2nd September 2020

Dear Akshay and team

Ofgem's RIIO – 2 Draft Determinations

Sustainability First is an independent think tank and charity focused on promoting economic, social and environmental wellbeing in public utilities.

We welcome the opportunity to comment on Ofgem's Draft Determinations for the gas and electricity transmission (T2), gas distribution (GD2) and Electricity System Operator (ESO) RIIO2 price controls. Our comments draw on our experience as members of Ofgem's RIIO-2 Challenge Group, the position of two of our Associates as chairs of Consumer Engagement Groups (and as members of others) and our participation in a number of the Ofgem RIIO-2 working groups. We also draw on 20 years of deep expertise in consumer issues (engagement, vulnerability, data, behaviour change etc), policy and regulation (innovation, price controls, incentive frameworks etc), environmental issues and business leadership and practice.

All economic regulators need to do their job of ensuring that the monopoly companies that they regulate do not abuse their position. At the current time, a focus on bills and affordability is particularly important, but that is not the only consideration. The importance of the wider environment, particularly in the context of a green recovery, and a continued focus on decarbonisation are also key to ensure fairness within and between generations.

There is a lot of material in the Draft Determination documents and we have not tried to respond to all the different questions and proposals for individual company Business Plans. However, we have drawn out below what we see as some important themes – around engagement, vulnerability, de-carbonisation and incentive regulation - and in particular highlighted two areas where we think a stronger intellectual framework is needed – on **reputational incentives and adaptive regulation**.

Price controls are one of the traditional 'hard levers' of regulation. We are extremely pleased to see that Ofgem has recognised that its regulatory approach needs to adapt to address net zero. To succeed, however, this change can't be 'bolt on' or piecemeal. A focus on outcomes, clear and consistent signalling of what matters and transparently explaining the reasons for regulatory decisions are all vital to help create the environment in which **company culture and behaviours** are focused on and responsive to customers and stakeholders. Getting this wrong now could risk 'winning the battle' but 'losing the war' – the need to facilitate business transformation for a net zero future in an age of radical uncertainty.

We have provided some initial thoughts in these areas and will continue to develop our thinking as part of our Fair for the Future work[1] of which Ofgem is a co-sponsor.

We have also provided an **annex with responses to a selection of the specific questions** where we have a particular contribution to make.

Consumer and Stakeholder Engagement

Consumer and stakeholder engagement is vital to ensure that monopoly services meet consumer and community needs, for procedural justice and for a 'just transition'. We are pleased that Ofgem has acknowledged this in the enhanced engagement arrangements that it has put in place for RIIO-2 and our reflection from our individual involvement in the process is that the engagement has led to significant improvements in the quality of the business plans that Ofgem has received.

However we are very concerned at the limited emphasis that Ofgem appears to place in its Draft Determinations on consumer and stakeholder inputs.

Beyond commenting on the requirement for companies to meet the minimum standards on enhanced engagement – which they all do – Ofgem gives no **view on which of the eight companies have done better in terms of engagement** in developing their business plans. In contrast, Ofwat's Initial Assessment of water company business plans for PR19 included an assessment of 'engaging with customers.'[2] Similarly there is little sense of what Ofgem expects in terms of engagement in the RIIO-2 price-control period with many of the individual company proposals around ongoing engagement being rejected (or over-looked)

One specific issue is that there is no recognition for GD/T of the **step up that is required to support local authorities in developing Local Area Energy Plans.** While the requirement to consider LAEPs was introduced at a late stage into the Business Plan Guidance for GD/T, and has been reinforced for ED2 with the CSE / ESC guidance, the Draft Determinations do not seem to attach any importance to this new and important role for the GD/T networks, working with and supporting local authorities on their net-zero plans, recognising that these organisations may lack the necessary skills and resources themselves.

The Challenge Group noted a wide variability in the standard of engagement, giving companies a range of scores from full green to amber / red. Ofgem has given no sense in the Draft Determinations of whether it agrees with this assessment. For companies who have gone the extra mile in using engagement to shape and improve their business plans, there is no recognition, financial or reputational. This provides no incentive for companies to put effort into doing any more than the minimum going forward.

This apparent disregard for stakeholder engagement also comes through in the decisions that Ofgem has taken on the **range of bespoke outputs** that companies have proposed. The fact that there was strong stakeholder support for particular initiatives does not seem to have been a consideration in Ofgem's decisions. While EAP targets have in many cases been agreed for GD on the basis that they have been tested with stakeholders, there is a concern that this could reflect a lack of Ofgem interest in the environmental impacts of GD rather than reflecting consideration of specific

[1] https://www.sustainabilityfirst.org.uk/fair-for-the-future We will be producing a major Fair for the Future Project paper on policy and regulatory frameworks at the end of this year which will address issues such as adaptive regulation.

[2] https://www.ofwat.gov.uk/wp-content/uploads/2019/01/PR19-initial-assessment-of-plans-Summary-of-test-area-assessment.pdf

stakeholder evidence. That said "delegating" an area such as the EAPs to be agreed with stakeholders (subject to some boundaries set by Ofgem) could have merit as part of a strategic approach to enhanced engagement.

Where Ofgem dismisses **proposals that have been developed with significant stakeholder input** there is a risk of discouraging stakeholders from engaging in future. Of course, Ofgem cannot be expected to simply accept all proposals that have stakeholder support but there is an onus on Ofgem to consider that evidence and to explain more fully than it has done why it has decided to over-ride stakeholder views.

This applies in particular to proposals that have been actively endorsed or developed in response to challenges to the companies from the CEGs and user groups. These groups – often involving senior, experienced people – have devoted significant time and have closely scrutinised the proposals and the underlying consumer and stakeholder evidence. Ofgem needs to show how those inputs and those of the Ofgem CG have been given due weight in their decisions

There is ongoing discussion in the regulatory community around the idea of "**negotiated settlement"** as a more effective way of developing price controls (see Stephen Littlechild's input to the CMA[3]). Sustainability First will be considering this approach in its final Fair for the Future project paper on the implications of the purposeful business agenda for policy and regulatory frameworks. While a full negotiated settlement may be considered by Ofgem as a step too far, there clearly is a middle course whereby there would be a presumption in favour of proposals that have clear CEG or user group backing. The approach to EAP targets noted above – where CEGs and user groups have considered the many different trade-offs in some detail - could be positioned positively as a step in that direction.

In contrast, in some areas, in particular on **vulnerability and customer service for GD**, Ofgem seems to have decided that national standards are more appropriate to avoid what it sees as a postcode lottery and has rejected proposals from the companies that they have developed with their stakeholders. This is confusing and a waste of time and resources. If local variation is ultimately not seen as acceptable in this area, then Ofgem would have been better signalling that at the outset and saving significant effort on the part of the companies and groups. However, in our view the company engagement spurred some real innovative thinking through the co-creation process which would be lost through a centrally driven approach.

Given that CEGs / user groups and the Challenge Group will all doubtless respond to the consultation Ofgem has a chance and can still show that it does attach weight to their views in its Final Determination – both in terms of the substance and the way it justifies its decisions.

Social Impact and vulnerability

There is much that is positive for customers in vulnerable situations in Ofgem's draft determinations for gas distribution companies, but collectively the proposed package doesn't yet deliver what customers and stakeholders want or need in terms of accessibility, safety and affordability outcomes. This includes customer expectations on the scale of support, the type of support, and who should be eligible. The approach is not obviously aligned with Ofgem's Consumer Vulnerability Strategy and it doesn't deliver the stated aims of the regulator's SSMD. We welcome the

3 https://assets.publishing.service.gov.uk/media/5eda3e6ce90e071b7bd7a2ed/Stephen_Littlechild_submission.pdf

commitment by senior leaders that Ofgem is open to improvements in this area and would recommend consideration of the following points:

- We'd encourage Ofgem to provide transparency around **how the DD vulnerability package reflects customer and stakeholder insight** and adapt its approach to reflect new research and the changing context including Net Zero and Covid-19 pandemic.
- We are aware that a number of proposals around support for vulnerable customers have been rejected because Ofgem has decided to maintain its £30 million limit on spend in that area (ie **the Use it or Lose It allowance** - **UIOLI**). As noted above, this has been allocated between GDNs on a national basis in proportion to the number of customers regardless of the quality of the proposals put forward, in order to avoid what might be perceived as a postcode lottery. In reality there is already significant variation in the services provided, their quality, and the eligibility criteria. There are also significant regional differences in need. This decision means that there was little point in companies engaging or seeking to be more ambitious in this area. Given the added affordability challenges post Covid-19 we hope that Ofgem will revisit this in Final Determinations.
- We'd encourage Ofgem to **learn the lessons from RIIO-1 in designing its UIOLI Allowance** that were flagged in our Project Inspire report Innovate for All[4] which Ofgem sponsored.
- We note that Ofgem has rejected some proposals around support for **energy efficiency** and advice provision because it does not consider that to be the networks' role. While policy on delivery of energy efficiency programmes is set by government, we believe Ofgem could have allowed some discretion for the networks in this space. Ofgem faced a difficult decision around the continuation of the FPNES scheme at a time when we need to be looking to decarbonise heat. In the Grid Edge Policy report on electric storage heating which Sustainability First contributed to[5], the point was made that the FPNES scheme is driving the replacement of electric storage heating when the latter may well be a more viable long-term solution in the context of net zero. Improving the energy efficiency of these properties could provide a better solution than installing gas heating and the regime would benefit from allowing some flexibility in such situations.
- We'd encourage **Ofgem to monitor GDN vulnerability service provision** in a similar way as it does for suppliers. This will help with the deliverability of its stated aims for the consumer vulnerability package; that "We want to ensure that all consumers in vulnerable situations receive an appropriate minimum level of service from their network company, regardless of where they live."
- Greater **safeguards are needed for customers not on the Priority Services Register**. In particular, in line with the strong focus on inclusive design in its 'new' Consumer Vulnerability Strategy, we encourage the regulator to consider some kind of accessibility and inclusivity metric (see page 22 of the Annex) and give greater focus to customer satisfaction in terms of help received related to planned/unplanned interruptions.
- There is value in Ofgem working with companies to develop a number of their **bespoke proposals** that have been rejected (eg unsafe appliances and carbon monoxide awareness).
- Ofgem has provided little **commentary on companies' consumer vulnerability strategies** as part of the Business Plan Incentive and has provided limited feedback on their approaches. It

[4] https://www.sustainabilityfirst.org.uk/images/publications/inspire/Energy%20for%20All-%20Innovate%20for%20All%20(full).pdf
[5] 'An Electric Heat Pathway: Looking Beyond Heatpumps' available here.

is unclear what Ofgem considers good practice. Ofgem could draw upon our Project Inspire report here.

