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NGET and NGGT response to RIIO-2 Informal Licence Drafting Consultation: Executive Summary



National Grid Response to Ofgem's RIIO-2 Informal Licence Drafting Consultation

Executive Summary

Introduction

This is the executive summary for the response from National Grid Electricity Transmission plc (NGET) and National Grid Gas plc (NGGT) to Ofgem's RIIO-2 Informal Licence Drafting Consultation published on 30 September 2020.

Our responses to the consultation questions are set out in Appendix 2 to the consultation and our detailed comments on the draft licence conditions are set out in the Annex to this response.

For RIIO-T1, the first informal licence drafting consultation ran for around 2 months, with a further informal consultation running for a month (prior to the statutory consultation). We have engaged fully in Ofgem's licence drafting working groups since September 2019 on many (but not all) of the licence modification proposals. The Associated Documents were also not part of that process. This working group process should not be seen as a substitute for meaningful consultation on the overall licence drafting package.

With the informal March licence consultation having been understandably cancelled due to COVID-19, this consultation is the first opportunity for licensees to comment in writing on the overall package of proposed licence changes. We have had just 28 days to respond to a consultation that proposes fundamental change to the licences as part of the RIIO-2 framework. We will continue to review the proposals, noting that the themes and concerns raised highlight the significant work that is required to finalise the licences and Associated Documents.

We understand that the drafting is generally based on Ofgem's Draft Determination policy. In some places, we refer to our Draft Determination response, but in general we do not repeat the points made in our response. Our position remains as in our response.

In this summary, we set out our views on a number of key themes and concerns that emerge from the consultation document, the draft licence modifications and the Associated Documents. This summary covers the following themes followed by our proposed remedy:

1. We need visibility of everything that forms the price control together as a package.
2. Licensees should retain a right of appeal for material within-period changes and Ofgem needs to make timely decisions.
3. Obligations and material price control mechanisms need to sit in the licence and not in Associated Documents.
4. The principal revenue restriction formula in the PCFM must be corrected.
5. Transparency and audit trail of information of the regulatory instruments is needed.
6. Policy needs to be finalised for LOTI, CPM, and Funded Incremental Obligated Capacity before any drafting is further progressed.
7. Clear linkages are needed with other price control related processes.

1. We need visibility of everything that forms the price control together as a package

We are concerned that the consultation contains an incomplete package of drafting proposals, which in many cases we understand will change before the statutory consultation.

Gaps in the proposals consulted on mean that we are currently unable to evaluate the overall package of

measures which Ofgem proposes to use to implement its RIIO-2 Final Determinations. It also makes it difficult for us to assist Ofgem in its efforts to finalise the licence and accompanying Associated Documents since we are simply not able to comment on those aspects of the framework that we have not seen. The key gaps we have identified are;

- Of the 22 Associated Documents referred to in Chapter 3 of the consultation proposed to give effect to the RIIO-2 framework, only 2 were issued at the launch of the consultation. Five further documents were issued during the subsequent fortnight. This situation makes it impossible to assess the overall impact of the framework and means any appraisal is necessarily disjointed and incomplete. That is of significant concern in the context of what ought to be a carefully interrelated complete package of proposals.
- Explanations for Ofgem's position are often missing from the consultation and gaps have not been acknowledged, leaving the reader to speculate at the gaps and Ofgem's intentions. These include the introduction of a number of new licence obligations, such as minimisation of business rates. This undermines the objectives of consultation.
- There are many instances where it appears Ofgem has simply not yet formulated proposals to a point where there is clarity of the intended operation upon baseline allowances or adjustments to allowances. Examples include where terms are introduced in licence drafting (such as Use it or Lose It allowances), yet their intended operation is not explained in the consultation document, the draft licence condition or the accompanying Price Control Financial Handbook.
- Ofgem intends to streamline regulatory instruments with the Price Control Financial Model (PCFM) taking on the role of submission of reporting information, revenue calculation and performance reporting. Also, the PCFM is now designed to capture Ofgem's proposed forecasting framework with allowances and totex forecasts driving revenues. Each of these changes requires a major rewrite of the PCFM, so whilst we support the intention, we have reiterated the concerns we have raised previously with Ofgem regarding the limited time to produce completed and correct regulatory instruments.
- We have yet to receive either the performance reporting element of the PCFM or PCFM guidance which we understand will provide further detail on forecasting approach. We therefore cannot comment in full on whether the PCFM fulfils Ofgem's objectives and results in correct outputs for revenues and performance.
- We have identified that for Price Control Deliverables the process to flow allowances from determination through to allowed revenue is neither clear nor transparent, for example, how elements such as PCDs and re-openers link together. The definition of totex allowance should be updated to reflect which terms fall within it.
- 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 being 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 (e.g. the Strategic Innovation Fund licence condition. In this example there is not even 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 Final Determinations and the statutory consultation). In another example, previous discussions have led us to expect a NARM Funding Adjustment and Penalty Mechanism Methodology Document. However, this is not mentioned in the list of 22 Associated Documents leaving us unclear as to Ofgem's intentions.

