UK Power Networks

Office of the Chief Executive

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Dermot Nolan
Chief Executive
Ofgem
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Dear ~~Dermot~~ Dermot.

**UKPN'S OUTSTANDING CONCERNS WITH RIIO-ED1**

We are approaching the end of Ofgem's window of engagement with the DNOs prior to finalisation of the Final Determinations for RIIO-ED1. Therefore, I would like to highlight to you the key concerns that UKPN has with the Draft Determinations, and our proposals for addressing them. These have all been the subject of detailed discussions with Maxine and the ED1 team, but I wanted to reinforce them directly with you as they are critical to our assessment of the Final Determination.

**Central London operational and capital expenditure**

As you know, UKPN has opened a new depot in Central London (Shorts Gardens) operating on a 24/7 basis to provide fault response, asset planning and inspection resources appropriate for a major world city with challenges unique to UK Power Networks. Ofgem disallowed the expenditure for this, worth £23m in the Draft Determinations. Ofgem also disallowed £32m of investment in remote control and unit protection, even though similar solutions proposed by SP Manweb for Liverpool have been approved. Finally Ofgem has reduced two of five Central London strategic reinforcement projects by £9m on a benchmarking basis, even though we have submitted detailed scheme papers for all these projects.

We request that Ofgem approves the £64m of Central London expenditure that it disallowed at Draft Determinations, to enable us to keep the Shorts Gardens depot open and to provide Central London with the service it deserves. We have promised an additional 0.5 CI and 0.8 CML of quality of supply benefits to all LPN customers to reflect this change.

**Real price effects (RPEs)**

In the Draft Determinations Ofgem cut our requested ex-ante allowance of positive £265m based on circa 1% pa RPEs to minus £26m, a cut of £291m.

Ofgem's cut assumes significant negative RPEs in 2013/14. However Ofgem now has the 2013/14 DNO RRP returns, which show that this fall did not in fact occur. Work by NERA and Frontier Economics for the DNOs identifies errors in Ofgem's analysis including using short term data series, not allowing for mean reversion, the treatment of wage costs, and over-adjusting for RPI. Taken together, these corrections more than justify our original ex-ante request. Additionally, UKPN faces regional RPE factors in London and the South East. We have provided evidence to Ofgem that contractor price inflation is 0.5% higher than the national average, and Arup's assumption for the Greater London Authority that infrastructure RPEs for London will average 2% per annum to 2050.

Uniquely amongst the DNOs, we have proposed a true-up to our ex-ante allowance based on an out-turn index, so that if our forecasts are incorrect, the ED1 allowance will be reduced or even become negative.

We request our original plan RPE allowance of £265m, with a true-up mechanism to protect customers. Therefore if Ofgem's view is correct and UKPN is wrong, customers will not pay a penny more overall. However based on the Draft Determinations, if UKPN is correct then our costs and financial stability will be under-funded by £291m, which is not a fair settlement.

**Link boxes**

The Ofgem team has met to discuss this topic with both the HSE and UKPN. The HSE has made clear to both of us that UKPN must move to an age based replacement strategy in order to address the increasing number of disruptive link box failures, despite our current condition based strategy, and that they will enforce this through an improvement notice if necessary.

We request an additional £95m of ex-ante funding in ED1 to allow for the 'scenario 5' strategy we have discussed with HSE and Ofgem, namely replacing all link boxes in high and very high risk locations by age 50, and all other link boxes by age 70. In order to protect customers, we propose a symmetrical re-opener mechanism that can be triggered by either Ofgem or UKPN, so that if actual replacement volumes are above or below this level our revenues will be adjusted accordingly so that we only receive funding for our actual costs.

**Smart grid savings**

We are disappointed by the further reductions that Ofgem has applied to the DNOs' business plans for smart grid savings. This area stands out by some distance as the least well justified element of the Draft Determinations and is little more than a top down 'stretch' with no proper justification.

