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17 January 2023

Dear Steve

Notice of statutory consultation on a proposal to modify the Standard Conditions and Special Conditions of the electricity distribution licence, plus consultation on Price Control Financial Instruments (PCFIs) and Associated Documents

Thank you for the opportunity to comment on the statutory consultation and other consultations noted above dated 14 December 2022. This response should be regarded as a consolidated response on behalf of UK Power Networks' affected distribution licence holding companies: Eastern Power Networks plc; London Power Networks plc; and South Eastern Power Networks plc.

My team has been reviewing the documents issued as part of the consultation and have raised Final Determination Questions (FDQs) where we believe there is an error or that clarification is required from Ofgem; we appreciate your team's support in providing prompt answers to these. A number of these FDQs have already resulted in confirmation from Ofgem of corrections to be made to licence conditions and PCFIs which we look forward to seeing amended in the final versions. However, there are a number that are still outstanding, and we would appreciate Ofgem's prompt clarification on the points that we have raised and amendments made where necessary. We have summarised the key issues in Appendix 1 of this letter.

We look forward to receiving updated versions of the PCFIs as part of the proposed issuing of an updated PCFM later this month to enable us to validate that the corrections have been made prior to the formal issue of the PCFM. The documents issued should also include a full suite of cost models underpinning the updated PCFM to allow validation of the values contained therein.

Further to recent discussions, we request a change to the "Initial Profiling Adjustment" and associated "Time Value of Money Profile Adjustment" values that were included in the PCFM model provided on the 14 December 2022. A key change in the RIIO-ED2 price control framework is that the truing up of revenue assumptions to actual data is moving from a two year lag to a one year lag. A consequence of this change is that both the 2022/23 and 2023/24 true ups to actual inflation are being collected in 2024/25 revenue. We wish to use

revised profiling adjustments to remove the effect of the 2022/23 inflation true up (the Legacy TRU term) which currently increases 2024/25 revenue by £120m (2020/21 prices). Our proposal is to evenly spread the recovery of this revenue over the years 2025/26, 2026/27 and 2027/28 and hence remove the impact of this spike in recovery caused by the change from RIIO-ED1 and RIIO-ED2.

Accompanying this letter are the following appendices:

- Appendix 1 contains a summary of the key issues;
- Appendix 2 contains our completed logs for each condition/document where we have feedback
- Appendix 4 contains key common issues raised by all DNOs

Appendix 3 regarding cyber PCD wording is confidential and submitted via Ofgem secure email system only.

If you have any queries on this letter or Appendix 1, please contact Sul Alli or James Hope in the first instance. For queries on Appendix 2 or 3, please contact Paul Measday in the first instance.

Yours sincerely



Basil Scarsella  
Chief Executive Officer  
UK Power Networks

Copy: Suleman Alli, Director of Strategy, Regulation, IS and Finance, UK Power Networks  
James Hope, Head of Regulation & Regulatory Finance, UK Power Networks  
Paul Measday, Regulatory Returns & Compliance Manager, UK Power Networks



## Appendix 1 – key issues

| Key issue raised by FDQ process   | Ofgem response  |
|---|---|
| UKPN008 – the baseline targets for “Value of fuel poverty services delivered” and “Value of low carbon transition services delivered” for UKPN’s licensees have been incorrectly set based on our submitted stretch performance targets   | Ofgem acknowledged this error and have agreed to correct it.        |
| UKPN009 – the Baseline Network Risk Outputs for EPN and SPN have been incorrectly represented, with the targets being switched around   | Ofgem acknowledged this error and agreed to correct it.             |
| UKPN018 – DNOs noted the contradiction in the “Reasons and effect doc” regarding the PCFM Guidance i.e. it will be coming post stat con/it is part of the stat con. We have not been able to find the file in the statutory consultation and are awaiting confirmation on:<br>A) Whether the PCFM guidance is part of the statutory consultation<br>B) If it is not part of the statutory consultation, a date it will be published as this is a key document for DNOs to be able to review and ensure it works correctly   | We are considering the response provided by Ofgem to this FDQ.      |
| UKPN026 – we have reviewed the proposed formula that calculates the Indirect Scaler and note that as written, it double funds indirects associated with activities within the ex ante element of the LVSVD and SRVD volume driver mechanisms.   | Ofgem acknowledged this and requested we include it in our response |
| UKPN027 – we have identified an error in how the Collaborative Streetworks Projects equation has been defined in special condition 4.10.4. The error stems from the application of the Totex Incentive Strength (TIS) after the maximum incentive reward has been applied. This contradicts the reward values Ofgem stated in the Final Determinations. The equation set out by Ofgem in the stat con effectively leads to a halving of the values from the Final Determination, meaning that the Collaborative Streetworks Projects ODI (F) is set at 0.1% of Regulatory Equity instead of the intended 0.2% figure. | We are awaiting a response to this FDQ.                             |



| Key issue raised by FDQ process   | Ofgem response  |
|---|---|
| <p>UKPN030 – we believe the way Ofgem has set the caps for both the LVSVD and the SRVD is flawed and risks creating a barrier for licensees to facilitate decarbonisation. To set the LVSVD caps, Ofgem has used licensees' M13 data that contains monetary values for undertaking LV Services that go beyond a baseline scenario. Ofgem takes the median of these values to then set an industry uplift of 108%, which is then applied to individual licensees' baseline LVSVD values. This means that a licensee with a larger baseline allowance will receive a larger cap regardless of what they requested in their Business Plans and the volumes they may need to deliver. We are awaiting clarity from Ofgem that the methodology will be updated and licensees will have cap values that better reflect the work needed to facilitate a Leading the Way pathway on a DNO by DNO basis.</p> | <p>Ofgem acknowledged this error and agreed to correct it</p>   |
| <p>UKPN031 – the use of negative terms in Special Condition 3.1 (Allowed Network Asset Risk Metric Expenditure), results in a number of errors regarding use of &gt; or &lt; symbols. We have proposed corrections to these issues.</p>   | <p>We are awaiting a response to this FDQ.</p>  |
| <p>UKPN032 – the RIIO-ED2 statutory consultation points at the cyber IT and cyber OT Final Determination documents for the details of the wording on the PCDs. Having reviewed the output column in Appendix 2 of these documents, the wording needs greater clarity to give us comfort on what is required to be delivered to meet the PCD. We therefore also believe it would need greater clarity for Ofgem to have the ability to clearly ascertain if the PCD had been met. This enhanced clarity will also assist the licensee in ensuring the requirements of the PCD are met.</p>   | <p>Ofgem have confirmed support for tabling of revised PCD wording and this is contained in Appendix 3 of this response.</p>                              |
| <p>UKPN036 – there is an error in Special Condition 4.8.7 regarding the calculation of the reward for licensees for the Stakeholder Survey element of the DSO ODI. Using the current formulas if SPN and/or EPN were to receive a score of 9 they would not receive the maximum reward specified by Ofgem in Appendix 1. This is despite Ofgem stating that a score of 9 would result in a maximum reward.</p>  | <p>Ofgem have confirmed that additional decimal places will be added to the figures in the licence. We are assessing whether this resolves this issue</p> |
| <p>UKPN042 – we believe that Ofgem has made an error in setting common unit cost allowances for the LRE volume drivers that apply to all licensees. Instead, unit costs should reflect a post reversal of normalisations and any regional factor adjustments and should therefore not be set the same across all DNOs.</p>  | <p>We are awaiting a response to this FDQ.</p>  |

| Key issue raised by FDQ process   | Ofgem response  |
|---|---|
| UKPN044 – the removal of SLC47 means that there is no obligation on the licensees to publish their RIIO-ED1 final year report as Special Condition 9.1 does not cater for the RIIO-ED1 guidance document and reporting requirements. Special Condition 9.1 focusses on RIIO-ED2 reporting requirements only. We recommend that SLC 47 is retained with a sunset clause to ensure this obligation falls away after the final RIIO-ED1 report is published in 2023. | Ofgem responded to this FDQ and requested we raise it in our response to this consultation. |

