Ofgem call for evidence on the Electricity Transmission, Gas Transmission, Gas Distribution and Electricity System Operator Business Plans for RIIO-2

Citizens Advice submission

February 2020

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Executive Summary

Citizens Advice welcomes the opportunity to respond to this consultation as part of its statutory role to represent domestic and small business energy consumers in Great Britain (GB). This response is not confidential and may be published on your website.

Five principles for RIIO-2

In August 2018, we published[1] our 5 principles for RIIO-2.

1. Profits are lower than the previous price control, to more accurately reflect the relative low risk for investors in this sector.
2. The value of any unspent funding for infrastructure projects is returned to consumers promptly and in full.
3. Industry business plans and regulatory decisions are directly informed by consumer (including future consumer) feedback and research.
4. Companies are required to publish complete information on their performance, financial structures, gearing and ownership.
5. Innovation funding and incentives support consumers in the transition to a low-carbon future, particularly those consumers in vulnerable circumstances.

We revisited progress by Ofgem in meeting these 5 principles in April 2019 in 'Are your energy bills delivering value?'[2].

Enhanced engagement

We are pleased that Ofgem has introduced the enhanced engagement process. Our review of the business plans of the network companies has identified a positive step change in the stakeholder engagement programmes used in developing their RIIO-2 business plans. We believe that this marked improvement is a direct result of the requirements introduced through the Ofgem enhanced engagement process for this price control, including the need to demonstrate robust and high quality engagement and to establish a company

[1] 'Will Ofgem's next price control really deliver for consumers?', Citizens Advice, August 2018: https://wearecitizensadvice.org.uk/will-ofgems-next-price-control-really-deliver-for-consumers-e9f01c034e35

[2] 'Are your energy bills delivering value?: We revisit our 5 tests to see how well Ofgem is performing', Citizens Advice, April 2019: https://wearecitizensadvice.org.uk/are-your-energy-bills-delivering-value-86879737da91

challenge group. **We would firmly recommend the retention of these enhanced engagement requirements for future price controls.** In 2018 we published our views on Strengthening the Consumer Voice in Energy Network business planning[3] which demonstrated the value of engaging with consumers and consumer stakeholders in these processes.

Open Hearings

In this response we have highlighted where we think Ofgem should look further in the Open Hearings. As well as areas that we have identified, we have highlighted relevant areas that the Challenge Group (CG), Customer Engagement Groups (CEGs) and User Groups (UGs) raised. We have also provided additional evidence that can feed into the Open Hearings and draft determinations. We have used Ofgem's business planning guidance framework to assess our view of the quality of the companies business plans. We've prioritised our review on the areas we had identified at the beginning of RIIO-2 as priorities for consumers[4] (see above).

Acting in the interest of consumers

It is vital not only that the business plans put forward by companies are good value, but that Ofgem can have confidence that companies will act in the best interests of consumers. We have highlighted areas where companies have acted in ways that we think Ofgem can have more confidence in three key ways:

- Returning money to consumers in RIIO-1. Two companies have returned money to consumers:
    - Scotia Gas Networks (SGN) returned £145m to consumers
    - SHET (SSEN) returned £65m
    - In addition Cadent & National Grid both took actions to reduce consumers' bills and deferred investment in RIIO-1. National Grid returned £150m to consumers following the sale of Cadent establishing a Warm Homes Fund
    - SP Transmission set up a £20m Net Zero fund[5]

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[3] https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-policy-research/strengthening-the-voice-of-consumers-in-energy-networks-business-planning/

[4] https://wearecitizensadvice.org.uk/will-ofgems-next-price-control-really-deliver-for-consumers-e9f01c034e35

[5] https://www.spenergynetworks.co.uk/news/pages/green_economy_fund_launch.aspx

- Social responsibility

Most companies mentioned activities they would undertake to show social responsibility, such as linking executive pay to customer outcomes, achieving the Fair Tax mark or giving their staff time to volunteer - all very welcome activities but none of them stood out in this regard. Several companies have created funds to spend on important social and environmental causes (though except for Cadent, we are uncertain whether these funds come out of company profits):

    - The Cadent Foundation will invest 1% of post-tax profit (around £6m) into vulnerability and environmental challenges
    - Northern Gas Networks' Hardship Fund of £150,000 per annum will be available for those in need of direct financial help
    - National Grid Gas Transmission (NGGT) proposes a community fund of 0.3% of the costs of major projects for community improvements
    - National Grid Electricity Transmission (NGET) pledges £7.5m to support those affected by their construction activity

- Transparency and accountability

Many companies engaged with the issue of transparency and accountability, mentioning that they would improve reporting and keep their Challenge or User Groups to hold them to account. However, none of them deeply engaged in the debate around their sustainable licence to operate or their social contract with their customers. For example for the water price control PR19, Bristol Water brought all of their commitments together in a social contract[6], in which their Challenge Panel and consumer panels have a specific role, and it's clear how financial outperformance links to bill reductions. That said, we welcomed the following in particular:

- Cadent undertook specific research with end-consumers to understand how the company could gain their trust. This resulted in Cadent's Trust Charter (Business Plan page 110) which they commit to reporting on every year. Although some of the topics within the Charter are also mentioned by other gas distribution network companies (GDNs), Cadent put concrete measures and targets in place for some, and committed to reporting on them in one place on their website and social media, making it easier for consumers and stakeholders to hold them accountable.

6 https://www.bristolwater.co.uk/wp-content/uploads/2019/01/Bristol-Water-our-purpose-and-social-contract-to-build-trust-beyond-water.pdf

- Both NGET and SHET (SSEN) engaged their customers and stakeholders on what reporting they expect. Both have come up with proposals for more comprehensive, transparent reporting on service and financial performance, which we welcome (see NGET report page 150 onwards and SHET report page 103 onwards). There is still scope, however, to become more specific about what exactly will be reported and through which outlets.

Our engagement

We have engaged with the developments of the network companies' RIIO-2 business plans in a number of ways:

- We have had bilateral meetings with companies who have discussed their plans with us at various stages and sought our views
- We have been part of Ofgem's RIIO-2 Challenge Group
- Citizens Advice staff have been members of GDNs' Customer Engagement Groups (Cadent, SGN and WWU) and the ESO's User Group (ESRG)
- We have presented our evidence to Customer Engagement Groups and User Groups where we have not been members

This document represents the views of Citizens Advice following a review of the companies final published business plans alongside the published Challenge Group, CEG and User Group reports. In general we have not reviewed the additional material (annexes etc) supplied by companies alongside their plans.

Consumer Value Proposition

We agree with the comments made by the RIIO-2 Challenge Group about the additionality offered by the Consumer Value Propositions. We are not convinced that the companies' Consumer Value Propositions, when presented as a whole demonstrate significant additional value for consumers, although there is value demonstrated in some of the constituent parts (eg as bespoke outputs). Because of the incentive that companies can be awarded for these proposals, **we think that in the Open Hearings Ofgem should challenge companies to demonstrate that they have met the Consumer Value Proposition criteria that Ofgem have set out at**.