Net Zero and De-carbonisation

The need for RIIO-2 to drive a strategic, timely and whole system approach to net zero delivery features heavily in Ofgem's draft determination. We warmly **support the proposals around innovation funding** to support the transition and **understand** why Ofgem has chosen to rely strongly on **uncertainty mechanisms** to deal with some of the more strategic investments and uncertainties (subject to some not insignificant practical concerns we have set out below).

However, we observe that the Draft Determinations focus largely on net zero and the significant transition that is required with rather l**ess emphasis on the actions the companies can take to reduce carbon, including their own company emissions**, over the RIIO-2 period.

On business carbon footprint Ofgem seems satisfied provided companies are signed up to long-run **science-based targets** (which they all are as this was a minimum requirement) without acknowledging that these **can be more or less ambitious** – and indeed that the science based targets organisation is now encouraging companies[6] to sign up to targets consistent with 1.5 degrees (reflecting the latest IPPC work that underpinned the UK statutory move to net zero) rather than simply to be consistent with the Paris agreement which is the standard Ofgem refers to. **As a minimum Ofgem should require the companies to make clear what level of science-based targets they have signed up to and to give credit to those who are more ambitious.**

As the Challenge Group highlight, it is hard to compare companies' proposals on their **Business Carbon Footprint** as the **definitions in terms of scope and timeframes vary**. While we welcome Ofgem's effort to drive consistent reporting, it is disappointing that Ofgem have only just requested the data to do this. The ability to compare across companies is key if performance in this area is to be driven through reputational incentives (as discussed further below).

We are also concerned that in pursuing a common definition Ofgem has told the GDNs (2.129) to exclude leakage from their science-based targets. This appears to run counter to the formal guidance on the definition of Scope 1 emissions within science based targets as including fugitive emissions.[7] It is helpful, in terms of transparency, to break out the different categories of emissions but it is **essential that Ofgem's reporting framework is aligned with the Greenhouse Gas Protocol reporting standards** and presents a full picture of the Greenhouse Gas impacts of company activity.

On the operational aspects which represent the overwhelming majority of the emissions that the companies have direct control over and which could deliver material carbon savings in RIIO-2, there is something of a mixed picture:

- On **SF6** in electricity transmission we welcome the continuation of the IIG financial incentive and the support for the companies' IIG strategies including specific funding to reduce the use of SF6 on their networks.

- On **gas transmission** we welcome the inclusion of a financial incentive on **compressor venting** (where methane is released into the atmosphere).

- In contrast, on **gas distribution** we remain very concerned about the lack of priority attached to **leakage** by Ofgem as reflected in its decisions on repex across the GDNs (where it has rejected most

[6] https://sciencebasedtargets.org/step-by-step-guide/

[7] See for example Iberdrola's certified statement of its emissions – here

proposals for accelerated repex or steel mains replacement) and on funding for some more innovative proposals put forward by SGN, for example. While there is a financial ODI this is limited to specific drivers of leakage that are currently modelled ie average pressure and gas conditioning (and excludes repex because it is separately funded). The overall reputational ODI covers "shrinkage and environmental emissions" and hence mixes uncombusted methane (leakage) with what will be combusted methane (theft and own use). These have very different climate impacts and hence need to be separately reported. The reporting needs to clearly show the greenhouse gas impacts (in terms of CO2e) not just the volumes of gas as now. As noted above our understanding is that formally these form part of the companies' Scope 1 emissions under the Greenhouse Gas Protocol.

- On **losses,** for electricity transmission, there is welcome support for the companies' losses strategies and while reporting has moved from being a licence condition to the AER this is reasonable provided that Ofgem continues to track company performance and ensure that the strategies (eg to purchase low loss equipment) are adhered to in what is a technically complex area. Emissions associated with losses must be separately identifiable but also reported within the BCF.

Throughout the Draft Determination documents, Ofgem stresses the increased financial savings that its proposals will deliver. In contrast, for progress on decarbonisation, Ofgem does not directly address the impact of its Draft Determinations compared to company Plans. The impact assessment gives an overall carbon saving figure but does not attempt to identify the **carbon savings implicit in the different options** it presents. It is also not clear what the **implicit cost of carbon** is that Ofgem has used in making its decisions on specific proposals. The guidance to companies has been to use HMT assumptions but Ofgem's own IA guidance talks about carrying out sensitivity assessments at the high-end of the HMT range. This is because HMT figures have not yet been updated for net zero.

From the ED methodology consultation, it appears that this higher carbon value may have been used in the transmission data templates (but it is unclear whether this also applies to GD). It is essential that in assessing individual proposals as part of final determinations Ofgem takes a common approach across all sectors and vectors and uses a cost of carbon that is consistent with net zero. We would welcome Ofgem setting out clearly the assumptions that it has used for the cost of carbon when it comes to Final Determinations.

Delivering Outcomes

The principle underlying RIIO is that revenue would be determined by incentives for delivering outputs (or ideally outcomes). This approach still applies in some of the areas that are more established elements of the regulatory framework such as on reliability and on customer satisfaction. However the general trend, as signalled in the framework decision, is to **scale back significantly on the rewards available through financial incentives** which is driven by a desire to drive performance gains from RIIO1 into BAU and also to avoid over-rewarding companies to keep costs down for customers. As a result, even where financial incentives are used, Ofgem has put more emphasis on the use of penalties rather than rewards.

In some instances this makes sense. But there are two risks with Ofgem's approach. The first is that the **companies cease to focus on the outputs that may be important to consumers** but that Ofgem has decided are now BAU and / or should not be the subject of a financial incentive.

The second is that **if financial incentives are wrongly calibrated the company will spend more than the value that customers would place on a particular level of service** (or not spend enough). This applies equally whether it is a reward or a penalty (eg the company may spend money to maintain service levels and avoid a penalty when customers might have preferred lower bills and a slight drop in performance). The basis on which Ofgem has set the target levels and incentive rates seems largely arbitrary. There seems to be no consumer research commissioned by Ofgem to underpin Ofgem's decisions on incentive structures (except arguably on VOLL in electricity transmission). While willingness-to-pay research can be problematic, in the spirit of our earlier comments on consumer engagement, we would encourage Ofgem to take full account of consumer evidence presented in company responses in this area to aid incentive calibration.

We would also note that there does seem to be a **philosophical difference in the approach that is taken as between social and environmental outputs in GD**. On the social front Ofgem has tended toward a mix of prescription, for example mandating the provision of hot meals and hot water for washing for PSR customers, a new principles based licence obligation and financial incentives. In contrast, on the environmental front in GD, Ofgem is happy to rely almost entirely on reputational regulation, underpinned by a formal reporting requirement. This does not feel coherent with no reasons given for the difference in approach.

We also note that Ofgem has accepted the proposals put forward by NGET and NGGT for a financial incentive linked to a scorecard of EAP measures. While Ofgem ostensibly looked at applying this approach to other TOs (and concluded it could not) it has not looked at whether it could be applied to the GDNs. Given the AEP / AER was intended as a common approach across sectors – and given the effort that Ofgem is putting into the design of the ODI for NGET / NGGT there would seem to be a good case for looking to adopt such an approach more widely rather than simply relying on reputational regulation of the AERs. This will also be true for Ofgem's approach to ED2.

Reputational regulation

As noted above a strong feature of the RIIO2 Draft Determinations is the new reliance that Ofgem is placing on reputational regulation either through formal ODI-Rs or through the mechanism of the Annual Environmental Reports – or indeed simply through the CEGs / user groups having an enduring role reporting on the commitments the companies have made in their plans.

This shift to reputational regulation (and in particular for monopoly businesses) carries risks. If the final price control proves to be as tough as Ofgem is signalling, then the companies will be under pressure from shareholders to limit the discretionary activity they undertake. We have seen this already in the water sector with companies pulling back from commitments made in their business plans – endorsed by their customer challenge groups – and which they say are no longer viable.

