include any rephasing of allowances that cannot be done through the PCFM, timing differences of delivery of outputs (eg volume drivers), known changes to future output delivery (eg volume drivers)", Ofgem, RFPR RIGs Guidance v3.0, June 2023

risk companies could be provided allowances twice for the same activity and the underspend benefit to customers not delivered.

The following chart (Figure 12) shows the resultant net totex performance incentive as a proportion of return on regulatory equity (RoRE).

Figure 12. Electricity transmission totex incentive performance by company (% RoRE)



The chart shows totex incentive RoRE percentages are highest for SHET which did not apply any enduring value adjustments.

Customers served by these networks will also receive some benefit from totex underspend through sharing factors. However, if this totex underspend is simply being deferred and reclaimed in the next price control then customers may not receive this benefit for some time or may not receive it at all.

Overall, it does not appear that a consistent recording and monitoring approach for enduring value adjustments is being used by companies or Ofgem.

b) Transmission Sector Output performance

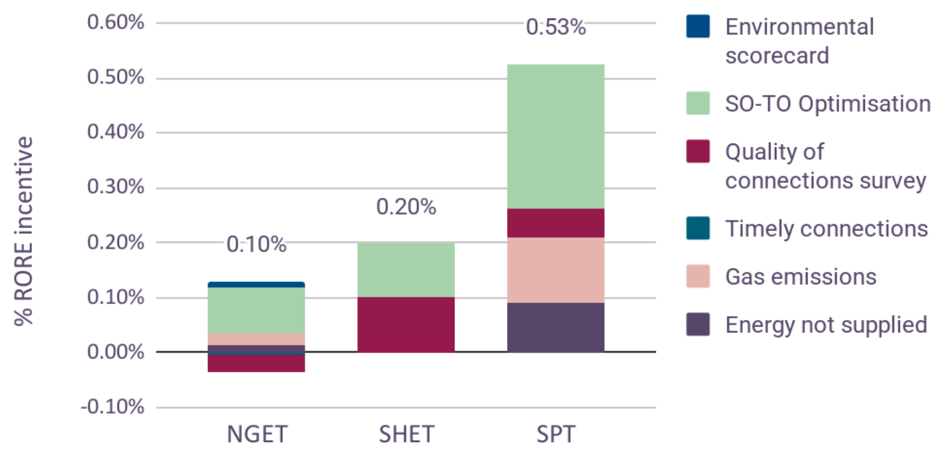
The RIIO-ET2 price control put in place a range of outputs and incentives including Licence Obligations, Price Control Deliverables (PCDs) and Output Delivery Incentives (ODIs) to drive improved performance. Of the ODI's, these are divided into reputational incentives (ODI-R) and financial (ODI-F) incentives.

For electricity transmission, the common ODI-Fs are:

- **Energy Not Supplied** – to improve network reliability and reduce outage times
- **Greenhouse gas emissions** – to reduce greenhouse gas emissions from transmission assets
- **Timely connections** – to deliver timely connection offers
- **Quality of connections survey** – to improve service for connection customers
- **SO-TO optimisation** – incentive to work with the NESO to improve network optimisation and realise consumer benefit
- **Environmental scorecard** – to meet several environmental targets

The following chart (Figure 13) shows the performance of each company against these metrics for the first three years of RIIO-ET2. It highlights the RoRE reward or penalty for each incentive and the aggregate resultant figure for each company.

Figure 13. RIIO-2 Electricity Transmission Sector Output performance



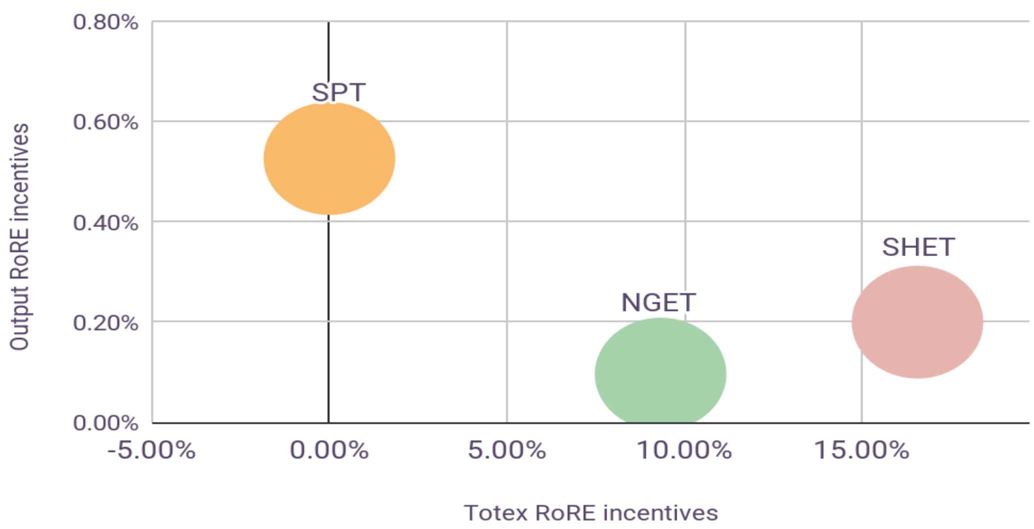
The chart shows the aggregate incentive rewards range between 0.53% RoRE for SPT and 0.1% for NGET. The main reward for all the companies has been derived from the SO:TO incentive. This was trialled for two years and was then extended to the end of RIIO-ET2.

NGET received a penalty for its connections survey. Connections are a key issue for the sector with currently over 700GW of capacity seeking transmission connections.

Electricity transmission output performance

This section reviews both the totex and output incentive performance for each of the companies. The following chart (Figure 14) illustrates the performance of individual companies against both incentive regimes as reported by each company for the first three years of RIIO-ET2.

Figure 14. Electricity Transmission Operational RoRE performance



The chart illustrates that SPT has achieved the highest output performance, while SHET has achieved the greatest totex underspend.

c) Electricity transmission return on regulatory equity (RoRE)

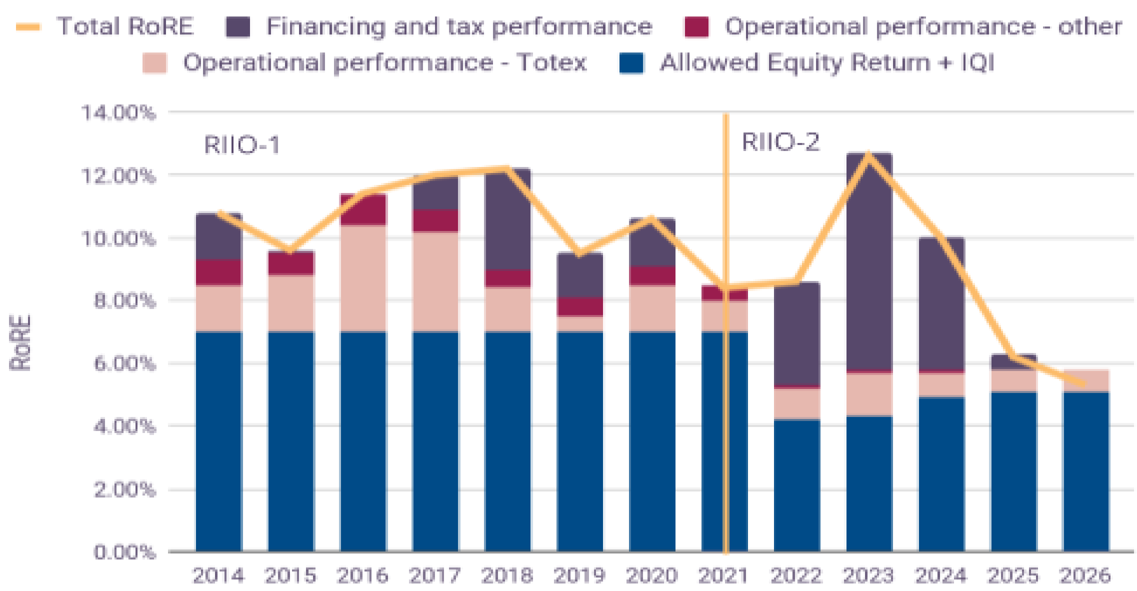
The RIIO-2 price control recognised that the RIIO-1 period had seen companies benefit from high returns on investment, due to attractive equity returns and output incentive targets that were relatively easy to outperform. The aim of the

RIIO-2 price control was to address this issue, while still ensuring that the companies could finance the increased investment requirements.

As such, the RIIO-ET2 final determinations reduced cost of equity from RIIO-1, also reducing notional gearing to 55% (from 60%) to ensure that companies could finance this investment. The following diagram shows the actual RoRE for the electricity transmission sector between 2014/15 and 2023/24.

The chart (Figure 15) compares companies based on notional gearing to give a more representative comparison.

Figure 15. Electricity transmission sector RoRE performance 2014-2024 and forecast to 2026



The sector average total RoRE for the first three years of RIIO-ET2 is 10.4%, slightly lower than the 10.6% average for 2014 to 2021. However, RoRE remains significantly higher than expected by Ofgem when setting RIIO-2 returns.

The main reason for this change is the cost of debt. The average financing/tax benefit during RIIO-ET2 for the first three years is 4.8% of RoRE. This equates to a benefit to transmission companies of around £1.6 billion (in 2023/24 prices).