- In the Draft Determinations, Ofgem consulted on three Large Project Delivery mechanisms, to be available for large (£100M+) transmission projects in the RIIO-2 period. However, these mechanisms are not mentioned at all in the informal licence drafting consultation and do not appear to feature anywhere in the drafting which has been provided. The draft LOTI guidance provided for comment on 6 October 2020 refers to the mechanisms, but with a placeholder for further content to be added. We are very concerned that at this stage in the process, drafting has been consulted on for large projects without any clarity on the previously proposed large project delivery mechanisms.

There is significant work to be done if the extensive comments that we make in response to this consultation are to be duly considered by Ofgem. The fundamental objective now must be to agree and have drafting in place for the statutory licence consultations that is complete and fit for purpose. That must include both licence drafting and a full and complete suite of accompanying Associated Documents that form the basis of the price controls and which allows it to be assessed as a whole which need to be read alongside the licences. To achieve this, we must be afforded the opportunity to work closely with Ofgem over the coming weeks to address the issues raised in this consultation response in order to ensure that these documents are complete and that we all have confidence that there will not be material errors or omissions in them at the time of the statutory consultations.

Ongoing engagement and development of the licences and Associated Documents must also reflect the areas where thinking has progressed based upon the constructive engagement that we have had with Ofgem since the publication of Draft Determinations in July.

We will ensure that our legal, finance and policy specialists are available to work with Ofgem, bilaterally where appropriate, to resolve outstanding issues. Given the significant amount of progress that needs to be made over the coming weeks, we recommend a move to a way of working that is licensee specific. That will allow us, if it would assist Ofgem, to provide licence drafting and further support on company specific areas for Ofgem's consideration.

Remedy

- The statutory consultation needs to be a complete package with no material errors or omissions
- Licence drafting should reflect where thinking has moved forward since the publication of Draft Determinations
- Drafting in gap and updated areas should be shared at the earliest opportunity before the statutory consultation to maximise the time available for meaningful review and comment
- Ofgem should ensure that all policy proposals not yet explained are explained at the earliest opportunity and prior to the statutory consultation
- Ofgem should conduct licence specific bilaterals to enable networks to assist Ofgem in providing a complete package for the statutory consultation

2. Licensees should retain right of appeal for material within-period changes and Ofgem needs to make timely decisions

Statutory licence modification for material Ofgem decisions

In our response to the Draft Determination, we noted that there are an extensive range of licence conditions which provide for future decisions that will have a significant and material impact on the overall price control package and NGGT and NGET's activities during the period and/or which relate to new and untested licence mechanisms, and that accordingly it is appropriate that a suitable route of appeal to the CMA is included in the price control framework.

In our Draft Determination response, we stated that these areas include Ofgem's decisions in respect of net zero, CPM (notwithstanding our objection to the inclusion of this condition), LOTI, Funded Incremental Obligated Capacity and other specified gas projects.

However, it is clear on reviewing the informal consultation that the effect of such re-opener decisions and PCD delivery assessments by Ofgem will have a cumulatively material impact on the NGET and NGGT RIIO-2 price control frameworks, such that the framework may look substantially different following a number of Ofgem directions. As referred to above, these areas also include Ofgem's decisions in relation to the significant volume of re-openers that will change outputs and allowances in the licences.

We therefore propose that all Ofgem decisions changing outputs, delivery dates and allowances should be through statutory modification, preserving a right of appeal. This will require Ofgem to follow the statutory process to modify the relevant licence, as opposed to making directions under a pre-existing licence condition as is currently proposed in the licence drafting.

