

3. NATIONAL GRID GAS TRANSMISSION RESPONSE TO RIIO-2 DRAFT DETERMINATION: CORE DOCUMENT

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Introduction

National Grid Gas Transmission (**NGGT**) has serious concerns with Ofgem's RIIO-2 Draft Determination (**DD**) and its consequences for Great Britain. The DD cuts our proposed business plan baseline allowances from £2.6bn to £1.53bn and reduces the outputs we proposed in our business plan. Whilst we share Ofgem's stated objectives for RIIO-2, 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. **Introduces significant risk to the reliability and resilience of the network,**
2. **Creates unnecessary complexity and volatility in the framework, and**
3. **Erodes regulatory stability and investor confidence.**

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 are currently unacceptable and numerous remedies are necessary for Final Determination to address the 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 will also continue to engage constructively with Ofgem over the weeks and months leading up to the Final Determination with a view to ensuring our evidence is fully understood and the necessary changes secured.

Structure of this response

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

1. A covering letter
2. An executive summary of our response
3. **Our response to the Core Document**
4. Our response to the Gas Transmission sector annex
5. Our response to the NGGT annex
6. Our response to the Network Asset Risk Metric (NARM) annex
7. Our response to the Finance annex

We have set out a number of concerns on the following areas at the beginning of our response to the NGGT annex, which should be read in conjunction with the question responses and detailed evidence provided in this document:

- Totex incentive mechanism
- Business Plan Incentive mechanism
- Interlinkages and Appeals

Response to Ofgem Core Questions Q1 to Q43

3. Embedding the consumer voice in RIIO-2 Enduring role of the UGs and CEGs

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, User Group members may feel their input is invalid and we may lose their valued expertise in the enhanced engagement process. We have committed to an ongoing role of the User Group on an enduring basis.

The National Grid Gas Transmission User Group (for the rest of our response we will refer to as “the User Group”) is an independent group and since submission of our December 2019 business plan they have been working on updating 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 Group would be to continue to challenge our engagement activities, scrutinise our business plans and verify our annual reporting, including our preparation for RIIO-3.

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

We propose that the User Group 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 and ensure insights are useful and taken into account.

The User Group will develop, and review annually, principles for prioritisation to inform their 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 Group 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 Group 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 Group should report annually and include details on this in question 3. In addition, the User Group 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 Group 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 Group website.

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

- All stakeholders given the User Group 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 and particularly the quality and use of related stakeholder engagement.

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 as stated in question 1, we would see a role for the User Group to scrutinise new investment proposals developed through uncertainty mechanisms and the associated stakeholder engagement.

We note that Ofgem has proposed a considerable amount of uncertainty mechanisms, and on some of them, getting the User Group 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 that the User Group would ultimately scrutinise 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 Group 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 report should be wider than customers including all 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 Group 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 Group 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 NGGT User Group; 4 members have left, and 5 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 Group 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.”

4. Quality of service – setting outputs for RIIO-2

Cross sector outputs

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 are unable to confirm and, equally believe there is insufficient information available to any stakeholders to determine if these licence obligations will support the delivery of a digitalised energy transition. At present we are unable to support the licence conditions as the Digitalisation Strategy and Action Plan (DSAP) guidance cannot be fully understood and the guidance has not been fully factored into companies RIIO-2 business plans.

Ofgem’s current position to issue by direction reduces transparency for all parties. To reach a decision on the licence obligations we expect Ofgem to fully consult on the guidance with stakeholders to ensure the impact on the industry and network companies price controls is fully understood and considered. This process should then allow network companies to propose the costs to meet the licence obligations.

We continue to support the steps been taken by Ofgem to support and encourage the digitalisation of the energy system.

Digitalisation Strategy and Action Plan (DSAP)

The requirements to publish regular updates to digitalisation strategies and actions plans could be an appropriate way to provide transparency to stakeholders. We understand from ongoing RIIO-2 licence drafting workshops that the feedback contained in the RIIO

digitalisation strategies open letter will be developed further into DSAP guidance. Compliance with this guidance, that has not been published or a draft made available, is also proposed as part of the licence condition. The only detail of this guidance has been provided within the draft licence condition which makes provision for specific content and levels of stakeholder engagement networks will be expected to meet.

It is difficult to support this element of the licence condition when the implications of the DSAP guidance cannot be understood and have clearly not been factored into our or any other network companies RIIO-2 business plans. Further we would expect such guidance to be fully consulted on with all stakeholders to ensure that the impact on the industry and network companies price controls is fully understood and considered. Not as is currently Ofgem's position to issue by direction.

Our ability to deliver against our strategy will be dependent on appropriate funding for the investment in new technologies that will underpin it. Just as vital are the skilled employees within our Closely Associated Indirect teams who will continue driving forward our adoption and integration of new technologies. Please see our response on NGGT question 31 relating to Closely Associated Indirect funding.

Data Best Practice

The principles of the Data Best Practice guidance are reasonable and can help build consistency of approach amongst data custodians. Principles alone will be open to interpretation and so we continue to engage through the Energy Networks Association (ENA) in developing the industry approach to open data.

We believe that the licence condition to work in accordance with the principles set out in the Data Best Practice guidelines should clarify the reference to "where in the interest of consumers". This is relevant for an obligation placed on regulated network companies as it allows us to recognise our overarching requirement to be economic and efficient in the best interest of energy consumer. If there is a cost of making certain data open, then the benefit of doing so should outweigh that cost.

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

The proposed frequency of publication of updates is reasonable. We welcome the move to publish updates once every two years and this should align with the Non-operational IT and Telecoms capex re-opener to ensure regulatory funding aligns with the action plan requirements. If funding is not agreed to deliver against the DSAP, then network companies should not be held account to meet the requirements. This is dependent though on further clarity on the expectation of the scale of updates, the stakeholder engagement requirements, the level of feedback from Ofgem and obligation to implement such feedback. We expect these to be outlined in the DSAP guidance. We would again highlight our concerns set out in Q5 that the DSAP guidance has not been published or a draft made available.

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?

Market data such as that we already share through the Prevailing View and Market Information Provision Initiative (MIPI) platforms and pipeline location. MIPI hosts and provides stakeholder with the current suite of market data. We hope to invest in MIPI throughout RIIO-2 to develop it in line with the Data Best Practice guidelines and to ensure we are meeting the evolving expectations of the stakeholders who make use of the data provided through this system. Asset location data such as we already publish, providing the location of our pipelines and key sites. We continue to improve the granularity and accessibility of this data through our investment in our geospatial platform.

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 to ensure delivery of our commitments in our engagement strategies. We believe it will be for the User Group to determine their 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. This is one of the key considerations and we believe the User Groups should set out what they will prioritise and the reasons for this prioritisation.

As stated in the purpose of the User Group (question 3), one of the key areas of work for the User Group 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 Business Carbon Footprint (BCF), we are committed to working to reduce our carbon emissions as a business. We are also comfortable with the concept of the Environmental Action Plan (EAP) commitments to be reported on as part of the Annual Environmental Report (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 Closely Associated Indirects (CAI) (please see question NGGT31) 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 and the additional environmental reporting commitments proposed in Draft Determinations. Our funding needs to take into account drivers such as age and complexity of demands the network, compliance with safety and environmental legislation and the need for engagement with distribution networks 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. Ofgem as a remedy should ensure that their CAI proposals do not jeopardise the delivery of our environmental commitments to benefit society.