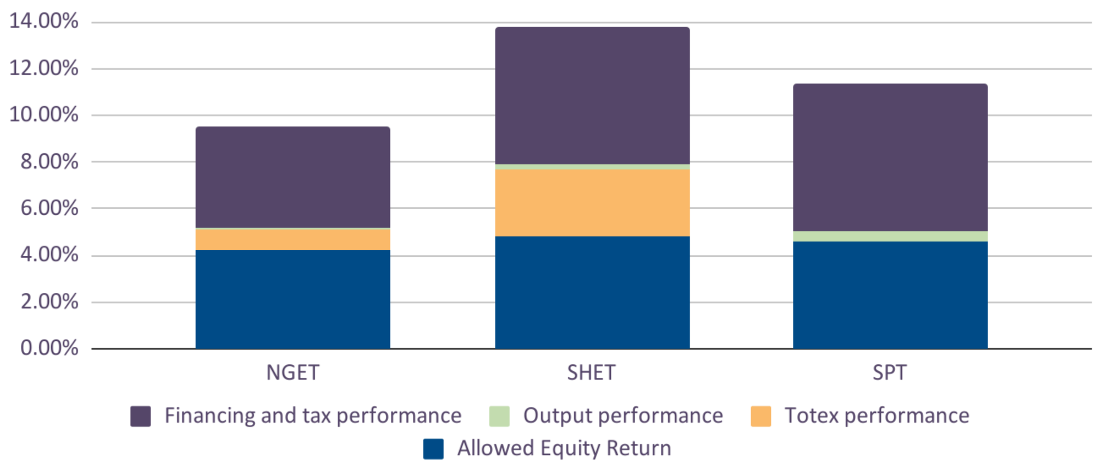
This is because the costs incurred by companies related to fixed rate debt do not vary with inflation once issued, and so as outturn inflation has risen above the long-run assumption the real cost of fixed rate debt rate has fallen and a mismatch has occurred between debt costs and debt allowance.

The chart also shows the companies have forecast a substantial reduction in the average financing/tax gain by the end of the period.

This reduction is mainly due to an expected decrease in financing and tax benefits. However, this will be dependent on outturn inflation assumptions and benefits may be higher than this if inflation remains above the long-term assumption. As such, these financial returns may not fall as significantly in RIIO-2 from current levels and are likely to remain significantly higher than expected by Ofgem, and then RIIO-3 will reset the returns. Therefore, the regulatory regime in RIIO-2 is likely to continue to allow most companies to benefit from a windfall financial gain at the expense of customers.

The following chart (Figure 16) shows the difference between individual company (notional) performance for the first three years of RIIO-2.

Figure 16. Electricity transmission company RoRE performance 2022-2024



The chart shows individual company RoRE's (including financing and tax benefits) range between 9.6% (NGET) to 13.8% (SHET). SHET has the greatest benefit from the totex incentive and SPT has the greatest benefit from financing and tax performance.

d) Electricity Transmission – key observations

This section has reviewed the performance of electricity transmission companies after three years of RIIO-ET2. Key highlights are:

- **Totex allowance -** Ofgem has agreed that Totex allowances for the 5-year price control should increase by £10 billion, or 77%, reaching £23 billion. However, large strategic investments have been approved with lower levels of scrutiny of costs and benefits to consumers, and delivery of vastly increased allowances in the last two years of the price control appears challenging.
- **Totex performance -** the sector allowances were underspent by 21%, but the underspend is reduced to 10% after adjustments were included.
- **Output performance -** this ranges between +0.1% to +0.5% of RoRE, not demonstrating particularly strong or weak performance overall. SO:TO incentives provided the greatest rewards. We have previously stated[40] that we believe this incentive delivers rewards which are unduly generous to companies and disproportionate to the effort and costs incurred by companies. In year 2, the TOs were able to earn over £8 million in incentive rewards compared to costs of £1 million. This is an extraordinary rate of return.
- **Combined totex/output RoRE performance -** this showed SHET as gaining the highest totex incentive and SPT the highest output performance incentive.

Total RoRE – total returns ranged from just under 10% to 14% which means returns have remained at the excessive RIIO-1 levels. Companies essentially received windfall gains from their financing arrangements. Across all ET companies, this additional return totals around £1.6 billion for the first three years of RIIO-ET2 and could continue to grow.

[40] Citizens Advice, RIIO-3 Sector Specific Methodology Consultation response, March 2024

Gas Transmission (National Gas)

This section reviews the performance of the National Gas transmission network. It does not include their separate gas transmission system operation business.

a) Gas Transmission Totex

In December 2020, Ofgem approved the efficient baseline totex for National Grid Gas (now National Gas) in the RIIO-GT2 Final Determinations. These 5-year allowances (from the February 2021 Ofgem price control model) are compared below (Figure 17) with the latest totex allowances from the May 2024 Ofgem financial model.

The May 2024 model includes subsequent changes to allowances made by Ofgem after the first year of the price control to address allowed adjustments and uncertainty mechanisms. All figures are shown in 2023/24 prices.

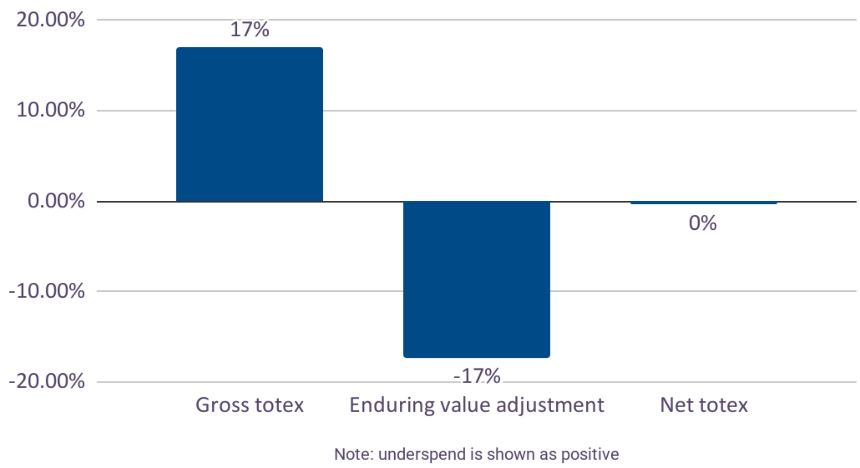
Figure 17. Gas transmission totex allowances

£m (23/24 prices)	Feb-21	May-24	£m change	% change
Load related capex	14	86	72	526%
Asset replacement capex	872	921	50	6%
Other capex	289	564	275	95%
Opex - non load	272	278	6	2%
Opex - indirects	432	522	90	21%
Non-operational capex	144	154	10	7%
Total	**2,022**	**2,525**	**503**	**25%**

Since the start of the price control, an additional £500m of totex has been agreed, increasing the totex allowance by 25%. As shown above, this is attributable to adjustments to capex allowances (load related and other). These changes appear to result from totex reopeners e.g. to address emissions, asset health, that were put in place at the start of RIIO-GT2.

The totex performance results for the first three years of RIIO-GT2 for National Gas are shown below. The chart shows the gross totex underspend together with enduring value adjustments.

Figure 18. Gas transmission totex under/overspend (3 years – 2022 to 2024)



The chart shows a totex underspend of 17% over the first three years of RIIO-GT2 is offset by enduring value adjustments of 17%. This underspend is £270m in 2023/24 prices. Once the enduring value adjustment was applied, the underspend fell to near zero. National Gas states that enduring value adjustments were due to rephasing of allowances over the price control.

b) Gas Transmission Output performance

As for other sectors, the GT2 price control put in place incentives for totex and output performance. The output incentives included Licence Obligations, Price Control Deliverables and Output Delivery Incentives (ODIs) to drive improved performance. The key financial ODIs are:

- **Customer satisfaction survey**: improve quality of customer service
- **Environmental scorecard**: rewarding achievement of several environmental outcomes

The cumulative output performance over the first three years of the RIIO-2 period for the key financial Output Delivery Incentives is shown below for National Gas.

Figure 19. RIIO-2 Gas Transmission Output performance (3 years)

Output incentives	RoRE (%)
Totex outperformance	0.0%
Customer satisfaction survey	0.2%
Environmental scorecard	0.0%

The table shows that the only gas transmission incentive reward after three years of the price control is realised by the customer satisfaction survey.

c) Gas Transmission RoRE

As was the case for the electricity transmission sector, the RIIO-GT2 final determinations reduced the allowed cost of equity from RIIO-1. The following table shows the total RoRE earned over three years of RIIO-GT2 by investors based on notional gearing. This includes the allowed equity return plus totex/operational incentives, and financing/tax incentives.

Figure 20. Gas Transmission RoRE performance 2022-2024

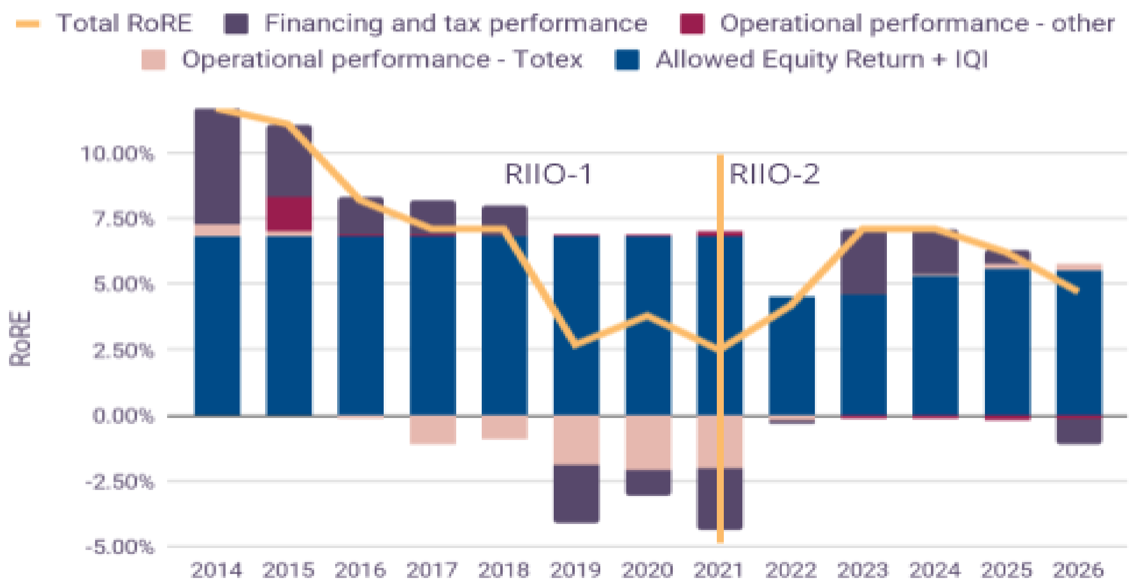
GT2 - 3 year performance	% RoRE
Allowed Equity Return	4.6%
Totex performance	0.0%

Operational performance	0.1%
Operational RoRE	4.7%
Financing and tax performance	1.4%
Total RoRE - with financing and tax	6.1%

Over the first three years of the price control, total RoRE averaged 6.1%, with 1.4% attributable to financing and tax performance. The financing and tax performance benefit over this period totalled around £120m in 2023/24 prices. Operational RoRE was 4.7%.

