National Grid Electricity Transmission (NGET)
Response to RIIO-2 Draft Determination
EXECUTIVE SUMMARY

Introduction

This is the executive summary for the response from National Grid Electricity Transmission (NGET) to Ofgem's RIIO-2 Draft Determination (DD) consultation.

There are eight parts to NGET's full response as follows:

1. A short covering letter
2. **This 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 ET 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
8. Our response to Ofgem's Finance document questions

We are also submitting numerous annexes containing evidence and analysis to support our response.

The draft determination has an unacceptable impact on our customers, stakeholders and end consumers

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

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

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

3. **Erodes regulatory stability and investor confidence in the sector**

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

We share Ofgem's objectives for RIIO-2, but the DD does not achieve them

Ofgem set out a number of objectives for RIIO2 which we support. However, we consider the DD fails to achieve these objectives for the following reasons:

	Ofgem said it would:	In the DD:
1	"Give consumers a stronger voice in setting outputs, shaping and assessing business plans"	**The DD has not taken account of consumer and stakeholder priorities** that underpinned our business plan or the views of the independent User Group. Customers, stakeholders and consumers alike said their top priority was to maintain current levels of reliability, and the DDs cut reliability investment allowances by 80%, allowing risk levels to rise by at least 24% consequently reducing reliability.
2	"Allow network companies to earn returns that are fair and represent good value for consumers, properly reflecting the risks faced in these businesses, and prevailing financial market conditions"	**The DD does not allow us to earn even its low proposed base return** because of the cumulative impact of decisions such as erroneous cost disallowances, erroneous clawback of T1 allowances and application of punitive and unjustified penalties. Added to this the risks in the DD package are skewed to the downside and provide little upside opportunity. This will discourage the investment needed for net zero and erodes regulatory stability and investor confidence in the sector.
3	"Incentivising network companies to respond in ways that benefit consumers to the risks and opportunities created by potentially dramatic changes in how networks are used"	**The DD's proposes few, low powered incentives to drive benefits for consumers.** The key totex cost efficiency incentive is weak due to underpowered sharing factors derived from a flawed methodology. The totex incentive is then undermined in many significant cost areas by proposals for discretionary ex-post regulatory adjustments to the incentive outturn at the end of the T2 period. The DD rejects new incentives aimed at supporting net zero, resulting in a small ODI incentives package for NGET with 6 times more downside than upside.
4	'Using the regulatory framework, or competition where appropriate, to drive innovation and efficiency'	**The DD stifles innovation and efficiency and introduces delays to net zero projects**. The DDs define many input project details as "secondary deliverables" rather than outputs, negating the incentive to innovate or drive efficiency. For large net zero projects DDs also introduces the potential to apply its undeveloped competition proxy model which Ofgem's own analysis shows to be uneconomic adding further delay to an already cumbersome and slow multi-stage funding application processs.
5	'Simplifying the price controls by focusing on items of greatest value to consumers'	**The DD framework is overly complex and administratively burdensome.** The DD leaves the funding of many types of investment projects to a range of complex reopener mechanisms. Further it introduces multiple ex-post reviews and 'discretionary adjustments' all of which create will be a large administrative burden for network companies and their supply chain, Ofgem, and stakeholders.

The DD reduces the reliability and resilience of the UK's electricity supply

Maintaining the reliability of the electricity transmission system at its current level was our stakeholders and consumers' top priority for our business plan. This emerged consistently from the extensive stakeholder and consumer engagement we carried out on our RIIO-2 business plan. We asked an independent agency to check this finding. In August 2020 the independent agency surveyed a representative sample of 4,018 people and found that investing in the reliability of the electricity network remained their top priority. In addition, 76% of respondents favoured more investment over cutting spending and those in the worst financial position still favoured reliability and addressing climate change over cutting spending.

Ofgem's DD proposes large reductions to our business plan total expenditure ("totex") for asset health as follows:

- an 80% cut in allowances for investment in network reliability and resilience from £3.3bn to £0.7bn, which is one third of the historic investment rate
- £0.6bn of this is for a single project in London, leaving £0.1bn to invest in the network for the rest of the country
- Network Maintenance allowances cut by over 70%

Ofgem acknowledges that its DD will lead to an increase in network risk of 24% by the end of T2 compared to T1 levels due to not replacing or refurbishing the assets included in our business plan. Notwithstanding that this is a significant underestimate, the DD's proposals go against our stakeholders and consumers' top priority of maintaining reliability, despite Ofgem having committed to "giving consumers a stronger voice" in RIIO-2.

