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14 March 2019

Dear Jonathan,

RIIO-2 Sector Specific Methodology Consultation

This response is from National Grid Gas plc (NGG) and National Grid Electricity Transmission plc (NGET) Transmission Owner. In light of the imminent legal separation of the Electricity System Operator (ESO) business from NGET, ESO will be responding separately to this consultation. The response summarises our views on the RIIO-2 Sector Specific issues that Ofgem indicates it will make decisions on in May 2019. The response highlights the concerns that we have with Ofgem's current proposals which need to be addressed prior to the May Sector Specific Methodology decision.

At National Grid, we believe the UK's energy future needs to be affordable, green and support growth and prosperity. Our vision is of an energy future where bills are kept low for consumers, energy is decarbonised, innovation is encouraged and together this supports the growth and prosperity of the UK economy more broadly. Energy networks are key to this because they connect people to the energy they use. They are the country's backbone, vital to our industry, businesses, communities and homes. They will continue to play an important role in our future, facilitating government policy objectives and delivering initiatives that people care about such as decarbonisation of transport and heat. RIIO-2 is an important opportunity to prepare our energy system for the future. If our energy networks are to continue to deliver in the years to come, we need to invest and innovate in the infrastructure we need to keep the energy flowing, to provide green energy and maintain security of supply and cyber security in the digital age.

The framework proposals set out by Ofgem in the Sector Specific consultation are a step in the right direction but they will not bring about the changes we need. There is not enough focus on how the framework interacts to sustain long term delivery for consumers. We agree there is evidence that base returns are lower now than they were when RIIO-1 was settled. We also agree that the RIIO framework needs to be modified following the learnings of RIIO-1 but the principles which focus on incentivisation, innovation and outputs remain sound. They need to be maintained into RIIO-2 rather than discarded. We are concerned that as currently set out, Ofgem's proposals will not bring about the change consumers need.

Within our response, we outline:

- Where Ofgem's current proposals are not in the long-term interests of consumers and why this is the case; and
- Our proposed changes to the current proposals to better meet the shared ambition of amending RIIO-1 where appropriate and keeping the fundamentals which are in the best interests of existing and future consumers.

Main areas of concern:
Our three main concerns with Ofgem's current proposals are set out in the sections below:

Level of allowed return: Setting the right allowed return is vital in ensuring networks are able to fund future infrastructure and have adequate financial capacity to manage uncertainty around the energy transition. This is important to the resilience of the energy sector as a whole, but it is nowhere more pronounced than in transmission where the uncertainty and complexity of investment requirement, and the scale and pace of market disruption is markedly higher than in other sectors. The required financial capacity is assured by networks receiving a fair return for the risks they hold, which relies on a stable regulatory regime. We agree that there is evidence for lower base returns than those in RIIO-1 but not to the extent being proposed. The return has to be fair for consumers and investors alike, being free from errors, based on a balanced methodology and all the available evidence. This is a fundamental pillar of all regulatory regimes.

Instead of considering all these important requirements, the low returns in Ofgem's proposals are supported by errors in approach, arbitrary adjustments and the selective use of available evidence. There are real and tangible errors in the methodology which need to be corrected as part of this consultation.

The estimation of asset beta introduces flawed new concepts around gearing and market premia which are compounded by incorrect implementation. These concepts also double count with the proposed introduction of an outperformance wedge. The interpretation of inflationary impacts on the total market return is flawed and a material departure from long standing precedent. Furthermore, a beta estimation has currently been arrived at based on incomplete analysis and without any assessment of underlying risk managed by the networks.

In relation to allowed debt, the intended policy decision of full indexation is not being fully applied in practice. The intention to base funding on rolled forward actual debt rather than a fully available independent benchmark is in reality the same as the partial indexation option that Ofgem have discounted. Further, the nature of the transmission sector means that this would in fact revert to a near pass-through mechanism for our networks which undermines any incentive benefits Ofgem were trying to protect through removing this option in the first place.

These errors and others have substantial impacts on the allowed return. Ofgem's working assumption for RIIO-2 is less than half the equivalent allowed equity figure in RIIO-T1. Such a return does not fairly reward the risks of a transmission business and runs counter to the concept of a stable, predictable regulatory regime. The allowed equity return figure is a full 100 basis points below the proposals for the water sector, where less market disruption is expected in the next price control period and construction risks are lower.