Giving consumers a stronger voice

Overall Citizens Advice comments

Our review of the business plans of the network companies has identified a **positive step change** in the stakeholder engagement programmes used in developing their RIIO-2 business plans. We believe that this marked improvement is a direct result of the requirements introduced through the Ofgem enhanced engagement process for this price control, including the need to demonstrate robust and high quality engagement and to establish a company challenge group (either a Customer Engagement Group or User Group). We would firmly **recommend the retention of these enhanced engagement requirements** for future price controls.

While all companies have shown improvement within the business plans, in many cases, the stakeholder engagement process still represents a work in progress and further **embedding and development of engagement programmes will be needed** throughout the RIIO-2 price control period.

Our review of the companies' business plans identified a **degree of variability in the stakeholder engagement approaches and activities** undertaken by the companies, with some apparently striving to attain best practice while others looked to be at an earlier stage in their stakeholder engagement development. Similarly, we noted the different standards that the companies were held to by their Customer Engagement Groups (CEGs) or User Groups (UGs). For instance, the Cadent CEG appeared to hold Cadent to the highest standards of practice not only within the energy industry but in comparison with other industries, such as the water sector. The business plans and the CEG and UG reports reflect these different aspirations and standards. As such, an apparently more critical

CEG or UG report may actually reflect a company with a higher current standard of stakeholder engagement performance than some others within the sector.

From our review of the business plans, we do not believe that the Open Hearing process needs to consider the issue of stakeholder engagement in general (ie at the cross cutting hearing). However, we do believe that there would be value in Ofgem considering setting out detailed standards for engagement that the companies are obliged to meet for future price controls including RIIO-ED2. A **consistent quality of engagement standard** and set criteria for evaluation would enable a future CG, the CEGs and UGs to scrutinise and assure using the same measures.

The RIIO-2 Challenge Group (CG), CEG and UG reports have proved useful in assuring processes and outcomes as well as highlighting areas of concern. We are not repeating every comment revealed within these reports but have highlighted the points where further Ofgem scrutiny may be warranted and where we also support that viewpoint. We have raised some additional issues for Ofgem to consider which are beyond those noted by the CG, CEGs or UGs.

National Grid Electricity Transmission (NGET)

CG comments

The CG raised a point regarding the qualified acceptability of the business plan. It notes that "NGET says that 87% of 'household and business customers combined' agreed that the Plan was acceptable. However, it adds that, for household consumers, this is 'conditional on limited increases in other components of their overall energy bill', and that 'NG proposals would not be acceptable if all parts of the energy bill were to increase by similar proportions'. We suggest that Ofgem explore this qualified consumer response with NGET at the Open Hearings as well as exploring the extent to which acceptability testing with consumers in future could take account of the total impact of energy costs on consumers' bills." (Page 102 of the CG report).

UG comments

The UG notes a number of areas where they would welcome further scrutiny by Ofgem, however, none relate exclusively to engagement practices.

Citizens Advice comments

There is not clear evidence within the business plan that there has been extensive engagement to gather stakeholder views relating to regional aspects. Particular stakeholder groups that could have a considerable input in this regard include devolved governments (such as the Welsh Government), local Mayoral offices, and other local council governmental bodies and initiatives (such as Local Area Energy Planning). The views of these stakeholders may have implications for NGET's business plan, especially with regard to transition and climate change issues. For instance, many devolved and local government entities have more stringent net zero targets than the national government goals. The UG report also notes that they have challenged the company in regard to appropriately incorporating regional input (pages 29-30). **We would recommend that the extent of regional input within NGET's business plan is scrutinised as part of the Ofgem business plan review process**.

National Grid Gas Transmission (NGGT)

CG comments

The CG notes that: "The future cost of 'enhanced' engagement is given as £850k per annum for the RIIO2 period. The Plan says this includes a small central team plus the cost of additional stakeholder engagement activities and research including agencies and consultants. Given the way that its sister-company NGET distinguishes between the cost of enhanced engagement at a similar level, and business-as-usual engagement at a further cost of £3.7m per annum, it would be worth Ofgem clarifying the full cost of NGGT's engagement activities." (Page 127 of the CG report).

UG comments

The UG notes a comment regarding stakeholder engagement for whole energy systems where they would welcome further scrutiny by Ofgem: "The chapter includes some good evidence of stakeholder engagement and clear definitions of where NGGT will lead and facilitate in the whole energy system. National Grid has put forward clear and positive commitments about how it will build the evidence base and support policy-making regarding the future role of the NTS ready for RIIO-3; in particular through its work through the Hydrogen Programme Development Group chaired by BEIS. However, the UG remains unconvinced that NGGT has fully responded to the expectations of its stakeholders in its leadership role towards the future energy system and in facilitating whole system outcomes." Given the high importance to the government's net zero goals and the need for whole system solutions, we would recommend that Ofgem considers this aspect closely within NGGT's business plan." (Page 27 of the UG report).

Citizens Advice comments

The stakeholder engagement by this company appeared sound, with many good practice aspects, however, **we also support the UG's concern for further scrutiny regarding engagement relating to whole energy systems** (see paragraph above).

Scottish Hydro-Electric Transmission (SHET)

CG comments

The CG report notes a number of weaknesses and 'serious concerns' in the SHET stakeholder engagement including with respect to acceptability testing and engagement with end consumers (Pages 202-203 of the CG report).

UG comments

The UG notes a number of areas where they would welcome further scrutiny by Ofgem, however, none relate exclusively to engagement practices.

Citizens Advice comments

The SHET business plan, when reviewed in comparison with other network RIIO-2 business plans (i.e. not including supporting documentation), is much lighter on detail in a number of aspects. For instance, there is less information on the nature of the stakeholders engaged with, the methods used to collate and assure priorities, the process for how various source data was triangulated, the principles used to undertake triangulation or to make trade-offs for conflicting views, and the measures used to ensure acceptability of the plan. As such, it is not as clear that there is a 'golden thread' between the engagement and the final decisions proposed. The UG report notes on page 14 relating to enhanced engagement that "The User Group believe the minimum requirements set by Ofgem have been met and exceeded". The UG has not raised any points specifically on stakeholder engagement for further scrutiny by Ofgem suggesting overall satisfaction with the engagement processes of the company. The UG, however, will have had access to additional information beyond the business plan to make their assessment.

One of the main requirements set by Ofgem in relation to stakeholder engagement was for the business plan to include evidence of "robust and high quality engagement with stakeholders in designing the plan" (page 10 of the Ofgem RIIO-2 Business Plan Guidance[7]). Given the CG misgivings and our own review of the business plan, **we believe that it would be suitable for Ofgem to**

[7] https://www.ofgem.gov.uk/system/files/docs/2019/10/riio-2_business_plans_guidance_october_2019.pdf

undertake further scrutiny of the way SHET's have used consumer and stakeholder engagement in their business plan. This scrutiny would give assurance that the various engagement processes used by SHET represent robust and quality engagement and would provide confidence that SHET's stakeholder engagement underpins the decisions proposed within the business plan.

