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Sent by email: RIIOED2@ofgem.gov.uk

25 August 2022

Dear Jonathan

RIIO-2 Draft Determinations for Electricity Distribution including ENWL

We have considered the Draft Determinations published by Ofgem very carefully. Our specific context for this consideration comes from the requirements expressed to us by our customers and stakeholders and our role in delivering regional and national Net Zero ambitions. Our business plan sought to deliver an ambitious reduction in customer's bills whilst investing to support essential customer and stakeholder priorities including the transition to Net Zero. This provides confidence that the increases in allowances required to address the essential problems we have identified with the Draft Determination are consistent with an industry leading bill reduction.

We are pleased to see some of the specific requests of our customers and stakeholders reflected in the Draft Determination, such as the emphasis customers have placed on improving the speed of removal of emergency roadworks, their ambition to improve network performance for the worst served customers in rural areas and to support the most vulnerable in the North West. Stakeholders have told us they welcome this and most particularly the fulsome support for the Smart Street programme that will make such a difference to domestic customers electricity consumption and production. Furthermore, stakeholders are pleased to see that their huge ambition for new nuclear power in Cumbria and the ambitious plans to accelerate decarbonisation in Greater Manchester, Lancashire and Cumbria ahead of the national targets and timescales are also recognised.

However, stakeholders also tell us they are concerned about why the cost allowances in the Draft Determination seem to be severely cut, when there is little evidence that the cost base or unit costs are inefficient and where the assessed plan is confusingly much larger than the business plan submission they supported. They fear that the cuts Ofgem are proposing will mean that core elements of our business plan will become unviable.

Stakeholders have also noted that a number of other proposals that are strongly supported are currently excluded from the Ofgem determination, placing particular emphasis on the need for ring-fenced funding to support decarbonisation activities. Elected officials in Greater Manchester, Lancashire and Cumbria have told us they will write to you directly seeking a change. We have explained that we are working with the Ofgem team to correct errors in the approach to the Draft Determination and that through constructive collaboration we hope to bring solutions to the problems they identify with the Draft Determination.

We have identified a significant number of errors of calculation, logic and methodology in the Draft Determination that require correction to achieve Ofgem's stated policy intentions. Significant developments are needed to these Draft Determinations to create an ED2 framework and package that will deliver for customers. As we have demonstrated since the Draft Determinations have been published, we are focussed on constructive engagement with the Ofgem teams to find solutions to the issues identified in time for Ofgem's final determination.

This letter sets out at a headline level some of the key issues we have identified in the Draft Determination across five broad topics and highlights our commitment to work with Ofgem to put solutions in place.

1. The Draft Determination fails to secure Electricity North West's financeability, even on a notional basis, which is not in the interests of customers

In proposing to fund the cost of debt at the sector average, Ofgem's Draft Determination does not ensure that efficiently incurred debt costs will be funded by customers. This passes a very significant risk on to equity. A risk that equity is unable to manage, and, to the extent that equity has to subsidise the underfunding of efficiently incurred debt costs, means that returns to equity in such cases are below the minimum level required to attract equity to the company. For Electricity North West the subsidy from equity to debt in ED1 is £60m and this is currently set to be repeated by a further £125m in ED2. This nearly halves the equity return from the minimum necessary to attract investment, as determined by Ofgem, reducing it by 2.34% to 2.41%. With the potential level of investment required to meet Net Zero commitments, and the damage to customers' interests if this investment does not take place, the failure of the regulator to set a price control that is financeable, in a wide range of outcomes, is of serious concern.

Given that the level of debt allowances being set purports (noting errors in this setting) to equate to the average debt cost of the sector, this approach of (largely) setting a single cost of debt allowance, by definition, creates 'winners and losers'. This forces some customers to pay more than the efficient debt cost of their licensee, right at the time of a painful cost of living crisis, and creates significant risks to the delivery of investment, in particular in our region.