The following chart (Figure 21) shows the actual gas transmission returns from 2014 to 2024 and forecast to 2026.

Figure 21. Gas Transmission RoRE performance 2014-2024 and forecast to 2026



The chart shows that the total RoRE fell in 2022 as lower equity returns were introduced at the start of RIIO-2. RoRE has since increased, mainly due to the impact of financing and tax benefits. These are forecast to reduce by the end of the price control period but will depend on how quickly inflation reduces.

d) Gas Transmission – key observations

This section has reviewed the performance of National Gas after three years of RIIO-GT2. Key highlights are:

- **Totex allowance -** Ofgem has agreed that Totex allowances for the 5-year price control should increase by £0.5 billion, or 25%, reaching £2.5 billion.
- **Totex performance -** National Gas underspent their allowance by 17%, but the underspend is reduced to zero after adjustments were included.
- **Output performance -** this was 0.2% of RoRE, attributable to the customer satisfaction survey, overall showing relatively weak output performance.

Total RoRE – total return was 6.1%, lower than the RIIO-1 average of 10% between 2018 to 2021. The financing outperformance was 1.4%, equivalent to £119m in 2023/24 prices.

Gas Distribution

a) Gas Distribution Totex performance

Totex allowances

In December 2020, Ofgem approved the efficient baseline totex for each gas distribution company in the RIIO-GD2 Final Determinations. The allowances were published in the associated price control financial model in February 2021 and are shown below in 2023/24 prices.

Figure 22. Gas Distribution totex allowances

£m (23/24 prices)	Feb-21	Jul-24	% Change
Cadent	6,096	6,135	1%
NGN	1,537	1,508	-2%
SGN	3,479	3,540	2%
WWU	1,497	1,559	4%
Total	12,609	12,742	1%

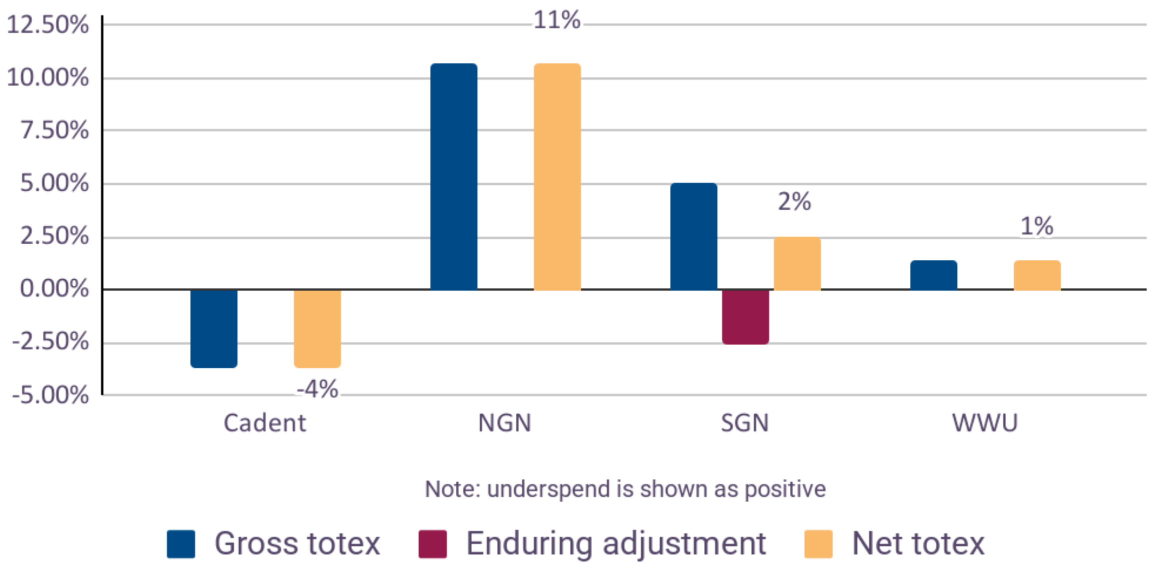
Other than inflation, there has been little change in gas distribution allowances since the price control began. Unlike in electricity where future demand is set to grow significantly, the demand for the gas network is highly likely to decline. This means that the need for additional investment within the price control is comparatively low.

Totex performance

The chart below (Figure 23) shows totex performance over the first three years of GD2. It shows gross and net totex under/overspend for each company as a percentage of annual totex allowance. The difference between these figures results from enduring value adjustments.

The chart shows underspend below allowance as a positive figure and overspend as a negative figure.

Figure 23. RIIO-2 Gas Distribution Totex performance (3 years)



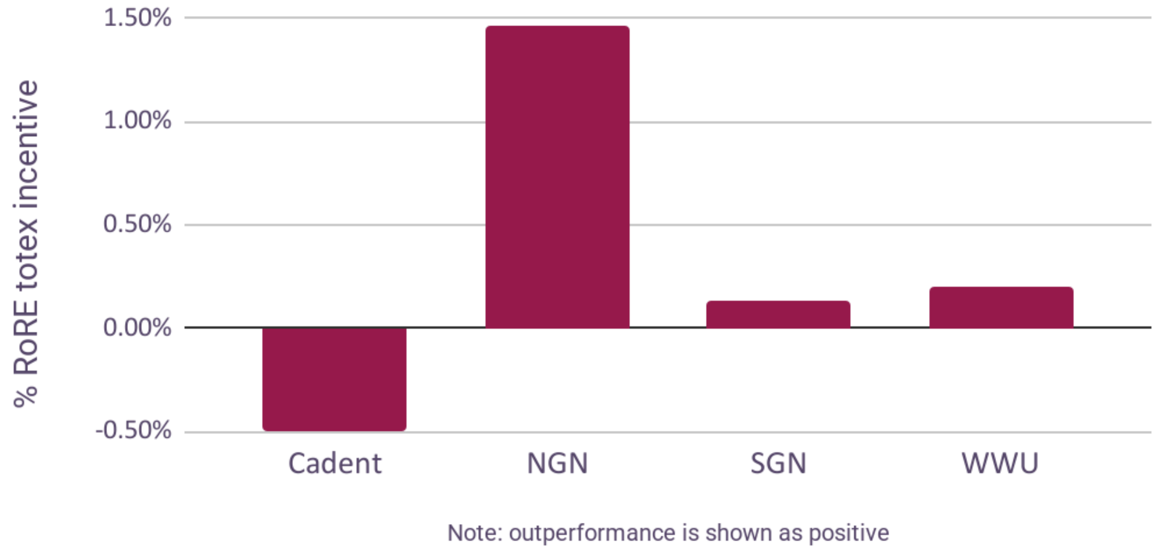
Over the three years to date, the gas distribution totex has matched the allowances overall, with an overspend at Cadent being balanced by underspend at other GDNs, especially by NGN. In 2023/24, there was a sector overspend of 10% which balanced underspend in previous years.

Only SGN has used enduring value adjustments to reduce its totex underspend – other companies have not made any adjustments.

Totex incentive performance

The chart below (Figure 24) shows totex incentive performance over the first three years of RIIO-GD2.

Figure 24. RIIO-2 Gas Distribution Totex incentive (3 years)



Overall NGN has demonstrated the strongest performance to date in relation to the totex incentive.