SP Transmission (SPT)

CG comments

The CG report notes that there are 3 bespoke incentives in the engagement area. The CG report asks for further Ofgem scrutiny of these incentives: "We see value in some of these proposals but are unconvinced that they merit an extra financial incentive. The engagement around understanding the impact of a black start, particularly on vulnerable communities, is welcome, and building resilience during these events should be valuable. But we felt that engagement of this type should be an essential part of a transmission company's approach. Upskilling Community Energy schemes would be valuable and should support the energy transition, although we would prefer greater clarity on costs. The AA standard target is welcome but not outstanding compared with other companies' plans. Overall, we suggest that Ofgem explores this area further at the Open Hearings, including SPT's apparent plan to leave wider engagement with individual vulnerable consumers to its distribution business." (Pages 183-184 of the CG report).

UG comments

The UG report makes a recommendation to Ofgem regarding stakeholder engagement: "We would make a specific recommendation to Ofgem to enable and underpin more effective stakeholder engagement and co-creation in the future. This recommendation is that more specific and explicit direction needs to be given to the requirements and implications of the type of 'green energy system' required to meet the UK's Net Zero commitments. This links to what SPT refers to in their Business Plan as a sustainable Net Zero future. However, the Net Zero ambitions (set by the UK and Scottish Government after the Business Plan process was initiated) have implications not only in terms of the costs of generating and transmitting zero carbon energy, but also in terms of regulation requirements and costs, and will interact with conditions in the wider economy. In addition to direct energy bill effects, the outcomes will impact consumers' well-being through a wider range of prices, household incomes, and other factors. Thus, a broader Net Zero perspective needs to enter Ofgem guidance to Network Operators (and other system actors) in preparing their Business Plans." (Page 11 and Page 43 of the UG report).

The UG also notes that "SPT are proposing to engage with vulnerable customers using a distribution-led approach. While the User Group was concerned that it may be an option for SPT to use a distribution-led approach to helping vulnerable customers, this is not an approach open to all of the Transmission companies." (Page 32 of the UG report).

Citizens Advice comments

We agree with the comments made by the CG and UG. We are not raising any additional comments regarding engagement which seek further scrutiny by Ofgem.

Cadent

CG comments

The CG appears generally satisfied with the engagement undertaken by Cadent. However, they raise one comment regarding the bespoke incentives proposed by the company where they ask for further scrutiny by Ofgem: "Two bespoke output incentives are proposed in this area. The first is a reputational incentive for an annual report to 'demonstrate continual improvement' in Cadent's stakeholder engagement approach and delivery of its commitments. This is an important initiative – although we note that other companies promise similar initiatives without feeling the need to shine a light on them via a reputational incentive. The second bespoke incentive is an evolution of the current stakeholder engagement incentive focused in particular on 'whole system solution initiatives and those related to energy transition' with performance assessed by an independent panel. Cadent presents this as a 'proposed common' financial incentive. This is clearly a worthwhile activity but we suggest that Ofgem explores during the Open Hearings whether this merits an additional reward given how central to stakeholder engagement these issues should be during RIIO-2." (Page 61 of the CG report).

CEG comments

The CEG notes a number of areas where they would welcome further scrutiny by Ofgem, however, none relate exclusively to engagement practices.

Citizens Advice comments

We are not raising any additional comments regarding engagement which seek further scrutiny by Ofgem.

Scotia Gas Networks (SGN)

CG comments

The CG does not raise any comments regarding engagement which seeks further scrutiny by Ofgem.

CEG comments
The CEG notes a number of areas where they would welcome further scrutiny by Ofgem, however, none relate exclusively to engagement practices.

Citizens Advice comments
The overall level of stakeholder engagement by this company appears to be extensive and the CEG report largely supports the enhanced engagement process undertaken by SGN. However, it was not clear from the business plan which principles or techniques were being used to trade-off differences of opinion between various groups of stakeholders. The CEG report gives assurance that "SGN's business plan has been underpinned by extensive consumer and stakeholder engagement, much of which has been undertaken to a high standard" (page 1). Nevertheless, **we would recommend that Ofgem scrutinises the triangulation and trade-off practices underpinning the business plan proposals to ensure that there is secure stakeholder and customer underpinning for SGN's business plan**.

National Grid Electricity System Operator (ESO)

CG comments
The CG does not raise any comments regarding engagement seeking further scrutiny by Ofgem.

UG comments
The UG does not raise any specific comments relating to engagement where they have asked for further scrutiny by Ofgem.

Citizens Advice comments
The stakeholder engagement undertaken by the ESO appears to have issues in respect of the level of collaboration with the electricity Transmission Operators (TOs) and electricity distribution networks (DNOs). The ESO's UG notes on page 13 that "the ESO appears to be proposing to take on new roles that currently sit with TOs and DNOs, and it is not clear to what extent these parties have been consulted". The UG mentions the same point in multiple places throughout its report and the importance of collaboration to avoid confusion in roles and responsibilities. **We would recommend that Ofgem scrutinises the comprehensiveness of the ESO's engagement and how decisions are evidenced and linked to stakeholder engagement, particularly with these key stakeholders.** This engagement should underpin and validate the ESO's business plan proposals.

The UG also notes that future collaboration with the TOs and DNOs will be needed as the role of the ESO evolves. **We would further recommend to Ofgem that they scrutinise the ESO's ongoing stakeholder engagement strategy** to ensure that appropriate engagement will be undertaken with all key stakeholders such as the TOs and DNOs, and that future engagement will incorporate triangulation and measures to appropriately address conflicting stakeholder views.

Meeting the needs of consumers and network users

Interruptions

Throughout multiple research pieces, we have seen consumers rate reliability as their top priority. It is important, therefore, that networks put forward well calibrated, ambitious interruption targets.

We echo recommendations from the RIIO-2 Challenge Group (CG) and some Customer Engagement Groups (CEGs) that Ofgem should scrutinise all **unplanned interruption average restoration time targets** of gas distribution networks (GDNs) to ascertain whether they followed the hybrid methodology expected by Ofgem and put forward reasonable targets which meet Ofgem's intention of protecting "against any significant deterioration". We found that all GDNs put forward very cautious targets, which were sometimes even lower than their current performance, and therefore could allow slippage in service levels to occur. We welcome that some GDNs have set more ambitious targets internally on a reputational basis.

Similarly, Ofgem should scrutinise in detail the **Energy Not Supplied targets** of electricity Transmission companies. The targets put forward by the three companies all represent a tightening of targets, ranging from 21% to 45% improvement. Ofgem needs to ensure that these are all reasonable and ensure that they are equally stretching for each company.