The proposed allowances for investment in network reliability and resilience do not come close to safeguarding the reliability of the network. The main consequences for consumers and stakeholders of the DD's proposed cuts in asset health expenditure are:

- A depletion in our ability to avoid power cuts in serious weather events with certain regional impacts due to specific rejected investments;
- putting at risk the investment needed to support the delivery of net zero because we'll need to access our network more to carry out more repairs and recover the bow wave of work in the future;
- moving the burden of investing in the reliability of the electricity transmission network on to future electricity consumers and increasing costs to consumers overall; and
- impact on the ability of our supply chain to retain critical skills and efficient delivery capacity, which will make it more expensive to carry out work in the future.

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

Remedies needed for maintaining reliability:

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

The DD will slow down the delivery of net zero

Rapid progress is needed towards net-zero greenhouse gas emissions by 2050 to help protect the environment for current and future generations. We will rightly play a leading and central role in this transformation and this was one of the main priorities of our stakeholders and consumers for our business plan. The RIIO-2 period is critical to make substantial progress in these investments with targets such as meeting 30 gigawatts of offshore wind by 2030 dependent on our investment in connections and boundary upgrades.

The DD will slow down the delivery of net zero in the ways we describe in the following paragraphs.

Poorly designed uncertainty mechanisms

We recognise that uncertainty mechanisms have an important role to play in the transmission price control, especially at a time when the pathways to net zero are not fully clear. However, the DD is relying more heavily on individual project based reopeners, that involve detailed reviews by Ofgem project by project. In the past, reopeners have proved to be slow and administratively burdensome processes for all involved but were generally limited to a small number of large projects. The more extensive use of reopeners for a much greater number of projects will cause delays to investments until certainty of funding is provided. More specifically we are concerned by:

- A failure to provide any ex-ante funding to initiate, develop and obtain consents for new large projects required for net zero, relying on ex-post regulatory review of justification for cost recovery, with no incentive to drive efficiencies;
- a project specific funding application process for the construction phase of new large projects which is inflexible, bureaucratic in design, and adds delays of 12-24 months to project delivery;
- For smaller new projects, of which there is a significant volume, a second bureaucratic funding application process as a ‘one-off’ opportunity in 2024 or no ex-ante funding at all;
- For connection projects, an automatic funding mechanism that is set far too low through flawed analysis at £9/MW when the costs are £25/MW, creating a perverse incentive to avoid connecting low carbon generators or to supply offtake capacity to customers such as HS2.

Rejection of Incentives that support net zero
The DD rejected our accelerating low-carbon connections ODI that the independent User Group (IUG) encouraged us to develop and supported in its report on our business plan. Accelerating a 1GW wind farm connection by one year would save carbon emissions worth around £50m per year. Instead the DD has introduced new, and currently unquantified, penalties for the late delivery of large projects which add risk and therefore costs to project delivery.

The DD also rejected an incentive to drive NGET to undertake additional types of activities that could help reduce constraint costs in England and Wales by up to £188m each year, with higher potential savings in the future.

The effect is that consumers will miss out on the huge potential benefits that these incentives could bring over the next 5-year period, specifically in areas that are directly related to accelerating the delivery of net zero and achieving it at lowest total cost.

An unclear competition framework
The DD does not say whether we or, through competition, third parties will deliver the large reinforcement projects in the RIIO-2 period that are so critical to net zero. A number of them are already in the development phase and we do not know whether to plan for having the capability to deliver those projects. Ofgem's financeability assessment currently ignores them yet, the default position is that we will be delivering them. The continuing uncertainty creates delays to progress.

Ofgem is proposing to embed its under-developed Competition Proxy Model (CPM in the RIIO2 licence. CPM is not competition, it is an alternative price control mechanism. By Ofgem's own analysis CPM is not expected to deliver any net benefits compared with the RIIO2 regulatory model. However, adding a delay to consider the application of a CPM model that is already known to be not fit for purpose in its current form, and has been demonstrated to not deliver a net benefit, is clearly not in end consumers' interests and serves only to slow progress of net zero projects.

