



**Draft Determination
Redacted
NGET Draft Determination Response to
Core Annex Document**

As a part of the NGET Draft Determination Response

nationalgrid

National Grid Electricity Transmission's response to Ofgem's RIIO-2 Draft Determination – Core Document

Contents

Introduction	3
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)?	3
Q2 What role should Groups take with respect to scrutinising new investment proposals which are developed through the uncertainty mechanisms?	5
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?	5
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? ...	6
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?	6
Q6. Do you agree with our proposed frequency for publication of updates to the digitalisation strategy and the digitalisation action plan, respectively?	7
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?	7
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? ...	7
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?	8
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.	8
Q11. Do you agree with our proposed ongoing efficiency challenge and its scope?	14
Q12. Do you agree with our proposed common approach for re-openers?	20
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?	22
Q14. Do you consider that two application windows, or annual application windows, are more appropriate, and should these be in January or May?	23
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?	24
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?	24
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?	24
Q18. Do you agree with our proposal for the Non-operational IT and Telecoms capex re-opener?	25
Q19. Do you agree with our approach to using a re-opener mechanism for changes to government physical security policy?	25
Q20. Do you agree with our approach regarding legislation, policy and standards?	26

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 investments when the need becomes clearer? 27

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? 27

Q23. Do you have any views on our proposed approach to a Net Zero re-opener? 30

Q24. Do you agree with our proposals for the RIIO-2 Strategic Innovation Fund 31

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? 32

Q26. Do you agree with our approach to benchmarking RIIO-2 NIA requests against RIIO-1 NIA funding? 32

Q27. Do you agree with our proposals that all companies NIA funding should be conditional on the introduction of an improved reporting framework? 32

Q28. What are your thoughts on our proposals to strengthen the RIIO-2 NIA framework? . 33

Q29. Do you have any additional suggestions for quality assurance measures that could be introduced to ensure the robustness of RIIO-2 NIA Projects. 33

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? 34

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..... 34

Q32. Do you agree with our proposed position on late competition? 34

Q33. Do you agree with our proposed approach on early competition? 38

Approach to the Totex and Business Plan Incentives 39

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? 43

Q35. Do you agree with our rationale for why NGET and NGGT should be considered to have failed Stage 1 of the BPI?..... 43

The Business Plan Incentive (BPI) 43

Q36. Do you agree with our rationale for why Cadent and NGN are considered to have passed Stage 1 of the BPI?..... 78

Q37. Do you agree with our overall approach regarding treatment of CVP proposals? 78

Q38. Do you agree with our proposed clawback mechanism to treat received CVP rewards? 78

Q39. Do you have any views on the interlinkages explained throughout this chapter? 79

Q40. Are there other interlinkages within our RIIO-2 package that you think are relevant to the three pillars identified in this chapter? 83

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? 83

Q42. Do you have any views on the proposed pre-action correspondence, including on the proposed timing for sending such to Ofgem? 86

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?..... 88

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

Introduction

Whilst we share Ofgem's objectives for RIIO2, the Draft Determination (DD) for NGET as it stands is unacceptable because it fails to meet the needs of current and future consumers as well as the needs of our direct customers and broader stakeholder base. This is because the package as a whole reduces network reliability and resilience, jeopardises the pace of delivery of a net zero energy system, and erodes regulatory stability and investor confidence in the sector.

We welcome the fact that Ofgem has clearly signalled this as a consultation in which it is open to making changes based on stakeholder views and through consideration of new evidence. We note that on a number of topics Ofgem has specifically acknowledged that it is open to better options being brought forward, and potential weaknesses in current proposals. This is positive and important because we consider that a significant number of proposals are currently unacceptable and remedies are necessary for Final Determination to address serious issues identified.

We will continue to engage constructively with Ofgem and all stakeholders over the coming weeks to provide robust evidence and rationale to motivate and secure the necessary changes for Final Determination.

Navigating our response

There are eight parts to our overall response in which we provide the substantial evidence to justify and support the changes needed:

1. A short covering letter for GEMA
2. An executive summary of our response
3. A summary of key issues and proposed remedies
- 4. Our response to Ofgem's core DD document questions**
5. Our response to Ofgem's Electricity Transmission sector document questions
6. Our response to Ofgem's NGET-specific document questions
7. Our response to Ofgem's Network Asset Risk Metric (NARM) document questions
8. Our response to Ofgem's Finance document questions

This document is part 4 of our overall response and provides a summary, in one place, of the major proposals across the suite of Ofgem's DD consultation documentation that are currently unacceptable to us with significant remedies necessary.

Consultation Questions

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)?

We believe strongly that the involvement of the independent User Group supported our ambition of creating a stakeholder led business plan and improved our business plan significantly through the knowledge, challenge and expertise of user group members. We urge Ofgem to represent the views of user groups and wider stakeholders in decisions and set out clearly trade-offs made in relation to stakeholder views. We fear without this transparency of the role of stakeholders in decision making, then User Group members may feel that their input has not played any meaningful role.

We may then find it harder to secure their valued expertise in the enhanced engagement process. Moreover, the signal this would send would make it harder to recruit high quality individuals to join the group in future.

The National Grid Electricity Transmission User Group (for the rest of our response we will refer to these as “the User Group”) is an independent group. We have committed to an ongoing role of the user group and since submission of our December 2019 business plan we have been working with the User Group to update its Terms of Reference and the User Group purpose as follows:

1. Scrutinise and challenge company periodic business plans:

- a. Scrutinise and challenge the development of company regulatory business plans, consistent with Ofgem requirements

2. Monitor, interrogate and enhance transparency of performance against commitments:

- a. Hold National Grid to account in delivering its business plan commitments by monitoring delivery and enhancing transparency
- b. Act independently and publicly share its assessment as the voice of National Grid’s stakeholders
- c. Shaping National Grid as the pathway to Net Zero is developed and challenging how it responds to external change

3. Critical friend for strategy, culture and processes in key areas:

- a. Provide input and challenge to National Grid’s priorities and activities
- b. Provide input and challenge to National Grid’s stakeholder engagement and ensure that it’s part of decision-making processes and plans
- c. Help National Grid to become more stakeholder-led; demonstrating fairness, legitimacy and consumer-focus throughout the business

The high-level role of the User Groups would be to continue to challenge our engagement activities, scrutinise our business plans and verify our annual reporting, including our preparation for RII0-3.

The User Groups would hold us to account and ensure we deliver what our stakeholders want from us. As they are independent, the User Groups themselves will define the specifics of how they wish to do this.

We propose that the User Groups continue to have a strong consumer voice. We would expect them to provide challenge at the start of each year’s engagement programme to ensure our plans are comprehensive, representative and inclusive, and to challenge us on best practice. They will shape our engagement based on learning they have acquired from other sectors and organisations.

The User Groups will develop, and review annually, principles for prioritisation to inform an annual work programme which will be produced at the start of each business planning year. User Group outputs will be process- and issues-driven. The User Groups will identify, and review annually, a clear set of criteria, metrics and performance measures by which it can both hold National Grid to account and assess its own effectiveness. At the start of each year, the User Groups will agree its plan for outputs to be delivered and published during that year. This may be subject to review and change during the course of each year.

We agree the User Groups should report annually and include details on this in our response to question 3. In addition, the User Groups will maintain a challenge log. A challenge area is defined as a high-level theme arising from the agreed forward work programme. The key challenge(s) within each area will be reflected in a clear narrative setting out the User Groups expectation(s) of National Grid and why. The content of the challenge log, the National Grid response and a RAG status will be reviewed by the User Group quarterly, or at User Group meetings as appropriate. The default assumption is that the Challenge Log, redacted appropriately, will be published on the User Groups’ websites.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

The recipients of the outputs of the User Groups should be as below to aid transparency:

- All stakeholders, given the User Groups role is to represent stakeholders,
- Ofgem, to ensure the continued formal regulatory role of enhanced engagement, National Grid to ensure challenges and expectations are clearly understood and there is opportunity to act upon these.

We would see a role for the User Group to scrutinise new investment proposals developed through uncertainty mechanisms.

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

Linked to the User Group purpose number 1 and as stated in question 1, we would see a role for the User Group to scrutinise new investment proposals developed through uncertainty mechanisms. Engaging with the User Group as part of this process would ensure that a wide range of view points can influence the development of proposals from an earlier stage.

We note that Ofgem has proposed a considerable amount of uncertainty mechanisms and that a large proportion of eventual cost base may end up requiring bespoke scrutiny through one of these mechanisms. On some of them, getting the User Groups input and participation will be very important. Due to the potential number of these reopeners, however, the User Group will need to go through a process of prioritising those areas of focus and we will work with them to develop this.

We are also mindful that any wider stakeholder engagement processes associated with uncertainty mechanisms also needs to be timely to not hinder delivery of projects.

In line with our stakeholder engagement approach following AA1000, we would plan our engagement by applying the principles of materiality (an area of interest or genuine ability to influence) and inclusivity (identifying interested and impacted stakeholders). As with all topics, we would agree the User Groups' involvement and role upfront.

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?

We believe there is great value in the User Group publishing an annual report and the National Grid User Group has already committed to doing this. The production of such a report, and wider knowledge of the ongoing scrutiny of our work by an independent User Group, should increase transparency for stakeholders and build confidence in the fairness, legitimacy and consumer-focus in our plans, processes and decisions. The report should be wider than customers including all relevant stakeholders. To ensure independence and transparency, the appropriate metrics of assessment, channels of publication, methods of distribution and recipients would be agreed with the User Groups in advance and it would be helpful to agree a common structure with the other transmission user groups.

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?

In our December 2019 business plan, we proposed to retain a User Group to hold us to account. We see an enduring role for an independent user group in RIIO-2 to add significant value to National Grid and our customers, stakeholders and consumers. We have already committed to one group per company and have different membership for our National Grid Gas Transmission and National Grid Electricity Transmission groups. We feel that a single group per sector will not be able to carry out the detailed scrutiny and holding to account role in a way that is most valuable to all. To ensure, therefore that the User Groups are representative of all the stakeholder constituents that are relevant for that company, we believe that each network company having their own User Group would be the most viable way forward.

Since December 2019 we have already refreshed our membership. For the NGET User Group; 4 members have left, and 4 new members have joined, including new constituencies from net zero and whole system.

We have also been working with the User Groups to define their enduring role once RIIO-2 begins as described in question 1. This includes scrutinising and challenging company periodic business plans (which would encompass preparation for RIIO-3).

We have committed the following in the published Terms of Reference for the User Groups to ensure membership is refreshed:

“Ordinarily, the tenure of the Chair appointment will be three years which will be reviewed and may be repeated once, subject to mutual agreement between the Chair and National Grid.

Members shall be appointed by the Chair and for a minimum of two years. This tenure may be repeated once, subject to mutual agreement with the Chair. Reflecting best practice in corporate governance, every effort will be made to stagger or refresh terms of office to ensure the necessary continuity to allow the User Group to deliver its remit effectively.”

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?

We support the steps being taken by Ofgem to support and encourage Network Companies to digitalise the energy system to improve services and maximise the benefits provided to consumers and to deliver an energy system that meets the requirements for Net Zero carbon emissions at the lowest cost to consumers.

We agree that Network Company Digitalisation Strategies and Action Plans and adoption of Data Best Practice guidance will provide greater transparency to energy system data users and offer opportunities for collaboration between Network Companies and data customers.

We do not currently support the inclusion of Licence Obligations pertaining to the Digitalisation Strategy and Action Plan (DSAP) and adoption of Data Best Practice guidance as we have yet to see the content of the guidance and any associated consultation process. We also recognise the importance of Information Technology and Telecoms investment in underpinning Digitalisation Strategies and would encourage Ofgem to ensure clear alignment between digitalisation aspirations and IT investment.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

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

We note Ofgem's decision to adopt two yearly updates to Digitalisation Strategies and six-monthly updates to digitalisation action plans. We agree with the two-yearly update cycle for the Digitalisation Strategy and subject to having visibility of DSAP guidance consider that six-monthly updates to the action plan is appropriate.

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?

We support the development of data best practice guidelines and have engaged with the ENA Data Working Group and associated sub-groups in order to better understand these guidelines and how they can be practically and consistently applied across the energy sector. Where there is a value case from an end consumer perspective we will work within the guidelines. Examples of where we already share large amount of this data via our external websites, are set out below:

Network Mapping Asset location data such as that we already publish, providing the location of our cables, towers, overhead lines and substations. We continue to improve the granularity and accessibility of this data through our investment in our geospatial platform (GeoGrid) and are working hard with ENA to facilitate the creation of an energy system wide network mapping tool.

<https://www.nationalgrid.com/uk/electricity-transmission/network-assets/network-route-maps>

ConnectNow Network capacity, connection options, contractual milestones/activities/costs. This is an evolving digital platform in which we will be continuing to invest subject to funding allowances. So far, we've had very positive feedback from our customers on the new services being provided and plan to deliver more where this increases the speed and ease of transacting with us regarding potential new connections.

<https://www.nationalgrid.com/uk/electricity-transmission/get-connected/network-capacity-map>

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?

We agree that the User Group could have an enduring role to monitor progress and to ensure delivery of our commitments in our engagement strategies. We believe it will be for the User Group to determine priorities for each year of the price control and the User Group should be able to consider where they will add most value to the process and set out the reasons for this prioritisation.

As stated in the purpose of the User Groups (question 3), one of the key areas of work for the User Groups is to provide input and challenge to National Grid's stakeholder engagement and ensure that it is part of decision-making processes and plan, and to help National Grid to become more stakeholder-led; demonstrating fairness, legitimacy and consumer-focus throughout the business. This would be achieved through holding us to account on our business plan commitments which includes our stakeholder engagement strategy.

Our board has also signed on to our RIIO-2 engagement strategy through a stakeholder charter which commits the board to:

- the ambition and approach of our RIIO-2 stakeholder engagement strategy,
- approving stakeholder-led business priorities on an annual basis,
- tracking and monitoring key stakeholder engagement performance metrics twice a year,
- being actively involved in stakeholder engagement activities,
- assure across our business, at all levels.

An effective User Group would be an important part of our broader stakeholder engagement programme; increasing confidence across the RIIO-2 price control, improving transparency and decision-making. These factors play a critical role in ensuring that we deliver on our commitments within the RIIO-2 price control, delivering benefits for consumers and wider stakeholders.

We have already held several User Group meetings since the December 2019 business plan submission, including a meeting where we shared an initial view of our enduring stakeholder engagement approach ahead of RIIO-2 to gain feedback from the User Group and to ensure we meet the commitments stated in our business plan and stakeholder engagement strategy.

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?

Yes, we agree with the proposal for an ODI-R for BCF, we are committed to working to reduce our carbon emissions as a business. We are also comfortable with the concept of the EAP commitments to be reported on as part of the AER, subject to discussions on the form that this will take as this has not yet been shared with us. We will work with Ofgem and industry to take this forward on a cross-sector basis.

However, Ofgem's treatment of OPEX investment relating to the CAI (covered in the NGETQ6 relating to EVs and in NGET15 and ETQ9 for other CAI activities) puts at risk delivery of our environmental commitments. Ofgem has assumed that all indirect activities flex with capital plan, not recognising that a significant proportion of activities are in support of the ongoing operation of the network, the demands of which are largely unchanged by the level of capital work on the network. This includes drivers such as our taking forward our EAP commitments. Our funding needs to take into account drivers such as age and complexity of demands the network, compliance with safety legislation, need for engagement with DNOs and other stakeholders. Given the level of funding provided for OPEX, the level of cuts will mean that safety case activities are prioritised over engineering support to progress our net-zero and environmental ambitions.

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.

Summary position

We broadly agree with Ofgem's proposals for RPE allowances. However, we think that there are some issues in CEPA's materiality assessment and cost structure analysis that require correction, and that Plant and Equipment should be in scope for RPE indexation.

We believe that the uncertain effects of Covid-19 and Brexit and the extent to which these may or may not affect network companies, supports the view we set out in our business plan submission of taking a long-term ex ante approach for labour RPEs, which is matched to a long-term view on productivity.

Given the unprecedented changes the world has experienced since our business plan submission, there may be a case for taking a net nil view of labour RPEs and ongoing efficiency, leaving only external capex costs to be subject to RPE indexation.

NGET response to Ofgem’s RIIO-2 Draft Determination – Core Document

Rationale for our position

We think CEPA’s materiality threshold of 10% of totex is too high and inconsistent with materiality thresholds used elsewhere in the framework (e.g. uncertainty mechanisms). This puts the Plant and Equipment category out of scope for RPE indexation for NGET, which we disagree with. Based on the 1% of average annual base revenue (AABR) approach used for uncertainty mechanisms, Plant and Equipment would be in scope for RPE indexation. This should be corrected. Whilst it is right to include a materiality assessment in the RPE methodology, it is important to get the balance of this right to ensure that the mechanism is as reasonable a proxy for the effect of external factors on the cost base as possible. In this regard, provided cost categories are pegged to appropriate indices, we think it is better to include as much of the cost base within the scope of RPEs as possible, especially as a move to annual indexation raises the evidential bar rather than lowering it.

We cannot reconcile the cost structures CEPA have used to the information provided by us in our business plan. These should be based on actual positions that networks recognise, and on an agreed methodology. Against the information submitted in our plan, CEPA’s estimates appear overly weighted to labour categories.

We do not think that CEPA’s approach recognises the difference in prevalence of materials costs between opex and capex. Opex activities are more weighted towards labour costs, whereas capex has a much higher prevalence of materials costs than those in the DD. The proposed methodology uses different RPE indices for opex materials and capex materials similar to RIIO-T1. We have no objection to this, but it is important that the weighting of these reflects the nature of the cost base.

RPE indices will undoubtedly reflect the impact of economic uncertainties surrounding Covid-19 and Brexit. However, Ofgem discounts network company’s exposure to these in its views on ongoing efficiency. This implies that input prices should reflect this exposure, but that they will have no bearing on a company’s ability to deliver productivity gains. We do not believe the reality is this binary. In their report “Frontier Shift at RIIO-T2 Draft Determinations” NERA observe movement in labour RPE indices relating to Covid-19. It argues that the factors driving these (furlough schemes etc) are not pertinent to transmission network companies – we support this view as this has been our experience. When taking frontier shift overall, the logic between RPEs and ongoing efficiency is inconsistent. This indicates that either ongoing efficiency should be softened to match RPEs, or that RPEs should be adjusted to remove economic effects not relevant to transmission networks. The latter is the most appropriate course of action, and supports the proposition put forward in our business plan that labour RPEs should be based on a fixed ex ante basis aligned to the logic of weighting productivity targets to long-term trends. We agree with the case for indexation of materials costs and plant and equipment because these are external costs, the input prices for which are outside the control of the organisation. This is not to say that labour costs are fully within our control, but network companies are more able to at least manage the risks in the short term.

Our original business plan proposals can be summarised in the matrix below:

	Opex					Capex				
	Labour	Labour	Materials	Plant & Equip	Other	Labour	Labour	Materials	Plant & Equip	Other
	Internal	External	External	External	External	Internal	External	External	External	External
In scope for Ongoing Efficiency?	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No
RPE approach	Fixed	Fixed	Indexed	Indexed	CPIH only	Fixed	Fixed	Indexed	Indexed	CPIH only

This reflected a view that we are more able to lever productivity gains in opex due to the higher proportion of internal labour, and lower prevalence of external costs. Or put another way, that we could absorb our inability to lever productivity gains on external costs within our broader controllership of the opex cost base.

For capex, costs are far more exposed to external forces and indirect inputs to our cost base. Hence, we assume we can lever productivity on our internal labour, and that RPEs would capture the productivity gains of external companies. Including additional on-going efficiency on top of this would be a double count.¹

Our proposals were based on a holistic view of frontier shift.

Frontier shift should be seen as the net impact of movements in input prices and ongoing productivity gains taken together. The components need separate assessment, however, there are overlaps and interactions between these broad categories of influence that would be impossible to model precisely. Since the December business plans, the world has changed, and we cannot predict how long it will take to return to pre-Covid-19 situation, if at all.

Taking all things into consideration, perhaps a logical approach in these unprecedented circumstances might be to take a net nil view of labour RPEs and ongoing efficiency. This would reduce complexity, still affording symmetrical protections to both consumers and networks.

This view is informed by the close parity of labour RPE and productivity proposals in both our business plan submission, and CEPA’s frontier shift report, summarised in the tables below:

National Grid Frontier Shift Proposal	2022	2023	2024	2025	2026
Fixed ex ante labour RPE	1.3%	1.3%	1.3%	1.3%	1.3%
Ongoing efficiency	1.1%	1.1%	1.1%	1.1%	1.1%

CEPA Frontier Shift Output	2022	2023	2024	2025	2026
Forecast Labour RPE Index	1.3%	1.2%	1.2%	1.2%	1.2%
Opex Productivity (before sector uplift)	1.2%	1.2%	1.2%	1.2%	1.2%
Capex Productivity (before sector uplift)	1.0%	1.0%	1.0%	1.0%	1.0%

We consider the situation to be different for external capex costs. Network companies cannot directly lever productivity gains on external costs. Instead the productivity gains made by external companies will be reflected in their own prices, and manifest in market indices, along with an unquantifiable list of other upward and downward drivers. We therefore think it is correct to exclude external capex costs from the scope of ongoing efficiency, and subject them to RPEs only.

This alternative “netting off” approach with separate consideration for capex related factors is summarised in the matrix below:

	Opex					Capex				
	Labour		Materials	Plant & Equip	Other	Labour		Materials	Plant & Equip	Other
	Internal	External	External	External	External	Internal	External	External	External	External
In scope for Ongoing Efficiency?	No	No	No	No	No	No	No	No	No	No
RPE approach	CPIH only	CPIH only	CPIH only	CPIH only	CPIH only	CPIH only	Indexed	Indexed	Indexed	CPIH only

This would appear to offset the risk that labour indices capture economic effects not relevant to networks, with the likelihood that these factors will also influence economy wide productivity to an unknown extent and duration.

¹ We note the link to different on-going efficiency benchmarks Value Added (VA) and Gross Output (GO) here, as raised by First Economics in their report on Frontier Shift for the ENA. The VA figures should be applied to the direct elements of the cost base with the GO figures applied to the total cost base. The application of VA is analogous to the approach we have taken here.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

Other considerations

We continue to support a view that indexation plays a role within the approach for RPEs reducing the scope for windfall gains and losses, although the scope of this could be limited to external capex costs.

Our business plan submission recognised the likelihood of increased volatility in materials indices, as might naturally be expected.

A potential pitfall of RPE indexation is that where there is volatility in indices, this passes through directly into revenues (and therefore customer bills) where an annual true-up mechanism is employed.

The risk is softened by setting initial revenue allowances based on a forecast, which is iteratively updated, as is proposed.

On balance we therefore think an annual revenue true-up on RPE indexation does not represent a major concern in itself, particularly if the scope of indexation is limited as we discuss. However, we note that there a number of additional dynamic revenue mechanisms at play for T2, which underlines the importance of careful design in the RIIO-T2 price control financial model to ensure that these all interact correctly.

Conclusions

In making their final determination, Ofgem should:

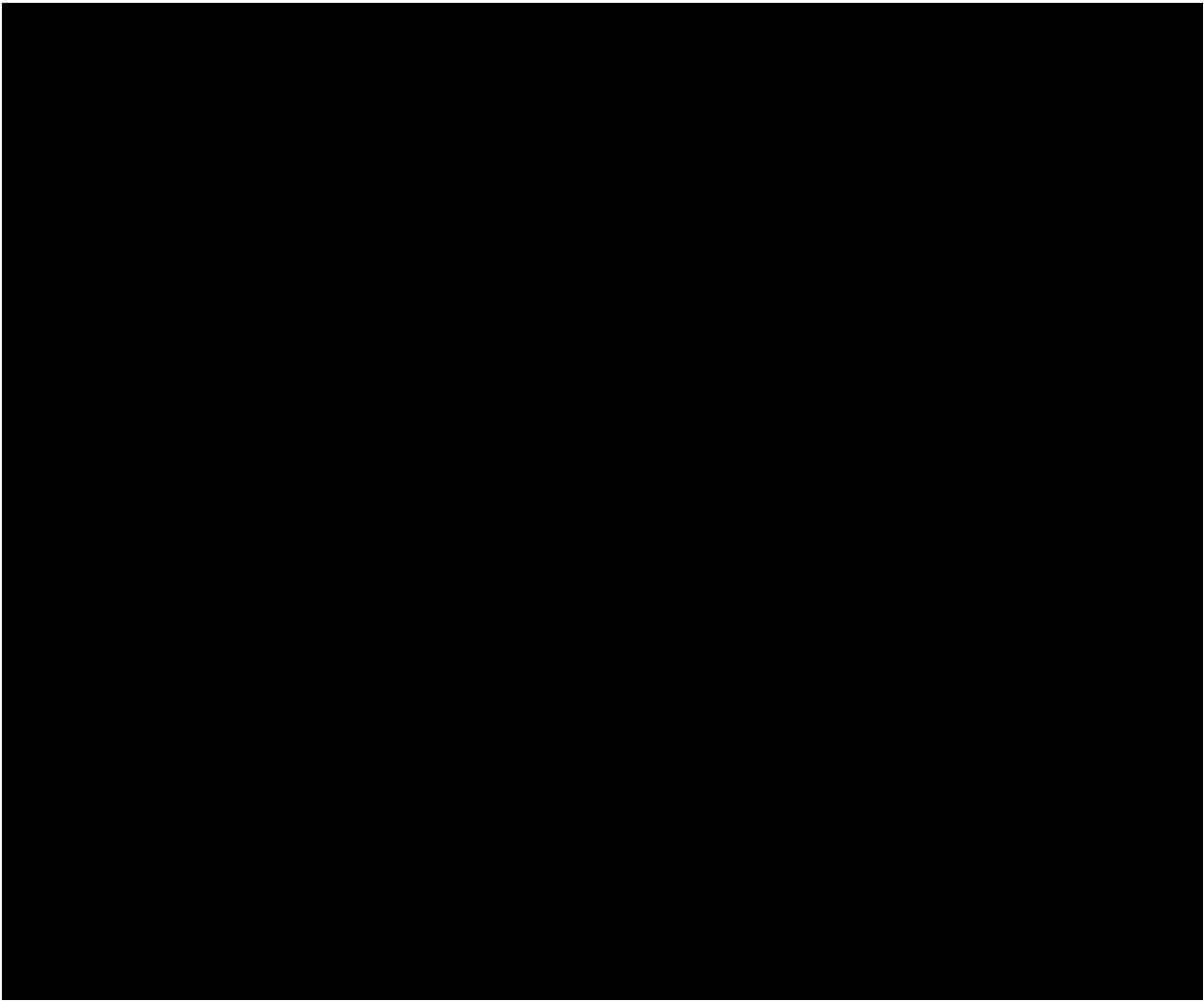
1. Include Plant and Equipment within the scope of RPE indexation for NGET / NGGT, based on a materiality threshold that is consistent with that used for uncertainty mechanisms.
2. Ensure that company specific cost structures are a fair reflection of actual positions and based on positions that companies recognise. Not only is this important for the correct application and outcome of the indexation mechanism, but also so that networks can replicate these for the purposes of quantification of ex ante RPE allowances, financeability / customer bill sensitivity assessment, and ongoing revenue forecasting.
3. Give particular attention to how indices are weighted between opex and capex. We think that CEPAs approach understates the prevalence of materials with the capex cost category.
4. Consider the consistency of its logic for the impact of economic shocks on networks arising from Covid-19 and Brexit. These will undoubtedly manifest in RPEs and CPIH yet are discounted for the purposes of ongoing efficiency targets.
5. In the light of the above, reconsider our proposal for a fixed ante approach for labour RPEs, which is matched to a long-term view on productivity.
6. In the light of economic uncertainties, and the extent to which these may or may not affect network companies, consider the case for taking a net nil view of labour RPEs and ongoing efficiency, leaving only external capex costs to be subject to RPE indexation.

Supporting evidence

Materiality threshold

We think CEPA's 10% of totex threshold is too high and inconsistent with the thresholds used for uncertainty mechanisms. The standard approach for re-openers is a materiality threshold of 1% of annual average base revenue. We see no obvious reason why this should not also apply to RPEs.

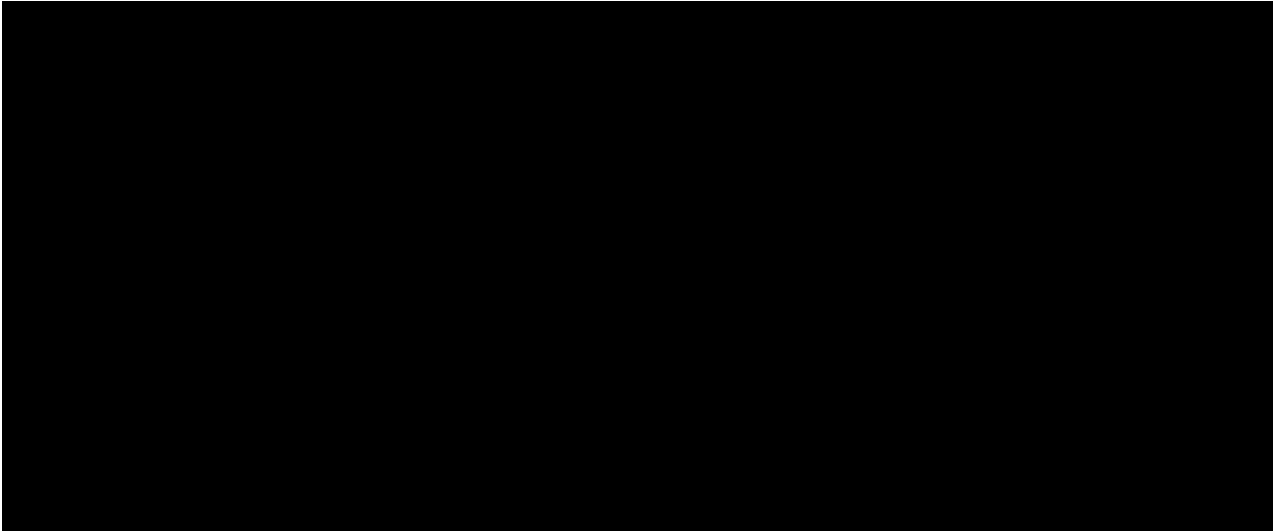
Taking this approach, Plant and Equipment would pass totex materiality test, as shown in the table below.



