2. NATIONAL GRID GAS TRANSMISSION RESPONSE TO RIIO-2 DRAFT DETERMINATION: EXECUTIVE SUMMARY

Please find this response from National Grid Gas Transmission (**NGGT**) to Ofgem's RIIO-2 Draft Determination (**DD**) consultation.

There are seven parts to our response in which we provide the substantial evidence together with annexes to justify and support the changes that we have identified are needed to deliver the energy systems that our stakeholders and consumers require:

1. A short covering letter
2. **This Executive Summary of our response**
3. Our response to the core DD document
4. Our response to the Gas Transmission sector document
5. Our response to the NGGT-specific document containing key issues and proposed remedies
6. Our response to the Network Asset Risk Metric (NARM) document
7. Our response to the Finance document

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

We have serious concerns with Ofgem's DD and its consequences for Great Britain. The DD cuts our proposed business plan baseline allowances from £2.60bn 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 and overall package 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.

In its RIIO-2 Framework Decision[1], Ofgem spelled out its objectives and how it intended to go about meeting them through its design choices. It stated that its objectives are to "*ensure that regulated network companies deliver the value for money services that both existing and future consumers want"* and it wants to see each company "*develop and maintain a reliable, safe and secure network that is flexible in supporting the transition to a low-carbon future*".

[1] https://www.ofgem.gov.uk/system/files/docs/2018/07/riio-2_july_decision_document_final_300718.pdf page 4.

National Grid fully supports Ofgem's objectives and is determined to play a key role in their achievement. Like Ofgem, National Grid wants to see:

- networks that are ready to deliver net zero;
- at an efficient, low cost;
- while maintaining world-class reliability;
- working within a flexible, adaptable price control;
- to secure excellent outcomes for customers; and
- a fair deal for investors.

However, we consider that the DD, and the process around it, fails to achieve these objectives for the following reasons:

	Ofgem said it would achieve its objectives by:	**In the DD:**
1	*'Giving consumers a stronger voice in setting outputs, shaping and assessing business plans'*	**Stakeholder views are not taken into account**: Ofgem has disregarded the extensive stakeholder evidence we have gathered and the views of the independent User Group[2].
2	*'Allowing network companies to earn returns that are fair and represent good value for consumers, properly reflecting the risks faced in these businesses, and prevailing financial market conditions'*	**The DD does not allow us to earn even its low proposed base return** because of the DD's erroneously cost disallowances and disproportionate penalties. Added to this the risks in the DD package are skewed to the downside.
3	*'Incentivising network companies to respond in ways that benefit consumers to the risks and opportunities created by potentially dramatic changes in how networks are used'*	**The DD proposes dampened incentives and with many ex-post reviews of costs and outputs.** Ofgem has dampened the incentives for networks to reduce cost and drive service improvements to the detriment of current and future consumers. Ofgem has underestimated the consumer value of a strong constraint management incentive including the benefits of avoiding customer disruption, increased security of supply and the impacts on wholesale market prices.
4	*'Using the regulatory framework, or competition where appropriate, to drive innovation and efficiency'*	**Innovation and efficiency are stifled**. Ofgem has provided limited funding to support innovation, seemingly not recognising that net zero cannot be delivered through business-as-usual innovation. By proposing a system that combines ex post review with a downside penalty framework, Ofgem's DD will discourage innovative thinking to the detriment of current and future consumers.
5	*'Simplifying the price controls by focusing on items of greatest value to consumers'*	**The framework is overly complex.** For example, the DD has moved 40% of expenditure to reopener uncertainty mechanism with ex-post reviews which creates a large regulatory burden for Ofgem, stakeholders and the network companies.

[2] https://isug.nationalgrid.com/files/NGGT-User-Group-report.pdf

Based on our detailed review we have established that the DD does not meet the needs of consumers or stakeholders at either an aggregate or a component level.

We unpack this in further detail below, focusing on the key issues of **introducing significant risk to the reliability and resilience of the network, unnecessary complexity and volatility introduced in the framework**, and **eroding regulatory stability and investor confidence**. These key issues are drawn from the extensive stakeholder and consumer engagement we carried out on our business plan and, importantly, reflect both what our customers have told us they need and want us to provide, and what we require in order to be able to deliver for them.