b) Gas Distribution Output performance

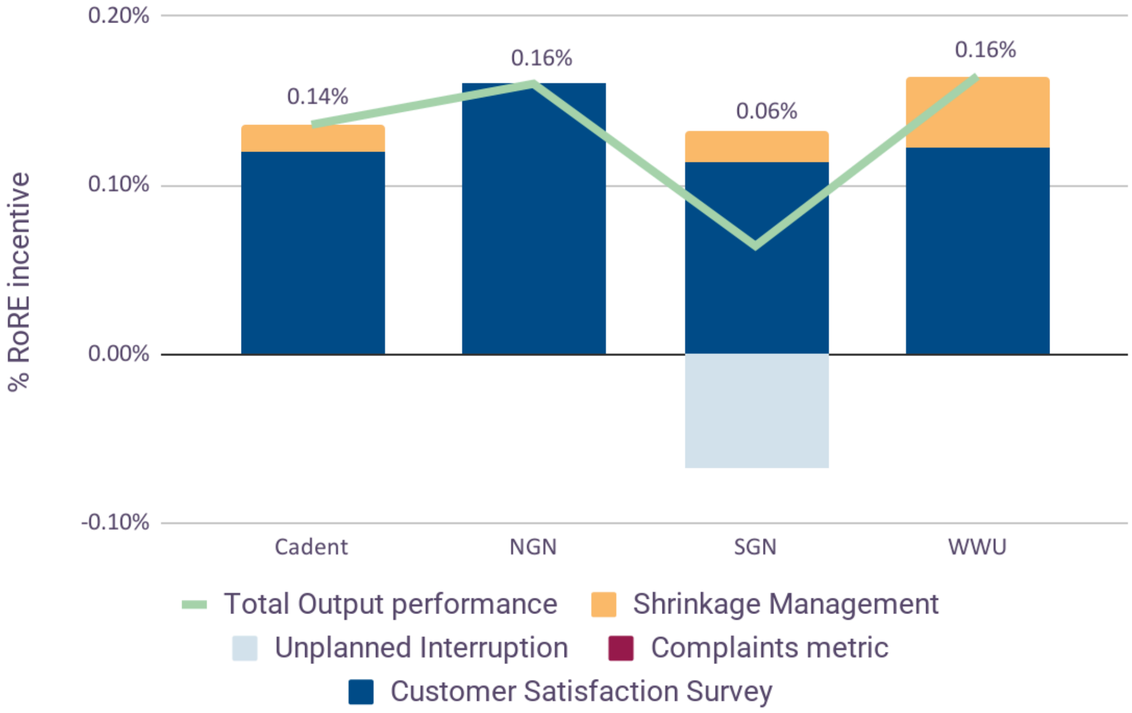
The RIIO-GD2 price control put in place a range of outputs and incentives including Licence Obligations, Price Control Deliverables and Output Delivery Incentives (ODIs) to drive improved performance. Of the ODIs, these are divided into reputational incentives (ODI-R) and financial (ODI-F) incentives.

The main common ODI-Fs for gas distribution are:

- **Customer satisfaction survey –** to maintain good customer service and reward exceptional performance
- **Complaints metric –** to ensure timely complaints handling
- **Unplanned interruptions –** to minimise customer interruptions
- **Shrinkage Management –** to reduce shrinkage of gas from networks. Shrinkage is gas that is lost from the network during its transportation and is attributable to a number of causes such as leakage and theft.

The following chart shows the performance of each company against these metrics for the first three years of RIIO-2. It highlights the RoRE reward or penalty for each incentive together with the net figure for each company.

Figure 25. RIIO-2 Gas Distribution Output performance to 2023/24

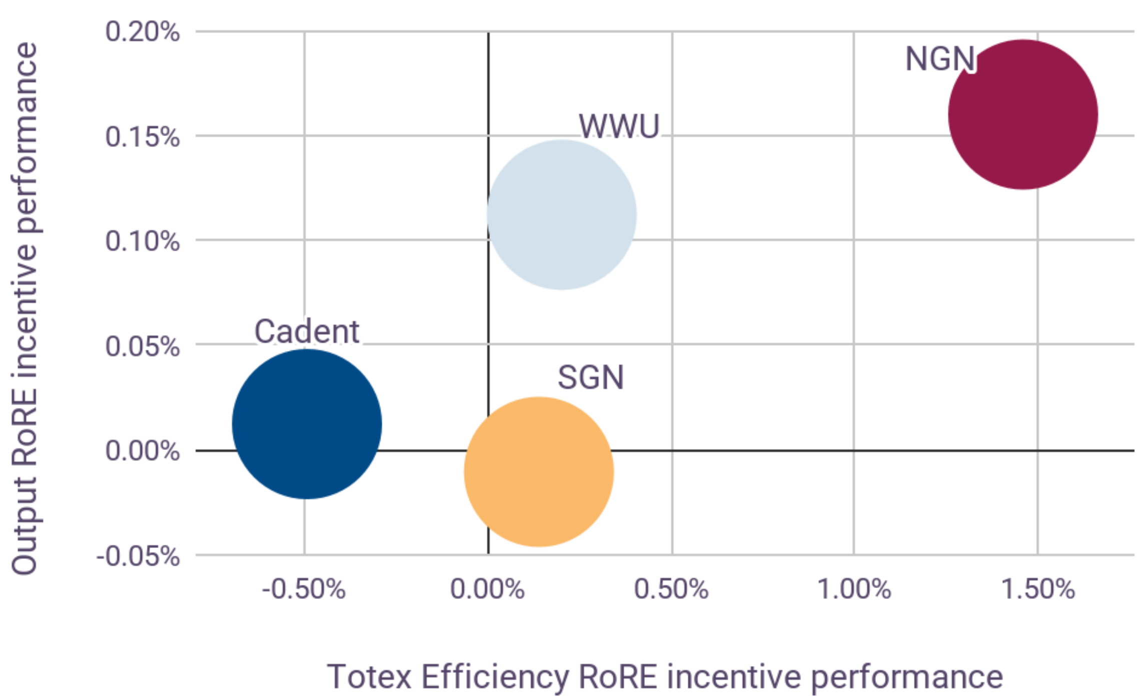


As shown above, the range of rewards for these incentives varies between 0.06% and 0.16% of RoRE. The analysis shows that:

- The results of the customer satisfaction surveys were positive for each company. These survey results dominate the GDN output incentives.
- Only SGN was penalised for unplanned interruption performance.

This section has reviewed both the totex and output incentive performance for each of the gas distribution companies. The following chart (Figure 26) illustrates the performance of individual companies against both incentive regimes as reported by each company for the first three years of the GD2 price control.

Figure 26. Gas distribution Operational RoRE performance

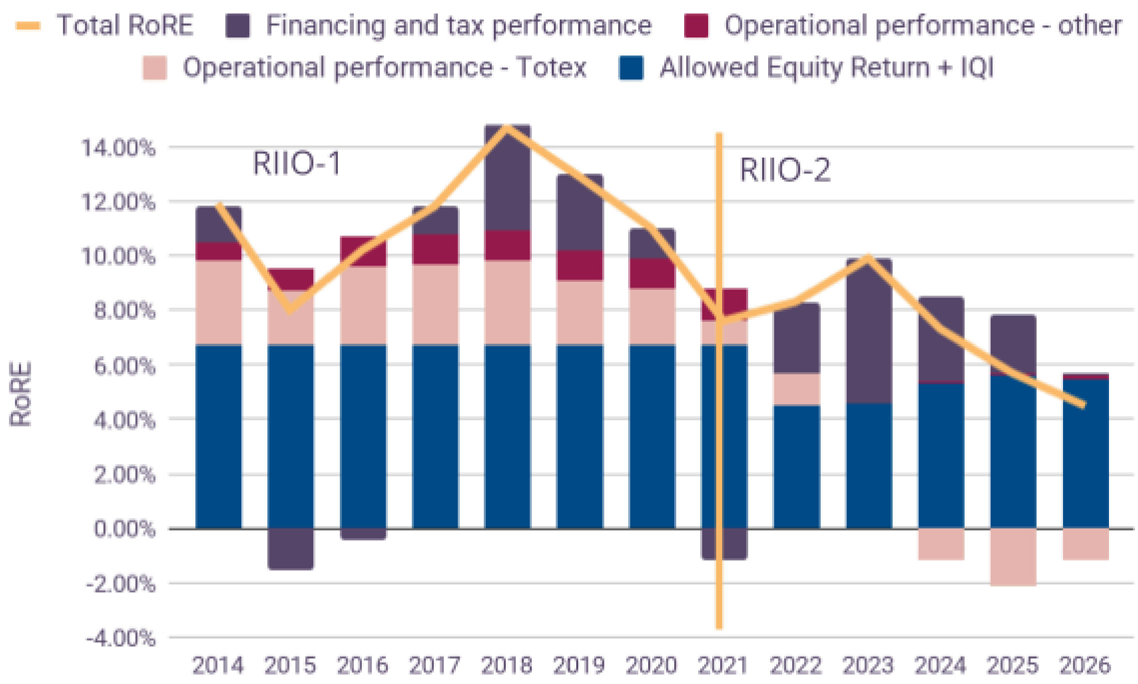


The chart illustrates that NGN has achieved the highest output incentive and the greatest totex efficiency saving, whereas Cadent has the lowest totex efficiency and SGN has the lowest output performance.

c) Gas Distribution RoRE performance

As was the case for the electricity transmission and gas transmission sectors, the RIIO-GD2 final determinations reduced cost of equity from RIIO-1, retaining gearing at 60% given lower demand for additional investment. The following diagram shows the actual RoRE for the individual gas distribution companies for the first three years of RIIO-2.