Beyond specific targets, we are concerned that the unplanned interruptions **incentive design for GDNs** has not resulted in targets that are in the best consumer interest. This concern was also expressed by WWU CEG (report page 11) and Cadent CEG (report page 20). Aggregation of Multiple Occupation Buildings (MOBs), non-MOBs and large incidents, and a penalty-only design have made companies put forward very cautious overall targets. **We would ask**

Ofgem to explore other incentive designs, if not for RIIO-2 then for RIIO-3. Cadent has put some thought into alternative incentive design which we think are worth considering.[8]

SP Transmission (SPT)

SPT are proposing a bespoke incentive in the form of a use-it-or-lose-it pot. The money would be spent to "mitigate the risk of no supply to consumers connected to our distribution network" as a result of "essential planned outages" (Business Plan page 154). The company would report on what they use the money for and the customer risk mitigated with it. Success would be measured in terms of customer interruptions (CI) and customer minutes lost (CML).
The User Group supported the inclusion of a funding mechanism to implement contingency measures but questioned whether instead of an allowance it should be an uncertainty mechanism (report page 36).

We certainly welcome the aims of this incentive and the fact that SPT will be reporting on the impact their interruptions have on their distribution network in CML and CI - something other transmission companies should emulate.

However, we do not believe that SPT made a sufficient case for this allowance in its Business Plan (note that SPT have made us aware that further justifications sit in its Annexes). For example,

- We could not see evidence of consumers' willingness to pay for this allowance, or whether any engagement with consumers or stakeholders had taken place on this allowance specifically. However, we know that SPT undertook Willingness To Pay (WTP) and Willingness To Accept (WTA) studies.
- We are also unclear why delivering these outcomes needs a dedicated allowance, when the Energy Not Supplied incentive should drive TOs to improve reliability. Would the activities funded by the allowance be wholly additional, i.e. encourage the company to undertake activities they otherwise wouldn't?
- The Business Plan doesn't explain what sort of measures could be paid for by the allowance, how much they might cost, whether therefore the £1.5 million per annum is reasonable, and whether that is commensurate with the benefit consumers can hope to derive from those measures.

[8] Appendix 07.03.06. Page 29 onwards https://cadentgas.com/nggdwsdev/media/Downloads/business-plan/APP_CAD_07-03-06-Getting-Our-Customers-Back-On-Gas.pdf

We therefore believe that this allowance needs further scrutiny from Ofgem.

Scotia Gas Network (SGN)

SGN's customers in their Southern network receive a worse service than their Scottish counterparts in terms of reliability. Whereas in Scotland the average unplanned interruption time has been 12.3 hours over the past three years, in the South it was 23 hours - almost twice as high. SGN says that this is "largely explained by the predominance of gas risers serving customers in high rise MOBs in London" (Business Plan, page 61).

We accept that MOBs can pose additional difficulties for a GDN but they should not be used as an excuse for poor performance. We would have appreciated a fact-based reflection on which elements of serving MOBs is outside of SGN's control, and which elements they know they can improve on. This was not provided. There was also no data provided that showed MOBs versus non-MOBs interruptions in the South, making it difficult to understand the issue further. Beyond promising future reporting on MOBs interruptions (business plan page 62), no commitments were made for customers in high risers.

We agree with SGN's CEG (report page 26) that SGN should narrow the gap between Scotland and South in terms of restoration time. **Customer feedback from the South shows that people there expect interruption duration to improve which the proposed targets do not facilitate. We therefore propose this area for Open Hearings.**

National Grid Electricity Transmission (NGET)

NGET are proposing a bespoke symmetrical financial incentive to incentivise them to manage outages better with the customers affected. We understand the survey would cover customers and stakeholders affected by outages.

We welcome the idea to measure satisfaction especially on a topic such as outage management, given reliability is a top priority for end-consumers. In the gas distribution sector, we have supported symmetrical financial incentives for improved consumer satisfaction, as it mirrors market pressures, i.e. the company is rewarded or penalised as customer satisfaction rises or declines. In that sector, we have seen great improvements in customer service as a result of the incentive.

It also strikes us to be able to deliver additional benefits, which may not be achieved through the ENS incentive, and the other two satisfaction surveys that will be introduced around quality of connections and engagement on transmission investment projects. We therefore see value in the incentive for consumers.

However, **further scrutiny from Ofgem is needed on the calibration of the targets and the size of the reward/penalty**. The RIIO-2 CG noted that the targets proposed by NGET do not look stretching given NGET's current and other TO's performance (report page 104). NGET's research shows that consumers were willing to pay a small amount to reduce the risk of power cuts.

Consumers in vulnerable situations

We were pleased to see that GDNs have proposed many incremental improvements that will benefit consumers in GD2. However, in light of the fact that GDNs were given increased funding and had a lot of freedom to spend the use-it-or-lose-it allowance, we are disappointed with this aspect of the proposals. Overall, companies have not consistently demonstrated activities that are significantly beyond BAU or their existing baseline, that propose significant ambition and scope. There are some exceptions that demonstrate ambition, for example Cadent's cross-sector funding proposal. **We think Ofgem should challenge the other GDNs to demonstrate their ambition in this area.**

None of GDNs have gone beyond their RIIO-1 FPNES (Fuel Poor Network Extension Scheme) targets. We think the companies have made efforts and explain why they have set their targets at this level, but in light of the impact on affordability that this scheme potentially provides we think Ofgem should challenge the GDNs further.

Further **scrutiny is also required by Ofgem to ensure that there is not a postcode lottery between GDN areas with regard to CO awareness and provision**. Proposed spend on CO activities as a proportion of the use-it-or-lose-it allowance ranges from one sixth of the allowance (SGN) to half of the allowance (NGN). WWU and Cadent both propose to spend approximately one third of their allowance on this area. **Consideration is required by Ofgem on the implications of these approaches to the use-it-or-lose-it allowance**.

We are concerned that uptake of locking cooker valves (LCV) still remains low . 565 were reported as being installed across all GDN areas for the 2013-18 Discretionary Reward Scheme period. We note the specific targets of 100 installations per year by WWU (Business Plan, page 69) but note the absence of specific targets by other GDNs. GDNs have a unique role to play in this area and while we welcome SGNs widening of its criteria to cover a greater range of vulnerabilities (Business Plan, page 55), we think there is a risk that the overall level of provision could be low and so the scale of installations by GDNs across the board would benefit from further scrutiny by Ofgem.

In addition we note that reporting of costs and net benefits to customers in the main Business Plans remain inconsistent and make direct comparisons difficult, especially where multiple measures are packaged together.

Looking forward, with many activities drawing a reputational incentive, **we urge Ofgem to monitor that these incentives are delivering positive outcomes for consumers.**

Finally, we welcomed the bespoke proposals in this area from transmission companies. We have referred specifically to the proposals made by SPT in the sections above on Engagement and Acting In The Interest Of Consumers.

