RIIO-GD3 Draft Determination Consultation Response

Cadent Annex

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Cadent Annex Response

Outputs & Incentives Question

CADQ1. Do you agree with our proposed design of Cadent's FWACV Compliance PCD?

No comment

CADQ2. Do you agree with the proposed design of Cadent's London Medium Pressure PCD?

No comment

CADQ3. Do you agree with our proposed design of the PCD for Cadent's Grays Medium Pressure project?

No comment

CADQ4. Do you agree with our proposed design of the PCD for the Tinsley Viaduct Diversion project?

No Comment

CADQ5. Do you have any views on our proposal to reject Cadent's Advanced Leakage Intervention programme and fund its non-mandatory repex programme based on the RIIO-GD2 approach?

We agree with Ofgem's approach.

NGN has prioritised and proactively invested in Non-mandatory repex since the inception of the RIIO Framework. NGN considers that the implementation of Advanced Leakage Detection (ALD) does not constitute anything significantly different to the historic practice that NGN has employed in delivering a varied workload across repex tiers to deliver added benefit to consumers within existing allowances. NGN's performance across tiers can be sources from its most recent RRP submission.

NGN supports proactive leakage detection to minimise carbon and manage network risk and as more data is collected it can be seen as a means to inform investment decisions.

CADQ6. Do you agree with our proposal to reject Cadent's Net Zero Transition Planning proposal?

No Comment

CADQ7. Do you agree with our proposal to reject Cadent's Capacity Upgrades PCD?

No Comment

CADQ8. Do you agree with our proposal to reject Cadent's West Winch Pipeline PCD?

No comment

BPI Questions

CADQ9. Do you agree with our view that Cadent passed all of the minimum requirements and as such are considered to have passed Stage A of the BPI?

Yes

CADQ10. Do you agree with our assessment results for Cadent against Stage B of the BPI?

No.

We provide in our own response and in appending documents a significant number of challenges and improvements to the Stage B assessment, in addition to material errors within the cost assessment process. These corrections must be applied and Stage B reassessed before meaningful comment can be provided on the assessment.

Stage B of the Business Plan Incentive (BPI) is the most financially significant component, designed to reward gas distribution networks (GDNs) for submitting cost-efficient and deliverable business plans.

We have concerns and have undertaken additional analysis to demonstrate that the assessment places over emphasis on cost ambition and rewards ambitious cost forecasts, even if they lack deliverability or a historic track record. Coupled with this there is no direct penalty for over-optimism or failure to deliver forecasted efficiencies. This creates a misalignment between ex ante ambition and ex post accountability. We also observe a lack of integration with Service Quality, which distorts the value that is delivered and masks poor performance. The assessment of Stage B rewards demonstrates how Ofgem has inadvertently decoupled cost assessment from service quality performance, despite a stated goal of incentivising value for money.

Unlike the RIIO-GD1 IQI mechanism, Stage B does not adjust the TOTEX Incentive Mechanism (TIM) based on business plan ambition. This weakens the incentive for networks to submit realistic and deliverable plans.

Stage B is mechanistic, and the rewards should be commensurate with the value delivered and confidence in delivering following Ofgem's cost assessment process.

Our appended report, prepared by Oxera provides a comprehensive overview of the performance of GDNs on both cost efficiency and services performance, specifically Section 4 of the report and Figures 4.2-4.7 present GDN performance from a cost and service perspective, this must be taken account of to ensure incentives and rewards are in the interest of consumers.

CADQ11. Do you agree with our assessment results for Cadent against Stage C of the BPI?

No.

Overall, we consider the Stage C assessment is subjective and Ofgem must apply it consistently to derive value from the business plans. Stage C of the Business Plan Incentive (BPI) comprises two components:

- Clarity: Evaluates the structure, accessibility, and coherence of the business plan.
- Commitments: Assesses the ambition of service offerings across net zero, resilience, and service quality.

Having reviewed the draft determinations, NGN commissioned Oxera to review the BPI incentives[1] and they found that stage C had:

[1] BPI Incentives at the RIIO3 DD

- Limited Incentive Strength: The maximum reward for outstanding service quality performance is 13 basis points (bps), significantly lower than the 40bps available for cost efficiency under Stage B.
- Balanced Scorecard Dilution: Rewards are further diluted through a scorecard approach, with equal weightings across four criteria (deliverability, consumer value, stretching performance, and new proposals).
- Skewed Incentive Architecture: The current framework heavily favours cost reduction over service quality, both ex ante (during plan submission) and ex post (during delivery).

In relation Cadent's plan we specifically note that the assessment is inconsistent with Ofgem's balanced scorecard and how it has been applied to other networks.

Clarity

Ofgem have awarded a grade of "outstanding" for stage C –for "coherence", "layout and structure" and "accessibility", however, their own assessment highlights inconsistencies or errors, such as "lack of sign posting" or "several incoherent areas". This finding aligns much closer to an "Acceptable" rating as per the balanced scorecard. This is inconsistent with assessments of other business plans and appears to be based on subjectivity of the reviewer rather than an overall consistent approach. NGN considers consistency in the application of BPI rewards is essential.

Commitments

Ofgem's assessment of Stage C of Cadent's business plan commitments focuses on the group level which comprises four networks, however, its Stage B assessment focuses on network specific costs. This is an inconsistent approach, potentially to the detriment of other networks, as all Cadent's networks perform at different levels and with a different cost base.