In addition to the above issues raised in the FDQ process, we have the additional key feedback:

1. We request a change to the “Initial Profiling Adjustment” and associated “Time Value of Money Profile Adjustment” values that were included in the PCFM model provided on the 14 December 2022. A key change in the RIIO-ED2 price control framework is that the truing up of revenue assumptions to actual data is moving from a two year lag to a one year lag. A consequence of this change is that both the 2022/23 and 2023/24 true ups to actual inflation are being collected in 2024/25 revenue. We wish to use revised profiling adjustments to remove the effect of the 2022/23 inflation true up (the Legacy TRU term) which currently increases 2024/25 revenue by £120m (2020/21 prices). Our proposal is to evenly spread the recovery of this revenue over the years 2025/26, 2026/27 and 2027/28 and hence remove the impact of this spike in recovery caused by the change from RIIO-ED1 and RIIO-ED2. The 2022/23 inflation true up value is now largely fixed, as it is based on actual inflation up to November 2022, and hence the impact of any future under/over recovery in relation to it would be small.

The tables below set out provisional values for both the initial profiling adjustments and the associated time value of money adjustments. We are aware that Ofgem are making amendments to the Price Control Financial Model and these values will need to be revised to reflect these updates. We would be happy to work with Ofgem to develop the final profiling adjustments required to achieve the proposal above.

|                                   |                 |     | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|-----------------------------------|-----------------|-----|---------|---------|---------|---------|---------|
| <b>Initial Profile Adjustment</b> | £m 20/21 prices | EPN | -33.39  | -76.65  | 26.47   | 37.17   | 46.40   |
|                                   | £m 20/21 prices | LPN | -20.83  | -53.04  | 11.45   | 25.39   | 37.03   |
|                                   | £m 20/21 prices | SPN | -12.05  | -50.61  | 13.57   | 23.91   | 25.18   |

We have calculated provisional “Time Value of Money Profile Adjustments” in the table below and request you validate these.

|  |                 |     | 2023/24 | 2024/25 | 2025/26 | 2026/27 | 2027/28 |
|--|-----------------|-----|---------|---------|---------|---------|---------|
| <b>Time Value of Money Profile Adjustments</b> | £m 20/21 prices | EPN | 0.88    | 3.75    | 5.05    | 3.36    | 1.19    |
|  | £m 20/21 prices | LPN | 0.55    | 2.47    | 3.55    | 2.57    | 0.95    |
|  | £m 20/21 prices | SPN | 0.32    | 1.95    | 2.91    | 1.92    | 0.65    |

The intention is that we will, with Ofgem’s approval, reduce the recently published tariffs for 2024/25, to reflect the agreed change in profiling.

2. The relevant unit costs in SpC 3.9 should reflect the post reversal of regional adjustments consistent with our ex ante allowances set at FD. Failure to do this, would result in a reduction to allowances in period through operation of the volume driver mechanism, even

if the exact volumes of MVA and kms are delivered in line with FD allowed volumes. This situation should not arise – the operation of the volume driver is not to adjust allowances for a revised set of unit costs – it is to adjust allowances to reflect the volumes of MVA and kms delivered relative to those volumes assumed in setting ex-ante allowances. This issue also applies for the other uncertainty mechanisms including the PCB volume driver.

3. Given how the licence conditions have been expressed with regards to ex ante allowances, the relevant ex ante allowance and ex ante allowed volume values for each re-opener need to be formally recorded. DNOs must be provided with the annual allowances and annual volume allowances that align to the scope of each re-opener that are included in ex ante allowances in order that they can meet the requirement to provide an annual profile for the proposed allowance adjustments, for example by providing DNOs with an updated version of the RIIO-ED2 Licence values and calculations document with these values included. The associated allowance calculations must also be provided for full transparency on the basis by which they have been derived.
4. Special Condition 8.1.4 incorrectly states that that the correction of a manifest error will not impact Allowed Revenue. Ofgem's response to earlier feedback on this was that such wording is in the RIIO-ED1 licence – that is correct; however, it is caveated by additional wording stating that this is without prejudice to the licensee's right to make representations on the significance of the impact. This omission should be corrected to ensure licensees have no less protection in RIIO-ED2 than they currently have in RIIO-ED1.
5. Most of the re-openers in Special Condition 3.2 require that the DNO provides evidence that the allowances that are being applied for are not included within ex ante (non variant) allowances that are provided in the Final Determination. With the exception of those re-openers that have opening PCDs ascribed in Special Condition 3.3, the value of the relevant ex ante allowances is not set out on the face of the licence. It is also not possible to infer the value of those ex ante allowances from any of the other licence documents and we do not have visibility of the relevant values that must be considered when demonstrating that the "tests" in Special Condition 3.2 have been met. To resolve this, these values need to be formally recorded in an appendix to Special Condition 3.2.

Finally, we propose that DNOs work with Ofgem to use the housekeeping modification condition to pick up the numerous formatting errors in SLCs which are not being updated as part of RIIO-ED2 as Ofgem had declined to change these as part of RIIO-ED2 process.

## **Appendix 2 – logs**

Please see separate Excel logs.

## **Appendix 3 – cyber PCD wording**

Please see response submitted via Ofgem secure email system only.

## Appendix 4 – key common issues from all DNOs

The following items are key common issues across all DNOs. Due to the length of some of the narrative, the titles are included in a numbered list immediately below. The detail then follows on subsequent pages with the heading numbering matching the list:

1. Use of the term “manifest error”
2. Amendments required to SpC 1.3 (Common Procedure)
3. Issues and inconsistencies for Real Price Effects (RPEs) in various allowance modification processes
4. RIIO-2 Cyber Resilience IT and OT PCD Reporting Guidance introduces adjustments that conflict with SpC 3.3
5. Allowed Network Asset Risk Metric expenditure – sign transposition
6. The relevant ex ante values that must be taken into account in re-opener applications must be set out on the face of the licence
7. Material issues in statutory consultation version of Load Related Expenditure conditions and associated guidance

### 1. Use of the term “manifest error”

The term “manifest error”, which is used in four special conditions, is not defined and so gives rise to uncertainty as to what is meant by the concept of “manifest error” and what is the nature and effect of the presumption in the relevant conditions. This uncertainty should be addressed by making “Manifest Error” a defined term.

SpC 3.9.13 provides that, for the purposes of SpC 3.9.12 (which identifies by reference to SpC 3.9.14 the categories of change that can be made to the Governance Document by direction), *“it is to be presumed that a modification which serves to correct a manifest error will have no impact on the licensee’s Allowed Revenue”*.