Introducing significant risk to the reliability and resilience of our network

Reliability and resilience of the network has consistently been identified as a top priority for our stakeholders and consumers. Based on this feedback our business plan includes asset health work to maintain the absolute level of risk[3] on the network. The DD will not allow us to do this.

We're managing an ageing network and we're experiencing more condition related issues than ever before. This means to maintain the current level of risk, and subsequent reliability, we need to do more. Our allowances for RIIO-1 significantly underestimated the scale of work required to maintain a reliable and safe network. With aggressive prioritisation and sharp focus on efficiencies we spent £300m[4] over our allowances to maintain our service levels and it was in the interests of consumers to do so. We have taken forward the benefits of this focus on efficiency, innovation and prioritisation into our RIIO-2 plan.

The annual allowances detailed in the DD are 37%[5] lower than our business plan proposals and 10% lower than we have been spending in RIIO-1. This level of funding is not adequate when considering the investment we made above allowances in RIIO-1 to maintain our 99.996% reliability and to counter the continued asset deterioration.

The proposed reduction in baseline asset health investment will not allow us to maintain the level of risk on the network and will see the level deteriorate by 19% over the next ten years. The increase in risk occurs even if we try and live within proposed allowances during RIIO-2 and then try and recover in the following price control period. Even if all the uncertainty mechanisms proposed are subsequently approved, the long-term risk on the network will deteriorate by 14%. In addition, Ofgem has only provided funding to efficiently deliver 83% of our legislative requirements.

We note that the above is a conservative assessment of the impact on risk. This is based only on assets covered by the Network Asset Risk Metric methodology; the risk impact could be greater if non-lead assets and major projects remain underfunded. For example, Ofgem has rejected a pipeline resilience project near Great Manchester to protect consumer supplies, which could increase the likelihood of loss of supply.

[3] Risk being the monetised value of fatalities & injuries, transport disruption, system outages, volume of gas emitted and associated operational cost impacts.
[4] On asset health, opex and non-operational capex
[5] Real in 18/19 prices

The consequence of increased risk on the network can impact reliability. Reliability issues can lead to constraints and limit the ability of our customers to bring gas on and off the network where and when they want. We know that increased constraints have a direct wholesale market impact for consumers with these costs being significantly above the cost to maintain the reliability of the network and is an unnecessary risk to pass on to consumers. Our EY study[6], submitted with our business plan, modelled the impact of a constrained network under certain conditions and is evidence of the impact constraints can have on wholesale energy costs.

It is vital that Ofgem's Final Determination provides the asset health allowance needed to fulfil our legislative and licence obligations. This can be achieved by adding £115m[7] with the associated output commitments to our baseline allowance. We have provided the additional evidence to Ofgem demonstrating the need for the investment and in our response to Ofgem's NGGT annex questions 25-28 (inclusive).

Remedy needed: increase asset health volumes and associated output commitments to maintain network risk.

Unnecessary complexity and volatility introduced in the framework

Uncertainty mechanisms

Within our business plan we proposed a robust package of uncertainty mechanisms to protect consumers from less certain costs or to ensure where needs change so do our allowances. However, in the DD, Ofgem has far extended the proposed use of uncertainty mechanisms. While some of these serve a sensible function, many introduce an unnecessary level of regulatory burden, complexity and uncertainty on us and our stakeholders.

Ofgem has used 'reopener' type uncertainty mechanisms for all additional mechanisms deployed in DD with ex-post reviews of all activities, i.e. pre-construction / development phase and post construction phase. These mechanisms are by nature intrusive, time consuming, add lengthy delays at a time when agility and flexibility is critical, and are resource intensive across network companies, Ofgem and our stakeholders.