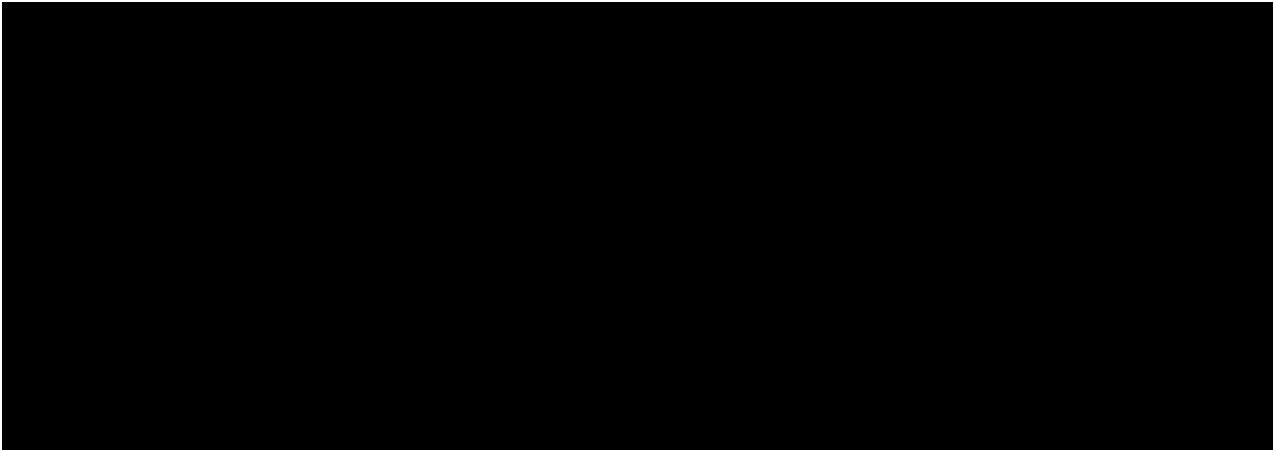
We request that Ofgem instructs CEPA to adopt a consistent approach to materiality assessment, and by virtue of this, includes Plant & Equipment within the scope of RPE indexation.

Cost structures and weightings

CEPA use company specific cost structures for the transmission networks, which we have no objection to. However, the costs structures employed by CEPA in their analysis do not match the information we provided in our business plan submission. Given the sensitivity of the outcome for this, the differences should be reconciled, preferably with an agreed ongoing methodology. The differences we observe are summarised in the table below, which indicates a weighting towards labour categories in CEPAs workings compared to our view.



Furthermore, CEPA appear to take a top-level view of the opex and capex proportions of the cost base when weighting materials indices (note, there are separate indices for opex materials and capex materials). The top-level view does not reflect the weighting of materials costs between opex and capex. Opex is more labour weighted, whereas capex has a much higher prevalence of materials costs. This is summarised in the table below which is based on the composition of our original plan submission:



In the mechanics of the RPE allowance calculation the weightings of the indices need to reflect the correct prevalence of the cost categories within the total cost base. We think CEPA's calculations need correction for this.

If the cost structure assumptions for RPEs are intended to be fixed, this again underlines the importance of the weighting of the indices being based on actual positions that companies can agree to.

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

We do not agree with the proposed ongoing efficiency challenge of 1.2% per annum for capex, and 1.4% per annum for opex. These proposals are above regulatory precedent and are excessively stretching in the context of a significantly tightened price control that places additional downside risk on networks, whilst imposing additional “catch-up” efficiency challenges through Ofgem’s cost assessment process. Ofgem fails to take account of the sustained period of low productivity currently observed, the risk of these enduring, and the significant future economic uncertainties surrounding Brexit and Covid-19.

The proposed underlying productivity targets are based on a flawed range of estimates that are inconsistently calculated and that are not prepared in accordance with recognised regulatory practice. Ofgem’s reliance on medium term OBR forecasts that indicate a rising trend in productivity belies the reality of repeated downward revisions to short-term estimates driven by low outturn positions.

Further pressure is exerted on networks through the proposed 0.2% innovation adjustment applied globally to both opex and capex, which is without substance, duplicative of efficiencies already embedded in plan submissions, and without cognisance of innovation funding arrangements, which see network companies bearing an element of the cost without recompense. This adjustment is unjustified and should be removed entirely.

Ofgem has taken the very upper end of CEPA’s estimates, without attenuation for any of the factors above, and against the advice of its economic consultants. Furthermore, Ofgem’s quantification of totex efficiency targets are systematically magnified as a result of cost miscategorisation between opex and capex, and the duplication of efficiencies included within our direct opex submission.

In our business plan submission, we put forward stretching 1.1% future productivity target across our operating costs and capitalized labour costs; the most ambitious target of all networks’ business plan submissions. This was on top of compelling enduring savings we expect to deliver by the end of the T1 period. Our proposal was linked to our request for a fixed labour RPE allowance, in recognition of the more specialised and long-term dynamics of our workforce and the greater role that networks can play in managing pay. It was also linked to the evidence we submitted that our business plan costs were at the efficient frontier as we started the T2 period. We did not place any ongoing efficiency target on our direct capex in recognition of the fact that our direct capex costs represent the cost of our third-party contractors and supply chain, and their expected level of productivity was already captured by RPE indices and / or CPIH.

Our business plan proposals made a link between long term input price influences on labour, with a long term view on productivity, and we think this approach addresses considerations for economic uncertainty during RIIO-T2, and the extent to which these may or may not impact transmission network companies, and in or response to Q10 on Real Price Effects, we ask that Ofgem consider the merits of this approach in the unprecedented circumstances we face. We also suggest that they may be merit in taking a net nil view on labour RPEs and ongoing efficiency given their close parity, leaving only external capex costs subject to RPE indexation, which we consider also capture the productivity gains of external companies.

Given all of the above, there is a strong case that Ofgem should revisit its ongoing efficiency targets.

In making its final determinations Ofgem should:

- i) Place greater weight on post-2008 financial crisis productivity levels in its historical productivity ranges given the lack of evidence of a return to pre-crisis levels.
- ii) Consider the extent to which current economic conditions, and this risk of these enduring, should inform forward productivity forecasts.
- iii) Use productivity data from sectors that are reasonable comparators for the activities undertaken by energy networks and make consistent usage of wide and narrow industry definitions when arriving at a plausible range.
- iv) Use Gross Output as the primary measure of productivity in line with regulatory precedent and calculate the upper and lower bounds of its range consistently.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

- v) Disregard the 0.2% innovation adjustment on the basis of its unjustified grounding, its spurious calculative basis and double-count of efficiencies embedded within network business plans and general productivity measures.
- vi) Cross check the level of stretch it is targeting through ongoing efficiency with catch-up efficiency reductions applied through their cost assessment of current network costs.
- vii) Consider the extent to which productivity on external capital costs are already captured within RPE indexation and CPIH.
- viii) Ensure that calculation of quantified totex efficiency targets are based correct opex and capex classifications, and that there is no double count of efficiencies embedded within cost submissions.
- ix) In the light of economic uncertainties, and the extent to which these may or may not affect network companies, consider the case for taking a net nil view of labour RPEs and ongoing efficiency, leaving only external capex costs to be subject to RPE indexation, which we consider also captures the productivity gains of external companies.

Our response is supported by NERA's report "Frontier Shift at RIIO-T2 Draft Determinations" commissioned jointly by National Grid and Scottish Power Transmission. The report conducts a critical appraisal of Ofgem's proposals for RPEs and ongoing efficiency, and the methodology adopted by CEPA in their frontier shift annex which supports these positions. We recommend that Ofgem reads the report in conjunction with our response, but we reference the pertinent sections that support our points of argument.

Recent UK regulatory decisions for ongoing efficiency

All recent regulatory decisions in the UK since 2012 have established ongoing efficiency targets at around the 1% level, the most recent being Ofwat's PR19 determination which finalized at 1.1% in December 2019, which carries an uplift for potential productivity gains it perceives to arise from a transition to a totex and outcomes based framework. It is therefore surprising that Ofgem's draft RIIO-T2 proposals set ongoing efficiency targets at 1.2% for capex and 1.4% for opex only 6 months after the PR19 decision, higher than any relevant UK regulatory precedent, and amidst unprecedented economic uncertainty surrounding Covid-19, and without attenuation of CEPA's proposed upper range in any way. Even when excluding the proposed 0.2% innovation adjustment, the targets are above the norm, which does not logically correlate to the current economic climate.

Ofgem does not appear to have appraised its ongoing efficiency targets against the context of its broader RIIO-2 framework proposals, which create additional downside risk for networks, constrained levels of incentive performance potential, and significantly curtailed baseline totex allowances, all underpinned by the lowest ever level of proposed equity return, inclusive of a downward outperformance wedge. As such, we do not believe that the RIIO-2 framework provides the foundations for the achievement of enhanced productivity in excess of its previous decisions and those of other regulators.

The proposals are all the more aggressive when considered in the context of the switch from RPI to CPIH for revenue indexation, which means that any elements of the cost base not subject to RPEs will be funded at slower inflation growth.

Ofgem's position is influenced by inconsistencies and methodological flaws by its economic consultants, magnified through its unjustified innovation efficiency uplift. We discuss these issues in further detail below.

Prevalence of shorter-term dynamics in productivity growth

CEPA's analysis considers the longest possible range available in the EU KLEMS data set, covering the period between 1997 to 2016. Taking a long-term view avoids volatility distortions that can manifest in short range data and incorporates the cumulative effect of technological and process efficiencies that are captured within the time series. It is therefore not unreasonable that

ongoing efficiency targets give due weight to long term trends in the context of long-term regulatory decision making.

However due credence should also be given to current trends where these are not consistent with the long-term view. Since the global financial crisis, we have observed a sustained period of low productivity growth such that average productivity since 2008 is markedly lower than the preceding long-term trend, a reality that CEPA recognises in its frontier shift report.

In its assessment of the Total Market Returns (TMR) component of the regulatory cost of equity, Ofgem aims to give appropriate balance between the foundation of long-term historical averages, and more recent trends, and our view is that the same principles should apply for the assessment of productivity growth. We do not suggest that Ofgem's view should be solely based on recent trends, but that the long-term averages represent a top of range view for the T2 period, and more recent evidence should be given due weight (either explicitly or implicitly) particularly where there is a risk that current trends endure.

Please see section 2.2.1 of NERA's report for further detail and evidence on these points.

Interpretation of OBR forecasts in forming a view of forecast productivity

In the years since the financial crisis, productivity growth has remained below the preceding long-term trend in every single year. CEPA use OBR (and Bank of England) forecasts to corroborate its long-term reference point of 1.1%.

The OBR forecasts assume a reversion to steady state productivity in the medium-term horizon. However, we observe repeated downward revisions to the start point of its projections driven by low outturn positions.

Our view is that this clearly highlights a strong risk that current low productivity growth trends will continue, and that OBR forecasts should be used with caution when forming a view out to the end of the RIIO-T2 period.

Please see section 2.2.2 of NERA's report for further detail and evidence on these points.

Use of Gross Output versus Value Added productivity measures

In section 2.3 of its report, NERA provides an overview of how Gross Output (GO) and Value Added (VA) productivity measures are typically utilised in regulatory practice, with the GO measure consistently taking greater prominence on the grounds of reliability and closer approximation to network cost bases.

By contrast, CEPA take the VA measure in establishing its reference values, and use GO in their downside scenarios. NERA suggest that as a minimum CEPA should give equal weighting to the measures, rather than give primacy to VA against regulatory practice.

In its inconsistent application of the two measures, CEPA also create selectivity in their downside scenario by excluding a narrow industry view of its GO based low-end but taking account of both narrow and wide views in its VA based reference values. Not only is this internally inconsistent, but also means that CEPA's low-end scenarios are artificially high.

Please see section 2.3 of NERA's report for further detail and evidence on these points.

Innovation adjustment wedge

Our position is that Ofgem's proposed 0.2% innovation uplift is entirely unjustified, is based on highly questionable logic, and should be entirely removed. The proposal has fundamental flaws both in CEPA's calculative methodology, and its underlying principles.

Section 2.5 of NERA's report expands on the points made in the following sections.

Innovation adjustment - calculation

In establishing its 0.2% innovation funding adjustment, CEPA's approach seeks to estimate the level of cost savings to consumers that would be required to represent a reasonable return on innovation investment. In doing this, it assumes RIIO-T1 innovation expenditure at a level of 1% of totex, and that all benefits of innovation manifest in cost savings that accrue from the beginning of RIIO-2 and endure for a 20-year period, with a required return of 4.2%. It then back calculates a

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

cost profile across RIIO-2 that would achieve this level of saving for customers. Whilst CEPA does not provide detailed workings, we observe a number of issues with this methodology:

- CEPA's approach does not appear to take account of the element of innovation expenditure that is directly funded by networks (unfunded NIA expenditure plus NIC compulsory contributions) which accounts for around 17% of the total transmission sector spend. *(source: Transmission Network 2019/20 Regulatory Financial Performance Reports)*
- It is incorrect to assume that all innovation benefits manifest as cost savings. Of the £88.5m NIC funded innovation projects across the transmission sector in RIIO-1 less than £10m was directed to projects primarily focused on reducing price control costs.
- CEPA assumes that networks' plan submissions do not already reflect innovation related savings. This is not the case, and any financial benefits identified from RIIO-1 innovation are already embedded in our business plan costs. We provided evidence that our RIIO-2 plans benefitted from £707m of reduced or avoided capex costs from RIIO-1 innovation and efficiencies.
- The payback is based on a notional expected return to consumers, with a back solved profile to deliver this, which must therefore be based on arbitrary inputs rather than on an assessment of what an efficient company could reasonably achieve, and as such is entirely decoupled from the broader mechanics of the regulatory framework.
- By extension of its calculative methodology, CEPA assumes that all innovation projects will earn the same rate of return. This is implausible, and at odds to the nature of innovation projects, which involve risk and uncertainty of outcome, with many not earning a positive return. Furthermore, if innovation projects were as profitable as CEPA's calculations assert, they are likely to have been made without the need for a separate innovation allowance.

Innovation - other conceptual flaws

We have already noted that Ofgem's proposed ongoing efficiency targets before the innovation adjustment are higher than regulatory precedent, and at odds to current productivity trends. If the underlying target is excessively stretching, then adding a further 0.2% is beyond the reach of what an efficient company could reasonably be expected to achieve. This is compounded by the presumption that plan submissions do not already embed innovation benefits, which our plan submission proves not to be the case.

By Ofgem's own definition of them, the RIIO-T1 innovation models were not created with the sole objective of driving cost savings, with environmental and energy security benefits also being primary objectives. Even then, cost saving objectives are in the context of a transition to a low carbon economy rather than wholesale totex reductions. To retrospectively subject all historical innovation expenditure to the same blanket cost reduction hurdle is therefore unreasonable. In section 2.3 of their report, NERA provide a useful summary of RIIO-T1 projects funded by NIC, and find that only a small number, both in number of projects, and in proportion of total expenditure, had cost reductions as the core objective.

The proposed innovation funding adjustment is intended to reflect additional cost savings that companies could achieve over and above a reference value productivity target. Economy wide innovation benefits will already be captured in productivity. As NERA highlight, UK R&D expenditure has been between 1.5 and 1.7 per cent of UK GDP in every year between 2000 and 2018. Even if we were to accept CEPA's assumption of 1% of totex, the transmission sector is spending well below economy wide levels. This being the case, it would not be unreasonable to assert the following:

- The transmission sector would have to significantly increase its innovation expenditure just to keep pace with economy wide productivity.
- Even if expenditure levels were on par with the wider economy, the 0.2% adjustment would effectively impose a (retrospective) requirement that transmission innovation projects outstrip the cost saving benefits of projects from other sectors. CEPA provide no justification

as to why the energy sector should be able to drive a higher level of cost reduction than the wider economy.

Ofgem’s interpretation of CEPA’s report and justification for taking top of range

Ofgem takes the top end of CEPA’s 0.5% - 1.2% (capex) / 1.4% (opex) range, without attenuation or recognition of the caveats and recommendations that CEPA make. This is contrary to its own previous decision and those of other regulators which take a more balanced view of a range based on the evidence available. It makes very limited justification for its position.

In section 2.6 of their report, NERA summarise the position very succinctly:

“Instead, Ofgem now places full weight on the upper bound of CEPA’s estimate, and hence places full reliance on the methodological choices which feed into the upper bound. If these methodological choices do not reasonably reflect the conditions faced by an efficient operator, then the resulting ongoing efficiency challenge is not one that Ofgem can “reasonably expect” companies to achieve.”

By taking the top end of the range, Ofgem is therefore proposing:

- An ongoing efficiency target that is higher than any other relevant UK regulatory precedent, despite recent trends in productivity growth, and amidst economy uncertainties surrounding Covid-19 and Brexit.
- The relevant comparator sector is the “wide” definition which includes most industries.
- That productivity growth will return to the 1997-2016 long-term average as soon as 2021, and not continue at the current low levels
- A view of long term versus short term averages which appears at odds to the approach it takes when assessing the regulatory cost of equity
- That Value-Added productivity measures have primacy to Gross Output measures, in contrast to regulatory precedent and its own previous decisions
- That GB energy transmission companies are able to significantly outstrip productivity gains from innovation projects compared to other sectors, even where cost reduction is not the primary objective
- That the spurious basis of the 0.2% innovation adjustment is correct
- That networks should be expected absorb the effects of slower revenue growth for costs not subject to RPEs arising from the transition from RPI to CPIH.

Ofgem provides little to no justification or evidence of its position, or its deviation from regulatory precedent and its own previous decisions. For instance:

- It states that network companies are not exposed to short term economic shocks, but provides no reasoning for this, or evidence to support its view
- It places full weight on the wide industry definition without providing evidence that this a suitable comparator sector
- Its states that it believes no weight should be applied to GO measures, and provides no explanation for this beyond noting the practical difficulties associated with estimating GO
- With regard to the innovation adjustment Ofgem state that it believes network companies can achieve 0.2% in efficiency gains arising from innovation projects but provides no evidence for this.

Taking the upper end of CEPA’s range, without taking due consideration for the caveats and recommendations that it makes, and with such limited justification for doing so, could naturally lead to an interpretation that the outcome is Ofgem’s primary focus rather than the robustness of the underpinning assessment.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

Issues with Ofgem's application of ongoing efficiency in totex allowances

At our request, Ofgem provided its workings for the £248m ongoing efficiency target published in the draft determination document. This raises some concerns regarding how Ofgem has implemented its efficiency targets within its totex allowance proposals. We observe issues in three categories: scope, cost classification, and overlap / duplication.

- **Scope:** aside from some minor exclusions, Ofgem applies its ongoing capex efficiency to the vast majority of its baseline capex allowances. Our plan submission excluded external capex costs from our ongoing efficiency proposal. This is because transmission companies have limited ability to drive efficiency gains in capex where work is delivered through third parties, and on the substantial proportion of spend that relates to materials and purchased equipment. The indices used for capex materials RPEs track a mixture of input and output Producer Price Indices, which will capture the effect of productivity against within them. Applying an ongoing efficiency target to this element of the cost base therefore inherently gives rise to duplication. We therefore believe that Ofgem should alter the scope of its efficiency target for capex accordingly, as this should be captured through RPEs.
- **Cost classification:** owing to the different efficiency targets for capex and opex, Ofgem's calculation must be targeted to the correct cost categories. Owing to the structure of Ofgem's Business Plan Data Tables (BPDTs) and instructions for completion of these, some categories of cost include both capex and opex elements. For instance, Network Operating Costs (NOC) contains significant capex elements in the Repairs and Maintenance and Legal and Safety sub categories. However, Ofgem's ongoing efficiency calculations treats the entirety of NOC as opex. We have discussed this with Ofgem's Cost Assessment team, who have agreed to consider our position against supporting evidence we provide. Our position is that Ofgem's reporting classification should not override the correct financial treatment, and if a separate target is set for capex, it should be applied to capex costs, and therefore Ofgem's calculation requires correction. Closely Associated Indirects (CAI) are another cost category that has a significant capex element (around 67%). Ofgem has shared its view that it has assess CAI at a gross cost / function level, in order to deal with differences in capitalisation policy. We understand why it has taken this view from a cost assessment perspective, but nonetheless, our position, consistent with that for NOC, is that the correct proportion of CAI should be targeted to the capex efficiency calculation. Given that Ofgem have taken the company split of costs for applying RPEs, they should be comfortable applying the same for efficiencies.
- **Overlap / Duplication:** Ofgem's ongoing efficiency calculation is undertaken separately to its cost assessment process. Unlike the process for capex cost assessment, which is undertaken on a pre-efficiency basis, Ofgem assess direct opex costs inclusive of embedded efficiencies and specific upward cost drivers. The resulting outcome is then fed into Ofgem's separate ongoing efficiency calculation. This gives rise to a likelihood that Ofgem's ongoing efficiency targets for opex are overlaid on top of the networks own proposals in this regard, giving rise to a double count. We have discussed this issue with Ofgem's Cost Assessment team, and we suggest that the issue lies in the cost assessment process in the first instance. A practical solution to this would be to undertake the direct opex cost assessment on an underlying basis in the first instance (i.e. exclusive of efficiencies and specific upward cost drivers). Ofgem should then separately assess the case for any specific upward cost pressures based on the merits of the evidence presented. The resulting position can then be fed into Ofgem's separate ongoing efficiency calculation without risk of double count. We accept that this would involve presentation of data in way that accommodates this approach but consider this to be the most logical way of addressing the issue. We will continue to engage with Ofgem's Cost Assessment team on this matter ahead of final determinations.

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

Ofgem have relied heavily on the use of re-openers in the RIIO-T2 period so it is important that they are agile enough to enable the efficient investment required to facilitate net-zero and the broader economic recovery.

As currently proposed in the Draft Determination, the framework of re-openers and related policies represent a material increase in risk for network companies, a blocker to the efficient progression of important projects that benefit consumers and will stifle innovation.

Whilst a common approach to re-openers makes sense and is a continuation of the approach used in RIIO-T1, we have concerns about (i) the extensive use of ex-post assessments and true-ups, (ii) the restrictiveness of application windows, (iii) the lack of any guidance on application requirements, (iv) the sweeping powers Ofgem has to re-open the contract through the broad scope of authority triggered re-openers, (v) the funding gaps introduced through materiality threshold levels in some areas, (vi) the explicit exclusion of some areas of customer driven investment and, in the case of the Large Onshore Transmission Investment (LOTI) mechanism, (vii) the lack of consideration of the impact across related policy areas – i.e. preconstruction funding, the timing of a decision on competition, the cumbersome timing of the final needs case decision, the large project delivery penalty and ex-post assessment of expenditure (viii) The route to challenge re-openers

(i) Use of ex-post assessments and true-ups

The extensive use of ex-post true-ups is a step away from RIIO principles and will destroy consumer value because networks will not stretch beyond delivering exactly what is set out in the PCD agreed through the re-opener to mitigate risk in the ex-post assessment process.

In many cases the PCD includes a set of “secondary deliverables” that defines the output using the detailed inputs set out in the relevant Engineering Justification Paper, removing all incentives to innovate. Our response to NGETQ5 (PCD question) details our concern on why secondary deliverables are not a suitable output and our response to ETQ13 (MSIP question) and ETQ11 and ETQ12 (pre-con questions) focuses on why the use of ex-post assessment and true-up is not in the best interest of consumers.

Ofgem cannot continue to delay decisions – into re-openers and then into ex-post true-ups – and expect that this will not have a detrimental impact.

(ii) Application windows

We agree that providing notice of submission 6 months prior should be workable, subject to guidance on application requirements.

Many areas covered by the re-openers do not align well with a single re-opener window in January 2024. For these areas, such as cyber security and boundary capability investments. The delivery timescales for some investments will require certainty of funding before the end of 2024 if they are to be delivered in time for when they are required and are to maximise consumer benefits.

A single window will also mean that both Ofgem and network companies are inundated with a single wave of submissions and assessments that would be better spread across the price control; an annual window would be preferable as this would allow projects to proceed and spread industry workload.

We would advocate an annual application window as being more proportionate.

We do not support the concept of an open-ended period for Ofgem to arrive at re-opener decisions. There must be a clear deadline for Ofgem to make decisions so that the process does not adversely impact the efficiency of the reopener process, our planning and execution of work, utilisation of system access outages and contracting with the supply chain

(iii) Guidance on application requirements,

Given our experience working with regulatory guidance on the submission of our business plan, we think it is important that Ofgem publish their proposed guidance on application requirements

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

as soon as possible and before Final Determinations. This guidance may have implications on how workable other aspects of the common approach to re-openers are.

(iv) Authority triggered re-openers

This is primarily in relation to the proposed net-zero reopener (Q21 provide the more detailed net-zero response). In summary, we disagree with the sweeping powers to retrospectively re-open the price control contract that authority triggered re-openers represent due to the how their scope is defined and, by only allowing the authority to trigger these mechanisms, the incentives for all parties to work together to find solutions to cross-sector net-zero challenges is removed.

We propose a process that allows other parties to trigger the net-zero reopener and that its scope is limited only to requirements not already covered by other aspects of the price control in order to close down an open-ended risk for networks.

(v) Materiality thresholds

Ofgem have not provided their analysis used to establish appropriate thresholds to ensure they maximise consumer benefits by balancing administrative burden and regulatory oversight with the level of funding risk networks are being asked to take. In some areas, the threshold level appears arbitrary and does not represent an equitable balance; particularly in the context of the “low risk, low return” price control that Ofgem have set out to deliver.

We disagree that the use of a materiality threshold that limits access to re-openers to cases where the resultant revenue adjustment times the TOTEX incentive (TIM) rate for a company (39.2% for NGET in the DD) is greater than 1% of annual average baseline revenue (~£15m for NGET). In practice, based on the proposals in the DD, this would set the threshold for NGET at approximately £38m. This level of threshold would leave disproportionate funding gaps. We recommend the removal of the TIM multiplier and a setting of the threshold at 1% of annual average baseline revenue alone. The threshold for aggregated re-openers, set at 3% in the Draft Determination, should not exclude projects that meet the 1% threshold when aggregating to avoid even bigger funding gaps in aggregate.

We disagree that the £25m threshold for some categories Medium Size Investment Project reopener is appropriate as this introduces the potential for sizable funding gaps for generation, demand and boundary capability projects (both on individual projects and in aggregate across the portfolio of projects likely to be delivered in the period). The additional criteria of costs needing to be twice the proposed unit cost allowance for generation and demand (which itself is less than 30% of the T1 allowance for this category) does not represent an efficient level of funding for networks to carry out their licence obligations. In some areas, such as boundary capability, thresholds should have regard for the consumer value the project delivers, which is multiples of the project cost or allowance. Our response to the Electricity Transmission Annex ETQ13A on MISP provides more detail.

We propose that the approach used to calculate unit cost allowances (a) uses the robust input data that we have provided Ofgem, which is representative of the range of likely investments we will have to make for our customers in the T2 period, (b) recognises the fundamental differences in key cost drivers between generation and demand customers through separate mechanisms for these and (c) ensures that the resultants of the regression used to calculate the unit cost allowances is statistically significant. Our response on the common sector generation & demand and reactor unit cost allowance can be found in response to questions ETQ13B and ETQ13C of the Electricity Transmission Annex and NGETQ17 focuses on our response on the boundary capability uncertainty mechanism. The resultant, more robust and cost-reflective unit cost allowance would reduce the need for a reopener.

(vi) Exclusion of some areas of investment

The externally driven investment requirements category of MSIP explicitly sets out the areas of investment eligible for assessment through this reopener. It excludes (a) the potential need to upgrade protection and control equipment to ensure it operates effectively despite changing system conditions arising from the move to net-zero; determined as eligible in the NGET Document, (b) the need to up-rate equipment at the distribution interface as a result of distributed generation connections and (c) broader resilience (climate change adaptation measures).

(vii) Coordination across policy areas for LOTI

When taking together certain related policy determinations across pre-construction funding, timing of decisions on competition, prerequisites to and decisions arising from the Final Needs Case stage of LOTI and the potential for Late Project Delivery penalties we anticipate that projects >£100m will be delayed by 15 to 24 months as network companies are no longer able to efficiently parallel consenting and procurement activities and will seek to further de-risk their programmes to stay within Ofgem’s constraints, avoid disallowances in ex-post assessments and mitigate the potential for late delivery penalties. Our response to ETQ10 provides more detail on the concerns raised supported by case studies demonstrating the impact of the delays.

(viii) Requirement for a route to CMA appeal

The route to challenge re-openers is not an issue covered explicitly in the Draft Determination. Price control determinations are subject to statutory appeal to the CMA as a consequence of being introduced through licence modification. In RIIO-1, for re-openers contained in pre-existing licence conditions, following any re-opener decision Ofgem would direct a change to the licence, without a right of appeal to the CMA against that decision.

Under Ofgem’s RIIO-2 proposals the breadth of uncertainty mechanisms across the price control is much wider. There are a range of areas which have a significant and material impact on the overall price control package and NGET’s activities during the period and/or relate to new and untested licence mechanisms. In these areas, which include for example CPM, LOTI project decisions and the Net Zero reopener, it is vital that a route of appeal to the CMA is included in RIIO-2. This will require Ofgem to follow the statutory process to modify the relevant licence, as opposed to making directions under a pre-existing licence condition. We have discussed this issue previously with Ofgem through the RIIO-2 Licence Drafting Working Group. We will continue to work with Ofgem to identify areas where it is vital to retain a route of CMA appeal and will cover this issue further in our response to Ofgem’s September licence drafting consultation.