SpC 3.9.14(e) only provides an example as to the meaning of “manifest error” i.e. *“discrepancies between the [Governance Document] and the other special conditions”*. which leaves open the question as to when a discrepancy amounts to a “manifest error”, as opposed to merely an unintended outcome.

The importance of the precise meaning of “manifest error” depends in part on the nature and effect of the presumption in SpC 3.9.13. If the condition gives rise to an irrebuttable presumption that the correction of a “manifest error” will have no impact on a licensee’s Allowed Revenue, that could only be potentially acceptable if the condition were to apply only to the correction of errors that the licensee must have known were drafting errors (such that it never in fact expected to receive allowed revenue in accordance with the erroneous provision). Stronger and clearer language is, therefore, required to establish an irrebuttable presumption that the correction of a “manifest error” will have no impact on a licensee’s Allowed Revenue.

This would be achieved by including “Manifest Error” as a defined term in SpC 1.2, as follows:

*“Manifest Error means a drafting error that is so obvious that no licensee could have relied on the error and/or expected to receive Allowed Revenue in accordance with its effects.”*

It should also be made clear that the presumption is rebuttable by the addition of *“(unless the licensee shows otherwise)”* such that SpC 3.9.13 reads:



*“For the purposes of paragraph 3.9.12, it is to be presumed (unless the licensee shows otherwise) that a modification which serves to correct a Manifest Error will have no impact on the licensee’s Allowed Revenue”.*

As the term “manifest error” is also used in other special conditions, this change would bring clarity to each of those conditions. The term “manifest error” should, therefore, be capitalised in SpC 3.1.8(c), SpC 3.9.13, SpC 3.19.14(e), SpC 8.1.4, SpC 8.1.5(e) and SpC 9.2.20(e).

The principle noted in paragraph 3.5 also applies to SpC 8.1.4, which should, therefore, read:

*“For the purposes of paragraph 8.1.3(b), it is to be presumed (unless the licensee shows otherwise) that a modification which serves to correct a Manifest Error will have no impact on the licensee’s Allowed Revenue”.*

## **2. Amendments required to SpC 1.3 (Common Procedure)**

### **Amendments required to SpC 1.3 (Common Procedure)**

In general, we support the concept of the introduction of common procedures in SpC 1.3. The standardisation of processes across equivalent mechanisms is welcome and aids readers’ ability to follow and understand the licence.

However:

- A number of the processes are incompletely drafted and require expansion; and
- The common processes need to be correctly and consistently cross-referenced from the other conditions that they are relevant to.

A number of changes are required to implement these common processes correctly.

### **A The definition of Associated Document is unclear and does not provide certainty as to the scope of SpC 1.3 Part A**

The current definition of an Associated Document is:

“means a document issued and amended by the Authority in accordance with Part A of Special Condition 1.3 (Common procedure) and any reference to an Associated Document is to that document as amended from time to time unless otherwise specified. It does not include the “ED2 Price Control Financial Instruments.”

This definition is unclear and does not provide certainty as to scope:

- Ofgem’s issues log suggests that the Regulatory Instructions and Guidance (RIGs) should fall into scope but the RIGs are not issued or modified under SpC 1.3 and SLC 46 confirms the associated process.
- As the RIIO-ED2 LRE Volume Drivers Governance Document and Network Asset Risk Workbook are licence instruments it should be clear that SpC 1.3 does not apply to the RIIO-ED2 LRE Volume Drivers Governance Document and Network Asset Risk Workbook, consistent with the ED2 Price Control Financial Instruments.

Consequently:

- The definition of Associated Document should list all of the Associated Documents that can be modified under SpC 1.3.
- The exclusion from the scope of Associated Document should be expanded to include all licence instruments.



## **B The process for Ofgem directing an additional Re-opener application window in SpC 1.3 Part B needs to be expanded**

We welcome the inclusion of Part B of SpC 1.3 in the licence. It is essential that the process via which the Authority will direct additional Re-opener application windows is clearly set out on the face of the licence such that it meets the CMA's criteria. However, the level of detail currently proposed is insufficient.

There should be more detail on how this process will work and the aspects that Ofgem will consider when deciding whether to direct an additional window.

The process needs to be expanded to explain:

- The process that Ofgem will follow if the DNO requests an additional window be directed;
- The factors that Ofgem may consider in deciding whether to direct an additional application window; and
- Any minimum time period between the date of the direction and the application window.

Proposed additional wording:

*1.3.7 Where the licensee has requested that the Authority directs an additional period during which the licensee may make an application under a Re-opener, the Authority shall consider the information provided by the licensee, including any supporting evidence, when deciding whether to direct such additional period.*

*1.3.8 The Authority shall consider whether to direct such an additional period in situations where it believes that it is directly or indirectly in the Customers' interests to provide licensees with an additional opportunity to submit Re-opener applications.*

*1.3.9 The Authority shall make a decision on whether to direct an additional period as soon as is reasonably practicable.*

*1.3.10 Unless otherwise agreed with the relevant licensee, the minimum period of time between the date on which the Authority makes a decision regarding the direction of an additional period of time and the date on which the additional Re-opener application window closes will be 28 days.*

Some further information is provided in the Re-opener Guidance Document (Appendix 12, paragraph 1.32). It would be helpful to include 'directly or indirectly' here to make it clear that there may be external factors that mean that a project or costs are necessarily delayed (which may not be directly in Customers' interests, but would be indirectly as it would mean that the costs would be recovered when they were more certain), as follows:

*It may be appropriate to exercise this option in situations where we believe that it is directly or indirectly in consumers' Customers' interests to provide licensees with an additional opportunity to submit Re-opener applications. Prior to any such direction we would discuss the option with relevant stakeholders. For example, in a situation where external factors have led to the relevant project not being sufficiently advanced to allow a well evidenced application to be made during the window specified in the licence and we consider it is in the interest of consumers to allow a later submission.*

## **C The procedures in SpC 1.3 need to be consistently cross referenced from relevant conditions**

It is important that the common procedures in SpC 1.3 are cross referenced from other conditions to which the common procedures apply. Without this cross referencing, it may not be obvious to the reader of a relevant condition that the common procedure in SpC 1.3 must apply.

This cross-referencing has been undertaken from conditions where Part A is relevant, but has not been undertaken for Parts B or C.

The process in Part B of SpC 1.3 needs to be cross referenced from all relevant conditions and Parts.

Proposed wording for all relevant conditions:

*during such other periods as the Authority may direct after following the procedure for the direction of additional Re-opener application windows that is set out in Special Condition 1.3 (Common procedure).*

The process in Part C of SpC 1.3 needs to be cross referenced from all relevant conditions and Parts.

Proposed wording for all relevant conditions:

*unless otherwise directed by the Authority under Special Condition 1.3 (Common procedure), ....*

### **3. Issues and inconsistencies for Real Price Effects (RPEs) in various allowance modification processes**

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.

#### **A RPEs and re-openers**

RPE allowances are not being calculated in the Price Control Financial Model (PCFM) for re-openers (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.

## **B 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:

1. 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.

2. 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.