Cadent

CG comments

The RIIO-2 Challenge Group (CG) highlighted (page 62) Cadent's FPNES target in their report, noting that this falls short of its RIIO-1 target. They also asked Ofgem to look further at the SROI supporting some of Cadent's bespoke outputs where these were based on a trial of advice carried out with a Local Citizens Advice. They queried whether there was evidence that the level of efficacy of this advice would continue to be as high as 64% of people taking action if scaled up (page 64).

CEG comments

On FPNES, the CEG had mixed views on whether Cadent's ambition is high enough – with some thinking this is appropriately low given the low carbon agenda and value for money of other measures. Others feel this is not justified (page 18 of the CEG report).

The CEG highlighted that costs upon which the justification for their off-gas-grid community trial is based do not take full account of capital costs that would be borne by consumers in switching their heating systems to gas. The CEG said that it is also not clear that this would result in a no - or low-regrets outcome for customers (page 15 of the CEG report).

The CEG also has mixed views about if Cadent's proposal for 2 million direct conversations, a four-fold increase, is the most effective approach. The CEG encouraged Ofgem to explore whether the ambition is supported by customers or the SROI is well-founded given it is based on a 60% registration rate onto the PSR. (Page 18 of the CEG report).

Referring to Cadent's partnership strategy, the CEG wanted to know that systematic stakeholder mapping has taken place. (Page 27 of the CEG report). The CEG noted that there is more work to be done on non-domestic vulnerability. (Page 18 of the CEG report).

Citizens Advice comments

Overall in our view Cadent's level of ambition really stands out amongst the GDNs. We welcome this and think that delivery of their proposals should improve outcomes for consumers in vulnerable situations. **Cadent's target for FPNES is lower than in RIIO-1 which we think Ofgem should investigate further during the Open Hearings**. The business plan demonstrated positive levels of understanding of current consumer vulnerability and how it will change in the future with the continuing advance of technology.

We particularly welcome the ambitious pilot to develop a cross-sector centralised funding model. Such a model would represent a step change in developing a joined up approach between separate sources of funding and responds to a clear need. The CEG noted that this model responds to customers' desires for all customers in fuel poverty to receive support (Page 22 of the CEG report). We also agree with the CEG that if Cadent installs energy efficiency measures, it must ensure high standards of customer experience and delivery. The reported 70% increase in the average number of annual interventions compared to GD1 is a target that Ofgem should monitor to ensure the new funding model is delivering at this target. We would encourage all GDNs to monitor the trial closely and consider replicating such a scheme.

The plan to have 2 million conversations with customers about the PSR is a laudable target but we note that stakeholder engagement and the CEG report highlight that quality is more important than quantity. **Further scrutiny from Ofgem on the effectiveness of this target would be useful.**

We welcome the intention to deliver 3 million CO monitors but particularly welcome the piloting of more accessible and smarter CO monitors which could provide additional protection for consumers in a range of vulnerable situations.

Northern Gas Networks (NGN)

CG comments
The CG picked up that NGN's FPNES target is lower than in RIIO-1, and also noted that NGN's approach to partnering across utilities and strategically is not as full or as strategic as those proposed by other GDNs (page 148).

CEG comments
The CEG did not raise any points in this area.

Citizens Advice comments
We welcome the movement of large parts of GD1 activities into BAU for GD2. NGN's target is lower than in RIIO-1 for FPNES, even where they are stretching this target and **we think Ofgem should investigate this further during the Open Hearings.**

We welcome NGN's intention to self incentivise to ensure FPNES connections are delivering improved efficiency in homes. The penalty is unique and received support from the CEG, however we consider that further scrutiny is required from Ofgem to ensure that it is meaningfully incentivising partnership work at the point of connection and partnerships are utilised to improve the efficiency of properties receiving a first time connection.

Scotia Gas Networks (SGN)

CG comments
The CG noted that SGN's FPNES target is lower than in RIIO-1, but that it is the closest of all the GDNs to GD1 levels (page 165).

CEG comments
The CEG did not raise any issues in this area.

Citizens Advice comments
Because **SGN's FPNES** target is lower than in RIIO-1**, we think Ofgem should investigate this further during the Open Hearings**. We note that SGN's social value for joint works proposal is very well justified.

We welcome SGN's targets in Scotland and their monitoring of changing fuel poverty definitions in Scotland which reflect the importance of this issue to stakeholders.

Further scrutiny of the tiered framework of support for vulnerable customers is required to ensure that the number of customers receiving the greatest levels of support are adequately ambitious. We note the CEG considered the target of 1,500 customers a year to be low, and potentially not reflective of customers' views on what SGN should prioritise (Page 21 of the CEG report). Further scrutiny from Ofgem would also be welcome to ensure support within the framework does not include BAU activities where use-it-or-lose-it funding is being proposed, for example, the support provided during supply interruptions. We welcome the inclusion in the business plan to address specific emerging issues relating to CO safety and alarms that have been identified as this represents new thinking in this area.

Wales and West Utilities (WWU)

CG comments
The CG highlighted that WWU's FPNES target is lower than in RIIO-1 and overall level of ambition is low in this area. They also queried the funding WWU have asked for to meet an inclusivity target, arguing that other companies have built this into BAU (page 222).

CEG comments
CEG said it wanted to understand WWU's role in working with other agencies and programmes: - to meet upfront costs of heat pumps, so that they can be affordable.

The CEG wanted to see more assessment of the role and effectiveness of WWU's partnerships in relation to their Consumer Vulnerability Strategy.

Citizens Advice comments
Overall, we view WWU's level of ambition as being low compared with current performance. In particular a table on P62 of the business plan (about spend on Social Obligations) shows that overall spend is declining from £3.08m/year to £2.68m/year. WWU told us that their proposed spend for GD2 to support vulnerable customers is not lower that GD1 actuals. **We think Ofgem should challenge WWU about why its level of spend on supporting consumers in vulnerable situations appears to be lower than during GD1. WWU's FPNES target is lower than in RIIO-1 which we think Ofgem should investigate during the Open Hearings.**

We note and agree with the view of the CG that the bespoke output for the inclusivity standard does not adequately justify £15,000 of funding and **requires further scrutiny by Ofgem.** Financial figures on page 69 of the business plan describing annual "investment in CO in GD2 '' have calculation errors and require further scrutiny. We welcome the target to increase PSR sign ups to 12,000 per year but note the CEG's views on the importance of quality.

Maintaining a safe and resilient network

Workforce Resilience

Scottish Hydro Electricity Transmission (SHET)

CG comments
When reviewing SHET's workforce strategy, the RIIO-2 Challenge Group (CG) noted that "SHET provided two appendices with their December submission, which set out general "good practice" and appeared to be written more in the form of consultation documents, and we are concerned that, based on our review in the time available, there is a relatively weak link to resource plans." This is an area which they have asked Ofgem to look at further. (Page 205 of the CG report).