The reason that Ofgem had developed the concept of **price control deliverables** was to ensure that companies did actually deliver on the commitments they had made and been funded for. However, Ofgem has pulled back from this on EAP proposals, presumably to avoid making the regime overly complex for what are relatively small sums of money. In numerous places Ofgem instead argues that reputational pressure will ensure these commitments are delivered.

While many of the companies may well be committed to delivering against the commitments they have made to their stakeholders, this cannot be relied on and Ofgem needs to weigh that risk more carefully.

Moreover, if Ofgem is to rely on reputational regulation then it needs to consider seriously what is needed to make that as effective as possible. To supplement our response to the consultation we have pulled together some initial thoughts on what we see as the key criteria for reputational regulation, based on an earlier UK Regulators Network (UKRN) report[8] on the subject and previous Sustainability First thinking. We would like to promote a wider discussion on these issues and would be happy to work with Ofgem to facilitate such a debate. We expect to take this forward as part of our Fair for the Future project.

Based on our initial thinking, **key themes** that Ofgem will need to address are:

1) Ensuring comparative data is readily accessible to enable benchmarking within / beyond a sector
    - Ensuring there are common definitions, baselines and consistent approaches
    - Providing assurance that data is reliable
    - Ensuring data is readily accessible
    - Proactive provision of ready comparisons to help lightly resourced stakeholders
2) Reflecting on the sources of reputational influence (and how best to strengthen them)
    - "Doing the right thing" where companies have a broader public purpose
    - Changes to Section 172 of the Companies Act and ESG as a growing concern among investors. These factors, and others, are driving changes in corporate reporting across the economy. Our forthcoming Fair for the Future Project paper on Sustainability Metrics and Public Utilities examines these issues in more detail
    - Corporate reputation through eg media or select committees – noting also the role that social media can play in amplifying any reputational issues[9]
    - Company credibility and the implication for future regulatory decisions
3) Wider regulatory interests
    - Prospect of formal regulation in future if reputational regulation not delivering
    - Unintended consequences eg companies more able to ignore stakeholders if Ofgem is not interested (in either the outcomes or in the stakeholders' views)
    - Stakeholders will expect Ofgem to know what is happening in the sector and see Ofgem as a trustworthy source

What this framework reinforces is that **reputational regulation is an important tool but not an easy option**. Ofgem will of course also still want to show leadership in these areas and actively engage themselves on those issues squarely within their remit (e.g. on reliable service, on vulnerability, on environmental impacts including carbon emissions). In the same way that Ofgem reports on the companies' financial performance under RIIO and on the State of the Market in retail, it should be providing consolidated reporting on what the network companies are delivering in terms of outcomes.

This framework also highlights the importance of a focus on corporate purpose. This needs to be recognised as a way of creating the right culture to deal with uncertainty and to ensure ongoing focus on delivering beneficial economic, social and environmental outcomes. Where a company genuinely seeks to be a purposeful business that should be acknowledged and encouraged. Our work on Fair for the Future is helping to take this debate forward across the energy, water and communications sectors.

This also raises the question of what Ofgem sees as the end game for reputational regulation. Is it to drive companies to assume greater responsibility for both the outcomes they identify and for

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[8]

[9] Discussed in a Fair for the Future working paper - here

delivering against them, consistent with being a purposive company? Or is it just another tool in the regulator's toolkit for tracking progress against what are effectively regulator determined outputs?

Adaptive regulation

These price controls are the first real test of Ofgem's approach to adaptive regulation, heralded in its Decarbonisation Action Plan. Ofgem's vision is that uncertainty mechanisms, net zero re-openers and Strategic Innovation Funding will together provide the flexibility needed for an uncertain future and the range of pathways for reaching net zero. In announcing the Draft Determinations, it was clear that Ofgem wanted to move to having a much larger part of the revenue allowances subject to these sorts of uncertainty mechanisms and to have a much-reduced base revenue. In the investor briefing Ofgem made clear that ultimately the total level of investment could be significantly higher to meet net zero.

We absolutely recognise the drivers behind this in terms of the policy and wider uncertainty and strongly support the direction of travel. However, we would like to support you in giving **more thought to how adaptive regulation would work in practice, what the risks are and how these would be mitigated.** We know Ofgem are starting to think about some of these questions and would be happy to discuss our thinking with you.

In the context of the Draft Determinations there is also an **essential question as to whether the bar has been set at the right level** in terms of what is seen as sufficiently certain to be included in base revenue and what should be deferred to be considered through uncertainty mechanisms. For example, SHE Transmission effectively proposed a similar model with a "Certain View" of what they considered necessary investment to meet net zero and a package of additional investment that might be required and was subject to uncertainty mechanisms. Ofgem has taken a different view on where to draw the line on what is sufficiently certain to justify being counted as base revenue. While overall Ofgem says it has allowed around 90% of load related expenditure there is other investment, such as pre-construction work, where the same issues arise.

From a regulatory governance perspective, at this stage there are a number of issues that we have identified with **Ofgem's shift to adaptive regulation** and which need more thought ahead of Final Determinations:

How to maintain visibility of the overall bill impact. Ofgem announced that its T2/GD2 proposals would reduce bills by £20 but ultimately if the various uncertainty mechanisms work as expected bills will nonetheless increase. While – by definition – Ofgem cannot be totally clear what that impact of new strategic investment will be, it is essential that Ofgem is transparent and does not present a misleading picture of the likely ultimate bill impact.

Ensuring that Ofgem is geared up to take timely decisions. Given the importance of some of the investments that have been relegated to uncertainty mechanisms it is vital that when companies bring forward proposals Ofgem is geared up to take decisions in a timely way. While Ofgem rightly has ambitions to be more agile, and has had that as a goal for several years now, it is easier said than done given the scrutiny and consultation that is required. A clearer articulation is needed of how Ofgem will achieve this and the timescales it will be working to. **A structured lessons-learned exercise should be carried out looking at the experience of existing tools like the Strategic Wider Works programme to assist this process.**

How to maintain a transparent process with adequate engagement. Building on this point it is notable that significant stakeholder engagement – including the involvement of the CEGs / user groups and the CG – has gone into the development of the RIIO Business Plans. Companies are unlikely to be able to bring that level of scrutiny to bear on individual proposals that they bring forward (although targeted local engagement will be necessary for planning). **Ofgem needs to be clear what level of wider engagement it expects as part of this process and how its timelines will accommodate that**. The involvement of the Net Zero Advisory Group in the process is welcome to provide cross government input but this needs to be transparent.

Having a broad enough toolkit of mechanisms. As set out in the Draft Determinations Ofgem is essentially relying on two mechanisms to deal with uncertainty around the need for investment – reopeners (purely discretionary) and volume drivers (mechanistic). For RIIO-2 Ofgem also introduced the concept of price control deliverables where it could claw back revenue if projects were not delivered. In some cases, companies have proposed projects as PCDs where there is some continuing uncertainty, with the idea that Ofgem could claw back the funding if the project is not needed. However, Ofgem has typically rejected such PCDs as being insufficiently certain. This seems to be missing an important chance for a lighter touch mechanism that would not require a further round of consultation and scrutiny. In the ED2 methodology consultation Ofgem puts forward the idea of PCDs with funding triggers. This concept could usefully be adopted for GD/T even at this stage.

Recognising that uncertainty (and inter-dependencies) will not go away. The implicit assumption in the framework of uncertainty mechanisms is that there will come a point at which the uncertainties will be resolved and reopeners can be employed. On some issues clearly there is a timing angle – as Ofgem rightly says, policy does not develop in 5-year cycles aligned to RIIO. However significant uncertainty, and complexity, will always remain. Given the lead time for major infrastructure investment, the levels of future demand will always be uncertain. And experience in terms of delays to the Energy White Paper, National Infrastructure Strategy etc would indicate that policy clarity is not always forthcoming when it is promised. The limited government bandwidth due to Covid-19, Brexit etc.is likely to continue into the foreseeable future. Moreover, we have also seen for example the challenge with the Shetland project where Ofgem declined to provide funding unless it was certain that the generators had CFDs. At the same time the generators were struggling to get CFDs because it was not clear that the network capacity would exist. Finding ways to deal with the enduring uncertainty and “chicken and egg” situations needs to be a part of the adaptive regulation toolkit.

Applying an option value mindset. One reason that coping with uncertainty seems so problematic is that Ofgem is generally trying to take an “all or nothing” decision on projects. In the commercial world the question would not be shall we do this whole project or not but what can we do now that would give us an option in future – which may be to accelerate, slow down or cancel[10]. In effect companies would look to take their investment decisions in an adaptive way. **Adaptive regulation is likely to mean asking a different question – how to facilitate that adaptive approach - not just waiting and then asking the same “all or nothing” question.** There is an element of that thinking already in the allowances that electricity transmission companies have for pre-construction works. This is investment that ensures they are ready to move ahead swiftly if / when approval is given. There is some risk in this expenditure as one needs to do it when there is less certainty about the overall needs case but the sums involved are much less than for the projects themselves. In the Draft Determinations Ofgem has seemingly applied a high threshold for including pre-construction costs in the baseline but with an acceptance that they could be funded following an ex post assessment at the end of RIIO-2. This seems to create unnecessary risks for companies (and shifts costs from

[1010] As highlighted by Jonathan Brearley himself - here current to future consumers). A conditional approval subject to the projects getting a NOA "proceed" signal from the ESO would seem a more flexible approach.

