Northern Gas Networks

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on 0800 111 999

RIIO2@ofgem.gov.uk

Akshay Kaul
Networks Director
Ofgem

4 September 2020

Dear Akshay

NGN Response to RIIO-2 Draft Determinations

Thank you for the opportunity to comment on the draft determination for NGN and the other GDNs. In the current challenging environment, it is more important than ever that network price controls are calibrated in a way which delivers a pathway to net zero in the most efficient manner. Such a pathway must not overlook the need to maintain the health of the existing network assets in accordance with statutory requirements and best practice over the short to medium term. There are elements of the draft determinations which currently will not deliver net zero in the most efficient manner nor maintain existing network assets in accordance with best practice or statutory requirements. These need to be addressed in final determinations.

The specific issues that need correcting for NGN are:

- **Mains Replacement Allowances**

  Allowing the full work requested in our business plan with regard to Tier 3 iron mains, greater than 2" steel mains, iron mains which are greater than 30 metres from properties and "other" types of mains which includes asbestos, PE and phoenix mains. In draft determinations NGN has been allowed no investment to replace any of these assets before 2026. The implications of this decision have not been reflected in our maintenance and repair costs, nor has the impact on customers from increased interruptions and costs been assessed, and neither has the environmental damage from this decision been considered.

  In some instances, we would be unable to meet our statutory obligations. If this was not resolved, NGN would have little choice but to pursue the appeal option.

  You will find enclosed with this submission additional detailed evidence which should allow this issue to be resolved. If you consider this is insufficient it is important that your team communicate this quickly and precisely what is missing so we can resolve before final determinations.

- **Outperformance Wedge (OW)**

The assumed outperformance of 25 bps should be removed. Ofgem has made a number of public statements about how challenging the RIIO-2 price controls are for network companies and that shareholders can expect very significantly reduced returns from these businesses. We concur with these statements but then to impose an assumed outperformance wedge at the notional company level is wrong on both a principle and analytical level.

At a principle level, the OW is a double count with other regulatory mechanisms, blurs the regulator's responsibility to appropriately calibrate each aspect of the price control and weakens incentives for cost reduction and innovation. It is interesting to note that other regulators in the UK along with the CMA have not identified any requirement to include such a mechanism within the relevant regulatory frameworks. Instead they have shown confidence in their ability to put in place the correct mechanisms and calibrate correctly to achieve the desired outcome. This is further supported by a new study by First Economics that contains the results of interviews conducted in August 2020 with 32 former regulators and provides compelling support for the position that the Outperformance wedge is unnecessary and arbitrary.

At an analytical level, relying on historical analysis to calibrate a price control where there has been very significant changes from one control period to another is flawed. The GD2 package has been calibrated with a negative skew on overall financial package as measured by comparison of the RoRe ranges between GD1 and GD2. Important differences between RIIO-1 and RIIO-2, that will materially change the prospects for companies to outperform, have not been adjusted for in Ofgem's analysis. A full analysis of the flaws in Ofgem's analysis can be found in a report prepared by Frontier Economics on Ofgem's Proposal to Adjust Baseline Allowed Returns.

Frontier Economics calculates that once Ofgem's backward-looking analysis is corrected to reflect the new RIIO-2 framework, there is net underperformance of the GD sector in RIIO-2. In particular, Frontier Economics' restatement of the RIIO-1 performance under more appropriate RIIO-2 assumptions reveals 0.2% of expected underperformance. It should be noted that this assessment is conservative, given that some potentially significant downside factors (such as the impact of NARM and PCDs) have been excluded from Frontier's analysis.

The evidence shows that the case for the proposed Outperformance Wedge cannot be supported either in principle or practice. We would therefore strongly urge Ofgem to drop the proposed Outperformance Wedge and set an allowed rate of return consistent with an unbiased appraisal of the evidence.

- **Customer Value Proposition (CVP)**

  Increase the Reward for NGN's CVP. Our business plan contained a wide range of bespoke outputs derived from our extensive stakeholder engagement programme which potentially could have been included within our CVP. Following a robust challenge process from our Customer Engagement Group (CEG) we included only 12 as CVPs which the CEG and ourselves assessed as strictly meeting the criteria set out in the business plan guidance. Ofgem accepted one and rejected 11 on the basis that they were either CSR/BAU or that customer research indicated they were not worthwhile.

  This is very much at odds with our own customer research, the views of our CEG and general trends in society with regard in particular to four of the CVPs – appointments for purge and relight, complaint resolution, restoration to appliance and quicker reinstatement. Customers want services quicker, problems resolved quicker and compensating when this is not achieved. It is very disappointing and damaging to the sector if Ofgem sees no value in network businesses adapting their services to reflect such expectations.

  We are challenging Ofgem's assessment of some of the proposals that have been rejected, as we consider that they deliver clear benefits with clear customer support beyond what is currently being delivered or expected from companies in RIIO-1. We consider that overall, NGN has submitted the most ambitious and efficient business plan with clearly evidenced proposals. We also have a clear track record of delivering and maintaining a safe and reliable service offering. The CVP and BPI were proposed as a mechanism that would differentiate our plan as sector leading and we do not consider the CVP has adequately differentiated our plan from other companies. We note that many of our proposals are supported through further shareholder investment and are at no incremental cost to customers. A differentiating factor that has not been taken into account in Ofgem's analysis.