## **C 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 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.*

## **D 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 most 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.*

#### **4. RIIO-2 Cyber Resilience IT and OT PCD Reporting Guidance introduces adjustments that conflict with SpC 3.3**

##### **A The confidential nature of the documents involved here**

Note that this issue relates, in part, to mechanisms that are set out in Appendix 4 of the RIIO-2 Cyber Resilience IT and OT PCD Reporting Guidance ("Appendix 4"), which is a confidential document. Therefore, we have provided only minimal details here that we do not consider include confidential information.

We think the level of detail provided here should be sufficient for Ofgem to understand and resolve the issues. However, we can provide further details if the Ofgem team requires it.

##### **B Conflict between licence documents regarding the cyber OT UIOLI mechanism**

During the overall RIIO-ED2 consultation process, Ofgem considered whether it was appropriate to include in the licence a Use It or Lose It ("UIOLI") mechanism in respect of the Cyber resilience PCDs. The outcome was that Ofgem removed the Cyber resilience UIOLI mechanism from the informal consultation version of the licence.

Ofgem did not include the Cyber resilience UIOLI mechanism on the face of the relevant licence condition (SpC 3.3 Evaluative Price Control Deliverables) in the statutory consultation version of the licence.

However, Appendix 4 to the RIIO-2 Price Control Deliverable Reporting Guidance and Methodology Document regarding Cyber Resilience OT and IT reporting ("Appendix 4") contains



references to Ofgem applying a UIOLI mechanism or a form of UIOLI mechanism for PCDs funded under Cyber Resilience Operational Technology plans and Cyber Resilience Operational Technology Re-opener applications. There is, therefore, a significant conflict between the licence and Appendix 4.

Appendix 4 has the status of an Associated Document. Consequently, it is subordinate to the licence, the provisions in the licence take precedence and there is no provision for a UIOLI mechanism in the licence i.e. the licence does not provide for any such adjustment to be made and SpC 3.3 sets out specific circumstances under which the Authority may adjust the cyber OT allowances (CROTt and CROTREt values). An underspend situation is not one of the scenarios in respect of which the Authority has given itself the ability to adjust allowances in the licence.

For example,

- 3.3.15(a) sets out that “where an output is Fully Delivered With An Alternative Specification and the licensee demonstrates that any underspends against the associated allowances are attributable to Efficiency or Innovation, the Authority may not make any adjustment to the associated allowance”.
- 3.3.15(d) sets out that where the output is Partially Delivered or Partially Delivered With Alternative Specification the Authority may direct an adjustment to the associated allowance only in accordance with the given formula.

We note that there is some ambiguity in the FDs regarding this issue. We do not believe that a UIOLI adjustment is required in respect of cyber OT. The evaluative PCD adjustment process is sufficient to protect customers because the mechanism in SpC 3.3 allows for the clawing back of any allowances associated with Price Control Deliverables (PCDs) that are ultimately not delivered under relevant circumstances.

We therefore believe that the most appropriate course of action for Ofgem to take is to:

- Confirm that no UIOLI mechanism will apply to cyber OT and that any ambiguity in the FDs is wrong (i.e. there is an error in the FD drafting);
- Carry out a complete review of Appendix 4 to ensure that it is drafted in a way that is consistent with Ofgem’s intended policy, with all references to UIOLI adjustments and mechanisms being removed; and
- Consult again on Appendix 4 to ensure that those changes are implemented correctly.

However, if Ofgem disagrees and does intend to apply a UIOLI adjustment to cyber OT, some fundamental changes are required to SpC 3.3 and to Appendix 4 (these are expanded on in the sections below) to:

- ensure that they are drafted in a way that is internally consistent;
- avoid any double counting between adjustments for PCD non-delivery and adjustments for underspend via UIOLI; and
- ensure that the UIOLI adjustment operates at an overall cyber OT programme level, and not against individual PCDs.

### **B1 Drafting issues that would need to be resolved in order to correctly introduce a UIOLI mechanism for cyber OT**

Without prejudice to our view that a UIOLI mechanism for cyber OT is not necessary, the following issues would need to be resolved in order for a UIOLI mechanism to be correctly implemented via the licence and Associated Documents:

### Issue 1 – UIOLI mechanism needs to be included on the face of SpC 3.3:

As explained in section 1 above, the UIOLI adjustment is not included on the face of SpC 3.3. An underspend situation is not one of the scenarios that the Authority had given itself the ability to adjust allowances for in the licence.

The UIOLI adjustment needs to be recognised on the face of SpC 3.3. Without the recognition of this in SpC 3.3, the adjustments envisaged in Appendix 4 could not be made.

Any UIOLI mechanism would need to be included into SpC 3.3 (rather than SpC 3.4 with other UIOLI mechanisms) so that the interaction with the adjustments (of the same PCFM variable values) under SpC 3.3 Part C is clearly articulated in a way that avoids any double counting.

The mechanism would need to follow the style of algebraic approach used in SpC 3.4 for other UIOLI adjustments, but evolved to reflect the fact that allowance adjustments may have already been made under SpC 3.3 Part C. DNOs have previously provided drafting to Ofgem that would provide for a UIOLI mechanism in SpC 3.3 that correctly interacts with adjustments permitted under Part C of SpC 3.3.

### Issue 2 – Appendix 4 conflates PCD adjustments and UIOLI adjustments in a way that risks introducing double counts

The hypothetical examples in Appendix 4 give rise to a risk of double counts between evaluative PCD adjustments and UIOLI adjustments that could result in inappropriately large adjustments being made to allowances.

The hypothetical examples in Appendix 4 seem to conflate the two separate adjustments. For example, they wrongly include UIOLI mechanisms being used to make adjustments for non delivery of a PCD. SpC 3.3 would envisage such adjustments being made following the process in Part C of SpC 3.3.

These inconsistencies give rise to a risk of double counts between evaluative PCD adjustments and UIOLI adjustments that could result in inappropriately large adjustments being made to allowances.

Any UIOLI mechanism needs to be introduced in a way that avoids any double counting of allowance adjustments between PCD non-delivery adjustments and UIOLI adjustments. Principles need to be established to ensure that, in combination, these two adjustments lead to appropriate allowance values being determined, with no double counting of adjustments.

### Issue 3 – any UIOLI adjustment needs to operate at a programme level, not the level of individual PCDs

The hypothetical examples in Appendix 4 suggest that UIOLI adjustments may be made at an individual PCD level, rather than a programme level. For DNOs with more than one cyber OT PCD, this risks the UIOLI mechanism being incorrectly applied to individual PCDs rather than at programme level, meaning that DNOs cannot offset overspends in one PCD against underspends in another.

Figure 1 (Application of use it or lose it mechanism for cyber resilience OT PCDs) of Appendix 4 recognises that the two adjustments should be separate adjustments, and that the UIOLI mechanism operates at a whole programme level. However, the specific examples included cause

doubt as to how the two separate mechanism would operate. For example, hypothetical examples 10, 11 and 13 all incorrectly refer to making UIOLI adjustments at an individual PCD level. Any UIOLI mechanism needs to operate at a programme level, not an individual PCD level.

## **B2 Required Changes**

In order to resolve these issues, changes need to be made to:

- Introduce a UIOLI mechanism into SpC 3.3, making it clear how that mechanism interacts with the evaluative PCD mechanism and avoids any double counting adjustments.
- Amend Appendix 4 such that the application of the evaluative PCD mechanism is clearly separated from UIOLI assessment in hypothetical examples.