A lack of clarity for anticipatory investment
The DD proposes ruling out making any decisions on anticipatory investments in the FD. Instead the DD says companies can bring forward proposals during the RIIO-2 period, which Ofgem will assess involving the Net Zero Advisory Group (NZAG). The governance process is not clear on the role of NZAG, government departments and government bodies such as the Office for Low Emission Vehicles (OLEV) or how Ofgem will assess anticipatory investment proposals. This uncertainty will lead to delays in progressing our net zero anticipatory investment proposals for electric vehicle charging at motorway services and an offshore ring to reduce the costs and speed up the connection of offshore windfarms to the transmission network. There needs to be clarity on where the responsibility for decision making lies.

NGET must be financeable to deliver future net zero investments
In the DD Ofgem has modelled financeability against an investment level based on the Common Energy Scenario of less than £5bn, which is 75% of our five-year equivalent spend in RIIO-1, rather than stress testing against net-zero scenarios which are at least double that level. There is a risk to the connection of customers and provision of new network capacity needed to support net zero because the significant lag between expenditure and revenue from uncertainty mechanisms creates cashflow risk when the higher scenarios are modelled.

An inadequate return for investors
In the next section we discuss how Ofgem's DD means we cannot even achieve the low base return in the DD. This will impact our ability to efficiently finance the large amount of investment we need to make to support the transition to a net-zero greenhouse gas emissions energy system.

The box below sets out the remedies we propose for supporting the delivery of net zero, which is what our stakeholders and consumers expect.

Remedies needed to support the delivery of net zero:

- Ofgem should use automatic uncertainty mechanisms to fund smaller projects and development costs for large projects
- Ofgem should correct the underpinning analysis for new connection UM funding rates
- Ofgem should remove proposals to make discretionary ex-post adjustments to incentivised cost outturn
- Ofgem should introduce positive incentives to encourage the acceleration of low-carbon connections as a balance for the penalties for late delivery of major projects.
- Ofgem should not include CPM in the RIIO2 licence to provide much needed clarity for the delivery of large projects in the T2 period under a RIIO-2 model. Ofgem should focus on developing a robust CATO model rather than its CPM framework.
- Ofgem should provide more certainty over its approach to anticipatory investments so that we can start this work in RIIO-2.
- Ofgem needs to make sure that we are financeable in a scenario where we are delivering all the investment needed to deliver net-zero.
- Ofgem needs to provide a balanced overall risk and reward package which provide a fair return for investors (see the next section).

Eroding regulatory stability and investor confidence in the sector

Ofgem states £25 billion of investment could be required in the RIIO-2 period for net zero and other customer outputs. This is across the gas distribution and transmission sectors however the eventual figure will almost certainly be higher because customer triggers suggest our overall investment alone could be over £10bn in the period.

A stable regulatory regime has been the reassuring anchor for investors to provide low cost financing over the last thirty years and has underpinned financial resilience through the uncertainty of Covid-19. But the DD risks this by proposing movements away from regulatory precedent, introducing ex-post reopeners and applying disproportionate, unjustified penalties.

The allowed equity return in the DD is below that of UK water and international energy sector benchmarks. More broadly, the DD offers limited reward to drive better performance and service levels for both customers and consumers, and worse, would not enable investors to achieve the allowed equity return; a fundamental tenet of regulation and part of Ofgem's financing duty. The result is a framework which will erode regulatory stability and push capital away from the UK energy sector at a time when significant investment is required, increasing costs of delivery for consumers.

> "We see divergence between political narrative on economic recovery and net zero, with Ofgem's objective…we also see incumbent companies i) diverting capital to higher return regimes and ii) disincentivised to provide novel and innovative net-zero solutions"
> *Barclays Research, August 2020*

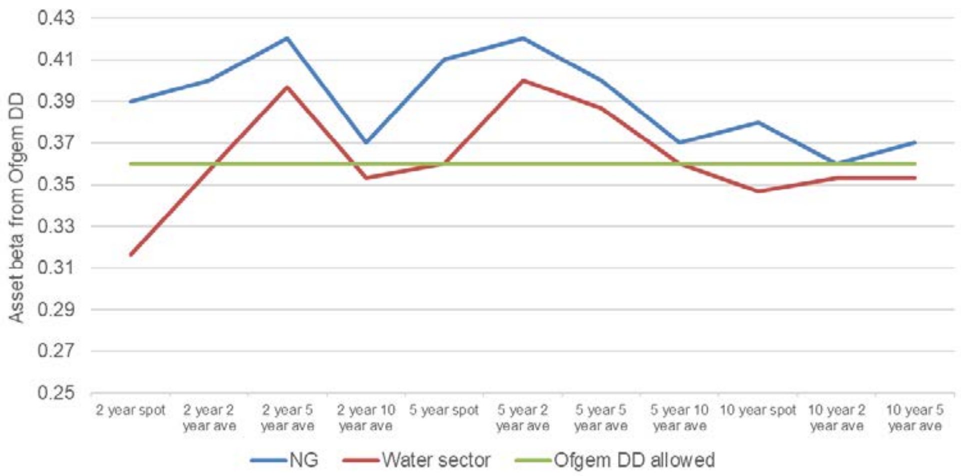
We outline the issues and remedies required in this area under the following sections:

- an inadequate allowed equity return;
- an unachievable allowed equity return due to:
    - an unjustified and disproportionate BPI penalty
    - an unjustified clawback of T1 allowances
    - crude and overly stretching efficiency targets
- an incentive package skewed towards penalties and ex-post clawback and away from incentives to deliver for consumers; and
- a marked weakening of financial resilience;

Inadequate allowed return
It is vital that the allowed rate of return is set within a plausible range, however Ofgem's figure of 3.7% is set far too low, owing primarily to three errors in how their range has been determined.

- **Relative risk (beta) is far too low**: Ofgem has conducted a flawed assessment of the available evidence in which it rejects all evidence that supports a higher number, including their own data. Figure 1 shows National Grid plc's asset beta, the relative risk to the market, has been higher than the equivalent in the DD for the last ten years (blue line compared to green line in graph below).

Figure 1: Asset beta from Ofgem's DD for multiple time horizons and averaging periods



- **Total market return is incorrectly reduced:** the continued use of a flawed inflation back-cast data set, which even its authors do not endorse, compounds the low return from beta (and we note that this approach is currently before the Competition and Markets Authority (**CMA**) in the context of the PR19 water redetermination references).

- **Flawed outperformance wedge:** Ofgem proposes to deduct an unjustified wedge in anticipation of outperformance in RIIO-2. As a matter of principle this concept is flawed and presupposes Ofgem cannot correctly calibrate the totex and incentives in its own price control. Moreover, practically it seems unclear how any meaningful level of outperformance can be expected based on the DD. The evidence Ofgem points to in support of its 25 basis points calibration for the wedge contains multiple errors and would only support historical totex performance being in line with allowances at best. The result is a flawed reduction to returns which is the equivalent to an unjustified 5% stretch totex efficiency, much like the RIIO-ED1 smart grid efficiency which was removed by the CMA on appeal.

The UK needs a progressive regulatory framework that encourages investment into the energy sector but the message to investors from the DD will be to invest overseas or in the UK water rather than energy sector. Ofgem's proposed cost of capital of 3.7% (after the outperformance wedge) is below the rate four water companies are currently referring to the CMA and below US and comparable continental European benchmarks. Taken together, these decisions therefore create a significant risk that allowed rate of return will be set far too low. We address the allowed return in detail in our response to the Finance Document.

Remedy needed for allowed return:
Develop a more balanced appraisal of allowed equity return and remove the flawed outperformance wedge.

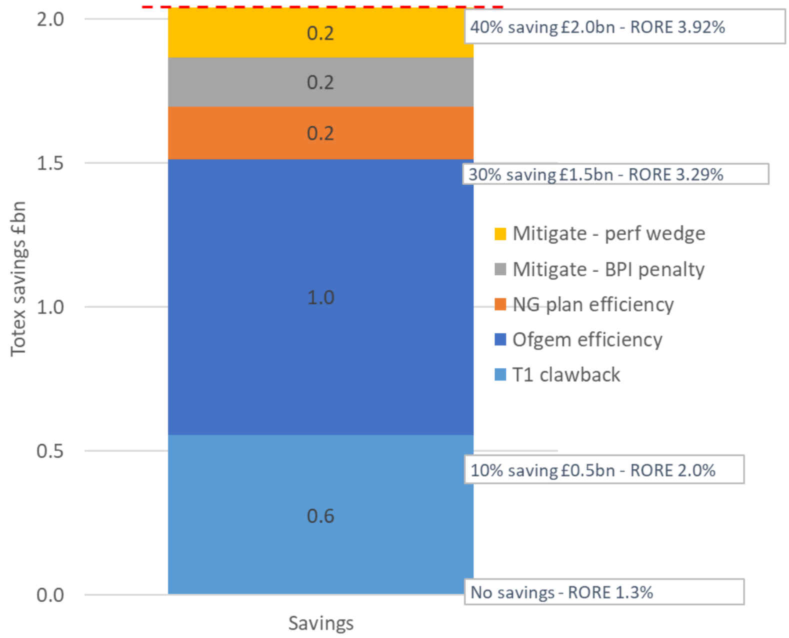
An unachievable allowed equity return
As well as the allowed return being inadequate, based on the cumulative effect of the multiple DD mechanisms and efficiencies, we would start the RIIO-2 period with a substantial gap to our allowed equity return. Without any savings from today we would be facing a Return on Regulated Equity (RoRE) of 1.3%. We would have to deliver our funded workload for 40% less than our current operations to deliver the allowed return. Even achieving maximum incentive profit and the highest network totex performance delivered in RIIO-1 would not enable us to close this gap.