We note that the draft licence conditions include such a process for CPM decisions, but only partially (in relation to a CPM Project Assessment Direction) and contain an inconsistently limited process for LOTI decisions (in relation to Project Assessment Directions only where Ofgem considers that its decision is not "significantly different" from the application). No explanation has been provided for this in the consultation. While we welcome acknowledgement of the need for the statutory modification process for such major project decisions, Ofgem needs to consider the mechanism further to create a process which is consistent and comprehensive.

We do not see any there being any negative impact on Ofgem for decisions changing outputs, delivery dates and allowances to be made through statutory modification. We consider that the rules of the CMA on allowing only material issues to be appealed mean that this would not open Ofgem up to the potential of a large number of appeals. However, we welcome further engagement with Ofgem on any concerns it has with this proposal.

Self-modification processes

Ofgem's power to introduce licence conditions which are self-modifying (i.e. which can be changed outside of the statutory licence modification process) must be used appropriately. Such conditions should be included only where there is a clear justification and having considered the impact on licensees, including any cases where the licensee is deprived of a right of appeal to the CMA. Ofgem's proposals in the consultation do not align with this principle in two areas.

First, the proposals include a change to remove the provision allowing a licensee to insist that Ofgem follows the statutory process for changes to the Price Control Financial Instruments, where the licensee reasonably considers that the change will have a significant impact. Ofgem has not justified this proposed change, stating only that Ofgem should decide which process should apply. Indeed, the change cannot be justified. The current provision strikes the right balance between allowing the potential for a quicker process for changes to the PCFI, while ensuring that the fuller process (which encompasses

a right of appeal) is available for changes which the licensee regards as having a significant impact.

Second, the proposals include a new proposed “housekeeping” condition which, if implemented in its current form, will allow Ofgem to make changes to the licence by direction where it considers the change to be “minor”. Although the definition of such changes contains a list of changes which are unlikely to prove contentious, this is not set out as an exhaustive list and what constitutes a “minor” change is therefore extremely unclear. It is also not explained what is burdensome about the statutory process, such that the envisaged housekeeping process is justified. The statutory process could be used adequately to implement any of the housekeeping changes which are described.

Ofgem obligations associated with licence conditions

The licence drafting principles, adopted in the consultation, make a number of changes to the licence drafting on the basis that “*Licence conditions impose obligations on licensees not Ofgem*”. This is used as the justification for stating that Ofgem “*will*” take actions set out in the licence, rather than “*must*”. 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. The change is for clarity but makes no substantive difference to the operation of the licence and Ofgem recognises that it is required to act in accordance with the mechanisms set out in the licence (e.g. minimum periods for consultation, timetables for decisions etc).

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 in some way to lessen the obligation on it to follow those rules, this would be extremely concerning. Ofgem needs to make its intention in making the change clear so licensees can properly consider its implications.

Removal of Ofgem commitment to timescales for discharge of key regulatory process steps

We are also very concerned that, in its drafting of the licences, 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 the price control, such as reopeners, as well as other operationally significant processes, such as the approval of NGGT’s entry and exit capacity methodology statements. In licence drafting working group meetings, this approach has been justified by Ofgem 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 this proposed change in approach nor sought to justify it.

The approach in the currently proposed RIIO T2 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. A particular example of this issue concerns NGGT’s entry and exit capacity methodology statements where, as a consequence of removing the specific timeframe for approving these statements and the associated “safety net” provision, Ofgem’s decision to approve any revisions to these statements may come too late to be implemented for the current year’s capacity processes. In this situation NGGT would have no option other than to implement the previous year’s approved methodology statements but would do so in the knowledge that it has recommended changes to those statements that it considers would better deliver its broader licence and Gas Act duties. Our stakeholders have told us that they want predictability and stability of charges, however our ability to deliver this for them will be materially impeded where Ofgem does not commit to

take decisions within transparent, specified timeframes.

Clarity of the required timing for Ofgem's decisions and a "safety net" provision are now of even greater importance 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 and their customers and stakeholders are left in a state of uncertainty for an indeterminate period of time. Such approach increases uncertainty for all parties and may in some instances prevent licensees from taking timely investment decisions, which ultimately will not be in the interests of consumers.