Recognising the costs and risks in delay. While "least regrets" is often cited as a model for decision making under uncertainty it is important that this looks at the costs and risks in the round. It is relatively easy to quantify the potential **stranding risks** if an investment turns out not to be needed but it is not clear that the same thought is given to the **risks of delay**. If the network capacity is not available that may well reduce the probability of the UK meeting net zero – but these risks are hard to quantify. If there is delay but the need then becomes clear and becomes more urgent then the costs of delivering against a compressed timetable are likely to be higher, in standing up supply chains at short notice for example. Again, this needs to be factored in but is hard to quantify.

Limits to pragmatism and collaborative working. The Covid-19 crisis has been an excellent example of the regulator being nimble and pragmatic and of government, Ofgem, consumer bodies and the companies working collaboratively. It might be easy to think that this provides a template for adaptive regulation going forward. However, while there will clearly be valuable lessons, it has to be recognised that these were exceptional circumstances. Where there are significant financial sums at stake this model is not going to work. We saw in RIIO1 how, while Ofgem was able to persuade some companies to make a voluntary contribution from the high returns they had earned, not all companies were willing to play ball. Formal regulatory decisions will be needed to provide clarity and certainty to companies and stakeholders and this presents a challenge to a more agile approach.

Accountability for net zero. While Ofgem has signalled its commitment to net zero and offered the prospect of funding being opened up when the need is clearer **it is not obvious how it has assessed whether its Draft Determinations would still enable net zero to be delivered**. The risk is that Ofgem will remain under pressure to keep bills low and companies will struggle to provide the certainty in terms of investment justifications that Ofgem seems to require. Without clear accountability for delivery of the crucial net zero infrastructure investment there is a real risk that certain net zero pathways would not be achievable (or will ultimately be more costly). In Final Determinations we expect to see a clear articulation of how the decision would accommodate the range of net zero pathways in FES and in the CCC's work, including the 6th carbon budget.

Overall we strongly support Ofgem's idea of "adaptive regulation" and consider this is absolutely a move in the right direction. However, if it is to be the big idea reshaping regulation then it needs a **stronger intellectual underpinning and clearer articulation, as well as a mindset shift on some issues.** There are resources that might help with that and could enable some genuinely new regulatory thinking for the new world.

- First, a scan of the academic literature on adaptive regulation yields a **taxonomy** that distinguishes between unplanned adaptive (coping with Covid) and planned adaptive (RIIO price controls) as well as between mechanisms that are automatic (volume drivers) or discretionary where there is less certainty (re-openers) - with a framework for thinking about which to use when.
- Another perspective is provided by John Kay and Mervyn King in their book Radical Uncertainty. They make the point that **uncertainty won't go away** which **puts limits on undue reliance on cost benefit analysis and the quest for an optimal solution based on perfect foresight. This suggests the need for a potential mindset shift from Ofgem to accept something that is roughly right and that takes the industry in the right direction**,

rather than trying to overly-optimise and expecting the companies to be able to forecast 'exactly' how much capacity will be needed where and when with the same level of confidence as was possible in the past. In an uncertain future, some element of 'redundancy' may not simply be 'inefficient'. It may also offer optionality and therefore important resilience. We have noted that, notwithstanding the recent NIC report on the subject the Draft Determinations do not directly address the increasingly important issue of resilience, except in the context of cyber security.

- Finally **stakeholder engagement** has a key role to play in adaptive regulation. In an uncertain world you need a **diversity of views and strong antennae** to help navigate through the unchartered waters. There is a **strong case for putting more decisions in the hands of those impacted rather than trying to control everything from the centre**. This has a particular relevance for regional and devolved decision making.

Again this is an area where Sustainability First would be happy to work with Ofgem to help promote a wider debate and which we will be considering further as part of our Fair for the Future work.

We hope these comments are helpful and would be happy to discuss any of these points with you.

Sharon Darcy

Director Sustainability First

Annex: Sustainability First Responses to Specific DD Questions

Core document

Q1. What role should Groups play during the price control period and what type of output should Groups be asked to deliver? Who should be the recipients of these outputs (companies, Ofgem and/or stakeholders)?

A1 The Groups can provide challenge to the companies where changes need to be made to the Plan during the price control and assurance to stakeholders and Ofgem on delivery of commitments in the Plan.

The Groups could have the following role during the price review period:

1. *Scrutinise and challenge proposals and reports going to Ofgem*. As demonstrated, early challenge by the groups resulted in substantial improvements to the company's business plans, reducing the amount of follow-up questions required by the regulator and the RIIO-2 Challenge Group.
2. *Hold the company to account on the promises made in its business plan - in particular those without financial incentives.* This is especially important as history teaches us that a relatively tough financial settlement can result in companies cutting what they see as 'non-essential' spend. Ofgem is relying heavily on reputational incentives for a number of outcomes that are a priority for customers including proposals to improve the environment and sustainability, consumer vulnerability and affordability.
3. *Ensuring company decision making reflects and responds to the changing needs of its customers and society including monitoring progress on the Consumer Engagement Strategies*
4. *Providing advice and challenge to Ofgem's on its wider policy decision making, including the development of RIIO-3 framework.* Early and independent challenge is useful to any organisation. The groups have collectively a wealth of expertise, knowledge and understanding of the companies and network price controls. It would be a missed opportunity not to capitalise on this 'free to the regulator' expertise.

We believe that 'an enduring role for the groups' needs to be required by Ofgem or an expectation set by the regulator in this area in order to maximise both the independence and effectiveness of the company-only groups

Q2. What role should Groups take with respect to scrutinising new investment proposals which are developed through the uncertainty mechanisms?

There's a useful role for the Groups to play with respect to scrutinising new regulatory proposals, particularly under uncertainty mechanisms. The Groups could challenge the optioneering undertaken by the company, the robustness of their evidence base including customer insight and willingness to pay, and clarity of proposals. This should improve the overall quality of proposals ahead of their submission to the regulator. The Groups could then provide feedback to Ofgem and ssuggest areas that Ofgem may want to particularly focus on.

. However, it is only worth the Groups expending effort on providing that input if it is actually going to be of value to Ofgem, which we believe it should be. However, based on the draft determinations the use that Ofgem has made of the reports is not clear.

Q3. What value would there be in asking Groups to publish a customer-centric annual report, reviewing the performance of the company on their business plan commitments?

A3 Given the extent to which Ofgem is relying on reputational incentives – and given the Groups' understanding of the background to the plan – there is value in an independent perspective alongside any report the company themselves might produce. However Ofgem should not over-estimate the extent to which this sort of reputational incentive will ensure companies do deliver outputs that are not formally required if they are facing shareholder pressure to improve returns.

The benefits of a report are that:

- It strengthens the influence of the groups. If companies know the regulator and wider stakeholders will read the report it keeps them focused on engaging effectively with and listening to the groups on an ongoing basis. It's also a useful tool to engage the Board on.
- It can provide useful feedback for regulators and wider stakeholders on how companies are doing. This includes progress on aspects outside of Ofgem traditional monitoring frameworks such as on engagement, consumer vulnerability and affordability, responsible business. It can provide a more contextual/qualitative insight e.g. on company restructures, company culture, ambition levels.
- It helps to ensure transparency and accountability for the group's activity. This is good practice governance, especially as groups are funded by customers' money.
- While developing a report takes resource and time it needn't be onerous and Ofgem could allow flexibility in how this is done. The process of writing a report is useful and provides an opportunity to take stock of activity and progress, and to review and improve approaches

Q4. What value would there be in providing for continuity of Groups (albeit with refresh to membership as necessary) in light of Ofgem commencing preparations for RIIO-3 by 2023?

A4 There is a significant learning curve for Groups and hence continuity of membership would bring benefits. There is also value in being able to challenge the credibility of commitments offered in RIIO-3 against what was said versus what was delivered in RIIO-2. However as implied in the question some refresh of membership is also important to avoid capture and to ensure groups have the appropriate skills and expertise for their post business plan submission role.

Q5. Will the combination of the two proposed Licence Obligations support the delivery of a digitalised energy system and maximise the value of data to consumers?

Yes – but we would encourage Ofgem also to think about the role of smart meter data and the conclusions from the CSE / Sustainability First PIAG project (phase one) which looks at the use of smart meter data for public policy purposes and which Ofgem has supported – see https://www.smartenergydatapiag.org.uk/

Q6. Do you agree with our proposed frequency for publication of updates to the digitalisation strategy and the digitalisation action plan, respectively?

Q7. What kinds of data do you think should comply with the data best practice guidance to maximise benefits to consumers through better use of data?

Q8. Do you agree that the Groups could have an enduring role to work with the companies to monitor progress and ensure they deliver the commitments in their engagement strategies?

A8 Yes – as part of the wider role envisaged above. This is especially important because companies still lack maturity in this area and despite the RIIO-1 incentives engagement is still not BAU or ongoing as Ofgem expects.

However it is important that Ofgem demonstrates an interest in the companies' performance in this area (which was not evident from the draft determinations).

We recommend Ofgem feedback on the quality of the proposed strategies as it said it would in the SSMD. The Groups will need to come together to benchmark activity for assessments to ensure there is a common understanding of good practice.

Q9. Do you agree with our proposal to accept the proposals for an ODI-R for BCF and the other proposals set out above as EAP commitments and to require progress on them to be reported as part of the AER?

