

## NGGT & NGET response to Ofgem's RIIO-2 Informal Licence Consultation Questions

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## **Annex**

### **Introduction**

This Annex sets out the responses of NGET and NGGT to Ofgem's consultation questions (set out in Appendix 2 to the consultation).

We do not respond to questions 28-30 relating to Gas Distribution and ESO.

Questions 6, 19, 23, 25, 26 and 27 seek views on proposed changes to particular categories of licence condition. In response to these questions we point to a number of Appendices to this Annex in which we set out our detailed views and comments on a condition by condition basis. Appendix 1 also contains our detailed response on the two draft Associated Documents published alongside the consultation: the Price Control Financial Model (PCFM) and Price Control Finance Handbook (PCFH).

### **Consultation questions**

#### **Q1 - Chapter 1 – Introduction - Do you have any views on the RIIO-2 licence drafting principles, set out in Appendix 1?**

It is helpful for Ofgem to adhere to a set of licence drafting principles, to ensure a consistent and deliberate approach to drafting across the licence. We note that Ofgem is not proposing to change the whole licence to align with the proposed drafting principles and in some cases it has not been clear to us why particular licence conditions have been selected for change (in particular given this has allowed less time for Ofgem to develop the new conditions and mechanisms which are proposed).

It is important to note that the licence drafting principles are not only a matter of form, dealing with how policy is expressed in the licence. Several areas involve substantive obligations on the licensee and are, in effect, policy rather than solely drafting issues. An example would be the proposed “best endeavours” starting point. Below, we have a number of important comments on these substantive issues, as well as on issues which are purely drafting issues.

We recognise that, subject to some amendments, the RIIO-2 licence drafting principles set out in Appendix 1 reflect those shared for comment at the first Licence Drafting Working Group (LDWG) in September 2019. Many of the principles are logical. However, we make the following observations (following the order of the principles Ofgem has set out):

- Structure of conditions - Headings

In a number of conditions throughout the ET and GT licences, headings within conditions have been framed in the form of a question rather than as a statement. We have raised this issue in feedback at the LDWG but the point has not been addressed consistently. A heading should be in the form of short statement capturing the provisions that follow within the section rather than in the form of a question about what can be done or what process must be followed. Examples include: Special Condition 3.7 (Co-ordinated Adjustment Mechanism Reopener) Part D – “What process will the Authority follow in making a direction?” Electricity Transmission Special

Condition 3.11 (Demand Schemes PCD) Part B – “What is the licensee funded to deliver?”  
Special Condition 8.2 (Annual Iteration Process for the ET2/GT2 Price Control Financial Model)  
Part C/D – “What if the Annual Iteration Process is not completed by 30 November?” Gas  
Transmission Special Condition 3.12 (Asset Health Re-opener) Part A -” What costs are within  
the scope of this re-opener?”

- **Structure of conditions - Paragraphs**

The Principles state that each paragraph should generally contain only one sentence. We consider that the licence should be consistent throughout and that paragraphs should always contain only one sentence. This makes the licence easier to read and makes cross-referencing clearer.

- **Obligations (guidance)**

The Principles state that, if necessary, obligations can be set out in guidance. Our views on this are set out in response to Question 4 below.

- **Obligations (qualifying obligations)**

The principles state that that the starting point for new obligations that are qualified would be expected to be “best endeavours” but that the policy area in question must be properly considered and may well warrant the use of “reasonable endeavours”. We would note that, in the main, Ofgem’s starting point for new obligations has been to require the use by licensees of best endeavours but there has been limited or no discussion as to the policy rationale for such an approach on a case by case basis and no such rationale provided in the consultation. Accordingly, it is not clear as to why the use of reasonable endeavours in a particular instance is not a wholly appropriate form of obligation to impose on the licensee. We would urge Ofgem to conduct a review of these new obligations in order to fully explain the reasoning for the approach in relation to RIIO-2 obligations.

We note that the consultation paper states that Ofgem would expect to use best endeavours “since we have considered the obligation worth adding to the licence”. This is a flawed approach. What standard should be applied to a licence obligation is a separate matter to whether there is a good reason to introduce some form of obligation in the licence.

The Principles state that the use of best endeavours is the starting point for new obligations. However, we would note that many existing obligations are being modified within the proposed RIIO-2 drafting in order to move from a qualified “reasonable endeavours” obligation to a “best endeavours” obligation (such as the obligation to retain an investment grade issuer credit rating). We see no justification for Ofgem’s proposed reframing of existing licence obligations and Ofgem has not justified this approach. Such obligations should remain as presently drafted. As with the point above, this seems to be

an approach that has been driven out of the desire to achieve consistent language across the licences and has not fully considered the policy implications of moving from a reasonable to best endeavours obligation on a case by case basis. We would urge Ofgem to conduct a review of these changed obligations in order to fully explain the reasoning for the change of approach in relation to RIIO-2 obligations.

- **Making changes to the licence conditions or obligations and Associated Documents**

The September 2019 version of the Principles stated that the *“self-modification procedure for example the process we use to modify the PCFM (see SpC 2A in the GDN licence), ....would include the option for licensees to request the full licence modification process is used”*.

This Principle has now changed to state *“self-modification procedure. This will not include the option for licensees to require the Authority to use the statutory process.”*

We are concerned by this change, the rationale for which is not explained in the licence drafting principles. The reasoning given in paragraph 4.37 of the consultation paper is that *“as an independent regulator we should be determining whether to use the self-modification process...”*. It is not at all clear why this is considered to be the case or that Ofgem has considered the impact on licensees of the change.

The legislation sets out a framework for Ofgem to make modifications to licence conditions and includes a power for conditions to be self-modifying. That power must be used appropriately and in line with best regulatory practice. In particular, a self-modification procedure should only be included in the licence where there is a clear justification for this in the particular case (i.e. why it is appropriate for the licence to be modified other than through the statutory process) and having considered the impact on licensees (including any procedure which removes a right of appeal to the CMA, being a right which, unlike judicial review, was developed by Parliament for this particular context).

The particular procedure put in place should also align with the justification. The current change control framework for price control financial instruments for RIIO-T1 acknowledges that there may be merit in a separate process for changes which have no significant impact but, noting that what is significant may not be clear cut, takes a proportionate approach by allowing licensees to require the statutory process to be followed where they have a reasonable view that there will be a significant impact. Licensees are best placed to give this view. Ofgem has not justified the proposed change to this procedure and should retain it to be used for the price control financial instruments and in other areas if appropriate.

We have further concerns in relation to specific self-modification procedures which have been proposed in the consultation, such as the broad procedure proposed in relation to housekeeping changes and the proposed procedure in relation to LOTI decisions. We also propose that, given the cumulative materiality of reopener and other directions on the NGET and NGGT RIIO-2 price control framework in terms of output obligations and allowances, it is our view that all decisions on PCD and other output conditions and associated allowances should be made by statutory licence modification rather than direction. Further views on this are set out in the Executive Summary to our response to Ofgem's informal consultation and also in the relevant Appendices in response to the specific question on these cross sector and Electricity Transmission licence changes.

Finally, on the drafting principles, we note that it is stated that Ofgem will avoid two stage consultations. No reason for this is given. In our view Ofgem should follow regulatory best practice in following a consultation strategy which is appropriate to the issues in question, including supplementary consultations where this is appropriate. Ofgem should not adopt such a blunt and inflexible approach as a licence drafting principle.

- **Consistency rules and style guide**

The licence drafting principles state that "*Licence conditions impose obligations on licensees not Ofgem*". It is, of course, correct to say that the licence is subject to licence conditions and licensees are obliged to comply with those or face potential enforcement action. The licence cannot impose licence obligations on Ofgem.

However, the licence sets out mechanisms for Ofgem to take various actions, which in effect impose obligations on licensees. It is entirely proper that those mechanisms should have limits and that Ofgem is bound to comply with those limits. For example, the licence conditions consulted on have a standard provision under which Ofgem must consult for at least 28 days before issuing a direction (where the direction will change the licensee's obligations). Ofgem must comply with the rules of the mechanism if it is to lawfully apply the mechanism. What those rules will be depends on the circumstances and what best regulatory practice dictates.

For this reason, Ofgem is wrong to state that provisions should not have certain limitations on the basis that the licence is not intended to impose obligations on it. What matters is what is appropriate for the particular mechanism. We request that Ofgem acknowledges this and ensures that any decision it makes in relation to licence mechanisms in which it has a role is based on what is appropriate for the mechanism in question. For example, it is not a justification for a proposal that a set timescale for consideration of a re-opener application by Ofgem should be removed to say that the licence should not impose obligations on Ofgem.

The licence drafting principles also state that the licence should say that Ofgem "will" or "will consider" doing something, rather than that it "must" or "may". Our understanding of this change is that Ofgem is intending to make a distinction between obligations on licensees (using "must") where a breach may lead to enforcement action and rules around licence mechanisms in which Ofgem has a role. This acknowledges the above point that licence obligations are not imposed on Ofgem. In other words, the change is for clarity but makes no substantive difference. This is our understanding, from Ofgem's response to a query in a licence drafting working group

meeting. On this basis, although we do not consider it necessary, we do not object to using "will".

If, contrary to our understanding, Ofgem's intention is that it is not bound by (and required to comply with) rules set out in licence mechanisms and "will" is intended to lessen the obligation on it to follow those rules, this would be extremely concerning. If this were intended to be the effect of the licence conditions, this would need to be made very clear in Ofgem's statutory consultation on the licence changes.