We would strongly encourage Ofgem to look at this general principle again and reconsider its approach generally to this issue in drafting the RIIO T2 licence.

Remedy

- Ofgem should not make the change proposed at paragraph 4.37 of the consultation paper but should retain the position on changes to the PCFI set out in the licence currently
- Ofgem should not introduce a housekeeping condition. If, contrary to this, such a provision is introduced, the list of changes set out in the definition should be the only changes which fall within the process or the licensee should be able to insist on the statutory process
- Ofgem should make very clear in the statutory consultation that any changes as to how its role is described is not intended to have any substantive effect from the current licence
- We propose that the RIIO T2 Licence should contain specific binding timeframes for each Ofgem reopener decision
- Ofgem should engage with licensees via the Licence Drafting Working Groups and part of bilaterals to determine what a suitable timeframe for each individual reopener licence condition decision should be
- Ofgem should provide timely written feedback on PCD reports to help ensure licensees are on track to deliver Ofgem's expectations
- All decisions relating to outputs, delivery dates and allowances associated with PCDs and re-openers and delivery assessment, the net zero re-opener, Funded Incremental Obligated Capacity, CPM and LOTI projects should be required under the relevant licence conditions to occur through statutory licence modification rather than by direction

3. Obligations and material price control mechanisms need to sit in the licence and not in Associated Documents

Major expansion of scope/number of Associated Documents

We are concerned with Ofgem's proposed major expansion of, and reliance on, Associated Documents - documents that are incorporated into, but sit outside of the licence. 22 Associated Documents are listed in paragraph 3.8 of the consultation covering a range of issues and obligations. Many of these are, in effect, additional licence obligations placed in a different document capable of being amended by Ofgem with no associated right of appeal to the CMA for licence holders impacted by the document. As Ofgem continues to develop Associated Documents, it should also be aware that these have the potential to introduce unnecessary complexity which will reduce transparency for stakeholders and risk error by

Ofgem (or licensees) in RIIO-2.

Material obligations on licensees and the associated steps that are required to be taken by Ofgem through licence mechanisms should be recorded on the face of the licence, rather than in Associated Documents. Associated Documents 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 clear reason (such as technical detail), but where the material obligations are still in the licence. We request that Ofgem commits to follow these principles or otherwise commits to revisit the modification process for these documents to allow for self-modification only where the licensee considers that the proposed Associated Document has no significant impact.

Ofgem has set out principles relating to Associated Documents and our response to Q4 outlines further principles which should be followed. It is clear from a review of Associated Documents to date that there are proposed Associated Documents which do not align with our principles or indeed with Ofgem's principles for such documents, notably that "*Obligations on licensees must be drafted clearly... so licensees can be sure of what is expected of them*".

We also have concerns in relation to the proposed timetable for consulting on and implementing the Associated Documents. Given that the Associated Documents are intrinsically linked to licence obligations that give rise to them and require compliance with them, it is essential that licensees are afforded appropriate opportunity to review and comment on the proposed content of the Associated Documents.

In order to do this, licensees must be able to review the Associated Documents alongside the review of the licence drafting. It is therefore concerning that, at the time of this response, only 7 Associated Documents have been issued by Ofgem, 2 of which were issued at consultation launch and a further 5 in the subsequent two weeks. On the current proposed timetable, it is inappropriate and unacceptable that some Associated Documents are not expected to be published until Q1-2 2021. 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. All obligations need to be known and understood by licensees at the time that the licence modifications giving effect to the RIIO-2 price control are directed by Ofgem.

That means that all Associated Documents applicable to RIIO-2 must be available for review and comment by licensees as soon as is possible, as is envisaged by paragraph 3.7 of the consultation and, in any event should be made available prior to the date of publication of the notice of the December 2020 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.

PCD and associated mechanisms that affect revenues and outputs are core to the price control and should be in the licence

Material issues relating to the operation of the PCD mechanism (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 Associated Documents.

Financial implications of events and outcomes associated with the PCD 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.

Licensees first need to understand the intent of Ofgem's drafting through the full suite of documentation before they are able to fully assess whether the regulatory instruments fully enact this intent. Such material issues need to be known and understood by licensees at the time of Ofgem's 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 should be available and understood by licensees when the licence modifications implementing the RIIO-2 price control are brought forward by Ofgem for statutory consultation.