## **C Conflict between licence documents regarding evaluative PCD adjustments**

In a number of instances, the hypothetical examples set out in Appendix 4 propose adjustments to allowances that are inconsistent with the specific circumstances set out in SpC 3.3 under which the Authority may adjust the cyber OT and cyber IT allowances. For example:

- Sub paragraph 3.3.15(c) only allows for the reprofiling of allowances where re-profiling would have a material impact on allowances, whereas Appendix 4 hypothetical example 9 suggests that allowances would be re-profiled for Delayed PCDs, with no reference to a check on the material impact;
- Sub paragraph 3.3.15(d) only allows for allowance adjustments to be made using the formula set out in SpC 3.3.15(d), whereas Appendix 4 hypothetical example 11 suggests that the adjustment will be calculated based on the level of underspend against allowances; and,
- Sub paragraph 3.3.15(a) says '*where an output is Fully Delivered With An Alternative Specification and the licensee demonstrates that any underspends against the associated allowances are attributable to Efficiency or Innovation, the Authority may not make any adjustment to the associated allowance*'. However, Appendix 4 hypothetical example 10 shows Ofgem adjusting the PCD allowance down using the UIOLI mechanism, with no check to see if the underspend is due to efficiency or innovation.

The hypothetical examples in Appendix 4 must be updated so that that the examples are consistent with the specific circumstances set out in SpC 3.3 under which the Authority may adjust the cyber OT and cyber IT allowances.

## **D Confusion regarding the applicability of the Totex Incentive Mechanism (TIM) to cyber PCDs**

We note a number of instances where there seems to be confusion as to how the allowance adjustments that may be made SpC 3.3 interact with the operation of the TIM.

The Price Control Financial Model will automatically calculate allowance adjustments associated with the operation of the TIM in any instance where a difference between allowed totex and actual totex exists.

In combination with the operation of the PCFM, the allowance adjustment mechanisms set out in SpC 3.3 will automatically result in adjustments via TIM if the DNO's expenditure is different to the associated allowances (where appropriate, including RPE allowances and after any adjustments under SpC 3.3 to reflect the delivery of evaluative PCDs). We think this is correct.

Appendix 4 seems to suggest that an adjustment to allowances would be required in order to enact the TIM adjustments (for example hypothetical example 8). However, this is not the case.

Appendix 4 should be updated so that it does not suggest that further allowance adjustments are required in order to achieve the sharing of any under- or over-spend via the TIM.

## 5. Allowed Network Asset Risk Metric expenditure - sign transposition

The sign convention used to calculate allowance adjustments in SpC 3.1 is erroneously based on the assumption that NARMS risk reduction is measured in the Network Asset Risk Workbook as a positive value. In fact, both targets and delivery are measured as negative numbers in the Network Asset Risk Workbook. This sign convention inconsistency results in materially incorrect allowance adjustments being calculated via the formulae in SpC 1.3.

This error is unintentional. We have already provided Ofgem with details of the changes that are necessary to correct the error. For completeness, we set out the required changes below.

| Reference<br>(Part X, Para Y) | Comment  | Suggested alternative drafting<br>(if necessary)   |
|-------------------------------|--|--|
| 3.1.30                        | The 'greater than or equal to' and 'less than or equal to' signs are the wrong way around. Because the targets and delivery is measured in risk reduction (i.e. a negative number) the signs need to be the other way around.  | $[NRO_{BL} * (1 + DB_L)] \geq NRO_{OA} \geq [NRO_{BL} * (1 + DB_U)]$   |
| 3.1.31                        | The < sign is the wrong way around. Because base line risk and delivery are defined with negative numbers, an under-delivery is actually a greater number than the baseline. i.e. if delivery was -9 and the target was -10. This represents an under-delivery, but -9 is greater than -10.                                    | $NRO_{OA} > [NRO_{BL} * (1 + DB_L)]$   |
| 3.1.32                        | As per above, the > sign is the wrong way around.  | $NRO_{OA} < [NRO_{BL} * (1 + DB_U)]$   |
| 3.1.35 and 3.1.37             | <p>NRO(OAD) is calculated in two different ways depending on whether the delivery is under or over the Baseline Network Risk Output.</p> <p>The calculations are set out in 3.1.35 and 3.1.37, however the introductory text does not make clear which it is referring to, therefore this should be made explicitly clear.</p> | <p>3.1.35 - If the licensee has been deemed to have un-justified an under-delivery against its Baseline Network Risk Output then the Determined Outturn Network Risk Output (NROOAD) is derived in accordance with the following formula: ..... etc</p> <p>3.1.37 - If the licensee has been deemed to have justified an over-delivery against its Baseline Network Risk Output then the Determined Outturn Network Risk Output (NROOAD) is derived in accordance with the following formula:..... etc</p> |



| Reference<br>(Part X, Para Y) | Comment   | Suggested alternative drafting<br>(if necessary)  |
|-------------------------------|---|---|
| 3.1.36                        | <p>The determination of the term UCR(AD) is incorrect. Because both the UCR (BL) and UCR (OR) are negative numbers, the definition stating that the Adjusted Unit Cost of Risk is the 'lower of' these two terms gives a larger unit cost to multiply to calculate the NARM(AD) value.</p> <p>We do not believe this is Ofgem's intention. We believe the intention is to multiply by the most efficient unit cost, and thus, given the negative terms, this should be the "higher of".</p> | <p>UCR<sub>AD</sub> - is the Adjusted Unit Cost of Risk (£/£risk), which is the <b>higher</b> of the Baseline Unit Cost of Risk (UCR<sub>BL</sub>), derived in accordance with 3.1.38, and the Outturn Unit Cost of Risk (UCR<sub>OR</sub>), derived in accordance with paragraph 3.1.39.</p> |

## 6. The relevant ex ante values that must be taken into account in re-opener applications must be set out on the face of the licence

Most of the re-openers in SpC 3.2 (Uncertain Costs Re-openers) require that the DNO provides evidence that the allowances that are being applied for are not included within ex ante (non-variant) allowances that are provided in the Final Determination. The various Parts of SpC 3.2 require this in different ways, depending on the nature of the re-opener, for example:

- “additional costs associated with such changes” (SpC 3.2.6)
- “relative to the assumptions used by Ofgem to set allowances” (SpC 3.2.14)
- “is not provided for by ex ante allowances” (SpC 3.2.75(c))

With the exception of those re-openers that have opening Price Control Deliverables (PCDs) ascribed in SpC 3.3, the value of the relevant ex ante allowances is neither set out on the face of the licence nor elsewhere. It is also not possible to infer the value of those ex ante allowances from any of the other licence documents.

The relevant values can also not be identified or inferred from the cost assessment output files that Ofgem has shared with DNOs, because the ultimate allowances are not presented at a sufficient level of disaggregation.

The DNOs, therefore in almost all circumstances, have no visibility of the relevant values that must be considered when demonstrating that the “tests” in SpC 3.2 have been met, or in proposing the values of allowance modifications that are required by the associated application requirements. This creates the risk of protracted discussions at the time of re-opener applications and the potential for applications to be inappropriately disallowed or reduced.

Given how the licence conditions have been expressed with regards to ex ante allowances, the relevant ex ante allowance and ex ante allowed volume values for each re-opener need to be formally recorded.