We note that, in any case, where the licence is creating a mechanism for Ofgem to do something (such as giving a direction), we suggest that it is far clearer to state that Ofgem "may" do that thing than that it "will consider" doing it. The provision is creating the ability for Ofgem to do something which has an effect under the licence. The licence should clearly state that this is the case, by using "may".

**Q2 - Chapter 1 – Introduction - Do you have any views on the definitions and the defined terms set out in the Annex?**

Our comments on the definitions and defined terms set out in the Annex to the informal consultation are made as part of our detailed comments on the relevant licence condition or conditions that give rise to the defined term. These are set out in the Appendices to this Annex.

**Q3 - Chapter 2 - SpC Structure - What are your views on the proposed changes to structure of the SpCs?**

We are generally supportive of the proposed structure of the Special Conditions and can see that this is a logical approach to adopt given the re-write of the price control principal formula and the broad categorisation of new licence conditions that will be introduced into the licence for RIIO-2. Specifically in relation to the NGG licence, we do not object to the transmission owner and system operator provisions being grouped in the same chapter. However, we have noted in specific comments some areas where provisions are not properly divided between transmission owner and system operator.

We note that a number of the proposed licence conditions contain mechanisms which will not actually be used during the RIIO-2 period, but will be used following the end of the period to close out allowances based on RIIO-2 performance. It would be helpful for Ofgem to consider and confirm how it will propose to update the licence for RIIO-3 given that these conditions will need to continue, regardless of the RIIO-3 settlement. We do not propose any changes on this at this time.

There are a number of instances where the consultation states that "this condition is not being included as part of this consultation" (e.g. the disapplication provisions in the NGET and NGGT licences and activities restriction and allowances in respect of security period conditions in the NGET licence). It is assumed that this is because such conditions are not to be changed for RIIO-2 but this is not clear from the consultation. Ofgem should clarify the position here.

Some drafting is simply not included in the consultation and has not yet been seen to date (e.g. the Strategic Innovation Fund licence condition). In this example there is not a placeholder for

the condition in the draft licences. Such drafting must be made available to licensees as soon as possible for proper consideration ahead of the statutory consultation.

We also note that some conditions within the draft structure are relevant to some licensees but not others. For instance Special Conditions 9.13, 9.14 and 9.15 in the Electricity Transmission Special Conditions do not apply to NGET. We therefore assume that these conditions will appear as "Not Used" in the NGET licence if the numbering of the conditions are to be retained as consulted on.

#### **Q4 - Chapter 3 - Associated Documents - Do you agree with our principles for Associated Documents?**

We believe that the Associated Documents principles generally provide some helpful guidance as to the intended use and purpose of Associated Documents.

The licence drafting principles state that, if necessary, obligations can be set out in guidance. The consultation paper also notes (para 3.1) that Associated Documents are for "information, requirements and guidance that are not proportionate for inclusion in the licence conditions". These points should form part of the Associated Documents principles. They set out a high threshold, meaning that any decision to introduce or place detail in an Associated Document must be considered, deliberate and added for good reason.

We would emphasise that it is important that the following Associated Document principles are closely followed:

- Associated Documents should only be used where more detail and explanation is required, beyond that in the relevant licence condition;
- The licence must set out the circumstances in which the licensee has to comply with or have regard to the Associated Document; and
- Obligations on licensees must be drafted clearly whether in the licence or the Associated Document so licensees can be sure what is expected of them.

We have previously made the following points in relation to the use of Associated Documents following the June 2020 LDWG. Whilst we recognise that some of these points are covered in the Associated Document principles, this is not the case for all so we reiterate them again here as we believe that they are relevant in deciding whether an obligation should be set out on the face of the licence or in an Associated Document.

It is our view that the following high-level principles should apply where any new Associated Documents are to be introduced via the licence for RIIO 2 (and should continue to apply when any changes are made to such documents):

- If a document is to contain requirements, it should not be referred to as a guidance document. "Guidance" means that the document is advisory rather than mandatory and a more appropriate approach would therefore be to say that the licensee might "have regard" to such guidance.



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- It should be clear from the licence condition what the guidance is going to cover. There should not be a general ability for the Authority to give guidance which is a licence requirement (as this would be contrary to the principles of best regulatory practice).
- If a licensee is required by its licence to comply with a document then such document should only contain provisions and requirements that the licensee is able to comply with. In particular, whilst advisory guidance documents may be drafted less formally, provisions which are licence requirements should be drafted with the same precision as licence conditions to ensure that the licensee has sufficient certainty. These requirements should be limited to procedural steps or to levels of detail which it would not be appropriate to cover in the licence condition for some reason (such as technical detail), but where the material obligations are still in the licence. Associated Documents should provide regulatory certainty. Accordingly they should be drafted in a manner that is clear and unambiguous such that obligations are clearly understood by all relevant stakeholders and are not open to interpretation.
- Material issues (e.g. what is meant by non-delivery or late delivery of a PCD and the financial consequences of such events) should be set out on the face of the licence and not in supplementary documents such that the introduction and amendment of such key terms is subject to the statutory licence modification process and associated appeal rights.
- Financial implications of events and outcomes should also be on the face of the licence in order to provide clarity and certainty and to aid the desire for licence simplification. This is one of the overarching licence drafting principles and central to the proposed re-writing of the principal formula, where Ofgem has said that the reader should be able to understand the financial implications without having to go to other documents because the algebra should be self-explanatory. Drafting either algebra or financial consequence into guidance documents outside of the licence runs counter to this aim.
- Such material issues need to be known and understood by licensees at the time of draft and final determinations in order that the price control package can be assessed as a whole. Such matters cannot be set out in documents that may or may not exist at the start of the Price Control Period. All obligations need to be available and understood by licensees when the licence modifications implementing the RIIO-2 price control are brought forward for statutory consultation.
- Procedural supplementary documents should be in place at the start of the Price Control Period if there is an obligation that licensees must comply with it. To prevent confusion, if the supplementary document may not be determined when the licence condition takes effect, the drafting should provide that compliance is required with "any" document made.

We are concerned that Ofgem has not followed the above principles in developing the licence conditions and Associated Documents. We flag elsewhere in this response our comments relating to how the licence drafting sets out Associated Documents and will comment further on the draft Associated Documents provided (as part of this consultation or subsequently).

We also note the principle that Associated Documents must be published in a timely fashion bearing in mind the specifics of the Associated Document and the obligation in question. We cover this point in response to Question 5 below but would reiterate here that based on the expected timetable for publication of Associated Documents set out in paragraph 3.8 of the consultation, we do not believe that this principle is being adopted. Publication of Associated Documents for the first time in December 2020 or even Q1 or Q2 is neither appropriate nor timely for the reasons set out in response to Question 5.

**Q5 - Chapter 3 - Associated Documents - Do you have any views on our proposed list of Associated Documents and the timetable for consulting and implementing them?**

Ofgem is expanding its use of subsidiary licence documents as part of RIIO-T2. There is an extensive number of Associated Documents (22 are listed in paragraph 3.8 of the consultation) and these cover a wide range of issues and obligations. These documents impose a significant regulatory burden on both licensee and regulator. In general, these are not traditional guidance documents, which are intended to give helpful advice on how a licensee complies with less detailed licence obligations. Many of these are, in effect, additional licence obligations placed in a different document. We have commented on first drafts of some Associated Documents and are currently in the process of considering others, raising areas where the drafts do not comply with the principles we have raised above.

As Ofgem continues to develop Associated Documents, it should be aware that these have the potential to impose significant regulatory burden on licensees and to make licence obligations less transparent. For this reason, in accordance with the principles referred to in our response to Question 4 above, such obligations should be captured on the face of the licence in order to provide transparency and regulatory certainty (unless the principles applied to the particular circumstances justify an Associated Document). We request that Ofgem considers this issue in detail and explains its approach following such a review.

We also have concerns in relation to the proposed timetable for consulting on and implementing the Associated Documents. Given that these documents are intrinsically linked to the licence obligations that give rise to them and require compliance or regard to them it is essential that licensees are afforded appropriate opportunity to review and comment on the proposed content of the Associated Documents prior to any consultation conducted prior to them being directed into effect.

In order to do this, licensees should be able to review the Associated Documents alongside the review of the licence drafting. We have been able to review the PCFM and PCFH Guidance which were published alongside the informal consultation and we comment on these documents as part of this response. We have subsequently received copies of the re-opener, CPM, LOTI, FIOCR and PCD guidance during the course of the consultation period and will respond on these in accordance with the requested timescales. It should however be noted that there are a significant number of Associated Documents that have yet to be seen by licensees. All Associated Documents applicable to RIIO-2 must be available for review and comment by licensees as soon as is possible and, in any event, should be made available no later than the

date of publication of the notice of statutory consultation on the licence modifications that are proposed to implement the RIIO-2 Final Determinations. In order to be able to appropriately respond to such consultation, and to form a view as to whether such licence modifications achieve the effect stated by Ofgem, licensees must be able to review all Associated Documents that are intended to apply in the RIIO-2 price control period alongside the statutory consultation on the licence modifications. On the current proposed timetable it is therefore inappropriate and unacceptable that some associated Documents are not expected to be published until Q1-2 2021.

It is noted in paragraph 3.5 of the consultation that some Associated Documents will not come into force until after the start of RIIO-2. However, for the reasons stated above, this should not mean that the relevant Associated Document should not be developed to a point that it can be considered and commented on at the time of the statutory consultation in respect of the condition(s) that will give effect to the scheme to which the Associated Document relates.