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?

The whole system coordinated adjustment mechanism (CAM) may allow for some optimisation between regulated network companies where one party is able to deliver a more efficient or effective solution for consumers than the party that has been provided allowances to deliver an output.

The utilisation and consumer benefits derived from the whole system CAM are likely to be minimal, because it only allows for a transfer of existing allowances between networks and the interaction with the totex incentive mechanism is unclear.

Ofgem’s use of PCDs that specify “Secondary Deliverables”, pointing to a detailed scope in an Engineering Justification Paper (i.e. an output defined by the inputs that deliver it –specific detail in our PCD response to NGETQ5), renders the whole system CAM completely ineffective for these outputs; this is the case for the vast majority of NGET’s load-related plan.

Our views on (i) the materiality threshold, (ii) financial incentive, (iii) foreseeable criteria and (iv) who should trigger the application are set out below.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

(i) Materiality threshold

We agree that there should be no materiality threshold for this reopener, so it does not exclude projects which could create consumer value. This rationale is not unique to the whole system CAM.

(ii) Financial incentive

There should be a financial incentive in place that rewards companies for seeking the best overall whole energy system solution that delivers the best value to consumers. At a minimum, companies should be able to recover costs for exploring the opportunity to transfer or receive a whole system solution.

There should also be consideration made to how the share of savings is distributed. In some cases, it may be appropriate that all parties involved receive an equal share. However, the company delivering the solution may be able to outperform through the TIM mechanism (dependin . Careful consideration is needed to ensure the share of the benefit reflects the efforts of each party and the overall consumer value it delivers.

It is not clear that simply leaving it to companies to agree a “compensatory value for risk passed between them” will incentivise companies to drive towards the discovery of whole system alternatives. Indeed other aspects of the DD, such as PCD's with Secondary Deliverables and ex-post assessments, completely undermine all incentives to deliver a solution other than that prescribed in the PCD.

(iii) Foreseeable criteria

We agree that there is no reason to include a 'foreseeable' criterion.

(iv) Who should trigger and make an application

We believe it would be best for both parties to apply together but we acknowledge that if a single licensee does apply it must include a statement of agreement with the licensee who was originally assigned the responsibility and associated revenues for the output or project. We disagree that this is a reopener that Ofgem can trigger as per the proposed Licence Drafting wording.

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

Specific reopener windows might add unnecessary constraints into the process and we would suggest an automatic approach to triggering the mechanism. Having to wait a period of a year or longer before knowing that spend could be transferred to another party, whilst at the same time being committed to timely output delivery, would likely lead to a decision to simply ensure delivery of the output. This is because the risk of not delivering an output and the associated penalty (especially if outages are required) is a critical aspect that needs consideration.

If not automatic, then we suggest the reopener should be annual and if Ofgem were set on a particular window than we would prefer a shorter timeframe as this would minimise delay in delivery of the output, therefore a May deadline would be more appropriate. However, it will be important to take account of how many other reopeners may fall into the same timeline in networks business plans.

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?

As set-out in response to Q13, the design of the whole system CAM and the use of PCDs with Secondary Deliverables and ex-post assessments means it is unlikely that this mechanism will be utilised extensively. Nevertheless, the RIIO-2 electricity distribution licences should be amended to use the CAM from April 2021 so that consumers can benefit immediately if opportunities are forthcoming.

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?

We agree with the proposed timing of the re-opener windows for both Cyber resilience OT and IT at regulatory year 2021 (1 April – 8 April 2021) and 2023 (mid period, 25 January – 31 January 2023). We welcome the opportunity to submit updated plans for both Cyber Resilience OT and IT at the beginning of RIIO-2. We support the proposal of no materiality threshold and no aggregation.

We intend to submit updated evidence as part of the April 2021 re-opener window to justify our existing plans as well as evidence to justify new or updated proposals for activities in respect of which allowances are not included as part of Final Determinations. These would take the form of updated appendices to our December 2019 Business Plan and should be read alongside that Business Plan rather than a new plan, as discussed with the Ofgem cyber team in our engagement sessions, and we request written confirmation that this is acceptable. We require further clarification on the process, timelines, including the evidence and granularity that Ofgem require to assess our plans as the process for re-openers needs to be robust and agile.

We do not support the concept of an open-ended period for Ofgem to arrive at its re-opener decisions. Our view is that there must be a clear deadline within which Ofgem must make reopener decisions otherwise this adversely impacts the efficiency of the reopener process, our planning and execution of work, utilisation of system access outages and contracting with the supply chain.

Please see our separate response to core document Q12 where we set out our further views in relation to Ofgem's proposed common approach for re-openers.

Our response to Ofgem's Draft Determinations for Cyber Resilience OT and IT have been submitted confidentially.

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?

We agree that the PCD should include alongside the delivery of project-specific outputs the delivery of outputs such as CAF outcome improvement, risk reduction and cyber maturity improvement as this is consistent with our December 2019 Business plan.

We are committed to working alongside the Competent Authority in an efficient and effective manner to report our progress on these outputs. In relation to the periodic reporting requirements there should be an obligation upon Ofgem to provide written views to us on our reports as we move through the RIIO-2 period. There is such a requirement already in the 2018 Enhanced Security

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

Reopener periodic reporting process. The purpose these “handshakes” is to ensure a mismatch in expectations does not build up and avoid any surprises at the end of the RIIO-2 period.

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

We support the proposal to have two re-opener windows for Non-operational IT and Telecoms capex as this will help network companies to better manage the uncertainties of later years investment and potentially exploit advances in technology and product development to digitalise the energy sector to the benefit of consumers.

A re-opener at the start of the T2 period and mid-term seems appropriate, and it is important that the re-opener process is effective and proportionate and can be achieved in a timely manner and without being overly burdensome to either party. We would suggest that the regulatory response to the re-opener should not be open-ended and that a decision should be given within a maximum of three months from re-opener submission.

The use of re-openers provides flexibility and helps to manage uncertainty, however appropriate ex-ante baseline funding is essential for efficient IT investment. In particular, funding for investments shared between regulated entities eg NGET and NGGT, should be incorporated consistently in the baseline to provide certainty of cost and delivery, as this approach is in the best interest of consumers. Similarly, investments required in the first two years of the T2 period should be included in baseline to allow these projects to be initiated without delay. Assuming re-openers are managed efficiently and without undue delay, required baseline funding for NGET is £282.5m.

We recognise the importance of Information Technology and Telecoms investment in underpinning Digitalisation Strategies and would encourage Ofgem to ensure clear alignment between digitalisation aspirations and IT investment.

We note the Ofgem proposal for the ESO to ‘implement a new autonomous IT model from the beginning of the 2023-25 Business Plan’. NGET shares a number of applications and services with ESO and any move to an independent model is likely to have capex and opex costs for NGET which have not been considered as part of our Business Plan submission and will require inclusion via the re-opener at the start of T2 or via another mechanism.

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

We agree with the purpose of the physical security reopener to adjust revenues following government mandated changes to network site security requirements. We agree with the timing of re-opener windows at regulatory year 2023 (mid-period) and 2026 (close-out). We request that specific dates be outlined as has been provided for Cyber Resilience OT and IT.

However, we do not support the concept of an open-ended period within which for Ofgem to arrive at its re-opener decisions. Our view is that there must be a clear deadline within which Ofgem must make reopener decisions otherwise this adversely impacts the efficiency of the reopener process,

our planning and execution of work, utilisation of system access outages and contracting with the supply chain.

There needs to be confirmation of regulatory allowances ahead of spend. This is particularly important because the challenging RIIO-2 finance framework proposed by Ofgem contains no contingency for networks to spend at risk or absorb small spends. Therefore, we do not support there being a materiality threshold applied to this category or any other resilience categories. These areas of expenditure stem from government mandated requirements to protect consumers and Ofgem should recognise this in the speed of its adjustment to regulatory allowances. As such we propose the regulatory treatment should be consistent with Ofgem’s position of no materiality threshold being applied for Cyber Resilience. If a materiality threshold were to be attached to the mid-period reopener, then the end of RIIO-2 closeout reopener should operate with no materiality threshold.

Please see our separate response to core document Q12 where we set out our further views in relation to Ofgem’s proposed common approach for reopeners.

Whilst we accept the proposed determination for NGET Physical Security, on reconciling the numbers it appears that though the total submission values are correct across new sites and refresh, the split is wrong. We would request that this is corrected in the final determinations. Please see the tables below;

Ofgem Annex

NGET December Submission

Physical Security Capex	NGET	Ofgem allowance	Physical Security Capex	NGET
New sites	24.4	22.5	New sites	25.0
Asset refresh	3.0	2.8	Asset refresh	2.4
Total	27.4	25.3	Total	27.4

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

Whilst we agree that a broad reopener covering all areas of legislative policy change is unnecessary, there is a strong case for providing a route to changes in funding for changes in technical standards; specifically the NETS SQSS.

Design of the network to the standard set out in the Security and Quality of Supply Standards (NETS SQSS) is a licence obligation for TOs. It ensures that changes to connections, capacity and configuration of the network do not jeopardise security of supply. As such, this technical standard underpins the designs of all the projects that change connections, capacity and the configuration of the network contained in our business plan (i.e. all of our load related plan). The value of our submission for this part of our plan is over £1.1bn. To illustrate materiality; a change in standards resulting in only a 5% increase in cost, could therefore have an impact of over £50m across the load-related plan. When compared to proposed materiality threshold for common reopeners, it is clear that the potential monetary impact is sufficiently material to warrant a reopener.

NGET response to Ofgem’s RIIO-2 Draft Determination – Core Document

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 investments when the need becomes clearer?

Q21 is answered within Q22 below.

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?

We agree with the policy intent of meeting Net Zero at lowest cost to consumers and to, “*make the RIIO-2 price control flexible enough to inject the necessary funding, at the right time, to enable the achievement of Net Zero.*” but we do not agree that this intent has been translated into a proposed approach in the Draft Determination that is likely to achieve the stated aim.

Through seeking to put in place a control that will allow, “*for funding to be made at any time in the price control period, rather than having everything settled at the beginning of the control*” Ofgem have placed a much greater reliance on a robust and agile suite of uncertainty mechanisms to meet Net Zero at lowest cost to consumers. The full suite of non-financial mechanisms for NGET are shown in the diagram, below.

T2 Draft Determination Non-Financial Uncertainty Mechanism Framework for NGET

Cross-sector mechanisms	Electricity transmission mechanisms	
① All projects	② Projects >£100m	③ Projects <£100m
Uncertainty dealt with through cross-sector <u>re-openers</u> : i. Whole system CAM ii. Cyber resilience IT iii. Cyber resilience OT iv. IT and Telecoms v. Physical security policy vi. Legislation, policy and standards vii. Net-zero	Uncertainty dealt with through <u>re-opener and ex-post true-up</u> : i. Pre-construction funding (PCF ex-post true-up) ii. Large Onshore Transmission Investment (LOTI reopener)	Uncertainty dealt with through <u>volume drivers, re-opener and ex-post true-up</u> : i. Generation and demand connection shunt reactor volume drivers ii. Visual amenity in designated areas provision iii. Medium Size Investment Project (MSIP reopener) a) Generation and demand connection outliers b) Boundary capability c) Externally driven – including: Flooding, Black start, ESO-driven requirements, SQSS compliance, Harmonic filtering, Energy Data Taskforce, Port of Tyne iv. <i>Bespoke: Net-zero carbon capital contributions</i>

When considered as a complete package, alongside the baseline allowances proposed, **the Draft Determination fails to provide funding at the right level, at the right time and with enough certainty** for projects to progress at a pace that will deliver Net Zero on time and at lowest cost for consumers. We set out our summary concerns across the package of uncertainty mechanisms, followed by further detail for the critical load-related mechanisms in Electricity Transmission. Our proposed remedies for these concerns are included alongside our detailed response to the relevant question(s) for each issue.

Lack of funding at the right level

Across both cross-sector and electricity transmission sector mechanisms, the DD proposes various materiality thresholds with little or no rationale for the level at which the thresholds have been set and no sign that the consumer value an investment delivers has been considered. Across the package these materiality thresholds leave massive funding gaps and introduce perverse incentives that will delay investment and increase costs.

The unit cost allowances proposed for generation and demand connections systematically underfunds many generation connection types our customers require and all potential demand connections we may have to deliver. The DD fails to propose a mechanism for shunt reactors, which reduce ESO costs of operating the network.

The categories of externally driven investments eligible for the MSIP re-opener exclude those required on protection and control and at grid supply points as a result of the increasing decarbonisation and decentralisation of generation.

Lack of funding at the right time

The timing of proposed reopener windows for many cross-sector mechanisms and MSIP (e.g. a single window in 2024) and the proposal to simply true-up pre-construction funding at T2 close-out for large projects would provide allowances far after efficient costs have been incurred for material levels of expenditure causing unnecessary uncertainty and delays.

Bunching up re-openers into windows will also lead to an inefficient spread of workload for Ofgem and companies, at best worsening an already increasing administrative burden and, at worst, leading to delays due to the process.

The more prescriptive and cumbersome LOTI process and pre-construction funding definition will preclude activities that would normally be efficiently carried out in parallel from progressing in this way, introducing considerable delays.

Lack of funding with enough certainty

The extensive use of ex-post assessments and true-ups alongside PCDs with detailed “Secondary Deliverables” will completely undermine the incentive to drive for efficiency and innovate as companies seek to simply deliver the investments detailed in PCDs to mitigate risk. The lack of certainty of allowances will inevitably delay investment decisions and the delivery of projects that enable Net Zero at lowest cost to consumers.

The extensive breadth of the Net Zero reopener as currently proposed allows Ofgem to reopen the price control contract for any changes in assumptions made at the start of the price control. This further adds to the uncertainty and risk faced by companies.

Further detail for the critical load-related mechanisms in Electricity Transmission

The specific drawbacks of Ofgem’s proposals for Electricity Transmission, as they relate to individual investment areas critical to delivery Net Zero, are described below:

Generation and demand connections (see response ETQ13B for further detail):

Ofgem directed networks to design baseline plans around only the most certain schemes and align assumptions against the lower end of the industry’s Common Energy Scenario. While this approach ensures only the most certain schemes are included in our baseline it is acknowledged that the volume of connections identified through these assumptions would not deliver Net Zero. It is understood that achieving Net Zero will mean that during the T2 period networks will have to deliver many more customers connections than identified in our baseline. This approach means that the uncertainty mechanisms associated with these connections will be key in allowing networks to deliver for customers.

We proposed an automatic ex-ante unit cost-based uncertainty mechanism for these customer connections. To ensure maximum cost reflectivity, our proposal separated projects by type (i.e. generation or demand) and by specific cost drivers (e.g. connections to existing sites or those requiring new substations). Our proposals were not supported by Ofgem in Draft Determinations.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

While Ofgem have proposed a version of an automatic ex-ante volume driver for these connections it is much more limited in its scope and does not account for differences in customer and connection type. Ofgem acknowledge this that approach will mean only a subset of schemes are appropriately funded and hence have proposed to support this UM with a re-opener mechanism (the Medium Sized investment Project – MSIP mechanism). However, this mechanism has thresholds that limit which schemes would be eligible and only a single re-opener window (2024) has been proposed. This approach means that networks must carry significant risk in delivering these customer schemes resulting from either uncertainty around what funding will be allowed (i.e. awaiting results of MSIP assessment) or through being underfunded for projects that are not sufficiently funded by the UM but that do not meet the MSIP thresholds.

Ofgem's proposals will mean networks are less able to respond to the rapidly changing customer requirements that will emerge in T2 as we transition towards Net Zero and will seek to manage the risk imposed by Ofgem's proposals through taking a conservative approach to project development and delivery in cases where funding is insufficient or uncertain. We believe Ofgem's proposals will ultimately restrict our ability to meet our customer's needs and will delay customer projects that are vital to Net Zero during the T2 period.

Boundary Capability Reinforcements (see response NGET17 and ET13A for further detail):

Boundary capability reinforcements are vital to ensure that there is sufficient capacity across the network to allow power to be transported from where it is generated to where it is consumed with minimal restrictions. When there is insufficient capacity, the ESO must manage generation output which increases operational costs (constraint costs) which are ultimately paid for by the consumer or delay connections of new generation to the network. The ESO runs an annual assessment process (Network Options Assessment- NOA) that recommends, based on cost benefit analysis, which boundary capability projects should be delivered by what date to maximise consumer benefit. It is therefore vital that boundary capability reinforcements can be delivered when required by the ESO to ensure that unnecessary constraint costs are not incurred.

While Ofgem have included a range of boundary capability schemes in our baseline, the Draft Determination proposes the use of PCDs with "Secondary Deliverables" to define the exact scope that must be delivered. This PCD would be used in an ex-post assessment to potentially claw back allowance where networks have not delivered exactly to the specified scope (even if the network output has not changed). This approach will remove the incentive to innovate for networks as any deviation from the agreed PCD is likely to result in cost dis-allowance. This incentivises networks to reduce the risk of changes through submitting fewer options to be assessed in NOA and to limit investigation of innovative alternatives due to uncertainty over allowances. We believe these two effects are contrary to the aims of the ESO's NOA process, RIIO ex-ante regulation and Ofgem's goals for the T2 price control. By removing the incentive to innovate and seek better options the transition to Net Zero will not be achieved at lowest cost for consumers.

To manage changes to boundary capability investment needs throughout T2, we proposed an automatic ex-ante unit cost uncertainty mechanism for boundary capability projects that would allow us to quickly respond to each annual iteration of the ESO's NOA process and progress with the development and delivery of any projects that were not included in our baseline in the most efficient manner to maximise consumer benefit. Our proposal has been rejected in Draft Determinations and the MSIP re-opener mechanism (described above) is proposed to be used to manage any changes in requirements, but Ofgem note that they are open to working with us on an alternative approach.

The DD proposal creates significant risk and uncertainty for networks in this vital investment area where the key to delivering maximum consumer value lies in having an agile process that can respond to the annual iterations of NOA and provide ex-ante certainty of funding. Ofgem's proposal means we will not know what allowances are available for any new investment requirements until after the MSIP process (one re-opener window proposed for 2024) and in cases where the MSIP threshold is not met (£25m), no additional funding would be allowed and networks would be expected to deliver projects that are recommended by the ESO as delivering consumer value

entirely at our own cost. These proposals will again have the effect of incentivising networks to minimise risk through delaying investment and minimising innovation at a time when the exact opposite approach is required to meet the Net Zero goals.

Pre-Construction Development of Major Projects (see response to ET10,11&12 for further detail):

Ofgem have proposed that construction funding for projects with a total cost of >£100m are managed through the Large Onshore Transmission Investment (LOTI) process. We support this approach and agree with aims of ensuring additional scrutiny of optioneering and costs for these major projects, but have concerns over the delays the process set out in the DD will introduce.

The pre-construction phase of these projects is critical to network's ability to deliver these in projects by the required dates. As these projects are often associated with large low-carbon generation connections or will deliver wider network capacity to reduce operational costs for consumers, they are vital to achieving Net Zero at lowest cost. However, DD proposals for managing pre-construction funding in T2 do not reflect the importance of this work and will lead to these critical projects being delayed.

The DD proposes to include pre-construction funding for only two LOTI schemes in our baseline allowance. Any other pre-construction spending required during T2 would then be carried out at the networks risk ahead of an ex-post assessment of costs at the end of the T2 period. This approach is unacceptable due to the requirement it places on networks to incur spending at risk to progress customer connections or to deliver major network upgrades that are recommended by the ESO.

The most recent ESO NOA publication recommended that an additional £443m of T2 pre-construction investment would be required (on top of that included in our proposed baseline allowance) to develop major network upgrades by dates that would maximise consumer value.

While we are working with Ofgem to update our baseline allowance to reflect these requirements it remains likely that further pre-construction investment requirements will emerge during T2, either from additional ESO recommended projects or through customer applications that trigger major connection works. It is therefore vital that additional pre-construction funding can be triggered in a way that provides sufficient certainty

If Ofgem maintain their current position it is likely that networks will seek to mitigate this risk through delaying the development of these projects until funding certainty can be obtained. This places at risk customer connections and the delivery of network upgrades that will benefit consumers. Both of these are vital to achieving Net Zero.

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

As we have previously communicated in our response to Ofgem's Open Letter on Initial Engagement around development of a Net Zero reopener for the RIIO-2 price controls on 21 May 2020, we agree with the spirit of what is being proposed for meeting Net Zero and that the RIIO-2 framework must be an enabler to the UK achieving Net Zero.

We support the inclusion of a broad Net Zero re-opener in the draft determination that can accommodate major changes in national or industry policy that trigger investment needs that are not covered by other aspects of the T2 package. However, we have the following concerns with the proposed governance and administration of this mechanism.

Companies, as well as Ofgem, should be able to trigger the Net Zero reopener so that all parties have a strong incentive to work together to develop solutions to Net Zero challenges and so solutions that are in consumers' interests can progress effectively, this is in line with the precedent set in RIIO-1.

We believe that in order to remain agile to the needs of Net Zero, it may be necessary to trigger the mechanism as and when required, rather than a fixed point of the price control.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

The role of Ofgem's Net Zero Advisory Group, its role in assessing solutions and the process that will be followed is not sufficiently well defined. Given the likely complexity of many solutions (e.g. energy and transport) there is a risk that the process will not be agile enough.

Any materiality threshold should be set to ensure that materiality of the Net Zero project costs and outputs should not exceed the cost of the regulatory process (transaction cost).

The Net Zero opener should not be able to undermine or cut across other mechanisms defined in the framework. **The scope should be more tightly defined to be limited to only those new requirements not covered elsewhere in the framework.**

The scope of the Net Zero reopener, as currently defined, adds additional risk and uncertainty into the price control for companies. The RIIO-T2 framework already includes layer, upon layer of adjustment mechanisms and true-ups ensuring companies deliver exactly what was assumed at the time of setting the price control. The purpose of the Net Zero reopener should not be to provide yet another layer of regulatory oversight by allowing Ofgem to adjust allowances, outputs and reporting requirements for any change in assumptions since setting the control.

We note that Ofgem has established a Net Zero Advisory Group. We think it is important that network companies are invited as and when appropriate to make representations to this group directly and we would welcome more information from Ofgem on the intended role of this group, terms of reference and roles, specific membership and what outputs are envisaged to aid transparency as to the role of this group. We request sector representation on the Net Zero Advisory Group as currently the membership does not have operational energy network knowledge.

We would also like to highlight, that in accordance with the rest of the price control, it is vital that the network company has the right to appeal new output requirements and funding decisions that may result from this mechanism, particularly given they could be very material. This will require the Authority to follow the statutory process to modify the relevant Licence, as opposed to making directions under a pre-existing licence condition.

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

We welcome the focus of the proposal around delivering net zero and supporting decarbonisation as well as the proposed additional flexibility that it will provide above the existing annual NIC arrangements. The size of the available fund appears to be commensurate with the challenges faced.

Having an innovation strategy set by an independent board with a series of challenges for networks to meet this strategy is a very new approach in this area, but could be extremely positive provided there is opportunity for all parties to engage with the challenges and deliver truly innovative and beneficial solutions.

Collaboration on significant projects across the areas identified is very beneficial, however enforced collaboration does not necessarily lead to the positive outcomes, therefore the rules around this area need careful consideration.

Overall we are positive about the proposals, however it is difficult to come to a definite conclusion as no detailed document describing SIF rules is currently available.

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?

We are keen to understand how priority directions for SIF will be defined and how network licensees will be included into this discussion. Clearly the setting of the innovation strategy and the definition and process around the challenges will be key to the success of the proposal, and therefore it is critical that all stakeholders are consulted during the development of the rules for the fund.

We will welcome diverse set of challenges and themes that will be interesting for all network licensees and encourage collaboration. Additionally, it will be beneficial to present the challenges in advance (one or even two years prior to proposal submission date) as big projects, especially with several key partners, require significant time to prepare; and it will allow long term planning for innovation priorities and activities across the networks.

We are keen to understand how “compulsory contribution” will correlate with technology readiness. In 8.53 it is stated that “Additionally, eligible projects could include anything from early-stage research through to deployment trials.” and in 8.57 “...for each Innovation Challenge, we propose to consider on a case-by-case basis what percentage of projects would be funded via the SIF”. It will be important to understand how each challenge will define the level of technology readiness expected and how the maximum funding percentage covered by SIF will be arrived at, as it is important that all network companies are keen to engage with the challenges rather than be discouraged by the level of contribution required for the level of TRL that is to be achieved.

We note that you intend to review the definition of innovation for the purposes of the SIF and we welcome a debate in this area to ensure definitions do not constrain creativity and the opportunity for delivering value for consumers.

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

We are comfortable with this approach.

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

NGET is actively working with other Network licensees to develop a new reporting framework via the activity led by the Energy Network Association (ENA). We are in final stages of this activity. We strongly believe that this new framework should deliver more value to the consumers by providing a greater transparency, better monitoring and reporting.

We recognise the overall value in introducing an improved reporting framework for the RIIO-T2 period. However, a successful introduction of the improved framework before final determination also depends on the timely understanding of Ofgem’s expectations from the framework. The network companies are engaging with Ofgem through ENA to build more understanding on these requirements. We agree in principle that the NIA funding may be made conditional on the introduction of an improved reporting framework, subjected to timely feedback and clarifications from Ofgem to allow this to be achieved in the timescales available.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

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

In our opinion, the proposal on the RIIO-2 NIA framework take the programme in the right direction. We do, however, need more clarity on the following subjects:

1. Scope of eligible projects:

More clarity is required on what kind of research and innovation activities can be carried out under Energy system transition or Addressing consumer vulnerability. We see a continued need of NIA funding to support high risk and low TRL Innovations, which have a well-defined benefit case for consumers. We believe the cost efficiencies and environmental benefits achieved through network innovation will provide support to vulnerable consumers. Without innovation, the cost of the energy transition will be immense and it will more adversely impact consumers living in vulnerable conditions. Energy system transition should allow the research and development of a wide variety of technologies which help the UK meet its net-zero goal, and therefore ensuring eligibility criteria are broadly defined within the energy transition context is critically important. For transmission businesses, which are at least one step removed from direct interaction with vulnerable customers, defining eligibility criteria is potentially problematic and we would therefore look to see that innovation projects that aim to drive down cost for consumers, improve resilience or support social mobility and access to services should be included within the eligibility criteria given that the benefit these provide to vulnerable customers are proportionally higher than to other consumers due to their proportionally lower disposable income, ability to access services etc.

We support that NIA funding should not be used for demonstration projects for technologies that have been trialled successfully in other countries and which can then be directly utilised in the UK. Nevertheless, a clear definition is required for “commercially available technology” so that it does not restrict NIA funding for high TRL innovation opportunities that have been used elsewhere but will need further innovation and development to allow deployment in a UK context.

2. Quality assurance of projects

We support the transparency offered by the existing NIA process. It allows stakeholders to get regular updates through the collaboration portal. Network companies are working together to improve the portal and introducing a new benefit tracking framework. This will allow even more seamless information sharing with the stakeholders. therefore, we believe that a peer review or independent review for quality of research should only be required at a portfolio level, or for those projects exceeding a cost threshold, e.g. those costing more than £500,000. This would ensure that audits of this nature delivered value for money.

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

The peer review/ independent review to ensure compliance with quality of research should be mandatory only for the NIA projects spending more than a cost threshold, e.g. £500,000.

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?

We welcome this.

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.

We agree with this proposal, however, this should be applied after the Data Best Practice guidance is fully developed and accepted by all network licensees.

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

We continue to support the introduction of genuine competition where it is in the interest of consumers. However, of the three late competition models proposed in the Draft Determinations we consider that only the CATO model has the potential to deliver the benefits to consumers associated with actual competition, including the benefits of innovation in project design, delivery and operation, price discovery and the revealing of new cost benchmarks. We have fundamental concerns regarding the regulatory design of both the CPM and SPV models, and hold particular reservations on CPM's ability to deliver benefits to consumers (indeed, it seems possible that this model will deliver a serious consumer harm). We are extremely concerned that, due to the limited development of the other models, CPM is the only alternative delivery model for T2 for the foreseeable future. We are of the view that Ofgem should focus its efforts on the development of a model that can deliver the benefits of genuine competition for consumers.

CPM does not involve actual competition in either the design or delivery of a project, and is instead a regulatory process which involves Ofgem setting a project WACC on a project-specific basis, rather than by reference to the RIIO-T2 parameters. Ofgem should be clearer that CPM is not a competition model, but rather a price control model, and an inferior one compared to RIIO. CPM cannot deliver the benefits to consumers associated with genuine competition, and – on analysis of its regulatory design – is highly unlikely to deliver any consumer benefit at all (while risking increasing costs to consumers). On this basis, the inclusion of CPM as a late competition model within T2 is not consistent with Ofgem's stated objective to "...extend the use of competition where it is in the interests of consumers..." as set out in paragraph 9.2 of the Core Document.

We have set out our specific concerns regarding the regulatory design of CPM during previous engagement with Ofgem on its minded to decision to apply CPM to the Hinkley-Seabank project, and have restated these in summary in the attached **[Appendix – NGET_CORE_Q33a Limitations of CPM]**. The Draft Determinations do not contain any new policy developments on CPM which address any of our previous concerns, and indeed we note that there have been no Ofgem policy developments on CPM since the update on the CPM delivery model published on 14 September 2018. As such we remain of the view that CPM is a deeply flawed financing model that is no more appropriate for RIIO T2 than it was for T1. We do not agree that CPM should be included as an option in T2.

Whilst the SPV model involves some elements of actual competition it remains undeveloped with several fundamental unresolved issues concerning risk allocations, the practical operation of the model and its compatibility with the existing regulatory framework. The Draft Determinations do not contain any new policy developments on these issues and, as such it is not possible to determine whether the model can deliver benefits for consumers once all relevant factors are taken into account, if indeed a workable model can be found.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

We set out below our views on the proposed late competition models.