In setting the capitalisation rate of 98% for the uncertainty mechanisms, all of the funding requirement for any increase in expenditure above the tightly constrained base allowances, falls onto our ability to be able to raise finance, through debt and equity, compounding the risk to customers in this regard.

We continue to stress that this debt funding issue is not just about the cost of embedded debt. Given the uncertain inflation and interest rate outlook, there is a very real possibility that the costs of our future efficient debt issuances will not be met by customers. We continue to stress that licensees should be able to invest, confident in the knowledge that their efficiently incurred debt costs will be funded. The proposed mechanism provides no such certainty. It assumes a flat annual issuance profile, which does not reflect the financing requirements of the business, both in the future as in the past.

By ignoring the specific characteristics of Electricity North West, notably its status as an infrequent issuer, Ofgem are locking our company into being a perpetual 'loser' through the impact of ratings on debt issuances. This is not in our customers' interests as our financing costs diverge and increase structurally. This approach is compounding the under-funding of debt costs, underfunding that was subsidised by our shareholders in ED1, penalising essential steps taken during the previous price review to preserve financeability and raising the perception of risk in the whole sector.

Even at the Notional Company assessment level, Ofgem incorrectly state in the Draft Determination that Electricity North West is financeable at BBB+ when the ratios published demonstrate that the notional company doesn't achieve the ratings level floor published by Moody's for the sector. Ofgem also fails to create a proposal that has any resilience to credible shocks such as the emerging interest rate reversion.

We are significantly concerned about the limited extent of risk-based modelling Ofgem appears to have undertaken. We are very concerned to observe that the long-term modelling assessment published relates to the gas and transmission sectors rather than to this sector, reflecting the paucity of work carried out on this area. Ofgem should be looking at the financeability metrics under a wider range of scenarios, significantly longer time frames rather than just ED2 and a wider range of metrics. In particular we are concerned about the direction of travel for ED3 and ED4 credit metrics for the sector, especially Funds From Operations (FFO) to Net Debt, and were surprised not to see this covered. The longer-term outlook for the sector will start to influence ratings agencies (and therefore fund raisings) from the middle of ED2, so this is not a matter to be left for ED3.

The Draft Determinations contain a significant number of errors of methodology that contribute to the financeability problem. Ofgem fails to recognise that Electricity North West has a greater need for an infrequent issuer premium (IIP). At Draft Determinations, Ofgem have awarded an IIP to some licensees, ignoring the group treasury functions that they use, and basing the definition on the pattern of debt issuance in a completely different sector. The Draft Determinations fails to consider the additional risk that ENWL, as a true infrequent issuer, runs compared to the larger groups in the sector.

Furthermore, Ofgem has added to investors' perception of risk in the electricity distribution sector by launching an ambiguous debate about the treatment of inflation in energy utilities as a whole, through the ED2 Draft Determination consultation. This has had a destabilising effect already by raising the prospect of changes to a fundamental aspect of the regime that benefits customers through attracting patient capital to invest and provides an inflation linked return to fund pensions. This should not have been raised for ED2 alone, at Draft Determination, with its limited summer consultation window. It appears to us that this is a wider policy matter applicable not only to all infrastructure regulated by Ofgem, but by other regulators, and should be consulted upon more widely with properly thought through and risk assessed proposals.

<u>We remain committed to working with Ofgem to develop an approach to determining the cost of debt that builds upon the sector-wide average approach, but also ensures appropriate adjustments are made for individual company circumstances and creates an appropriate risk sharing mechanism to maintain investor confidence in the sector and the ability of all licensees to be able to fund customers' needs.</u>

2. There are mathematical, logical and methodology errors in Ofgem's proposed approach to cost assessment, including erroneous efficiency challenges, which must be corrected in the Final Determination