To be able to effectively review and comment, drafts of all relevant Associated Documents should be shared with licensees (as is envisaged by paragraph 3.7 of the consultation) prior to the December 2020 statutory consultation. Accordingly it is not acceptable, as stated in paragraph 3.4, that Ofgem “will aim to share a draft.....before carrying out the consultation required by the licence”. Such an approach deprives licensees of the ability to fully consider the Associated Document alongside the licence modifications which seek to give effect to the RIIO-2 Final Determinations.

**Q6 - Chapter 4 - Finance Conditions - What are your views on the proposed changes to the SLCs, SSCs and SpCs outlined in this finance chapter?**

We refer Ofgem to Appendix 1 (Proposed licence changes outlined in the Finance Chapter) to this Annex. We note that Appendix 1 sets out a single table of our views for each licence condition, with the exception of the conditions set out in Chapter 2 of each licence (Revenue Restriction) and the legacy adjustments (FT22) where we consider it assists Ofgem to have a single table for each.

**Q7 - Chapter 4 - Finance Conditions - Do you agree with our reasons for making the proposed finance related changes that will have effect throughout the SpCs?**

Ofgem sets out three main reasons for the proposed finance related changes through the SpCs:

- to remove duplicative text from the licence;
- to consolidate the various financial instruments and reporting templates so that the Price Control Finance Model (PCFM) will contain all the information required to calculate allowed revenue; and
- to simplify drafting and have consistency across sectors.

We agree with the reasons for making the proposed finance related changes. These are consistent with improving the efficiency and transparency of the regulatory instruments and associated processes. However, streamlining and simplifying should not be at the expense of

reducing licensees' and stakeholders' visibility of the performance against the RIIO-2 framework or weakening the audit trail and governance for the various reporting and calculation processes.

There are several areas where we view the proposed drafting as being inconsistent with these underlying principles which we cover in the following sections.

#### Removal of duplicative text

Under the RIIO-1 framework, the Output Delivery Incentive (ODI) performance reporting is included in the Revenue Regulatory Reporting Pack (RRP) and the Costs and Outputs RRP. We consider this to be an example of duplication. However, it is important that the inputs and the calculations are retained in a regulatory instrument to maintain transparency and accuracy of ODI revenue calculations.

We note that to date there has been no draft regulatory instrument published or shared by Ofgem which includes the calculation of ODI revenue values. In line with Ofgem's stated intention to contain all information required to calculate allowed revenue within the PCFM<sup>1</sup>, we expect the PCFM to include the ODI revenue calculations. Including these calculations within the PCFM will form part of a strong audit trail and governance process where the output delivery can clearly be seen to deliver the revenues prescribed according to the licence.

#### Consolidation of financial instruments

We appreciate the improved efficiency which can be achieved through combining the Revenue RRP, PCFM and Regulatory Financial Performance Reporting (RFPR). We note that there are still elements of the PCFM yet to be developed, such as the Financial Performance Reporting, and so cannot fully comment on whether all calculations are included correctly and reporting information presented transparently. We note two examples below.

Firstly, it is not clear from the consultation document whether the intention is to include all financial information within the PCFM that is currently provided within the RIIO-1 Regulatory Financial Performance Reporting model. Paragraph 4.5 of the consultation document states:

"The Revenue Regulatory Reporting Pack (RRP) and the Regulatory Financial Performance Reporting (RFPR) model are two templates that are currently submitted to us as part of the RIGs submissions made each 31 July. As noted above, with the exception of the detailed debt and financing data tables in the RFPR, we propose to remove these templates from the RIGs suite of templates and include them within the PCFM so that they are no longer stand-alone."

Paragraph 4.26 then states that the RFPR Guidance document will be removed and combined with a single PCFM Guidance document. It is unclear from these statements whether the financing and debt information will still be required. We request clarification from Ofgem as to how this information is captured within the reporting instruments, and which elements will be included within the PCFM.

Secondly, footnote 24 of the consultation document states that the tax reconciliation statement will be submitted as part of the PCFM; this area is yet to be developed.

We also raise two process issues regarding the combined regulatory instruments

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<sup>1</sup> RIIO-2 Informal Licence Drafting Consultation, Ofgem, 30 September 2020, para 4.48

We note that, in Table 2.1 of the Price Control Financial Handbook, Ofgem refers to submission of a populated RIIO-2 PCFM on 31 July 2021. This timescale coincides with the submission of the RIIO-1 regulatory reporting instruments i.e. the Cost & Outputs RRP, the Revenue RRP and the RFPR. (The RIIO-1 PCFM is not submitted on 31 July by licensees under the RIIO-1 process). We would welcome discussions with Ofgem on the interaction of the RIIO-1 and RIIO-2 submissions and further consideration of the timelines given the regulatory reporting burden this may create.

The RIIO-2 PCFM takes on the role of reporting instrument, calculation tool for Allowed Revenue, published document for the statement of Allowed Revenue and performance reporting instrument. Ofgem proposes that the PCFM containing financial, totex and non-totex data is submitted on 31 July as part of the regulatory reporting process. To populate and submit the PCFM according to the proposed timetable, we require a final version of the PCFM for a particular reporting year to be released to the licensee by 1 April.

#### Simplified drafting and consistency across sectors

Ofgem has made clear their intent to amend the principal revenue restriction formula to introduce a “live” revenue calculation to accommodate forecasting of outputs, totex expenditure and non-totex performance and remove the requirement for separate true-up adjustments.

Ofgem has gone further in the amendments to the revenue restriction formula and proposed that the ADJ and K correction terms can be combined should the same interest rate be applied to each<sup>2</sup> (paragraph 4.15 of the consultation document). Reducing the number of algebraic expressions used in the calculation of Allowed Revenue does not automatically result in simplification of the licence. In this instance, the approach proposed in paragraph 4.15 of the consultation document reduces transparency of the individual impacts of performance and revenue collection on the Allowed Revenue.

The Totex Allowance regime is an area which we consider has increased in complexity with Price Control Deliverable, volume driver, re-opener and Use It Or Lose It (UIOLI) allowances contributing to the total allowance position alongside non-variant allowances. An area of particular complexity, and therefore concern, is the interaction of Totex Allowance terms which include both PCD and re-opener elements, such as UIOLI resilience allowances. We require further explanation from Ofgem and sight of the PCFM Guidance to understand how this complex interaction is intended to operate in practice before we can assess whether the allowances and therefore the revenues correctly reflect the RIIO-2 framework.

#### **Q8 - Chapter 4 - Finance Conditions - What are your views on the detail of the finance related changes that we have proposed? Are the new concepts such as allowed and calculated revenue clear?**

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<sup>2</sup> This policy is yet to be finalised and we draw Ofgem's attention to our response to Draft Determinations – Finance Annex FQ31, FQ32 and FQ33.

## NGGT & NGET response to Ofgem's RIIO-2 Informal Licence Consultation Questions

There are numerous finance related changes proposed within the licence conditions, PCFM and PCFH. Our comments relating to the detail of these instruments are included at Appendix 1.

In terms of the specific concepts of Allowed and Calculated Revenue as raised in Q8, whilst we consider the algebraic terms within the licence and wording within the PCFH adequately define these terms, we do not consider that their calculation fully enacts the policies proposed by Ofgem in the RIIO-2 Draft Determinations documentation or provides the necessary simplicity and transparency of understanding that the licensees and their stakeholders require.

### Errors in the calculation of Allowed Revenue

We have noted errors within the calculation of Allowed Revenue which arise in the derivation of the ADJ and K terms in our response to Q10.

### Ambiguity in the inclusion of forecast data

As detailed in our responses to Draft Determinations - Finance Annex FQ12, FQ34 and FQ35, we support Ofgem's policy to allow totex spend, incentive performance and certain allowances which can be varied through uncertainty mechanisms to be amended during the price control for revenue forecasting purposes. We reiterate here, we do not agree that allowances which are determined through the re-opener mechanism should be excluded from the forecasting process.

The introduction of the Calculated Revenue "live" term supports enactment of the forecasting policy. We support the seeming extension of the forecasting policy to re-opener terms where these values have not yet been determined (paragraph 2.32 of the PCFH). However, we note that this policy has yet to be reflected in the RIIO-2 framework documentation. Paragraph 2.33 specifies that the licensee must calculate provisional values using the approach specified within the Handbook or the PCFM Guidance and otherwise provide a best estimate with the information available at the time. However, the PCFM Guidance and proposed methodology for calculation of provision values has yet to be shared with licensees.

### Lack of transparency of performance against Final Determinations

Both the Allowed Revenue and the Calculated Revenue values are live values, as defined by Ofgem:

- “• Calculated Revenue (R), is a 'live' calculation of real revenue allowances in accordance with the licence. It is not fixed to represent base revenue at final determinations but stands on its own as the method for calculating allowed revenue, either ex-post or ex-ante.
- Allowed Revenue (AR) takes the calculated revenue using data at the preceding AIP, plus a catch-up for historical revisions and charging over/under-recovery. This value is published at each AIP.”<sup>3</sup>

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<sup>3</sup> “RIIO-2 Informal Licence Drafting Consultation”, Ofgem, 30 September 2020, para 4.5

Our stakeholders value a simple and transparent statement of revenue changes from those set out in Final Determinations (FD). This enables both the revenue impact and, by inference, customer bill impact of the licensee's performance to be readily accessed and understood. A revenue term which represents a 'live' calculation limits the ability to present this impact in a transparent manner.