Inappropriate absolute licence obligations

Ofgem has proposed a number of outputs-based licence conditions where delivery of the output by the delivery date is an absolute licence obligation. In particular, we refer to cyber resilience (IT and OT) and the LOTI and CPM licence conditions which carry the formulation: "*the licensee must deliver the outputs...specified in Appendix 1*". This is different to the generic PCD licence construct which reads "*Appendix 1 specifies the outputs that the licensee is funded to deliver...*" It does not appear to us that Ofgem has properly considered the introduction of these obligations and whether they are necessary. None of these proposed obligations were explained in detail in the Draft Determinations or the informal licence consultation. The obligation proposed for CPM is also inconsistent with the brief explanation provided in the Draft Determinations.

In our view it is not necessary to include these obligations in the licence, since licensees already have relevant statutory and licence obligations which will oblige them to deliver projects in an efficient and effective manner. Instead, the licence obligation would allow a double penalty in many cases by allowing Ofgem to take enforcement action in circumstances where there is already a proposed mechanism within the PCD framework allowing it to claw back allowances if delivery dates are not met.

In any case, the licence obligations as proposed are disproportionate, by creating an automatic breach in the event of a failure to meet delivery dates, regardless of whether the circumstances justify a delay, the delay is caused by the licensee or the consumer interest changes such that a delay becomes the right course of action. This inflexible approach does not promote behaviour which is in the consumer interest.

Inclusion of confidential information within the licence conditions

During the course of the consultation period we have drawn Ofgem's attention to our concern that its proposed approach to drafting certain aspects of the RIIO T2 licence conditions and the added complexities, may result in the confidential information of licensees and/or third parties being publicly disclosed. Such disclosure arises as a result of Ofgem's general approach to include much more specific and granular levels of detail in the licence than previously has been the case. We have provided details in our comments on the relevant licence drafting as to the specific licence conditions that are affected by this issue. The disclosure of such confidential information may have serious financial and commercial consequences for both licensees and third parties and may ultimately serve to operate against the interests of consumers. We do not consider that the inclusion of such confidential information on the face of the licence is either necessary or justified and would expect Ofgem to explain why its potential inclusion is appropriate.

Volume of re-openers and Ofgem directions

We have commented in detail in our response to the Draft Determination consultation on the unnecessary complexity and volatility that has been introduced within the framework through the large number of re-opener and Ofgem direction provisions. We do not repeat the points made in our response here but note that once the proposed licence conditions are viewed as a package it is clear that there are a vast number of conditions requiring Ofgem decisions.

Across the proposed electricity transmission and gas transporter special conditions, there are a combined 19 re-opener conditions where the licensee may or must make an application to Ofgem for a direction (sometimes within defined windows throughout the price control). A number of these conditions including the net zero re-opener also enable Ofgem to propose re-opener directions of its own accord. Each application will involve detailed material and evidence in accordance with the re-opener guidance and the majority will involve Ofgem consulting on its position. These processes will impose significant regulatory burden on licensees and will also require significant time and resource commitment from Ofgem if the processes are to operate as envisaged. We remain to be convinced that Ofgem has fully considered these implications and our concerns are heightened by the point raised above in relation to Ofgem's proposal that it should not be required to take steps (such as to make a direction) within prescribed timescales. Ofgem needs to give further consideration to these timescale issues and should also give necessary assurance to licensees and other affected stakeholders that it is in a position to manage these processes effectively.

We do not consider that Ofgem has adequately considered the burden and impact of the above framework, both on Ofgem (taking decisions across all licences) and on licensees. We request that Ofgem considers further and, if it does not move substantially from the current approach provides a full and detailed impact assessment of the above processes and further explains how it will ensure that decisions are made in time to ensure that licensees are not unduly prejudiced by delays.

The volume of re-openers means that significant and material changes to the licences are proposed to be implemented by Ofgem directing changes to PCD and other output conditions (such as LOTI) and associated allowances. We remain concerned with Ofgem's intended approach that such material outputs, delivery dates and associated allowances 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 should be made by statutory licence modification rather than direction.