UG comments
The UG did not raise any significant concerns around workforce strategy. They noted, on page 22 of the UG report, that "the Sustainable Workforce Strategy and Action plan were developed in consultation with both the User Group and The Stakeholder Advisory Committee." It was also noted that the 'Likely Outturn' and 'Net Zero' views were likely to be better indicators than the 'Certain View' of project scope and therefore resource requirements during RIIO-2.

Citizens Advice comments

According to SHET's business plan, directly employed workforce needs to increase from around 600 today to ~700 by the start of RIIO-2 (page 102, figure 6.7). This level remains flat throughout the RIIO-2 period. This plan is based on the Central View which might be too low, given that the UG has highlighted that the Likely Outturn and Net Zero views are likely to better indicators of resource requirements. **We agree with the CG that there is little evidence of resource plans, particularly for Likely Outturn and Net Zero scenarios. We suggest that Ofgem explores this topic in the Open Hearings.**

National Grid Electricity System Operator (ESO)

CG comments

The CG noted, on page 86 of the CG report, that while they welcomed the additional steps that the ESO has proposed to manage a major IT delivery programme, "We remain concerned that this planned step change in IT developments presents risks both in achieving delivery aims but also in addressing the associated transformation of the organisation." They also highlighted concerns around deliverability of the plan and the associated organisational transformation required.

UG comments

While the UG supported the ESO's proposals, they did note some concerns, particularly around the ESO's ability to deliver the scale of complex IT projects that will be required. The UG noted that the company will need to increase resources and expertise in both engineering and technology, and that there will be competition for these skills and expertise from other network companies and other sectors.

Citizens Advice comments

Given the concerns raised by the CG and UG, **it feels appropriate that this topic is explored in further detail in the Open Hearings**. At the end of RIIO-1 the ESO's workforce will be around 620 FTE employees (page 193). The ESO plans to recruit an additional 127 FTE employees in 2021-22, which is a 20% increase. Onboarding and training employees takes time and there is little detail in the plan as to how this will be achieved and by when. Historic attrition rates may not necessarily provide a good indication of future attrition rates, as employees might be more mobile and able to apply their skills to different industries. Therefore recruitment numbers and rates may need to be adjusted.

There will be competition for the skills and expertise that the ESO needs in order to deliver their plan. We would like to see further detail on how the ESO plans to recruit these skills.

Delivering an environmentally sustainable network

Net Zero Ambition

National Grid Gas Transmission (NGGT)

CG comments
The CG's view was that NGGT's plan for net zero is heavily focused on NGGT's role within gas, and within that is focused very much on hydrogen-based futures. While the plan does provide some detail on the practicalities of hydrogen, e.g. market regimes, as well as assets and the safety case, it does not include details of the specific steps or scale of investment required to accomodate hydrogen and increased access for renewable gases. The group also noted that there appears to be little or no discussion of the extent of NGGT's assets that are compatible with 100% hydrogen or any indication that work is planned to ascertain the potential optionality. (Page 130 of the CG report).

UG comments
The UG noted that "the Net Zero uncertainty mechanism is positive, but there isn't much detail to support it and the User Group believes that NGGT could have developed this much further. NGGT needs to show it can respond quickly and strategically during the RIIO-2 period. The User Group feels that NGGT has not fully met stakeholder expectations nor has it demonstrated sufficiently that it can act at a pace required to meet the challenges the User Group expects to arise within the RIIO-2 period." (Page 27 of the User Group report).

Citizens Advice comments
It is understandable that hydrogen has a prominent role in NGGT's plans to meet net zero. Given the potential increasing urgency of change, we believe that the NGGT plan does not go far enough to discuss when existing assets which may or may not be compatible with 100% hydrogen will need to be replaced. **We think this is a suitable topic for further exploration as potentially work to**

transform the gas transmission network could be required before the end of RIIO-2 or early in RIIO-3.

Scottish Hydro Electricity Transmission (SHET)

CG comments

The CG noted that "SHET describe reasonably clearly their whole-system vision / objectives at a high level. The plan is largely focused on connecting low carbon generation (renewables) in the north of Scotland and consequent transmission needs. While this may in practice be SHET's main contribution to net zero, we think this needs further expansion. The plan is built around SHET's "Certain View", which includes details of proposed generation projects. This is compared with various alternative scenarios. The Appendix on Planning for Net Zero explains how SHET seeks to take a holistic approach and avoid "stranded investment". However, the plan is largely focused on electricity, with little attempt to demonstrate engagement with or understanding of issues for related sectors." (Page 206 of the CG report).

UG comments

The UG does not raise any comments regarding net zero seeking further scrutiny by Ofgem.

Citizens Advice comments

Similar to our comments on SHET's approach to workforce resilience, the plan is centred around its Certain View[9] of electricity connections which SHET has acknowledged might be an underestimation of the workload to meet net zero. **Alongside the workforce resilience topic, we feel this would be a useful topic for Ofgem to explore further in the Open Hearings.**

Northern Gas Networks (NGN)

CG comments

The CG noted that there is some good material in NGN's plan towards net zero and continuation and development of existing pilot proposals. But they also noted that "there is not as yet a full or equal assessment under the full range of scenarios for decarbonising heat – BEIS end states are referenced, but it is not clear they are at the heart of thinking - and the balance is very hydrogen centric.

[9] The Certain View is stated in SHET's BP as an underestimate of the requirements for net zero

Wider issues, e.g. heat pumps and transport, are largely covered in passing. There are a number of specific commitments around data, e.g. control rooms, sponsorship of the open data institute and hybrid systems, and there is engagement with sector wide initiatives. But the Plan does not fully engage with other sectors and is more focused on pilots and creating networks than on credible delivery of whole systems proposals." (Page 150 of the CG report).

CEG comments
The CEG noted that "A stronger sense of urgency will be required to achieve the trajectory towards Net Zero which cannot be delivered based purely on past performance. However, NGN have provided evidence of their leadership role in relation to hydrogen and whole systems thinking which will provide a base for further research and trials in RIIO-2." (Page 7 of the CEG report).

Citizens Advice comments
NGN have understandably focussed on increasing the injection of hydrogen in their network as a route to net zero. We note the active and important live trials currently underway which will continue during RIIO-2. But, as the CG suggested, this approach is not necessarily balanced against the range of credible decarbonising heat scenarios. **We suggest this topic is explored further by Ofgem in the Open Hearings.**

Wales and West Utilities (WWU)

CG comments
The CG noted that "the net zero strategy relies heavily on the availability of biogas and implicitly assumes transmission is a constraint (hydrogen therefore needs to be consumed close to production) which is at odds with assumptions in other plans and therefore should at least be addressed. And the strategy mostly relies on a regional (self generated) variant of the FES. There is very little attempt to address the impact of falling gas demand despite our challenge that the likely pattern of peak demand should be further explored." (Page 227 of the CG report).

CEG comments
The CEG does not raise any comments regarding net zero seeking further scrutiny by Ofgem.