For example, in reporting a Year 1 adjustment to totex (either allowances or expenditure) through the Year 2 Annual Iteration and reporting processes, the Year 3 Allowed Revenue term will reflect:

- Revenue adjustments impacting Calculated Revenue for Years 1 and 2; captured within the Year 3 ADJ term.
- Revenue adjustments impacting Calculated Revenue for Year 3; captured within the Year 3 R term.

A straightforward comparison of the FD Allowed Revenues and the revenue variance as a result of totex and ODI performance would therefore be beneficial in simplifying the presentation and providing stakeholders with accessible performance information.

#### Base Revenue definition is not transparent

Ofgem proposes a definition of Base Revenue within Draft Determinations – Finance Annex. This term is a definition distinct from those of Allowed Revenue and Calculated Revenue and is used as a reference point for several areas of the RIIO-2 framework to calculate revenue streams. Ofgem's proposed policy is that the Base Revenue is fixed at FD.

We disagree with application of this policy across all elements of the RIIO-2 framework requiring a Base Revenue reference point, as already stated in our response Draft Determinations – Finance Annex FQ37. In line with our response to Draft Determinations – Finance Annex FQ37, we do not consider that a single Base Revenue definition and set of values is appropriate in all circumstances. The different revenue reference points should be defined with distinct nomenclature and where appropriate values clearly stated within the licence or the PCFM.

The current drafting of both the ET2 and GT2 PCFMs includes a Base Revenue value within the Revenue tab. The Base Revenue values within the PCFM will be updated annually as actual and forecast totex, ODI and financial data is reported. Therefore, the Base Revenue definition within the PCFM is not consistent with Ofgem's proposed policy of a static value.

#### **Q9 - Chapter 4 - Finance Conditions - What are your views on the proposal to replace the MOD term?**

We support replacement of the MOD term providing the alternative terms and presentation are sufficiently well-defined and transparent to provide stakeholders with readily accessible information on a licensee's performance against Final Determinations (FD).

Within the RIIO-1 framework, the MOD term adjusts the Base Revenue determined at Final Proposals for historic performance against the totex outputs, totex expenditure and certain

financial parameters as set out in the RIIO-1 framework. This provides a clear indication of the revenue impact of the licensee's performance which, in turn, is indicative of the impact of performance on customer bills.

Under the proposed framework and drafting, the revenue adjustment for performance is no longer solely historic but also includes forecast totex output delivery and spend as well as historic and forecast performance against ODI. We appreciate that this is effectively an expansion of the MOD term and therefore understand that Ofgem may wish to change the nomenclature.

However, the removal of the MOD concept and term from Allowed Revenue calculation should not mean that the FD base revenue or the comparison of forecast revenues to this reference point becomes less readily available to stakeholders. Although the publication of the FD will include a PCFM, we do not consider comparison of revenues between the various publications of the PCFM to be an efficient process. Therefore, we consider that the Allowed Revenue as set out in RIIO-2 FD should be clearly stated as standing data in each iteration of the PCFM and also with relevant licence conditions. This is important for two reasons:

#### Transparency of performance under RIIO-2 framework

We propose that the re-forecast revenues determined through the Annual Iteration Process are directly compared (ideally in a simply summary table) against FD revenues. The proposed structure of the PCFM records Allowed Revenue, Calculated Revenue, ADJ and K terms (in the Live Results tab) but does not clearly show the changes in revenues as compared with those set at FD which arise from changes in output delivery and performance. We are aware that our stakeholders value a simple and transparent view of the revenue variances and that these are also use as an indicator of customer and consumer bill impacts of our performance.

#### Clarity of thresholds within the RIIO-2 framework

We reference Ofgem to our response to the Draft Determinations – Finance Annex FQ37 where we set out our views on the use of FD Base Revenue in the re-opener materiality threshold and the tax trigger mechanism. We maintain that there should be a permanent record of the opening revenue allowances in the relevant licence condition as set at FD to provide a transparent reference point for the reopener threshold.

#### **Q10 - Chapter 4 - Finance Conditions - Would you support a consolidated K/ADJ term if the interest rate being applied was the same in both cases (eg both WACC or both short term cost of debt based)?**

We would not support a consolidated K/ADJ term if the interest rate being applied was the same in both cases. We also refer Ofgem to our response to Draft Determinations – Finance Annex FQ31, FQ32 and FQ33 which sets out our views opposing Ofgem's proposed use of a debt-based interest rate for all applications of time value of money adjustments.



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The ADJ adjustment reflects changes in revenue which arise due to performance under the RIIO-2 framework, covering both totex and non-totex output delivery and also totex efficiencies. The revenue adjustment captured by ADJ is therefore an absolute adjustment impacting the overall level of revenue across the price control period.

The K term is an adjustment to reflect under/over collection of revenues against previous years' allowed revenue. The revenue adjustment under this term is a relative adjustment, that is, the cumulative Allowed Revenue total relating to the RIIO-2 price control period is not impacted.

Combining the K and ADJ terms would reduce the clarity currently afforded under RIIO-1 and the proposed RIIO-2 structure which enables stakeholders to view the revenue impact of a licensee's performance.

We are therefore supportive of the principle currently adopted under Special Condition 2.1 (Part B within the NGET licence, Part C within the NGG licence) of the proposed licence drafting and also enacted in the draft PCFM (both ET2 and GT2 versions) which maintains separation of the ADJ (performance adjustment) and K (revenue recovery) revenue terms.

However, we draw attention to significant concerns we have over the proposed drafting for the ADJ and K terms:

There are errors in the drafting of the principal revenue restriction formula

- The ADJ term does not correctly reflect changes in prior year revenues arising from licensee performance.

The ADJ term calculates the revenue impact in prior years relating to updated delivery and performance. The principle revenue formula then incorporates this revenue adjustment into the Allowed Revenue calculation.

We understand that the intent is to calculate prior year revenue impact by comparison of the Calculated Revenue in a particular Regulatory Year with the Calculated Revenue in the previous iteration of the PCFM.

The error in calculation arises due to the definition of the Calculated Revenue as per the previous iteration of the PCFM (the ADJR term). Special Condition 2.2 Part B paragraph 2.2.4 defines that Calculated Revenue "*for Regulatory Year  $t$ , as of the AIP publication in Regulatory Year  $t-1$* ". The reference to the publication in Regulatory Year  $t-1$  is both confusing and incorrect. The Annual Iteration Process used to calculate Allowed Revenue for Regulatory Year  $t$ , will occur in year  $t-1$ . For example, the Allowed Revenue for Regulatory Year 2023/24 is calculated through the November 2022 Annual Iteration Process. Application of the  $t-1$  Regulatory Year to refer to a previously published revenue results in use of the Calculated Revenue within the current PCFM as a comparative figure. Therefore, the ADJ term will always be zero as the comparative revenue is the same value (from the same iteration of the PCFM) as the current revenue for a given Regulatory Year.

This issue similarly arises in the calculation of the SOADJR term in Special Condition 2.6.4 of the Gas Transporter Licence.

We appreciate that Ofgem has chosen to use a single term, Regulatory Year, to reference time bound calculations. If Ofgem prefers not to use an alternative definition to reference the year in

which the Annual Iteration Process is carried out, we suggest reversion to wording in line with the RIIO-T1 framework which referred to prior year revenue changes as a result of updating the PCFM as the incremental change for year  $t$ .

- The ADJ term in the licence does not correctly reflect adjustments to historic revenues

Even correcting for the error noted in the previous section, the ADJ term still requires further revision to correctly reflect the magnitude and direction of adjustments to historic revenues.

We have identified a further error within the calculation of the ADJR term (Special Condition 2.2 Part B paragraph 2.2.4 for NGET and NGG and Special Condition 2.6 Part B paragraph 2.6.4 for NGG) which results in the ADJ adjustment being made in each subsequent year, with the direction of adjustment being the reverse of the prior year. This impacts every year from the Regulatory Year after that in which the initial ADJ adjustment is made onwards.

The ongoing annual adjustment occurs as a result of the algebra used to calculate ADJR. The current Calculated Revenue for a given Regulatory Year is compared to the Calculated Revenue for the Regulatory Year as per the previous Annual Iteration Process plus the ADJ adjustment used to describe the revenue catch up for previous years. The inclusion of the ADJ adjustment in the comparison is incorrect and results in the perpetual cycle of annual ADJ adjustments.

There is no net impact on the Allowed Revenue term as, for all years post the Regulatory Year in which the initial ADJ adjustment is applied, the K term is calculated to include an adjustment equal in magnitude but opposite in sign to the ADJ term (Special Condition 2.3 Part A paragraph 2.3.3 for NGET; Special Condition 2.3 Part A paragraph 2.3.4 and Special Condition 2.7 Part A paragraph 2.7.4 for NGG). The cumulative impact of 5 years of adjustment to prior year performance is also likely to result in ADJ and K terms of increasing magnitude across the price control period.

Whilst the overall magnitude of Allowed Revenue may be correct, the values reported under ADJ and K will not correctly reflect the performance and level of revenue recovery delivered by the licensee. This is misleading from a reporting perspective.

We propose that this error can be resolved through removal of the algebra defining the ADJRt term and replacement of the ADJR term in the calculation of ADJ with a term referencing Calculated Revenue ( $R_t$ ) as per the PCFM published in the previous Annual Iteration Process.