5. Ensuring efficient cost of service

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.

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 NGGT, 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" which is an annex to our response, 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:

Table Core1

	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 plan, 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, 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:

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.

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Table Core2

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%	1.3%	1.3%	1.3%	1.3%
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:

Table Core3

	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?	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.

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 RIIO-2, which underlines the importance of careful design in the RIIO-2 price control financial model to ensure that these all interact correctly.

Conclusions

In making their final determination, Ofgem should:

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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.

Table Core4

Plant & Equipment materiality assessment based on 1% of annual average base revenue	NGGT
Average annual base revenue (AABR) (National Grid view per submission)	993
Average annual base revenue (AABR) (Ofgem per Draft Determination)	886
1% of AABR (per submission)	10
1% of AABR (per Draft Determinations)	9
Plant and equipment as % of totex (National Grid view per submission)	5%
5-year totex value of Plant & Equipment (National Grid view per submission)	130
Annual totex value of Plant & Equipment (National Grid per submission)	26
5-year totex value of Plant & Equipment (Ofgem view per Draft Determinations)	78
Annual totex value of Plant & Equipment (Ofgem view per Draft Determinations)	16
5-year totex value of Plant & Equipment > 1% of AABR (National Grid per submission)	TRUE
Annual totex value of Plant & Equipment > 1% of AABR (National Grid view per submission)	TRUE
5-year totex value of Plant & Equipment > 1% of AABR (Ofgem view per Draft Determinations)	TRUE
Annual totex value of Plant & Equipment > 1% of AABR (Ofgem view per Draft Determinations)	TRUE

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.

Table Core5

Difference in cost structure weightings	NGGT	CEPA	Variance
Labour	46%	51%	5%
Materials	25%	26%	1%
Plant & Equipment	5%	5%	0%
Other	24%	18%	(6%)
Total	100%	100%	(0%)

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:

Table Core6

Gas Transmission	Opex	Capex	Total
Labour	27%	30%	57%
Materials	2%	22%	24%
Plant & Equipment	0%	6%	6%
Other	7%	6%	13%
Total	37%	63%	100%

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.

In our business plan submission, we put forward a stretching 1.1% future productivity target across our operating 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 RIIO-1 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 RIIO-2 period.

Our business plan proposals made a link between long term input price influences on labour, with a long-term view on productivity. This approach addresses considerations for economic uncertainty during RIIO-2, 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:

1. 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.
2. Consider the extent to which current economic conditions, and this risk of these enduring, should inform forward productivity forecasts.
3. 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.
4. 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.
5. 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.
6. 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.
7. Consider the extent to which productivity on external capital costs are already captured within RPE indexation and CPIH.

8. 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.
9. 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.

Shortly after the DD publication Ofgem notified us of an error in their efficiency calculation this amounted to an additional £40.9m efficiency attributable to opex, reducing our allowances by the same amount. Ofgem's revised calculation duplicated embedded efficiency of £1.6m within our submitted SO Direct opex. Correction of this error would increase our allowances by the same amount. We have logged both errors with Ofgem for addressing at Final Determinations.

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 finalised 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-2 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 RIIO-2 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 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 £43m of reduced asset health 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-1 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-1 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.

6. Ensuring efficient financing – N/A

7. Managing uncertainty

Approach to setting uncertainty mechanisms

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

We have a fundamental concern about the use of re-openers within the RIIO-2 price control settlement. Ofgem have moved from a proportionate £650m to circa £1bn of UMs or 40% of our controllable costs. Ofgem has created a vast, sprawling, granular regime relating to uncertainty mechanisms that involves micromanagement and second guessing of business decisions in many areas. Project delays caused by uncertainty of funding have the potential to have a negative impact on consumers, and this is a particularly key issue given the amount of the NGGT plan being subjected to re-openers.

Our main concerns from a framework-wide perspective are around a lack of clarity around the regulatory framework. From a Gas Transmission perspective, we have some specific concerns around upfront funding for development costs and financeability, which are addressed in GT Sector question 3 and a number of NGGT specific questions.

Lack of framework clarity and consultation

It is vital that the process through which uncertainty mechanisms proceed is clearly established ahead of Final Determinations. The lack of full visibility of the licence conditions and associated reopener guidance against which submissions will be assessed is concerning. To reach a view on the reopener framework, we expect Ofgem to fully consult on the guidance with stakeholders to ensure the impact on the industry and network companies price controls is fully understood and considered. These licence conditions and the associated reopener guidance should:

- Clearly establish a route of appeal to the CMA in respect of Ofgem reopener decisions which have a significant and material impact on the overall price control package;
- Provide a commitment from Ofgem to decision making timescales to avoid project delay, to avoid adversely impacting the efficiency of the reopener process, our planning and execution of work, utilisation of system access outages and contracting with the supply chain; and
- Not provide Ofgem with the ability to trigger re-openers unilaterally at any point within the price control period, creating uncertainty for us, our customers and the supply chain.

We have set out our specific views on reopener parameters aligned to the Draft Determinations document below.

Reopener application windows

Project delays caused by uncertainty of funding have the potential to have a negative impact on consumers, and this is a particularly key issue given the amount of the NGGT plan being subjected to re-openers. It is therefore important that Ofgem make timely decisions on re-openers. We do not support the concept of an open-ended period within which Ofgem would arrive at its 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.

We would like to see Ofgem commit to decision making timescales for each type of reopener. We would be happy to work with Ofgem in developing such timescales. For example, in our recent engagements relating to compressor re-openers we provided information to Ofgem around when decisions would need to be made to ensure that projects would not be delayed.

Application requirements

As set out earlier in this question response we have received insufficient information on application requirements to form a view on this. We expect Ofgem to consult on this to ensure the impact on the industry and network companies price controls is fully understood and considered

Authority triggered reopeners

We also do not support the unilateral ability of Ofgem to trigger reopeners at any time. We do not believe in many cases that this would be necessary. For example, for major projects reopeners such as Bacton, there are already project defined trigger points which are due to be set out within the licence.

In certain cases, a price control reopener may be triggered by Ofgem at any time during the price control period. Yet there is no symmetric right for companies, only a time limited and carefully circumscribed set of narrow reopener windows. The critical net zero reopener can only be triggered by Ofgem (and is not clearly defined). This creates a huge risk for companies, who again would be exposed in full to downside risk, while Ofgem has the ability to reopen at any time in the price control in the event of an unforeseen upside emerging. We also note the burden placed on an already stretched stakeholder community to engage continuously through the RIIO-2 period to allow the opportunity to have their voice heard in all reopener decisions.

Materiality thresholds

Whilst we agree with the materiality threshold being set at 1% as a principle where it applies, it is not clear the basis on which this is calculated. Please see our response to Finance Q37. We have set out in individual UM responses our view of materiality thresholds for specific reopeners.

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 NGGT's activities during the period and/or relate to new and untested licence mechanisms. In these areas, which include for example incremental obligated entry and exit capacity and the Bacton, St Fergus and Wormington project and net zero reopener decisions, 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.

Ability to respond to reopeners

Ofgem has assumed that all indirect activities flex with capital plan and reduced our baseline CAI opex allowances by 60%, not recognising that we will need indirect costs to support the many reopeners proposed under RIIO-2. Therefore, we are not sufficiently funded support these reopeners. Please see NGGT question 31 for more information.