The reopener mechanisms deployed fail to recognise that upfront ex ante allowances for pre-construction and development costs can be set by Ofgem. This approach avoids regulatory burden; gives networks certainty of funding ensuring we can build and retain the right skills over the long-term; provides simpler reopener design; and avoids passing unnecessary risk to consumers. In addition, we have areas of our plan with high cost confidence, however the volume of work is uncertain. The use of a volume driver should be deployed in these circumstances to again remove the regulatory burden and uncertainty. We have provided the supporting evidence for Ofgem to implement an approach that only uses a full review of costs where this would be of benefit to consumers.

Net zero and innovation mechanisms

The combined mechanisms and design outlined in DD could slow down our progress to ensure the UK is hydrogen ready by 2026 as set out in our 'journey to

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[6] https://www.nationalgrid.com/uk/gas-transmission/document/129526/download

[7] Increase required in Asset Health Main Plan (as described by Ofgem in DD) from £390m to £505m

net zero' roadmap published with our business plan[8]. There is a lack of detail provided on the proposed Net Zero and innovation mechanisms, which must be addressed before Final Determinations.

We 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. The scopes are defined by BEIS Hydrogen Programme Development Group and our own hydrogen programme. For example, FutureGrid sets out a number of phases to test and trial the ability to transport hydrogen across our existing assets and Project Union will demonstrate a 'hydrogen backbone' to join the developing industrial clusters. We have provided Ofgem with the project details for these and the other portfolio of projects and Ofgem needs to ensure the framework can provide the necessary upfront funding to progress these projects for the benefit of consumers.

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.
The critical Net Zero reopener which could be used to facilitate hydrogen developments can only be triggered by Ofgem. We believe this should be able to be triggered by network companies as many of the portfolio of projects that we and other gas networks need to deliver to be hydrogen ready could lead to networks signalling changes to allowances. In addition, the mechanism needs to consider the risk for companies, who would be exposed in full to downside risk, and further volatility for customer charges as revenue will not align to the underlying costs. We address this further in our response to Core question 12 and GT sector question 3.

Volatility of charges
Our customers have told us stability of charges is vital for them in running their business. The DD introduces significant unnecessary variation in the charges which our customers, and ultimately consumers will face, given that we will be unable to meaningfully forecast revenue and required investment will only be funded by reopeners in the period. Based on current predictions, customers would face a 40% increase in charges in the last year of the price control as funding for investments in the period is stored up and then all released in the same year.

Cashflow risk caused by delays in revenue under the uncertainty mechanisms would constrain our ability to deliver stakeholder needs as our credit metrics would deteriorate to sub-investment grade. We would have no choice but to push back investment to maintain financeability, leading to inefficiencies, delays to customer outputs and innovation being stifled which goes against consumers interests.

This can be avoided. For many of the proposed reopener uncertainty mechanisms the need has been established. Uncertainty only exists in the precise scope or cost of activities. In these circumstances, variability can be reduced by aligning our baseline allowances with likely spend and adjusting from that position. This was proposed as part of our business plan and would remove many of the problems which the overuse of reopener uncertainty mechanisms has introduced.

[8] https://www.nationalgrid.com/uk/gas-transmission/document/129016/download

In addition, Ofgem has introduced the concept of forecasting of outputs in RIIO-2 which will enable revenue to more closely reflect the underlying spend than it did in RIIO-1. We are advocates of this approach as it improves transparency and predictability of customers' costs and our revenue. However, Ofgem has discounted this approach for reopener uncertainty mechanisms which effectively excludes this method for Gas Transmission. This needs to be reversed in order to improve financeability and enable our revenue to more accurately reflect the underlying costs. We address this further in our response to Core question 12, GT sector question 3 and Finance document questions 34 and 35.

Remedy needed:

- Provide ex ante allowances for pre-construction works based on our evidence of efficient costs
- Deploy volume driver mechanism where costs have already been assessed as high confidence by Ofgem
- Provide baseline allowances for uncertainty mechanisms and more closely match expected spend and revenue through forecasting of outputs
- Allow NGGT to trigger net zero reopener uncertainty mechanism to facilitate hydrogen developments
- Increase the Network Innovation Allowance to £75m to bridge the gap between Net Zero and Strategic Innovation Funding mechanisms

Eroding regulatory stability and investor confidence

Ofgem state £25 billion of totex could be required in the RIIO-2 period for net zero and other customer outputs which is a substantial amount of investment. A stable regulatory regime has been the reassuring anchor for investors to provide low cost financing over the last thirty years and has underpinned financial resilience through the uncertainty of Covid-19. But the DD risks this by proposing movements away from regulatory precedent, introducing ex-post reopeners and applying unjustified and disproportionate BPI penalties.