Ofgem has mis-understood our business plan and represented the ranges of uncertain costs as baseline requirements. As discussed in recent bilateral engagements with the Ofgem team, the costs presented in Draft Determination (£2,015m) are at significant variance to our submitted costs (£1,790m) and thus misrepresent our submission. Ofgem's alteration of our business plan has distorted its cost assessment for all companies, particularly our own. Half of the 18% reduction Ofgem proposes to make to every element of our business plan is the result of the subsequent removal of the £225m costs Ofgem has added. Without this "correction", our business plan would have been judged as requiring a 9% reduction. Making the necessary correction would result in an improvement in the efficiency frontier, creating additional challenge to the rest of the industry and an overall improvement for customers. Therefore, this manipulation distorts the level of efficient costs Ofgem have identified for all DNOs. We are surprised and disappointed that Ofgem did not engage with us before embarking upon such misrepresentation of our business plan submission.

This approach by Ofgem has been very confusing for, and difficult to explain to, stakeholders, as the plan as reported in the Draft Determination differs so materially from what we had discussed with them and they had expected.

Ofgem's cost assessment approach needs to be significantly reworked and improved between Draft Determination and Final Determination. Allowances are materially and irrationally misallocated between cost categories by Ofgem's modelling approach, which has very meaningful consequences.

There are also a significant number of other errors that we have identified and notified to Ofgem during the SQ process and bilateral discussions. These errors include £54m of mathematical errors and £200m of errors of logic, the £255m total creating a further significant distortion to Ofgem's assessment of efficient costs for Electricity North West and other DNOs.

In addition, there are a number of other issues related to the cost assessment process that must be addressed including how to derive baseline allowances for uncertainty mechanisms (including volume drivers), how to derive baseline allowances for price control deliverables and specific investment areas and how to calculate funding for essential indirect costs, such as design and project management, where such additional costs are currently not provided by uncertainty mechanisms, but are essential components of our delivery.

It is clearly essential that Ofgem must consult with and provide details to each DNO group on changes to the cost assessment process and modelling, including of resulting outcomes, ahead of Final Determination so that meaningful input and checking from the DNOs can occur to improve quality assurance. This engagement should be undertaken with time for Ofgem to make any subsequent adjustments, before publishing Final Determinations and much more timely and effective sharing of underlying information must happen at Final Determinations stage to allow any remaining errors to be identified quickly.

The result of all the errors in the costs assessment process is to create a serious disconnect between the required ambition of the Draft Determinations and the calculations of the efficient level of funding. As an example, in IT, the networks are being encouraged to deliver significant improvements in data visibility to support the DSO strategy, significant improvements in productivity and an improvement in cyber security (which entails both cyber spend but also a faster system replacement/upgrade cycle). The need to continually assess and improve cyber resilience is a function of new geo-political risks resulting from the conflict in Ukraine and continues to increase at a near exponential rate. However, the efficient level of expenditure for operating costs to enable this change has been assessed by placing significant reliance on ED1 run rates. This is at a time when the IT world is moving from on-premise, licence-based systems to cloud based/Software-as-a-Service based solutions, which moves costs from capital programs to operating costs. Making an assessment of future efficient costs based upon out-of-date operating environments suggest a disconnected and over-simplified approach. We are keen to explore with you approaches that take account of our concerns in these areas to ensure that we set ourselves up for success in ED2 and are not hamstrung by looking backwards rather than forwards.

Our analysis and assessment of the Draft Determination is that the catch-up efficiency challenges for Totex models are incorrect, unduly burdensome, not supported by evidence and unjustified in how they are calibrated. Currently the modelling suite used for ED2 fails key statistical tests and performs worse than those used in ED1 and as such a more stringent benchmark than upper quartile utilised in ED1 has not been justified by the evidence presented. Additionally, the overall challenge placed by Ofgem on disaggregated models (which represents 50 percent of the sector challenge) is beyond what a frontier company could achieve. This is clearly an untenable position where no company in the sector is at or beyond the benchmark set which suggests a failure of the modelling process specifically for disaggregated modelling.