DNOs must be provided with the annual allowances and annual volume allowances that align to the scope of each re-opener that are included in ex ante allowances in order that they can meet the requirement to provide an annual profile for the proposed allowance adjustments, for example by providing DNOs with an updated version of the RIIO-ED2 Licence values and calculations document with these values included. The associated allowance calculations must also be provided for full transparency on the basis by which they have been derived.

It is imperative that DNOs are given the opportunity to check these values prior to modification notices being issued.

Each Part of SpC 3.2 also makes reference to modifications to allowances being made relative to the re-opener terms in Appendix 1. Appendix 1 is currently completed as showing 'N/A' across all terms and years. Modifications cannot be requested against 'N/A'. Therefore, these need to be amended to show zero.

## **7. Material issues in statutory consultation version of Load Related Expenditure conditions and associated guidance**

### **Introduction**

The quality of drafting of the load-related conditions and associated guidance documents has improved since the informal consultation. However, a number of issues remain unresolved and some new issues have been introduced. Some of the issues also interact with each other, creating larger issues and meaning that the changes needed to resolve them are quite complex to enact.

This document focusses on the following material issues:

- RIIO-ED2 load “closeout” Load Related Expenditure allowance adjustments are incomplete and unclear;
- The extent of the possible disallowance of volumes set out in the RIIO-ED2 LRE Volume Drivers Governance Document is much too broadly drafted and - at the extreme - could leave DNOs with no allowance at all;
- The “check” to ex ante allowances to determine if volumes may be curtailed is not clearly defined in the RIIO-ED2 LRE Volume Drivers Governance Document, and contradicts the calculations in the RIIO-ED2 LRE Volume Drivers Workbook;
- Difficulty identifying, confirming and documenting ex ante allowance values for load related activities;
- The net to gross adjustment for Load Related Expenditure (SpC 3.11) should not be modified into the RIIO-ED2 licence;
- The baseline percentage of Gross Load Related Expenditure expected to be delivered via Specific Customer Funded Reinforcement values set out in Appendix 1 of SpC 3.11 has been calculated on an inappropriate basis;
- Net to gross condition adjustment basis is ambiguously drafted and may disallow some legitimate adjustments as well as allowing Ofgem to make adjustments in inappropriate circumstances;
- Submission requirements include some aspects that DNOs may be unable to comply with and others that do not have any clear role in Ofgem’s allowance setting process;
- Legal status of documents/ modifications has not been consistently implemented, and document hierarchy is unclear;
- The scope of activities to be included within the volume driver remains unclear;
- Incorporation of flexibility services into SpC 3.9 is ambiguously implemented, and contradicts some of the calculations in the LRE Volume Drivers Workbook;
- Important wording changes needed in the description of the circumstances under which a Load Related Expenditure Re-opener adjustment may be made;
- Amendments to the various transmission connection point charges definitions have fundamentally changed the boundary between Load Related Expenditure and Pass-through in a way that is not consistent with our understanding of Ofgem’s policy; and

- The scope of the review of the LRE Volume Drivers during RIIO-ED2 introduces regulatory uncertainty during the early years of the Price Control Period.

DNOs have had helpful initial discussions with Ofgem regarding these issues. We welcome that early engagement on these important issues and the fact that Ofgem has already acknowledged that it understands and agrees in principle with many of the issues.

### **A RIIO-ED2 load “closeout” Load Related Expenditure allowance adjustments are incomplete and unclear**

#### Issue(s)

All DNOs agree that the net to gross adjustment for Load Related Expenditure (SpC 3.11) should not be modified into the RIIO-ED2 licence. Additionally, some DNOs have concerns with other aspects of Ofgem’s policy approach to RIIO-ED2 load closeout that they will respond on separately.

Without prejudice to those policy concerns, the adjustments to Load Related Expenditure allowances that are to be made at the end of RIIO-ED2 are incomplete, inconsistently drafted and do not appropriately acknowledge the potential interactions between the various adjustments.

- The adjustment to be made to Load Related Expenditure allowances at the end of RIIO-ED2 if a DNO has spent less than 80% of FD allowances (referred to in FD core para 3.18) has not been incorporated into the licence at all.
- The adjustment to flexibility services allowances is only briefly documented in the RIIO-ED2 LRE Volume Drivers Governance Document (para 2.14) and is not referred to in SpC 3.9 itself. The drafting of this adjustment also fails to recognise that, provided that the reduced expenditure on flexibility services arises due to lower than anticipated volumes, the volume driver mechanism will have already operated to remove the associated allowances. The adjustment also operates based on spend rather than re-calculated allowances and seems to have the effect of removing any outperformance or under performance that would otherwise have been taken account of via TIM.
- The end of period net to gross adjustment under SpC 3.11 is unable to take account of the two other end-of-period adjustments to Load Related Expenditure allowances (3.11.9).

#### Consequence

The gaps in and wording of existing drafting leads to a lack of clarity of the intended allowance adjustments that may be made at the end of RIIO-ED2.

At present, therefore, there is significant potential for these adjustments to double count each other or to double count the adjustments made mid-RIIO-ED2 via the volume driver or re-opener mechanisms.

This makes it difficult for DNOs to reasonably foresee how the conditions will operate and revenue will be affected.

It is also not possible for DNOs to predict the associated allowance changes when setting use of system charges for Regulatory Years within RIIO-ED2.

#### Fix

The end of period allowance adjustments all need to be drafted in a way that (a) include all relevant adjustments, (b) explain how the various end of period calculations interact with each other and (c) also take account of allowance adjustments that have already been made during the course of RIIO-ED2.

This may be easier to achieve by incorporating all end of period adjustments into one RIIO-ED2 load closeout licence condition.

Some specifics:

- The adjustment to be made to Load Related Expenditure allowances at the end of RIIO-ED2 if a DNO has spent less than 80% of FD allowances (FD core para 3.18) needs to be incorporated into the licence. While the specific details of the assessment may be subject to a close-out consultation, the licence should recognise that 80% of allowances is a trigger for an assessment of a potential adjustment. Without such visibility licensees have no reference for what value of expenditure would attract an adjustment.
  - The inclusion of such an adjustment would be consistent with the approach taken during the modification of the RIIO-ED1 licence by the inclusion of potential end of Price Control Period adjustments in CRC3G.
  - Some of the drafting and algebra in CRC3G could be used in drafting an equivalent adjustment for RIIO-ED2.
  - This adjustment should be very clearly constrained to the ex ante funding provided for the sub-set of Load Related Expenditure that matches the scope of the Load Related Expenditure Re-opener i.e. it does not apply to ex ante allowances for flexibility services or any other activities that fall within the scope of the volume drivers.
- The end of period adjustment for flexibility services needs further thought:
  - If the intent is to true-up for the actual volumes and nature of flexibility service contracts delivered during RIIO-ED2, the volume driver (as drafted in the statutory consultation) will already achieve this. In that case no further adjustment is required.
  - If the intent is to somehow true up for actual spend, care needs to be given to both the incentive properties of such an approach and the associated drafting. If such an adjustment is required, it must be documented in the special condition, in order to avoid any apparent conflict between the condition and the guidance. Effectively treating flexibility as a pass-through cost is inconsistent with the ethos of minimizing costs to customers.
  - Note that this issue interacts with the issues set out in section 9 (the operation of the volume driver for flexibility services during RIIO-ED2).