Cross-sector uncertainty mechanisms

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.

Materiality threshold - We agree that there should be no materiality threshold for this reopener, so it does not exclude smaller projects which could create consumer value.

Financial incentive – We believe there should be a financial incentive in place that rewards companies for seeking the best overall whole energy system solution and for delivering the best value to consumers. At a minimum, companies should be able to recover costs for exploring the opportunity to transfer an activity to 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 can outperform through the totex incentive mechanism (TIM). Careful consideration is needed to ensure the share of the benefit reflects the contribution of each party and the overall consumer value it delivers.

Foreseeable criteria – agree no reason to include a 'foreseeable' criterion.

Who should trigger and make an application – We still 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.

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 constraint and limits onto the process and we suggest an automatic approach to triggering the mechanism. The reason for this view is that having to wait a period of a year or longer before knowing that spend could be transferred to another party whilst still being committed to a specific window for an output delivery, the most likely decision will simply be to ensure delivery of that output. This is because the risk of not delivering an output and the associated penalty (especially if outages are required and penalties are applied by Ofgem for late delivery) is a critical aspect that needs consideration. If the activity is associated with a price control deliverable (PCD), consideration needs to be given to potentially halting any associated timeline with this PCD from the time of the application and subsequently extended until Ofgem make a decision.

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. 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?

Yes, the RIIO-2 electricity distribution licences should be amended to use the CAM from April 2021 to ensure any whole system proposals can be accelerated without potentially delaying benefits to consumers.

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 Operational Technology (OT) and Information Technology (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. This is as per discussions 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 project specific outputs?

We agree that the PCD should include alongside the delivery of project-specific outputs the delivery of outputs such as cyber assessment framework (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 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 see the benefit in the proposal to have two reopener 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 reopener at the start of RIIO-2 and mid-term seems appropriate, and it is important that the reopener 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 reopener should not be open-ended and that a decision should be given within a maximum of three months from reopener submission.

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 and contracting with the supply chain. Please see our separate response to Q12 where we set out our further views in relation to Ofgem's proposed common approach for reopeners.

The use of reopeners provides flexibility and helps to manage uncertainty, however appropriate ex-ante baseline funding is essential for efficient IT investment. Funding for investments shared between regulated entities e.g. NGET and NGGT, should be included in the baseline to provide certainty of cost and delivery, as this approach is in the best interest of consumers. Similarly, as a minimum, investment required in the first two years of RIIO-2 should be included in baseline to allow these projects to be initiated without delay. For NGGT this will mean that £159m currently included in uncertainty mechanisms (UM) should be moved to baseline funding. £69m of this is correcting the inconsistent assessment of shared indirect investments between ourselves and NGET.

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'. NGGT shares a number of applications with ESO and any move to an independent model is likely to have capex and opex costs for NGGT which have not been considered as part of our Business Plan submission and will require inclusion via the re-opener at the start of RIIO-2 or via another mechanism.

We agree with the proposal of no materiality threshold and aggregation aligned with Ofgem's position that IT investment is important to the digitalisation of the energy industry and enabling efficiency within companies. If Ofgem does not move materially from its current position of minimal baseline and significant UM funding then given the potentially large numbers of projects to be developed ahead of the reopener, we believe there is a strong case for ex-ante allowances to support this development of capital projects.

We do not support the concept of an open-ended period within which for Ofgem to arrive at its reopener 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 and contracting with the supply chain.

We would like to see Ofgem commit to decision making timescales for each type of reopener. We would be happy to work with Ofgem in developing such timescales.

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.

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 reopener 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 in a similar manner to that for pipeline diversions (see also our response to NGGTQ35).

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.

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 adapting to consequences of climate change.

UK leadership depends on building resilience to climate change, a resilience which no UK sector has yet demonstrated for even a 2°C rise in global temperature. This is a moment to improve the effectiveness of national planning for the threats from climate change that are already inevitable, as well as the uncharted but potentially catastrophic change if higher levels of warming occur." (Reducing UK emissions Progress Report to Parliament June 2020).

The CCC have identified adaptation as a priority action, planning for a minimum 2°C and consideration of a 4°C global temperature rise (by 2100 from pre-industrial levels). Despite temporary reduction in emissions from the COVID crisis, global greenhouse gas emissions are still on a pathway for 3°C or more of warming by 2100.

The ENA is actively working to secure the resilience of the energy network, to which aim the ENA has created the industry wide Adaptation to Climate Change Working Group to understand adaptation vulnerabilities in the next round of adaptation reporting.

There is a risk that we will fail to deliver resilient assets to mitigate the impacts of climate change, due to a lack of understanding, knowledge and subsequent action. Consequently, we are actively seeking to understand how the nature, likelihood and intensity of hazards will change in line with the most up to date climate model (UKCP18 was released in 2019) and so assess the vulnerability of our network and the impacts and identify possible adaptation options. This will consider how multi-hazards (e.g. a combination of drought, high rainfall and high temperatures) will lead to physical impacts on our network. The result of this work is due in quarter one 2021 and we will need to act on the findings. As this is in progress, we can't yet say what the financial impact would be, only that it would be prudent to include a reopener in RIIO-2 should the models suggest we need to take immediate action (within RIIO-2) to ensure no adverse effects on our customers and to maintain reliability and resilience. The consequence would be a failure to secure suitable funding and investment to continue to deliver gas to end consumers in future climate change scenarios. We would therefore like to discuss with Ofgem provision of extending the Electricity Transmission (ET) sector medium sized investment projects reopener (which covers flooding for example) to Gas Transmission (GT).

8. Net zero and innovation

The Draft Determination proposals could derail our progress in trying to ensure the UK is hydrogen ready. As a new technology, hydrogen requires us to take on more risk and invest more in building capability with the UK. Our innovation allowance for investing in technologies such as hydrogen has been cut by 20% compared to RIIO-1. We will have to delay as much as £129m of investment in preparing the country for a hydrogen transition, delaying the point at which major decisions on the future of the energy system can be made.

We are unable to make an informed decision on whether Ofgem's proposed mechanisms for net zero and innovation will provide timely and sufficient investment, due to the lack of detail provided on the net zero reopener or the strategic innovation fund (SIF). We are generally concerned with the mechanisms potentially stifling net zero, for example the decrease in our Network Innovation Allowance (NIA) compared to RIIO-1 levels, the potential delays to the SIF and the Net Zero reopener not being fully defined.

SIF and the Net Zero reopener will be progressed at network company risk ahead of being successfully funded, creating a risk if the cost incurred for the proposal not being recovered. There will be more hydrogen related projects required to deliver net zero, and we will have no clarity on whether they will be accepted or not, coupled with the overall package for RIIO-2 there is no incentive to spend money at risk, which may stifle the need to progress these longer-term activities. Ofgem has assumed that all indirect activities flex with capital plan and reduced our baseline CAI opex allowances by 60%, not recognising that we will need indirect costs to support the pathway to net zero. Therefore, we are not sufficiently funded to develop the ideas for hydrogen and other innovation projects for use in the SIF or net zero reopener ahead of funding being provided under these mechanisms.