Citizens Advice comments

WWU's commitment to net zero by 2035 is laudable and is a reasonable expectation of stakeholders. We note that there is a consideration of whole system impacts. But, as the CG noted, there are some questions about the reliance of biogas in their ability to meet net zero, and differences with assumptions within other plans - particularly around transmission constraints. **There should be a level of consistency within assumptions across business plans and we would therefore recommend that this topic is further explored by Ofgem in the Open Hearings.**

Leakage

Because natural gas is a potent greenhouse gas, leakage of gas from the network is an important decarbonisation issue. We would like to see significantly more action from GDNs regarding their levels of leakage, including a clear plan for formally offsetting this damage. Without this, all ambitions to genuinely reach net zero carbon emissions in the gas distribution sector will be rendered unachievable. We would like to see this issue covered in the Open Hearings, as none of the companies have made genuinely ambitious proposals for leakage and offsetting with a clear trajectory to meeting net zero.

While we support genuine efforts to tackle their carbon footprints, the damage and scale that leakage is causing to our global climate is too large to be left to future price controls beyond RIIO-2. Leakage accounts for over 90% of a gas distribution companies' total carbon footprint (TCF) and

> *"accounts for around 1% of Great Britain's total greenhouse gas emissions. As such, reducing losses aligns with achieving the UK government's emissions target and contributes to reducing customer bills."*[10]

Given the scale of this damage, we think going forwards **Ofgem should consider methods for requiring gas distribution companies to account for all their leakage**, in order to meet their own (and the UK's) net zero targets. For example, genuine offsetting methods could be used to account for this portion of the companies' TCF, and gradually introduced over a 10 year period from the start of RIIO-2. This would support the GDNs to become genuinely net zero by about 2033. Providing the costs sat largely with equity investors, as well as minimal support from the RIIO allowances as a pass through (and only in the

[10] This figure refers to shrinkage (of which 95% is caused by leakage). Text from the gas distribution company Shrinkage and Leakage Model Review 2019, available: https://www.gasgovernance.co.uk/Shrinkage/Consultations.

initial years where used), there would be a strong incentive for companies to reduce leakage (and invest in genuine innovation), where currently there is little.

Cost and financial information

A number of companies[11] have challenged Ofgem's position on the cost of capital, implying or stating that the level implied by Ofgem is too low to enable them to finance their operations. In contrast, we provide evidence that Ofgem's current proposals should be set further in consumers' favour, and that at the very least Ofgem should stick to its current position in order to avoid awarding a windfall gain to network companies.

Rather than accepting Ofgem's cost of equity assumption of 4.8%, all the transmission networks have proposed their own equity return assumption level of 6.5%. This covers SP Transmission[12], Scottish Hydro-Electric Transmission[13], National Grid Gas Transmission[14] and National Grid Electricity Transmission[15]. Similarly, in the gas distribution sector, the companies have also proposed their own higher levels of equity return assumptions. Cadent[16] propose a figure of 5.6%, Scotia Gas Networks[17] propose a figure of 6% (at 60% notional gearing), Wales and West Utilities[18] propose a figure of 6.1% and Northern Gas Networks[19] state that Ofgem's assumption is "too low and indeed outside of the plausible range".

Given that this general position is uniform across these networks, we will not provide commentary on individual company cost of capital positions stated in their business plans. Instead, we focus on Ofgem's proposed methodology for estimating the cost of capital in order to identify the extent to which the existing

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[11] This covers all transmission and the majority of gas distribution companies, excluding Northern Gas Networks. The National Grid Electricity System Operator has not proposed an alternative, see https://www.nationalgrideso.com/document/158051/download
[12] https://www.spenergynetworks.co.uk/userfiles/file/RIIO-T2_Annex_25_Finance.pdf
[13] https://www.ssen-transmission.co.uk/media/3761/a-network-for-net-zero-final-business-plan.pdf
[14] https://www.nationalgridgas.com/document/129016/download
[15] https://www.nationalgridet.com/document/131776/download
[16] https://cadentgas.com/nggdwsdev/media/Downloads/business-plan/Cadent_BusPlan_PART3_Full-Plan_NC.pdf
[17] https://www.sgnfuture.co.uk/wp-content/uploads/2019/12/SGN-RIIO-GD2-Business-Plan.pdf
[18] https://www.wwutilities.co.uk/media/3567/3-wwu-business-plan-december-2019.pdf
[19] https://www.northerngasnetworks.co.uk/wp-content/uploads/2019/12/NGN-RIIO-GD2-Business-Plan-2021-2026.pdf

proposals are appropriate. In doing so, we will highlight where and why we consider Ofgem's current position to be generous to energy network companies, at the expense of consumers. These centre on four key areas: 1) the equity beta; 2) actual vs Ofgem's forecasts; 3) cost of equity cross checks; and 4) expected outperformance adjustments. These are also reflected more fully in the attached independent consultancy report by HMK Advisory Ltd.

The equity beta

We have previously made arguments regarding the equity beta, including in our 2018 'Things can only get beta' report[20], finding that a lower equity betas are more reflective of market conditions and should lead to better value for money for consumers. Our more recent evidence from HMK Advisory Ltd finds that Ofgem should: a) look for alternative measures of the risks of regulated wholesale energy networks; and b) do more work to understand the reasons for the differences in UK and US betas.

Ofgem's current calculation of equity beta for a notional company is based on a sample of just 5 companies, and only 2 of these have regulated energy network businesses. Further, such a limited sample size is only reliable if the risk profiles of that sample accurately reflect a notional pure regulated energy network company, which they do not.

The US may provide suitable measures of regulated energy market risk, and has large numbers of quoted regulated utility companies. The most recent data for 37 US utility companies suggests asset betas in the range of 0.17-0.32, which is significantly below Ofgem's proposed range of 0.35-0.40.

We accept that there are difficulties (relating to market structures and other factors) in making direct comparisons between US and UK markets. However, the minute sample sample available in the UK and its evident lack of robustness (in comparability to a pure network business) provides a weak foundation for making beta estimations. Ofgem should reconsider its rejection of international comparisons, and work to better understand the differences in UK and US betas.

[20] https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/energy-policy-research and-consultation-responses/energy-policy-research/things-can-only-get-beta-an-opportunity-to-g et-financing-costs-right-for-consumers/

Our evidence, based on comparisons with US markets, suggests that Ofgem's methodology may overstate the beta used in its calculation of cost of equity. This approach could provide an alternative measure of the underlying risks of regulated energy networks.

In contrast to the views of network companies given in their recent business plans, this evidence suggests that Ofgem may currently be estimating the equity beta too high - and so given the framework it has already identified **we think it would be appropriate for Ofgem to use its lowest estimate of its range of equity betas for RIIO-2 along with the out-performance wedge**.

Actual market forecasts and Ofgem's forecasts

The rate of return for a well run company must be adequate to ensure that it can finance its activities. However, it is important that this rate is not higher than it needs to be, otherwise shareholders will profit at the expense of consumers. In attempting to set the rate of return at the correct level, regulators often use forecasts as a means of estimating market expectations. However, instead of using actual investor market forecasts, Ofgem (like other UK regulators) have used historical long-term actual returns.