The drafting of the net to gross condition needs to clearly show how the adjustments in SpC 3.11 will be calculated in a way that avoids double counting the other RIIO-ED2 closeout adjustments.

**B The extent of the possible disallowance of volumes set out in the RIIO-ED2 LRE Volume Drivers Governance Document is much too broadly drafted and – at the extreme – could leave DNOs with no allowance at all**

Some DNOs have concerns with Ofgem's policy related to the calculation and application of aspects of the volume driver checks and associated disallowance of volumes that they will respond on separately.

Issue(s)



Paragraph 4.5 of the RIIO-ED2 LRE Volume Drivers Governance Document allows Ofgem to move to step 2 in the process where Ofgem then has to decide whether or not to disallow all volumes within a particular volume driver if one metric has been failed and the resultant allowances exceed those at FD. As written, this would allow Ofgem to remove all volumes, including those assumed at FD. It should be clear that only volumes and the resultant expenditure above the ex ante allowance within the relevant volume driver may be disallowed and the RIIO-ED2 LRE Volume Drivers Governance Document should set out in much clearer detail what Ofgem will take into account when determining the number of volumes to be disallowed.

The same paragraph also talks about Ofgem “withholding expenditure”, whereas we assume that Ofgem would disallow some volumes from being included in the volume driver calculations in this circumstance (i.e. Ofgem would adjust totex allowances rather than somehow amending the level of actual expenditure that would flow through to actual totex in the PCFM).

At the moment, if the DNO has spent more than its FD ex ante allowances, as soon as one metric is failed it seems that all volume driver allowances (for the variable value in question) can be removed (4.3, 4.5).

### Consequence

The mechanism in paragraph 4.5 of the Volume Drivers Governance Document noted above permits Ofgem to disallow all volumes associated with one of the load volume drivers, even if only one metric is slightly into “fail” and if expenditure exceeds that provided in the baseline. Because the volume driver overwrites in the PCFM, this allows Ofgem to remove all volumes, including those assumed at FD, leaving a DNO with no allowance. It is therefore important that the process that Ofgem must follow when determining any disallowances is clearly defined and that adjustments are appropriately constrained. For example, it is currently unclear how Ofgem will separate expenditure linked to volumes that are efficient and have passed metrics, from expenditure associated with from volumes that have failed a metric.

The extent of this adjustment could be far greater than is needed to return the DNO to the level of allowance assumed at FD, or to remove sufficient volumes to return the relevant metric to “pass” status.

### Fix

The process that Ofgem will follow/ things it would consider when disallowing any volumes should be explained in much clearer detail in order to more appropriately constrain the quantum of disallowed volumes.

As no adjustments are made if the DNO is within its ex ante allowances it would seem logical for any volume disallowance to be limited to returning the DNO to its ex ante allowance. Similarly, as no adjustments are made if the DNO is within the defined tolerance of the metric, it would seem logical that the extent of any adjustment goes no further than returning the DNO to a position where the metric is within the defined tolerance.

In addition to the text in 4.5 setting out that adjustments can only be made if “the Authority is not satisfied that the expenditure above the ex ante allowance was justified”, the following further constraints to the extent of adjustments should be included:

- The scope of any adjustment should be constrained to the sub-set of activities that the metric is designed to test. It would help to include a simple mapping table showing which metrics relate to which volume driver “activities”. (i.e. similar to the table shared on slide 5

of Ofgem's deck from the load policy meeting of 7 December 2022). For example, it is illogical for the transformer metrics to adjust allowances for circuit work.

- The extent of any volume disallowance should be constrained to be no greater than the smaller of:
  - The quantum required to return the DNO's allowances to its original ex ante allowances at FD for the activities measured by the metric that has "failed"; and
  - The quantum needed to return the metric in question to a "pass" status.

**C The "check" to ex ante allowances to determine if volumes may be curtailed is not clearly defined in the RIIO-ED2 LRE Volume Drivers Governance Document, and contradicts the calculations in the RIIO-ED2 LRE Volume Drivers Workbook**

Issue(s)

The "check" to ex ante allowances to determine if volumes may be curtailed is not clearly defined in the RIIO-ED2 LRE Volume Drivers Governance Document. For example:

- The "ex ante allowances" that must be exceeded is inconsistently named in the RIIO-ED2 LRE Volume Drivers Governance Document but does not make it clear that it is the 5 year allowance at FD (excluding RPEs). It could be interpreted as an annual allowance amount.
- It is unclear what activities are to be included in the "ex ante allowances" i.e. the level of disaggregation at which the comparison is undertaken:
  - 2.24 could be read to suggest that only the allowances relevant to the metric that has been failed will be considered;
  - 4.2 simply refers to "ex ante allowances", which could be interpreted as broadly as full Load Related Expenditure allowances or even full totex allowances; and
  - The RIIO-ED2 LRE Volume Drivers Workbook suggests that the comparison to be undertaken is to be based on all activities within the volume driver in question.
- The description of the cumulative adjusted "costs" that are to be compared to the 5 year FD allowance refers to "efficient unit rates". We assume that the intended comparator is adjusted allowances based on actual volumes (minus any that have been previously disallowed) multiplied by the relevant unit cost in SpC 3.9, but this is not clear in the way the guidance has been drafted. As noted earlier in our response, the relevant unit costs in SpC 3.9 should reflect the post reversal of regional adjustments consistent with our ex ante allowances set at FD. Failure to do this, would result in a reduction to allowances in period through operation of the volume driver mechanism, even if the exact volumes of MVA and kms are delivered in line with FD allowed volumes. This situation should not arise – the operation of the volume driver is not to adjust allowances for a revised set of unit costs – it is to adjust allowances to reflect the volumes of MVA and kms delivered relative to those volumes assumed in setting ex-ante allowances.

In general, we think this calculation is more clearly set out in the RIIO-ED2 LRE Volume Drivers Workbook (although the lack of populated allowance values means that we cannot be certain).

Consequence

This key calculation is unclear. Different interpretations of the required calculation could lead to volume adjustments being applied in very different scenarios.

As the RIIO-ED2 LRE Volume Drivers Governance Document conflicts with the RIIO-ED2 LRE Volume Drivers Workbook, it is unclear what status the calculation in the RIIO-ED2 LRE Volume Drivers Workbook has in this regard.

## Fix

There are two broad options available here:

- Make changes to improve the clarity of drafting of the “check” to ex ante allowances in the RIIO-ED2 LRE Volume Drivers Governance Document (see specifics below); or
- Refer in the RIIO-ED2 LRE Volume Drivers Governance Document to the relevant calculations in the RIIO-ED2 LRE Volume Drivers Workbook, and remove specifics from the RIIO-ED2 LRE Volume Drivers Governance Document (using the same approach to cross referencing that is used to refer from PCFH to PCFM).

If the comparison is to be retained in the RIIO-ED2 LRE Volume Drivers Governance Document, we recommend that defined terms are created to cover:

- The relevant ex ante allowances
  - 5 year values
  - Excluding RPEs
- The adjusted allowances that they are to be compared to
  - Cumulative adjusted allowances for RIIO-ED2 years to date, based on actual volumes (minus any that have been previously disallowed) x unit costs in SpC 3.9, excluding associated RPEs

The RIIO-ED2 LRE Volume Drivers Governance Document would need to set out the scope / level of disaggregation at which the comparison is undertaken.