Figure 27. Gas Distribution RoRE performance 2014-2024 and forecast to 2026

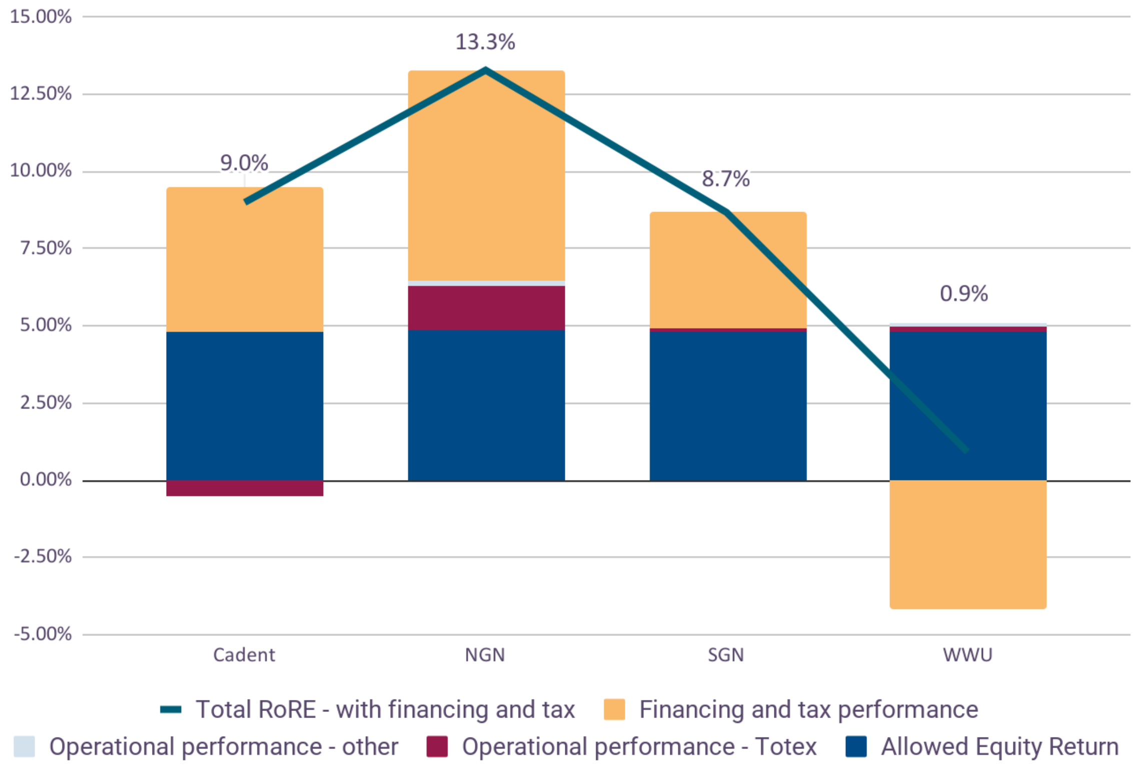


The gas distribution sector GD2 RoRE to date is 8.5%. This compares to an average RoRE of 11% for the gas distribution sector between 2014 and 2021, when the allowed equity return was 6.7%. The key changes from RIIO-GD1 are:

- totex and output incentives are both lower than RIIO-GD1.
- As with other network sectors, the RIIO-GD2 RoRE is increased by financing and tax benefits, totalling 3.7%. This financing/tax benefit over the first three years of GD2 represents around £1.1billion additional investor benefit across all the companies (in 2023/24 prices).

The performance of individual companies is shown below.

Figure 28. Gas Distribution RoRE performance 2021-2024 (3 years)



The chart shows individual company RoRE's (including financing and tax benefits) range between 0.9% (WWU) to 13.3% (NGN). NGN has the greatest benefit from financing/tax (6.8%). WWU is showing a negative value for financing and debt.

d) Gas Distribution – key observations

This section has reviewed the performance of gas distribution companies after the first three years of RIIO-GD2. Key highlights for the sector are:

- **Totex allowance -** totex allowances have only increased by 1% since the start or the price control.
- **Totex performance –** after three years, sector actual totex is closely tracking the allowance to date.

- **Output performance –** this ranges between +0.2% to -0.1% of RoRE, not demonstrating particularly strong or weak performance overall. Customer service is the greatest source of incentive rewards.
- **Combined totex/output RoRE performance –** this demonstrated a range of outcomes with NGN scoring highest.

Total RoRE – total returns ranged from 0.9% to 13.3%. Some companies have essentially received windfall gains from their financing arrangements. Across the sector, this additional return totals around £1.1 billion for the first three years of GD2.

Electricity Distribution

The electricity distribution price control covers the five-year period between 1st April 2023 and 31st March 2028. Ofgem's objectives for RIIO-ED2 were:

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

In March 2023, Citizens Advice published views[41] on Ofgem's Final Determination for RIIO-ED2, highlighting that Ofgem could have gone further in reducing the cost of capital saving customers around £1.5 billion. We also highlighted that Ofgem could have further strengthened incentives to also provide customers with better value for money and services.

This section examines the performance of electricity distribution companies after the first year (2023/24) of RIIO-ED2. It examines the areas of total expenditure (totex), output performance and returns.

a) Electricity Distribution totex

Baseline totex allowances

In December 2022, Ofgem approved the efficient baseline totex allowances for electricity distribution companies in the RIIO-ED2 Final Determinations. These 5-year allowances (from the February 2023 Ofgem price control model) are

[41] Ofgem, Our views on the Ofgem RIIO-ED2 Final Determinations for the electricity distribution sector, 2023

compared below (Figure 29) with the latest allowances from the July 2024 financial model.

The July 2024 model includes subsequent changes to allowances made by Ofgem after the first year of the price control to address allowed adjustments and uncertainty mechanisms. All figures are shown in 2023/24 prices.

Figure 29. Change in 5-year electricity distribution totex allowances

£m (23/24 prices)	Feb-23	Jul-24	% Change
ENWL	2,087	2,318	11%
NGED	7,097	7,404	4%
NPg	3,373	3,361	0%
SPEN	3,552	3,458	-3%
SSEN	4,685	5,393	15%
UKPN	6,008	6,012	0%
Total	26,803	27,946	4%

Since the price control decision, the overall totex allowance for electricity distribution companies has increased by £1.1 billion, or 4%. The main reason for this has been increased load related expenditure allowances for ENWL, NGED and SSEN.

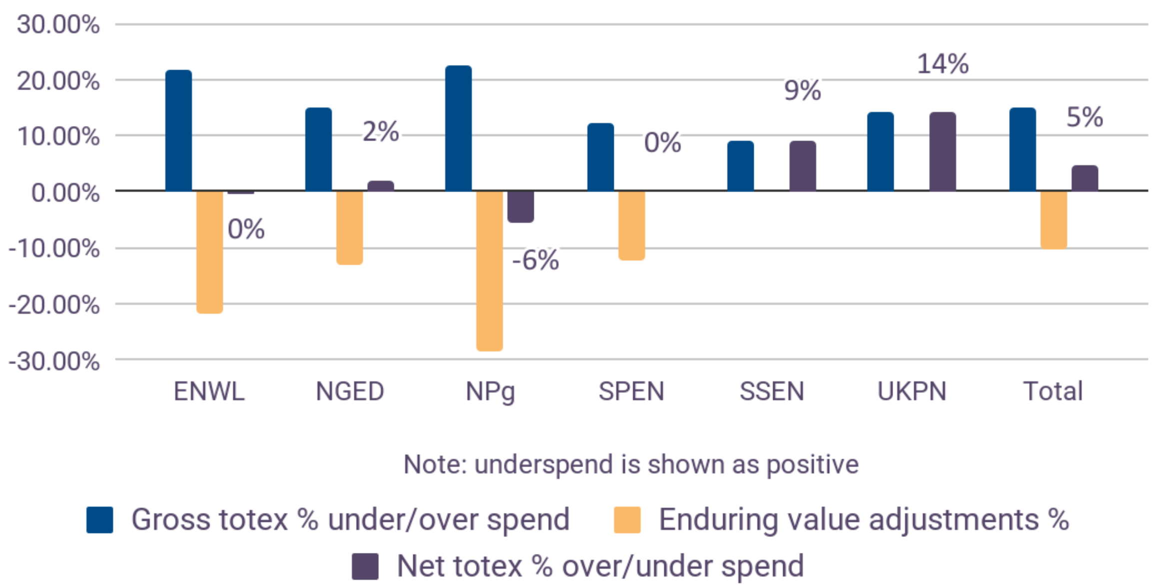
Totex performance

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

The following chart (Figure 30) illustrates the totex performance for 2023/24, the first year of RIIO-ED2. It shows gross and net totex under/overspend for each company as a percentage of annual totex allowance. The difference between these figures results from enduring value adjustments.

The chart shows underspend below allowance as a positive figure and overspend as a negative figure.

Figure 30. Electricity distribution totex performance against allowance



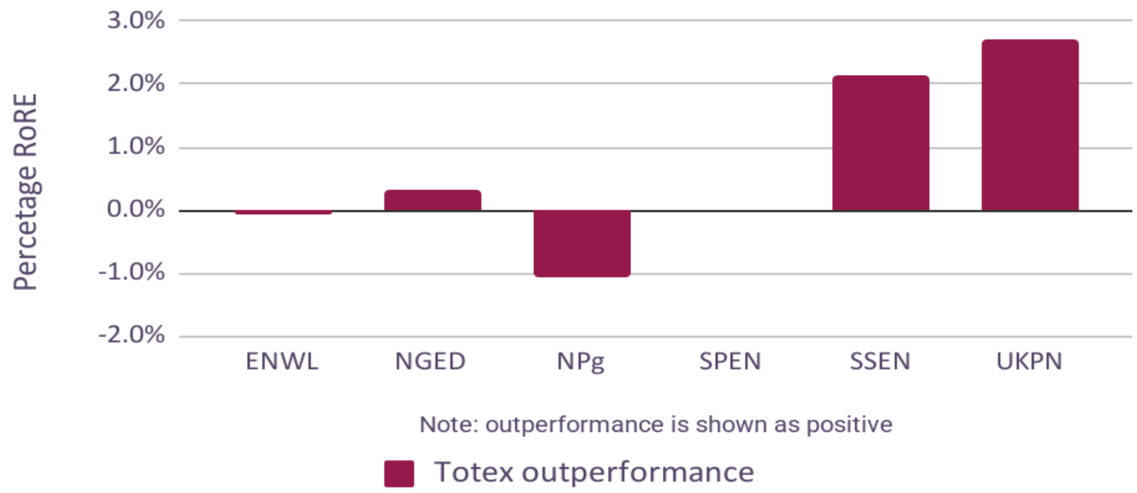
The chart shows that all companies underspent their totex allowance in 2023/24, ranging from above 20% for ENWL and NPg to 9% for SSEN. Across all DNOs, the gross totex underspend was 15%, or £795m in 2023/24 prices. About half of this could have been returned to customers.