The consequences of applying such a reduction in the core incentive to invest would impact consumers in the short and long term. Investors are likely to find UK energy networks less attractive investments and the industry could miss the opportunity to attract new money into the sector. Companies would be forced to become more cautious on investment, needing funding security before beginning any work leading to risks being passed onto consumers. Such an approach in RIIO-1 would have impacted hundreds of millions of pounds of infrastructure work where we invested ahead of secured funding in areas of network resilience and renewable generation connection. The impacts of these reactions and other unintended consequences would quickly offset any short-term bill reductions from the currently proposed levels of return.

The outperformance wedge: Ofgem proposes to make a downward adjustment of 50 basis points to the allowed equity return to reflect its expectations that companies will outperform the targets that it sets. This adjustment is conceptually and practically flawed.

From a conceptual perspective, the justification confuses windfall gain from poor price control setting and outperformance from incentives. If the wedge is meant to apply to windfall gain, then this suggests lack of confidence in proper calibration of the price control even before it has been attempted. This cannot be the case. Ofgem has adequate tools and data to be able to achieve this and is also proposing to introduce Return Adjusting Mechanisms (RAMs) to deal with any significant windfall gains or losses if they were to arise.

If instead, the wedge is being introduced in relation to outperformance from incentives, then the approach does not recognise and appreciate the consumer benefit of incentives-based regulation, the widely-accepted solution to the existence of monopoly. In this model, expected return will differ from allowed return to the benefit of consumers. To converge the two would result in a reversion to rate of return regulation and undermine the behaviours that drive dynamic efficiency which has driven huge benefit to consumers over the last 25 years.

Practically, little evidence is offered for the existence or quantum of the outperformance wedge. Ofgem claim there is systematic outperformance due to information asymmetry, but the historical data shown is limited and does not adjust for either efficiency that was not foreseeable before price controls were set, nor the more downwards biased nature of the RIIO-2 framework. Broader performance data sets show that there have been many instances of under-performance of price controls, for example in the airports sector and the gas distribution controls ending in 2007. Our electricity and gas transmission businesses in RIIO-1 offer evidence closer to home of varying performance in a price control with forecast outperformance by electricity but underperformance by gas. Both would be impacted by the blunt 50 basis points adjustment proposed.

To further this point, the proposed 50 basis points wedge can be directly translated into an additional annual totex efficiency of between 5% and 14% for each network, with companies being impacted in a non-uniform way. For example, the figure for our electricity transmission business would be 5% with a 14% adjustment applied for gas transmission. This differential would appear unjustified given the recent history. More fundamentally, any such totex adjustment would need to be justified with evidence before being applied. This is the same for the outperformance wedge. No such justification has been provided for the outperformance wedge and it will have serious negative consequences for sector confidence and incentives on management if applied. The proposed outperformance wedge therefore needs to be removed from the framework through this consultation process and should form no part of the RIIO-2 framework.

The incentivisation approach: Ofgem's current direction of travel on incentivisation will not deliver its stated principal objective for RIIO-2 which is to ensure that regulated network companies deliver the value for money services that both existing and future consumers need, delivering the outcomes of: improving the consumer and network user experience; supporting the energy system transition and improving the network and its operation. This is because, across the sector wide and specific electricity and gas transmission incentive packages:

- Incentivisation is being undermined by proposals to make ex-post adjustments;
- Incentivisation is asymmetric, leaning towards more penalties than scope for rewards;
- The strength of incentivisation is being reduced;
- The scope of incentives is reducing by approximately 50% compared to RIIO-1, without supporting customer or consumer based evidence, with no new proposals focused on encouraging companies to rise to the challenges of the future;
- There is a creep towards micro managing of network inputs rather than focusing on customer outputs and;
- Risks are being placed with parties who are not best placed to manage them.

Incentives based regulation over successive price controls has driven at least £15bn of long-term consumer value in electricity transmission over the last 25 years. The RIIO-1 framework introduced within period totex risk and benefit sharing which, in addition to driving longer term benefits, has already returned over half a billion pounds of consumer benefit in the short term from our gas and electricity transmission businesses alone. Strong incentives that align the interests of consumers with those of shareholders are a cornerstone of RIIO, and Ofgem's current proposals on incentivisation will lead to an environment of risk aversion and penalty avoidance, stifling innovation and improvement, rather than the progressive behaviours where companies strive to innovate, think large scale and discover what is possible. This will lead to five years of missed opportunities for consumers at this critical time in the transformation and decarbonisation of the energy system when Ofgem should be strengthening existing incentives and seeking to drive new ways for companies to deliver consumer value.