Remedy

- Ofgem should implement the principles set out in our response to Q4 that guide whether an obligation should be set out on the face of the licence or an Associated Document
- All Associated Documents should be made available for review and consideration as soon as possible and certainly by no later than the statutory consultation on licence changes that they must be read alongside. Obligations in Associated Documents should be clear
- 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's decisions which change outputs, delivery dates and allowances should be made by statutory licence modification rather than by direction
- In each of cyber, LOTI, CPM conditions, the absolute obligation to meet the delivery date should be removed. Any specific provisions relating to late/non delivery should be linked to allowances

4. The principal revenue restriction formula in the PCFM must be corrected

The revenue restriction formula sets out the amount of allowed revenue that may be recovered through charges and is the key element of the licence which ensures that the licensee is correctly funded in line with the agreed RIIO-2 framework. It is the foundation of the licence with its structure influencing other financial licence terms and the regulatory instruments, such as the PCFM. However, the current drafting of the revenue restriction formula is both ambiguous and contains fundamental errors. There are also inconsistencies with other elements of the licence and PCFM. Errors within the formula result in a licensee being incorrectly funded and customers being incorrectly charged for the outputs delivered and the costs incurred by the licensee.

Ofgem has proposed a significant change in the formula used to calculate Allowed Revenue, the primary drivers being the inclusion of “live” revenue terms to better accommodate forecasting of outputs and allowances and the simplification of licence terminology through removal of the need for true-up terms. We support both the introduction of forecasting and simplification of the licence where this is possible and note that Ofgem has presented several versions of the principal formula for review through the licence drafting working groups. However, the form of formula that is included within the electricity transmission and gas transporter licences within the consultation has not previously been shared with licensees and includes several errors both in the licence drafting and in the enactment through the PCFM.

There are fundamental errors that impact both NGGT and NGET in the drafting of the revenue restriction formula presented in the consultation including:

- Changes in allowances and totex and ODI performance which impact previous years’ revenues are ultimately not passed through to allowed revenue in the price control
- The performance and over/under recovery terms do not accurately reflect the licensees’ position with perpetual annual adjustments in both terms arising from totex and ODI performance in a single year
- The PCFM mechanisms do not implement the licence drafting for the allowed revenue and, whilst we agree with the approach in the PCFM, the licence takes precedence where there is a conflict of meaning
- A new totex performance input is introduced to the PCFM which results in incorrect calculation of performance and therefore error within the Allowed Revenue

Remedy

- Ofgem needs to correct for the errors we have identified in the revenue restriction formula
- The PCFM needs to be aligned to the licence
- We propose that our finance team should have focused bilateral working sessions with the Ofgem PCFM team to urgently fix the parts that don’t currently align

5. Transparency and audit trail of information of the regulatory instruments is needed

Our experience from the RIIO-1 price control is that a well-governed process with a strong audit trail of information is of benefit both to Ofgem and licensees and is highly valued by stakeholders in interpreting the impact of the price control framework.

There are several areas proposed within the RIIO-2 regulatory instruments which limit the transparency of information for all stakeholders. Whilst we agree in principle with Ofgem's proposal to combine the PCFM, Revenue Regulatory Reporting Pack and Regulatory Financial Performance Reporting, the information contained within these instruments should not be lost. Streamlining the regulatory instruments should not mean excluding information to the detriment of the performance audit trail.

Ofgem has been unable to provide reassurance that all PCFM inputs will be subject to a transparent calculation process with suitably robust sign off procedures. Legacy terms and non-totex incentives are of particular concern in this regard. There would be PCFM inputs which are not transparent to stakeholders and which could give rise to inefficient and ad hoc governance processes involving licensees and Ofgem in order to review these revenue elements. One such example is the exclusion of ODI revenue calculations from the PCFM. The algebra to translate the ODI performance into revenues can be complex and will still need to be carried out by licensees and, we anticipate, reviewed by Ofgem as part of a strong governance process. A bespoke calculation subject to annual review is a much more inefficient process and also results in reduced transparency of the licensee's performance against ODI targets.

Ofgem's proposed changes to the Annual Iteration Process also require a clear framework and strong governance process. Ofgem has outlined that "self-publication" of the PCFM aligned to the charge setting process will potentially drive more cost reflective charge setting than would otherwise be achieved. However, no details are presented within the consultation and the engagement required to develop a clear process operating with a defined framework should not be underestimated.