However, once the enduring value adjustments were applied, the net overall underspend fell to 4.6% or £240m in 2023/24 prices. Only four DNOs applied these adjustments, and each have reduced their totex underspend (and customer reward) significantly. ENWL, NPg and SPEN each had enduring value adjustments that fully eliminated their underspend. ENWL and NPg stated that these adjustments were due to phasing of expenditure within the price control period, and SPEN attributed the adjustment to emerging requirements.

It is difficult to ascertain whether the application of enduring value adjustments will offer benefits to customers over the course of the price control. Tracking these adjustments from one price control to the next would be key to ensure companies don't receive allowances twice for the same activity across multiple price controls and that benefits of underspends are shared with consumers.

The following chart (Figure 31) shows the resulting net totex performance incentive as a proportion of return on regulatory equity (RoRE).

Figure 31. Electricity distribution totex incentive performance



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

b) Electricity Distribution Output performance

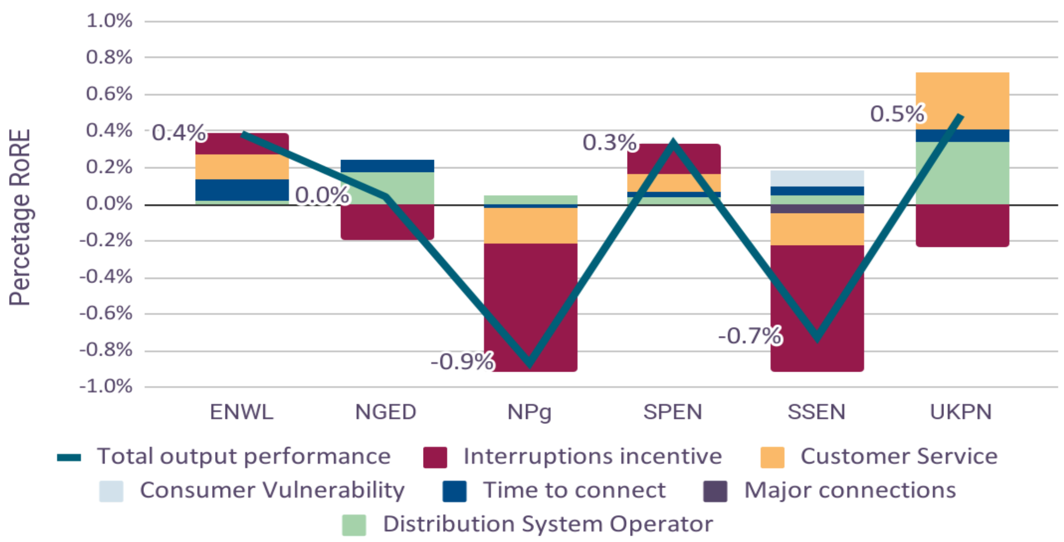
The RIIO-ED2 price control put in place a range of outputs and incentives including Licence Obligations, Price Control Deliverables and Output Delivery Incentives (ODIs) to drive improved performance. Of the ODI's, these are divided into reputational incentives (ODI-R) and financial (ODI-F) incentives.

The common ODI-Fs for electricity distribution are:

- **Interruptions Incentive Scheme:** to improve network reliability and reduce the number of interruptions and their length
- **Customer service Incentive:** to improve quality of customer service
- **Consumer Vulnerability Incentive:** to provide appropriate support services for customers in vulnerable situations
- **Major Connections Incentive:** to improve quality of service for major connection customers
- **Time to Connect Incentive:** to reduce time to connect smaller customers such as domestic connections
- **Distribution System Operator (DSO) Incentive:** to incentivise more efficient network development and operation, considering smart and flexible alternatives to network reinforcement

The following chart (Figure 32) shows the performance of each company against these metrics for 2024. It highlights the RoRE reward or penalty for each incentive together with the aggregate net figure for each company.

Figure 32. RIIO-2 Electricity distribution output incentive performance



The chart shows the aggregate incentives range between plus 0.5% RoRE for UKPN, and minus 0.9% RoRE for NPg. This result only captures one year of RIIO-2 performance and may not be representative of future performance. None of the companies are yet reaching the higher available levels of output performance incentive. This could indicate either that performance is poor or that the targets are challenging to achieve.

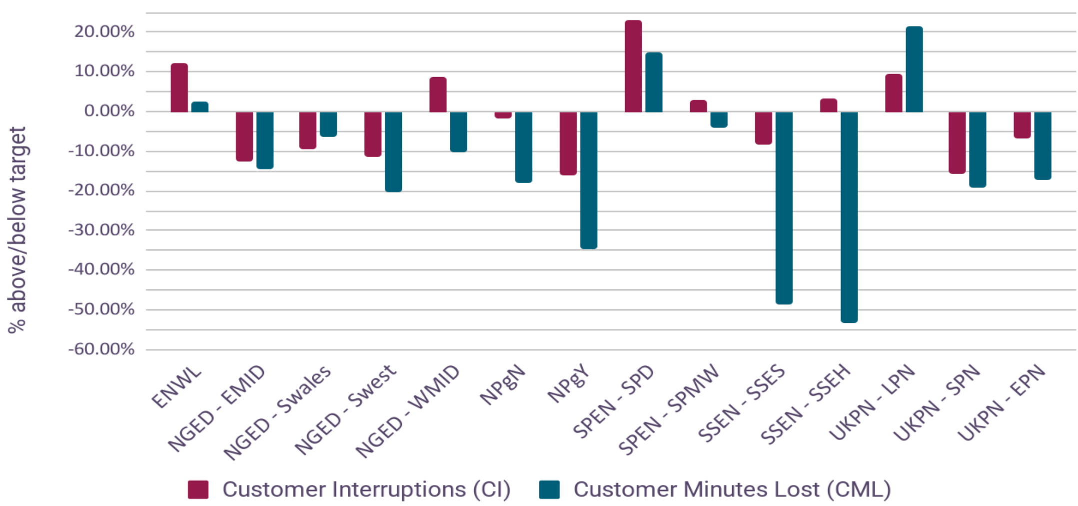
The incentive with greatest impact upon company performance is the interruptions incentive which has resulted in penalties for several companies. This is discussed further below.

Interruptions – quality of service

The following chart shows performance of individual DNO's against loss of supply targets, both in numbers of incidents (CI) and average duration (CML). It shows the percentage change from the target for each measure.

Individual targets were set by Ofgem for each DNO area, and for each year of the price control. For most DNOs these targets were strengthened from RIIO-1, targeting improved reliability performance for RIIO-2 and to address concerns we expressed that incentive rewards of around £1billion in RIIO-1 were unjustifiably high.

Figure 33. Electricity Distribution Interruptions Incentive performance against target

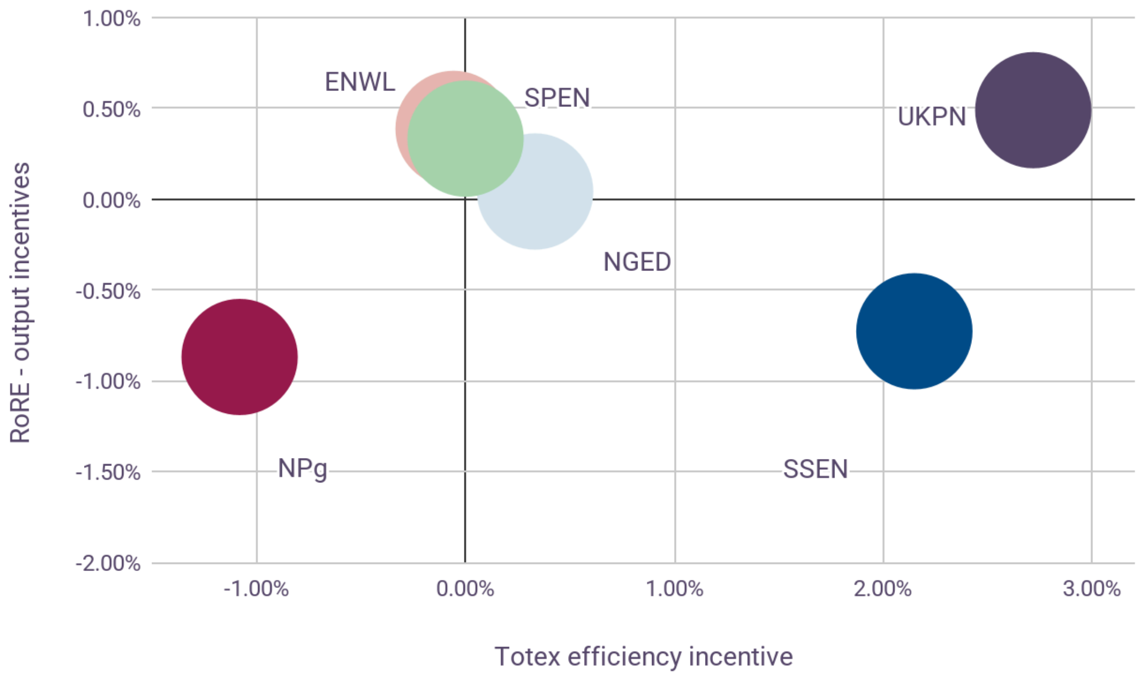


The chart illustrates that most DNOs are underperforming against their 2023/24 CI/CML targets. SPEN and ENWL are the best performers, with SSEN and NPg being the weakest, which they attribute to extreme weather events during the year.

Electricity distribution overall output performance

This section has reviewed both the totex and output incentive performance for each of the companies. The following chart (Figure 34) illustrates the performance of individual companies against both incentive regimes reported by each company for 2023/24.