We acknowledge there are gaps and imperfections in the RIIO-1 framework which have led to the perception of windfall gains and losses, but the solution is to close these gaps, not reduce incentivisation to compensate. Ofgem has provided itself with a cleaner and more transparent method of providing a safety net through Return Adjustment Mechanisms (RAMs). Whilst ideally these would not be required, we recognise that they may be needed in the short term to maintain legitimacy and allow other areas of the framework to be developed unfettered by concerns of excessive returns.

We specifically disagree with Ofgem's overall position that it expects totex sharing factors to be lower in RIIO-2 than RIIO-1. We do not think this can be in consumers' interests as the totex incentive sharing factors, coupled with the duration of the price control, determines the strength of incentive on companies to drive cost efficiency to lower consumer bills both in the period and also in future price controls. Ofgem has already reduced the incentive strength by shortening the control period back to five years. Therefore, to drive larger scale, higher cost innovation and efficiency initiatives that improve long term network outcomes, higher sharing factors than RIIO-1 are required for transmission to maintain the overall strength of the efficiency incentive.

We also strongly disagree with Ofgem's proposal to introduce ex post adjustments to totex sharing factors under any circumstances, as this fundamentally undermines the incentive properties, as well as creating windfall gains and losses and potential unintended consequences for within period re-openers.

Ofgem's proposal for a business plan incentive which is based on shared reward but absolute penalty, does not work for the transmission sector. We are concerned that the asymmetry of such an incentive more strongly incentivises companies to avoid a penalty rather than submitting ambitious plans, which is the stated intent of the incentive. Part of the rationale for a shared reward is for consumers to 'only pay once' to reveal the cost frontier. There are significant differences in the networks and activities between the gas and electricity transmission companies so the extent of read-across of common efficiency frontiers is very low. There is also insufficient competition in the transmission sector due to the small number of companies to make a shared reward incentive effective. We note both these points were the justification Ofgem used in its July 2018 RIIO-2 framework decision to remove fast tracking for transmission and therefore a competed reward business plan incentive for transmission would be inconsistent with that decision.

We are concerned that Ofgem's proposal to move the Network Asset Risk Metrics (NARMs) framework from an absolute level of network risk to a 'relative reduction' in network risk, is silent on the more important consequences of this change. These relate to the incentives on companies to innovate and also on the allocation of risks between networks and consumers. Whilst we understand that this detail is still to be determined, these are the central issues for consumers and should have been an explicit part of the consultation. Therefore, until we are clearer on the implications of the proposed reforms, we cannot support a change as we are concerned that costs to consumers will increase due to the:

- Potential to transfer asset risk to consumers who are not best placed to manage it, and to transfer risks away from companies associated with their past asset management decisions;

- Potential for the regime to shift from being an 'outputs' regime to becoming an 'inputs' regime which is inconsistent with RIIO. This approach would fundamentally incentivise capital investment work delivery rather than an outputs regime which incentivises companies to innovate across the entire asset management lifecycle to find alternative ways to avoid investment where it is in consumers long term interests to do so; and

- Proposed relative target of 'risk reduced' rather than absolute target of 'residual risk on the network' does not in practice deliver the outcome that consumers are most interested in which is reliability.

Our proposed changes:
To date, we have been broadly positive about the development of the RIIO-2 framework. The direction of travel seemed to be maintaining the foundations that made RIIO a strong, stakeholder-led regime that has delivered significant benefits for consumers. We continue to be an advocate of greater constructive engagement with our stakeholders. However, we raised concerns in our response to the framework consultation that the RIIO foundations were at risk of being undermined by a short term, backward looking focus. Instead of being addressed in the Sector Specific Methodology consultation, this position has been exacerbated by the proposals which are at risk of being RIIO in name only. More fundamentally, a framework with low returns, an outperformance wedge and reduced incentivisation tilted towards downside is not internally consistent. This combination shows the proposals have not been sufficiently considered at a holistic level and will drive unintended consequences for consumers.