The PCFM does not enact the proposed licence drafting RIIO-2 framework

- The PCFM does not reflect the licence drafting for calculation of the ADJ term

The Price Control Financial Handbook sets out the order of precedence of the regulatory instruments, with the relevant licence conditions taking priority (Price Control Financial Handbook paragraph 1.8). The PCFM should therefore enact the calculations contained within the licence conditions.

However, in this case, the PCFM calculates the Allowed Revenue in the manner expected but not enacted in the licence, as explained above. The ADJ term in the PCFM is calculated to reflect the revenue impact in prior years relating to updated delivery and performance with the adjustment impacting a single Regulatory Year. There is no ongoing annual adjustment offset by an equal and opposite K term as described above as the comparison between current and prior year Calculated Revenue does not take the ADJ value for the previous year into account.

We consider this to be the correct approach to derive the ADJR term which in turn feeds the calculation of ADJ and therefore propose that the licence algebra is aligned with the PCFM.

The Totex Incentive Mechanism is incorrectly applied in the PCFM

- The application of the Totex Incentive Mechanism determines the outcome of Calculated Revenue. The Totex Incentive Mechanism is split between baseline totex and Uncertainty Mechanism totex. The Uncertainty Mechanism expenditure value on the TIM tab in the PCFM is assumed and set equal to Uncertainty Mechanism allowances. For NGG, this is even despite the availability of actual data due to separation of inputs for Baseline and Uncertainty Mechanism totex expenditure within the NGGT TO inputs tab.

We do not agree with this approach as:

- the resulting baseline and Uncertainty Mechanism performance will be incorrectly stated and misleading to stakeholders; and
- notwithstanding our views on the determination of the capitalisation rate (reference our response to RIIO-2 Draft Determinations – Finance Annex Q24), incorrect allocation of allowances and expenditure between baseline and uncertainty mechanism categories results in incorrect revenues in a given Regulatory Year due to the differing capitalisation rates as proposed by Ofgem between baseline and Uncertainty Mechanism totex.
- A new Totex Performance input is introduced resulting in errors in the calculation of allowed totex. Ofgem has introduced a Totex Performance input which has not previously been raised through either framework or licence drafting discussion. This input impacts the Calculated Revenue for a specific Regulatory Year and the reason for its introduction and its purpose are both erroneous and unclear.

The Totex Performance input is categorised as standing data and so is not subject to update without review and agreement by the PCFM Working Group. This fixed percentage determines the performance on Uncertainty Mechanism and baseline expenditure through amendment of the actual totex expenditure value. This approach is without precedent and results in erroneous and misleading calculations of totex performance and, as a result, Calculated Revenue. Our concerns as summarised as follows:

- The Totex performance percentage is standing data and therefore subject to change only through review and agreement of the PCFM Working Group; it is unclear how this value would be determined and agreed.

- A single percentage applied across each Regulatory Year is not representative of performance under Uncertainty Mechanisms.
- Notwithstanding our argument against the introduction of this reporting policy, the application of the Totex performance percentage factor is subject to a 2 year lag which is inconsistent with Ofgem's intent to introduce forecasting to the RIIO-2 framework.

We propose that the PCFM Input tab captures totex expenditure separately for baseline and Uncertainty Mechanism totex categories (as is already the case for NGGT TO). This information can then be used to more accurately calculate the baseline and Uncertainty Mechanism totex expenditure. The allocation of allowances is already provided through the Variable Value inputs.

**Q11 - Chapter 4 - Finance Conditions - Will the changes proposed to AIP, and the other changes proposed in this chapter, work with the charging arrangements that exist for each licensee and sector? Or are any further modifications required?**

We refer Ofgem to our responses to Q12 and Q15 in which we consider the interaction of the regulatory instruments and processes with the terms within the charging arrangements.

**Q12 - Chapter 4 - Finance Conditions - Do you support moving towards a required 'self publication' of allowed revenue aligning with any tariff setting, as opposed to one as a result of the AIP process? What process would you propose?**

In principle, we support aligning the publication of Allowed Revenue with the licensee's charge setting process. However, there is still considerable detailed thinking required around this process and whilst we describe an overview below, we would welcome the opportunity to discuss this further with Ofgem prior to the statutory licence consultation.

The remainder of our response to Q12 is specific to NGGT which is subject to two charge setting cycles within the Regulatory Year. However, the same process could also apply in principle to NGET which makes a single revenue submission annually to the Electricity System Operator to inform the tariff setting process.

Under the RIIO-1 framework, the ODI, totex performance and revenue recovery elements of Allowed Revenue are determined prior to the start of the Regulatory Year, due to implementation of a two-year lag. However, those elements of Allowed Revenue which can fluctuate within the year can be re-forecast by NGGT. Under the RIIO-1 framework, there are a number of Allowed Revenue streams which can change in the year, in particular the pass through costs and incentives which form part of the Gas System Operator (GSO) revenues. As there are two charge-setting point for Gas Transmission charges within a Regulatory Year, re-forecasting enables NGGT to reflect changes to within year revenues improving the cost reflectivity of charges and limiting over or under collection against Allowed Revenue. The Allowed Revenue is finally determined through submission of the Revenue RRP and it is against this value that revenue recovery is assessed.

Ofgem has made two proposals which, combined, limit a licensee's ability and incentivisation to perform this re-forecasting process:

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- consolidation of all elements of the revenue within the PCFM; and
- publication of an Allowed Revenue value through the Annual Iteration Process prior to the start of the Regulatory Year, this value to be used for charge-setting<sup>4</sup>.

Under the annual process, the Allowed Revenue will not be republished during the year with the penalty for under or over recovery of revenues assessed against this published Allowed Revenue value. The licensee is therefore incentivised to set charges to recover the published Allowed Revenue even if the actual calculated revenue that outturns for the year is forecast to change during the course of the year. This will have a direct impact in reducing the cost reflective nature of customer charges for the price control period.

We agree that re-forecasting of Allowed Revenue should be aligned with the licensee's charge setting process in order to incentivise cost reflective charging. However, Ofgem's proposal of "self-publication" of Allowed Revenue describes a process which is unbounded in scope and timing and there is no regulatory mechanism or process to adjust the Allowed Revenue terms, against which the recovered revenues are targeted, to the re-forecast values.

We are also concerned that stakeholders will not have transparency over the status of the PCFM and Allowed Revenue published by Ofgem as part of the Annual Iteration Process and any "self-published" models and values calculated by the licensee.

We support the direction of the proposal and propose that it can be improved further by adopting the following:

- Clarification through the regulatory instruments that any "self-publication" is bound specifically to the charge setting process and is not designed to provide information on any other elements of the licensee's performance under the RIIO-2 framework.
- Clarification of the status of the PCFM and Allowed Revenue value published under the Annual Iteration Process as compared with those models and values that are "self-published". For example, we would require Ofgem to confirm whether it will similarly be required to agree to the re-forecast revenue.
- Development of a re-forecasting process and governance structure that has sufficient rigour to ensure that both the licensee and Ofgem support the re-forecast Allowed Revenue values but which is not overly onerous for either the licensee or the regulator.
- Regulatory mechanisms to adjust the Allowed Revenue terms against which revenue collection is targeted to reflect the re-forecast values. Without this mechanism, the licensee is still not entitled to target the revised Allowed Revenue through the charge-setting process, particularly if this results in breach of the licensee's obligation to use its best endeavours to ensure that Recovered Revenue does not exceed Allowed Revenue (Gas Transporter Licence; Special Condition 2.1, Part A, para 2.1.3 and Special Condition 2.5, Part A, paragraph 2.5.3). Additionally, without formal recognition of the revision of Allowed Revenue, there is no incentive for the licensee to collect the revised Allowed Revenue value as a recovery penalty could potentially be incurred.
- Agreement over which revenue terms within the Allowed Revenue calculation will be forecast. Currently, in RIIO-T1, only the revenue streams which fluctuate within year

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<sup>4</sup> "RIIO-2 Informal Licence Drafting Consultation", Ofgem, 30 September 2020, paras 4.51 – 4.53

and which are likely to have a significant impact on Allowed Revenues are re-forecast and flowed through to the charge-setting process. This limits re-forecasting to a manageable process. We propose that Ofgem considers adopting a similar policy and framework for RIIO-2 with licensees encouraged to consider only those revenues likely to have the most significant impact on charges. One way to achieve this is to limit the re-forecast to the non-performable elements of Allowed Revenue, such as shrinkage, O&M and Residual Balancing costs for GSO revenues and innovation revenue for the Gas Transmission Owner revenues.

**Q13 - Chapter 4 - Finance Conditions - Do you feel it is necessary for the licence to contain algebra for ADJ and K, or is it sufficient to have the calculations contained in the PCFM and explained in the PCFM Handbook?**

We agree that it is necessary to have clarity on what the terms ADJ and K are intended to represent. However, the full algebraic expressions to calculate these terms are extremely lengthy and complex and so, provided the terms are correctly calculated in the PCFM and defined and explained in the PCFH, we do not consider it necessary to include the detailed algebra within the licence.

**Q14 - Chapter 4 - Finance Conditions - Do you think FT35 should remain in the SLCs/SSCs or be moved to the Special Conditions?**

We believe that FT 35 (credit rating of the licensee and resulting obligations) should remain in the SLCs/SSCs as is the case today and should not be moved to the Special Conditions.