Hydrogen and other green gases will play a major role in decarbonising the economy to meet net zero goals. National Grid is committed to developing hydrogen as a strategic energy carrier for heat, power, transport and industry. Since our December business plan, we have continued to develop our roadmap for net zero and have made significant progress in identifying the strategic network investments needed throughout RIIO-2. We have continued to work with our stakeholders to identify and develop projects to determine the feasibility of using low carbon gases in our network and the impact on consumers.

In April this year, ENA launched the Gas Goes Green programme, with a new commitment from the five gas network companies (Cadent, National Grid, NGN, SGN, and Wales & West Utilities) to create the world's first zero-carbon gas grid in the UK, by ensuring that Britain's gas grid is ready to replace natural gas with hydrogen and biomethane. The gas network companies set out proposals for £904m of investment in hydrogen related projects across Great Britain between now and 2026, under the Gas Goes Green Zero Carbon Commitment.

We have further developed our proposals and thinking through work undertaken as part of the Hydrogen Programme Development Group (HPDG). We have worked collaboratively with BEIS, Industry and the Gas Distribution Networks (GDNs) to build a comprehensive programme of work to provide the necessary evidence to assess key issues for hydrogen, including safety, feasibility, costs and benefits and the overall consumer experience to inform policy. The outputs of this programme will inform and help accelerate future government policy on heat. The networks will submit a revised plan to BEIS and the formal HPDG in September. Currently, a large part of this work is unfunded.

We now have a portfolio of 52 projects requiring approximately £129m of funds, to allow us to accelerate the transition to hydrogen and deliver Net Zero at pace. Approximately £60m are applicable to the Strategic Innovation Fund and we don't believe any meet the criteria of the Net Zero reopener mechanism. This leaves the only funding route for the remaining £69m being through the Network Innovation Allowance, where Ofgem have reduced our business plan request from £30m to £20m, which significantly falls short of the funding required to be

hydrogen ready. **We therefore propose an increase to the Network Innovation Allowance to £75m to bridge the gap between Net Zero and Strategic Innovation Funding mechanisms.** For more details please see NGGT Annex Innovation.

The full scope of activities around working group outputs such as the HPDG roadmap and FutureGrid were not included in the business plan submission and at our business plan proposal and Ofgem's Draft Determination proposed NIA funding levels, some key activities in our plans would need to find alternative funding or be delayed to RIIO-3.

These strategic roadmaps are evolving as critical projects deliver outputs that inform future activities, in some cases identifying further work required, in others accelerating the development. This iterative evolution of the programme will continue throughout RIIO-2 to ensure that our focus remains on the critical activities to facilitate the Energy System Transition. A key requirement for the remainder of 2020 is to reflect the outcomes of the Final Determinations including the scope and scale of NIA, SIF and our business plan settlements (including resource) in order to provide a robust roadmap as a foundation for our RIIO-2 activities. With Final Determinations due in December as mentioned we have serious concerns around delays to projects. Later this year we will have a full plan for 21/22 and an assumed plan for the following years. This includes the work ongoing with BEIS around the HPDG requirements.

We have also identified several other projects, beyond those currently in the portfolio of Gas Goes Green and HPDG, that are in development. These projects aim to progress along the evidence pathway to demonstrate the role that hydrogen can play in the National Transmission System (NTS), explore the role that the NTS can play in supporting industrial clusters and bring together the full hydrogen supply chain to support the transition to net zero in large regional demand areas.

Examples of hydrogen projects possibly at risk include:

- 'Project Union' – Front end engineering works, which would allow the future connection of the industrial clusters and potential strategic hydrogen entry points to form a UK hydrogen backbone that would reduce hydrogen build costs, improve resilience and allow excess hydrogen to reach demand centres away from the cluster.
- Project Centrum' – Front end engineering works, to design a solution to deploy low carbon hydrogen at scale into the Midlands and East Anglia with both blue and green hydrogen production facilities creating future jobs in the Theddlethorpe and Bacton areas.
- RIIO-2 FutureGrid phases - Our FutureGrid RIIO-1 NIC bid will accelerate the transition of the gas transmission network to transport hydrogen and deliver the UK's Net Zero 2050 targets. This ambitious programme seeks to build a hydrogen test facility from decommissioned assets, building on existing H21 distribution facilities. This will allow for comprehensive testing to demonstrate the ability to transport 2%, 20% and 100% hydrogen blends within the National Transmission System (NTS). FutureGrid is a platform that enables further work vital to our customers and stakeholders to facilitate the transition of the network, planned to commence in RIIO-2. Phase 2 will test and trial various hydrogen deblending technologies and also trial compression of hydrogen and the impacts on the network. Phase 3 focuses on opening the facility for third party testing, facilitating SMEs in developing, trialling and implementing hydrogen ready assets vital for our future decarbonised network, whilst also providing a platform for training and upskilling our hydrogen workforce. The FutureGrid online phase will take our learning from the offline test environment and take this onto the NTS to inject hydrogen into the network and transport it to an offtake as a live consumer trial

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

We agree with the overall principle of meeting Net Zero at the lowest cost to consumers with the required pace of change needed. For NGGT we have seen a significant amount of work being developed to support net zero since our business plan was submitted in December 2019, primarily through the Hydrogen Programme Development Group and the ENA Gas Goes Green work, therefore we do welcome the agility of funding being provided to meet these ongoing developments.

However, we do have concerns with the approach, further work is required to define the process for both the SIF and the Net Zero reopener to allow us to identify how our proposed pipeline of projects to support Net Zero can be progressed. Historically, Gas Transmission has not needed anticipatory investments, but with the potential of hydrogen, this type of investment may become necessary and more exploratory investment will be required to help build the evidence base to inform policy. This also includes being sufficiently funded to develop works ahead of being successfully funded under an uncertainty mechanism. This work includes broader, strategic and ongoing analysis to ensure we are working with our stakeholders to develop a holistic roadmap for the role of Gas Transmission in supporting heat, power, transport and industry to meet Net Zero.

We also have concerns on how the mechanisms facilitate a whole system approach. We see little incentive to ensure a whole system approach to meeting Net Zero is developed, such as required interactions between Transmission and Distribution or between gas and electricity sector integration, value chain of supply, transmission and demand.

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 welcome the flexible approach to the package of uncertainty mechanisms, however more detail and development are needed to understand the drivers and triggers for each. A specific list of sector-specific changes that would trigger a reopener and how this differs from innovation funding is needed. It must be noted that network companies need to be sufficiently funded in baseline totex to carry out the exploratory pre-works to develop these uncertainty mechanisms and therefore need to be funded to allow these Net Zero projects to be developed.

The heat policy reopener for the Gas Distribution sector is also applicable to Gas Transmission, and we welcome Ofgem's inclusion of NGGT into this reopener. Two of the five triggers defined are equally applicable to NGGT as they are the Gas Distribution Networks, they are:

1. The quality and composition of gas, as set out in the Gas Safety (Management) Regulations 1996 or Gas (Calculation of Thermal Energy) Regulations 1996

Changes to the regulations related to the quality and composition of gas will be required to facilitate the blending of biomethane and or hydrogen gas with natural gas supplied to consumers. These changes may result in the need for investment in new systems and monitoring equipment.

2. The future role of gas networks in the heat sector as determined by government policy that may result in parts of the existing network either being decommissioned or made ready to convey hydrogen.