We want a better way: an evolved RIIO framework which will allow us and other networks to keep bills lower for longer, drive the right investment and enable innovation to evolve the energy system that we need for the future. We have stepped back from the individual elements and developed principles for a future looking framework rather than the backward looking one Ofgem is currently proposing. This means a framework that focuses on:

- **Accountability:** companies held to account for delivering the outcomes they have committed to with clear consequences of non-delivery

- **Risk allocation:** a framework which transparently balances risk and reward fairly between consumers and networks based on the principle of risks borne by the party best able to manage them

- **Incentivisation:** a framework which strongly incentivises companies to innovate and drive efficiency to the benefit of end consumers

- **Competition**: the framework should include true (as opposed to proxy) competition across the full value chain where this will drive consumer value

- **Ex-ante regulation:** allowances, incentive targets and outputs should be set out clearly up front to best stimulate the progressive behaviours seen in a competitive environment

- **Flexibility:** ex-ante agreed mechanisms which flex to ensure networks can respond to changing customer and stakeholder requirements and minimise potential for forecast error

- **Avoiding windfall gain / loss**: a regime which seeks to avoid windfall gain and loss whilst retaining incentivisation where in the best long-term interests of consumers

Using these principles, we set out changes to the areas of concern with Ofgem proposals below. These changes will better meet the shared ambition of amending RIIO-1 where appropriate and keeping the fundamentals of the RIIO framework which are in the best interests of both existing and future consumers:

Level of allowed return: Ofgem needs to address the errors in its allowed return methodology and support investor confidence by adopting a method that respects both the full range of available evidence and reasonable regulatory precedent. The impact of not doing so would not just affect the energy industry it would reach further into the economy and undermine one of the pillars of the regulatory regime.

Once the errors are corrected, the resulting range for allowed equity will more closely reflect the appropriate level for the energy industry and the allowance for debt funding would be based on independent benchmarks. Ofgem and networks should then jointly undertake a transparent analysis and allocation of risks with stakeholders. This assessment will evidence the level of risk managed by transmission and should respect the regulatory precedent of transmission being higher risk relative to the water industry and the rest of the energy sector.

Within our response, we show that rectifying the individual errors in the current proposal and taking a balanced view of the full suite of evidence results in an allowed equity return of 5.5% (relative to RPI) for transmission.

The outperformance wedge: The flawed and unjustified outperformance wedge needs to be removed from the proposed RIIO-2 framework with a focus on calibrating the totex allowances and incentives correctly. This would demonstrate Ofgem's support and commitment to the benefits of incentive-based regulation and would remove distortion in the incentives on management to discover and deliver improvements through the period.

The incentivisation approach: Ofgem should change direction on its approach to incentivisation and re-embrace the proven benefits of strong outcome-focused financial incentives to drive innovation and efficiency. Specifically, it should:

- Provide a meaningful, stronger magnitude of incentive for embedding ambition in the business plans. Take a symmetrical approach to risk and reward for the business plan incentive and make the reward for transmission company performance absolute rather than shared to maximise value derived for consumers. Avoid cost ambition being 'capped' by a fixed reward, and the cliff edge effects created by stepped rewards. For the incentive to be fully effective the assessment criteria should be complete, unambiguous, objective and transparent and be published well in advance of the May 2019 Sector Specific Decision given the first draft business plans will be submitted on 1 July 2019.

- Take a symmetrical approach to the design of financial output incentives and broaden the scope of financial incentives. These should include incentives on whole system outcomes both across the system operator and distribution interfaces with transmission and to facilitate decarbonisation of transport, as well as incentives to drive customer service improvements and delivery of improvements that are in the broader public interest, as set out in our proposals published alongside Ofgem's December consultation.

- Abandon plans to introduce ex-post adjustments to incentives. Strengthen the primary efficiency totex incentive to drive long term cost reduction and innovation benefits, by using strong sharing factors, upwards of 70%, in areas where there is confidence that costs are likely to be ongoing in future control periods.

- Ensure the implementation of the NARMs framework remains an ‘output’ delivery regime; allocating risks with those best placed to manage them, and, in conjunction with a strong totex incentive, facilitates driving improvement and innovation across the entire asset management life cycle.

Our significant concerns with key aspects of Ofgem’s current proposals and our proposals for change to address these are laid out in more detail in the main body of our response. These include significant concerns regarding the intent of para 2.20 of the December consultation in relation to Ofgem’s proposed approach to considering the possible consequences of a successful appeal on other elements of the price control. We do not believe that such an approach is required or that Ofgem has the vires to implement such an approach. We also set out our more detailed views on the Cross Sector, Finance, Gas Transmission and Electricity Transmission annexes of the consultation, along with responses to the full set of questions posed in the consultation. Where appropriate the response is accompanied by independent reports which form part of our evidence base.

If you have any queries about this response, please contact Mark Brackley or myself.

Yours sincerely,

Chris Bennett

[by email]

Director, UK Regulation