Figure 3 shows the DD means we will be unable to achieve our allowed equity return. Figure 3 starts with Ofgem's proposed allowed return of 3.92% (pre outperformance wedge) in the DD and we then have to deduct the following elements:

- the performance wedge (in yellow) is equivalent to NGET having to reduce its totex by a further £0.2bn. We explain above why the performance wedge is unjustified.
- the business plan incentive (BPI) penalty (in grey) is equivalent to NGET having to reduce its totex by a further £0.2bn. We explain below why the BPI penalty is unjustified and disproportionate.
- Our own efficiency commitment (in orange) included in our business plan was £0.2bn from current expenditure.
- Ofgem's flawed and excessive efficiency assumptions (in dark blue) are equivalent to us having to reduce totex by a further £1bn. We explain below why the DD efficiency assumptions are simplistic and excessive.
- the unjustified T1 clawback (in light blue) is equivalent to us having to reduce totex by a further £0.6bn. We explain below why the T1 clawback is unjustified.

Overall, figure 2 shows that we would have to reduce our totex by 40%, which is far from a realistic proposition, to achieve even the inadequate DD allowed return.

Figure 2: 40% totex savings required to close starting RoRE gap of 260bps



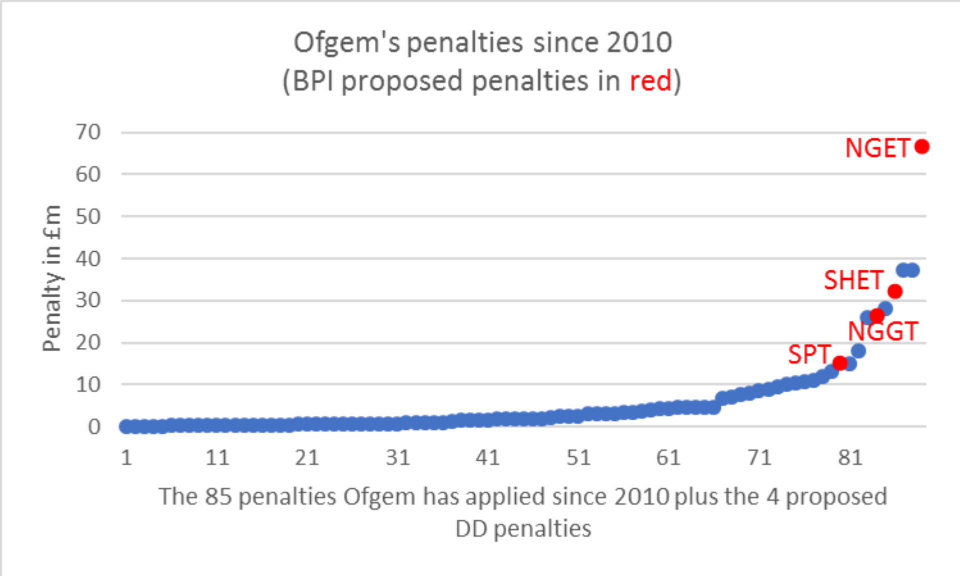
Even if we deliver the DD future productivity efficiencies which are more than twice the productivity level of the general economy, we would be facing equity returns of 1.55%[1], more than 230bps below the allowed return.

We address this issue in more detail in our response to the Finance document, under unachievable allowed equity return. In the next sub-sections we explain three of the bars in figure 3: the unjustified and disproportionate BPI penalty, the simplistic and excessive efficiency assumptions and the unjustified T1 clawback.