There is a possibility that government could decide that by a target date, certain sections of the gas network are solely for the conveyance of hydrogen gas, while others are no longer required. These decisions are not mutually exclusive, and both could be implemented simultaneously on different parts of the network. While it is not anticipated that any such decisions would be implemented during the RIIO2 period, investment could be required and or adjusted output levels deemed appropriate, in preparation for full implementation of any decision.

Net zero reopener

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. However, there are still concerns to the proposed approach. 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. Please see our response to question 12 for further information.

Mechanism Type - we agree in principle with the concept of an additional mechanism to provide funding to enable critical new Net Zero outputs that are not otherwise catered for in the price control. We think the right mechanism is a project specific funding re-opener to fund new outputs that are required, for example, strategic projects that currently sit outside of the RIIO framework, but which may be required to deliver Net Zero. We do not believe a more expansive re-opening of other parts of the RIIO-2 settlement is necessary to achieve the flexibility required or is appropriate because it undermines the certainty and incentives created by a price control settlement for 5 years, which is in consumers interests. We would recommend a project specific output and funding re-opener mechanism.

Scope - the scope should cater for new outputs, relating to the delivery of Net Zero, that are not already catered for in other parts of the RIIO framework. Examples of this that we know of today could include policy driven strategic investment projects relating to infrastructure to support creating 'hydrogen ready' assets or anticipatory investments required ahead of firm need. The RIIO price control framework already contains a full suite of self-contained mechanisms which adjust allowances up and down according to certain external triggers (including changes in demand, generation and network capacity). The Net Zero reopener should be limited to new outputs alone and should not be able to undermine or cut across other mechanisms defined in the framework including baseline outputs and funding levels.

Trigger - in line with the precedent set in RIIO-1 we believe it is appropriate for this mechanism to be triggered by either Ofgem or the Licensee where a policy change results in new outputs being required and funded in pursuit of achieving Net Zero. Any materiality threshold should be set to ensure the materiality of the Net Zero project costs and outputs should not exceed the cost of the regulatory process (transaction cost).

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

Process - we would expect the party triggering the re-opener to have done thorough stakeholder engagement on any proposal in advance of triggering the re-opener process. We would expect the Independent User Group established for each network company RIIO-2 to have a role in providing high level scrutiny and challenge where a proposal is brought forward by a network company. We would then expect Ofgem to run a consultation process which includes, as a minimum, an initial view and a final decision.

It is important that once triggered the regulatory process is timebound to provide clarity and prevent delay of critical Net Zero investments as, for example, was the case for the 'May 15' and May '18' re-opener processes in RIIO-1.

The requirements and expectations on parties involved should be set out in advance, to ensure clarity in the preparation of any 'submission' that is likely to be needed to support projects being brought forward through this mechanism.

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.

Innovation

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

We welcome the inclusion of the Strategic Innovation Fund (SIF) as a key driver to help us to facilitate Net Zero. This evolution of the Network Innovation Competition (NIC) for RIIO-2 is vital to be able to address the challenges faced by customers and stakeholders across all gas and electricity network licensees. Over the past two years there have been significant developments in the road map towards a net zero future, with a clear need to accelerate plans in order to meet challenging targets to decarbonise.

Whilst we do welcome and support SIF, there is significant concern about the timeline to establish the details around this mechanism and ability to develop required governance arrangements in a timely manner to ensure there is no 'cliff-edge' of funding whilst the transition from NIC to SIF occurs. There appears to be some alignment of SIF to other funding options, such as Innovate UK, which could be a suitable approach to structure the mechanism, given that consortiums are robust.

The concern is further compounded by the limited information currently available about how the SIF mechanism would work and rationale behind it. For example, the £5m minimum spend for SIF projects is very restrictive and does not align with the spirit of SIF to be flexible to adapt to changing needs and challenges facing the sector.

In addition, and most concerning of all is that there is very little visibility of the initial challenges for SIF in year 1 of RIIO-2. The size and scale of NIC projects requires several months of upfront planning, development and engagement across stakeholders and the wider industry to develop programmes. Without knowledge of the first challenges ahead of the first SIF project calls opening, there will be significant delay as network licensees will only be able to develop detailed proposals once this information is available, as they are very costly and resource intensive activities.

Information around the challenges and calls throughout the RIIO-2 period need to be identified at the beginning of the period for example, 10 challenges at 6-month intervals as per Innovate UK including estimated timing. Challenge topics need to be concluded via a consultation with key groups who will use the funding to ensure they are relevant and enable projects moving forward. Each challenge needs an introductory call event to allow companies to present their call projects/ideas and ask for support from other groups, including small SMEs and other companies outside of the energy regulation groups. After the call event there must be a sensible period for bids to be created (at least 6 weeks) and there could be interviews as per NIC. We are keen to understand and help develop the challenge process.

We feel that under the Hydrogen Programme Development Group (HPDG) there has been time spent developing this collaborative programme of work of significant scale and there may be a view that this could be used as the basis for SIF funding to avoid delay in having to set challenges.

For example, a key priority of our stakeholders and customers is to develop deblending technologies in order to facilitate a flexible, phased and cost effect transition of the system to hydrogen. This was further highlighted at the recent Gas Goes Green Hydrogen Deblending Workshop which supported this need with a diverse range of deblending use cases identified. In addition to meeting the deblending challenge, there is a need to demonstrate the operability of the network such as the compression of hydrogen. These are two key stages for 2021/22 as outlined in the HPDG integrated trials sub-board. Risk to accessing funding due to delays in developing the governance framework or misalignment of these stakeholder needs against the SIF challenges could cause significant set-backs in the UKs accelerated programme to decarbonisation. The knock-on impact would be significant as without deblending and compression development online hydrogen trials would be delayed along with third party industry involvement in these trials including end users to cover heat, power and transport. These concerns lead us to ultimately question whether the SIF will be ready for the start of the RIIO-2 price control. We are seriously concerned with the roadmap and process for this mechanism. It does not seem as if it will be ready before Summer 2021, which will potentially risk derailing the ambitious plan for the Hydrogen Roadmap, causing delays of 6 to 12 months, as well as a general significant funding gap in Year 1 of RIIO-2. We suggest Ofgem to consider rolling over the NIC for the first year (2021/22), if there is a possibility that there may be delays to the start of this mechanism.

We would also appreciate clarity on how Ofgem proposes to appoint the Third-Party Coordinator for this mechanism and would welcome consultation with network companies on their appointment.

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 have addressed our main concerns in the previous answer (Q24) where we have highlighted the need for clarity of how the SIF will operate, be governed and when it will be operational, taking into consideration the several month lead times required in order to fully engage our stakeholders and develop bids for larger scale projects. We urge Ofgem to consider the risk that delays to accessing SIF funding will have on achieving the needs of our customers and stakeholders in relation to the decarbonisation agenda, particularly those more imminent requirements in 2021/22. Without a smooth transition there is likely to be a 'cliff edge' at the end of RIIO-1 with the accelerated programme of work set out by the HPDG being derailed. There may be ways to address these issues, such as extending NIC for the first year of RIIO-1, and clarifying the link to other mechanisms, such as the Net Zero reopener.

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

Benchmarking our RIIO-2 allowances against our RIIO-1 spend on innovation fails to recognise the future needs of the gas industry to progress towards net zero and fund transformative markets and our network to transport hydrogen. The work required to reach net zero is not BAU and therefore to base funding on RIIO-1 risks the required innovation to facilitate net zero.