The credit rating condition is just one of a number of financial ring fencing conditions that apply to all licensees on a common basis. Other such conditions are those relating to disposal of assets, provision of information to the Authority, prohibition on cross subsidies, restriction on activity and financial ring fencing, availability of resources, undertaking from ultimate controller and indebtedness. This suite of ringfencing conditions is consistent across licensees and therefore sits with Standard (ET) and Standard Special (GT) conditions.

Whilst it is proposed that FT35 is modified for RIIO-2 this does not provide a reason to move FT35 to a special condition; it will remain a standard obligation across relevant licensees and so should remain in the SLC/SSC sections of the licences along with the remainder of the suite of financial ring fencing conditions as is the case today.

**Q15 - Chapter 4 - Finance Conditions - Do you agree with our proposal to make the recovery penalty upper and lower bounds consistent for all licensees?**

We do not necessarily agree with Ofgem's proposal to make the recovery penalty upper and lower bounds consistent for all licensees. We have identified complex interactions between the licence and the Uniform Network Code (UNC) for the Gas Transmission licensee which could unintentionally trigger the recovery penalty. These issues require further investigation and engagement with Ofgem to resolve and we propose that the recovery penalties for the Gas

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Transmission Owner and the Gas System Operator are reviewed once the impact of the issues is better understood.

We cover NGET and NGGT separately within this response to Q15 as the penalty regime differs significantly between the two licensees.

We also refer Ofgem to our response to the statutory consultation on a proposal for a COVID-19 contingency plan for RIIO-2. We note in our response that a delay to the publication of Final Determinations (FD) could result in Allowed Revenues used for charge setting purposes being different to those published under FD. In the circumstances where FD publication is delayed, the FD Allowed Revenue information will not be available for use in the charge setting process and we propose that the licence drafting contains a provision for the derogation of the recovery penalty should Ofgem's contingency plan be implemented.

### NGET

NGET's licence does not include a recovery penalty. The tariffs set to collect Allowed Revenue are calculated and issued and the revenue collected by the Electricity System Operator. Therefore, as control over recovery lies with the Electricity System Operator as opposed to NGET, we agree that the exclusion of a revenue recovery penalty from NGET's licence is appropriate.

However, the ET2 PCFM includes a recovery penalty calculation (on the AR tab) which is triggered when recovered revenue falls outside of a 6% threshold of Allowed Revenue. The triggered penalty flows into the Allowed Revenue calculation, which is inconsistent with the proposed licence drafting. This section of the ET2 PCFM should be removed entirely to ensure consistency with the licence drafting. In addition, any reference to the recovery penalty, such as the presentation of the annual values within the Live Results tab, should be removed to align with the licence.

### NGGT

We do not necessarily agree with Ofgem's proposal to make the recovery penalty upper and lower bounds consistent for all licensees. The recovery penalties should be consistent according to the sector in which the licensee operates and the charge setting regime which applies.

Our initial review of the RIIO-2 licence drafting has highlighted a potential risk regarding revenue under-recovery which could impact on customers' charges through the K collection term and the licensee through potential trigger of the recovery penalty. Specific areas that initially require review are in relation to the Gas Transmission Owner (GTO) and Gas System Operator (GSO) revenue restriction conditions. This risk also extends to the current RIIO-1 licence and therefore we consider that the Revenue Restriction condition applicable for 2020/21 should also fall under this review.

A potential under recovery could result from certain capacity revenues (based on processes under the Uniform Network Code and treatment in the licence) effectively not contributing towards Allowed Revenue collection. These revenues may become more visible and sizeable

as Shippers adapt and update their capacity booking patterns to the updated Pricing Regime implemented from 1 October 2020.

The immediate concern is in regard to potential impacts on charges to customers that would adjust for any under recovery. We consider it prudent to review specific elements of the GTO and GSO revenue recovery conditions (e.g. those under the RCOM term) in relation to certain capacity revenues. Dependent on the level of under recovery, the recovery penalty could also be triggered despite revenue collection complying with the licence and the UNC. Therefore, the applicability and methodology of the recovery penalty requires assessment as part of the review.

National Grid will share further details with Ofgem in due course and where any changes to the UNC and / or licence may be necessary we would welcome the opportunity to discuss further. Should changes be required, with the engagement of Ofgem and wider industry, we would aim to complete this as soon as is practicable.

**Q16 - Chapter 4 - Finance Conditions - Do you agree with our proposals relating to DRS? Do you see merit in clarifying and documenting the mechanisms behind each category of DRS and in particular do you have a view on how the various elements of DRS expenditure and revenue are reported, how they are treated within the price control and whether they are included within Allowed Revenue.**

We understand the changes that Ofgem wants to make to the DRS arrangements, previously known as Excluded Services. We support Ofgem's proposals to introduce standardised numbering across the networks which will aid transparency and consistency across the energy sectors and to provide clarification of the mechanisms behind the DRS categories.

The remainder of our response to Q16 is specific to NGET. We have raised the treatment of revenue and costs associated with directly remunerated connection assets in our response to Draft Determinations – Finance Annex FQ34 and here provide further explanation of our views.

NGET has two type of connections asset; pre-vesting, covering those assets installed prior to 1990 and post-vesting covering those installed after that date. In previous price controls, pre-vesting assets revenues have been included within the Allowed Revenue term. The Allowed Revenue is submitted to the Electricity System Operator showing a split between a pre-vesting element and an amount to be collected via TNUoS charges. In effect, this gives rise to an automatic annual true-up of pre-vesting revenues should there be any change in value across the price control period. To complement this, Ofgem introduced a true-up for post-vesting connections in RIIO-T1 which will take place at the end of the RIIO-T1 price control period. We propose the introduction of an annual true-up for all directly remunerated connection charges (both pre- and post-vesting) and therefore consider that the licence drafting should be amended to allow true-up of the post-vesting element on an annual basis.

In order for all connection charges to be subject to an annual true-up, a variable value needs to be created for the connections element of DRS. This will enable annual inputs to the PCFM to be updated for revised forecast and actual revenues for pre- and post-vesting connections. To facilitate this process, Special Condition 9.10.3 requires amendment. Special Condition 9.10.3 states that TNGT is equal to ART less EXSt, where EXSt is defined as the income from connection charges remunerated under Special Condition 2.1. However, we are proposing for



pre- and post-vesting income to be included within the DRS term which results (as per Special Condition 2.1.6) in all directly remunerated connection charges being excluded from the Allowed Revenue. Therefore, the formula in Special Condition 9.10.3 should be amended to state TNGET is equal to ART.

For the avoidance of doubt, the remainder of the DRS income and costs should be treated as a standing item (as opposed to a Variable value) within the PCFM.

Special Condition 9.7.10 (a) can also be amended to remove the statement in parentheses, that is the wording, "(but only to the extent that the service is not already remunerated under one of the charges set out paragraph 9.7.8)".

It should be noted that the DRS connections values provided within NGET's December 2019 Business Plan submission and therefore in Ofgem's Draft Determination Financial Models include only the post-vesting element of connection charges consistent with RIIO-T1 precedent. We will provide the pre- and post-vesting combined values for use in the RIIO-2 Final Determinations on adoption of this policy.

In addition to the proposed licence changes, changes to the industry's commercial codes will be needed, including to the charging methodology in Section 14 of the Connection and Use of System Code (CUSC) and to each of the Transmission Owner's charging statements. The Electricity System Operator is best placed to assess changes to the CUSC and the appropriate governance route; and updates to the TO Charging Statement could be included in the next annual update ahead of RIIO-T2. In both cases, a clear policy statement is needed from Ofgem in order for these to be progressed with the industry.

**Q17 - Chapter 4 - Finance Conditions - Do you agree with our proposal to retain the allocation of costs and revenues condition (FT35) for the Gas sectors? Do you agree with the proposal to apply this condition to the ET and ESO sectors? If so, do you have a view on the business activities that costs and revenues should be attributed across and if not, are there any reasons that this condition should not apply to ET and ESO licensees?**

Ofgem helpfully confirmed to National Grid on 2 October 2020 that the reference in this question to FT 35 should be to FT 29.

We do not agree that FT35 should be retained for the gas sector and suggest that it is removed from the licence. The condition no longer serves the same purpose it did at the start of RIIO-1 and, as with the approach for other conditions that will become redundant at the start of the RIIO-2 period, we suggest that it is deleted from the GT licence. Given that some of the business activities referred to in the current GT Special Condition 11B have ceased to operate we see little benefit in the retention of this condition. It is not clear what the condition adds over other obligations relating to allocation and apportionment between licensee activities that already exist in Standard Special Condition A30 (Regulatory Accounts) dealing with apportionment and allocation as between, amongst other things, the NTS TO and SO activities.

We would further note in response to this question that, notwithstanding our comments here that the condition should be removed, we also do not agree with the proposed amendment to the current Special Condition 11B that is reflected in the drafting proposed at GT Special Condition 9B. This drafting includes reference to the Metering Business. We comment on this further in

our attached views on Special Condition 9B but we do not believe that it is appropriate for paragraph 9.9.7 to refer to revenues earned and costs incurred by the Metering Business for the purposes of allocation and attribution to the activities referred to in sub-paragraphs (a) - (c ) as they will not be allocated to such activities. The inclusion of this activity is not appropriate and the proposed inclusion has not been discussed to date.