Our appended report, prepared by Oxera provides a comprehensive overview of the performance of GDNs on both cost efficiency and services performance, specifically Section 4 of the report and Figures 4.2-4.7 present GDN performance from a cost and service perspective. When assessed at a group Level Cadent's networks are among the poorest performing networks across the main RIIO-GD2 Service measures. Similar to Ofgem's approach to engineering justification analysis we consider significant weight should be placed on delivered past performance when assessing anticipated performance and notably:

1. Ofgem should not be seen to be rewarding companies at RIIO-GD3 FD who have failed significant service standards in RIIO-GD2.
2. Ofgem must be consistent in how they assess commitments at the group and network level to avoid masking or rewarding poor performance.
3. A sufficient incentive for under delivery or poor performance must be explored.

This is particularly important given parallels with shortcomings observed in Ofwat's cost and service assessment practices since PR14, where over-reliance on optimistic forecasts created *perverse incentives* of chasing business plan rewards and left companies unable to invest adequately to maintain and improve service levels. A similar approach here would risk rewarding networks that failed to meet core service standards in GD2, such as the 1- and 2-hour gas emergency standard. That outcome would be unfair to consumers and damaging to Ofgem's credibility if it were to reward companies who failed these core service standards or those with significant overspend in RIIO-GD2 but are now benchmarked favourably, noting this issue has significant implications at both the group and network level. Such an approach would be contrary to Ofgem's principal objective to protect the interests of existing and future consumers. Effective regulation requires that incentives and rewards are tied to demonstrable performance against required standards, which in turn ensures trust in the framework and supports desirable outcomes for consumers over the long term

We note the ambitious plans that were submitted at RIIO-GD2 and suggest Ofgem sense check how companies have performed in delivering against those outcomes before finalising its Stage C assessment.

Managing Uncertainty Question

CADQ12. Do you agree with our proposed design of Cadent's London Subways and Tunnel Re-opener?

No comment

Cost of Service Question

CADQ13. Do you agree with our approach to cost exclusions and technical assessment for Cadent?

No.

As outlined in our own response we consider that the current methodology is flawed as it applies cost exclusions inconsistently across networks and Cadent's assessment has clearly benefited from this. A notable example is in relation to street works exclusions Cadent has applied certain exclusions, improving their apparent efficiency. This clear inconsistency distorts regression results and creates the risk, or at least perception, of regulatory gaming, where outcomes are driven by unscrutinised accounting choices or strategic cost allocations rather than genuine efficiency. When companies can be rewarded or penalised based on cost allocation rather than (just) genuine performance, this represents a fundamental error in approach that risks undermining the credibility and fairness of the regulatory assessment process.

Cost exclusions must therefore be applied consistently across networks.

We reference para 5.6 in the Cadent annex and our concerns and supporting evidence within NGN's own response that means Ofgem's aim in this area has not been met. *"To ensure that our cost benchmarking is carried out on a comparable basis between GDNs, submitted data may need to be adjusted to correct for inconsistencies and external factors. For example, adjustments may be made to exclude costs that are unsuitable for comparative assessment, or to remove costs associated with work that we propose to separately assess, or where we have not accepted the needs case for a proposed investment."*

Too much weight is placed on untested forecasts which introduces inconsistencies in cost exclusions (IT&Telecoms and streetworks) meaning benchmarking is not done on a consistent basis. These costs must be appropriately justified before exclusion, or allow for all companies to exclude on a consistent basis, to meet the requirement set out in Business Plan Guidance:

"Stage B - we will assess whether the costs submitted as part of the business plan are adequately justified and efficient. We will use two separate assessment methodologies, one for costs which are assessed comparatively, and one for more bespoke costs". These inconsistencies do not appear to be

due to company size and there is no clear consensus on reporting in the Business Plan Data Tables (BPDTs). This can be referenced back to inconsistency in inclusions in IT&Telecoms BUS table in BPDTs . The applications of streetworks exclusions causes a significant and material movement in efficiency ranking based and Ofgem must carefully consider this approach. We specifically note:

- Loss of productivity for streetworks should not be allowed and introduces inconsistencies in the benchmarking
- Group level scale effects should be taken into account in modelling (ref back to precedent from RIIO-ED2)
- At RIIO-GD1 benchmarking NGN had an adjustment of c£0.75m added to our costs in our base allowances due to failing a performance standard prior to RIIO-GD1. A similar approach must be taken for consistency for networks who have failed the 1 and 2 hour standard in RIIO-GD2.

CADQ14. Do you agree with our engineering assessment of Cadent's RIIO-3 Business Plan?

We don't have the full detail or understanding of the risk position of Cadent's asset base to fully answer this question. However, we consider that Cadent, must be provided with sufficient allowances to ensure that they meet health and safety, security of supply and customer outcomes at an efficient cost, taking account of their historic delivered performance. We note that customers should not pay twice for work that has already been funded in previous price controls.

Innovation Question

CADQ15. Do you agree with the level of proposed NIA funding for Cadent?

No comment.

Data & Digitalisation Question

CADQ16. Do you agree with our proposed level of funding for Cadent's data and digitalisation investments?

No Comment