Appendix 4 – RPE Inconsistencies

There are inconsistencies in the application of RPEs across a number of the allowance modification processes, relating to how RPEs are recognised in actual and forecast costs and in corresponding allowances. We do not believe these are intentional. We set out the issues and potential proposed solutions below.

1. RPEs and reopeners

RPE allowances are not being calculated in the Price Control Financial Model (PCFM) for reopeners (these are classed as 'RPEs Don't Apply').

At the time of making a re-opener application, DNOs may have already incurred some actual costs. DNOs may be applying for modified allowances to reflect both actual and forecast costs. Depending on the nature of the re-opener and the manner in which the DNO proposes to deliver the associated activities, there may be a need to reflect RPE allowances for forecast cost elements of a re-opener. This creates a potential disconnect between allowances for incurred actual costs, which rightly should not have RPEs applied as they will be implicitly included in actual costs, and allowances for forecast costs, which should be uplifted for RPEs.

Rather than a change in the PCFM (which may be complex across the actual and forecast costs included in the re-opener), we propose that an amendment is made to the RIIO-2 Re-opener Guidance and Application Requirements Document. An additional bullet point should be included in para 3.20 of this document allowing DNOs to apply for allowance adjustments that are inclusive of RPEs:

Including Real Price Effects for both actual costs and forecast costs

This would ensure RPEs are accounted for in both actual and forecast costs with no further amendments being required in the PCFM.

2. RPEs and Use It Or Lose It (UIOLI) mechanisms

There are inconsistencies in the application of RPEs associated with the UIOLI mechanisms (for example, in relation to the Worst Served Customers term (WSCt) and the Visual Amenity Projects term (VAPt)). There are two separate issues:

i. The UIOLI allowance determined via the calculations in SpC 3.4 (Use It Or Lose It Allowances) will be either the value of the cap (which does not have RPEs embedded) or the value of actual expenditure (which will have RPEs embedded). The PCFM then classifies UIOLI as 'RPEs Apply' which double-counts RPEs if actual expenditure is used.

   To avoid this inconsistency, we propose that UIOLI allowances are categorised as 'RPEs Don't' Apply' in the PCFM. This then avoids the double-counting of RPEs on actual costs.

ii. The cap in the licence has been calculated without any consideration of RPEs. This means that RPEs could artificially constrain (or inflate) the amount licensees can spend on these cost areas.

   We suggest the values of the caps for each UIOLI allowance term in SpC 3.4 Appendices are uplifted by RPEs on an annual basis, using the updated annual RPE modelling assumptions. It would then also be correct that 'RPEs don't apply' in the PCFM, as per the amendment proposed in point 1 above.

3. RPEs and Evaluative Price Control Deliverables (PCDs)

Evaluative PCDs that are introduced for the start of the Price Control Period (including cyber and bespoke PCDs) are classed as 'RPEs Apply' in the PCFM. The values referenced in SpC 3.3 are pre-RPE, so for these baseline allowances it is correct that additional RPE allowances are calculated.

However, an issue occurs if Ofgem makes a decision to allow efficiently incurred costs for any non-delivered PCD, following the process in Part C of SpC 3.3. Assuming that "the costs of undertaking reasonable and necessary work until the decision to not deliver the output was made" referred to in sub paragraph 3.3.15(b) are based on actual expenditure as submitted in the PCD reports, there is a risk that RPEs will be double-counted.

We suggest that a solution would be for Ofgem to exclude the implied contribution of Real Price Effects that would be calculated using the methodology set out in chapter 5 of the Price Control Financial Handbook from the allowance values that it directs, so that once the indices are applied in the PCFM the directed values plus the associated RPE allowance equals the actual costs that Ofgem has determined should be funded by customers.

We believe that it would be sufficient to set out this methodological approach in the Price Control Deliverable Reporting Requirements and Methodology Document, probably by including an extra paragraph in chapter 5 (Adjustments to allowances) setting out that:

> *If Ofgem makes an adjustment for any relevant evaluative PCD allowance t that (a) is calculated relative to actual expenditure and (b) adjusts allowances that attract RPE allowances in the PCFM, the Authority will direct allowances adjustments in such a way that, once the real price effect (RPE) allowances calculated in the Price Control Financial Model are taken into account, the total of the adjusted allowances and RPE allowances summates to the relevant actual costs.*

4. RPEs and Network Asset Risk Metric (NARM) expenditure

Network Asset Risk Metric Expenditure is classified as 'RPEs Apply' in the PCFM and so attracts RPE allowance. This is correct in the vast majority of cases as the associated unit costs that are used to calculate ex ante assumptions will not have had RPEs included.

However, the calculation of the Outturn Unit Cost of Risk (UCRRORR) uses Incurred NARM Expenditure for the Price Control Period as an input, which will (implicitly) include RPEs. Incurred NARM Expenditure (used in the calculation of Outturn Unit Cost of Risk) is based on actual spend, which would reflect any RPEs experienced by the DNO. The unit costs calculated using that would then be further uplifted by RPEs.

- If RPEs are positive, the extra volumes associated with a Justified Over-Delivery would effectively be funded at greater than DNO's actual cost.
- But if RPEs are negative, the DNO would not be fully funded for the extra outputs.

This difference only matters if (a) if the DNO has a Justified Over-Delivery and (b) Outturn Unit Cost of Risk is lower than Baseline Unit Cost of Risk. But, because of the size of spend associated with NARMs, the difference could prove material.

We think the simplest solution is to amend the definition of Incurred NARM Expenditure so that actual expenditure is adjusted to reflect the RPE indices (so that once indexed by the RPE index the actual expenditure is calculated):

> *means the total expenditure incurred by the licensee during the Price Control Period on NARM Asset Interventions, adjusted to reverse the implied contribution of Real Price Effects that would be calculated using the methodology set out in chapter 5 of the Price Control Financial Handbook.*