The above catch-up efficiency is also coupled with an ongoing efficiency challenge of 1.2% that when applied to years 7 & 8 of ED1 and to the whole of ED2 goes beyond what is supported by evidence as applicable for the ED sector. We had already strongly challenged ourselves on ongoing efficiency and included in our own plan 1% p.a. starting in ED2. As one of the most ambitious DNOs in this regard we are aligned broadly with recent CMA decisions in this area. We support Ofgem's drive for efficiency, but by extending this beyond the 5 years of the control period and increasing the efficiency challenge by 20%, Ofgem has doubled the impact of this challenge with the compounding effect, to an unreasonable and unachievable level.

As a single licensee, we do not have access to scale economies that are available to larger DNO groups. Ofgem's brief, high-level comment to dismiss our case for careful consideration of this effect is inappropriate and the cost assessment methodology creates a material disadvantage and bias against the determination of an efficient level of cost for a company of our size. There is extensive regulatory precedent for accounting for group-level or ownership-level scale effects and cost misallocation in the cost assessment process. Ofgem has structures in place that are designed to inhibit the ability of DNOs to merge freely. Importantly, the new energy security bill will require energy mergers to go through a special merger regime similar to that in the water sector. We have identified simple methods to account for group-level scale effects in Ofgem's cost assessment framework and are ready to work with the Ofgem team to incorporate these into the models for Final Determination.

<u>We have already had several constructive working sessions with the Ofgem team to explore the range of errors we have identified and to determine appropriate solutions to them. We were greatly encouraged by the positive feedback the Ofgem cost assessment team gave to our proposed solution to determining baseline allowances for each element of the price control where this is required. Correcting errors and recalculating Ofgem's models with our original business plan submission values will lead to a more robust outcome that will be more closely aligned to the needs of our customers and stakeholders. We would strongly urge Ofgem to share their corrected workings with us, prior to FD, so that we can assist in ensuring that these errors are not repeated.</u>

3. Ofgem's proposed uncertainty mechanisms do not work to support customers to charge their EV or connect their heat pump

The uncertainty mechanisms as proposed and drafted in the Draft Determination are not agile, nor fast acting as is needed for ED2 in terms of cash flow, which is a critical consideration to enable cash funding for delivering Net Zero. The proposal of applying a 98 percent capitalisation rate to variant allowances covered by Uncertainty Mechanisms is an error of assumption that additional projects do not require design, project management or any of the engineering support costs captured in Ofgem's cost category of closely associated indirect costs.

Given the number of reopeners Ofgem proposes in ED2 we are struggling to understand the proposal to use a materiality threshold which is twice as high as the materiality threshold applied in GD2 without any robust justification. Given the number of reopeners it should be clear there is even stronger justification for ED2 of aligning to the GD2 default materiality level or indeed going lower.

<u>We believe that Ofgem's approach to uncertainty mechanisms can be developed to correct the errors regarding the missing indirect costs and we are sharing our simple, specific proposals with the Ofgem team on this. The materiality threshold as proposed seems to be a clear error, and we look forward to its revision in the Final Determinations.</u>

4. Ofgem's proposed incentives package is skewed towards penalty and risk and does not protect the interest of customers

We recognise that Ofgem intended the Draft Determinations to demonstrate a clear shift in thinking on incentives, seeking to lock in current performance in key areas such as customer satisfaction and to stop driving improvements in some others such as reliability. It is vital Ofgem reconsiders this approach. Customers are clear that they wish to see continuous improvement. However, they should only pay companies for achieved results, valued by the measured value of the improvement to them. In our view, this stage of the Net Zero transition is not the right time to reduce the incentive package that has been so successful up to now and make returns asymmetric, exposing companies to disproportionate down side risk.

