National Grid House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

To Jonathan Brearley

Cc GEMA Board

Nicola Shaw CBE
Executive Director, UK

nicola.shaw@nationalgrid.com
Direct tel +44 (0)1926 65 3085

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www.nationalgrid.com

Dear Jonathan,

Response to Ofgem's RIIO2 Draft Determination for NGET

National Grid Electricity Transmission (NGET) has serious concerns with Ofgem's RIIO-2 Draft Determination (DD) and its consequences for the UK. Whilst we share Ofgem's stated objectives for RIIO2, the DD currently fails to meet the needs of our customers and stakeholders and is not in the interests of current and future consumers because it:

1. **Reduces the reliability and resilience of the UK's electricity supply**
2. **Jeopardises the pace of progress towards a net zero energy system**
3. **Erodes regulatory stability and investor confidence in the sector**

We welcome the fact that Ofgem has clearly signalled this as a consultation in which it is open to making changes based on stakeholder views and through consideration of evidence. This is positive and important because we consider that a significant number of the proposals and overall package are currently unacceptable and numerous remedies are necessary for Final Determinations to address the serious issues identified. We have therefore provided an evidence-based response, supplying new evidence where relevant and proposing remedies to the issues identified which better meet the interests of consumers.

1. Reduces the reliability and resilience of the UK's electricity supply

In relation to critical investment required to maintain current and future network reliability and resilience the DD for NGET proposes:

- an 80% cut in allowances for investment in network reliability and resilience from £3.3bn to £0.7bn, which is one third of the historic investment rate;
- £0.6bn of this is for a single project in London, leaving £0.1bn to invest in the network for the rest of the country;
- Network Maintenance allowances cut by over 70%; and
- To allow risk levels on the network to rise by at least 24% over the next 5 years

The proposed allowances for investment in network reliability and resilience do not come close to safeguarding the reliability of the network which is consistently signalled as the top priority for our customers, stakeholders and consumers alike. Our response shows that the negative impacts of the proposed levels of investment will be significant and felt for many years to come if not rectified in the Final Determinations. These consequences manifest as a material depletion in the ability to avoid power cuts in serious weather events, regional impacts associated with specific rejected investments, and higher costs in the future. We are also concerned that creating a backlog of work now, will in the future use up the available network outage capacity that will likely be needed to deliver investments for net zero, and also could impact on the ability of our supply chain to retain critical skills and efficient delivery capacity.

Ofgem has said that NGET has provided insufficient evidence to support the investments needed. We do not accept this. The evidence submitted was in line with the Ofgem's guidance in force at the time, despite this changing multiple times. We submitted two draft business plans through the course of 2019 and the seriousness of the gap that Ofgem now says exists was not communicated. Nonetheless, since submitting the Final business plans in December 2019 we are now aware of the considerable depth of engineering detail, over and above that mentioned in its business plan guidance, required by Ofgem to satisfy itself that the proposed investments are required. We have recently provided an additional 118 supplementary evidence reports covering every part of the network. With Ofgem stating in DD that it is willing to move from its draft position based on new evidence, and having tested the supplementary evidence we have supplied with an independent expert engineering organisation, we are even more confident that Ofgem has the evidence to make a very substantial increase in allowances for its Final Determination.

Remedy needed:

- Ofgem should use the engineering supplementary evidence to increase allowances and associated output delivery commitments to allow us to maintain existing levels of network reliability.

2. Jeopardises the pace of progress towards a net zero energy system

Substantial network investment will likely continue to be needed to keep pace with customers wanting to connect low carbon technologies to the energy system and ensuring there is sufficient network capacity to meet future demands. The DD for NGET proposes a range of uncertainty mechanisms to fund such future investments:

- For new large projects a project specific funding application process which is inflexible, bureaucratic in design and adds delays of 12-24 months to project delivery;
- The potential to apply an alternative regulatory model (competition proxy model) even though the economics don't support inclusion in RIIO2;
- For smaller new projects, a second bureaucratic funding application process as a 'one-off' opportunity in 2024 or no ex-ante funding at all;
- For connection projects, an automatic funding mechanism that is set far too low at £9/MW when the costs are £25/MW, creating a perverse incentive to avoid connecting customers;

- In addition to these mechanisms, the DD financeability assessment is based on 75% of historic totex, taking no account of likely net zero needs.