We do not agree with the proposal to introduce FT29 (allocation of revenues and costs for calculations under the price control) into the ET licence. This is not an existing licence obligation for ET and Ofgem has not introduced or consulted on any policy rationale for introducing the change as part of the RIIO-2 price control.

Furthermore, the bases of charging and apportionment as between the consolidated transmission business, de minimis business and consented business is dealt with under the provisions of Standard Condition B1 (Regulatory Accounts) so it is not clear what the addition of FT 29 to the ET (and ESO) licence would achieve.

**Q18 - Chapter 4 - Finance Conditions - Do you agree with our proposals relating to DRS? Do you see merit in clarifying and documenting the mechanisms behind each category of DRS and in particular do you have a view on how the various elements of DRS expenditure and revenue are reported and how they are treated within the price control?**

We received confirmation from Ofgem, on 2 October 2020, that this question is already covered within Q16. We therefore refer to our response to Q16.

**Q19 - Chapter 5 - Cross Sector Conditions - What are your views on the proposed changes to the SLCs, SSCs and SpCs outlined in this cross-sector chapter?**

We refer Ofgem to Appendix 2 (Proposed licence changes outlined in the Cross-Sector Chapter) to this Annex.

**Q20 - Chapter 5 - Cross Sector Conditions - What are your views on the principles we have created for drafting PCD licence conditions?**

The drafting principles for PCDs are set out in paragraph 5.5 of the consultation. We note that these points represent a summary of some, but not all, of the PCD drafting principles that were set out in Ofgem's PCD policy paper.

We responded to Ofgem's PCD policy paper on 11 September 2020. In response to this Question 20 we restate many of our comments made in our response on the PCD drafting principles, as they remain relevant.

In defining what licensees are funded to deliver, PCDs are a fundamental aspect of the proposed price control framework and it is therefore important to have absolute clarity in this area before Final Determinations. Notwithstanding that the licence condition and the PCD Reporting Requirements and Methodology Document are in an early draft state, with many provisions being ambiguous or incomplete, at a high level we fundamentally disagree with the PCD principles as set out within the licence consultation for these key reasons:

- 1) The PCD framework undermines the principles of the RIIO price control with the ability to **apply ex-post assessment** to evaluative PCDs – creating a cost pass through effect, rather than a bounded price control incentivising efficiency and innovation, and increasing risk and allowance uncertainty for companies;
- 2) Individual PCDs are **defined by way of inputs rather than outputs** and the level of definition inconsistently applied – this approach to defining price control deliverables has the effect of removing scope for innovation and reducing the flexibility of the licensee to efficiently respond to changing customer needs; and
- 3) There is an **overly complex and interactive framework structure**: The lack of clarity around how the regulatory framework fits together at best represents a regulatory burden for RIIO-2 and at worst risks revenues not flowing correctly and the licensee being penalised multiple times against one output deliverable.

1) Ex-post assessment undermines the principles of RIIO

In order to incentivise finding better ways to deliver outputs, ex-post assessments should be minimised. These proposed licence provisions allow for ex-post assessment of Evaluative PCDs, defined as a discretionary adjustment, undermining the TOTEX incentive mechanism. Adding in these further hurdles to assess the efficiencies or innovation of savings will disincentivise licensees to deliver in a different way and increase risk and uncertainty.

As ex-post adjustments increase risk and allowance uncertainty, where they are unavoidable, the discretionary aspect should be minimised as far as possible through the establishment of a clearly defined process and decision tree (including relevant examples) set out before the start of the price control.

Remedy needed: Engage with licensees to establish a clearly defined process, criteria and decision tree for PCD assessment, with a view to minimising the use of ex-post assessment where possible.

## 2) PCDs Defined by Inputs rather than Outputs

It is helpful that outputs and associated baseline allowances are defined, but this needs to be done in a manner that (i) does not comprise the confidential and commercially sensitive information of both licensees and third parties, and (ii) which drives licensees to find better ways to achieve an output. We urge Ofgem to consistently define the outputs rather than the inputs in order to create the best outcome for consumers.

Defining outputs at an appropriate level in terms of level of benefits to consumers is core to the principles of RIIO (as the O in RIIO). This is key to reduce the need for outputs to be substituted for others (as allowed within the PCD Reporting Requirements and Methodology Document). A licensee should be able to, under the principles of RIIO, use different solutions (or inputs or specifications) to deliver the same output and this should not be subject to an Ofgem ex post review of efficiency and innovation where the company has delivered the required output set out in the licence. Defining the deliverable as a fixed input makes it more likely that substitution would need to take place for example if alternative innovative solutions were found, although we do recognise that there are some specific circumstances where substitution of outputs would still be required (e.g. customer driven, legislation, as a result of a reopener).

In many of the PCD licence conditions, there are no provisions for amending the Appendix output tables in the absence of certain cost criteria being met. Ofgem should include provisions within these conditions to allow for a request to be raised in order to amend the PCD delivery date where such cost criteria may not be satisfied. This would enable Ofgem to consider whether such a request to move the delivery date is in the interests of consumers and make corresponding changes for example to delivery dates if agreed.

### Remedies needed

- Define PCDs based on outputs rather than granular inputs to avoid an overly complex regime that stifles innovation.
- Include provisions in PCD conditions to allow parties to request amendments to output Appendices (e.g. delivery dates).

## 3) Complex and Interactive Framework Structure

Ofgem has created an inherently complex framework structure, and it is not clear how processes fit together into a coherent regulatory package. Several key areas relevant to PCDs are:

**PCD/Licence obligation link:** The principles state that licence condition drafting will clarify where a PCD is also a licence obligation. In the PCD Reporting Requirement and Methodology Document, paragraph 2.5 it states that when a PCD is also a licence obligation the two approaches “will take effect in parallel”. Paragraph 5.5 of the licence drafting consultation states that a PCD licence condition will set out whether there are any enforceable licence obligations related to the PCD but PCD drafting presented in the informal consultation is not clear on this issue. Where a PCD is also a licence obligation, Ofgem should explicitly rule out double penalties for licensees in the event of not fully delivering a PCD that is also a licence obligation. More broadly, we are not clear that Ofgem has justified the inclusion of any licence obligation linked to a PCD in the informal consultation. In particular in circumstances where there is a mechanism to penalise the licensee through reduced allowances for non-delivery and broad

statutory and licence obligations already imposed on licensees relating to their licensed activities.

**Interaction between different PCDs and UMs:** The interaction with volume drivers and other uncertainty mechanisms is not clear (or acknowledged) and there is a risk that revenue adjustments will be made via the PCD review process in isolation to the adjustments that will automatically occur through the volume driver and therefore the adjustments will be made more than once for a single output. The interaction with NARMs is also unclear and the same could apply to double penalties being applied.

**Lack of clarity on terms:** Fundamental to the understanding of PCDs are further understanding of what Ofgem mean by “late delivery” and “equivalent delivery”. We seek further clarification as to how assessments of “late delivery” and “equivalent delivery” are intended to be made and how it will be calculated.

We also ask Ofgem to define the ‘Use It or Lose It’ (UIOLI) mechanism, as it stands there is no licence definition for how this will be administered.

**Inappropriate level of commercial information:** The BPDT with respect to customer projects was completed in April 2019 and the completion dates and cost profiles do not represent the contractual position of the projects, however, this information has been transposed into the Appendices of relevant PCD conditions. The inclusion of PCD Delivery Dates that do not align with the TEC register’s publicly available information compromises our customer’s confidentiality and commercial position, whilst obliging the licensee to deliver against a date that may change. The inclusion of profiled allowances at an individual project level also undermines the licensee’s ability to effectively tender such projects, which ultimately is not in the interests of consumers.

**Lack of reporting clarity:** The reporting must align with the RRP dates and process. The PCD principles introduce a quarterly reporting process and in principle we agree with providing frequent progress updates, but these must be proportionate to stakeholder needs and the resource requirements to achieve, which if they were to mimic the RRP process would become overly administrative and costly. Further detail is required to that set out currently within the PCD reporting and methodology guidance.

**Unclear process:** The overall governance and structure of the documentation building up the licence is complex, with many layers and references. This will lead to confusion and so creates risks for us around reporting. It is not currently clear how the process works for allowances to flow through to the PCFM. For example how reopeners and evaluative assessments interact with PCD allowances.

In terms of a specific example, in the generic PCD licence condition the construct is to define the PCD Variable Value term by an equation in the format, in the example of Non Lead Assets NGGT PCD:

$$NLAt = NLAA_t - NLAR_t.$$

It may be intended that in this example the NLAA<sub>t</sub> term is set at Final Determination and adjusted as an outcome of reopener(s). Then the NLAR<sub>t</sub> term is determined as an outcome of

Ofgem's assessment of PCD outputs based upon our PCD reporting. However, it does not appear to be described by Ofgem in PCFM, or PCFH, or licence condition or consultation document that this is indeed the intention. Nor is it possible to see the spreadsheet cells / algebra of how this will be done or the timing effects upon recovery of revenue, or how the NLAt term feeds into Calculated Revenue Rt.

It may be Ofgem's intention that these calculations are performed "offline". However, given the significant importance of absolute clarity over allowed revenue and adjustments to allowed revenue, our view is that the explicit operation of the formulae should be set out on the face of the licence and in agreed algebra in the PCFM. We note that, without further guidance about forecasting, in the above formula, where there is a base allowance this would mean  $NLAA_t$  being fixed at the amount of revenues allowed at the start of the period, with a new term introduced to represent allowance changes associated with a re-opener process.