We also feel that the spirit of these reductions conflicts with normal regulatory objectives. Regulatory allowances typically offer a combination of 'carrot' and 'stick', with target levels at top quartile or sometimes frontier performance levels for the peer group. However Ofgem has set smart grid savings which are 'all stick', representing a further £98m of stretch beyond the £141m of savings offered by UKPN which represents the frontier as the biggest savings offered by any of the DNOs.

We request that Ofgem removes the £98m unjustified 'stretch' from the draft determinations, and reverts to the £141m frontier level of savings offered by UKPN. In the unlikely event that further smart savings are achievable in ED1, these would in any case be shared with customers in the normal way through the Totex Incentive Mechanism.

**Cost of debt allowance**

UKPN was the only DNO to support Ofgem on the proposed 6.0% cost of equity, on the basis that it was packaged with an acceptable cost of debt allowance. UKPN welcomes the change from a 10 year debt index to a 10-20 year trombone index. However this change does not go far enough. The 10 year start point for the index is arbitrary as data exists to go back up to 15 years, and it strands £1.35 billion of bond debt that we issued before the proposed index start date of 1 November 2004 at rates which we have demonstrated to Ofgem were efficient at the time. As a result, the index will under fund our forecast cost of debt over ED1 by 0.46% (the difference between 2.24% average forecast allowance and 2.70% average forecast actual), which all else being equal will reduce our return on equity from the 6.0% headline allowance to 5.15%. Ofgem acknowledges this underfunding but has claimed that cost of equity 'headroom' and a halo effect for DNO cost of debt counter this. We have shown your team that neither of these points is justified, and that Ofgem's 'halo' analysis is incorrect.

We request a 15-20 year trombone, so that efficiently incurred historic debt is not stranded, and so that we have a chance of meeting the cost of debt allowance in ED1 and therefore achieving the allowed cost of equity.

**IQI**

UKPN has two concerns with the IQI adjustment made at the Draft Determination. Firstly we believe that the financial impact of the difference between the CoE used by companies and Ofgem's 6.0% CoE should be included in the IQI assessment to be consistent with the cost benchmarking approach at fast track. Secondly we have noted that the underlying IQI matrix is more punitive than that used in both the GD1 and T1 final proposals. We have proposed to Ofgem to use the matrix used in GD1 as it has been publicly recognised by Consumer Futures that the overall quality of the ED1 business plans has improved since this review.

**Other points**

We have highlighted other issues to your team including reductions to reinforcement and asset replacement based on benchmarking, even though we have provided detailed evidence to support the investment. This underfunds us by £140m. Ofgem criticised us at fast track for not supplying all 200+ scheme papers. Now that we have, we expect Ofgem to review all those where you have disallowed expenditure. Also Ofgem has not used our actual attrition rates to calculate the operational training allowance. This underfunds us by £27m.

**Conclusion**

UKPN has engaged constructively throughout the RIIO-ED1 process and has supported Ofgem on the fast tracking decision, even though it is now clear that the fast track company will benefit by nearly £1 billion compared to the Draft Determinations.

The issues we raise in this letter are important to us and are by no means a general request for more money. For example, we have accepted Ofgem's views on our cost efficiency and none of the points raised here challenge that. Wherever possible we have tried to protect customers, through tighter CI/CML targets against the Central London spend, and uncertainty mechanisms for RPEs and link boxes.

The ED1 settlement will deliver up front price reductions and broadly flat real prices thereafter. As such, customer affordability has been to a great extent addressed. What is important now is to deliver a settlement which is financeable and which allows the DNOs to invest in the networks adequately as we face the challenges of decarbonisation and smart grids.

We hope that Ofgem will address our valid concerns in the Final Determinations, so that UKPN can continue to support the RIIO process.

Yours sincerely

**Basil Scarsella**
**Chief Executive Officer**

Cc David Gray, Maxine Frerk