<u>The unjustified and disproportionate BPI penalty</u>
Ofgem's methodology said that the purpose of the BPI was to "encourage high-quality and ambitious Business Plans". However, what the DDs demonstrate is that instead it results in punitive and unjustified penalties, arising from a methodology which is highly subjective, manifestly disadvantages the Transmission sector and penalises for the same perceived failing multiple times. In the DD Ofgem is proposing large penalties of £140.2m (after the application of caps) to the four transmission companies combined, compared to only £1.6m of rewards for them. For NGET it is proposing a £66m penalty. Figure 3 shows that a penalty of this magnitude is higher than any penalty Ofgem has imposed on any energy company since its records began in 2010.

[1] Breakdown shown in NGGT Executive Summary - Figure 4: 25% totex savings required to close starting RoRE gap of 150bps

Figure 3: The BPI penalties in the DD are among the highest Ofgem has ever applied



In our detailed response on the DD core document we show the proposed BPI penalty for NGET is both unjustified and disproportionate. In brief:

- Ofgem has incorrectly assessed we have not met the minimum requirements because it has either missed evidence we have submitted or applied requirements that were not in its guidance. We have passed the stage 1 minimum requirements in all material respects.
- Ofgem has provided very little justification for the BPI penalty, despite its size, and has not followed its own methodology in the limited justification it has provided. For example, Ofgem has missed out the step of explaining why our costs are poorly justified that was meant to underpin its stage 3 penalty (which amounts to £180m, before the application of the cap) meaning we cannot properly respond.
- The BPI penalty is set far above regulatory precedent for business plan incentives and is contrary to Ofgem's guidance which implied the BPI would be symmetric.

As part of the expected price control process we have been working with Ofgem since before its DD to provide the greater level of detail Ofgem requires, above that mentioned in business plan guidance, to help it understand our plan. For example, we provided additional 118 supplementary evidence reports to Ofgem in mid-August on network reliability. We are also providing further information with our DD response which will help Ofgem to consider its approach to the BPI.

Remedy needed for the business plan incentive:

- Remove the unjustified and punitive penalties for NGET.
- Recognise the ambitious activities and costs in our business plan that add consumer value through rewards in the BPI.

<u>Unjustified clawback of T1 allowances</u>

Ofgem's DD proposes to re-open the T1 price control and claw back over £500m of fixed incentivised allowances settled back in 2012 and reduce T2 allowances accordingly. Ofgem gave us no warning of this huge disallowance (17% of our baseline totex at DD) in its sector-specific methodology or in its subsequent interactions with us. We are unable to identify any regulatory mechanism or vires for such action. Such action would ignore agreed risk sharing arrangements consulted on and confirmed by Ofgem numerous times since 2012, and be hugely detrimental to the basis of the RIIO regime and regulatory stability.

We firmly disagree that Ofgem has any right to apply a clawback in this area (and, even if such clawback were to be allowed, Ofgem's calculation contains multiple errors that exaggerate its size). Ofgem's DD first introduces this proposal in a footnote, and only contains 5 sentences of explanation. The DD does not explain or provide any evidence as to why Ofgem believes it is entitled to clawback settled allowances from T1.

Remedy needed on clawback of T1 allowances:

- Ofgem should remove the unjustified clawback of fixed RIIO-1 allowances.

Flawed cost assessment leads to efficient costs being disallowed

We recognise that we need to stretch ourselves to deliver efficiencies that save money for consumers. In our business plan we included over £300m of forecast totex efficiency to bring us into line with or be better than external benchmarks. On top of this we overlaid a 1.1 per cent per year productivity growth target for all our labour and operating costs. This is almost three times the current UK trend for productivity, and is the highest ongoing efficiency targets of any network business plan.

Ofgem's DD proposal is to disallow 13% of costs as inefficient resulting from the range of different cost assessment methodologies it has employed to different types of costs. We have found multiple flaws with the methodologies and analysis used to derive these disallowances.

The main issues include:

- The application of extensive reductions in allowances due to assessment of network capex costs as inefficient, which are actually the result of errors, methodology weaknesses, data handling issues and inconsistent comparisons.

- The DD's approach to efficiency for operating costs is wholly inappropriate as it is based on an unreliable regression approach. Additionally, Ofgem has scaled down our closely-associated indirect operating costs with the reduction in capex levels, but has ignored that a third of these operating activities do not flex with our capital programme. This results in lower allowances that would require significantly cuts in headcount and critical skills from current levels despite a sector view that more skills are required in the future to deliver net zero.