  There are a number of areas where Ofgem's interpretation of the proposals are incorrect. And in other areas the rationale for accepting or rejecting proposals is inconsistent or contradictory across transmission and distribution sectors. Combined these presents a strong basis for reconsidering the basis of the CVP awarded.

- **Reward for Ambition and Efficiency**

  Provide a reward under the stage 4 Business Plan Incentive for NGN's efficient costs. NGN was benchmarked as the most efficient company when the RIIO-1 cost benchmarking was carried out. Over the subsequent 8 years, NGN supported by investment from its shareholders, has continued to invest in order to drive the efficiency frontier. Measures such as moving to a new tier 2 contracting model and establishing modern terms and conditions for network employees have been hard to deliver. This has resulted in improvements which are being reflected across all network businesses going forward, not just NGN and in doing so driving value for all gas customers across the UK.

The RIIO-2 benchmarking has again confirmed NGN as the most efficient company and this has delivered for customers. To see no reward under the BPI for such achievement fundamentally undermines the basis of incentive regulation which will damage customer interest as the inevitable effect will be for costs to be higher in the long term than they would otherwise be. Referencing Ofgem's own analysis, NGN's position at the frontier of performance in the sector can be said to have delivered in excess of £500m to UK gas customers over RIIO-2. The stage 4 assessment needs to be reconsidered and the focus of this stage should be on the efficiency of unit costs proposed.

More generally, there are some areas within the proposed framework for RIIO-2 where Ofgem needs to consider very carefully the long-term implications for customers. One of these we have already covered with regard to the reward for efficiency but others we believe Ofgem should reconsider before final determinations are:

- **Network Asset Risk Metrics (NARMs)**

  We have a number of very serious concern about the proposed NARMs framework. It is our view that this represents one of the most significant changes and departures from the incentive-based regulation framework in the UK. And moves the wider regulatory framework to a regulation of inputs and not outputs. This includes a direct and significant role for Ofgem in the asset management decision making processes of companies but without the accountability for the outcomes.

  The proposed framework represents a gross over-simplification of the necessarily complex asset management and decision-making processes required to manage the dynamic risk profile of gas distribution networks. As such the proposed approach would be considered as a very poor approach to asset management and cannot be seen to be in the long-term interests of customers.

  The NARMs framework has been transformed from a useful but limited individual measure of asset risk that forms just one input to a multi-factor process, to be almost the sole basis for informing and deciding upon appropriate asset management interventions. This presents companies with an immeasurable risk of exp-post intervention from Ofgem when assessing how best to respond to dynamic asset risk and evolving issues over time. This along with the removal of any incentive to identify asset management and intervention options cannot be seen to present good value for customers in either the short or longer term.

  This change in approach has been introduced for the first time at draft determination stage. Unfortunately, much of the detail required by all stakeholders to evaluate and comment on the full proposals has not been put forward. Supplementary questions raised by NGN and other stakeholders requesting this detail have not yet been formally responded to via the agreed process. Given the very significant change to the regulatory framework that the NARMS proposals implies, we would contend that the draft determination cannot be considered as an adequate or effective consultation on the issues raised.

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- **Productivity & Efficiency**

  We have serious concerns about Ofgem's proposed ongoing efficiency challenge, which is significantly higher at 1.2% p.a. for Capex and Repex, and 1.4% for Opex p.a. Cumulatively this means NGN would have to make an extra £30m of savings to break-even. And this from a very strong position as the most efficient GDN in the UK. The process Ofgem and their consultants have used to derive these assumptions has material flaws.

  As in other areas of the proposals the assumptions in this area are inconsistent with key assumptions elsewhere, such as the outperformance wedge referenced above. This gives rise to an overall package that is unlikely to be delivered.

- **Rate of Return and Long-Term Investment**

  It is clear that the focus of the RIIO-2 price control outcomes has been to reduce customer bills to be as low as possible, reduce base shareholder returns and in large part remove the opportunity for additional financial return for exceptional performance. In many areas this has been at the expense of higher levels of service that were requested and supported by customers.

  However, it is also clear that this relatively short-term focus has put at risk the conditions necessary to attract levels of investment in our networks needed to deliver these strategic goals. An environment where delivery of base levels of investment and returns for shareholders is at risk cannot be seen to strike the right balance with attracting significant further inward-investment whilst the UK is striving to attract investment in a very competitive international marketplace.

The attachments to this letter set out in detail NGN's response to all of the issues raised within the draft determination consultation. We have also included further material that provides the evidence base to support the positions set out in our responses

There is clearly much to do over the coming months and we look forward to continuing to work with you and your team over the coming months to ensure that we reach an outcome that delivers our shared objectives of delivering a modern, low-carbon energy system in the UK. And that plays its full part in a robust and growing economy that enables opportunities to be captured and exploited fully for the benefit of all.

Yours Sincerely

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