SPV and CATO in T2:

Ofgem highlights that neither CATO nor SPV have been developed enough to apply to projects that have received baseline funding. Ofgem has not, however, confirmed whether any drafting will be brought forward for these two models during T2. We raise this as both models are complex, requiring sufficient time to be fully developed and there will be limited time to be able to undertake the necessary development and drafting activities without missing the window to apply them to a suitable project. In particular, it is not clear how Ofgem intends to address the serious questions we (and other stakeholders) have previously raised about the SPV model – for example, in respect of the compatibility of an unlicensed SPV delivering a transmission asset with section 4(1)(b) of the Electricity Act 1989. It will be important that Ofgem allows sufficient time to work through the complexities associated with developing workable models of late competition.

Further, Ofgem states that it expects network companies to “ensure that they do not carry out any development work that could be detrimental to any part of [relevant large investment] projects being suitable for delivery through late competition” (paragraph 9.11 of the Core Document). Given that the CATO and SPV models are as yet insufficiently developed to apply to projects that have received baseline funding, and significant work is still required on each model, it is unclear what network companies should refrain from doing and how this will impact project delivery. Ofgem should provide clarity in this regard. If network companies are required to refrain from activities such as early market engagement, we would expect this to delay project delivery, add unnecessary risk to projects, limit innovation and so overall deliver worse outcomes for end consumers.

LOTI assessment:

We are concerned about the timing of the proposed LOTI costs assessment process and its applicability to competition. In its current proposal, the LOTI timings cannot appropriately be applied without a detrimental impact upon projects. Leaving the competition decision until as late as Final Needs Case (FNC) would mean that in practice it is much too late to apply either CATO or SPV to a project because by such time, procurement activities should have already commenced, making it inappropriate to compete using these two models. Here we are assuming Ofgem will recognise that the proposed restrictions on procurement activities in the LOTI process should be removed given the delay to delivery they introduce, along with appropriate funding being provided for these critical path activities to continue. The later the competition decision for a project is taken the more unlikely it becomes that a network will be able to refrain from carrying out development work that would be detrimental to the application of competition without otherwise risking the project delivery date being achieved. We therefore consider that Ofgem should bring this decision forward to a minimum of the Initial Needs Case (INC) stage to ensure actual competition can be applied in a way that will deliver the maximum potential benefit for consumers.

CPM concerns:

Our understanding of the late competition proposals is that Ofgem intends the LOTI re-opener to be the default model for delivery of projects subject to uncertainty mechanisms.

The LOTI re-opener already involves a detailed project-specific assessment of costs under the RIIO-T2 framework. CPM echoes this process, albeit that it allows a project-specific WACC to be set (which, in and of itself, is no reason to assume that CPM will capture savings for consumers). Given that Ofgem's RIIO-T2 WACC will be set with regard to prevailing market conditions, the circumstances in which Ofgem will consider applying CPM to projects eligible for competition during RIIO-T2 is unclear. Ofgem should provide clarity in this regard. We also consider that, in light of the movement in the RIIO-T2 financial parameters since the Sector Specific Methodology Decision,

Ofgem should undertake a new impact assessment for CPM and the other late competition models which takes into account these changes to the RIIO-T2 financial parameters.

By contrast to genuine competition in the design and delivery of energy networks, which Ofgem rightly describes as having “a key role to play in driving innovative solutions and efficient delivery” (paragraph 9.1 of the Core Document), it is unclear what consumer benefit CPM will deliver. As stated above, we continue to have serious reservations about the regulatory design of CPM and its capacity to realise benefits for end consumers. We refer Ofgem to our detailed concerns in Appendix **[Appendix – NGET_CORE_Q33a Limitations of CPM]**, by reference to each of Ofgem’s stated three “key benefits” of CPM.² Our conclusion is that CPM cannot deliver real benefits for end consumers when all risks are fully considered. Not only that there is also a real risk that it will result in additional costs and risk transfers to end consumers (leading to a potentially serious consumer harm). CPM is therefore a flawed model which, unlike the actual competition envisaged by CATO, cannot deliver the benefits of genuine competition and therefore should not be brought forward as a late competition model in RIIO-T2.

More generally we are also concerned with the pace of processes and decisions concerning the application of CPM to a particular project, and the potential to create delay in project delivery that is not in consumers’ interests. We would refer Ofgem to the timescales associated with the potential application of CPM on the Hinkley-Seabank project which ultimately reverted to the prevailing RIIO-T1 Strategic Wider Works delivery model:

- 30 January 2017 Ofgem consulted on application of alternative SPV or CPM delivery models for Hinkley-Seabank.
- 23 January 2018 Ofgem published minded to decision to apply CPM to Hinkley-Seabank, by which time tendering for the Main Works Contracts (MWC) was already underway. Market engagement had been longstanding and tender launch occurred in September/October 2017).
- 30 July 2018 Ofgem published decision to apply CPM to Hinkley-Seabank, by which time the first of the MWC contracts had been awarded (in June 2018). The award of the remaining MWCs, covering all of the highest value work packages, occurred in February 2019. Works on the Western Power Distribution elements of the project had already begun (in April/May 2018), and full scale NGET construction works were scheduled to commence in April/May 2019.
- 15 October 2019 Ofgem consulted on minded to position not to apply CPM to Hinkley-Seabank.
- 22 May 2020 Ofgem published decision confirming it will apply prevailing Strategic Wider Works to Hinkley-Seabank

As well as giving rise to potential delay in project delivery, these extended timescales create additional unhelpful uncertainty in respect of CPM and prevent the overall procurement approach and contracting strategy being aligned to the delivery model. Overall, we do not support CPM as a late competition model in RIIO-T2. Instead, Ofgem should take the necessary time to develop a model that can deliver the benefits of true competition to consumers.

If Ofgem proceeds with its decision to incorporate CPM as a potential delivery model during RIIO-T2, we understand this decision will be effected by way of licence modification. Similarly, any later decision: (i) to apply the CPM to a competent project, and (ii) on the specific project allowance, should also be effected through a licence modification decision. This approach is consistent with CPM being in effect a price control model. Whilst we note that Ofgem has provided some clarity on these issues in the Licence Drafting Working Groups, we note that the Draft Determinations are silent on this point. We therefore request that confirmation of this position is provided in the Final Determinations. Ensuring that Ofgem’s CPM decisions are in all cases effected through licence

² <https://www.ofgem.gov.uk/ofgem-publications/157184>

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

modification is critical to ensure proper transparency and visibility for investors and stakeholders over the operation and application of CPM. Any failure to give effect to such determinations in this way could have a significant detrimental impact on investor confidence and investment appetite, which ultimately may increase costs for consumers.

Other opportunities to bring forward competition

As far as we are aware, Ofgem has not fully reviewed and discounted all potential options to introduce competition and would welcome further discussions on this.

Competition application to Dinorwig-Pentir Cable Replacement:

Ofgem's 'RIIO-2 Draft Determinations - Core Document' (para. 9.20) said that the Dinorwig-Pentir project had been identified as possibly meeting the criteria for competition, and an assessment against the competition criteria was not carried out in our Business Plan submission. NGET's continued support of competition is evident in its assessment of all of its Load and Asset Health projects against the competition criteria identified by Ofgem. An assessment of Non Load Related (NLR) projects with a value over £50m against the competition criteria was provided in the Business Plan at *Figure 9.21 Contestability assessment and how this has been applied to NLR projects*. This shows that that Dinorwig-Pentir was assessed for suitability for competition and discounted.

We have set out our view that there is limited consumer benefit to be gained for assessing asset health driven projects through the LOTI process in our response to ET Annex Q10. As is explained further in our supplementary evidence report [**NGET A9.08 Dinorwig - Pentir Cable Replacement**], the need, scope, costs and timings for the Dinorwig-Pentir project are well established. We do not consider that the application of competition or the LOTI mechanism to Dinorwig-Pentir would be appropriate because, for the reasons set out below, it would not be practical and would not be in consumers' interests. In particular, we have calculated that, in the best case, the application of the LOTI timeline to this project would result in a delay to the delivery of this critical infrastructure of almost 3 years.

Regulatory mechanism:

Prior to our Business Plan submission, we understood that LOTI would only be applicable to Load related projects. This was subsequently confirmed in workshop minutes from the 21st February 2020 LOTI workshop, para 2.9 of the minutes of which states, '*...Ofgem confirmed that the LOTI process is intended for all projects over £100m with a load-related element...*' (see Appendix **NGET_CORE_Q32b LOTI workshop 21022020**). Therefore, Dinorwig-Pentir should not be captured under the LOTI re-opener and should continue to be part of the Asset Health portfolio.

In the development of our Business Plan, stakeholders have confirmed the importance they place upon NGET maintaining network reliability and security. Dinor-Pentir is a critical piece of infrastructure that is essential for frequency response and has a direct influence on such reliability and security, any delay to delivery would have a negative impact on stakeholders and ultimately consumers and it is not a suitable candidate project for competition.

Competition criteria:

Although the project is over the £100m 'high value' threshold, the 'new' and 'separable' criteria are not met. This is because a phased substation replacement is required, where, to maintain operability during construction, new and existing equipment will be integrated. In addition, elements of the existing substation auxiliary equipment will be retained where asset condition means replacement is not necessary.

LOTI timeline:

The LOTI cost assessment timeline does not align effectively to the critical delivery of this project. The Initial Needs Case and Final Needs Case phases are both aligned to planning milestones (statutory consultation and planning permission), which are not relevant to the Dinorwig-Pentir project. We intend to use permitted development rights to secure consent for the new cable route for which a screening decision is expected in September 2020, with work to commence at the site in March 2021.

If the LOTI process was applied to the Dinorwig-Pentir project, it would prevent it from being progressed by its planned delivery date of 2026, which would have an adverse impact upon the network and consumers. We need to begin construction in March 2021 to meet this delivery date.

By contrast, the LOTI process could not formally start until the beginning of the T2 Period in April 2021. Ofgem's stated assessment periods alone would take between 15 and 30 months, without the additional time required to prepare submissions. Procurement could not begin until the Final Needs Case is approved, and the contracts could not be placed until the Project Assessment stage is complete. In the best case, we have calculated this would result in a delay to the delivery of the project of almost 3 years, from 2026 to 2029. This would have an adverse impact upon the network and consumers.

Further information on the relevant timings can be found in our supplementary evidence report **[NGET A9.08 Dinorwig - Pentir Cable Replacement]**.

We therefore ask that Ofgem reconsiders its position and provides confirmation that Dinorwig-Pentir is neither an eligible candidate for competition nor in scope for the LOTI-reopener. Funding should instead be provided in the RIIO-T2 baseline.

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

We continue to support the development of early competition in onshore transmission and believe it can realise significant benefits for consumers. NGET also supports the development work being undertaken by National Grid Electricity System Operator (NGESO) on early competition. We firmly believe that consumer value is far more likely to be delivered by introducing competition at a very early stage of the development of a transmission project so that the full benefits from innovation in design solutions, risk management and delivery can be realised. The late models of competition are by contrast much less likely to capture all of these benefits. As such, we believe that early competition is a preferable route to introduce competition in transmission.

We agree with the areas identified by NGESO to review and develop the early competition plan with support and insight from stakeholders from a variety of backgrounds. We are pleased to see the introduction of new concepts to help facilitate interest from a wider pool of bidders, identifying ways to reduce risks to consumers and bidders through the process.

We are however concerned with some items which we think will have an impact upon the final product and ultimately the process that will be implemented and request Ofgem give due consideration to these points:

1. *Timeline for Early Competition Plan (ECP) development:* the scope of work and areas covered by NGESO make it difficult to work with the challenging timeline that has been set to populate a detailed and robust ECP. The Phase 2 consultation highlights the considerable work still needing to be undertaken. Failing to give enough time and effort will have a negative impact on consumers and potential bidders due to the implementation of a sub-optimal process. This will have a long-term impact upon the types of projects likely to be tendered for, bidder appetite, increased cost and risks to consumers and the uncoordinated

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

development of the future transmission network thus detrimentally impacting on achievement of Net-Zero targets.

2. *More clarity*: we need more clarity on incumbent Transmission Operator (ITO) competition support actions to ensure we can put the necessary arrangements in place to be able to bid into future process on a level playing field alongside other potential bidders. Especially as the value in ITO involvement in the process is widely recognised, but also appreciating stakeholder concerns of such involvement.

We also include our response to NGESO as supporting document NGET_CORE_Q33a Early Competition Plan response.pdf and look forward to Ofgem consulting on the recommendations put forward by NGESO on how to progress the implementation of Early Competition to help realise benefits for consumers through the process.

^[1] <https://www.ofgem.gov.uk/ofgem-publications/157184>

Approach to the Totex and Business Plan Incentives

This section provides our response to Ofgem's draft determination on the totex incentive mechanism (TIM) and the business plan incentive (BPI). These are two important parts of the draft determination but surprisingly Ofgem has asked no questions about the TIM and no questions about its overall application of the BPI or its application of Stage 3 of the BPI under which Ofgem has applied a penalty of £179.6m to NGET. In the surprising absence of these questions we have provided our view in this section ahead of answering Ofgem's limited questions on the BPI stage 1 and Stage 2.

Our response on the totex incentive mechanism (TIM)

Ofgem has not asked a question about the TIM in its DD documents so we are responding to Ofgem's proposals in relation to the TIM here.

Summary of our response on the totex incentive mechanism (TIM)

- Ofgem did not take into account stakeholders' legitimate concerns in the design of the TIM sharing factor in its sector-specific methodology decision (SSMD). This has led to TIM sharing factors that are too low and which will not secure the best outcome for consumers. Ofgem's own impact assessment shows that the low sharing factors for transmission companies reduce benefits to consumers.
- Ofgem's application of the TIM sharing factor needs to be improved:
 - Ofgem has provided very limited explanation of why it has judged certain of NGET's costs to be lower-confidence;

- Ofgem’s methodology means it is more difficult for transmission companies to show they have high-confidence costs and as a result leads to them receiving lower sharing factors than gas distribution;
 - Ofgem’s approach does not take account of costs that will be in uncertainty mechanisms when its SSMD guidance says it will; and
 - Ofgem does not take account of additional tools it has added to the RIIO-2 framework to increase cost certainty for lower-confidence costs.
- Ofgem’s approach to the TIM does not achieve its objective of improving efficiency or creating benefits for consumers. Ofgem’s own impact assessment shows that the low sharing factors for transmission companies reduce the benefits to consumers.
 - Ofgem should reconsider how it has calculated its TIM sharing factor for NGET and increase the sharing factor in the final determination. This will lead to increased benefits for consumers.

We have a number of concerns with Ofgem’s approach to the TIM sharing factor in the DD, which does not produce the best outcome for consumers. We set out our concerns below and the remedy we propose for the TIM sharing factor for the final determination.

Ofgem did not take account of stakeholders’ concerns its be on the TIM approach

In their responses to the sector-specific methodology consultation (SSMC) stakeholders said that Ofgem’s proposed TIM sharing factor range of 15%-50% was too low to provide sufficient incentive for companies to seek out and deliver efficiency improvements within the RIIO-2 control periods. This has proved to be the case in the DD for the four transmission companies with low TIM sharing rates of between 30.9% and 39.2%.

Stakeholders also said that the assessment of whether costs were high or lower-confidence baseline costs would be subjective in nature and said that Ofgem needed to provide more detail on how it would make the assessment. Ofgem provided only limited information on its assessment approach in advance of companies submitting their business plans on 9 December 2019.

Ofgem’s application of the TIM sharing factor needs to be improved

The two key inputs to Ofgem’s calculation of the TIM sharing factor are the amount of high-confidence costs (£2577.6m) and the amount of lower-confidence costs in a network company’s total baseline (£3727.76m). Ofgem has not provided a detailed explanation for NGET of how it has allocated each cost line into the high-confidence and low-confidence categories. In an email on 21 August 2020 Ofgem did provide some more information about its general approach to allocating costs between high and lower-confidence costs, but not for each cost line in our plan. Ofgem has provided a Project Assessment Model (PAM) for our load-related expenditure (but not for our other categories of expenditure). However, although the PAM shows us which projects Ofgem has assessed as being lower-confidence it does not provide the reasons for this.

Ofgem’s application of the TIM sharing factor calculation means it is more difficult for transmission companies to show they have high-confidence costs and as a result leads to them receiving lower sharing factors than gas distribution.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

- The result of Ofgem's application of its TIM methodology is for sharing factors varying between 30.9% and 39.2% (average: 36.5%) for the four transmission companies and between 49.4% and 50% (average: 49.7%) for the four gas distribution companies.
- Ofgem is placing most weight on a subset of one of the four ways to prove costs are high confidence (in 11.37 of SSMD): econometric industry benchmark evidence. This method is not available to the transmission companies because there are an insufficient number of companies and because of their disparity in size and networks. Ofgem's approach makes it materially harder for a transmission company to show it has high-confidence costs. Ofgem acknowledges at paragraph 10.24 of the DD core document that it has "assessed a significantly higher proportion of costs in the Gas Distribution sector as high-confidence costs compared to the Electricity and Gas Transmission sectors".
- At a workshop on 27 July 2020 Ofgem said that it was a lot harder for transmission companies to justify their costs than for gas distribution companies under its RIIO-2 approach. For example, Ofgem's SSMD states: "It may be the case, for example in areas of significant change, that historical costs are not a good predictor of future costs" (11.59), thus undermining one of the high-confidence cost justifications available to transmission companies at time when the sector is changing significantly with the transition to a low-carbon energy system. Moreover, it is not clear that econometric evidence for four gas distribution companies is robust evidence compared to that submitted by the transmission companies given the poor statistical properties of a model relying on so few data points. Ofwat has commented on the drawbacks of its econometric models relying on ten sewerage companies in PR19, let alone four.

Ofgem's approach of just looking at baseline costs is too narrow. Ofgem's approach at RIIO-2 is to require companies to set low baselines with a large amount of RIIO-2 expenditure been allowed through uncertainty mechanisms (UMs).

- Ofgem's approach does not take account of costs that will be in uncertainty mechanisms, when its SSMD guidance says "We consider that the following types of information may be relevant to Ofgem's consideration of whether certain costs should be classified as high-confidence baseline costs: [...] Costs where we are able to determine a unit cost allowance with a high degree of confidence and where an appropriate volume driver or other uncertainty mechanism will be implemented and applied to a volume drawn from a baseline scenario volume" (11.37, main paragraph and fourth bullet point). Ofgem has included no such costs in its calculation of the TIM sharing factor, despite clearly signalling that it would. As a result, it has underestimated the proportion of costs that should be considered high confidence.
- For automatic UMs agreed in advance, Ofgem can have high-confidence in the costs, but less confidence in the volumes. Ofgem should add a central estimate volume for automatic UMs to NGET's baseline to reflect these high-confidence costs being likely to occur in the T2 period. This will increase the proportion of high-confidence costs in the TIM calculation.
- For reopener UMs, one of the main purposes is for Ofgem to have more certainty over network companies' costs. Ofgem should include a central estimate of the costs that it will approve during the T2 period which should be added to NGET's high-confidence costs because they will have been subject to an Ofgem specific review. This will increase the proportion of high-confidence costs in the TIM calculation.
- There are material allowances that have been approved already for the T2 period (Hinkley Seabank and Dorset VIP project) that are 'baseline costs' and should be included in the

calculation of the sharing factor as high confidence costs, given these costs will be incentivised via the T2 sharing factor.

Ofgem does not take account of the additional tools it has introduced into the RIIO-2 framework at DD, such as secondary deliverables and ex post reviews of delivery, which significantly reduce the cost uncertainty for Ofgem around costs. While we disagree with Ofgem’s application of these tools (as we explain elsewhere in our response) if Ofgem continues to apply them in its final determination then it should categorise the costs it applies these tools to as high-confidence costs.

The TIM approach does not achieve Ofgem’s objectives

Ofgem’s objective is: “The Totex Incentive Mechanism is designed to encourage companies to improve efficiency in delivery and ensures that the benefits of these efficiencies are shared with consumers.” (11.1, [sector-specific methodology decision](#)).

As regards improving efficiency, Ofgem’s framework has introduced reopeners and ex-post true ups across a large proportion of NGET’s cost base. This will have the effect of significantly increasing the incentive for us to deliver exactly what is in our business plans to reduce the risk of Ofgem reviewing our costs and lowering our allowances and has also given Ofgem more certainty over costs. However, this increased certainty over costs comes at the expense of innovation and efficiency. By also setting a significantly lower sharing factor for transmission companies for the RIIO-2 period, when combined with the substantial increase in ex post review, Ofgem has reduced the incentive for companies to lower their costs and pass a share of those savings on to consumers.

Ofgem’s DD impact assessment shows how the reduction in the TIM incentive does not benefit consumers. Table 15, on page 40 of the impact assessment shows for the ET sector that the impact of reducing the TIM sharing factor is negative for consumers if TOs react to a 10% reduction in the TIM sharing factor by reducing their underspend by 10%. Although Ofgem considers this is a “high case” it seems much more plausible than the “low case” Ofgem considers where TOs achieve the same level of underspend despite the TIM sharing factor being lower.

For NGET the following calculations using the approach in Ofgem’s DD impact assessment illustrate how consumers are made worse off by the DD proposed lower sharing factor. Ofgem assumes a counterfactual TIM sharing factor for NGET of 46.9% (which is 53.1% for consumers). The DD proposes a TIM sharing factor for NGET of 39.2% (which is 60.8% for consumers). The DD baseline is £3,330m and Ofgem assumes a central case underspend of 7.5% or £247.5m. The table below shows how consumers are worse off.

Scenario	Consumer benefit
Counterfactual: Underspend of 7.5% of £3,330m TIM sharing factor for consumers of 53.1%	$£3,330m \times 0.075 \times 0.531 =$ £132.6m
DD proposal: Underspend of 7.5% of £3,330m reduced by change in TIM sharing factor of 0.392/0.469 (which Ofgem’s impact assessment calls mapping 1:1) TIM sharing factor for consumers of 60.8%	$£3,330m \times 0.075 \times 0.392/0.469 \times 0.608 =$ £126.9m

The table shows that consumers are worse off in the DD scenario with a lower sharing factor than in the counterfactual scenario with a higher sharing factor.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

Remedy for the TIM sharing factor

Ofgem should reconsider how it has calculated its TIM sharing factor for NGET and increase the sharing factor in the final determination. This will lead to increased benefits for consumers. Specifically:

1. Ofgem should classify as high-confidence costs those costs that will be in uncertainty mechanisms, consistent with Ofgem's own SSMD Guidance:
 - a. For automatic UMs agreed in advance, Ofgem should add a central estimate volume for automatic UMs to NGET's baseline to reflect these high-confidence costs being likely to occur in the T2 period.
 - b. For reopener UMs, Ofgem should include a central estimate of the costs that it will approve during the T2 period which should be added to NGET's high-confidence costs because they will have been subject to an Ofgem specific review.
2. Material allowances that have been approved already for the T2 period (Hinkley Seabank and Dorset VIP project) that are 'baseline costs' should be included in the calculation of the sharing factor as high-confidence costs.
3. Ofgem should drop its misplaced emphasis on econometric benchmarking as the primary approach to demonstrating that costs are high confidence.
4. For those costs that Ofgem continues to classify as lower-confidence, Ofgem should provide evidence to support its classification. This would allow us the opportunity to engage constructively with Ofgem between now and the Final Determinations.
5. Ofgem should increase its TIM sharing factor for NGET to nearer 50%, which will respond to stakeholders' concerns and reinstate an effective incentive to reduce costs for consumers.

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?

No comment.

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

This section covers our responses to Q35 (core document), Q37 (core document) and NGETQ8.

The Business Plan Incentive (BPI)

Summary

We strongly disagree with Ofgem's proposed assessment of NGET's business plan.

Ofgem's proposed penalty of £66.6m and disallowance of rewards under Stage 2 of the BPI is wholly disproportionate. This penalty is the largest Ofgem has applied to any energy company since Ofgem's records started in 2010; many of those penalties relate to instances of serious service failure rather than perceived shortcomings in business plan submissions. This penalty is completely out of line with previous penalties regulators have applied to business plan submissions and with the tone of Ofgem's methodology, business plan guidance and impact assessments.

Ofgem should change its assessment of NGET's business plan as we describe in the remedy section below because:

- There were flaws in the development of the BPI;
- The design of the BPI is flawed; and
- The application of the BPI to NGET is flawed.

Flaws in the development of the BPI

There were fundamental flaws in the development of the BPI. Ofgem changed the BPI profoundly in its sector-specific methodology decision (**SSMD**) that it published on 24 May 2019 from the version it had proposed in the sector-specific methodology consultation document (SSMC), and Ofgem did not consult on its new approach.

The BPI is supposed to incentivise network companies to produce ambitious plans, but Ofgem only published its new BPI five weeks before companies had to submit full draft business plans on 1 July 2019. Indeed, at an Ofgem working group on the BPI on 19 June 2019, Ofgem said it had “not yet determined the methodology” for stage 2 of the BPI.³

In its BPI, Ofgem took no account of the primary concern we raised in our March 2019 response to the SSMC. We asked that the BPI take account of what is proportionate for a company with thousands of assets and projects compared with companies with much smaller portfolios, but Ofgem's BPI has not done this.

We asked in our March 2019 response to the SSMC for Ofgem to set out the assessment criteria for the BPI with sufficient time for companies to address them in their business plans. However, Ofgem published its business plan guidance (BPG) five times on 28 September 2018, 21 December 2018, 3 June 2019, 9 September 2019 and 31 October 2019 along with open letters on 29 July 2019 and 8 August 2019. These changed the business plan requirements close to the submission dates of 1 July 2019, 1 October 2019 and 9 December 2019. A similarly inadequate process took place in respect of the Business Plan Data Templates. Nevertheless, we complied with Ofgem's BPG as it applied at the time of our draft and final business plan submissions in all material respects.

Having not just one, but two, draft business plan submissions provided Ofgem with plenty of opportunity to provide feedback if it had concerns with our business plan. In addition, we had frequent engagements with Ofgem in the process leading up to submitting our final business plan. At no point did Ofgem suggest that the information provided in NGET's draft plan fell short of the quality and completeness standards that the regulator had set.

The design of the BPI is flawed

The design of the BPI fails to deliver Ofgem's main objectives. Ofgem wants the BPI to:

- Encourage high-quality, ambitious and innovative business plans. The BPI has the opposite effect. The BPI discourages network companies from proposing ambitious or innovative approaches because Ofgem is more likely to classify them as low-confidence costs, remove them from the baseline cost allowances and apply a 10% Stage 3 penalty. Further, the large penalties under the BPI undermine the confidence of companies and investors in the stability and predictability of the regulatory regime

³ Ofgem, 'RIIO 2 Business Plan Incentive Workshop' presentation, 19 June 2019, slide 11.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

and encourage companies to focus on low-risk, non-ambitious schemes to avoid further unexpected penalties.

- Simplify the process of assessing business plans. The BPI has made the business plan process more onerous for companies by the introduction of an untested and theoretically unsound mechanism. NGET was required to submit a very large quantity of information in its business plan and accompanying Business Plan Data Templates (BPDTs), which it added to with a large amount of information in response to Supplementary Questions (SQs). Despite this, Ofgem's DD cites as the basis for failing NGET under Stage 1 of the BPI numerous categories of information which were not directly requested in the BPG or BPDTs, leaving companies to 'second guess' Ofgem's requirements.

Further evidence that the design of the BPI is flawed is that Ofgem's own impact assessment provides no evidence of the benefits of the BPI. Ofgem's impact assessment shows only that the penalties on companies are higher than they would have been under the previous approach (called IQI). Ofgem takes no account of its impact assessment that accompanied its SSMD, which identified implementation risk around new tools such as the BPI.

The design of the BPI is also flawed because it is heavily skewed towards penalties for transmission companies. Ofgem's proposed application of the BPI at the DD stage has resulted in net penalties for the four transmission companies of £140.2m, compared with a net reward of £0.4m proposed for the four gas distribution companies. The way in which Ofgem has designed the BPI is favourable to the gas distribution sector, and unfairly penalises transmission companies due to features of the sector which are beyond their control, namely: transmission companies have larger, less frequent, less standardised, less repeatable projects and there is more change happening in the transmission sector because of the large increase in renewable generation. Ofgem's approach has not taken appropriate account of sector-specific differences.

Ofgem's BPI prioritises one method of establishing cost efficiency, econometric industry benchmarking, over other methods. Ofgem does not use econometric analysis for the transmission companies because of the features of the sector mentioned above. However, econometric analysis for the gas distribution companies relies on only four companies, which will result in weak statistical properties and it is not clear why Ofgem considers this evidence is better than that provided by the transmission companies. Ofgem acknowledges this design flaw in its SSMD, accepting that the historical cost evidence transmission companies can provide, when a sector is undergoing significant change, might not be a good predictor of future costs.⁴ Before proposing to apply large penalties to all four transmission companies, Ofgem's BPI should have accounted for the difference in evidence that transmission companies can provide.

⁴ SSMD, paragraph 11.59.

The design of the BPI is also flawed because the wide discretion which Ofgem has reserved to itself for assessing what constitutes a complete and satisfactory quality plan is inconsistent with the principles of best regulatory practice, specifically the requirement that decisions must be transparent and accountable.

The application of the BPI to NGET is flawed

The Competition Appeal Tribunal has clearly established that penalties of the magnitude that Ofgem is proposing to apply to NGET are “*serious*” and that “*strong and convincing evidence will be required*” to justify them. Ofgem’s description of the alleged deficiencies in NGET’s business plan in its DD falls far short of this standard.