Remedies needed for efficiency assumptions:

- Correct the flaws we have found in the DD's cost assessment methodologies as detailed in our response.

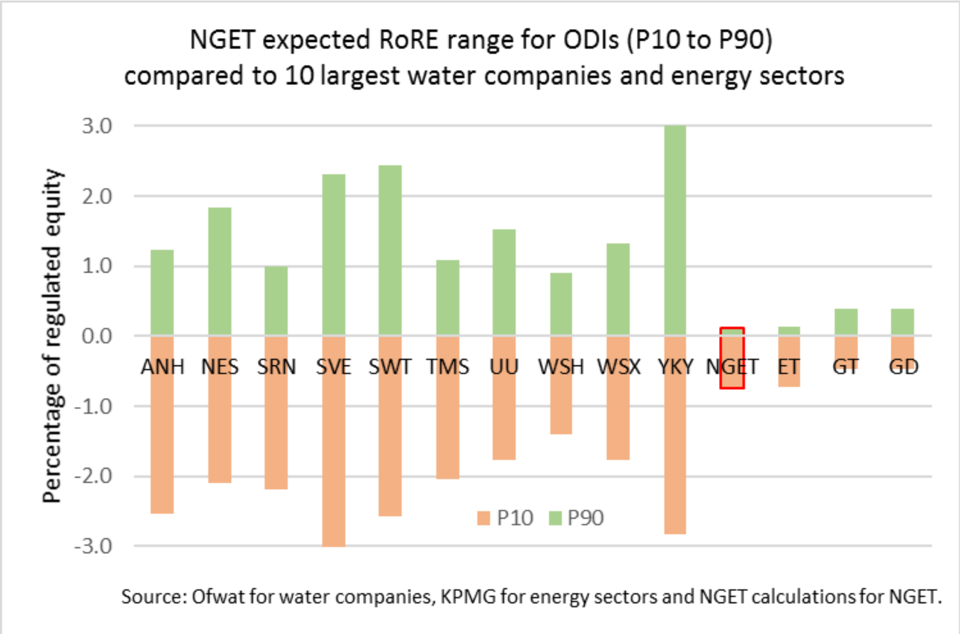
An incentive package skewed towards penalties and ex-post clawback and away from incentives to deliver for consumers

The DD proposes an incentive package for NGET that is skewed towards penalties and ex-post clawback and away from incentives to deliver for consumers. This matters for consumers because it strongly encourages us to focus on low-risk, cautious investments to avoid penalties and discourages from innovating and seeking new efficiencies because they will not be rewarded for the risk we'll be taking.

The DD's proposes ex post reviews of outputs if a company delivers something differently from what is in its business plan and to enable this introduces the concept of "secondary deliverables" that was not in the RIIO-2 methodology. The ex post reviews strongly discourage companies from taking innovative approaches because if they do, they risk Ofgem reducing their allowances if it disagrees that the approach was innovative or efficient. The lack of clarity around how these ex post reviews will work in the DD compounds the disincentive to innovate.

Figure 4 shows that the incentives linked to service performance are much weaker in the energy sector compared with the water sector. In addition, the electricity transmission sector has weaker positive incentives than the gas transmission or gas distribution sector.

Figure 4: NGET expected RoRE range for ODIs compared with water and the other energy sectors



Ofgem has rejected our stakeholder-supported incentives around accelerating low-carbon connections and savings consumers money through providing innovative, flexible services to the ESO even though they were supported by stakeholders. If Ofgem approved these at the FD it would deliver benefits for consumers and move our incentive package towards symmetry.

In the DD, Ofgem has weakened or nullified the incentives for us to reduce our costs:

- **The DD reduces the totex sharing factor** from 47% in RIIO1 to a proposed 39.2% in RIIO2. This lowers the incentive for network companies to reduce their costs. Ofgem's impact assessment shows that the lower sharing factors for transmission companies in the DD lead to lower benefits for consumers. Ofgem can remedy this by following its methodology for calculating the totex sharing factor more accurately by taking account of costs that will be in uncertainty mechanisms and its tools to increase cost certainty, which will increase our totex sharing factor.
- Through various proposals associated with Price Control Deliverables, Ofgem proposes to determine at the end of the period whether any outperformance of allowances to deliver the NARM output in RIIO-2 was "genuine" and make discretionary, asymetric ex-post adjustments accordingly. This is poor regulatory practice, reduces regulatory stability and undermines the core efficiency incentive.