Figure 34. Electricity distribution Operational RoRE performance



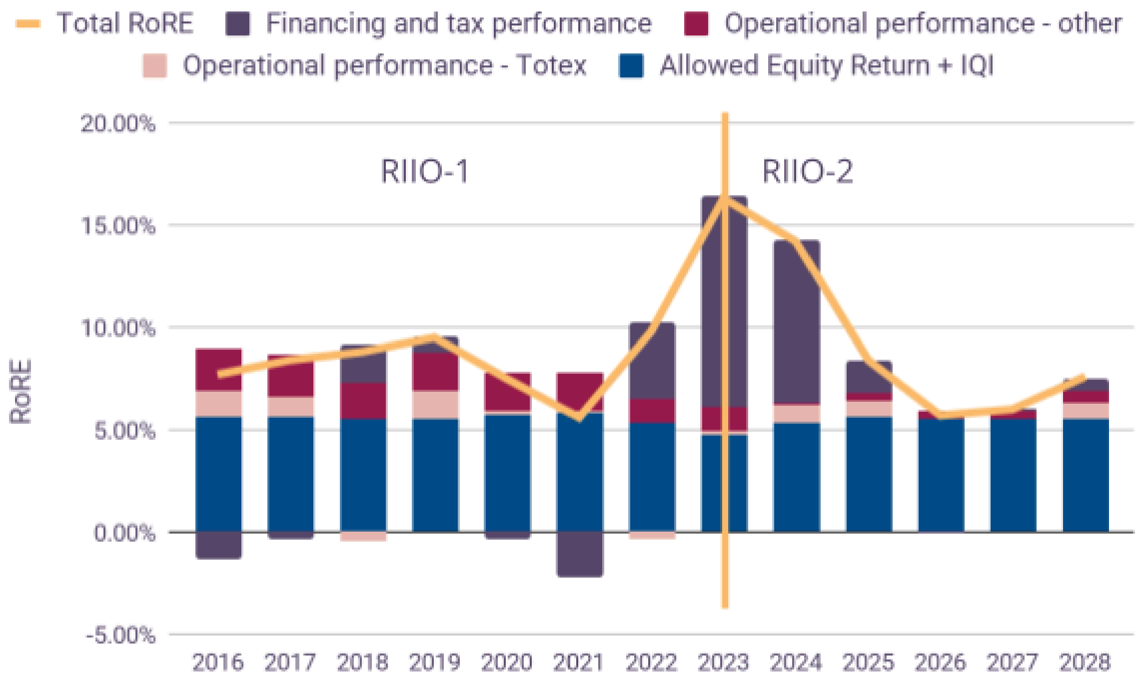
The chart illustrates that UKPN has achieved the highest output incentive and the greatest efficiency saving, whereas NPg has penalties for both. SSEN also shows low output performance.

c) Electricity Distribution RoRE

As was the case for all sectors for RIIO-2, the RIIO-ED2 final determinations sought to reduce excessive investor returns and reduced the allowed cost of equity from RIIO-1.

The following chart shows the actual electricity distribution sector returns from 2016/17 to 2023/24 and forecast to 2028. It shows the total RoRE earned by investors based on notional gearing. This includes the allowed equity return plus totex/operational incentives, and financing/tax performance.

Figure 35. Electricity Distribution RoRE performance 2016-2024 and forecast to 2028



The sector RoRE for 2023/24 is 14.2%. This compares to an average RoRE of 9.2% for the electricity distribution sector for RIIO-1.

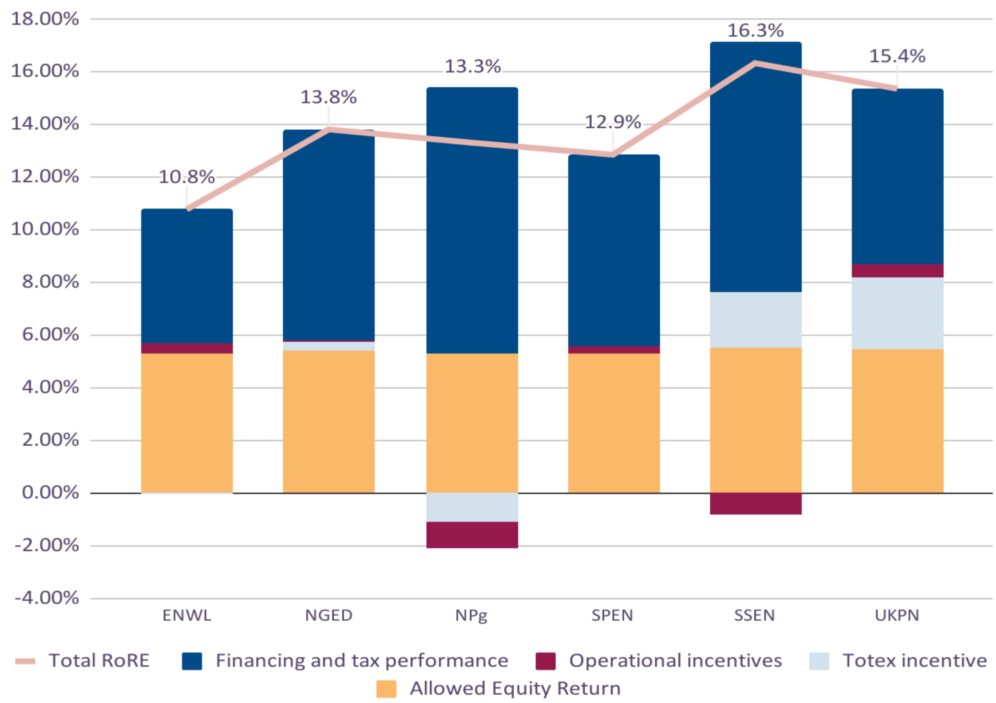
Similar to other network sectors, the 2023/24 increase is driven by financing and tax benefits totalling 8%. This financing/tax benefit over the first year of RIIO-ED2 represents around a £1.1 billion additional benefit for companies (in 2023/24 prices).

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

The chart also shows that companies forecast a significant reduction in RoRE for the remainder of RIIO-ED2 which would mean an average RoRE of 9.7%, still higher than in RIIO-1. This reduction is mainly due to an expected decrease in financing and tax benefits. However, this will be dependent on outturn inflation assumptions and benefits may be higher than this if inflation remains above the long-term assumption.

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

Figure 36. Electricity Distribution RoRE performance 2023-2024



The chart shows individual company RoREs (including financing and tax benefits) range well above average RIIO-1 levels and in double figures across the board at between 10.8% (ENWL) to 16.3% (SSEN). NPg has the greatest benefit from financing/tax (10%), but this is offset by operational and totex penalties.

d) Electricity Distribution – key observations

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

- **Totex allowance -** Ofgem has agreed that Totex allowances for the 5-year price control should increase by £1 billion, or 4%, reaching £28 billion.
- **Totex performance –** companies underspent their combined allowance by 15%, but the underspend is reduced to 4.6% after adjustments were allowed.
- **Output performance –** this ranges between +0.5% to -1%, not demonstrating particularly strong or weak performance overall. Reliability is the weakest area of performance with SSEN and NPg demonstrating poorest performance.
- **Combined totex/output RoRE performance –** this demonstrated a range of outcomes with UKPN scoring highest and NPg the lowest.

Total RoRE – total returns are in double figures across the board ranging from 10% to 16% which is even higher than the excessive RIIO-ED1 levels. Companies have received windfall gains from their financing arrangements. Across all companies, this additional return totals around £1.1 billion in just the first year of ED2.

Summary of analysis

This report has assessed the observed performance and returns earned by companies in the RIIO-2 network price controls and how these compare with the decisions made by Ofgem. The price controls for electricity transmission, gas distribution and gas transmission commenced in 2021, so three years have been reviewed. The electricity distribution price control commenced in 2023, so only one year has been reviewed.

The report has assessed totex, output and return performance, with the following key findings:

Totex allowances

The following table summarises the changes in totex allowances for each network sector.

Figure 37. RIIO-2 Allowances changes (to 2023/24)

£m (23/24 prices)	Initial	Latest	% Change
Gas Distribution	12,609	12,742	1%
Gas Transmission	2,022	2,525	25%
Electricity Transmission	12,869	22,782	77%
Electricity Distribution	26,803	27,946	4%
Total	54,303	65,996	22%

High inflation has already led to RIIO-2 totex allowances rising since the price control decisions. However, they have increased further to a total of more than

20% due to agreed adjustments to the price control allowances by Ofgem, particularly to accelerate electricity transmission investment.

However, this urgent acceleration of electricity transmission investment means that, in the interest of pace, value for money cost assessments may face less scrutiny by Ofgem for large projects, increasing risks that consumers may pay more than necessary. Accelerating investment is in the interests of consumers as it will deliver benefits to customers, including from reducing constraint payments. There is a risk that future investment could be endangered if public confidence is undermined by current investment not being delivered demonstrably at value for money.

The cumulative total of network totex is growing significantly, with many discrete decisions being made within price controls, without the same scrutiny that occurs when the price controls are set. This is making it harder to demonstrate value for money for consumers.

Totex performance

The following table (Figure 38) illustrates the totex performance for the first three years of RIIO-2. It shows gross and net totex underspend for each sector as a percentage of annual totex allowance.

The difference between these figures results from enduring value adjustments - these are intended to reflect the financial impact of any decisions or future events that have yet to be included in revenue or RAV.

Figure 38. RIIO-2 Totex underspend performance

£m 2023/24 prices	Gross Underspend		Net Underspend	
Gas Distribution	77	1%	23	0%
Gas Transmission	267	175%	-4	0%

Electricity Transmission	2,349	21%	1,129	10%
Electricity Distribution	795	15%	244	5%
Total	3,488		1,392	

The table shows that over £2 billion of enduring value adjustments have been applied since the start of RIIO-2. It is difficult to understand how these adjustments will be applied and how Ofgem is monitoring within and across price controls.