Remedy

- Ofgem needs to publish the PCFM guidance document for review and consideration as soon as possible and certainly by no later than the statutory consultation on licence changes to implement the RIIO-2 framework that the PCFM guidance must be read alongside in order to deliver transparent and robust regulatory processes and revenue calculations
- Further engagement is required between networks and Ofgem to develop strong governance process for "self-publication" of the PCFM

6. Policy needs to be finalised for LOTI, CPM, and Funded Incremental Obligated Capacity before any drafting is further progressed

We encourage Ofgem to continue dialogue with the electricity transmission licensees to ensure that the LOTI process and associated pre-construction funding (PCF) arrangements are sufficiently agile to enable these critical net-zero projects to be delivered at pace. In particular:

- PCF should be provided for all efficient activities on an optimal project timeline for all projects coming forward in the T2 period,
- the LOTI process should be more flexible to accommodate different planning regimes and project types and
- decisions on final needs case and competition should be made earlier in the process to avoid 'double jeopardy' with planning decisions and provide the certainty required to proceed with confidence.

As set out in our Draft Determination response, we do not support the introduction of CPM for NGET. We continue to have concerns regarding the design and implementation of the proposed CPM mechanism, which has come at the consequence of the lack of development of other true form of competitive models and as such does not deliver benefits but is a detriment to consumer value. We raise a number of significant policy concerns with the draft condition in this consultation response, but our comments in this response are subject to our general position that this mechanism should not be introduced. However, the policy issues raised further support our view.

For NGGT, we support the introduction of the FIOC re-opener. However, we note that it was not described as a PCD in the Draft Determination or in our previous discussions with the Ofgem team, and yet the licence drafting has been put forward as a PCD. It is unclear why Ofgem has now taken this approach or how it would seek to define the associated output.

In our view the associated output, when triggered, will be the release of the FIOC in respect of which we will have commercial obligations in keeping with our methodology statements and associated documents. We feel it would be inappropriate to overlay these obligations with PCD machinery. We are also concerned that there are no timeframes specified for the process steps to be undertaken in RIIO-2 by Ofgem in response to an FIOC reopener request. This is in contrast to prevailing RIIO-1 arrangements which have tightly defined process steps for both NGGT and Ofgem. We feel it is necessary for transparency and appropriate for the benefit of our customers and stakeholders that these processes are not left open-ended. We will provide further views in our subsequent response to the Draft FIOC Reopener Guidance Document.

Remedy

- PCF should be provided for all efficient activities on an optimal project timeline for all projects coming forward in the T2 period
- The LOTI process should be more flexible to accommodate different planning regimes and project types
- Decisions on FNC and competition should be made earlier in the process to avoid 'double jeopardy' with planning decisions and provide the certainty required to proceed with confidence
- CPM should not be introduced
- No PCD should be attached to the FIOC reopener
- The NGGT licence should include timebound process steps to be undertaken by Ofgem in response to an FIOC request

7. Clear linkages are needed with other price control related processes

T1 Close Out

Following the COVID-19 reprioritisation exercise carried out by Ofgem in June 2020, and with our support, the RIIO-T1 closeout consultation was delayed from 2020 until 2021. We note that the currently proposed licence drafting seems to reflect this – it deals with the RIIO-T1 legacy items which are mechanistic in their nature and mostly are a result of items with a 2-year lag within the T1 licences (with the exception of SpC 7.6 Close out of the RIIO-1 Network Outputs). There are however, closeout items not reflected in the NGET or NGGT licences which will need to be addressed through a separate closeout consultation. The scope of this is yet to be agreed with Ofgem. With regards to the RIIO-1 Network Outputs (SpC 7.6) we have

remaining concerns around the outstanding decisions on materiality thresholds required by the NOMs Incentive Mechanism and we would seek clarity on RIIO-T1 closeout parameters and closeout submission date ahead of the statutory licence consultation.