Although we do not agree with Ofgem's approach, if it continues to use this approach, we note that there is an error in this approach as the proposed amount for NIA funding in RIIO-2 has been calculated incorrectly. NGGT's RIIO-1 innovation allowance is an average of £5m per annum not £4.5m as previously stated by Ofgem, this would mean £25m not the £20m stated. Please see the detailed response in Q39 of the NGGT response document for specific details.

Our NIA funding mechanism request was for £30m which was based on our initial energy system transition strategy and forecast of innovation projects in summer 2019 and a reasonable review of the innovation spend growth year by year through RIIO-1. The £30m was on the assumption that non BAU innovations to support net zero would have other funding arrangements suitable to cover an extensive portfolio of hydrogen development projects on the gas transmission system over the next 5 years. Since putting the business plans together

further development on the innovation portfolio has been done alongside the HPDG working group activities.

We now have a portfolio of 52 projects requiring approximately £129m of funds, to allow us to accelerate the transition to hydrogen and deliver Net Zero at pace. Approximately £60m are applicable to the Strategic Innovation Fund and we don't believe any meet the criteria of the Net Zero reopener mechanism. This leaves the only funding route for the remaining £69m being through the Network Innovation Allowance, where Ofgem have reduced our business plan request from £30m to £20m, which significantly falls short of the funding required to be hydrogen ready. **We therefore propose an increase to the Network Innovation Allowance to £75m to bridge the gap between Net Zero and Strategic Innovation Funding mechanisms.** For more details please see NGGT Annex Innovation.

The full scope of activities around working group outputs such as the HPDG roadmap and FutureGrid were not included in the business plan submission and at our business plan proposal and Ofgem's Draft Determination proposed NIA funding levels, some key activities in our plans would need to find alternative funding or be delayed to RIIO-3.

Given the approach by Ofgem to benchmark RIIO-2 funding requests to RIIO-1, there is the implication that other than the specific requirements called out by Ofgem such as to (a) Ensure a Benefit Measurement Reporting Framework is in place; and (b) Produce guidance for third parties on the treatment of IPR and those discussed in our response to Q27 below; there are no further changes to the NIA governance process. This means that:

- Internal time costs associated to the core innovation team and personnel working on NIA projects is recoverable up to 25% of total project spend.
- Administrative costs associated with dissemination events and activities such as annual reporting is recoverable.
- Memberships, services and partnership costs providing essential support to the NIA portfolio are recoverable.

There remains a concern around the definition of Energy System Transition projects and the scope of eligible projects. As set out in our RIIO-2 Innovation Strategy (Annex 17.03) as part of our December 2019 business plan submission, there are three key areas of focus to achieving our decarbonisation goals:

- **Fit for the future** – focused on innovation that prepares and safeguards our assets for the challenges faced operating a decarbonised energy system with gases such as hydrogen
- **Ready for decarbonisation** – preparing our network to transport a blended mix of green gases with a focus on technology that can manage our network and assets through the transition
- **Decarbonised energy system** – focused on how green gases such as hydrogen interact with our network, considers the commercial market implications and customer interactions from industrial, transportation and commercial markets.

To achieve these goals, we must continue to innovate on our assets. These assets are vital to enabling the energy system transition. In our detailed plans we identify where NIA funding is required across all three areas, but also indicate where business as usual funding prevails. We would welcome further clarity and assurance that those asset-based, high risk and critical innovation projects required in order to facilitate the transition of the network to decarbonised gases is included within the scope of an eligible NIA project in RIIO-2. This must also consider those projects that unlock the operation and protection of a more complex energy system, with key digitisation and modelling programmes of work.

In addition, clarity is required around the definition of commercially available products and services which would be precluded from NIA funding in RIIO-2 along with further details on the definition of high-risk products and services.

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

We agree that an improved reporting framework would help with assessing the value of NIA projects, and through extensive engagement throughout the development of the Benefit Measurement Framework (BMF), our stakeholders have clearly stated the value that this will bring.

We are concerned about the level of detail provided to around specific improvements needed to the BMF developed in the later stage of RIIO-1. Clarity is required on criteria such as collaboration and how this can be quantified in the framework. Fundamentally, the focus of NIA projects in RIIO-2 is on Energy System Transition (EST) and Customer Vulnerability (CV) projects, which by their nature are difficult to quantify financially. This highlights the importance of the BMF and the range of measures to provide a mechanism to quantify the value of these projects, especially where the outputs are difficult to attribute specific financial benefits. Further consideration is required on this issue to ensure the BMF satisfies the criteria of Ofgem.

To date Ofgem have been a stakeholder to the framework development process, receiving updates as it has progressed. However, to successfully achieve an improved reporting framework that satisfies the needs of all stakeholders and provides Ofgem with the level of detail required, it is essential that Ofgem become more engaged as a partner in the final stages of development of the Benefit Measurement Framework to ensure all requirements are considered satisfactorily.

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

Overall, we are supportive in improvements to the framework, however we have concerns in three key areas that need consideration:

Intellectual Property Rights (IPR)

There is a risk that if the framework is too prescriptive on treatment of IPR, due to the nature of IPR being quite subjective, third parties might be excluded from projects. Some third parties from our experience take a balanced approach, for example the benefit of lower cost contracts does not necessarily outweigh the issues around IPR constraints. Furthermore, clarity on NIA eligibility needs to be understood to then be able to determine the impact of background versus foreground IPR discussions on project negotiations. There has been previous work by the Energy Innovation Centre (EIC) that could help to coordinate a clearer position on how to manage IPR in the context of NIA. This might also help us to understand historic challenges around IPR issues that would help to structure this aspect of the framework.

Impact Assessment on Vulnerable Customers

While we agree that this will help to ensure that innovation projects could help to benefit the most vulnerable consumers, much more clarity is needed on what this looks like. Further guidance is needed in respect to our role as a transmission company where we do not have a direct relationship with consumers.

Peer Review and Third-Party Audit

There were 522 gas projects in RIIO-1, which means that this would create a significant administrative workload with little to no tangible benefit to Ofgem or our wider stakeholders. In order to get the best value, it will be important to be specific as to what is being assessed, which organisations are being involved and what value they bring to the review. A clear definition is needed for the independent audit or third-party review addressing; what is the scale based on (project cost or number of projects?) and how that review will be carried out. There are a number of processes already in place which can be modified and developed in order to satisfy these criteria, rather than creating new and lengthy governance processes. For example, the existing processes used by the ENA Gas Innovation Governance Group (GIGG) and Electricity Innovation Managers (EIM) group could be streamlined across all network

licensees and developed to cover all specific requirements. This includes the before, during and after processes of the innovation project lifecycle, which could be supported by building on the Smarter Networks Portal with digital audit and assurance providing a centralised, agile system for anyone to access. Independent evaluations could focus on the robustness of the research being undertaken. Furthermore, upon completion, the Benefit Measurement Framework (BMF) will be aligned more closely to the processes in order to provide streamlined information across all projects regardless of network licensee.

The concern is that peer review and assessment of projects post completion could lead to project work being undertaken without validation that the activity is suitable. An alternative method would be to undertake the peer review prior to the project start allowing us to ensure our portfolios suitability. Our current project process ensures that projects commenced align to business needs and have a validated business benefit. We propose that project roadmaps are peer reviewed prior to start to ensure their relevance across the UK and prevent the need to individually review each project. This is currently done via our Gas Transmission Innovation Governance Group as an internal sanction on the project.