A9 We welcome the inclusion of the requirement for the companies to set out the environmental commitments in an EAP and for this to be broadly consistent across sectors. We agree that there needs to be at least an ODI-R and formal reporting requirement through the AER. However, as set out in our cover letter, we are concerned that this may not be enough to ensure that companies do deliver the outputs that they have been funded to deliver – and, importantly, to encourage them to look for further opportunities to reduce emissions through the RIIO-2 period – in particular if they are under pressure to look for savings in the context of a tight price control.

We also note that financial ODIs are proposed for NGET and NGGT against a scorecard of EAP metrics. Ofgem says "*Subject to resolving the issues discussed in paragraphs 2.15 to 2.18 [various detailed points on the metrics], we consider that an ODI-F would ensure NGET has a financial interest, proportionate with its involvement and effort, in achieving or exceeding the RIIO-2 targets set out in its EAP*." In our view this provides the rationale for applying the same sort of ODI-F approach across all networks.

If reliance is just to be placed on reputational incentives then further thinking is needed on how to make such incentives effective as set out in our covering letter.

Q10. Do you agree with our proposed RPEs allowances? Please specifically consider our proposed cost structures, assessment of materiality, and choice of indices in your answer.

Q11. Do you agree with our proposed ongoing efficiency challenge and its scope?

Q12. Do you agree with our proposed common approach for re-openers?

As set out in our covering letter it is essential that the approach allows for timely decision making by Ofgem, is transparent and allows for effective engagement. This is not an easy balance to get right.

Q13. Do you agree with our proposals on a materiality threshold, a financial incentive, a 'foreseeable' criterion, and who should trigger and make the application?

Q14. Do you consider that two application windows, or annual application windows, are more appropriate, and should these be in January or May?

Q15. Do you consider that the RIIO-1 electricity distribution licences should be amended to include the CAM, or wait until in 2023 at the start of their next price control?

Q16. Do you agree with our proposed re-opener windows for cyber resilience OT and IT, and our proposal to require all licensees to provide an updated Cyber Resilience OT and IT Plan at the beginning of RIIO-2?

Q17. What are your views on including the delivery of outputs such as: CAF outcome improvement; risk reduction; and cyber maturity improvement, along with projects-specific outputs?

Q18. Do you agree with our proposal for the Non-operational IT and Telecoms capex re-opener?

Q19. Do you agree with our approach to using a re-opener mechanism for changes to government physical security policy?

Q20. Do you agree with our approach regarding legislation, policy and standards?

Q21. Do you agree with our overall approach to meeting Net Zero at lowest cost to consumers? Specifically, do you agree with our approach to fund known and justified Net Zero investment needs in the baseline, and to use uncertainty mechanisms to provide funding in-period for Net Zero investment when the need becomes clearer?

A21 Getting this balance right is difficult and it is not clear at present whether Ofgem has got it right. The assumption seems to be that it is possible to meet Net Zero while only funding investments which have a high level of certainty ("known and justified") associated with them. Given the scale of the Net Zero challenge it seems possible that we will only meet Net Zero if companies are able to undertake some higher risk investments or if Ofgem more consciously funds critical path activities. At present it feels like Ofgem is more concerned about the risk of consumers paying more than they need to as against the risk of not meeting Net zero and the analysis that Ofgem has done, for example in its impact assessment, is focussed on looking in detail at the financial impacts not the carbon impacts of its decisions. Ofgem should present clearly how its final determinations are consistent with the various Net Zero pathways in FES and with the CCC's sixth carbon budget (and any restatements of earlier carbon budgets). It is also important that this is not just about the cost to current consumers but future consumers as well – with the risk that delaying investment could lead to higher costs to future consumers.

Q22. Do you think the package of cross sector and sector-specific UMs provides the appropriate balance to ensure there is sufficient flexibility and coverage to facilitate the potential need for additional Net Zero funding during RIIO-2?

A22 We fully support the need for a more adaptive approach in RIIO-2 and the range of uncertainty mechanisms proposed appear to provide that sort of flexibility. However as set out in our cover letter we consider that Ofgem still has more to do to provide assurance that in practice it will be able to deliver timely decisions in a transparent way with appropriate engagement.

Q23. Do you have any views on our proposed approach to a Net Zero reopener?

A23 We welcome the fact that the Net Zero reopener will only be used where other mechanisms are not appropriate and we support the proposed broad scope. Again there are questions about the practical operation including whether companies should have the ability to trigger a reopener.

Q24. Do you agree with our proposals for the RIIO-2 Strategic Innovation Fund?

A24 We agree with the effort to coordinate this with other government innovation funding – which we see as particularly valuable around hydrogen - but would note that there are some risks given pressures on public sector spending (and hence the potential for government to press for more to be done through the SIF for example). While we recognise the case for Ofgem identifying "challenges" that SIF bids must respond to, it is important that industry is engaged in this process as they will have a better understanding of the technical engineering challenges the networks face in the transition which Ofgem has less visibility of.

Q25. Do you have any comments on the additional issues that we seek to consider over the coming year ahead of introducing the Strategic Innovation Fund?

Q26. Do you agree with our approach to benchmarking RIIO-2 NIA requests against RIIO-1 NIA funding?

A26 Given the scale of the challenge of meeting net zero there is a case that spending on NIA should be higher than in RIIO-1. Where the focus is on decarbonisation the networks do not have any financial incentive to carry out innovation as BAU hence NIA funding is needed. The key requirement is that it is well spent (which Ofgem is addressing). Ofgem could agree to consider subsequent requests for top-up NIA funding as part of an adaptive approach.

We would also welcome confirmation that the "energy system transition" element of NIA is not limited to projects aimed at meeting the 2050 target but would also cover any short to medium term decarbonisation challenges around biomethane, leakage, losses etc

Q27. Do you agree with our proposal that all companies' NIA funding should be conditional on the introduction of an improved reporting framework?

A27 Yes

Q28. What are your thoughts on our proposals to strengthen the RIIO-2 NIA framework?

A28 We welcome the inclusion of the requirement on companies to conduct an impact assessment to assess the expected effects of the innovative solution upon vulnerable consumers. While it may not be relevant in all cases it provides an important check and aligns with the Sustainability First recommendations from our Project Inspire[11].

Q29. Do you have any additional suggestions for quality assurance measures that could be introduced to ensure the robustness of RIIO-2 NIA projects?

Q30. Do you agree with our proposals to allow network companies and the ESO to carry over any unspent NIA funds from the final year of RIIO-1 into the first year of RIIO-2?

A30 Yes

Q31. Do you agree with our proposal that all work relating to data as part of innovation projects funded via the NIA and SIF will be expected to follow Data Best Practice?

A31 Yes

Q32. Do you agree with our proposed position on late competition?

A32 It is important that competition is not seen as an end in itself and that Ofgem is clear that there are real consumer benefits, including taking account of any change in where risks sit.

Q33. Do you agree with our proposed approach on early competition?

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[11] https://www.sustainabilityfirst.org.uk/inspire

A33 See A32

Q34. Do you agree with our view that SHET, SPT, SGN and WWU passed all of the Minimum Requirements, and as such are considered to have passed Stage 1 of the BPI?

Q35. Do you agree with our rationale for why NGET and NGGT should be considered to have failed Stage 1 of the BPI?

Q36. Do you agree with our rationale for why Cadent and NGN are considered to have passed Stage 1 of the BPI?

Q37. Do you agree with our overall approach regarding treatment of CVP proposals?

A37 We have a real concern that the way the CVP was set up it is focussed on individual initiatives where Ofgem has said it was looking for a "wow" factor (although the business plan guidance just talks about rewarding activity that is beyond business as usual). There is no scope within the arrangements for looking at plans in the round. So, for example, although Ofgem acknowledges that there was considerable variation in the quality of the EAPs those companies who produced more ambitious EAPs do not get any recognition let alone reward for doing so. Similarly, the Challenge Group highlighted a wide variability in the quality of engagement in developing the plans but there is no recognition or reward for good engagement. The stated objective of the BPI and the CVP is to drive ambition in the plans To do that it needs to take a more holistic view rather than to focus on individual proposals, although we recognise that this is difficult in the light of the original guidance that Ofgem put out on the CVP (on which, as we recall, it never consulted). If Ofgem feels it has to retain its current approach then it does need to be clear that the initiatives it has singled out are genuinely cutting edge which we are not convinced they always are. There also need to be incentives for the CVP proposals to be delivered in practice even when the ODIs/PCDs that underpin them are rejected.

Q38. Do you agree with our proposed clawback mechanism to treat received CVP rewards?

A38 In principle yes but given the de minimis rewards given this seems disproportionately complex.

Q39. Do you have any views on the interlinkages explained throughout this chapter?

Q40. Are there other interlinkages within our RIIO-2 package that you think are relevant to the three pillars identified in this chapter?

Q41. Do you have any views on our proposal to include a statement of policy in Final Determinations that in appropriate circumstances, we will carry out a post appeals review and potentially revisit wider aspects of RIIO-2 in the event of a successful appeal to the CMA that had material knock on consequences for the price control settlement?

Q42. Do you have any views on the proposed pre-action correspondence, including on the proposed timing for sending such to Ofgem?

Q43. Do you think we need specific mechanisms in RIIO-2 to manage the potential longer-term impacts of COVID-19? If yes, what might these mechanisms be?

A43 We see Covid-19 as having potential long-term consequences and hence would support thought being given as to how these should be managed.