There needs to be opportunity within the licence and/or PCFM to enable recovery of RIIO-T1 legacy items. It is not clear how Ofgem intends to address these given the delay to the closeout consultation. There is currently no explanation of Ofgem's thinking in the informal licence drafting consultation document and no licence drafting to reflect these items. We do however note that there are inputs within the PCFM for 'RIIO-2 legacy price control adjustments to allowed revenue' and 'RIIO-2 legacy price control adjustments to RAV'. It could be Ofgem's intent to deal with the additional close out items through use of these inputs, but this is not clear within the licence or PCFH. We note the PCFH has a section on Legacy which is to be updated. We request that Ofgem makes clear its current approach and the next steps on the consultation to ensure a smooth transition across the price controls. All RIIO –T1 legacy close out items need to be clearly provided for in the RIIO-T2 licence drafting. Clarity on RIIO-1 closeout licence drafting, parameters and closeout submission dates is needed ahead of the statutory licence consultation.

Interaction with Covid-19 contingency proposal to have derogation provision for recovery penalty in year 1

Our understanding is that, as in RIIO-T1, Ofgem proposes to have an obligation on licensees to use best endeavours to ensure that recovered revenue does not exceed allowed revenue and to apply a penalty in the event that over or under recovery of revenues exceeds a specified margin (see SpC 2.3 and 2.7 in the NGGT licence and 2.3 in the NGET licence and our detailed comments on this drafting). On 23 September 2020, Ofgem published a statutory consultation on a licence condition which would put in place a change control framework, to be implemented if Ofgem is not able to publish the RIIO-T2 Final Determinations in December 2020 due to COVID-19. As noted in our response to that statutory consultation, if the Final Determinations have not been published sufficiently in advance of the date that charges are set in January 2021, there will be far less information available to licensees on which to base the setting of those charges.

We request that Ofgem confirms that, in the event Final Determinations are delayed, it will take a proportionate approach to its monitoring of the above licence obligations and will allow a derogation from the recovery penalty for the initial year of RIIO-2. We request that Ofgem commits to a dialogue with licensees on this issue.

Further engagement is required to align licence drafting with the charge setting process (Applicable to NGGT only)

Ofgem has posed a consultation question regarding the interaction of the Annual Iteration Process with the charge setting regime. We agree that this is an important area for review, in particular for the Gas Transmission network and propose that the licence drafting is also included within the scope.

A new Gas Transmission pricing regime was introduced from 1 October 2020 and we are currently assessing the interaction between the new charging regime, the resulting change in customers' behavior and the current RIIO-1 licence. The requirement to draft the RIIO-2 licence for the start of the RIIO-2 price control provides an opportunity to implement any licence changes required to improve the compatibility of the regulatory and charging regimes.

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. The immediate concern is in regard to potential impacts on charges to customers that would adjust for any under recovery.

As an immediate action, we would welcome the opportunity to work with Ofgem to review specific elements of the Gas Transmission Owner and Gas System Operator revenue recovery conditions 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.

Should these discussions highlight the need for any changes to the UNC and / or the licence, we will again work with Ofgem and also wider industry, to introduce these as soon as is practicable.

Separation of the ESO IT model

We note the Ofgem proposal for the ESO to 'implement a new autonomous IT model from the beginning of the 2023-25 Business Plan. As a consequence of being affiliated companies, NGET and NGGT share a number of applications and services with the ESO and any move to an independent IT model is likely to result in consequential changes to capex and opex costs for both NGET and NGGT which have not been considered by Ofgem as part of our December 2019 Business Plan submissions or our response to Ofgem's July 2020 Draft Determinations. Please refer to the ESO Draft Determination responses 8.2-8.13 and our consultation response to question 18 of the Draft Determination core document.

Remedy

- Ofgem should make clear their current approach in the licence and the next steps on the consultation for T1 close out to ensure a smooth transition across the price controls
- Should Final Determinations be delayed, Ofgem should take a proportionate approach to its monitoring of the SpC 2.3 and 2.7 in the NGGT licence and 2.3 in the NGET licence and allow a derogation from the recovery penalty for the initial year of RIIO-2
- We will identify to Ofgem licence and charging regime interactions, issues and options for resolution
- We will work together with Ofgem to review the options, agree appropriate changes to the licence and UNC and engage with the industry to ensure the changes are implemented in a timely manner
- ESO IT separation costs will require consideration via a suitable re-opener provision at the start of T2 or via another suitable mechanism. We propose further engagement with Ofgem to ensure this is reflected in the T2 licence drafting