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

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

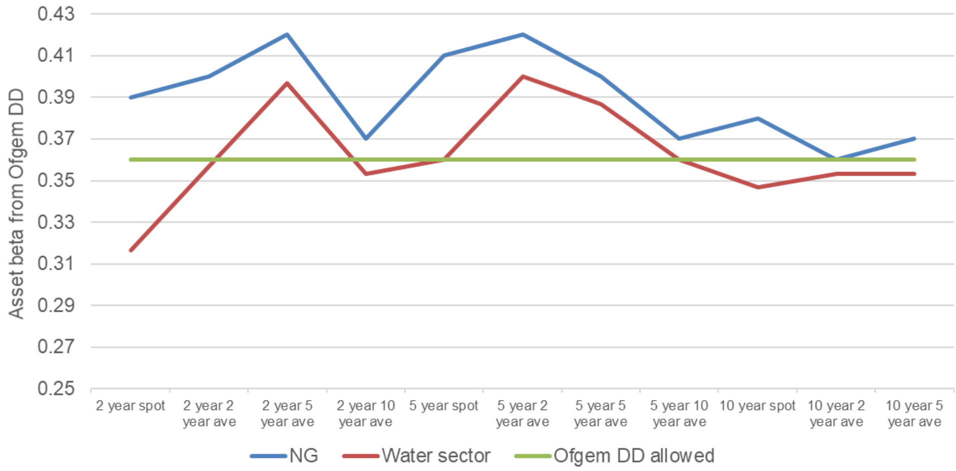
We outline the issues and remedies required in this area under the following sections: **inadequate allowed equity return**; **a marked weakening of financial resilience**; **disproportionate, unjustified BPI penalty**; **flawed methodology in setting efficiency targets**; **multiple penalties and ex-post clawbacks**; **dampened incentives**; and **unachievable allowed equity return.**

Inadequate allowed equity return

It is vital that the allowed rate of return is set within a plausible range, however Ofgem's figure of 3.95% is set far too low, owing primarily to three errors in how their range has been determined.

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

Figure 1: Asset beta from Ofgem's DD for multiple time horizons and averaging periods compared to the water sector and Ofgem's DD



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

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

The UK needs a progressive regulatory framework which encourages investment into the energy sector but the message to investors from the DD will be to invest overseas or in the water rather than energy sector. Ofgem's proposed allowed equity return is below the rate four water companies are currently appealing to the CMA and below US and comparable benchmarks from continental Europe.

Taken together, these decisions create a significant risk that allowed rate of return will be set far too low, driving up future financing costs and slowing down delivery of customer outputs. We address this in detail in our response to Finance questions FQ5 to 11.

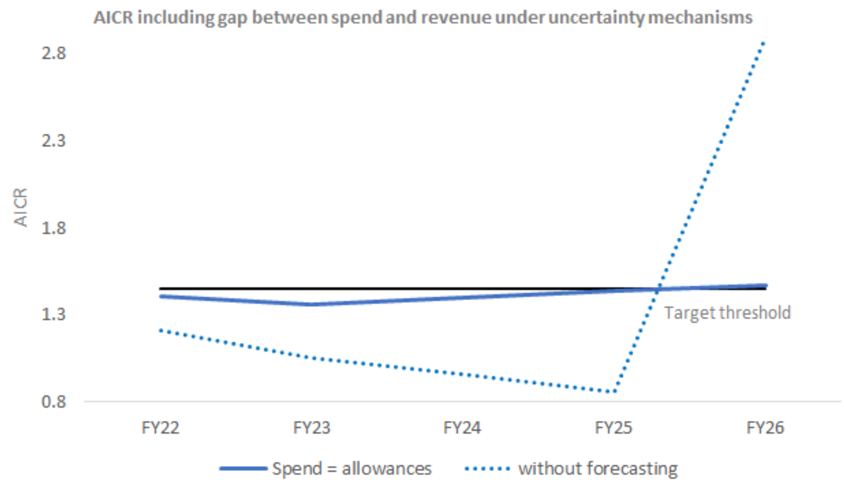
Remedy needed: Develop a more balanced appraisal of allowed equity return and remove the flawed outperformance wedge.