<u>Domestic customers are very clear that reliability of the network remains their top priority and further improvements are important to them. They strongly link greater reliance on electricity in a decarbonised future with the need for continually improved reliability. Therefore, the Interruptions Incentive Scheme for reliability should remain a key part of the regulatory framework in ED2. There remain significant disparities in service experienced between rural and urban customers on overhead and underground networks across the country. Whilst the worst-served customer approach is a welcome improvement to tackle some extremes, we would press to continue the operating costs and investments funded by the highly successful Interruptions Incentive Scheme that are required to drive improvements by reducing the spread of performance around the measured average. Furthermore, if Ofgem continues with the asymmetric risk approach then other elements of the price control need to be adjusted to address the downside risk created.</u>

We support that Ofgem, in its Draft Determination, has recognised some key bespoke items driven by customers and stakeholders with strong benefits cases, including activities in our business plan, for example Smart Street, our bespoke incentive 'Dig, Fix and Go' and our bespoke uncertainty mechanism considering the impact of nuclear development on the west coast of Cumbria. We urge Ofgem to give further consideration to some form of CVP reward for Smart Street to demonstrate the benefits to consumers of rolling this out in other DNO areas. We would also ask Ofgem to reflect upon the substantial potential benefits of the 'Dig, Fix and Go' incentive and restore the incentive power to the level supported by the evidence as originally proposed, because this will ensure our ability to drive improvements and is aligned with the benefit case for customers.

5. Ofgem's Draft Determinations fail to recognise key regional needs and fund a safety driven programme

We believe the views of our customers and stakeholders should be given more weight by Ofgem. We have grave concerns about how our regionally led plan is now changed by being fitted into a national framework. The key activities we proposed of rolling out LineSIGHT (a public safety programme) and investing to support Customers in Vulnerable Circumstances through a focussed network reliability programme are very strongly in customers' interest and therefore we urge Ofgem to include funding for these programmes at Final Determinations. We have therefore provided additional narrative to further explain the benefits of these key investment activities. Briefly:

- LineSIGHT monitors overhead lines for low or fallen conductors which nationally result in around 6 fatalities per year. We are leading the way introducing this completely new safety measure for ED2 and require Ofgem support. We are concerned that this new innovative approach, very far from business as usual, represents a "reasonably practicable measure to improve public safety" (as recognised by the HSE), which is being turned down for funding by Ofgem.
- Our CIVC Reliability Programme has been developed specifically because power cuts cause greater harm to customers in vulnerable circumstances. For example, these customers may not have the ability to leave the area of the power cut or may experience greater difficulties during a power cut. We have correlated data on concentration of customers in vulnerable circumstances, where these customers are most impacted by power cuts, where reliability is significantly poorer than the average performance AND where these customers will NOT be efficiently helped by reliability improvements that could be funded via the IIS. This reliability programme specifically addresses a gap that IIS does not cover.

We welcome the engagement we have had with the Ofgem team to date and look forward to this continuing at pace, working with Ofgem and other stakeholders to address the large number of substantive errors and inconsistencies presented by the Draft Determination and summarised in this letter and accompanying detailed response. We remain hopeful that an overall framework and settlement for ED2 that enables the delivery of key outcomes and ensures fairness for all customers and stakeholders can be achieved.

We have responded to the Draft Determinations focussing on the common questions and those directed to our business plan specifically in the five annexes and associated appendices to this letter. As always, this response should also be read in light of our previous correspondence on RIIO-2 and RIIO-ED2. If you have any questions relating to our response, please don't hesitate to contact me or Paul Bircham (paul.bircham@enwl.co.uk).

Yours sincerely,

Peter Emery
Chief Executive Officer

cc Akshay Kaul
Steve McMahon

Enclosures:

Annex 1: Response to RIIO-ED2 Draft Determinations – Overview Document;
Annex 2: Response to RIIO-ED2 Draft Determinations - Core Methodology Document;
Annex 3: Response to RIIO-ED2 Draft Determinations ENWL Annex;
Annex 4: Response to RIIO-ED2 Draft Determinations Finance Annex;
Annex 5: Response to RIIO-ED1 Draft Determinations Cyber Questions;