GD Sector Consultation

Output questions

GDQ1. Do you have any views on our common outputs that haven't been covered through any of the specific consultation questions set out elsewhere in this chapter? If so, please set them out, making clear which output you are referring to.

AGD1 We are aware that a number of proposals around support for vulnerable customers have been rejected because Ofgem has decided to maintain its £30 million limit on spend in that area (ie the UIOLI allowance). This has been allocated between GDNs in proportion to the number of customers regardless of the quality of the proposals put forward, in order to avoid what might be perceived as a postcode lottery. This means that there was little point in companies engaging or seeking to be more ambitious in this area. Given the added affordability challenges post Covid-19 we hope that Ofgem will revisit this in Final Determinations.

We also note that Ofgem has rejected some proposals around support for energy efficiency because it does not consider that to be the networks' role. While policy on delivery of energy efficiency programmes is set by government, we believe Ofgem could have allowed some discretion for the networks in this space. Ofgem faced a difficult decision around the continuation of the FPNES scheme at a time when we need to be looking to decarbonise heat. In the Grid Edge Policy report on electric storage heating which Sustainability First contributed to[12], the point was made that the FPNES scheme is driving the replacement of electric storage heating when the latter may well be a more viable long-term solution in the context of net zero. Improving the energy efficiency of these properties could provide a better solution than installing gas heating and the regime would benefit from allowing some flexibility in such situations.

GDQ2. What are your views on the reporting metrics we have proposed for the consumer vulnerability ODI-R?

AGD2 Consistent reporting is an important element of reputational regulation, alongside other factors set out in our covering letter. While social return on investment is not yet a sufficiently established metric to use for an ODI-R we would like to see encouragement from Ofgem for this to be developed through RIIO-2, noting the work being done by the DNOs in this space for ED2.

<u>Average PSR satisfaction score</u>

The requirement for GDNs to report on 'Average Customer Satisfaction for priority services register customers' is welcome. It would be useful in the Final Determination if Ofgem could be clear what outcome they are expecting this to deliver. A weakness of the current regulatory protections is the lack of monitoring of compliance with PSR licence conditions. The quality, availability and timeliness of safety and accessibility services provided currently varies across GDNs. A focus on satisfaction could help to drive improvements by shining a spotlight on good and bad practice. We make the following recommendations to further strengthen this proposal:

[12] '**An Electric Heat Pathway: Looking Beyond Heatpumps**' available here.

- Many networks already monitor PSR satisfaction, so the utility of this metric comes from how it is used. Publishing a league table of results including in Ofgem's annual vulnerable consumers report and *proactively* communicating this to relevant stakeholders, including the Customer Engagement Groups and media outlets, could help shine a spotlight on performance, improve accountability and raise the bar. As our Sustainability First Project Inspire report found:

  "There is broad support (albeit more cautious and not without caveats from energy companies) for publishing more comparative data on company performance and service – both customer- and industry-facing. Where this exists (e.g. the energy network incentives 'league tables' and Ofgem's domestic suppliers' social obligations reporting), it can be influential in driving improvements. At best some companies are motivated to innovate since they want to be 'best in class', while others are motivated by a desire not to be out of step with the industry, nor to find themselves in the bottom quartile.[13]"

- As with any satisfaction measure, the devil will be in the detail of the design – it will need to cover all those customers on the PSR, and distinguish between those who have/haven't received services; scoring should allow for sufficient differentiation between companies (for example performance out of ten, not five) if it is to really drive competitive behaviour between GDNs; and publication will need to be timely to ensure it's meaningful for example.
- Ofgem should adopt a similar approach for electricity network companies as part of ED2 and work with other utility regulators such as Ofwat, so cross-sector comparisons are possible. This will be important to deliver the 'best practice' it proposes in the SSMD.

<u>Average CO awareness score via common survey</u>

It would be useful to understand why Ofgem thinks this metric is needed and what it is hoping to achieve by it. Under RIIO-1 we've seen a large number of CO initiatives thanks to the Gas Discretionary Reward Scheme. Under RIIO-2 the UIOLI allowance already provides funding for this to continue. GDNs have a good track record of collaborating on safety issues, including carbon monoxide awareness with initiatives delivered under the GDR scheme currently quickly disseminated. Most companies now test participants' awareness after initiatives – some straight away, some after a short time to test retention/consolidate learning. Others monitor action taken as a result (arguably the most useful indicator). This is good practice and helpful to monitor and improve approaches' effectiveness.

This proposal would introduce a competitive element between GDNs that we do not see as necessary or even helpful. Importantly, it could undermine collaborative working in this area. It would discourage the timely sharing of good practice (as our research has found league tables do). In addition, it could incentivise companies to target CO awareness programmes at those most likely to understand and remember information provided, rather than the most vulnerable. The survey would need to be taken both before and after to compensate for existing awareness levels (a value

[13] https://www.sustainabilityfirst.org.uk/images/publications/inspire/Energy%20for%20All-%20Innovate%20for%20All%20(full).pdf p.8

add score) to be meaningful and mechanisms put in place to ensure it was robust and companies weren't encouraged to lead survey respondents.

Gaps in protections

We call for a couple of additional metrics to ensure that customers who are not on the Priority Service Register but at risk of suffering detriment, are also protected and receive accessible service.

As Ofgem states in its latest consumer vulnerability annual report "We acknowledge that using PSR data alone does not provide the full picture as a person may be in a vulnerable situation, but not require priority services available from the PSR in relation to their access, safety and communication needs.[14]"

Ofgem does not appear to have updated its approach in light of its new Consumer Vulnerability Strategy and the following metric in particular would support it in that aim.

- An Inclusive service provision metric - As Ofgem states in Outcome 4A of its CVS "We want products and services to be designed to meet the needs of a wide range of consumers (including the most vulnerable)". To deliver this, Ofgem should introduce some kind of common inclusivity and accessibility metric which measures how accessible a companies' key services are. This would complement the proposed PSR satisfaction metric and could for example include mystery shopping by customers with additional needs of a range of company services such as meter relocations; reporting gas leaks, accessing information on priority services and of course street works (where a poorly designed works can cause real detriment to customers who have poor sight or mobility problems for example). We would encourage Ofgem to work with organisations such as RIDC to explore how this could best be done in a consistent comparable way. Alternatively, the regulator could work with Cadent to develop its proposed Inclusivity ODI, pilot this and then roll it out more widely during the price control period as appropriate. This would update the DD decision in line with Ofgem's Consumer Vulnerability Strategy and would be a proportionate way to help monitor the effectiveness of the proposed new consumer vulnerability principle. There is a huge amount of good practice already available on inclusive design including Sustainability First's Project Inspire which was part funded by Ofgem. The latter provides practical examples as to how companies can deliver improvements. Much of this is low cost yet inclusivity is still not embedded into GDN practice. This needs to be addressed.

In addition, Ofgem should look at expanding the customer satisfaction metric questions in relation to customers who suffer planned and unplanned outages to ensure that they felt safe and well and pull this out as a separate score, recognising that any customer is potentially vulnerable when without supply.

This would be in line with the CVS and learning from the water sector following outages caused by the Beast from the East in Feb/March 2018.

GDQ3. What are your views on the design of the annual showcase events, including whether they should be held at a national or regional level?

AGD3 A national event is important for sharing learning across companies and providing a reputational incentive to make effective use of UIOLI funding. As suggested at the Ofgem working group this could be done most efficiently by piggy-backing onto other existing events such as the NEA conference. Regional events are also important for engaging with local stakeholders about the help that is available but companies are doing this in their own areas anyway as partnership working is key to delivering support.

However, lessons must be learned from showcasing events to date. This needs to be appropriately publicised including not just to other GDNs and other networks but third sector organisations and cross sector. The projects should be in the public domain. Ofgem may want to explore the introduction of a competitive element e.g. non-monetary prize. Learning also needs to be collated and pulled together in Ofgem's annual vulnerable customers report. Without some kind of independent facilitator and assessment approach, it could lack credibility and robustness.

GDQ4. Do you agree with our position to change the FPNES from a PCD to a capped volume driver?

AGD4 Given the policy uncertainty we understand the rational for this to be a volume driver. We are somewhat sceptical how many FPNES connections will be delivered in practice given the reliance on reputational incentives and ask Ofgem to re-consider the overall level of support that is provided to help with affordability, in particular given the impacts of Covid-19.

GDQ5. For GSOP3, is a 48 hour exclusion period for the provision of access to hot water and food in the event of a major incident appropriate? Should this be extended to cover interruptions that are not a major incident?

GDQ6. In relation to our proposal to extend quotation GSOPs on entry and exit connections, is it sufficient – in regard to green gas entry enquiries – for these GSOPs to apply to the provision of initial and full capacity studies? Are there other parts of the green gas entry process we need to consider to ensure an improved service provision?

GDQ7. What are your views on our consultation position to monitor the provision of and adherence to appointment timeslots for purge and relight activity through an ODI-R? Are our suggested reporting measurements reasonable?

GDQ8. Do you agree with our proposed option to provide Cadent and SGN with consumer funding through totex baseline or a financial ODI reward for collaborative streetworks activities?

AGD7 Streetworks is an important issue for consumers and the GLA and hence support for GDNs to work collaboratively makes sense. The aim should be for this joint initiative to pave the way for a common approach across all the networks as it addresses a historic problem that is a high customer / community concern.