A marked weakening of financial resilience

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

The lower returns in RIIO-2 sharply reduce our financial resilience with baseline plans leaving the notional company on the cusp of being downgraded from BBB+. More worryingly notional credit metrics drop to sub-investment grade once delays between spend and revenue under the myriad of uncertainty mechanisms are factored in.

Figure 2: AICR trend including gap between spend and revenue under uncertainty mechanisms



The financial resilience of the sector has to be assured to keep financing costs low for consumers. We have been able to weather recent economic turmoil caused by COVID-19 and Brexit by having sufficient financial capacity and in doing so we were able to provide a financial anchor to the rest of the industry. In the economic recovery and move towards decarbonisation this capacity will be important to maintain confidence. But by pushing returns too low and not adequately stress testing financeability for delays between spend and revenue under uncertainty mechanisms, the DD removes this creating unnecessary risks and costs for consumers. We address this in detail in our response to finance questions FQ12 and 13.

Remedy needed: Ofgem must undertake a financeability assessment which factors in delays between spend and revenue under uncertainty mechanisms

Disproportionate, unjustified BPI penalty

The punitive application of the Business Plan Incentive (BPI) across all networks is a particularly worrying development for RIIO-2. The BPI was developed to "*encourage high-quality and ambitious Business Plans*"[9]. In reality, across transmission companies Ofgem imposed large penalties of £286.6m (before the application of caps). This is compared to only £1.6m of rewards (with no rewards at all provided for ambitious costs).

Ofgem has provided very little justification for the significant penalty that is set well above regulatory precedent and completely disproportionate. What little information provided suggests that Ofgem has not followed its own guidance.

At Stage 1 (Minimum Requirements), Ofgem has wrongly applied the framework it set out in the Business Plan Guidance (BPG) and SSMD to our business plan to provisionally conclude – incorrectly – that our business plan did not meet the Minimum Requirements, and that this was sufficiently material to warrant failure against BPI Stage 1, leading Ofgem to propose a penalty of £7.8m. Ofgem has wrongly applied its framework at Stage 1 as follows:

- Ofgem wrongly concluded that our business plan did not meet the Minimum Requirements, because of a failure to provide specific types of evidence that are not mentioned in the BPG, and which Ofgem had not specified were required elsewhere.
- Where a specific type of evidence was required under the BPG, Ofgem either misapplied its framework by imposing a higher standard than that specified as a Minimum Requirement in the BPG or failed to properly take into account the evidence that we had already submitted to it.
- Ofgem did not take any account of the views of our Independent User Group in assessing whether the Minimum Requirements for Stage 1 have been met, despite this being required under the BPG.

We note also that whilst Ofgem alleges "systemic" failings on our part, this has never previously been raised with us either through feedback on the two full drafts of our business plan or during our extensive engagement with Ofgem staff.

Whilst we have covered stage 1 in our summary, our detailed response sets out the flaws in; the development of the BPI; the overall design; and the application of the BPI to NGGT. We address this further in our response to Core question 35.

Remedy needed: Drop the unjustified Business Plan Incentive penalty and recognise ambitious activities and costs which add consumer value.

[9] Ofgem's Sector Specific Methodology Decision, section 11.43

Unjustified efficiency targets

We have overspent our RIIO-1 allowances by over £300m, as it was in the interests of consumers to do so. This has meant that we already have an extreme focus on efficiency to deliver this activity at as low a cost as possible. On top of this we overlaid a further 8% efficiency ambition for our RIIO-2 plan.