Remedy needed for incentives:

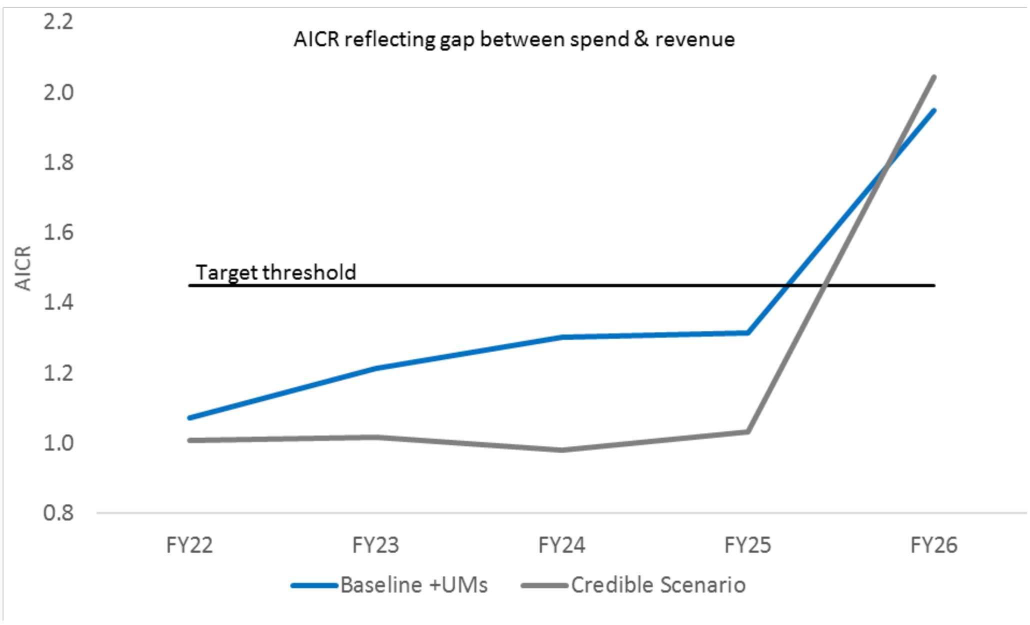
- Adjust the risk/reward of the overall package to drive service improvements and reduce costs to the benefit of current and future consumers.
- Approve new ODIs on accelerating low-carbon connections and savings consumers money through reducing constraint costs
- Adjust the common ODIs so that the incentive ranges are more symmetric and larger.
- Remove the discretionary ex-post incentive adjustment from PCD output delivery assessment
- Apply the totex sharing factor methodology more accurately to increase the totex sharing factor from 39.2%.

A marked weakening of financial resilience

Having introduced a requirement for our Board to give assurances that our business plan is financeable, Ofgem has materially changed the framework on which our plan was submitted. We are now being forced to markedly reduce our financial resilience yet at the same time carry highly material finance risks (and costly delays) owing to the widespread use of uncertainty mechanisms to fund necessary work and ex post review to confirm or deny that funding will be provided for various works.

The lower returns in RIIO-2 sharply reduce our financial resilience with baseline plans leaving the notional company on the cusp of being downgraded from BBB+. More worryingly credit metrics drop to sub-investment grade once delays between spend and revenue under the myriad of uncertainty mechanisms are factored in. Figure 5 below shows the Adjusted Interest Cover Ratio (AICR), one of the key credit metrics, for two totex scenarios more consistent with net zero and including delay in revenue from uncertainty mechanisms. As can be seen, the cashflows are below threshold for all but the final year when customers would face a sharp increase in charges.

Figure 5: AICR trend including gap between spend and revenue under uncertainty mechanisms



The financial resilience of the sector has to be assured to keep financing costs low for consumers. We have been able to weather recent economic turmoil caused by COVID-19 and Brexit by having sufficient financial capacity and in doing so we were able to provide a financial anchor to the rest of the industry. In the green recovery and move towards decarbonisation this capacity will be important to maintain resilience but by pushing returns too low and not adequately stress testing financeability for higher totex levels the DD removes this; creating unnecessary risks and costs for consumers.

We address financial resilience in detail in our response to FQ12 in the Finance document

Remedy needed for financeability:

- Ofgem should undertake a financeability assessment on totex levels which enable delivery of net zero and factors in delays between spend and revenue under uncertainty mechanisms.

Conclusion

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

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