GDQ9. How should we set targets for the shrinkage financial incentive?

AGD9 It is not clear why a "target" is relevant in this context (unless certain actions are separately funded) and there is no discussion of the marginal incentive rates that would be applied. We would encourage the GD team in Ofgem to follow the same approach as is proposed for compressor venting in GT where these issues have been properly worked through.

The purpose of the shrinkage financial incentive should be to internalise the environmental impacts of methane leakage. As such the financial penalty / reward for any increase / decrease over current levels should reflect the cost of those emissions using the latest evidence on the Global Warming Potential of methane and a cost of carbon that is consistent with net zero (noting that HMT are in the process of updating the Green Book figures). On the Global Warming Potential of methane we would note that there is a live debate in academic circles around how best to treat short-life but more potent emissions[15] and we would encourage Ofgem to ensure that its incentive design is flexible to evolve if formal guidance changes.

GDQ10. Do you have any views on what clarifications are needed to ensure a consistent method of calculating the benchmark shrinkage volumes?

AGD10 From an environmental perspective the focus should be on leakage – theft of gas is an element of shrinkage but does not represent unburned methane. The current volumes are essentially modelled figures and Ofgem should be pressing for further work to be done to improve the modelling of the most crucial aspect of the GDNs' performance from an environmental perspective. While consistency is important we would also like to see scope for companies to be rewarded for initiatives that reduce emissions in ways that are not reflected in the current model provided the reductions can be evidenced (and noting that the model has a wider role in allocating unidentified gas between shippers which can make the process of changing the model itself rather slow).

In this regard we would draw Ofgem's attention to work at an EU level on methane emissions from a range of sources including gas distribution networks. It is clear that countries like Germany[16] are placing a strong emphasis on measuring and managing leakage and we would encourage Ofgem to draw on this as it thinks about how to deal with leakage in RIIO-2 (including in assessing individual company proposals).

GDQ11. Do you think a deadband should apply to the financial incentive? If so, please provide evidence as to how this could be quantified.

AGD11 We cannot see a reason for a deadband and care should be taken that this does not undermine the incentives to properly factor in the carbon impact of leakage in investment decisions. As above we refer you to the GT compressor venting incentive as a model.

GDQ12. What are your views on our consultation position for the four GDNs' EAP proposals in RIIO-2 as set out in this document?

AGD12 While it is not entirely clear from the document it would seem that in many cases Ofgem has agreed funding for proposals but has not agreed to count them as price control deliverables, relying instead on the reputational incentive of the AER. As set out in our cover letter it is important that Ofgem reflects on the risks of companies not delivering and how best to ensure that reputational incentives are effective. We are disappointed that Ofgem has not set out its own views on which GDNs it sees as having been more ambitious in this area and has done nothing to try to encourage (or indeed require) weaker companies to raise their game. We are not in a position to comment on

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15 https://www.oxfordmartin.ox.ac.uk/news/get-the-maths-right-on-emissions-or-risk-missing-temperature-target-warn-oxford-scientists/

16 https://ec.europa.eu/info/sites/info/files/energy_climate_change_environment/events/presentations/speaker_intervention_-_dvgw.pdf

individual proposals that Ofgem has rejected but would urge Ofgem to consider carefully responses that it receives from stakeholders and from CEGs on specific outputs in this important area.

GDQ13. Do you agree with our consultation position to include progress on biomethane in GDN's AERs, alongside standard connections data?

AGD13 Increasing the level of biomethane on the system is one of the critical ways that carbon emissions can be reduced in the short term. This is important given that cumulative emissions are what drives climate change – it is not just about achieving net zero in 2050. As such we would expect Ofgem, in line with its statutory duties, to put a strong focus on biomethane in GD2. Ofgem suggests that the level of biomethane connections is largely outside GDNs' control. However there are various steps that networks can take that make connection easier or harder and a number of companies had proposed improved ways of working with biomethane producers. In particular one of the key challenges facing producers is that they are constrained off and unable to inject in summer periods when pressures are lower and there is the risk of "reverse flows" on the system. This is redolent of the challenges that ED has faced with connection of distributed generation. Thus while the level of biomethane connections is heavily dependent on policy support such as the RHI, there is still a central role for the networks in facilitating those connections (as there is with DG on the electricity side) and maximising input. What matters and needs to be monitored is not just the number of connections but the volume of biomethane injected onto the system. It is also vital, as set out in our cover letter, that Ofgem reflects on how to make this sort of reputational incentive effective.

GDQ14. Do you have any other comments in relation to this section?

GDQ15. What are your views on the proposed set of Workload Activities for the Tier 1 mains replacement PCD?

GDQ16. What are your views on our proposal to adjust allowances for the Tier 1 mains replacement PCD on the basis of mains decommissioned?

GDQ17. What are your views on our proposed approach to setting unit costs for the Tier 1 mains replacement PCD?

GDQ18. What are your views on our proposed Allowance Adjustment Mechanism and Allowance Adjustment Restrictions for the Tier 1 mains replacement PCD?

AGD18 We recognise that this is one of the largest areas of expenditure for the GDNs and that Ofgem is concerned to ensure that costs are kept to a minimum and that the mix of work done does not result in companies making a windfall gain. However repex is also the key way in which companies can reduce the level of methane emissions through leakage which is the area in which they have the largest environmental impact. Ofgem has decided that for RIIO-2 repex will be excluded from the shrinkage financial incentive. This makes sense in terms of not rewarding companies twice but what has been lost as a result is any incentive for companies to take account of the carbon impacts of different ways of meeting their overall repex obligation. This is a complex area that we do not have the resources to get into but would ask Ofgem to provide reassurance that the complexities of this mechanism do not distort in any way the incentives on companies to take account of carbon emissions when assessing which particular repex projects to pursue.

GDQ19. What are your views on our proposed Workload Activities for the Tier 1 services PCD?

GDQ20. What are your views on our proposed approach to setting unit costs for the Tier 1 services PCD?

GDQ21. What are your views on our proposed Allowance Adjustment Mechanism and Allowance Adjustment Restrictions for the Tier 1 services PCD?

GDQ22. What are your views on our proposal for a common PCD for capital investments?

GDQ23. What are your views on our proposals for delivery, clawback and deliverables for the capital projects PCD?

AGD23 We welcome the principle that customers should not pay for projects that have not been delivered. That said it is important that there is still flexibility for companies to find alternative ways of meeting the same outcomes more efficiently.

GDQ24. Do you agree with our approach for funding physical security for the GD sector? And do you agree that in light of the proposed baseline totex that the physical security PCD is no longer required for the GD sector?

GDQ25. Do you consider that the enhanced obligations framework for exit capacity and the additional information being sought are appropriate?

Approach to Cost Assessment Consultation Questions

GDQ26. Do you agree with our proposal of using a top-down regression model?

GDQ27. Do you agree with our proposed approach to benchmarking modelled costs at the 85th percentile?

GDQ28. Do you agree with our proposed approach to estimating embedded ongoing efficiency and values calculated?

GDQ29. Do you agree with our proposed pre-modelling normalisations?

Model Selection Consultation Questions

GDQ30. Do you agree with the selected aggregation level, estimation technique and time period for our econometric modelling?

GDQ31. Do you believe we should take into consideration revised cost information for the remainder of GD1 including 2019-20 (actuals) and 2020-21 (forecast)?

Opex Consultation Questions

GDQ32. Do you agree with our selected cost drivers for Opex?

GDQ33. What are your views on our proposed approach to the synthetic cost driver for repex?

GDQ34. What are you views on our proposed repex workload adjustments?

AGD34 We note that Ofgem has disallowed significant elements of repex on the basis of CBA assessments. Given the strong stakeholder and consumer support for many of these proposals we feel that a clearer explanation of Ofgem’s rationale is needed. Safety must be a priority and while the assets remain in use the GDNs have an obligation to keep them safe. Repex is also key to leakage reduction and hence has a critical environmental impact. Making the networks hydrogen ready has some option value in an uncertain future. Ofgem’s choice of a 16 year payback has not been justified in terms of any likely projections for the continuing use of the gas networks and as noted below in our response on the Finance annex, sits slightly oddly with the continued use of a 45 year asset life for depreciation. It is unclear how the reductions in leakage are assessed in the CBA but it is important that the methane to natural gas conversion factors use the latest numbers available (as proposed for the compressor venting incentive in GT) and that the cost of carbon used is consistent with net zero (which current Greenbook figures are not, as Ofgem acknowledge in their own impact assessment guidance). We would hope that with further evidence from the companies Ofgem will be able to reinstate much of the repex expenditure proposed.

GDQ35. Where we have disallowed workloads, should we consider making corresponding adjustments to opex costs? If so, how do you think this could be done?

Capex Consultation Questions

GDQ36. What are your views on our proposed approach to the synthetic cost driver for capex?

GDQ37. What are you views on our proposed capex adjustments?

Non-regression Costs Consultation Question

GDQ38. Do you agree with our assessment of non-regression costs and our proposed adjustments?

Technically Assessed Costs Consultation Questions

GDQ39. Do you agree with areas selected for technical assessment?

GDQ40. Do you agree with our proposed approach?

GDQ41. Do you agree with our proposed disaggregation methodology?