For our asset health unit costs there are flaws in the methodology used, which has led to an increased efficiency challenge. This includes flawed cost calculation adjustments, the exclusion of valid high-cost data points from the analysis and misinterpretation of the evidence we provided within our business plan. We have provided evidence to demonstrate why these are unacceptable in our response.

The approach used to determine our operating costs has been wholly inappropriate. The use of econometric modelling for gas transmission (a sector of one) incorrectly assumes comparability between transmission networks and does not statistically support the rejection of our costs as inefficient. Closely Associated Indirect costs have been scaled down with capex levels, ignoring that half of these operating activities do not flex with our capital programme, resulting in a £77m double count of disallowances for activities that do support our capital programme.

For this same reason the proposed opex escalator only tops up incremental activities associated with the capital plan leaving net operating activities underfunded. By linking these predominantly fixed costs to capex levels and then pushing capex into a myriad of uncertainty mechanisms, delivering the RIIO-2 allowances would require significant cuts in headcount and critical skills from current levels despite a generally held view that additional workload, and therefore skills, are required in the future.

Ofgem's decision puts at risk the resilience of our network today, by underfunding our incremental health and safety costs, ongoing operational training to maintain competencies and the workforce required to meet our Health and Safety Executive (HSE) approved safety case. It also undermines the resilience of future price controls, by failing to fund the recruitment and upskilling activities we built into our plan to ensure we maintain a skilled and diverse workforce in light of a projected 19% workforce retirement over the next 10 years. We address this further in our response to NGGT questions 31 and 38.

Remedy needed: Address issues with efficiency methodologies including correcting for flawed methods which compare our costs to those of electricity transmission and recognise the stretching efficiency ambition already applied to our plan.

Multiple penalties and ex post clawbacks

The overall package of DD stifles opportunity to innovate to develop new solutions to the benefit of current and future consumers. Indeed, by proposing a system that combines ex post review with extensive use of penalties and clawbacks, Ofgem's DD will strongly discourage innovative thinking.

Ofgem has introduced multiple "true up" or "adjustment" mechanisms which are impenetrable and the way in which they may (or may not) be applied is unclear. In many cases certainty would only be provided more than two years after the entire price control period is finished.

Unbounded decisions around whether Ofgem thinks certain actions were justified will lead to huge changes in funding long after actions were taken, resulting in reduced innovation and higher cost to consumers. The danger is that we may be held to impossible standards of perfect hindsight and may face material stranding and cost write offs long after decisions were taken, and the money spent. We think Ofgem has failed to consider the adverse consequences of introducing so much regulatory uncertainty into the process. We address this in detail in our response to GT questions 1 and 3.

Remedy needed: Adjust the risk/reward of the overall package to drive service improvements and reduce costs to the benefit of current and future consumers by ensuring appropriate incentivisation and removal of unwarranted ex post adjustments.

<u>Dampened incentives</u>

In the DD, Ofgem has damped the incentives for networks to reduce cost and drive service improvements to the detriment of current and future consumers.

- **Output Delivery Incentives scaled back**: Ofgem has significantly reduced the scope, value and targets of Output Delivery Incentives to the point of virtually switching them off. This move is directly contrary to the wishes expressed by stakeholders. Ofgem has underestimated the consumer value of strong constraint management incentive including the benefits of avoiding customer disruption, increased security of supply and the impacts on the wholesale market prices. This was supported in a study by EY, which concluded that even with perfect foresight and without taking account of an unexpected short-term shock, failure to maintain the existing capability of the NTS could have a significant impact on GB consumers, for instance by adding up to £877m on to gas and electricity cost by 2035. The lack of incentivisation and reduction in allowances brings into question our ability to maintain the same level of service.
- **Network Asset Risk Metric provides no incentive to innovate or focus on reducing risk at the lowest cost across our asset renewal expenditure:** weakening any incentive to pursue new ways of managing our assets or any departure from plan with an Ofgem ex post review of our decisions. This includes those needed to react to events, which we expect to be increasingly required given our ageing network and the inherent lack of perfect foresight.
- **Headline incentive rate (sharing factor) down**: the incentive to lower cost has been substantially reduced, from 44.36% last time to a proposed 36.65% this time. Looking across networks there does not appear to be a consistent application of the sharing factor, considering disallowed costs and movement to uncertainty mechanisms. Transmission companies appear particularly harshly targeted, given the relative lack of comparability through benchmarking.