**PCD guidance and methodology document:** Contained within Part B of Special Condition 9.3, we note that there is an ambiguous statement about how and when the PCD Reporting Requirements and Methodology Document will be updated. There is also nothing to clarify whether a new version of the document may not be retrospectively applied when the methodology is updated. The PCD Reporting and Requirements Methodology Document should be altered with rigour and industry consultation as it fundamentally affects the material aspects of reporting and revenue for licensees. We request that Ofgem updates this section with a full and clear explanation of the methodology consultation and publishing process, and clarifies that any changes will not have retrospective effect.

**PCD directions:** Finally, as set out in the Executive Summary to our response we remain concerned with Ofgem's intended approach that material allowances relating to PCDs can be changed after the start of the price control period through this direction process. Having seen the proposed licence drafting in the informal consultation, given the cumulative materiality of such directions on the NGET and NGGT RIIO-2 price control framework in terms of output obligations and allowances, it is our view that all such decisions, including those relating to PCD delivery assessment, should be made by statutory licence modification rather than direction. It is vital that a suitable route of appeal to the CMA is included in the price control.

Remedies needed:

- The statutory consultation needs to be a complete package with all material issues to the operation of the PCD mechanism and financial consequences set out in the face of the licence.
- The mechanism for re-openers needs to be simple to understand, easy to implement with a clear process set out on the face of the licence of how it is intended to operate, including the process steps to be undertaken by Ofgem.
- Ofgem should not publish confidential or commercially sensitive information within the licence.

- Ofgem decisions relating to output obligations and allowances, including those relating to PCD delivery assessment, should be made by statutory licence modification rather than direction.

**Q21 - Chapter 5 - Cross Sector Conditions - What are your views on the principles we have created for drafting re-opener licence conditions?**

We largely agree with the principles set out in paragraphs 5.22 and 5.23 of the consultation document itself.

However, we have some fundamental concerns about the current reopener framework:

1. given the importance of the reopener mechanism in the RIIO-2 framework it is essential that there is clarity in relation to the end to end reopener process from application to Authority decision
2. the reopener principles and the associated reopener licence conditions should provide for the timescale within which the Authority decision in relation to the reopener application will be given. The absence of such gives rise to unjustified regulatory uncertainty in respect of requested funding allowances.

Our comments on the Reopener Guidance and Application Requirements document will be provided separately in response to Ofgem's separate consultation on that document. Our fundamental concerns with the overall re-opener framework are set out below.

Proposed remedies relating to our specific reopener issues can be found in the Executive Summary to this response.

**1. Lack of clarity on reopener process**

Ofgem has not released the full suite of documentation relating to the reopener process (for example, only releasing guidance for Cyber and non-operational IT as annexes to the reopener guidance). Within the documentation there is insufficient level of detail to fully understand the requirements on the licensee. It is not even clear from point 1.8 of the reopener guidance which reopeners the guidance is intended to apply to.

In addition to this in the licence drafting we have received is not clear how the revenue process between reopeners and price control deliverables work and how these flow through into allowances (please see our response to Question 20 above).

**2. Requirement for Ofgem decision timescales**

We are concerned that in its drafting of the licence Ofgem has followed a general principle that it should not be subject to any prescribed timeframes for making decisions, even where these decisions concern issues that are highly material to the proper and efficient functioning of reopeners. Delays in decision making may impact on project timelines, increase costs and delay benefits to consumers. In licence drafting working group meetings, this approach has been justified on the basis that the purpose of the licence is not to place obligations on Ofgem. We do not consider that this justification is valid and are of the view that a key function of the licence is to provide clarity, transparency and regulatory certainty, not only in terms of obligations on licensees, but also those aspects of the licence that are subject to a decision from Ofgem.

Clear provisions around how and when Ofgem will take decisions provides transparency for licensees, stakeholders and consumers alike and has been the approach taken in the licence to date, including under RIIO-1 arrangements. Ofgem has neither consulted on the proposed change in approach nor sought to justify it.

The approach in the currently proposed RIIO-2 licence drafting is a considerable step back from the prevailing RIIO-T1 licence as it removes existing timeframes specified in certain licence conditions and the associated "safety net" provisions where Ofgem is deemed to have agreed or approved the relevant matter if it fails to notify a decision within the specified period. Such provisions are particularly important in the context of the RIIO-2 framework which introduces a vast range of PCD and re-opener arrangements that require timely action from both licensee and Ofgem if they are to function effectively. We do not support the concept of an open-ended period for Ofgem to arrive at its decisions, where licensees are left in a state of uncertainty for an indeterminate period of time. Such approach increases uncertainty for all parties and may prevent licensees from taking timely investment decisions, which ultimately will not be in the interests of consumers.

In addition to these concerns, as set out in the Executive Summary to our response, we remain concerned with Ofgem's intended approach that material outputs and associated allowances relating to re-openers can be changed after the start of the price control period through this direction process. Having seen the proposed licence drafting in the informal consultation, given the cumulative materiality of such reopener directions on the NGET and NGGT RIIO-2 price control framework in terms of output obligations and allowances, it is our view that all such decisions should be made by statutory licence modification rather than direction. It is vital that a suitable route of appeal to the CMA is included in the price control.

**Q22 - Chapter 5 - Cross Sector Conditions - Do you think the proposed new licence condition 'CS35 Housekeeping' should apply to the SLCs and SSCs or just the SpCs?**

It is not evident from the consultation document section dealing with CS35 (Housekeeping) and the associated drafting at Standard Condition B24 (ET) and Standard Special Condition A56 (GT) that the condition is intended to apply only to Special Conditions. However, this is implied by the question which seeks views on whether it should also apply to Standard and Standard and Special Conditions. Currently the drafting refers to "a process for making Housekeeping Modifications to the conditions of this licence" and so does not distinguish as to whether such modifications are intended to apply to Special Conditions only as implied by this Question 22. The drafting ("conditions of this licence") currently suggests that all conditions of the licence are within scope.

Notwithstanding the comments made above in relation to the application of the condition, we have significant concerns over the introduction of this licence condition in its currently proposed form for a number of reasons. These are set out in Appendix 2 to this Annex in relation to ET SLC B24 and GT SSC A56 (Housekeeping) but we repeat those concerns here:

- First, the condition would remove licensees' right of appeal to the CMA in respect of any "minor" changes through the housekeeping condition – any such proposal needs serious consideration and should only be adopted with clear justification.



- Second, the reason for introducing the condition has not been fully explained. The consultation states that the intention of the provision is to reduce regulatory burden, but it is not explained what is burdensome about the statutory licence modification process such that it should be avoided or how the process in this licence condition will assist. The minimum consultation period is the same in each case. There is a statutory standstill period for statutory licence changes, but it is not explained how this causes burden. Ofgem generally carries out an informal consultation before a statutory consultation, but there is no requirement for this in every case.
- Third, the process turns on the meaning of what is a “minor” change, which is open to interpretation, meaning that it will not be clear when this may be applied. Our understanding is that this process is intended to apply to non-substantive changes, but that is not clear from the drafting or the consultation paper. There is clearly the scope for disagreement over whether a change is minor or not.
- Fourth, best regulatory practice should be considered. Ofgem should set processes in place, including having adequate resources and sufficient time for consultation and consideration of responses such that it issues a licence with a high standard of drafting and does not direct licence modifications which contain errors. Further, interpretation provisions in the licence already deal with interpretation around changes to legislation (through the term of the licence incorporating the Interpretation Act 1978).

Ofgem has moved away from the position, which we understood that Ofgem considered reasonable in the licence drafting working group meetings, that the process should not apply where the licensee reasonably objects to the categorisation of the change as minor (similar to under the current change control framework for Price Control Financial Instruments). This change would remove many of our concerns and would align with Ofgem's policy intention as we understand it.

**Q23 - Chapter 6 - ET Conditions - What are your views on the proposed changes to the SpCs outlined in this Electricity Transmission licence conditions chapter and the Annexes?**

We refer Ofgem to Appendix 3 (Proposed changes to Electricity Transmission Special Conditions and Standard Conditions) to this Annex.

**Q24 - Chapter 6 - ET Conditions - Do you have any views on the definition of the Competent Authority in SpC9.13 Restriction on the use of certain information?**

Special Condition 9.13 (Restriction on the use of certain information) imposes a business separation obligation that applies to SPT and SHET but does not apply in respect of NGET. However, despite this condition and therefore the associated definition of Competent Authority not applying to NGET we would note that the proposed definition of Competent Authority appears to be unchanged from the existing definition within this condition.

**Q25 - Chapter 7 - ET and ESO Conditions - What are your views on the proposed changes to the SLCs outlined in this Chapter and the Annexes.**

We refer Ofgem to Appendix 3 (Proposed changes to Electricity Transmission Special Conditions and Standard Conditions) to this Annex.

**Q26 - Chapter 8 - GT and GD Conditions - What are your views on the proposed changes to the SSCs outlined in this Gas Transmission and Gas Distribution chapter and the Annexes??**

We refer Ofgem to Appendix 4 (Proposed changes to Gas Transmission Special Conditions and Standard Special Conditions) to this Annex.

**Q27 - Chapter 9 - GT Conditions - What are your views on the proposed changes to the licence conditions as outlined in this chapter and in the Annexes.**

We refer Ofgem to Appendix 4 (Proposed changes to Gas Transmission Special Conditions and Standard Special Conditions) to this Annex.