Overall, it does not appear that a consistent recording and monitoring approach for enduring value adjustments is being used by companies or Ofgem.

The totex incentive was designed to reward companies for finding efficiencies as well as mitigating genuine overspend risks. We are concerned that it may not work effectively when these adjustments may transfer gains and losses between years and between price controls.

Incentive performance

The following table summarises the RoRE for each sector, highlighting the incentives realised for totex and output performance.

Figure 39. RIIO-2 incentive performance

RoRE %	Totex outperformance	Output performance
Electricity Distribution	0.9%	0.1%

Gas Distribution	0.0%	0.0%
Electricity Transmission	1.1%	0.1%
Gas Transmission	0.0%	-0.1%

The totex incentives reflect the above comments on underspend and application of enduring value adjustments. The output incentives are generally balanced around zero – but it's not clear without further supporting commentary whether this is due to poor performance or difficult to achieve targets.

The exception is the electricity distribution incentives, which reflect under-performance in meeting reliability targets. These targets were strengthened in RIIO-2. However, the electricity distribution performance is only measured for a single year, so it is probably too early to draw conclusions on this metric.

Company returns

The final aspect of the price controls examined in this report is returns, as expressed by RoRE for each notional company.

The following table shows the finance and operational performance and total RoRE for each sector.

Figure 40. RIIO-2 RoRE performance

£m 23/24	Operational performance	Finance performance	Total	Total RORE %
Electricity Distribution	£129	£1,084	£1,214	10.4%

Gas Distribution	£9	£1,087	£1,096	8.5%
Electricity Transmission	£419	£1,671	£2,090	10.4%
Gas Transmission	-£7	£119	£112	6.1%
Total	£551	£3,961	£4,512	

The table shows the electricity distribution and transmission sectors are earning double digit RoRE, similar to the levels in RIIO-1. The financing benefit currently totals over £3.9 billion in 2023/24 prices.

Key observations

Totex allowances

These have increased by 22% since the start of RIIO-2, now reaching £65 billion overall. The scale of investment is essential but vast - there is a risk that these allowances, and subsequent updates, are not being effectively scrutinised for value for money. Future investment could be endangered if public confidence is undermined by current investment not being delivered demonstrably at value for money.

Totex performance

There appears to be significant underspend across most sectors, but this is being reduced by the application of enduring value adjustments. These enduring value benefits are difficult to reconcile, and may be distorting the effectiveness of the totex incentives and associated consumer benefits. We also note that some companies apply these adjustments while others do not.

While in theory these adjustments should even out over time and the benefits of underspends should be shared with customers, this relies on Ofgem tracking these adjustments and ensuring companies are not given allowances in subsequent price controls for spend which has been adjusted throughout the previous price control.

Incentive performance

It is difficult to fully understand the effectiveness of the operational performance incentives without further commentary and analysis being provided. Incentive payments have reduced significantly, which reflects targets being strengthened since RIIO-1.

Company returns

Many companies are realising returns on regulatory equity similar to the excessive levels of RIIO-1 and earning double figure returns. This is despite Ofgem intending that returns should be lower in RIIO-2 than RIIO-1.

The impact of high inflation on returns has led to a windfall gain to companies, with financial outperformance of nearly £4 billion to date.

Summary of recommendations

This report has identified a range of issues which affect the value for money consumers are getting from the RIIO-2 price controls and recommendations to address these. Below we set out a range of changes Ofgem should make to prevent these issues from recurring.

Cost of debt outperformance

Forward-looking changes

We note that Ofgem is proposing to make changes which would remove the indexation of fixed rate debt. This should mean that any future variance between outturn and long-term inflation does not result in a significant windfall gain (or loss) to the network companies. Despite the risk outlined above that this could crystallise gains for the companies we are supportive of this as the chance of windfall gains is greater than the chance of windfall losses. Nevertheless, this still reduces risk for the network companies. This needs to be recognised when future allowances are set to cover the cost of equity, with lower risk reflected in a lower allowance.

Regulatory intervention

We have reviewed whether direct regulatory intervention to address this windfall would be in the interests of consumers. Ofgem had suggested adjusting the RAV at the end of the RIIO-2 period as a method of reducing or removing the windfall. Whilst there is significant precedent for interventions to address unearned profits of this type, these have not generally been as a result of reopening regulatory settlements.

We recognise that the stability of the regulatory regime is of significant value to consumers. It will directly impact the cost to consumers of funding the infrastructure required to deliver the net zero transition. This means there is a high bar for intervening in a way that could be viewed as retrospective action, although it does not mean that regulatory intervention should always be ruled out. However, in this case, Ofgem, after consulting, ruled out taking action.

Although the size of the windfall, with financial outperformance at nearly £4 billion, is now likely to be above the top-end of the range that Ofgem indicated when consulting, action contrary to this Ofgem position would be viewed as a surprise, including by investors and credit rating agencies. This has potential to cause a downgrade in the credit rating of the Ofgem regulatory regime. Any downgrade would generate increased debt costs over the longer term that would outweigh the consumer benefit of recovering the windfall.

Voluntary action by the companies

Nevertheless, it remains that due to an economic sensitivity inherent within the price control, network companies have enjoyed a windfall, with financial outperformance at nearly £4bn . As network companies have effectively been beneficiaries of the cost-of-living crisis, we believe they have an obligation to help those who are still suffering as a result of the crisis and demonstrate and preserve a healthy 'social contract' with consumers.

So we are calling upon the network companies to use their windfall to:

1. **Make voluntary contributions** to the funding required to provide more extensive **targeted bill support**. In our Fixing The Foundation report we estimated our proposal for targeted bill support would cost £1.8 billion annually. Contributions could cover the total costs of providing enhanced bill support to a wider group of customers, who are struggling with affordability, in 2025/26 and 2026/27. This funding contribution could provide flexibility by ensuring there is an immediate and improved system of support in place while changes in the energy system and growth in the economy takes place to create space for longer term funding solutions.
2. **Make voluntary contributions** to the funding required to provide **debt relief for energy consumers**. Ofgem has recently consulted on the case for a debt relief scheme to write off up to £1.29 billion of debt. This includes exploring an option for suppliers to make direct voluntary contributions to the scheme. This should be extended to network companies.

3. **Facilitate the financing** of any remaining funding requirements for **providing debt relief**. As this is a windfall, it can clearly be used without causing any financeability issues for the network companies. Given the size of the windfall we believe the networks should waive any compensation and provide this as the equivalent of a low interest or interest-free loan.

Monitoring and transparency

It is important that consumers can have faith in the legitimacy of the regulatory arrangements and that company performance monitoring is visible and robust.

We are calling on Ofgem to commit to:

1. **Publishing annual comparative performance monitoring**, demonstrating how companies are performing financially, against their targets and metrics, and in comparison to each other. Ofgem already does this in the energy retail sector and we note that Ofwat publishes annual reports on water company performance[42].
2. **Publishing key data and metrics in easy and accessible formats** in the same way it publicises information in the retail market to give visibility to customers. This should take the form of league tables where it is appropriate to do so as this provides additional incentive to companies over and above the financial incentives in place. For reputational incentives, this publicity of information is essential and we would question the extent to which companies have reputational risk without this.
3. **Publish its own qualitative assessments of annual company performance** and of the operation of its price controls. At present it is unclear what monitoring activity is taking place and to what extent Ofgem is satisfied that its RIIO-2 price controls are delivering the

[42] Ofwat, Water Company Performance Report 2023-24

outcomes as intended. While the end of price controls is an opportunity to reflect, we believe this needs to become a more visible and embedded activity, particularly when the scale of investment is set to increase significantly.

4. Introducing requirements to **make all data** in companies' annual regulatory reporting packs **public by default** except for data which is genuinely commercially sensitive.

Getting fairer in RIIO-3

Over RIIO-1 and RIIO-2 we have seen network companies systematically outperform the level of return assessed by Ofgem as being appropriate. This has been, in part, due to the design of price controls. Outperformance in RIIO-2 so far is well over £4 billion, most of which, being due to financial outperformance, has been without any improvement in consumer outcomes. This undermines the legitimacy of regulatory arrangements and the social contract between customers, network companies and Ofgem.

Ofgem should:

1. **Get tougher** on ensuring that the **returns earned by companies are fairer** and that reasonable levels of rewards and outperformance are better tied to improved outcomes for customers.
2. **Ensure failsafe mechanisms**, such as the Return Adjustment Mechanism (RAM), **work well in reality**. It is right that there is protection for where unforeseen events and errors occur. This protection also de-risks these companies. But this is plainly not working in practice and is, instead, systematically providing a greater level of protection to companies (who already benefit from significant protection) at the expense of consumers.

As these mechanisms are intended to protect against unforeseen circumstances they must, by definition, be sufficiently broad in scope to prevent events falling outside of their remit.

If companies were underfunded by £3.9 billion we believe it is inconceivable that this would not be addressed. Under a legitimate social contract between energy customers, network companies and Ofgem, customers should expect the same level of protection.

3. Ensure that **core components** of price controls like the **totex incentive mechanism (TIM)** and the application of enduring value adjustments are **actually driving behaviours** which are **aligned to consumer interests** and that consumers see these benefits.

   At present, it is not necessarily clear whether company performance when underspending in RIIO-2 is good for consumers or not. The performance each year is also being masked by enduring value adjustments. The timing of when real performance is revealed could impact Ofgem's decision making when setting allowances for RIIO-3.

   If not effectively monitored and tracked, true performance and the reasons for any underspend could be revealed too late to be reflected in Ofgem's decisions and risk consumers funding the same activities twice and not getting the benefits of underspend in the price control in which they occur.

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