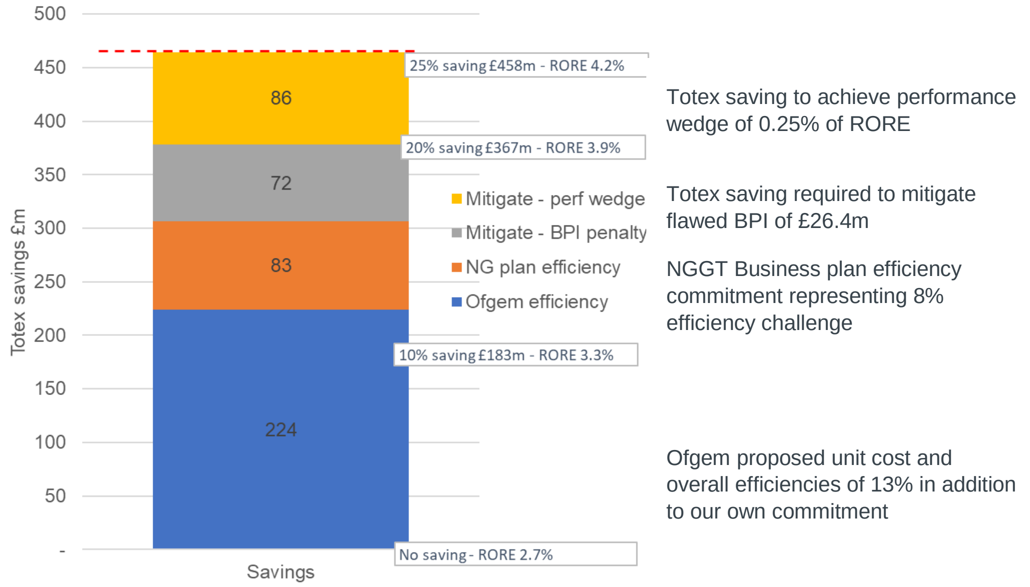
Ofgem's maximum quoted upside from the framework is only half the potential available to listed water companies, lower than the gas distribution sector and would only be delivered if we could save 10% against the totex allowances; not likely in a framework with multiple ex-post adjustments. We address this in detail in our response to NGGT questions 1 to 10 (inclusive) on ODIs, NARMs questions 1 to 4.

Remedies needed:

- Review new information that demonstrates the consumer value of ODIs and set improved incentive values that would drive service improvements for consumers
- Accept our alternative NARMs mechanism for the that simplifies regulatory regime whilst maintaining protection for consumers
- Reassess the treatment of high and low confidence costs to increase the totex sharing factor

<u>Unachievable allowed equity return</u>
Based on the cumulative effect of the multiple DD mechanisms and efficiencies, we would start the RIIO-2 period with a substantial gap to our allowed equity return. Without any savings from today we would be facing a Return on Regulated Equity (RoRE) of 2.7%. We would have to deliver the funded workload for 25% less than our current operations to deliver the allowed return.

Figure 3: 25% totex savings required to close starting RoRE gap of 150bps



Even if we deliver the DD future productivity efficiencies which are more than twice the productivity level of the general economy we would still be facing a return of less than 3%.

Given the nature of the RIIO-2 framework, this position could be worse. Of the £1.6bn baseline totex allowances included in DD, we are only incentivised on £1.1bn. The remaining 31% is subject to true up and claw back meaning we would not receive any benefit from innovations to reduce cost. When this is factored in, we would have to deliver 43% of totex savings from our current operations to achieve the allowed equity return. The approach to incentivisation means there is limited ability to close this gap and we would be left unable to achieve our allowed equity return. We address this further in our response to the Finance document.

Next Steps

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

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