At Stage 1 (Minimum Requirements), Ofgem has wrongly applied the framework it set out in the BPG and SSMD to our business plan to provisionally conclude – incorrectly – that our business plan materially failed to meet the Minimum Requirements, and that this warranted failure against BPI Stage 1, leading Ofgem to propose a penalty of £16.7m. Ofgem has wrongly applied its framework at Stage 1 as follows:

- Ofgem wrongly concluded that our business plan materially failed to meet the Minimum Requirements. In many places, Ofgem’s reasoning was based on a failure to provide specific types of evidence that are not mentioned in the BPG, and which Ofgem had not specified were required elsewhere.
- Where a specific type of evidence was required under the BPG, Ofgem either misapplied its framework by imposing a higher standard than that specified as a Minimum Requirement in the BPG or failed to properly take into account the evidence that we submitted with our business plan.
- Ofgem did not take any account of the views of our Independent User Group in assessing whether the Minimum Requirements for Stage 1 have been met, despite this being required under the BPG.
- Even if Ofgem’s view was correct that our business plan did not meet certain Minimum Requirements, Ofgem should have concluded that this was not sufficiently material to warrant failure at Stage 1, and the imposition of a penalty.

At Stage 2 (consumer value proposition), Ofgem accepted only one of NGET’s nine Consumer Value Proposition (**CVP**) proposals (“Caring for the natural environment”) and moreover concluded that NGET was not eligible for a reward for this CVP proposal due to Ofgem’s Stage 1 decision. Ofgem’s DD only proposed to accept three CVPs across all network companies, with an up-front value of £3.2m, out of the 117 CVPs network companies submitted. This shows a serious failure on the part of Ofgem to effectively communicate its expectations to network companies. Ofgem has dismissed CVPs such as “Supporting local urban communities” that Ofgem’s RIIO-2 Challenge Group said stood out as offering additional benefit and appearing to have the support of stakeholders.⁵ Ofgem also rejected our CVP on “SO:TO optimisation”, which has the potential to deliver huge whole-system cost savings for consumers.

At Stage 3 (lower-confidence costs), Ofgem provisionally determined that we should be subject to a penalty of £179.6m, representing 10% of the value of the costs which Ofgem

⁵ RIIO-2 Challenge Group Independent Report For Ofgem On RIIO-2 Business Plans, 24 January 2020, page 124. Available at: https://www.ofgem.gov.uk/system/files/docs/2020/01/riio-2_challenge_group_independent_report_for_ofgem_on_riio-2_business_plans.pdf.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

judged to be lower-confidence and excluded from our baseline. We set out in our response to questions NGETQ11 to NGETQ16 why Ofgem should not have provisionally disallowed our cost proposals in the DD. The DD documents contain limited details on Ofgem's reasoning for reaching its provisional conclusion, which makes it difficult for us to provide a comprehensive response. However, Ofgem's main overarching criticism in the DD relates to our Engineering Justification Papers, which Ofgem criticised for being *"generally grouped by asset type (lead and non-lead), rather than project or site specific"*. We were deeply surprised that Ofgem should make this observation in the DD because during the business plan development process Ofgem confirmed that a portfolio-based approach would be acceptable. A 'portfolio' approach enables Ofgem to assess a large volume of assets at once, similar to the way that econometric analysis allows Ofgem to assess a large volume of assets in aggregate rather than individually.

Ofgem's approach appears to have been to apply a 10% penalty under Stage 3 of the BPI to all disallowed "lower-confidence" costs, without clearly carrying out a separate assessment of whether those costs were "poorly justified" or instead disallowed for other reasons. Ofgem has not provided us with its justification for the £179.6m Stage 3 penalty beyond a spreadsheet showing it has applied a 10% penalty to all disallowed "lower-confidence" costs. Ofgem has not provided us with a line-by-line assessment of each of the costs where it has applied the 10% penalty, nor its reasons for doing so. While this limits our ability to respond effectively to the DD consultation, we have set out in Table Q35.4 our best estimate of Ofgem's reasons for applying a Stage 3 penalty, together with our response. In each case, we explain why no Stage 3 penalty should be applied to these cost categories.

Stage 4 of the BPI (high-confidence costs), appears to have been an empty process designed to give the BPI the appearance of balance, with two reward stages to balance the two penalty stages. Ofgem applied no rewards to any of the eight network companies under Stage 4. Network companies had raised with Ofgem their concerns that there were no real rewards available under Stage 4 of the BPI at Ofgem's BPI workshop on 19 June 2019. These concerns unfortunately have not been addressed.

Remedy

To correct the flaws in the BPI described above, Ofgem's Final Determination (FD) should:

- Stage 1: Revise Ofgem's assessment for NGET from "fail" to "pass", to reflect the fact that NGET's business plan complied in all material respects with the Minimum Requirements under the BPG and remove in full the penalty of £16.7m;
- Stage 2: Apply the appropriate reward to NGET for the CVPs that NGET included in its business plan and which were supported by sound evidence of additional customer value;
- Stage 3: Remove in full the penalty of £179.6m for NGET which Ofgem imposed based on its erroneous view that certain of NGET's cost claims were poorly justified; and
- Stage 4: Apply a meaningful reward to those areas of NGET's costs that helped Ofgem with its cost assessment process.

1. Introduction

In this section we provide our response to Ofgem’s DD decision on the Business Plan Incentive (**BPI**), as set out in section 10 of the Core Document, and the NGET Company Annex. Table Q35.1 lists the Consultation Questions which are addressed in this section.

Table Q35.1: DD Consultation Questions on the BPI
<p>Core Document</p> <p>Q35 (Core document): Do you agree with our rationale for why NGET and NGGT should be considered to have failed Stage 1 of the BPI?</p> <p>Q37. (Core document): Do you agree with our overall approach regarding treatment of CVP proposals?</p>
<p>NGET Company Annex</p> <p>NGETQ8. Do you agree with our proposals on the CVPs? If no, please outline why.</p>

We strongly disagree with Ofgem’s proposed assessment of NGET’s business plan. The DD outcome is evidence of a failure of Ofgem’s Business Plan Incentive (**BPI**), given the quality of our business plan, which was subject to review by experienced external consultants, as well as significant internal assurance and approval processes. Moreover, given the emphasis which Ofgem put on stakeholder engagement, we focused our efforts in this area, and worked closely with the Independent User Group (**IUG**) to achieve a business plan which they ultimately were content to describe as “stakeholder-led”.⁶ We respond to the specific questions raised by Ofgem below and detail the material flaws in Ofgem’s analysis of NGET’s business plan in section 4.

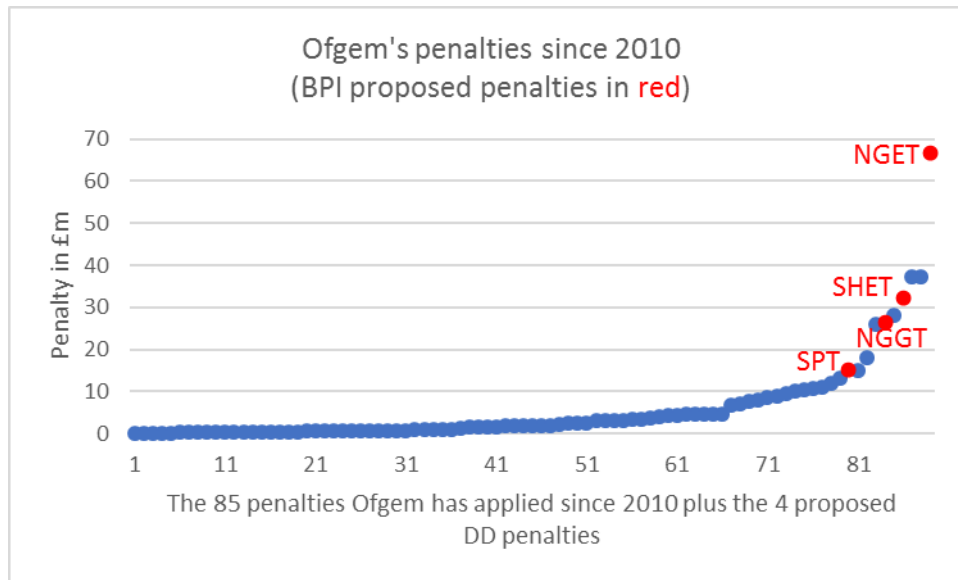
Ofgem’s proposed fine of £66.6m and disallowance of rewards under Stage 2 of the BPI is wholly disproportionate to the circumstances. The proposed imposition of such a material penalty in the absence of any compelling justification or properly reasoned submission is unacceptable.

Ofgem’s proposed BPI penalty for NGET of £66.6m is 78% larger than any penalty Ofgem has imposed on an energy company since its online records began in 2010. Those penalties related to instances of serious service failure or failure to comply with statutory obligations, rather than business plan submissions. **Figure Q35.1** below shows that the BPI has produced very large penalties for all four transmission companies and that they rank in the top 10 largest penalties Ofgem has imposed. It is not proportionate for Ofgem to impose a larger penalty in respect of alleged omissions from our business plan, than it has imposed on companies for serious service failure or failure to comply with statutory obligations.

⁶ RIIO-2 User Group Report National Grid Electricity Transmission, page 2. Available at: <https://isug.nationalgrid.com/files/NGET-User-Group-Report.pdf>

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

Figure Q35.1: Ofgem penalties imposed since 2010⁷



In the following sections we explain why Ofgem should change its assessment of NGET's business plan as we describe in the remedy section below because:

- There were flaws in the development of the BPI;
- The design of the BPI is flawed; and
- The application of the BPI to NGET is flawed.

In the final section we set out the remedy that is required for Ofgem to address these flaws with the BPI.

2. Flaws in the development of the BPI

a. Ofgem failed to consult properly on the development of the BPI mechanism

The BPI mechanism was first contemplated in the Framework Consultation in March 2018 as an alternative to the RIIO-1 Information Quality Incentive (IQI) which Ofgem stated was ineffective and "complex to understand and operate".⁸ Ofgem considered whether the mechanism could be adjusted or, alternatively, whether to retain a 'fast-track' approach for transmission companies.

In the combined NGET and NGG response to the SSMC, we considered both options to be flawed, citing the "complexity associated with [the] existing IQI" and the fact that "fast tracking has limited value in revealing an efficiency frontier in the Transmission sector due to the small number of companies of different scales as compared with distribution".⁹ We were in favour of the Constructive Engagement model to secure high quality plans that would be scrutinised in detail by informed stakeholders and thoroughly challenged on their efficiency. We emphasised that "the

⁷ Source: Ofgem, 'Investigations and enforcement data'. Available at: <https://www.ofgem.gov.uk/investigations/investigations-and-enforcement-data>.

⁸ Framework Consultation Document, paragraph 6.44.

⁹ Framework Consultation NGET/NGG Response to Q23-25, page 14.

independent reports resulting from this process will allow Ofgem to make an even more informed conclusion about the efficiency level within plans”.

It was disappointing that Ofgem felt unable to decide on an appropriate mechanism in its July 2018 Framework Decision and only decided to proceed with the BPI in the SSMD, published on 24 May 2019 – nearly a year later and, importantly, five weeks before we submitted our full draft business plan and seven months before the deadline for submitting final business plans. It is illogical that a mechanism designed to incentivise network companies to produce ambitious plans was made available only towards the very end of the business plan process.

To make matters worse, the BPI which ultimately emerged bore little resemblance to that consulted on in the Sector Specific Methodology Consultation (**SSMC**) published in December 2018. In particular, Ofgem failed to heed the **clear risks** we signposted in our response to the SSMD in March 2019.

First, we emphasised that Ofgem’s BPI needed to be **appropriately tailored so as to be able to account for NGET and NGG’s specific circumstances**:¹⁰

Ofgem should perform the BPI assessment separately for each sector with Ofgem assessing NGET and NGGT individually. NGGT is the sole operator within the gas transmission sector and so has no comparators. NGET represents over 70% of the RAV for the electricity transmission sector and comparison with other TOs would be distorted by its significant size and the different nature of its network.

NGET’s primary concern was that any mechanism which was designed for a ‘one size fits all’ application would put us at a material disadvantage given our size. In terms of what is **reasonable and proportionate**, a company with thousands of assets and projects cannot be expected to provide the same level of detail as a company with a much smaller portfolio, particularly within the time constraints that resulted from Ofgem’s delayed decision on the BPI and publication of the BPG. It would be more proportionate for NGET, but also Ofgem, to aggregate together similar assets so that they could be examined together. This approach would be consistent with Ofgem’s practice elsewhere: for example, Ofgem applies a similar approach when it uses econometric analysis of gas distribution companies’ asset portfolios, rather than looking at individual assets.

Second, we emphasised the need for Ofgem to set out the assessment criteria for the BPI with **sufficient time** for companies to address them in their business plans:¹¹

*You should **clearly set out the assessment criteria for the BPI as soon as possible** so that network companies have time to address them in their business plans.*

This was in circumstances where the first draft plans were due for submission on 1 July 2019. Our plan was very well developed by the first quarter of 2019. As we awaited Ofgem’s decision on the BPI, we sought to gain reassurances about the manner in which we were developing our plan. This included engaging in a series of meetings with Ofgem, which took place during February and March 2019, to ensure we understood Ofgem’s requirements. We felt confident following those discussions that our planned approach had Ofgem’s full support. We took care to emphasise the difficulties we would have in changing tack to the extent that Ofgem’s published requirements differed from those relayed to us in these critical meetings.

¹⁰ National Grid, Response to Ofgem’s RIIO-2 sector-specific methodology consultation - Cross-Sector, page 49.

¹¹ National Grid, Response to Ofgem’s RIIO-2 sector-specific methodology consultation - Cross-Sector, page 2.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

Third, we emphasised the need for the criteria for assessment to be clear so that the BPI might meet its objective of encouraging ambitious, well-justified plans:¹²

*The finalised BPI criteria should be **complete, unambiguous, objective and transparent**. The benefits of having clear criteria well in advance of network companies submitting their plans are that you will receive business plans that are closer to what you want companies to deliver for consumers. You will also receive more consistent business plans that are easier for you to assess. We suggest some ideas for assessment criteria for the BPI in our responses to the BPI questions in the appendix.*

We provided Ofgem with an illustrative list of 26 targeted questions that would promote transparency and reduce the risk of business plans being developed in a way that did not meet Ofgem's expectations.¹³ A few months later we were concerned about the clarity of the criteria because Ofgem had released two open letters on 29 July 2019 and 8 August 2019, the second of which introduced new Minimum Requirements for the BPI relating to pathways to achieve the UK's legislated target of net zero by 2050. Specifically, the 8 August 2019 letter stated that companies' business plans would have to meet the following additional Minimum Requirement:¹⁴

"In their Business Plans, networks will need to:

- identify where their baseline investment plan may impede the efficient achievement of any of these pathways, and*
- propose how their Business Plans can flex to address these impediments and facilitate timely investments which support potential pathways."*

We wrote to Ofgem on 23 August 2019 asking for clarification on these Minimum Requirements.

Fourth, we re-emphasised the importance of **independent scrutiny by informed stakeholders**, urging that Ofgem's assessment of the quality of network company plans should take account of the views of network companies' IUGs and the Ofgem RIIO-2 Challenge Group on those plans.¹⁵

There is no evidence that Ofgem took these views into account in the SSMD, although it made several changes to the design of the BPI which had not previously been consulted upon:

- Stage 1: as previously, companies found not to have complied with the minimum requirements would be subject to a penalty, although instead of being linked with Stage 4 of the BPI, this would be fixed at 0.5% of allowed baseline totex.¹⁶
- Stage 2: rather than categorising companies based on the ratio between their submission and Ofgem's view of costs, companies could bid for a reward based on CVPs.
- Stage 3: rather than categorising companies based on a qualitative assessment of the plan, Ofgem would assess whether any lower-confidence baseline costs which had been removed from companies' plans had been poorly justified, in which case Ofgem would apply a penalty of 10% of the value of those poorly justified costs.
- Stage 4: rather than applying a penalty / reward based on the company's rating on costs and quality under Stages 2 and 3, Ofgem would offer a reward to companies that had submitted

¹² National Grid, Response to Ofgem's RIIO-2 sector-specific methodology consultation - Cross-Sector, page 2.

¹³ National Grid, Response to Ofgem's RIIO-2 sector-specific methodology consultation - Cross-Sector, pages 50 to 51.

¹⁴ Ofgem, Letter to Network Companies and System Operators, 8 August 2019.

¹⁵ National Grid, Response to Ofgem's RIIO-2 sector-specific methodology consultation - Cross-Sector, page 49.

¹⁶ Sector Specific Methodology Decision, Core Document, paragraph 11.46.

forecasts lower than a benchmark that Ofgem would otherwise have used in setting the allowance.

Despite these changes, no further opportunity was afforded to comment on the design of the mechanism or its proposed application. Neither the SSMD, nor the various iterations of the BPG (further described below) adequately addressed our concerns that the assessment criteria for the BPI should be tailored to NGET's business; be provided in a timely fashion; set out clearly and unambiguously in advance; and that Ofgem's assessment should take proper account of the views of network companies' IUGs.

b. Business Plan Guidance Iterations

Ofgem first published its BPG on 28 September 2018. The BPG has since been revised several times, with updated versions published on 21 December 2018, 3 June 2019, 9 September 2019 and 31 October 2019. Ofgem also published open letters on 29 July 2019 and 8 August 2019, the second of which introduced new Minimum Requirements for the BPI relating to pathways to achieve the UK's legislated target of net zero by 2050, which introduced uncertainty as to whether the Minimum Requirements set out in the most recent version of the BPG were exhaustive. Network companies meanwhile were required to submit full drafts of their business plans on 1 July 2019 and 1 October 2019, before submission of the final plan on 9 December 2019. The result of this timeline was that network companies were constantly faced with changes to Ofgem's proposed approach for assessing business plans. This was a highly iterative process, where there was very little guidance from Ofgem and only a short time to review and reflect on the updated guidance before the next deadline for submission of the draft or final business plan.

For example, the version published in October 2019 came less than six weeks before the submission of the final plan, while the version published in June 2019 came less than four weeks before the first submission of the draft business plan. NGET's business plan covered a five-year period, thousands of assets, over £7.1bn of proposed expenditure and involved engaging with over 1,000 individuals representing our main stakeholders. By the time the revised 31 October 2019 version of the BPG was published, NGET had begun the final verification and governance approval process, and there was very limited scope to make amendments to the business plan. In any event, the limited information provided in the BPG meant it was often not evident what changes, if any, were required given the lack of clear prescription as to the way in which Ofgem intended to approach its assessment.

Network companies raised many of our concerns with the BPI at Ofgem's BPI workshop on 19 June 2019, although Ofgem did not make any changes to the BPI in response to the concerns network companies raised.

In relation to Stage 1: Network companies raised concerns about the "cliff edge", binary nature of the 0.5% of totex penalty at Stage 1 and raised scaling the penalty by the nature of the failure as an option. Ofgem responded by saying it was not expecting any companies to incur this penalty as the standard applied would not be a "high bar", but "a reasonably-set bar". Attendees also suggested that some of Ofgem's criteria were ambiguous, although Ofgem disagreed. Ofgem also said explicitly that it would not help network companies by identifying any deficiencies in their draft plans against the Minimum Requirements. If Ofgem was not prepared to make any efforts to assist companies to improve their business plans, this begs the question of why Ofgem included two rounds of business plan submissions in the RIIO-2 process. Moreover, Ofgem's refusal to give adequate feedback on draft business plans amounts to a breach of the principles of best regulatory practice, which require the regulator to be **transparent** and **consistent** in its dealings with companies.

In relation to Stage 2: Ofgem stated that it had yet to determine the methodology it would use to calculate the reward for CVPs. Ofgem said it had intentionally left it open to companies to explain their CVPs. Ofgem wanted us, wherever possible, to include a quantification of the proposed

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

benefits, but recognised this can be hard. Ofgem's admission that it did not have a methodology for a key Stage of its BPI less than two weeks before companies were due to submit full drafts of their plans is yet another example of the inadequacy of Ofgem's process.

In relation to Stage 3: one company repeated the point it had made before that it is harder for a transmission company to show its costs are high confidence because there are fewer comparators than for distribution companies. Ofgem clarified that Stage 3 did not mean that all costs removed from company forecasts would be subject to the 10% penalty. For example, Ofgem would not apply a penalty if it removed costs from a totex forecast into an uncertainty mechanism.

In relation to Stage 4: Several attendees argued that there was no real reward for companies in Stage 4. Following an explanation from Ofgem most attendees thought these benefits were marginal compared with the risk a company takes submitting lower-than-benchmark costs.

A similarly inadequate process took place in respect of the BPDT, which companies were required to complete and return to Ofgem to ensure data was collected on a consistent basis. The BPDT were first issued in March 2019, following which Ofgem revised and republished new versions several times, with the final versions issued in September 2019 to be completed and submitted with the final business plan submission.¹⁷

The numerous iterations of the draft business plan and completed BPDT provided Ofgem with plentiful opportunity to test whether the BPDT were sufficient to capture the information it needed to accurately assess the quality of network companies' business plans. Indeed, the BPG states that Ofgem would *"use the data collected from the draft BPDTs and supporting documents (including engineering justifications and CBAs) to test whether we have all the information we require for our cost assessment and to enable us to further develop our approach to assessing efficient costs."*¹⁸ When submitting the final version of our business plan in December 2019, we were careful to ensure that all of the information which had been requested in the final version of the BPDT was provided: this was an integral element of our pre-submission assurance process for the business plan. It therefore came as a significant surprise to NGET that Ofgem's DD asserted that our business plan had not met the Minimum Requirements under the BPG, based on an alleged failure to provide sufficient information in respect of specific baseline cost categories.¹⁹ Ofgem is now asserting that information should have been provided that was not requested in the BPDT, nor expressly referred to in the BPG (this is further discussed in section 0 below).

This discrepancy between Ofgem's provisional view in the DD and NGET's expectations arising out of engagement prior to submission of the business plan represents a serious failure on the part of Ofgem to carry out its process in accordance with the principles of **consistency** and **transparency** under the Principles of Better Regulation.²⁰ Failure to have due regard to these principles also constitutes a breach of Ofgem's statutory duties under s.3A(5A) of the Electricity Act 1989, which requires Ofgem to have regard to *"the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed"*.²¹ Several elements of the design and application of the BPI in the DD fail to meet the standard set by these principles:

Proportionality (*Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised*): The scale of Ofgem's

¹⁷ BPG (October 2019), paragraphs 3.18; 3.20

¹⁸ BPG (October 2019), paragraph 3.19.

¹⁹ DD Core Document, paragraph 10.39.

²⁰ Better Regulation Task Force, 'Principles of Good Regulation'.

²¹ Electricity Act 1989, s.3A(5A)

proposed penalties under the BPI at DD stage is out of all proportion to past regulatory practice in relation to business plan submissions.

Accountability (*Regulators must be able to justify decisions, and be subject to public scrutiny*): Ofgem's decision to impose a Stage 3 penalty is insufficiently reasoned, because no information is given for why certain disallowed costs are judged to be "poorly justified"; Ofgem's justification for imposing a Stage 1 penalty includes a supposed failure to provide information which was not expressly requested.

Consistency (*Regulation should be predictable in order to give stability and certainty to those being regulated*): Ofgem's failure to fully specify the information it required to assess business plans as high quality under Stage 1 in published guidance undermines the stability and predictability of the regulatory regime.

Transparency (*Regulators should be open, and keep regulations simple and user-friendly*): Given the significant changes made to the BPI after the SSMC (which were not part of the consultation), Ofgem failed to consult effectively. Ofgem similarly failed to provide adequate support to companies in the way of clear guidance on the elements required for a business plan to be considered high quality at Stage 1. At no point did Ofgem indicate that it considered our business plan was in danger of failing to comply with Stage 1.

Targeting (*Regulation should be focused on the problem, and minimise side effects*): If the aim of Ofgem's BPI was to incentivise companies to submit high-quality and ambitious business plans, then the DD fails to achieve this by penalising companies for proposing ambitious and innovative solutions because they are not in line with Ofgem's preferred lowest cost (and lowest output) option.

c. Ofgem feedback on draft business plans

As described above, the RIIO-2 process required network companies to submit two full drafts of the business plan to Ofgem on 1 July and 1 October 2019, prior to submission of the final business plan in December 2019. We worked hard to successfully meet those deadlines, and consequently Ofgem had ample time in advance of the DD to review our draft business plan and consider whether any information was missing for it to be considered high quality.

While we recognise that it is the company's role, rather than Ofgem's, to propose a high-quality and ambitious business plan, in light of the serious implications of failing Stage 1 of the BPI and the Stage 3 penalties, it was incumbent on Ofgem to set out its expectations clearly in the BPG and feedback sessions. Moreover, it is clearly in the interests of the regulator and customers that companies are enabled, by clear and unambiguous guidance, to submit plans which are ambitious in proposing efficient costs. Despite repeated engagement in the process leading up to submission of the final business plan, at no point did Ofgem suggest that the information provided in NGET's draft plan fell short of the quality and completeness standards which the regulator had set. Nor did Ofgem indicate that further information needed to be provided for NGET's business plan to be considered high-quality and thus avoid an up-front penalty under Stage 1 of the BPI.

Further, after we submitted our business plan, our engagement in the multiple rounds of supplementary questions mentioned in the DDs was highlighted as positive by the Ofgem senior leadership team.

d. Draft Determination

Under the DD, Ofgem has broadly retained the version of the BPI which was set out in its SSMD. Ofgem's high level explanations for provisionally deciding that NGET did not pass Stage 1 and

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

refusing to allow totex (which impacts the penalty applied at Stage 3) is not commensurate with the requirement for Ofgem to provide strong and compelling evidence prior to imposing a fine of the magnitude of the proposed penalty under the BPI.

In addition to the concerns we have set out above in relation to Ofgem's flawed consultation process for the BPI, we consider that Ofgem has committed serious errors in respect of the overall design of the BPI, and in the way it has been applied to NGET at the DD stage. These are set out in sections 3 and 0 below.

3. The design of the BPI is flawed

a. The BPI fails to achieve Ofgem's stated objective

In its SSMD, Ofgem set out three main aims of the BPI. First, to “encourage high-quality and ambitious Business Plans” and “achieve benefits for consumers”.²² Second, to “simplify[...] the process of assessing Business Plans”²³ by replacing the IQI mechanism which was used during RIIO-1, and which Ofgem described as “a complex and often misunderstood incentive mechanism”.²⁴ Third, to ensure that the information-revealing device would not “discourage companies from being ambitious, or from including innovative and new approaches to improve network services.”²⁵

The proposed application of the BPI by Ofgem in the DD would result in the BPI failing to meet these three objectives.

First, the version of the BPI which Ofgem included in the DD will not achieve benefits for consumers. The immediate impact of the BPI will be to undermine the confidence of companies and investors in the stability and predictability of the regulatory regime and to encourage companies to focus on low-risk, non-ambitious schemes to avoid further unexpected penalties. This will be to the detriment of consumers.

NGET is experienced in scoping investments and developing business plans. As Ofgem recognised when publishing its consultation on the RIIO-2 Framework Consultation in March 2018: “a stable regulatory regime allows companies to attract investment from around the world on behalf of consumers in Great Britain at the lowest cost.”²⁶ Anything which undermines investors' confidence in the stability of the regime will tend to increase the cost to consumers of running the energy networks in the long run.

The DDs impose substantial penalties under the BPI on transmission companies, amounting to £286.6m prior to the application of the $\pm 2\%$ of allowed totex cap (and a still substantial £140.2m after application of the cap).²⁷ These penalties have the effect of further reducing companies' baseline funding, with no corresponding reduction in the outputs which companies must provide during the RIIO-2 period. The result of these penalties (which are applied to Ofgem's view of efficient costs) is therefore to effectively reduce the amount of funding available to deliver stakeholders' and consumers' key priorities, given that investors' returns have already been significantly reduced, which cannot be in customers' interests.

²² SSMD, paragraph 11.43.

²³ SSMC, Section 9 “Simplifying Business Plan assessment”.

²⁴ SSMD, paragraph 11.32.

²⁵ SSMD, paragraph 11.61.

²⁶ Ofgem, 'Ofgem proposes new regulatory framework for network companies', 7 March 2018.

²⁷ DD Core Document, Table 15.

Second, the BPI mechanism and process which Ofgem has adopted in the DD has clearly not achieved the stated aim of *“simplifying the process of assessing Business Plans”*. The business plan process has in fact been made more onerous on transmission companies by the introduction of an untested and theoretically unsound mechanism. NGET was required to submit a very large quantity of information in its business plan and accompanying BPDTs, in addition to the additional information submitted to Ofgem subsequently in response to Supplementary Questions (**SQs**). This information was all subject to rigorous verification and internal audit processes, which used up an enormous amount of company resource. In spite of this, Ofgem’s DD cites as the basis for failing NGET under Stage 1 of the BPI numerous categories of information which were not directly requested in the BPG or BPDTs. A process which therefore leaves companies to ‘second guess’ Ofgem’s information requirements cannot be described as a simplification.

Third, the BPI mechanism will have the effect of strongly discouraging network companies from proposing ambitious and innovative approaches that could lower costs and improve service quality in future, to the detriment of consumers. Ofgem’s BPI is much more likely to categorise such proposals as lower-confidence costs and also to exclude them from the baseline. Such costs proposal are subjected to a 10% penalty under Stage 3 of the BPI where Ofgem judges them to be “poorly justified”.²⁸ However, Ofgem provided scant information on how it proposed to assess whether lower-confidence costs were in its view “poorly justified”, merely noting in the DD that *“we have taken account of the information provided by the companies to support both the forecast levels of activity and the forecast costs of undertaking that activity.”*²⁹ Ofgem’s DD proposal of issuing £286.6m of penalties under the BPI (before application of the caps) to transmission companies compared to proposing only one reward, which was only £1.6m, will stand as a stark warning to companies against proposing innovative approaches to improve network services. We would expect the electricity distribution network owners (DNOs) to learn the obvious lesson from the BPI and reconsider which projects they submit as part of their business plans. Understandably, the effect of the large penalties under the BPI will encourage companies to focus on minimising penalties by excluding innovative or new schemes to benefit consumers or stakeholders that Ofgem might penalise for having lower-confidence costs. Ofgem’s flawed approach in this area is strongly reminiscent of Ofwat’s historic approach. The Gray Review in 2011 said that *“More generally, we are sympathetic to the suggestion that the balance of risk and reward is tilted too far towards uncertain and potentially large penalties for failure, with relatively limited rewards for outperformance or innovation.”*³⁰ In focussing on penalties for failure ahead of incentives to innovate and outperform, Ofgem risks making the same errors that were identified in Ofwat’s approach ten years ago.