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

Alignment to the Benefit Measurement Framework will be a key method to ensure better quality assurance and robustness of the NIA projects. We have a system that we use within NGGT to ensure that metrics are captured at every stage of our innovation projects to aid reporting, capturing learning, and clarifying benefits that may contribute to the development of overarching quality assurance measurements. As with the BMF, it is key that Ofgem take a more active role in development of these quality assurance measures, as such we suggest some further workshops with the network licensees to help develop in this area.

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 agree with this proposal, as it will prevent a situation whereby, if further Covid-19 delays occur, projects would have to be cut short or their timelines significantly compacted in order to complete, particularly where projects have physical testing or trials planned.

We are still targeting all of our NIA projects in 2020/21 to deliver by 31 March 2021 however this is dependent on the developing situation around Covid-19, localised and national restrictions and company risk assessment with regards to site and personnel access. We continue to monitor the situation and engage with the networks via the ENA to ensure a consistent approach.

This also aligns with our ongoing stakeholder engagement, where we have proposed that unspent 2020/21 RIIO-1 NIA funding be carried forward into the first year of RIIO-2 (2021/22). Allowing RIIO-1 NIA projects to close during 2021/22 prevents any potential cliff edge on 31 March 2021 caused by further delays and issues by Covid-19 preventing any onsite activity. Furthermore, there is no negative impact on the consumer as the proposal does not provide any additional funds, but instead extends the deadline for existing allowances. This will ensure the projects can deliver to their planned scope, delivering the desired outcomes, consumer value and resulting in lessons to be shared across the industry.

Given the proposal from Ofgem to carry over RIIO-1 NIA funding into the first year of RIIO-2, the assumption is that the RIIO-1 governance position will be maintained and the transition of live projects from 2020/21 to 2021/22 will follow the same governance as projects transitioning between previous years in RIIO-1, namely:

- There is no approval required for live projects in 2020/21 to carry over to 2021/22, they should just follow the standard change control process to reflect a new end date (up to and no later than 31 March 2022) registered on the ENA Smarter Networks Portal.

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- Carryover of RIIO-1 spend includes the internal and admin costs associated with these projects.
- RRP Table 3.13 NIA Spend will remain in place to be reported as part of RRP on 31 July 2022 to report the final spend of the projects which have been carried over.

An outstanding question is whether network licensees are permitted to use remaining funding in RIIO-1 to start a RIIO-2 NIA compliant project earlier than 1 April 2021. How would the funding transition be dealt with? There is some precedent set following the transition from Innovation Funding Incentive (IFI) to NIA in RIIO-1.

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?

Yes, we have reviewed the Catapult document and agree with the proposal. We are already using our Portfolio Management System, DFN and SharePoint to ensure data compliance.

9. Increasing competition

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.

We are concerned with the limited developments of CATO and SPV to date, which leads to CPM becoming the only potential competition model for the foreseeable future. This is even though CPM does not involve actual competition in either the design or delivery of a project – it is merely a regulatory process which involves Ofgem setting a project WACC on a project-specific basis rather than by reference to the RIIO-2 parameters.

Our view remains that 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). We set out in NGGT Annex Late Competition our concerns against the three ‘key benefits’.

Within our NGGT Business Plan we flagged two of the three projects identified by Ofgem in their DD as being suitable for late competition. Paragraph 9.17 of the RIIO-2 Draft Determinations - Core Document states “we will not apply a late competition model to any project where a decision has already been reached to fund the project through either baseline allowances or through a relevant uncertainty mechanism”. The development of detailed uncertainty mechanisms supported by the projects assessment process as outlined in the Draft Determinations – NGGT annex, show that the Bacton and St Fergus projects fit this definition. The Milford Haven project will be funded through the well-established and carried over from RIIO-1 incremental capacity re-opener. We therefore do not expect late competition to be applied to any of these projects. To do so would only add cost and delay compared to the robust uncertainty mechanism processes that are in place.

Following our assessment ahead of our business plan we identified that the consideration of separability of gas transmission assets requires further discussion, understanding and development of sector specific principles of what is deemed separable. We continue to hold this view and expect to continue working with Ofgem on such principles that strike the right balance of risk for consumers.

In addition to our above reflection on Paragraph 9.17 of the RIIO-2 Draft Determinations - Core Document since the submission of our business plan, the potential network reinforcement project to increase entry capacity at Milford Haven has progressed further through the PARCA process. Based on the current preferred strategic option that has been reviewed with Ofgem, this project is no longer seen as a candidate that would meet the criteria for late competition as specified, in terms of threshold value, separable and new. We will continue our engagement

with Ofgem throughout the PARCA process and subsequent incremental capacity re-opener submission.

For any potential incremental capacity re-opener that may qualify for late competition, the introduction of this process would need to ensure there is no impact on the delivery to the customer. The proposed project submission stage in the reopener design, combines both need case and cost assessment and occurs post planning consent. The timing of this in the associated PARCA process may affect the application of the late competition models, either due to the requirement of imminent decisions, completed tender processes or development work such as the ordering of long lead time items. The introduction of an initial needs case assessment earlier in the re-opener design, as seen within the ET sector, may help identify such issues at an earlier stage as discussed in our response to the UM for incremental capacity proposal.

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

We support the principle of introducing early competition where the model and associated arrangements can deliver value for consumers.

The discussion in the Draft Determinations is focused on Electricity Transmission. As was our response to the Sector Specific Methodology consultation we do not support the ESO's involvement in gas competitions because it would not be consistent with the ESO's role or capability, which relate to the electricity sector. For early competition to be explored in the gas sector, the appropriate body to develop such plans needs to be identified and must be done in full consultation with the gas industry and relevant stakeholders.

10. Approach to the Business Plan Incentive and Totex Incentive Mechanism

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 response.

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

Please refer to NGGT Annex Business Plan Incentive for our full response to this question.

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

No response.

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

We support the principle of the consumer value proposition (CVP) driving additional value for consumers. CVPs help show the enhanced value our plan provides for consumers. It fits well with our increased emphasis on engagement and openness in our RIIO-2 business plan. We note that the CVP is only a small part of the consumer benefit of our business plan.

We note that CVPs are a new concept introduced for RIIO-2. It was challenging to identify what should be put forward for CVP and the approach to robustly quantifying this. This is reflected in the fact that across networks 117 CVPs were proposed and only 6 have (or would have subject to BPI stage 1 outcome) merited award. The scale of disallowed propositions demonstrates that the scope, approach and assessment criteria detailed by Ofgem was unclear. This has resulted in a flawed, asymmetric business plan incentive with limited opportunity to reward network companies for the parts of our plans which drive consumer value beyond that which could be expected of us.

We used external experts to independently assess what elements of our plan drive additional value to consumers and the robustness of potential methodologies. We also engaged with the

independent User Group and key consumer stakeholders to gain vital feedback on our CVP propositions. Our approach was only to submit those CVPs for which we were:

- confident in the robustness of the methodology,
- received stakeholder support,
- clearly demonstrated above minimum value.

This resulted in an initial long list of CVPs not being progressed. It also resulted in the inclusion of commentary on three CVPs where we could provide an order of magnitude estimate, but not a firm methodology (one of our stakeholders requested that this be included). These were not put forward as part of our CVP proposition, but we note that Ofgem assessed and subsequently rejected these.