While we appreciate the merits of this approach, which allow for statistical analysis of objective figures, there is a clear disconnect between these historical long-term returns and what we can reasonably expect from the period covering RIIO-2 (2021-2026[21]). As detailed in our 2019 RIIO-2 sector-specific consultation response[22], we do not agree with the assertion that a long run total market return (TMR) is necessarily the best approach. In fact, the evidence provided by HMK Advisory Ltd shows that actual forecasts - based on investment managers' forecasts - are significantly lower than the proxy forecast provided by observing historical long run actual returns.

This reality check is crucial if shareholders are not to receive unnecessarily high returns, at the expense of consumers. Our attached evidence shows that - after updating Ofgem's assessment of investment managers' forecasts set out in its

[21] This period excludes electricity distribution companies, for which the RIIO-2 period covers 2023-2028.

[22] https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-consultation-responses/riio-2-sector-specific-consultation-citizens-advice-submission/

May 2019 decision - the average expected market return is 5.5% (nominal), compared to Ofgem's previous estimate of 6.7%. Consequently, at the determination stages, **we think Ofgem should seriously consider updating its assessment of fund managers' forecasts of the TMR**.

Other cost of equity cross-checks

In addition to the investment managers' forecasts outlined above, Ofgem also relies on other cross-checks to inform its view on the TMR and equity forecasts. These include: the dividend growth model (DGM); returns included in investor bids in competitions it runs, including for Offshore Transmission Owners (OFTOs); infrastructure fund discount rates; and market to asset ratios (MARs).

Our view is that across these other cross checks, Ofgem's current position is at risk of being higher than the evidence suggests. Below we provide a summary of our evidence for this view of these cross-checks, which is given in full in the attached report by HMK Advisory Ltd.

In its May 2019 decision[23], Ofgem stated that its DGM cross-check indicated a TMR return of around 8% nominal (or 6% CPIH real[24]), and this calculation assumes that dividend growth will equal economic growth. However, in 2016 the Competition and Markets Authority stated[25] that

> *"it is essentially arbitrary to assume future long-run growth in dividends per share equal to potential economic growth. Indeed, we see empirical support for expecting long-run growth in dividends per share to be less than potential economic growth."*

A more valid approach to cross-checking the capital asset pricing model could use a DGM model based on long term dividend growth data. Ofgem have modelled this (via their advisors CEPA) and it gives a return of 6.75% nominal (or 4.7% CPIH real). We are concerned that Ofgem do not currently explain why this valid result is excluded from their cross-checks approach. Our view is that this should be included, and that it represents another area in which the TMR

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23 https://www.ofgem.gov.uk/publications-and-updates/riio-2-sector-specific-methodology-decision

24 This ignores the Fisher equation for simplicity, which would otherwise marginally reduce this.

25 Competition and Markets Authority, Private healthcare remittal - Assessment of the cost of capital, 22 April 2016, paragraph 35 (p12), available: https://assets.publishing.service.gov.uk/media/571a24a240f0b61584000000/remittal-cost-of-capital-WP.pdf.

estimate has been set in companies' favour, as this wider available evidence suggests that it should be lower.

Ofgem have used OFTO bids as a cross-check in calculating nominal rates of return, and in principle these provide a useful measure of required returns. However, we suggest that Ofgem treats with much greater caution these now dated[26] OFTO cross-checks, by using more recent OFTO bid returns if they become available.

The attached report by HMK Advisory Ltd provides an updated analysis of infrastructure fund discount rates used in the May 2019 decision. We find that this benchmark has fallen slightly from 7.55% to 7.35% (nominal), and that if Ofgem proposes to use this benchmark it must consider how to adjust them to reflect the difference in beta. Infrastructure fund discount rates may not be a valid benchmark without this, as required returns in regulated utilities are amongst the lowest of all infrastructure sectors, implying a relatively lower beta.

Finally, when addressing the MARs, the evidence provided in Ofgem's May 2019 decision does not appear to fully consider the impact that high market to asset ratios should have on its approach to calculating the allowed return. We see from the MAR evidence that there is a persistent expectation from investors that they can earn a higher than required rate of return from the regulated assets in question[27]. This strongly supports the case for making an adjustment for expected outperformance in the allowed return (discussed below).

Expected outperformance adjustments

As we stated in our 2019 RIIO-2 Sector specific consultation response[28], we are sympathetic to Ofgem's view that investors expect companies to outperform on

[26] The three used bids are from 2017-18, which are almost three financial years out of date.
[27] Further to this, this possibility of significant outperformance is implicitly supported by National Grid's Chief Executive, who said in September 2018 "...where is the outperformance going to come from? I'm very confident we've got the capability and the organisation... ...to be able to identify those opportunities. And let's not forget as well technology is always moving forward, and therefore technology also offers a great opportunity for us to outperform in delivering the output." See page 44 of National Grid, 2018. UK Investor Teach-In. Available: https://investors.nationalgrid.com/~/media/Files/N/National-Grid-IR-V2/seminar-centre/2018/World%20TV%20-%20National%20Grid%20-%20UK%20Investor%20Teach-In%20-%2021-09-18.pdf
[28] https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-consultation-responses/riio-2-sector-specific-consultation-citizens-advice-submission/

costs and outputs in RIIO-2. This is also supported by the evidence on MARs outlined above.

However, in that 2019 submission we stated that we would like to see a more formal approach for arriving at the proposed 0.5% adjustment. A formal approach will aid duplication of this mechanism for RIIO-3 and beyond, and ensure that the drivers and justification for such an adjustment are completely clear and measurable.

In this Call for Evidence submission, we suggest that an adjustment equivalent to 50% of historical outperformance is justifiable (detailed in full in the attached report by HMK Advisory Ltd). This should help to ensure that incentive mechanisms are not unduly impacted and that actual returns for a well run company do not fall below allowed returns.

Ofgem's working assumption of the level of the difference between allowed and expected returns (0.5%) sits lower than the evidence on outperformance from previous years, which is in the range of 2-3%. The more formulaic approach outlined above (incorporating a predictable adjustment based on historical levels of outperformance) would see adjustment rise from 0.5% to around 1.5%. Because of this we think it is imperative that Ofgem retains the proposed 0.5% performance wedge, and we have not seen any compelling evidence from network companies that this should not apply.

We think that for ED2 and beyond there is a need for a change in approach from Ofgem in calculating the allowed return (which constrains future outperformance and ensures consumers' interests are protected) is clear, and we consider this approach to be the most straightforward, measurable and straightforward way of doing that.

Ofgem's current proposal has moved a long way from RIIO-1 in protecting consumers from expected outperformance adjustments in companies' favour. In our view, this is laudable progress, but looking forwards there is further scrutiny of these methodologies to be considered to ensure value for consumers.

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