Ofgem has attempted to replace the constraints of the IQI framework with an assessment process that affords it wide discretion, but which gives insufficient guidance and certainty to TOs. Ofgem has failed to acknowledge that, in light of the significant penalties applicable under the BPI, Ofgem cannot reserve to itself broad discretion in the application of the BPG. To do so would be inconsistent with Ofgem’s statutory duties.

b. The method of calculating rewards / penalties under the BPI is unfairly negatively skewed / inconsistent with the supposed ‘incentive’ nature of the scheme

In the SSMD, Ofgem emphasised the incentive qualities of the BPI, and that companies would have a real opportunity to earn rewards. For example, Ofgem stated: *“We believe that all companies should [be] able to meet the minimum requirements, thereby avoiding a penalty at Stage 1 and becoming eligible for a reward under other elements of the BPI.”*³¹ This was reinforced by the symmetric cap and collar on the BPI and the symmetric number of reward and penalty stages in the BPI. Ofgem’s emphasis gave companies a reasonable expectation that the BPI would not

²⁸ SSMD, paragraph 11.66.

²⁹ DD Core Document, paragraph 10.92.

³⁰ ‘DEFRA, Review of Ofwat and consumer representation in the water sector’, page 30.

³¹ SSMD, paragraph 11.69.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

impose a significantly higher standard of evidence than companies routinely face in their dealings with the regulator. In other words, providing companies prepared their business plans in good faith, and with customary diligence, the BPI would not be expected to result in substantial penalties.

Therefore, Ofgem's clear expression of the Stage 1 process as an assessment against "*minimum requirements*", indicated that the threshold for passing the assessment would not be unduly high. This was reinforced at the 19 June 2019 Ofgem workshop on the BPI when attendees pushed back against the binary, cliff-edge nature of the Stage 1 penalty and Ofgem said that it was not expecting any companies to incur the Stage 1 penalty because it was not a "high bar", but "a reasonably-set bar". More than this, it is not open for Ofgem to impose a high barrier to passing the Stage 1 assessment given the high penalties for non-compliance and the lack of clear requirements for passing Stage 1.

Moreover, if at any point in the process Ofgem became concerned at the quality of a company's business plan drafts, such that it considered penalties at DD stage foreseeable, it was incumbent on Ofgem to state its concerns openly with companies, in an attempt to resolve the issues, notwithstanding its comment at the 19 June 2019 BPI workshop that it would not help network companies by identifying any deficiencies in their draft plans against the Minimum Requirements. Proposing to impose penalties at the DD stage without prior warning is inconsistent with the SSMD and Ofgem's duties.

Ofgem's proposed approach in the SSMD also emphasised a balance between the penalties and rewards on offer under the BPI. The BPG also suggested that the primary incentive factor would be the potential to earn rewards rather than the need to avoid penalties: "*The purpose of the BPI is to drive benefits for consumers by rewarding companies for plans that offer consumers additional benefits and value for money.*"³² However, in applying the BPI to transmission companies, Ofgem has proposed to impose £286.6m of penalties under Stages 1 and 3 (before application of the caps), against rewards of only £1.6m under Stage 2 (and no rewards at all under Stage 4). This extraordinary imbalance runs completely contrary to Ofgem's representations about the purpose and expected result of the BPI throughout the consultation process to date. Furthermore, in respect of rewards under Stage 2 of the BPI, despite "*recognis[ing] the significant effort that companies made to prepare CVP proposals*"³³ and "*commend[ing] some of the activities proposed*",³⁴ Ofgem's DD only proposed to accept three CVPs, with an up-front value of £3.2m, out of the 117 CVPs network companies submitted and rejected many CVPs that its independent RIIO-2 Challenge Group had considered were promising.³⁵

Ofgem's proposal to apply a cap of 2% of allowed totex to the BPI penalty is disproportionately high, and allows for penalties higher than Ofgem has applied to any company for the last ten years and higher than Ofgem or other regulators have applied following business plan assessments. For example, during Ofwat's PR19 price control in the water sector (which was generally acknowledged to impose a challenging settlement on companies), Ofwat did not apply any upfront penalties to companies in its lowest of 4 business plan assessment categories (so-called "significant scrutiny" companies), but instead focused on getting those companies to improve their plans to benefit consumers.

c. The BPI is unfairly punitive for transmission companies

³² BPG (October 2019), paragraph 5.2.

³³ DD Core Document, paragraphs 10.65.

³⁴ DD Core Document, paragraphs 10.66.

³⁵ Three additional CVPs, including one submitted by NGET and two by NGGT, would have qualified for a reward, but were discounted due to Ofgem's decision that these companies failed Stage 1.

It is notable that Ofgem’s proposed application of the BPI at the DD stage has resulted in net penalties imposed on transmission companies of £140.2m, compared with a net reward of £0.4m provided to gas distribution companies. The reasons for this significant discrepancy are not coincidental: it is not the case that transmission companies simply happen to have submitted poorer-quality business plans than gas distribution companies. Rather, the way in which Ofgem has designed the BPI is favourable to the distribution sector, and unfairly penalises transmission companies due to features of the sector which are beyond their control, namely: transmission companies have larger, less frequent, less standardised, less repeatable projects and a sector where there is more change happening because of the large increase in renewable generation. In taking this approach, Ofgem has prioritised a blanket sector-agnostic view, rather than appropriately taking account of sector-specific differences.

The basic cause of this imbalance is Ofgem’s approach to costs assessment, and specifically its prioritisation of one method of establishing cost efficiency, namely econometrics, over other methods.³⁶ Ofgem only uses econometric analysis for a small subset of transmission companies’ costs because of the features of the sector mentioned above, and this wrongly leads Ofgem to conclude that a high proportion of transmission companies’ submitted costs are “poorly justified” and/or “lower-confidence”. First, econometric analysis for the gas distribution companies relies on only four companies, which will result in weak statistical properties due to the low number of data points, and this undermines Ofgem’s preference for econometric benchmarking.³⁷ In respect of the electricity transmission sector, although there are three companies, NGET and the two Scottish TOs, given the significant differences in scale and network characteristics between the former and the latter, it is much more difficult to benchmark costs between them, for example, because the Scottish TOs have very few 400kV lines compared with NGET and have more radial, less-integrated networks than NGET.³⁸ Second, costs in the distribution sectors can be effectively benchmarked as they are often highly frequent, repeatable activities, whereas, as noted above, companies in the transmission sector have larger, less frequent, less standardised, less repeatable projects.

Ofgem acknowledged this issue, and recognised that transmission companies would find it harder to evidence the efficiency of their cost proposals under its RII0-2 approach, during Ofgem’s DD transmission owners’ workshop which took place on 27 July 2020. This is also implicitly acknowledged in Ofgem’s SSMD, where Ofgem stated “*It may be the case, for example in areas of significant change, that historical costs are not a good predictor of future costs.*”³⁹ Ofgem should have gone one step further and recognised that transmission companies are far more likely to need to undertake projects which significantly differ from historical projects, and therefore this method of establishing independent benchmarks of cost efficiency would not be available to them for all but a small subset of their costs. If it had done this, Ofgem would have realised the need to adjust its approach to assessing cost efficiency to treat transmission companies fairly. Ofgem recognises this issue explicitly in the DD:

“We recognise that we have assessed a significantly higher proportion of costs in the Gas Distribution sector as high-confidence costs compared to the Electricity and Gas Transmission sectors. This reflects differences between the sectors in the availability of independent cost benchmarks. The industry structure of the Gas Distribution sector makes it easier to construct independent cost benchmarks, whereas this is not always possible in the Electricity and Gas Transmission sectors. However, in our BPG, we set out a number of ways

³⁶ Other methods are available for assessing the efficiency of submitted costs, including comparison to historic RII0-1 baseline costs, and separate assessment of unit cost and volume drivers. See DD Core Document, paragraph 11.37.

³⁷ Ofwat has commented on the weakness of its econometric models relying on ten sewerage companies in PR19

³⁸ NGET represents over 70% of the RAV for the electricity transmission sector. We made this point our Response to CSQ65. of the SSMC.

³⁹ SSMD, paragraph 11.59.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

*in which companies can support a high-confidence assessment by providing information in their Business Plans.*⁴⁰

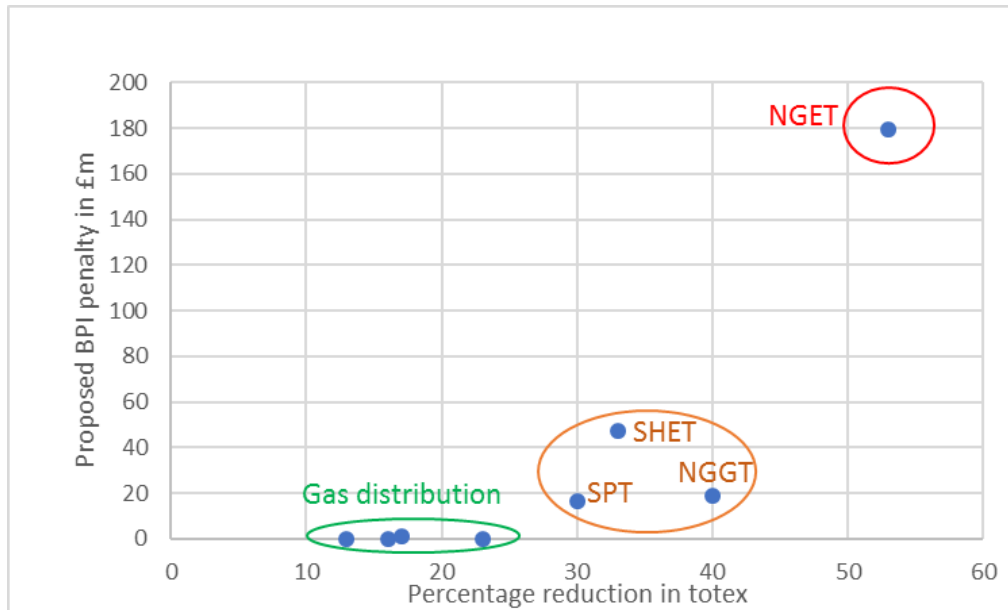
Ofgem's suggestion that transmission companies were not significantly disadvantaged by its reliance on econometric evidence is false. Due to the way in which Ofgem's BPI mechanism repeatedly privileges econometric evidence over other methods of establishing costs efficiency, transmission companies are penalised three times over:

- First, it is more difficult for transmission companies to prove that they have met the Minimum Requirements under the BPI Stage 1 assessment, making them more likely than distribution companies to face a Stage 1 penalty (see section 0 below for analysis of Ofgem's flawed approach to applying the BPI to NGET).
- Second, it is more difficult for transmission companies to establish that their costs proposals should be treated as high-confidence costs. This means that a higher proportion of costs will be subject to review for a Stage 3 penalty as lower-confidence costs, and a lower proportion of costs will be eligible for review for a Stage 4 reward, under the BPI.
- Third, where costs are deemed lower-confidence costs by Ofgem, it is harder for transmission companies to establish that those costs are justified, and thus avoid their removal from the baseline allowance, and also that they are not "poorly justified", and thus avoid the penalty of 10% of their value under Stage 3 of the BPI.

Figure Q35.2 below also shows how Stage 3 of the BPI is unfairly punitive for transmission companies. The four gas distribution companies are subject to proposed penalties of only £1.1m in respect of Ofgem reductions in their totex of 13% to 23%. By contrast, transmission companies, which are subject to incrementally higher Ofgem reductions in their totex of between 30% and 53%, face significant Stage 3 penalties, ranging from £16.6m to £179.6m. This graph shows that although gas distribution companies are subject to significant totex reductions, they face barely any Stage 3 penalties, whereas the transmission companies face significant Stage 3 penalties which are out of all proportion to their level of totex reduction, which in some cases is only marginally larger than that of gas distribution companies. In other words, the fact that the size of the Stage 3 penalty rises exponentially in the graph below once a totex reduction level of 23% is exceeded shows that Stage 3 of the BPI is unfairly punitive for transmission companies, and NGET in particular.

⁴⁰ DD Core Document, paragraph 10.24.

Figure Q35.2: Relationship between amount of reduced totex and size of the Stage 3 penalty (before the application of caps to NGET and SHET)



Gas distribution companies have also been favoured by Ofgem’s introduction of a materiality assessment under Stage 1 of the BPI. This change was introduced in the DD, and had not been anticipated or consulted on during the SSM consultation process.⁴¹ Ofgem stated that their materiality assessment “took account of the number and nature of the Minimum Requirements that were not met and the impact that the gaps have had on the completeness and quality of the Business Plan”.⁴² This change marks a significant departure from the BPI set out in the SSMD, reinforced by Ofgem at the 19 June 2020 BPI workshop, which noted that the Stage 1 assessment was “binary, in the sense that companies will either pass or fail”.⁴³ The introduction of a materiality assessment coincided with Ofgem’s provisional finding that two gas distribution companies, Cadent and NGN, had not met the Minimum Requirements, and enabled Ofgem to conclude that despite this, those companies should not face a Stage 1 penalty. The materiality assessment appears to have been introduced in order to insulate gas distribution companies from penalty under Stage 1, and is further evidence that the BPI is unfairly punitive for transmission companies.

d. NGET did not have sufficient opportunity to comment on the flawed design of the BPI

As detailed in Section **Error! Reference source not found.** above, we responded to Ofgem’s SSMC with several concerns about the form of the BPI which Ofgem was proposing at that point. The flaws in Ofgem’s chosen design of the BPI which are described in this Section only became apparent subsequent to our response to the consultation, either when Ofgem’s SSMD was published in May 2019, or else when Ofgem’s DDs were published in July 2020, and the manner in which Ofgem proposed to apply the BPI became fully apparent. We and other network companies raised some concerns about the design of the BPI at the 19 June 2019 Ofgem BPI workshop but Ofgem did not alter its BPI design in response to this feedback. This response to the DD is therefore our first formal opportunity to point out the flaws in Ofgem’s proposed approach.

⁴¹ DD Core Document, paragraph 10.34.

⁴² DD Core Document, paragraph 10.34.

⁴³ SSMD, Core Document, paragraph 11.68.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

4. The application of the BPI to NGET is flawed

Ofgem's proposed BPI assessment does not meet the relevant standard of proof or the evidential burden it must discharge. Ofgem has only set out high level guidance on its BPI assessment and provided only cursory statements of its concerns with NGET's business plan. This is not commensurate with the penalty proposed by Ofgem, which amounts to 2% of allowed totex over a five year period. The Competition Appeal Tribunal has clearly established that penalties of this magnitude are "serious" and that "*strong and convincing evidence will be required*". Indeed, the CAT considered that "*whether we are, in technical terms, applying a civil standard on the basis of strong and convincing evidence, or a criminal standard of beyond reasonable doubt, we think in practice the result is likely to be the same*".⁴⁴ Ofgem's summary in the DD of the alleged deficiencies in NGET's business plan fall far short of this standard.

Moreover, Ofgem has failed to articulate the assessment criteria for the BPI. This is particularly the case for the Stage 1 assessment, where Ofgem made it clear that "*all companies should be able to meet the minimum requirements*".⁴⁵ In failing to set out the criteria for assessment and not providing adequate feedback on NGET's draft business plans, Ofgem has not met its duty to act transparently and in a proportionate manner.⁴⁶

a. Stage 1

During its Stage 1 assessment, Ofgem has wrongly applied the framework it set out in the BPG and SSMD to our business plan. This has resulted in Ofgem provisionally concluding – incorrectly – that our business plan materially failed to meet the Minimum Requirements, and that this warranted failure against BPI Stage 1, in respect of which Ofgem imposed a penalty of £16.7m.

Our response to Ofgem's full reasoning for its Stage 1 decision is set out in **Annex NGET CORE Q35 Q38 BPI Section Annex**, but we summarise below the various types of error which Ofgem has made in its provisional Stage 1 application of the BPG:

1. Ofgem wrongly concluded that our business plan materially failed to meet the Minimum Requirements. Ofgem's reasoning included a failure to provide specific types of evidence which are not mentioned in the BPG, and which Ofgem had not specified elsewhere.
2. Where a specific type of evidence was required under the BPG, Ofgem either:
 - a. Misapplied its framework by imposing a higher standard than that specified as a Minimum Requirement in the BPG. For example, in respect of OHL Conductors and Fittings Ofgem provisionally concluded that our business plan "*did not consider all credible options*"⁴⁷ (emphasis added), under paragraph 3.10 BPG. This is a materially higher standard than that actually imposed by paragraph 3.10 BPG, which merely requires that companies provide "*consideration of options*";⁴⁸ or
 - b. Failed to properly take into account the evidence that was actually submitted with our business plan. For example, in respect of Circuit Breakers and Bays Ofgem provisionally concluded that our business plan did not explain "*why the critical age [for*

⁴⁴ CAT, Hutchison 3G UK Ltd v Office of Communications [2008] CAT11, paragraphs 107 to 108.

⁴⁵ SSMD, paragraph 11.69.

⁴⁶ Section 3A(5A) Electricity Act 1989.

⁴⁷ DD NGET Annex, page 102.

⁴⁸ BPG (October 2019), paragraph 3.10.

*intervention] is 50 years for bay equipment*⁴⁹ under paragraph 3.12 BPG. However, our business plan was clear that this was due to the definition in internal policy statement PS(T) EPS 12.06, which we have shared with Ofgem.⁵⁰

3. Despite clearly stating in the BPG that it would take account of the views of IUGs in assessing whether the Minimum Requirements for Stage 1 have been met,⁵¹ we have seen no evidence that this has occurred. In fact, Ofgem’s provisional conclusion that our business plan fails Stage 1 of the BPI runs contrary to our IUG’s conclusion that:

*“...the extent and quality of justification provided [in NGET’s business plan] is generally good, that cost proposals are generally robust and that NGET has presented a reasonable approach to ensuring that the plan is at an efficient level.”*⁵²

4. In some areas, Ofgem requested detailed additional information which was not specified in the BPG via the SQ process. We complied with these requests promptly and in full. This is also reflected by feedback from our IUG that *“The quality, timeliness and relevance of information received from NGET has been consistently good, delivered responsively, and in line with the Group’s expectations.”*⁵³ Where such additional information was provided, it is neither reasonable nor proportionate for Ofgem to conclude that failure to provide the information in the original business plan submission amounts to a Stage 1 material failure under the BPI.

Ofgem’s summary reasoning from the DD Core Document for why the business plan failed to meet the Minimum Requirements, together with our response, is set out in **Table Q35.2** below. For these reasons, Ofgem’s FD should revise its provisional Stage 1 decision from fail to pass. Annex **Annex NGET_CORE_Q35_Q38_BPI Section Annex** provides our detailed response to Ofgem’s full Stage 1 reasoning which was set out in Appendix 4 of the NGET DD Annex.

Table Q35.2: Summary of NGET Response to Ofgem Stage 1 BPI Provisional Decision		
BPG Paragraph	Ofgem’s Reasoning ⁵⁴	NGET Response
3.10	For c.£1bn of its proposed asset health led interventions, NGET has proposed methodologies without the background calculations, or a sufficient explanation of why the volume of intervention varies from historical volumes and cost. This Minimum Requirement said that “we expect companies to explain their costs/workload forecasts, particularly where these diverge from historical trends.”	Ofgem is wrong to question the sufficiency of the information provided in the business plan, which amply explains the costs and workload forecasts; Ofgem has overlooked information provided by NGET which explains variation to historical volume and cost; where Ofgem criticises NGET’s optioneering, this is an unsound assessment because NGET’s business plan explained why certain options were considered and others excluded.
3.12	Evidence supporting the asset health condition inputs has not been provided. No reports on repairs, asset age information, duty information, visual inspection reports	This Minimum Requirement relates to the need to clearly set out the key drivers of expenditure. NGET’s business plan provided this information, and Ofgem’s

⁴⁹ DD NGET Annex, page 104.

⁵⁰ See the explanation on NGET A9.03, page 10.

⁵¹ BPG (October 2019), paragraph 5.5.

⁵² RIIO-2 User Group Report National Grid Electricity Transmission, page 2. Available at: <https://isug.nationalgrid.com/files/NGET-User-Group-Report.pdf>

⁵³ RIIO-2 User Group Report National Grid Electricity Transmission, page 6. Available at: <https://isug.nationalgrid.com/files/NGET-User-Group-Report.pdf>

⁵⁴ DD Core Document, paragraph 10.39.

NGET response to Ofgem’s RIIO-2 Draft Determination – Core Document

	<p>or photographs of individual assets were submitted. This has required Ofgem and our consultants, Atkins, to sample the interventions proposed and to request all contributory information used to justify their inclusion. This should have been included in the original submission, as the BPG stated that “Business Plans must clearly set out the key drivers of expenditure for the RIIO-2 period - for example... conditions of assets/utilisation.”</p>	<p>assessment is an error because it wrongly assesses the justification for the chosen driver, which should have been assessed only at Stage 3 of the BPI. In any event, Ofgem has overlooked the reasons why NGET’s selected driver is well justified on the facts.</p>
<p style="text-align: center;">3.13</p>	<p>[Ofgem did not provide summary reasoning in the DD Core Document]</p>	<p>Ofgem wrongly challenges that actual asset condition / performance data was not provided, when this is logically inconsistent with NGET’s selected driver, and this is not a Minimum Requirement; Ofgem’s objection that NGET did not consider replication of RIIO-T1 volumes is also not relevant to the Minimum Requirement, and moreover is inappropriate to the costs case; Ofgem overlooks evidence which NGET provided on the deliverability of the preferred options; Ofgem’s challenge that “all credible options” be assessed is not a Minimum Requirement, and is moreover disproportionate.</p>
<p style="text-align: center;">3.14</p>	<p>NGET has not provided a clear rationale behind, or the assumptions used to assess, the volume of work that it proposes to undertake, which in turn makes it difficult for us to robustly assess its costs. Secondly, for non-lead assets where categories of expenditure are more uncertain and more difficult to forecast using historical/independent benchmarks, NGET has not considered mechanisms that mitigate risk associated with uncertainty, and/or other evidence to justify its submitted costs.</p>	<p>Ofgem has overlooked information which NGET provided justifying increases to unit costs from T1 to T2, (which is in any case not a Minimum Requirement); Ofgem has overlooked evidence NGET submitted on unit costs and efficiency compared to historical benchmarks.</p>
<p style="text-align: center;">3.21</p>	<p>NGET has not determined the minimum level of intervention required to remain compliant with legislation and has not considered a reasonable range of credible investment decisions. Due to the lack of detailed justification for asset health interventions, NGET’s submission is not open to “scrutiny and challenge”, nor is it “transparent about assumptions, inputs and rationale for decisions, calculations and results”</p>	<p>Ofgem is factually incorrect to assert that NGET has not provided detailed justification for asset health interventions; Ofgem has again misinterpreted its own framework, which does not require companies to assess all “all credible investment decisions”; Ofgem’s assertion that NGET’s submission was not “transparent about assumptions, inputs and rationale for decisions, calculations and results” is factually incorrect.</p> <p>Regarding the minimum level of intervention required to remain compliant with legislation, our business is not driven</p>

		<p>by minimum legislative requirements, (unlike distribution companies or gas companies). Therefore, rather than engage in an onerous process of creating bespoke scenarios for each asset category, we took a proportionate approach and highlighted where we made exceptions (for example where the 'do minimum' scenario wasn't credible and was therefore discounted).</p>
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Even if Ofgem's FD were to retain the view that our business plan did not meet certain Minimum Requirements, our view is that this would in any case not be sufficiently material to incur a Stage 1 penalty. We provided ample material in our business plan to enable Ofgem to carry out a thorough assessment, and have promptly supplemented the business plan with additional information where this was requested by Ofgem via an SQ. Moreover Ofgem has not identified any demonstrable consumer harm arising from the ambitious proposals included in our business plan.

b. Stage 2

During its Stage 2 assessment, Ofgem accepted only one of NGET's nine CVP proposals ('Caring for the natural environment'), and moreover concluded that NGET was not eligible for a reward in respect of this CVP proposal due to its Stage 1 decision. Ofgem's DD only proposed to accept three CVPs across all network companies, with an up-front value of £3.2m, out of the 117 CVPs network companies submitted, which shows a serious failure on the part of Ofgem to effectively communicate its expectations to network companies.⁵⁵ Indeed, Ofgem's guidance encouraged us to spend significant company time and planning resource and to use up stakeholders' scarce time developing our CVP proposals: the BPG listed nine types of proposals which might qualify as CVPs and added that *"The above are illustrations of the type of activities that might inform a CVP and companies are encouraged to think broadly about the areas within which they can show how their plan offers additional value."*⁵⁶ Based on this guidance, we originally developed a longer list of CVP proposals than was ultimately submitted, and worked through these extensively with stakeholders to define a shortlist of the nine best candidate CVP proposals for submission in the business plan. In addition, we submitted a more conservative set of CVPs, amounting to 3% of our totex, which was less than half that of the next company's, due to our engagement with stakeholders, the IUG and an expert review by economic consultants. Ofgem's decision to reject all but one of these proposals is completely out of line with both the quality of the evidence submitted, and also with the receptive approach we were led to believe Ofgem would take in the SSMD and at the 19 June 2019 BPI workshop.

⁵⁵ Three additional CVPs, including one submitted by NGET and two by NGGT, would have qualified for a reward, but were discounted due to Ofgem's decision that these companies failed Stage 1.

⁵⁶ BPG (October 2019), paragraph 5.19.

NGET response to Ofgem’s RIIO-2 Draft Determination – Core Document

Ofgem’s decision to reject our other CVP proposals was erroneous, and the FD should accept all of them for the reasons we set out in **Table Q35.3** below.

Table Q35.3: Summary of NGET Response to Ofgem Stage 2 BPI Provisional Decision		
CVP Name	Ofgem’s Reasoning⁵⁷	NGET Response
CVP5: Caring for the natural environment	Accept: We consider that caring for the natural environment CVP goes beyond BAU and provides demonstrable consumer benefit. Please see further information under the heading ‘Caring for the natural environment’.	We agree with Ofgem’s reasoning. We are working with Ofgem to agree the methodology to be used to finalise the value for this CVP. Please see our response to question NGETQ9.
CVP1: Optimisation of harmonic filtering	Reject: We are supportive of the principle of within period funding and consider there is merit in taking a more coordinated approach in harmonic filtering. However, we are not convinced that this is beyond BAU good practice. We request further analysis and robust evidence to indicate the frequency of a TO-led approach over T2 period, the probability of the approach being used and the level of benefit that can be realised relative to a customer-led approach. We also seek views on the wider administrative process to be undertaken to facilitate the implementation of the proposed solution. Specifically, further detail on the nature, scope and timing of necessary code changes to be implemented (including change to the Grid Code and Transmission Network Use of System charging methodology).	Ofgem should accept this CVP because: <ul style="list-style-type: none"> • Ofgem says in its DD that it considers there is merit in taking a more coordinated approach to harmonic filtering. • This is clearly beyond Business as Usual (BAU) because it does not happen at present. • Due to the clawback provisions for CVPs, Ofgem can award the CVP to NGET and if the benefits do not arise NGET will have to refund the money to consumers, so consumers cannot lose. • If Ofgem does not approve this CVP at final determinations, we propose that we take it forward through the MSIP reopener.
CVP2: Whole-system alternatives to reactor investments	Reject: There is insufficient justification to suggest that these alternatives go beyond BAU. We note that these works will be heavily influenced in future by the ESO’s actions in potential Pathfinder Projects for Reactive Control. We are proposing to approve all of the reactor works NGET proposed in its Business Plan and would expect these interventions to be undertaken as planned.	Ofgem should accept this CVP because: <ul style="list-style-type: none"> • This CVP goes beyond BAU, which would involve us including £184m of additional reactor investment in our baseline plan to maintain compliance with the Security and Quality of Supply Standard (SQSS). This CVP item will require a change in the way we, the ESO and the DNOs maintain compliance with the SQSS in relation to reactive power. It involves risk by taking a large amount of costs out of our plan and involves time, effort and cost for us to overcome the barriers to making alternative whole-system solutions happen.