Reporting requirement: We agree with the importance of reporting annually, and a more detailed close out summary. A common template covering status/commentary is sensible, aligned to specific metrics for individual CVPs. As part of our CVPs we proposed that the independent User Group would be a sensible body to provide a report to and are pleased that Ofgem is supportive of this approach.

Performance metrics: We agree with the need to produce metrics to ensure output is measurable. Of the two CVPs which were identified by Ofgem as meriting CVPs:

- Communities we have proposed specific metrics for (see NGGTQ19).
- For Natural Capital Improvements, in line with Ofgem's desire to provide a consistent methodology for this CVP we are working with Ofgem to define metrics for this (see NGGTQ17).

We agree there should be no monitoring of CVP proposals that were rejected.

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

We made the commitment to return some or all of any reward in the event of non-delivery. Determination on the amount should be clearly evident in the metrics and close out report. We note that no company came close to the cap on BPI reward, however it would seem sensible to ensure any clawback for non-delivery takes into account pre-cap reward.

We would note that any clawback should be based on the CVP award granted (not the consumer value). This is particularly important to note for our CVP regarding community initiatives where any clawback should not be related to any underspend on community initiatives (see response to NGGTQ19).

11. Interlinkages in RIIO-2 and Appeals Mechanism

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'².

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.

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 appeal³. 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 grounds⁴.

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 appeals⁵:

*"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*

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

³ *BGT v Ofgem* CMA Final Determination (2015), para 3.50 and *Northern Powergrid v Ofgem* CMA Final Determination (2015), para 3.49

⁴ *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

⁵ 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

*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.*⁶ (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.”*⁷

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 to explain why the component under challenge is wrong having regard to the interlinked aspects of the decision.”*⁸ (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-2 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*”⁹. 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 measures¹⁰. 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.

⁶ *BGT v Ofgem* CMA Final Determination (2015), para 3.52 and *Northern Powergrid v Ofgem* CMA Final Determination (2015), para 3.51

⁷ CMA letter to Ofgem dated 30 October 2019, para 16

⁸ CMA letter to Ofgem dated 30 October 2019, paras 14 and 15

⁹ RIIO-2 Draft Determinations – Core Document, paras 11.2 and 11.3

¹⁰ RIIO-2 Draft Determinations – Core Document, paras 11.4 - 11.8

- “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”¹¹ 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 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 interlinkages¹². 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 efficiency¹³ or that different mechanisms together “achieve the objectives of RIIO 2”¹⁴ 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)¹⁵.

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 process¹⁶. 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 results¹⁷. 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*’¹⁸. That is clearly contrary to the CMA’s guidance, which is that it is in circumstances

¹¹ RIIO-2 Draft Determinations – Core Document, para 11.9

¹² RIIO-2 Draft Determinations – Core Document, para 11.10

¹³ RIIO-2 Draft Determinations – Core Document, para 11.21

¹⁴ RIIO-2 Draft Determinations – Core Document, para 11.22

¹⁵ RIIO-2 Draft Determinations – Core Document, para 11.12

¹⁶ RIIO-2 Draft Determinations – Core Document, para 11.11

¹⁷ RIIO-2 Sector Specific Methodology Decision – Core Document, para 12.21

¹⁸ RIIO-2 Draft Determinations – Core Document, para 11.25

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-2 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 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 control¹⁹. 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 certainty²⁰.

In its RIIO-2 Sector Specific Methodology Decision, Ofgem stated that its policy thinking was still in development²¹. 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

¹⁹ RIIO-2 Sector Specific Methodology Consultation, para 2.20

²⁰ RIIO-2 Sector Specific Methodology Decision, paras 2.18-2.21

²¹ RIIO-2 Sector Specific Methodology Decision, para 2.22

“...where this would be of assistance in ensuring the overall coherence and consistency of the regulatory settlement”²². The 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 licence²³. We understand, following supplementary confirmation from Ofgem²⁴, 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 Ofgem²⁵ 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 law²⁶. 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 decision²⁷. 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 CMA²⁸ and a further duty to take such steps as it considers requisite to comply with any order setting out the CMA’s determination²⁹.

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 appellant³⁰.

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

²² RIIO-2 Draft Determination Core Document, para 11.32

²³ RIIO-2 Draft Determination Core Document, para 11.33

²⁴ Query reference: DDQ254

²⁵ Query reference: DDQ254

²⁶ Under the EU Third Package

²⁷ S.11F(2) of the Electricity Act 1989 and s.23E(2) of the Gas Act 1986

²⁸ S.11F(5) of the Electricity Act 1989 and s.23E(5) of the Gas Act 1986

²⁹ S.11H(3) of the Electricity Act 1989 and s.23G(3) of the Gas Act 1986

³⁰ *BGT v Ofgem* CMA Final Determination (2015), para 3.48 and *Northern Powergrid v Ofgem* CMA Final Determination (2015), para 3.47

control. If an appeal succeeds, the CMA will consider whether it is appropriate to make any consequential 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 Decision³¹.
- 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 incentive³².
- 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 needed³³.

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.

³¹ *BGT v Ofgem* CMA Final Determination (2015), para 3.53

³² *Firmus v NIAUR* CMA Final Determination (2017), paras 8.25 and 8.32

³³ *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 gas 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*"³⁴. 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 NGGT would appeal one or more aspects of the RIIO-2 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*"³⁵.

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.

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

³⁴ RIIO-2 Draft Determination Core Document, para 11.30

³⁵ CMA letter to Ofgem dated 30 October 2019, para 12

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 window³⁶.

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 licence³⁷ – 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 correspondence³⁸.

In addition, the CMA's statement in its response³⁹, 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 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 decision⁴⁰. 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

³⁶ RIIO-2 Draft Determination Core Document, para 11.36

³⁷ Sch 5A, para 1(3) of the Electricity Act 1989 and Sch 4A, para 1(3) of the Gas Act 1986

³⁸ 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

³⁹ CMA letter to Ofgem dated 30 October 2019, para 12

⁴⁰ RIIO-2 Draft Determination Core Document, para 11.36

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 Ofgem⁴¹. 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.

12. Impact of COVID-19 on the price controls

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?

We recognise the need to consider contingency planning for RIIO-2 in the event of subsequent 'waves' of COVID-19 infection meaning we, Ofgem, or the other network companies cannot adhere to the existing RIIO-2 timeline. We have responded to the 14th July 2020 Ofgem open letter on COVID-19 contingency plan for RIIO-2. We acknowledge the seriousness of the COVID-19 pandemic. Although we welcome Ofgem's confirmation that no delay is anticipated, 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 is a reasonable or proportionate option and we do not believe that it will deliver for 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 Final Determination giving rise to the need to introduce a contingency arrangement.

We note that since the COVID-19 situation emerged, Ofgem and network companies had to prioritise workload as a result, postponing some activities (such as closeout methodology). Ofgem and network companies came together to reach a suitable agreement on which activities to prioritise and attained easement where required from the normal regulatory framework without the need for licence or other formal changes. Moving forward, given the uncertainty over future potential 'waves' of infection, we believe a similar flexible approach should be adopted. We do not believe at this stage it would be beneficial to propose a specific reopener mechanism for the regulatory framework.

⁴¹ CMA letter to Ofgem dated 30 October 2019, para 15