Uncertainty Mechanisms consultation questions

GDQ42. Do you have any views on our common UMs that haven't been covered through any of the specific consultation questions set out elsewhere in this chapter? If so, please set them out, making clear which output you are referring to.

GDQ43. What are your views on the proposed re-opener for Tier 1 stubs?

GDQ44. What are your views on our proposal to introduce a <7bar diversions reopener?

GDQ45. What are your views on the triggers and windows for the MOBs safety reopener?

GDQ46. What are your views on our consultation position to address bespoke decarbonisation of heat re-openers through our proposed innovation stimulus, Net Zero and Heat Policy re-opener mechanisms?

AGD46 These mechanisms would seem to be broad enough in scope to avoid the need for bespoke mechanisms in this area.

GDQ47. What are your views on the questions set out in paragraph 4.57 of this document in relation to large hydrogen projects?

We would support the socialisation of costs for these large projects as a key aim at this stage remains demonstrating the benefits of hydrogen and extracting learning from which all GDNs can benefit.

GDQ48. Do you have any other comments in relation to this section?

GDQ49. What are your views on our proposal to introduce a new domestic connections volume driver?

AGD49 This makes sense given the uncertainty that exists around the volume of gas connections if gas heating is to be banned in new homes in future.

GDQ50. What are your views on our proposal to continue with the large loads reopener?

GDQ51. Do you agree with our definition of a 'large load' to use for this re-opener?

GDQ52. Do you agree with our proposal to continue with a smart meter rollout reopener?

GDQ53. Do you agree with our proposal to continue with a common streetworks re-opener?

Electricity Transmission Sector

ETQ1. Do you agree with our proposals to switch off the incentive in year one of RIIO-ET2 in order to pilot the Quality of Connections survey and develop the baseline targets?

ETQ2. Do you have views on the common milestones, target audience and question of overall satisfaction for the Quality of Connections survey incentive provided in Appendix 2?

ETQ3. Do you think there are any additional KPIs that have not been included in the final NAP which would support monitoring of performance in adherence to the NAP and/or add transparency of the outage planning, management and implementation process for relevant stakeholders?

ETQ4. Do you agree with our proposed LPD mechanisms and do you agree with the criterion that we are proposing to use for our LPD mechanisms?

ETQ5. What are your views on applying our LPD mechanisms to some or all of the projects identified at paragraph 2.74?

ETQ6. What are your views on our consultation position for the three electricity TOs' EAP proposals in RIIO-2 as set out in this document?

AET6 We welcome the fact that the majority of EAP proposals have been funded. However as set out in our cover letter we are concerned about Ofgem's reliance on reputational incentives for the companies to deliver on these commitments, in particular given what is expected to be a very tight price control.

We therefore welcome the proposal for a financial incentive for NGET / NGGT based on a scorecard of EAP metrics and taking account of the economic value of delivery of the benefits. Given the effort that Ofgem is putting into the design of this incentive we would have liked to see this approach applied across all TOs – and indeed extended to GDNs as well.

ETQ7. What are your views on our consultation position for setting the expenditure cap for visual amenity mitigation projects in RIIO-2?

ETQ8. Do you have any views on our outputs that have not been covered through any of the specific consultation questions set out elsewhere in this chapter? If so, please set them out, making clear which output you are referring to.

ETQ9. Do you have any views on our overall approach to setting totex allowances?

AET9 As set out in our covering letter we recognise why Ofgem is looking to move to more adaptive regulation given the uncertainties around the pathway to net zero and are supportive of the direction of travel. However we have concerns around the need for timely decisions but which provide transparency and appropriate engagement. Further information is needed on the processes and timelines that Ofgem will follow, We are also concerned that the bar may be set too high in terms of the level of certainty that Ofgem expects before it will agree to expenditure – uncertainty can be expected to be a feature of the world going forward and simply delaying decisions will not necessarily provide the certainty Ofgem has historically sought. Delaying expenditure potentially puts net zero at risk and increases the costs to future consumers.

While Ofgem is clearly mindful of the short-term pressure on bills and previous NAO criticism on returns, it can expect that going forward it will judged on whether it has helped or hindered progress to net zero. It is therefore important that it is clear that the approach it is proposing will deliver the necessary infrastructure to meet all potential FES pathways and the CC carbon budgets. This assessment does not appear to have been done. Having some view of the "likely" level of allowed revenues, not just the baseline would help. One view of this was reflected in the investor briefing but that was not linked directly to generation volumes and FES scenarios, and it has not been reflected in either statements around bill impacts or assessments of financeability.

ETQ10. Do you agree with our proposed eligibility criteria for the LOTI [large onshore transmission investments] reopener and do you agree with the assessment stages, and their associated timings?

AET10 Given the reliance that is being placed on this reopener to deal with large onshore transmission investments it is important that Ofgem is able to reach timely decisions, that are transparent and informed by appropriate engagement. Ofgem says that it has sought to learn the lessons from the predecessor mechanism – Strategic Wider Works. This is welcome but we would have liked to see a more structured and transparent lessons learned process.

ETQ11. Do you agree with our proposed definition of PCF [pre-construction funding] for RIIO-2, and the areas of work that we intend that definition to cover?

AET11 We support the idea of pre-construction funding to enable early progress to be made on projects where there is some uncertainty. We see this as facilitating a more adaptive approach to investment. The companies will be better placed than we are to comment on the precise scope that is needed.

ETQ12. Do you agree with our proposal to assess PCF costs as part of RIIO-2 Closeout, following the principles set out in Chapter 4?

AET12 We have concerns about this proposal as it creates uncertainty for the companies and shifts costs from current consumers to future consumers without any clear rationale. Given that there is already a clear trigger for pre-construction work in the shape of the ESO reaching a "proceed" decision for the project in its Network Options Assessment (NOA) there should be scope to deal with PCF through a mechanism that releases the funding once that trigger is met. The idea of PCDs with triggers has been suggested in the ED2 methodology consultation and, it seems to us, could usefully be employed here. While this may still leave some residual risk around the level of justification for the spend this would seem proportionate given that the PCF is only a small element of the overall project costs and needs to be undertaken to allow projects to be delivered on a timely basis.

ETQ13. Do you agree with our proposed scope of, associated eligibility criteria for, and timing of the submission window under the MSIP [medium sized investment projects] re-opener?

AET13 While we understand the rationale for this reopener to deal with projects that are atypical and would not fit within the normal volume driver mechanism, there is a need to ensure that a proportionate approach is taken to ensure Ofgem can take timely decisions, in a transparent way and with appropriate engagement.

Gas Transmission Sector

GTQ1. Do you agree with the outputs package that we are proposing for the GT sector?

We welcome the financial incentive for compressor venting aimed at encouraging NGGT to consider environmental impacts when making decisions about venting from NTS compressors. We agree with the proposal to update the natural gas to CO2 conversion factor from 21 to 25 (but note there is a wider debate on the appropriate treatment of short-life emissions)[17]. We would expect the cost of carbon used to be consistent with net zero but are unclear if the figure proposed is (noting that in Ofgem's own impact assessment guidance it proposes carrying out sensitivities with a higher cost of carbon until HMT figures are updated for net zero). Overall this approach to incentive design sends the right economic signals and we would encourage Ofgem to ensure that this same approach is adopted in GD on leakage.

We welcome the proposal for a financial incentive based on a scorecard of EAP metrics. As set out in our covering letter we have concerns about the reliance on reputational incentives for companies to deliver the EAP. Given the thought that is being put into design of the incentive for NGGT we would like to see the approach extended more widely.

GTQ2. Do you agree with our overall approach to cost assessment in the GT sector?

GTQ3. Do you agree with the UM package that we are proposing for the GT sector?

Finance

FQ22. Do you agree with our proposals [on depreciation], including the policy alignment for GT and GD, and to recover backlog depreciation for GT RAV additions (2002 to 2021) over 20 years from the start of RIIO-2?

AF22 Reflecting on the appropriate asset lives for gas network assets is complex but a critical issue given the risks that Ofgem highlight that future consumers will end up having to pay for assets that are no longer required. As well as the technical and economic lives of the assets Ofgem rightly notes the inter-generational fairness issues as demand for gas falls. On the face of it NGGT's proposal for a 25 year asset life seems more justifiable than Ofgem's proposal for a 45 year life (front loaded). 45 years takes us well beyond the 2050 net zero point and there is no discussion of the extent to which assets are re-usable in a hydrogen world which may well vary between transmission and distribution (and which would justify a different approach being taken).

Ofgem's reason for choosing a 45 year life for NGGT seems to be simply to align with GD noting that no GDNs proposed a change to asset lives. However in the sector methodology consultation Ofgem made clear it was not considering a change to asset lives and, although the door was left open for companies to bring forward proposals in the SSM decision, there is no real incentive for companies to do so if (as Ofgem suggests) their RAV is protected. Ofgem's failure to engage with the question of

[17] https://www.oxfordmartin.ox.ac.uk/news/get-the-maths-right-on-emissions-or-risk-missing-temperature-target-warn-oxford-scientists/

asset lives earlier in the process is to ignore what is a crucial issue of inter-generational fairness. The explanation given for rejecting NGGT's proposal does not feel robust.

It is also important to consider the question of asset lives alongside Ofgem's proposals for payback periods on CBAs. For GD Ofgem is requiring paybacks of under 16 years. Yet customers are expected to continue to pay for those assets for a further 29 years.

There does not seem to have been any consideration of payback periods for investments on GT.