⁵⁷ DD Core Document, Table 13

NGET Draft Determination Response – Core Document

		<ul style="list-style-type: none"> • Several of the IUG group members thought this CVP item was a big change in approach, involved risk by taking costs out of the plan and time, effort and cost to overcome barriers to making it happen. • Citizens Advice commented that it could see the benefits to consumers of this CVP item when we met with them. <p>Due to the clawback provisions for CVPs, Ofgem can award the CVP to NGET and if the benefits do not arise NGET will have to refund the money to consumers, so consumers cannot lose.</p>
<p>CVP3: Whole system approach to low-voltage substation re-builds</p>	<p>Reject: There is insufficient justification that these alternative solutions go beyond BAU. We consider in this instance that the basic optioneering for these works should include interfacing with DNO Licencees to optimise their networks to reduce fault current through alternative running arrangements.</p>	<p>Ofgem should accept this CVP because:</p> <ul style="list-style-type: none"> • This CVP goes beyond BAU, which would involve us including £105m of low-voltage substation re-builds in our baseline to manage faults at Grid Supply Points (GSPs) due to increasing levels of decentralised generation. This CVP item will require a change in the way we, the ESO and the DNOs manage faults at GSPs due to increasing levels of decentralised generation. It involves risk by taking a large amount of costs out of our plan and involves time, effort and cost for us to overcome the barriers to making alternative whole system solutions happen. • Several of the IUG group members thought this CVP item was a big change in approach, involved risk by taking costs out of the plan and time, effort and cost to overcome barriers to making it happen. • Citizens Advice commented that it could see the benefits to consumers of this CVP item when we met with them. <p>Due to the clawback provisions for CVPs, Ofgem can award the CVP to NGET and if the benefits do not arise NGET will have to refund the money to consumers, so consumers cannot lose.</p>
<p>CVP4: Tougher Energy Not Supplied (ENS) target</p>	<p>Reject: We propose to reject NGET's CVP proposal relating to the ENS Incentive, because it is not clear how NGET's proposed CVP goes beyond BAU. We consider that NGET's performance in RIIO-1 under the ENS incentive and the step-change in its ENS management should be reflected in</p>	<p>Ofgem should accept this CVP because:</p> <ul style="list-style-type: none"> • This CVP fits precisely with Ofgem's examples of CVPs in paragraph 5.18 of its 31 October 2020 BPG, which refers to "service quality levels that are higher than existing levels and delivered at the same or lower cost". Our business plan proposal for a

NGET response to Ofgem’s RIIO-2 Draft Determination – Core Document

	<p>target-setting, which would lead to a more challenging target.</p>	<p>method for setting our ENS target in the T2 period, which, on current data, reduces our target by 45% at no extra costs to consumers goes beyond business as usual. We consider our methodology that results in a 20% reduction in our ENS target compared with the T1 period, based on current data, represents a BAU approach.</p> <p>At its meeting on 22 November 2019 the IUG acknowledged that this CVP item was an example Ofgem specifically mentioned as a CVP and could see how a tougher target benefitted consumers.</p>
<p>CVP6: Supporting local urban communities</p>	<p>Reject: NGET's proposed CVP assumes additional consumer value beyond the proposed £50m Urban Improvement Provision UM, however it is not clear on what NGET intend to spend this money, therefore it is not possible to quantify the consumer value of this proposal. We do not agree with the justification for an assumed 50% additional social benefit in excess of cost for any money spent on supporting local urban communities as there was no reliable data to support it. Additionally, we are proposing to reject the bespoke UM which this CVP relates to, see Chapter 4.</p>	<p>Ofgem should accept this CVP because:</p> <ul style="list-style-type: none"> • Ofgem’s RIIO-2 Challenge Group said it thought the proposal stood out as offering additional benefit and appeared to have the support of stakeholders. • This is clearly beyond BAU because it is something our stakeholders wanted to benefit urban consumers to balance the benefits to rural consumers from the visual impact provision. • Due to the clawback provisions for CVPs, Ofgem can award the CVP to NGET and if the benefits do not arise NGET will have to refund the money to consumers, so consumers cannot lose.
<p>CVP7: Developing alternatives to SF₆</p>	<p>Reject: We propose to reject this proposal due to a lack of specific deliverables and cost breakdown. We also consider there to be other more appropriate routes for innovation funding, such as the NIA. There is also potential overlap with the proposed PCD for NGET's SF₆ asset intervention programme, discussed above.</p>	<p>Ofgem should accept this CVP because:</p> <ul style="list-style-type: none"> • In its letter of 25 October, the RIIO-2 Challenge Group mentioned “providing leadership in sustainability” as one of the three of our CVP areas where it thought we were “potentially delivering additional value”. We consider that innovating to find alternatives to the SF₆ insulation gas represents providing leadership in sustainability. • At its meeting on 22 November 2019 the independent stakeholder group thought this was a very good example of us providing environmental leadership. The group thought the value to consumers of this CVP item would be well in excess of the value we had conservatively calculated.

		<ul style="list-style-type: none"> • Due to the clawback provisions for CVPs, Ofgem can award the CVP to NGET and if the benefits do not arise NGET will have to refund the money to consumers, so consumers cannot lose. <p>However, we recognise that we have been working closely with Ofgem in relation to our SF₆ asset intervention programme and we submitted a proposal on this to Ofgem in August 2020. If we can reach agreement with Ofgem on the SF₆ asset intervention programme, then we would propose to drop CVP7.</p>
<p>CVP8: SO:TO optimisation</p>	<p>Reject: There are multiple existing tools in place to ensure sufficient engagement and collaboration. We consider this CVP could create a perverse incentive. We do not think that we have the tools to measure the impact of the delivery of this CVP, at this time. Please see further information under the heading ‘SO:TO optimisation’.</p>	<p>Ofgem should accept this CVP because:</p> <ul style="list-style-type: none"> • This CVP has the potential to unlock huge benefits to consumers because it can help the ESO tackle constraint costs, which it forecasts will reach £1.7bn to £3.7bn per year by 2026. • Our CVP can supplement the existing tools for engagement and collaboration by providing an incentive to research and implement new flexible options to help the ESO reduce constraint costs. • We propose this CVP to avoid perverse incentives, as well as the ESO continuing to scrutinise our outage plans. Only schemes where we can show we have used a non-standard approach would be included as part of the CVP. • We recognise that the benefits can be difficult to measure, but the ESO can provide reasonable estimates of these benefits, and this is not a valid reason not to try to achieve the potentially huge benefits for consumers. • Due to the clawback provisions for CVPs Ofgem can award this CVP to NGET and if the benefits do not arise NGET will have to refund the money to consumers, so consumers cannot lose. <p>We provide more justification for why Ofgem should approve an approach to SO:TO optimisation in our response to question NGETQ4.</p> <p>In our response to NGETQ4, we propose that the benefits of this CVP are so large for consumers that if Ofgem rejects this CVP in its FD it should provide baseline funding to the</p>

NGET response to Ofgem’s RIIO-2 Draft Determination – Core Document

		<p>TOs of £10m per TO to trial a market-based approach to providing flexible services to the ESO. Ofgem can clawback the baseline funding in the RIIO-2 close out process in proportion to any benefits not delivered to consumers.</p>
<p>CVP9: Deeside innovation centre</p>	<p>Reject: We expect innovation which was funded through the NIA in RIIO-1 to be rolled out as BAU in RIIO-2. As the centre opened in RIIO-1 with the intention for the facility to be used by wider industry, NGET has not demonstrated that this proposal goes beyond BAU. We do not agree with the assumption the innovation trials will be successful and result in carbon savings.</p>	<p>Ofgem should accept this CVP because:</p> <ul style="list-style-type: none"> • The Deeside innovation centre is unique and our proposal to open it up to third parties is innovative. • Due to the clawback provisions for CVPs Ofgem can award this CVP to NGET and even if the benefits do not arise from the innovate trials, NGET will have to refund the money to consumers, so consumers cannot lose.

c. Stage 3

During its Stage 3 assessment, Ofgem provisionally determined that we should be subject to a penalty of £179.6m, representing 10% of the value of the costs which Ofgem judged to be lower-confidence and which it concluded were poorly justified. We set out in our response to questions NGETQ11 to NGETQ16 why Ofgem should not have provisionally disallowed our cost proposals in the DD.

Ofgem’s SSMD sets out three steps Ofgem must justify when applying a 10% penalty on a specific cost item under the BPI (see paragraphs 11.43, 11.46, 11.60 and 11.66 of the SSMD). These steps are illustrated in **Figure Q35.3** below:

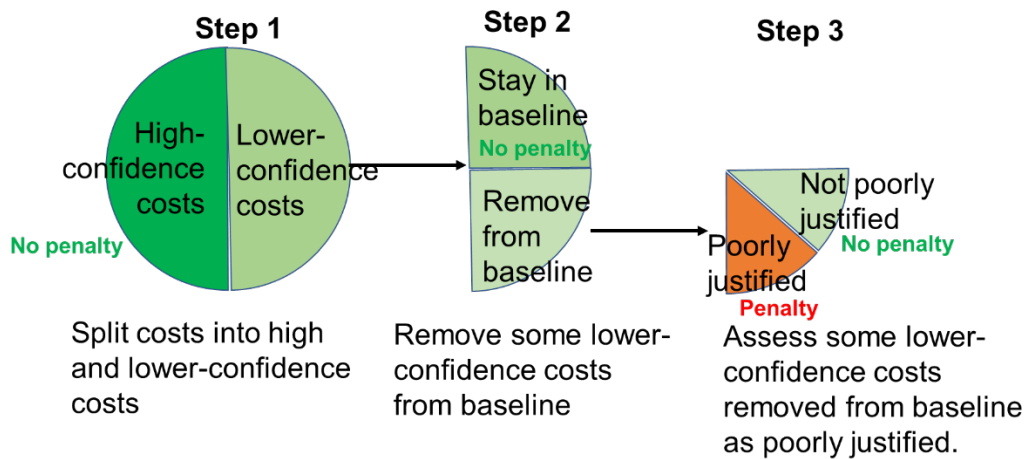
1. In **step 1** Ofgem must explain why a cost is “lower-confidence”. Ofgem assesses some costs as being “high confidence”.
2. In **step 2** Ofgem must explain why it has removed a lower-confidence cost from the baseline. Ofgem has not removed some lower-confidence costs from the baseline.
3. In **step 3** Ofgem must explain why any lower-confidence costs that it has removed from the baseline are “poorly justified”. Ofgem could remove a lower-confidence cost from the baseline for reasons other than it being poorly justified e.g. Ofgem rejects the stakeholder support for an investment.⁵⁸

As Ofgem explained to us in an email of 21 August 2020 sometimes an Ofgem engineering/needs-case review will find that a proposed activity is not justified and it appears to us from that email that Ofgem proposed to carry out steps 1, 2 and 3 simultaneously.

Figure Q35.3: Steps in the BPI Stage 3 penalty

⁵⁸ Ofgem confirmed that this was the case during its BPI workshop in June 2019. See Ofgem, ‘RIIO 2 Business Plan Incentive Workshop’ presentation, 19 June 2019, slide 12

Steps to get to BPI stage 3 penalty



Only costs that (1) Ofgem assesses as “lower-confidence”; (2) Ofgem removes from the baseline; and (3) Ofgem assesses as “poorly justified” will have the 10% penalty applied to them.

We do not recognise Ofgem’s provisional conclusion that certain of our submitted costs were poorly justified as an accurate assessment of the quality of our business plan. Notwithstanding this, the DD documents contain limited details on Ofgem’s reasoning for reaching this provisional conclusion and in particular makes no reference at all to “poorly justified” costs (step 3 in its SSMD), which makes it difficult for us to provide a comprehensive response. However, Ofgem’s main overarching criticism which is included in the DD relates to our Engineering Justification Papers, which Ofgem criticised for being “generally grouped by asset type (lead and non-lead), rather than project or site specific”, saying that “this made it difficult to use their content to support the interventions proposed in the Business Plan Data Template (BPDT).”⁵⁹ We were deeply surprised that Ofgem should make this observation in the DD, and concerned that this should have had an impact on the volume of submitted costs which Ofgem disallowed and imposed Stage 3 penalties on, because during the business plan development process Ofgem expressly confirmed that a portfolio-based approach would be acceptable.⁶⁰ A ‘portfolio’ approach enables Ofgem to assess a large volume of similar assets at once, similar to the way that econometric analysis allows Ofgem to assess a large volume of similar assets in aggregate rather than individually. As Ofgem will be aware (especially because a number of Ofgem engineers assessing the NGET business plan have worked for NGET in the past), NGET has operated with a portfolio-based approach for decades with its systems created and designed to operate the company in that manner, which is the efficient approach for company of NGET’s scale.

In addition, the method Ofgem has used to assess cost efficiency for certain cost categories involves systematically reducing all above-mean company costs to Ofgem’s view of an efficient sector mean, where Ofgem has derived an appropriate efficient cost. This approach does not recognise the natural spread of costs that exist in any portfolio of work. This means that all companies end up with mean costs lower than Ofgem’s efficient sector mean. This cost assessment method is unsound and is no basis to justify applying a further 10% penalty to disallowed costs.

Ofgem’s approach appears to have been to apply a 10% penalty under Stage 3 of the BPI to all “lower-confidence” costs it proposes to remove from our baseline, without clearly carrying out a separate assessment of whether those costs were “poorly justified” or instead disallowed for other reasons. Ofgem has not provided us with its justification for the £179.6m Stage 3 penalty beyond a spreadsheet showing it has applied a 10% penalty to all disallowed “lower-confidence” costs.

⁵⁹ DD, NGET Annex, paragraph 3.6.

⁶⁰ For example, at a meeting to discuss the business plan overview and EJR on 15 January 2020, Ofgem confirmed that it was comfortable with the portfolio approach, and recognised that it had previously approved this.

NGET response to Ofgem’s RIIO-2 Draft Determination – Core Document

Ofgem has provided us with no line-by-line assessment of each of the costs it has applied the 10% penalty and its reasons for doing so, including how it had followed the three steps in its SSMD. Ofgem did provide limited further information on its approach to calculating the Stage 3 penalty in an email on 21 August 2020. Ofgem pointed us to seven paragraphs in section 10 of the DD Core Document, ‘Approach to the Totex and Business Plan Incentive Mechanisms’ relating to its cross-sector approach to identifying ‘high confidence’ costs, together with a high level explanation of how Ofgem applied these to the ET sector. Ofgem clarified that some activities which span multiple price controls were exempt from the BPI mechanism. Ofgem did not provide an assessment of the costs it proposed to apply a Stage 3 penalty to with an explanation of how it assessed each cost area against the 3 steps needed to apply a Stage 3 penalty, despite us asking for this in our email to Ofgem of 18 August 2020.

While this limits our ability to respond effectively to the DD consultation, we have set out in **Table Q35.4** our best estimate as to Ofgem’s reasons for applying a Stage 3 penalty (based on Ofgem’s comments on costs which have been disallowed – i.e. in relation to step 2 described above), together with our response. In each case, we explain why no Stage 3 penalty should be applied to these cost categories.

Table Q35.4: Summary of NGET Response to Ofgem Stage 3 BPI Provisional Decision		
Cost Category	Ofgem’s Provisional Decision & Inferred Reasoning	NGET Response
Load Related Expenditure (LRE)	<p>Ofgem proposes to classify £607m of our LRE submitted costs as “lower confidence”, to disallow £97m as unjustified or inefficient costs, and to impose a £9.7m disallowance penalty.⁶¹</p> <p>No express reasoning is given in the DD for the provisional conclusion that costs were poorly justified.</p> <p>Ofgem’s comments on disallowed costs include:</p> <ul style="list-style-type: none"> • Wider works: <i>“We have used the latest NOA recommendations to determine the forecast level of baseline expenditure. On this basis, any projects removed under the most recent NOA have also been removed from our baseline proposal”</i>,⁶² • Protection and Control Co-ordination (TSS Infrastructure): <i>“As the scope of works associated with relay replacement and setting changes will be determined on competition of the study work, the volume of work associated with relay replacement and setting changes is</i> 	<p>Ofgem has provided a Project Assessment Model (PAM) for our load-related expenditure. However, although this shows us which projects Ofgem has assessed as being lower-confidence and which projects it has removed from our baseline it does not provide the reasons for this. Also, the PAM does not refer to the third step required for a 10% penalty under stage 3 of the BPI i.e. why Ofgem considers the costs are “poorly justified”.</p> <p>Ofgem has not provided us with the line-by-line justification against the three steps needed to apply a 10% penalty to our costs, but we address the limited comments Ofgem has made here.</p> <p>First, on wider works it is inappropriate to apply a 10% penalty to costs that Ofgem has removed from our baseline because the ESO’s Network Options Assessment (NOA) has changed. Ofgem required us to submit our business plan on 9 December 2019 and the ESO released the 2019/20 NOA5 in January 2020. The NOA updates every year to select those projects that it is best for TOs to take</p>

⁶¹ DD, NGET Annex, paragraph 3.50.

⁶² DD, NGET Annex, paragraph 3.28.

NGET Draft Determination Response – Core Document

	<p><i>currently uncertain. Accordingly, we propose to remove the Relay Setting Review request from baseline”;</i>⁶³</p> <ul style="list-style-type: none"> • Easements: <i>“NGET have proposed a funding request that exceeds the RIIO T1 run rate. No justification has provided for this increase over T1 figures. The baseline allowance has been adjusted accordingly”;</i>⁶⁴ • LRE project costs: <i>“Our review of submitted costs, combining the asset cost efficiency and non-asset cost elements (including risk and contingency), has resulted in a proposed reduction of £109m to the cost level across the remaining LRE projects.”</i>⁶⁵ 	<p>forward. This is an established part of the energy sector investment process designed to achieve the most efficient investment for consumers. It is inappropriate for Ofgem to apply a 10% penalty on us for projects removed from our baseline because the NOA has been updated.</p> <p>We are unclear whether Ofgem has included a penalty for protection and control co-ordination as part of its Stage 3 penalty. Given that Ofgem has funded the study and is proposing that we can apply for funding through the MSIP reopener for the work the study recommends we do not think Ofgem should apply a penalty for removing the funding from the baseline (if indeed Ofgem has applied or intended to apply a penalty).</p> <p>We are unclear whether Ofgem has included a penalty for easements as part of its Stage 3 penalty. We do not agree that easements should be subject to a penalty as we provide detailed justification of the proposed increase in the T2 allowance.</p> <p>On LRE projects costs the method Ofgem has used to assess cost efficiency involves systematically reducing all above-mean company costs to Ofgem’s view of an efficient sector mean, where Ofgem has derived an appropriate efficient cost. This approach does not recognise the natural spread of costs that exist in any portfolio of work. This means that all companies end up with mean costs lower than Ofgem’s efficient sector mean. This cost assessment method is unsound and is no basis to justify applying a further 10% penalty to disallowed costs.</p>
<p>Non-Load Related Expenditure (NLRE)</p>	<p>Ofgem proposes to classify £2,005.9m of our NLRE submitted costs as “lower confidence”, to disallow £1,351m as unjustified or inefficient costs, and to impose a £135.1m disallowance penalty.⁶⁶</p> <p>No express reasoning is given in the DD for the provisional conclusion that costs were poorly justified.</p>	<p>Ofgem has provided us with very little information on its Stage 3 assessment for non-load-related expenditure. Unlike for load-related expenditure, Ofgem has not provided a Project Assessment Model (PAM) showing us which projects Ofgem has assessed as being lower-confidence and which projects it has removed from our baseline (although the PAM does not provide the reasons). Ofgem has told us it has a</p>

⁶³ DD, NGET Annex, Table 17.

⁶⁴ DD, NGET Annex, Table 17.

⁶⁵ DD, NGET Annex, paragraph 3.40.

⁶⁶ DD, NGET Annex, paragraph 3.71.

NGET response to Ofgem’s RIIO-2 Draft Determination – Core Document

<p>Ofgem’s comments on disallowed costs include:</p> <ul style="list-style-type: none"> • Power transformers: <i>“Where asset replacement has been proposed for high CoF we consider replacement is not deemed proportionate to the needs case as the CoF will not change. Accordingly, we have rejected these volumes and associated costs.”</i>⁶⁷ • Overhead Line (OHL) Conductor and Fittings: <i>“We consider that the volume of work is uncertain... many of the fittings included in the proposal are not reported to have deteriorated to a point that would necessitate intervention.”</i>⁶⁸ • Circuit Breakers and Bay Equipment: <i>“For circuit breakers...[i]n a small number of cases where asset replacement has been proposed for high [cost of failure] assets we consider replacement is not deemed proportionate to the needs case as the CoF will not change...For bay equipment, NGET’s proposals prioritised intervention based on Anticipated Asset Life (AAL). Based on the information provided, it is not possible to assess the needs case justification for each individual bay asset.”</i>⁶⁹ • Cables: <i>“For Lead Cables... We are unable to ascertain if the risk of failure has changed since 2016, and this raises questions over the timing and requirement for intervention now... For non-lead cable replacements, the case for intervention has not been made.”</i>⁷⁰ • Protection and control: <i>“Without explanation, the allocation of assets to one of the three drivers, appears arbitrary, and without evidence or a description of scope we cannot</i> 	<p>spreadsheet with some analysis in, but it cannot share it with us because it has become corrupted and Ofgem has not proposed an alternative way of providing this information to us. Further, Ofgem has not provided information on the third step required for a 10% penalty under Stage 3 of the BPI i.e. why Ofgem considers the costs are “poorly justified”.</p> <p>While Ofgem has not provided us with the line-by-line justification against the three steps needed to apply a 10% penalty to our costs under Stage 3 of the BPI, we address the limited comments Ofgem has made here.</p> <p>First, on the categories of power transformers, Overhead Line (OHL) Conductor and Fittings, Circuit Breakers and Bay Equipment, Cables, Protection and control, Substation Auxiliary Systems, Instrument Transformers, Towers and foundations Ofgem’s DD has reduced our allowances by letting network risk increase. Ofgem’s DD has taken a different view to that of our stakeholders and consumers who said their top priority for our RIIO-2 business plan was for us to maintain our reliability level and hold network risk constant. We disagree with Ofgem’s proposal in its DD to allow network risk to rise. For the purposes of the Stage 3 BPI penalty Ofgem is unjustified in applying a 10% penalty to costs it has removed from our business plan because it has taken a different view to our stakeholders and consumers.</p> <p>On cost efficiency the method Ofgem has used to assess cost efficiency involves systematically reducing all above-mean company costs to Ofgem’s view of an efficient sector mean, where Ofgem has derived an appropriate efficient cost. This approach does not recognise the natural spread of costs that exist in any portfolio of work. This means that all companies end up with mean costs lower than Ofgem’s efficient sector mean. This cost assessment method is unsound</p>
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⁶⁷ DD, NGET Annex, Table 26.

⁶⁸ DD, NGET Annex, Table 26.

⁶⁹ DD, NGET Annex, Table 26.

⁷⁰ DD, NGET Annex, Table 26.

NGET Draft Determination Response – Core Document

	<p><i>ascertain whether the proposal is economic and efficient.</i>⁷¹</p> <ul style="list-style-type: none"> • Substation Auxiliary Systems: <i>“we consider that the proposed interventions for Diesel Generators, LVAC systems are not fully substantiated.”</i>⁷² • Instrument Transformers: <i>“The projected in period degradation has not been substantiated, and therefore the replacement of volumes is not justified.”</i>⁷³ • Towers and foundations: <i>“We noted a significant increase in cost over the T1 figures for Tower foundations, but evidence was not provided to justify this increase.”</i>⁷⁴ • Cost efficiency: <i>“we have made a systemic reduction across NGET’s submission of project risk and contingency.”</i>⁷⁵ 	<p>and is no basis to justify applying a further 10% penalty to disallowed costs.</p>
<p>Network Operating Costs</p>	<p>For the following cost categories, Ofgem proposes to classify £348.3m of our submitted costs as “lower confidence”, to disallow all £348.3m as unjustified or inefficient costs, and to impose a £34.8m disallowance penalty:⁷⁶</p> <ul style="list-style-type: none"> • Flood mitigation schemes within the "Legal and Safety" sub-category: No express reasoning given for the provisional conclusion that costs were poorly justified • Repairs and maintenance sub-category: At present we are not able to evaluate if the repair and maintenance investment performance in RIIO1 is efficient or economic. We note that the RIIO2 plan appears to be heavily influence by the 2018/19 expenditure values for these works, with limited evidence provided that the plan is built from condition based requirements.⁷⁷ • Operational protection measure and IT capex sub-category: in our view, NGET provided insufficient 	<p>Ofgem’s proposed Stage 3 penalties for network operating costs (NOC) are unreasonable in the light of the complexity associated with the data submission, and the limited degree of supplementary questioning particularly for direct opex and flood mitigation, and should therefore be reversed. In particular:</p> <p>On flood mitigation, in our December submission we explained that we had applied bandings to estimate the total cost of our programme of works, to include full and localised protection. These were provided in the justification paper.</p> <p>These bandings were based on an exercise where we took an initial view of the range of potential solutions required e.g. full site protection, single building protection, raising of a kiosk etc. This initial view was based on the EA / NRW flood maps, Flood Risk Assessments (where available), satellite images and existing knowledge of the sites. A low and high case cost was applied to each type of mitigation based on average costs of</p>

⁷¹ DD, NGET Annex, Table 26.

⁷² DD, NGET Annex, Table 26.

⁷³ DD, NGET Annex, Table 26.

⁷⁴ DD, NGET Annex, Table 26.

⁷⁵ DD, NGET Annex, paragraph 3.64; DD, Electricity Transmission Sector Annex, paragraph 3.27.

⁷⁶ DD, NGET Annex, paragraphs 3.90; 3.92.

⁷⁷ DD, NGET Annex, paragraph 3.86.

NGET response to Ofgem’s RIIO-2 Draft Determination – Core Document

	<p>evidence that two of the five schemes it is proposing can be delivered within the RIIO-T2 period.⁷⁸</p>	<p>works of a similar scale delivered during RIIO-T1.</p> <p>We received only one SQ for extreme weather requesting us to provide a best current view of the sites which will require flood defences as well as detail for each project the scope of works. Ofgem did not ask any questions on our proposed bandings. Ofgem provided very limited explanation in the DD NGET Annex (page 23) for its rejection of this expenditure and why it was based on the scope of works. We therefore consider the 10% Stage 3 BPI penalty on flood mitigation proposed in Ofgem’s DD is unjustified.</p> <p>On Repairs & Maintenance, the issues encountered with the assessment of this category are more driven by changes to Ofgem’s cost reporting classification and the totex-oriented structure of the BPDTs than a failure to justify the proposed expenditure. It is clear that Ofgem’s assessment process is not designed to take account of data tables with mixed opex / capex composition, and this does not represent any failure on our part. We have provided Ofgem with detailed reconciliation of IDPs to BPDTs and can demonstrate unequivocally that there are no overlaps or double counts in our submission. We received a very small number of supplementary questions relating to direct opex, and actively engaged with Ofgem to ensure it had what it needed in this regard. Although we accept that there is complexity involved, we think Ofgem has had ample opportunity to investigate and appraise our plan in the six months following our submission, however we remain committed to ongoing constructive engagement with Ofgem to support its data interpretation issues. We therefore consider the 10% Stage 3 BPI penalty on repairs & maintenance expenditure proposed in Ofgem’s DD is unjustified.</p> <p>On Operational Protection Measures & Operational IT Capex, our December submission set out proposals for the replacement of fibre-wrap as it approaches the end of its service life, the replacement of obsolete telecoms equipment and the implementation of a high bandwidth overlay (HBO) to</p>
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⁷⁸ DD, NGET Annex, paragraph 3.88.

		<p>segregate operational and business services and cater for significant growth in data volumes. We provided further information to Ofgem through the SQ process to address timeline and delivery queries amongst other things. Ofgem’s DD NGET Table 11, (page 23) stated that Ofgem “do not fully accept the need case for OpTel Refresh at present and have concerns over the deliverability of the proposal”. Ofgem proposed baseline funding ‘for only the final two years of RIIO-2 to enable NGET to begin this work’.</p> <p>We are surprised that Ofgem consider OpTel works to be of a lower cost confidence due to the bespoke nature of operational protection measures and IT work, as we have provided information explaining that our costs are based on previous actual costs from telecoms equipment refresh and fibre-wrap replacement costs based on actual costs from the BT21CN project and equivalent earth-wire works from our T1 overhead line replacement programme. We have provided further supplementary evidence to Ofgem in support of our OpTel proposals, confirming costs for Telecoms equipment and HBO implementation, and proposing an innovative approach to fibre-wrap replacement which does not require a system outage and therefore addresses deliverability issues. and can be achieved at lower overall cost. This approach will enable ageing fibre-wrap to be prioritised and replaced over a seven-year programme at the lowest cost to the end consumer and with minimal system outage requirements, ensuring that the reliability and resilience of this essential service is maintained. We therefore consider the 10% Stage 3 BPI penalty on operational protection measures & operational IT capex proposed in Ofgem’s DD is unjustified.</p>
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d. Stage 4

Stage 4 of the BPI (high-confidence costs), appears to have been an empty process designed to give the BPI the appearance of balance, by giving the BPI two reward stages to balance the two penalty stages. Ofgem applied no rewards to any of the eight network companies under Stage 4. Network companies had raised with Ofgem that there were no real rewards available under Stage 4 of the BPI at the Ofgem BPI workshop on 19 June 2019.

During its Stage 4 assessment, Ofgem provisionally concluded that our business plan was not eligible for rewards due to its view that the business plan had failed the Stage 1 assessment. In addition, Ofgem’s provisional view appears to be that none of our proposed costs would be eligible

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

for a reward under Stage 4 in any event.⁷⁹ However, Ofgem has not clearly explained the basis for its provisional decision in this area, so we are unable to fully assess the basis for Ofgem's decision. If Ofgem had correctly applied Stage 4 to its own proposed approach to cost assessment (which we do not agree with for the reasons set out in section 4c), it would have proposed a Stage 4 reward for our plan because it used our cost information for certain cost categories to help it set mean costs lower than Ofgem's efficient sector mean.

5. Requested remedy

As we have clearly explained in this section, Ofgem's provisional BPI decision in the DD is deeply flawed, both in terms of the overall development and design of the BPI, and in terms of the way it has been applied to NGET's business plan. The cumulative result of these flaws is a provisional BPI penalty which fails to reflect the quality of our business plan, which is out of all proportion to previous regulatory incentives on business plans and the expectations Ofgem created in its own guidance, and which is not offset by any corresponding reduction in the outputs required in the RIIO-2 period. On the contrary, the business plan we proposed would have provided significant additional benefits to consumers, compared to the more limited range of outputs Ofgem is proposing in the DD. Ofgem's BPI assessment – and the imposition of a penalty on NGET – exacerbates the other negative elements of the overall RIIO-2 package, including an implausibly low WACC, significantly decreased allowed return, and a balance of risk which is skewed to the downside for network companies.