The impacts of these proposals are to create unnecessary delay and uncertainty to the delivery of projects supporting net zero, perverse incentives to delay low carbon connections and avoidable regulatory burden and transaction costs. Fortunately, the remedies to increasing the pace of these critical investments are straightforward.

Remedies Needed

- Revisit Ofgem's proposed decision making timelines for large project funding and its sequential requirements that prevent optimal project delivery activities and remove uncertainty over the competition delivery model by excluding CPM from RIIO-2.
- Use automatic uncertainty mechanisms to fund smaller projects and for pre-construction costs and correct the underpinning analysis to properly fund new connections
- Ensure NGET is financeable for a plausible range of future expenditure, ensuring financial resilience to enable net zero investment

3. Erodes regulatory stability and investor confidence in the sector

The DD for NGET contains a number of proposals that individually and in aggregate will erode regulatory stability and in turn make the sector substantially less attractive for investors. Ultimately this will cost consumers more in the long run. Individual decisions in the determination that give rise to these concerns include:

- Inadequate base equity returns, below those of the UK water sector and most comparable international benchmarks due primarily to errors in setting relative risk to the market (beta) and total market return parameters and the inclusion of a flawed outperformance wedge;
- Proposal to re-open and clawback fixed, incentivised allowances from the settled T1 price control where no mechanism or vires exists to do so;
- A punitive and unjustified business plan incentive penalty of £66m which is the largest penalty Ofgem has levied across any energy company in the last 10 years, arising from a methodology which is highly subjective, manifestly disadvantages the Transmission sector and penalises for the same perceived failing multiple times. The penalty comprises an element for failing to meet minimum requirements despite Ofgem demonstrably applying a higher test than its stated 'minimum requirements', and then a further £180m penalty (before being capped) for which there is very little specific explanation as to how it has been determined to allow us to properly respond.
- A cost assessment process which has disallowed 13% of costs as 'inefficient' which are actually the result of methodology weaknesses and errors, data handling issues and inconsistent comparisons;
- Proposals to conduct discretionary ex-post adjustments to the totex incentive outturn for substantial parts of the price control, undermining incentives to strive for efficiency and innovation;
- Rejection of incentives supporting net zero that are supported by stakeholders, resulting in a negligible incentives package for NGET with 6 times more downside than upside; and
- A marked weakening of financial resilience leaving the notional company on the cusp of being downgraded from Ofgem's target credit rating and which drops below investment grade once cashflow delays are factored in.

The most serious and concerning impact is when these individual policy decisions are stacked together and the package is considered in the round. Even if we were able to deliver the DD future productivity efficiencies, which are more than twice that forecast for the UK economy, then:

the current DD package would result in an equity return of 1.6%,
which is more than 230bps below the proposed base equity return of 3.92%.

With minimal upside potential from incentives and totex performance potential undermined by weak sharing factors and ex-post regulatory adjustments, the framework offers little opportunity to close the gap through excellent operational performance.

Remedies needed:

- Develop a more balanced appraisal of allowed equity return and remove the flawed outperformance wedge
- Adjust the overall risk and reward package to provide a fair return for investors, removing the clawback of RIIO-T1 allowances, dropping the BPI penalty and addressing issues with efficient cost assessment methodologies
- Revisit proposals for net zero incentives and drop ex-post regulatory intervention and adjustments to totex incentive outturns

Conclusion

Since publication of DDs we welcome the constructive dialogue we are having with Ofgem on these issues and urge Ofgem to consider the evidence presented in our response, which supports our proposed remedies, for Final Determinations. The impact of these remedies will not have material impacts on the household bill but a revised package will deliver a reliable network service, enable the green transition to net zero and provide a fair return for investors. To support our response, we have commissioned an independent expert organisation (also used by Ofgem) to test consumer preferences in light of current economic circumstances. The results of this research are included within our response and clearly and consistently show consumers' preference for investment in reliability and net zero above short term bill reductions across the various demographic groupings.

We hope you find our response and supporting documentation helpful and look forward to our continued engagement in the coming weeks, including at the open meetings in October, as we work towards a final determination which enables us to deliver for our customers, stakeholders and current and future consumers.

Regards,

Nicola

Nicola Shaw CBE
Chair, National Grid Electricity Transmission