As explained elsewhere in this section, the BPI penalty under the DD came as a significant surprise to us, given the extensive dialogue we had with Ofgem on our business plan in the seven months following its submission in December 2019, in which time we received positive feedback on our engagement from Ofgem. A mechanism implemented in this way cannot possibly function as an incentive for network companies to submit ambitious and challenging business plans. On the contrary, if Ofgem were to retain its proposed decision on the BPI in the FD, the result would be to discourage companies from proposing or pursuing innovative or ambitious projects that benefit consumers for fear of large, unexpected and poorly justified penalties. Moreover, the proposed imposition of such a material penalty in the absence of any compelling justification or properly reasoned submission is unacceptable. To correct the problems with its proposed application of the BPI in the FD, Ofgem should:

- Stage 1: revise its assessment in relation to NGET from “fail” to “pass”, to reflect the fact that the company's business plan complied in all material respects with the Minimum Requirements under the BPG, and remove in full the penalty of £16.7m (prior to the BPI cap);
- Stage 2: apply the appropriate rewards to NGET for the CVPs included in our business plan, which provide sound evidence of additional customer value;
- Stage 3: remove in full the penalties of £179.6m for NGET which Ofgem imposed based on its erroneous and unexplained view that certain of our cost claims were poorly justified; and
- Stage 4: apply a meaningful reward to those areas of NGET's costs that helped Ofgem with its cost assessment process.

⁷⁹ See DD, NGET Annex, paragraphs 3.50, 3.71, 3.81, 3.97 and 3.120.

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

Please see our response to Q35 on the BPI.

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

Please see our response to Q35 on the BPI. This covers our view on Ofgem's overall approach to network companies' CVP proposals.

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

The CVP can work as a really effective tool to incentivise network companies to deliver additional value for consumers. Ofgem's DD proposal to reject all but three of the 117 CVP proposals network companies submitted in their business plans is a missed opportunity to benefit consumers.

The clawback mechanism for the CVP is a vital part of the incentive because it means if a network company does not deliver the benefits to consumers, Ofgem will clawback the upfront CVP reward in proportion to the benefits not delivered.

We are disappointed that Ofgem describes its approach to a clawback mechanism in just three paragraphs (10.80 to 10.82 of the core DD document) when we submitted an eight-page paper to Ofgem on 26 March 2020 on CVP reporting and repayments with more detail of how the clawback mechanism could work (see annex NGET_CORE_Q38_CVP Reporting and repayment).

We support your proposal to clawback only the proportion of any CVP reward that has not been delivered. However, Ofgem should provide more detail and examples on how the clawback mechanism for the CVP will work (we make some suggestions for this in annex NGET_CORE_Q38_CVP Reporting and repayment). This is because the CVP clawback is an ex post review and without some guidance about how it will operate network companies are likely to take a cautious, non-innovative approach to delivering their CVPs, no matter how circumstances change, to reduce the chance of Ofgem clawing back the CVP reward.

In paragraphs 10.83 and 10.84 of the DD core document you discuss the case where net rewards for a company for the BPI at Final Determinations exceed 2%. This seems a very unlikely scenario given that only one network company (NGN) has a net reward on the BPI in Ofgem's DD, and that is only 0.1% of its totex. Nevertheless, we agree that with the principle that Ofgem should not seek to clawback a CVP reward that a company never received because of the 2% of totex cap on BPI rewards.

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

Interlinkages in RIIO-2 post appeals review and pre-action correspondence

Key Points:

- In the Draft Determination, Ofgem makes a number of proposals relating to the regime for appealing its price control decisions to the CMA. We do not agree with these proposals, which are not consistent with the appeals regime and the CMA's decisions and guidance.
- We do not agree that Ofgem's explanation of interlinkages aligns with the CMA's decisions on interlinkages or the CMA's response to Ofgem's open letter. The onus is on Ofgem to set out interlinkages and the reasons for them in its decision documents and we expect Ofgem to consider this issue further prior to the Final Determination. We would be willing to engage with Ofgem and other stakeholders further to assist with this.
- The proposal to include a policy statement around post-appeal reviews in the Final Determination is unnecessary and how the policy would be applied is unclear. We would expect any knock-on impacts from a successful appeal to have been raised by Ofgem and considered by the CMA as part of the appeal. Ofgem is already subject to a duty to comply with the CMA's directions following an appeal. We do not understand the rationale for this proposal, but we are seriously concerned by any proposal suggesting that Ofgem might seek to, in its view, redress the balance following a successful CMA appeal. This would clearly undermine the CMA appeals regime. Such an approach is damaging to investor-confidence and against the consumer interest.
- If considering an appeal we would look to conduct pre-appeal engagement with Ofgem in a manner appropriate in the circumstances. However, we believe that the proposal for a pre-action correspondence stage between the publication of the Final Determination and the opening of any window of appeal is unworkable. We would also note that the CMA's statements on this issue, and its appeals rules and guidance, do not provide any basis for Ofgem to expect such pre-action correspondence.

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

Context

The Draft Determination sets out Ofgem's view on how proposals in one area relate to decisions made and assumptions used elsewhere in the price control, stating that it hopes '*to provide further clarity for stakeholders on the overall RIIO-2 framework*'⁸⁰.

The term '*interlinkages*' has been used as a term of art to describe links between aspects of a price control which are appealed by a network and aspects of the price control that are not appealed. We therefore understand that this part of the Draft Determination is setting out Ofgem's proposed views on interlinkages, to inform any appeal to the CMA against its final price control decision. We respond in that context.

⁸⁰ RIIO-2 Draft Determinations – Core Document, para 11.2

The CMA’s position on interlinkages

The issue of how to address interlinkages in the context of a CMA appeal arose in the RIIO-ED1 appeals. In considering the scope of its jurisdiction on appeal, the CMA was clear that it is not required to review the price control at a global level (as is still the case in a number of other sectors). Rather, the legislative framework allows an appellant to appeal any decision within the price control where it considers there to be an error falling within one or more of a number of statutory grounds of appeal.

The CMA has been clear in previous energy licence modification appeals that whether a price control decision was made by Ofgem or accepted ‘on a *global basis*’ or to reflect an ‘*in the round*’ assessment is not relevant in the context of an appeal⁸¹. The issue for the CMA to determine is whether the components of the price control that are subject to appeal contain errors on one or more of the statutory grounds⁸².

Nonetheless, the CMA has acknowledged that there may be links between aspects of a price control that are the subject of an appeal and those that are not. It set out its position in the ED1 appeals⁸³:

*“We consider that the question as to whether there are sufficient links between the parts of the Decision which are challenged and parts which are not challenged must be decided on a case-by-case basis taking into account the circumstances of each case. Where there are such links, we would, in the first instance, **have expected GEMA to have highlighted these and addressed them in its response.** GEMA merely stated in its Response... that the decision is ‘made up of a number of discrete but inter-connected determinations that together give rise to the decision itself’. We accept, however, that if, in the evidence submitted to the CMA, such links become apparent, we may take this into account where appropriate.”⁸⁴ (our emphasis)*

More recently, in its letter to Ofgem of October 2019, the CMA reiterated that:

*“...[T]he overall price control set by a regulator is the combination of a number of individual decisions, and we do not accept that it can be beyond the CMA’s powers to review these individual decisions, on the basis that they need to be considered “in the round” with decisions that are otherwise unconnected parts of the regulatory settlement”.*⁸⁵

In the same letter, the CMA set a firm expectation that it expected regulators to clearly explain interlinkages and the reasons for them in their decision documents:

*“...to the extent that such interlinkages form part of the response to an appeal, in stating that an error on one part of the price control is linked to another part of the price control, **we encourage regulators to explain these interlinkages, and the reasons for them, in their decision documentation...** Where there are such interlinkages **described clearly by the regulator**, we would encourage appellants*

⁸¹ *BGT v Ofgem CMA Final Determination (2015)*, para 3.50 and *Northern Powergrid v Ofgem CMA Final Determination (2015)*, para 3.49

⁸² *BGT v Ofgem CMA Final Determination (2015)*, para 3.48, *Northern Powergrid v Ofgem CMA Final Determination (2015)*, para 3.47 and *Firmus v NIAUR CMA Final Determination (2017)*, para 3.21

⁸³ The CMA has maintained this position in subsequent decisions under the equivalent appeals regime in Northern Ireland – see *Firmus v NIAUR CMA Final Determination (2017)*, paras 8.25 and 8.32 and *SONI v NIAUR CMA Final Determination (2017)*, para 13.3

⁸⁴ *BGT v Ofgem CMA Final Determination (2015)*, para 3.52 and *Northern Powergrid v Ofgem CMA Final Determination (2015)*, para 3.51

⁸⁵ CMA letter to Ofgem dated 30 October 2019, para 16

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

*to explain why the component under challenge is wrong having regard to the interlinked aspects of the decision.*⁸⁶ (our emphasis)

It follows that, in accordance with its previous appeal determinations, the CMA will take a case-by-case approach to considering interlinkages, which are raised during an appeal. In doing so, the CMA's clear expectation is that Ofgem will first explain the existence and impact of any interlinkages and the reasons for these interlinkages in its core decision documents (which for RIIO-T2 include the Framework Decision, Sector Specific Methodology Decision, Draft Determination and the Final Determination).

The general approach to interlinkages in the Draft Determination

The general approach to interlinkages set out in the Draft Determination is inconsistent with the CMA's clear position set out above, both in terms of the explanation of interlinkages as a concept and what Ofgem should set out in its decision documents.

In relation to the interlinkages as a concept, while we acknowledge that the price control framework is complex and contains a number of component parts, the implication of the Draft Determination is that interlinkages is a nebulous concept, on which only a "*high-level view*" can be provided due to the overall "*integrated price control package*"⁸⁷. That is not the case and is not how the CMA views interlinkages.

The Draft Determination explains that the price control package is made up of three intrinsically linked pillars – outputs, allowances and uncertainty and other risk mitigating measures⁸⁸. Although we acknowledge that these are important building blocks of the price control package, the implication here that effectively all parts of the package are linked to each other is again not consistent with interlinkages as a concept or in line with the CMA's view of how regulators should explain such interlinkages and the reasons for them.

Ofgem's descriptions of the two broad categories of interlinkages set out in the Draft Determination are unclear. Our views on each are:

- "*Interlinkages that are relatively mechanistic in nature*" – we see these as where a specific input to part of the price control (which might be subject to an appeal) is also an input to another part, such as in a specific formula.
- "*Interlinkages which are less mechanistic and involve a degree of regulatory judgement*" – we see these as where Ofgem's assessments, assumptions and decisions in respect of one aspect of the price control cannot be separated from those leading to another aspect of the price control. However, Ofgem seems to mean something broader than this. References to "*decisions that are taken at a global level*"⁸⁹ is not a concept which is consistent with the CMA's position on interlinkages. Neither is it helpful to simply refer to decisions which need to be considered "*in the round*", without further explanation. It is essential that these interlinkages are properly explained by Ofgem where it considers that they exist.

In relation to the coverage of interlinkages in Ofgem's decision documents, the Draft Determination clearly does not provide sufficient specificity to enable network companies, stakeholders and the

⁸⁶ CMA letter to Ofgem dated 30 October 2019, paras 14 and 15

⁸⁷ RIIO-2 Draft Determinations – Core Document, paras 11.2 and 11.3

⁸⁸ RIIO-2 Draft Determinations – Core Document, paras 11.4 - 11.8

⁸⁹ RIIO-2 Draft Determinations – Core Document, para 11.9

CMA (on any appeal) to understand how aspects of the price control are interlinked or the reasons for such interlinkages.

The Draft Determination sets out a non-exhaustive list of interlinkages, on the basis that it would not be proportionate to attempt to set out all of the interlinkages⁹⁰. This is not consistent with the CMA's expectation of Ofgem, which as stated above, is to explain all interlinkages in its decision documents which appellants ought to be aware of.

In addition, where interlinkages are highlighted, in many cases the interlinkage is not explained or the explanation is extremely limited. For example:

- Statements that there are “*intrinsic links*” between pillars, “*strong links*” between two particular areas relating to efficiency⁹¹ or that different mechanisms together “*achieve the objectives of RIIO 2*”⁹² are not sufficient to explain an interlinkage between different parts of the price control.
- It is not sufficient to state that two elements of a price control are connected because one aspect is an overall assessment of level of risk and the other aspect has a bearing on risk (as stated in relation to cost of equity)⁹³.

For the interlinkage to be clear, Ofgem must explain specifically how one aspect of the price control has fed into its decision on the other aspect and clearly set out the reasons for this.

Given all of the above issues, we do not comment in more detail on the particular interlinkages set out in the Draft Determination. In some cases it would be difficult to do so. As an exception to this, we note that we find the interlinkages set out around cost of equity particularly confusing. The Draft Determination appears to set out interlinkages to other parts of the price control relating to Stages 1 and 2 of Ofgem's 3-step cost of equity setting process⁹⁴. This is clearly inconsistent with those stages of the process as set out and applied by Ofgem, namely assessing the CAPM evidence and cross-checking the CAPM results⁹⁵. Cost of equity should be assessed based on a fair assessment of the market evidence.

We note that some of the other interlinkages raised relate to proposals in the Draft Determination on which we have elsewhere in this response raised fundamental concerns around flaws in the approach set out (for example, in relation to expected returns versus allowed returns).

Next steps

The Draft Determination states that Ofgem expects appellants to raise interlinkages ‘*in the first instance*’⁹⁶. That is clearly contrary to the CMA's guidance, which is that it is in circumstances where an interlinkage has been raised and explained clearly by Ofgem that networks are encouraged to explain why the component under challenge is nonetheless wrong, with regard to that interlinkage.

To enable appellants to do that, Ofgem should explain in detail any interlinkages in the RIIO-T2 price controls in its Final Determination and we welcome Ofgem's confirmation that it will continue to consider this issue. We would expect that it would explain interlinkages and the reasons for them with a far greater degree of specificity than is currently the case, in line with the explanation set out above.

While as noted above the onus is on Ofgem to explain interlinkages (and Ofgem is generally best placed to comment in the first instance on how the price control package has been developed), we

⁹⁰ RIIO-2 Draft Determinations – Core Document, para 11.10

⁹¹ RIIO-2 Draft Determinations – Core Document, para 11.21

⁹² RIIO-2 Draft Determinations – Core Document, para 11.22

⁹³ RIIO-2 Draft Determinations – Core Document, para 11.12

⁹⁴ RIIO-2 Draft Determinations – Core Document, para 11.11

⁹⁵ RIIO-2 Sector Specific Methodology Decision – Core Document, para 12.21

⁹⁶ RIIO-2 Draft Determinations – Core Document, para 11.25

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

consider that this is a matter on which it is likely to be helpful for Ofgem to engage in further detail with stakeholders prior to publishing its Final Determination. To that end we suggest that Ofgem sets up an industry working group to consider this further. We would be willing to engage further with Ofgem on this issue, with the aim of reaching an agreed industry view on interlinkages. Such an agreed view would contribute positively to the achievement of the CMA's overriding objective in any appeal – to dispose of appeals fairly and efficiently and at proportionate cost within the time periods prescribed.

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

As noted in response to Q39, although we acknowledge that outputs, allowances and uncertainty mechanisms are important building blocks of the price control package, the implication here that effectively all parts of the package are linked to each other is again not consistent with interlinkages as a concept or in line with the CMA's view.

For the reasons set out in response to Q39, we do not comment in more detail in this response on the particular interlinkages set out. However, we suggest that Ofgem sets up an industry working group to consider this further. We would be willing to engage further with Ofgem on this issue, with the aim of reaching an agreed industry view on interlinkages.

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?

Context

In its RIIO-2 Sector Specific Methodology Consultation, Ofgem noted that it was considering measures “(for example, a discretionary mechanism)” to address the extent to which a successful appeal has consequences for other components of the price control⁹⁷. Respondents raised several concerns about this proposal, including that it was unclear, that it went beyond Ofgem's statutory powers and that it could undermine the current appeals framework and have a negative impact on regulatory certainty⁹⁸.

In its RIIO-2 Sector Specific Methodology Decision, Ofgem stated that its policy thinking was still in development⁹⁹. We welcome Ofgem's decision not to include the above proposal in the Draft Determination.

The Draft Determination sets out a proposal that Ofgem would include in the Final Determination a statement of policy of Ofgem's intent to carry out a post-appeal review “...where this would be of assistance in ensuring the overall coherence and consistency of the regulatory settlement”¹⁰⁰. The

⁹⁷ RIIO-2 Sector Specific Methodology Consultation, para 2.20

⁹⁸ RIIO-2 Sector Specific Methodology Decision, paras 2.18-2.21

⁹⁹ RIIO-2 Sector Specific Methodology Decision, para 2.22

¹⁰⁰ RIIO-2 Draft Determination Core Document, para 11.32

Draft Determination explains that, through such a post-appeal review, Ofgem would consider whether it was necessary to adjust any element of the price control which is linked to those aspects of the price control which have been overturned by the CMA on a successful appeal.

The Draft Determination states that Ofgem does not consider that it would be appropriate or necessary to include provision for post-appeal reviews in the licence¹⁰¹. We understand, following supplementary confirmation from Ofgem¹⁰², that if Ofgem considers that any change is needed to any aspect of the price control following a post-appeal review (including to any allowance, output or incentive), it would bring forward licence changes under the statutory modification process. We respond on the basis of that understanding. If, contrary to this response, Ofgem adopts such a policy statement, it must be clear on this point.

Further, the Draft Determination states that one of the aims of the proposal is to provide clarity to non-appealing networks. Our understanding following supplementary confirmation from Ofgem¹⁰³ is that a post-appeal review might consider whether the licence of a non-appealing network should be changed following a successful appeal by another network. No explanation of the purpose or scope of this is given and so we are not able to comment on this meaningfully as part of this consultation.

The appeals regime and the CMA's position on consequential changes

The appeals regime is intended to provide effective rights of appeal to networks in respect of Ofgem's licence modification decision, implementing rights under EU law¹⁰⁴. The CMA is the appellate body under the legislation.

For price control decisions in particular, the regime grants the CMA wide-ranging powers to order remedies in any successful appeal. In addition to quashing the decision and remitting the matter back to Ofgem for reconsideration and determination in accordance with any directions, the CMA also has the power to substitute its own decision¹⁰⁵. Whether a decision is remitted or substituted, the CMA also has the power to give directions to Ofgem.

Ofgem has a duty to comply with any direction given to it by the CMA¹⁰⁶ and a further duty to take such steps as it considers requisite to comply with any order setting out the CMA's determination¹⁰⁷.

Under the appeals regime the CMA has the power to consider whether any successful appeal might have consequences for another aspect of the price control decision.

The CMA's appeal rules require that any notice of appeal sets out the particular decision subject to appeal and the grounds of appeal on which the appellant relies. The CMA has been clear in its decisions that its role is to determine the appeal through the "*prism*" of specific errors alleged by the appellant¹⁰⁸.

However, as explained in further detail in our response to Q39, the CMA will take a case-by-case approach to considering interlinkages which are raised during an appeal, and this extends to whether a successful appeal might have a knock-on impact on other parts of the price control. If an appeal succeeds, the CMA will consider whether it is appropriate to make any consequential

¹⁰¹ RIIO-2 Draft Determination Core Document, para 11.33

¹⁰² Query reference: DDQ254

¹⁰³ Query reference: DDQ254

¹⁰⁴ Under the EU Third Package

¹⁰⁵ S.11F(2) of the Electricity Act 1989 and s.23E(2) of the Gas Act 1986

¹⁰⁶ S.11F(5) of the Electricity Act 1989 and s.23E(5) of the Gas Act 1986

¹⁰⁷ S.11H(3) of the Electricity Act 1989 and s.23G(3) of the Gas Act 1986

¹⁰⁸ *BGT v Ofgem* CMA Final Determination (2015), para 3.48 and *Northern Powergrid v Ofgem* CMA Final Determination (2015), para 3.47

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

provision, including whether it should substitute any decision or whether any matter should be remitted to Ofgem.

In each of the appeals processes previously conducted under the current regime and under the equivalent regime applicable in Northern Ireland, parties have made submissions about knock-on impacts of successful price control appeals and the CMA has determined the issue:

- In the ED1 appeals, the CMA determined to allow British Gas's appeal in respect of Ofgem's Information Quality Incentive, but did not agree with submissions that it should also re-open other unappealed parts of the Decision¹⁰⁹.
- In the Firmus appeal, the CMA determined that changing the allowance for legal and professional costs associated with geographic information systems would not have consequential effect on other parts of the UR's determination, but that there should be some consequential changes based on the changed level of connection incentive¹¹⁰.
- In the SONI appeal, the CMA stated that it had considered whether its proposed remedies required other changes to the overall price control decision and decided that no other changes were needed¹¹¹.

It follows that the CMA is not only already able to consider any issues that parties consider exist around knock-on impacts, but has shown itself to be willing to do so in each appeal process conducted to date.

The Draft Determination proposal on post-appeal reviews

The Draft Determination sets out a proposal that Ofgem would include in the Final Determination a statement of policy of its intent to carry out a post-appeal review in specified cases.

As set out above, the proposal is unnecessary under the existing legal framework. Any view Ofgem has that a ground of appeal raised would, if successful, have a knock-on impact on another part of the price control can and should be raised in its submissions to the CMA. If the CMA is satisfied that Ofgem has sufficiently evidenced that these aspects of the price control are, in fact, interlinked, it is within the CMA's power to determine the issue as part of the appeal. The CMA can either determine the point itself or, if appropriate, remit the matter to Ofgem to reconsider. Ofgem is subject to a duty to take steps to comply.

In addition, both scenarios Ofgem gives in the Draft Determination where the proposal could apply involve the CMA giving a direction to Ofgem. As explained above, Ofgem already has a statutory duty to comply with any direction. There is no reason for a policy statement in the Final Determination confirming this – Ofgem would be doing no more than setting out the existing position.

The Draft Determination states that the two scenarios it gives are not an exhaustive list, but the other circumstances in which Ofgem might seek to conduct a post-appeal review are not clear. We would be extremely concerned if Ofgem's proposal meant that Ofgem might seek to make adjustments for knock-on impacts through a post-appeal review with no decision by the CMA that it should do so. The proposal also leaves open the possibility that Ofgem might do this in areas where there is no clear and previously explained interlinkage with the appealed matter but where Ofgem is considering broader factors in "*the overall coherence and consistency of the regulatory settlement*". In either case, it would be wrong for Ofgem to contemplate such activity:

- Ofgem makes its price control decision, in light of all relevant circumstances.

¹⁰⁹ *BGT v Ofgem* CMA Final Determination (2015), para 3.53

¹¹⁰ *Firmus v NIAUR* CMA Final Determination (2017), paras 8.25 and 8.32

¹¹¹ *SONI v NIAUR* CMA Final Determination (2017), para 13.3

- Under the legal regime for appeals, discrete elements of that overall decision may be subject to appeal on the basis of specific errors.
- Ofgem must implement the remedies from any successful appeal, including any decision relating to knock-on impacts on the other parts of the price control given by the CMA.
- In these circumstances, any broader revisiting of the decision would have the effect of undermining the CMA's findings and thereby frustrating the appeals regime. It is surprising that the Draft Determination even leaves open the possibility that Ofgem might take such action.

The advancement of this proposal unnecessarily introduces uncertainty for licence holders about the predictability of the regulatory regime. A stable appeals regime is not only in line with best regulatory practice, but is fundamental to a credible environment for investment in the electricity sector. Any undermining of that stable regime seriously prejudices that environment and is detrimental to consumers.

The Draft Determination states that any review would be conducted in compliance with any final decision of the CMA and would not undermine the appeals framework, but the above issues are not acknowledged and no explanation is provided of how Ofgem would ensure this.

Any decision to change any part of the price control framework following a post-appeal review leads to the further practical point, that Ofgem should raise and evidence any knock-on impact that it considers relevant as part of the original appeal. It would be entirely inefficient and a waste of both time and cost for any matter of contention around knock-on impacts to be determined through a second CMA appeal, where the issue could properly have been argued and determined in the initial appeal.

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

Context

The Draft Determination also sets out Ofgem's expectation that any stakeholder who is considering appealing will write to Ofgem in the form of pre-action correspondence, between the publication of the Final Determination and the opening of any window of appeal to the CMA.

We note the statement in the Draft Determination that Ofgem is "*consulting... on the practicalities and timeframes of when we would expect to receive such correspondence*"¹¹². However, our understanding from the above consultation question is that Ofgem is also consulting on the principle of pre-action correspondence and we respond on that basis.

Pre-appeal engagement

Any decision on whether NGET would appeal one or more aspects of the RIIO-T2 price control to the CMA will not be made until after the publication of the Final Determination. In any circumstances where we are considering bringing an appeal, we agree that active engagement is likely to be of assistance. This is in line with the CMA's view that "*active engagement is beneficial for all parties, whilst recognising that it cannot bind any ultimate decision on whether to appeal*"¹¹³.

Precisely what engagement is appropriate, and the extent to which it will be appropriate to refer to linked aspects of the price control, will depend upon the circumstances.

The purpose of pre-appeal engagement must be to ensure that the regulator has had a chance to consider relevant issues and is able to avoid an appeal by either changing position or providing an explanation which the network might accept.

¹¹² RIIO-2 Draft Determination Core Document, para 11.30

¹¹³ CMA letter to Ofgem dated 30 October 2019, para 12

NGET response to Ofgem's RIIO-2 Draft Determination – Core Document

We note that the Draft Determination does not state the extent to which Ofgem will be open to change the position it has adopted in the Final Determinations, following any pre-appeal engagement. In the absence of this, the purpose of the proposal is not entirely clear. Ofgem should confirm its position on this in the Final Determination.

Any pre-appeal engagement should occur before the point at which Ofgem is no longer open to change position on material aspects of the price control package. We would expect that, if we were to be in a position where we engaged on pre-appeal matters with Ofgem, Ofgem would engage constructively to see whether an appeal could be avoided. We request that Ofgem confirms its position on this in the Final Determination.

The proposal in the Draft Determination

The Draft Determination states that Ofgem expects any potential appellant to send pre-action correspondence at an early stage between the publication of the Final Determination and the start of the appeals window¹¹⁴.

This proposal is unworkable:

- At the point pre-action correspondence is proposed, no final decision to implement the price control has been made.
- That final decision is the direction to modify the relevant licence to include licence conditions implementing the price control.
- Ofgem must conduct a minimum 28-day statutory consultation prior to making the final decision and its decision must necessarily be capable of changing following that consultation.

It would be inappropriate for pre-action correspondence to occur before Ofgem has made the final decision. The legislation requires that any application for permission to appeal to the CMA must be made within 20 working days of Ofgem's direction to modify the relevant licence¹¹⁵ – unlike in the usual litigation context, this timeframe cannot be stayed by consent between the parties. By the time Ofgem has made its final decision, there is insufficient time for any formal pre-action correspondence stage.

The proposal is therefore unworkable - there is no time for formal pre-action correspondence after the final decision. Moreover, although not referenced in the Draft Determination, any pre-action correspondence stage would need to allow time for Ofgem to send a pre-action response. That is clearly not possible.

The above is consistent with the position of the CMA, which is to encourage active engagement rather than expecting - still less requiring in its appeal rules or guidance - any formal pre-action stage. The CMA has not endorsed a formal pre-action stage in any decisions or guidance, even in its response to Ofgem's express invitation in October 2019 for the CMA to encourage appellants to engage in pre-appeal correspondence¹¹⁶.

In addition, the CMA's statement in its response¹¹⁷, paraphrased in the Draft Determination, that "*Ideally, we would prefer such pre-notification to include the potential scope of any appeal*" clearly referred to a notification to the CMA of an upcoming appeal. It did not refer to pre-appeal

¹¹⁴ RIIO-2 Draft Determination Core Document, para 11.36

¹¹⁵ Sch 5A, para 1(3) of the Electricity Act 1989 and Sch 4A, para 1(3) of the Gas Act 1986

¹¹⁶ Ofgem letter to CMA dated 30 October 2019, para 20; CMA response is in para 12 of CMA letter to Ofgem dated 30 October 2019

¹¹⁷ CMA letter to Ofgem dated 30 October 2019, para 12

engagement with Ofgem, as the Draft Determination implies.

The Draft Determination states that Ofgem expects potential appellants to explain any alleged errors having regard to interlinked aspects of the decision¹¹⁸. As noted above, we believe that the extent to which it will be appropriate to refer to linked aspects of the price control in any pre-appeal engagement will depend upon the circumstances. However, we note that the CMA's stated encouragement of networks doing this relates only to submissions to the CMA where such interlinkages have already been described clearly by Ofgem¹¹⁹. Our position on interlinkages is set out in more detail in our response to Question 39.

We do not believe that the proposal for a pre-action correspondence stage between the publication of the Final Determination and the opening of any window of appeal is workable. Neither do the CMA's statements on this issue, and its appeals rules and guidance, provide any basis for Ofgem to expect such pre-action correspondence.

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?

In relation to the potential short-term effect of COVID-19 on completing the RIIO-2 price controls in time for 1 April 2021, we recognise the need to consider contingency planning. We have responded to the 14 July 2020 Ofgem open letter on COVID-19 contingency plan for RIIO-2. While we welcome that Ofgem anticipates no delay to setting the RIIO-2 price controls, we recognise that there is the potential for the situation to worsen. We agree that a contingency plan should be considered. However, we do not believe that Ofgem's proposal in its 14 July 2020 open letter was a reasonable or proportionate option and we do not believe that it would benefit consumers. Any contingency arrangement does not need to be implemented now and could be implemented by a statutory consultation process beginning in December 2020. This provides sufficient time for Ofgem to engage with industry to discuss viable contingency options. By this point more will be known about the ongoing impact of the pandemic and the potential for any delay to the RIIO-2 Final Determination giving rise to the need for a contingency arrangement.

In relation to managing the potential longer-term impacts of COVID-19 we note that since the pandemic emerged, Ofgem and the network companies have had to prioritise their workloads, postponing some activities such as the closeout methodology. Ofgem and the network companies came together to reach a suitable agreement on which activities to prioritise and agreed easements from the normal regulatory framework where required without the need for licence or other formal changes. Moving forward, given the uncertainty over future potential 'waves' of COVID-19, we believe a similar flexible approach should be adopted. We do not at this stage believe it is necessary to introduce a specific reopener mechanism for COVID-19 into the RIIO-2 regulatory framework.

¹¹⁸ RIIO-2 Draft Determination Core Document, para 11.36

¹¹⁹ CMA letter to Ofgem dated 30 October 2019, para 15