### **D Difficulty identifying, confirming and documenting ex ante allowance values for load related activities**

DNOs cannot identify all relevant ex ante allowances in FD files

## Issue

In general, DNOs are finding it difficult to identify the ex ante allowances that will be used in a number of the “tests” and calculations in the various load related licence conditions.

## Consequence

DNOs cannot confirm the values that will apply for their DNOs during RIIO-ED2.

Differences of view may arise when we come to use these mechanisms and “tests” during the Price Control Period or at the closeout of RIIO-ED2.

## Fix

Please provide DNOs with details of the relevant ex ante allowance values for all the various Load Related Expenditure components for review prior to modification notices being issued.

The annual and 5 year ex ante allowance values for all relevant components of Load Related Expenditure must be clearly set out on the face of a document with an appropriate legal status. (Note that the values in the PCFM will be over-written annually and cannot be used for this purpose).

The LRE Volume Drivers Workbook must be populated with fixed DNO-specific data prior to modification notices being issued

Issue

The version of the LRE Volume Drivers Workbook that was issued for the statutory consultation has not been populated with important, fixed DNO-specific data. For example, it has not been populated with the ex ante allowances which are required to determine whether any failed metrics may result in volumes being disallowed.

Consequence

DNOs have been unable to review the version of the LRE Volume Drivers Workbook that will ultimately be used to set allowances, to check that they agree with the values included within it or to check the operation of the LRE Volume Drivers Workbook with relevant values populated.

Fix

Provide a copy of the LRE Volume Drivers Workbook that has been populated with individual licensee data so that each DNO can check its intended operation prior to modification notices being issued.

The ex ante allowances for activities that fall within the scope of the Load Related Re-opener need to be set out on the face of the licence

Issue

Sub paragraph 3.2.75(c) sets out that one of the criteria that must be satisfied for a Load Related Expenditure Re-opener application to be made is that the increase in Load Related Expenditure “is not provided for by ex ante allowances”.

The value of those ex ante allowances is not set out on the face of the licence. It is also not possible to infer the value of those ex ante allowances from any of the other licence documents. In particular, the assumed inclusion of flexibility services ex ante allowances within “non-variant allowed load related capex” means that the values populated in the PCFM cannot be used for this purpose.

Consequence

The DNOs have no visibility of the relevant values that must be considered when demonstrating that the “test” in 3.2.75(c) has been met, or proposing the required values of  $LRE_t$  required by paragraph 3.2.77(f).

Fix

We suggest that a new appendix to SpC 3.2 be created for this purpose, with a cross reference to that new appendix provided in paragraph 3.2.75(c)(i).

The appendix would need to provide an annual allowance for each DNO, in order that DNOs can meet the requirement in 3.2.77(f) to provide an annual profile for the proposed  $LRE_t$  allowances.



Also, in order access the re-opener the DNO must be able to show that its costs have, or will, increase relative to the:

- Planning scenario used by Ofgem to set ex-ante allowances (3.2.75(a)(i));
- Access SCR assumptions used by Ofgem to set ex-ante allowance (3.2.75(a)(ii)); or
- Conditions on the system assumptions used by Ofgem to set ex-ante allowances (3.2.75(b)).

Consequently, Ofgem needs to specify what its assumptions were for the baseline.

**E The net to gross adjustment for Load Related Expenditure (SpC 3.11) should not be modified into the RIIO-ED2 licence**

The need for the net to gross adjustment for Load Related Expenditure (SpC 3.11) has neither been justified nor subject to policy consultation.

In Ofgem's "reasons and effects" document, Ofgem sets out that its reason for including the condition is "to improve the structure and clarity of the licence and ensure it is coherent with the new uncertainty mechanisms introduced for Load Related Expenditure". However, the condition does not achieve the effect that Ofgem says it will achieve:

- SpC 3.11 does not improve the clarity of the licence. The basis of any adjustment to be made under this condition is unspecified, and acknowledged by Ofgem to be unclear. In its issues log Ofgem is clear that "it may be very difficult to know exactly how that change would be made". Such a lack of certainty regarding the adjustments that could be made under this condition cannot improve the clarity of the licence.
- It also does not ensure that it is coherent with the new uncertainty mechanisms. Throughout the evolution of the LRE toolkit via working groups, this mechanism has not been part of policy discussions or proposals and has not been part of policy consultations. As a result, the logic for keeping it is unclear. Furthermore, the condition is not drafted in a way that explains how this mechanism will interact with other load "closeout" mechanisms that will operate at the end of the Price Control Period.

Load Related Expenditure policy has undergone a significant overhaul to ensure that DNOs can enable net zero by having sufficient funding to invest, whilst protecting customers. However, this consultation seeks to introduce broadly the same mechanism as in RIIO-ED1, without fully considering the interactions with the new Load Related Expenditure mechanisms or the implications of Access SCR.

We believe that Ofgem has given itself all the tools that it needs to adjust Load Related Expenditure allowances for likely changes in the drivers of Load Related Expenditure during the Price Control Period in the other tools within its toolkit of uncertainty mechanisms, namely the Load Related Expenditure Re-opener and the Load Related Expenditure volume drivers.

This toolkit of regulatory mechanisms segments expenditure down into different categories depending on the type of expenditure, each with safeguards for customers to ensure optimal investment. These safeguards include:

- Ex-ante allowances set by stringent benchmarking accompanied by a downward adjustment of volumes using the lowest net zero compliant scenario, putting Load Related Expenditure allowances at lowest credible value and all networks on a common basis;
- Closeout assessment if DNOs have not spent more than 80% of their non-volume driver Load Related Expenditure ex-ante allowances;

- Volume drivers in place for secondary network and LV services, accompanied by a licence status governance document which includes 6 check metrics and criteria for which investment needs to meet;
- Maximum revenue caps on volume driver expenditure;
- Review of volume driver operation at year 3;
- Discrete ex ante and variant allowance for flexibility services procurement, with any unspent ex ante allowances returned to customers in full at the end of the period; and
- Use of Price Control Deliverables for Strategic Investment projects.

The proposed net to gross adjustment for Load Related Expenditure also fails to fully consider the implications of Access SCR. Within DCP404, DCUSA defines the objective of the Access SCR, with a key deliverable being: “The overall connection charge faced by those connecting to the distribution network will be reduced removing the contribution to wider network reinforcement costs for demand connections and reducing it for generation connections”. The extensive work that has been undertaken in agreeing the conditions and charging arrangements of the Access SCR will provide sufficient protection for customers wanting to connect onto the distribution network.

Access SCR will have a fundamental impact on net to gross percentages. It is well understood that future customer contributions from 1 April 2023 will be minimal. Any contributions required will be based upon recently revised connection charging arrangements implementing Ofgem’s Access SCR decision.

As a result of the extensive customer protections Ofgem has implemented within its toolkit of Load Related Expenditure mechanisms, and the changes to Access SCR, the fact that the introduction of SpC3.11 neither adds clarity to the licence nor takes into account interactions with the other mechanisms and the planned close-out assessments means that the net to gross adjustment for Load Related Expenditure condition (SpC 3.11) is unnecessary and should be removed from the RIIO-ED2 licence.

**F The baseline percentage of Gross Load Related Expenditure expected to be delivered via Specific Customer Funded Reinforcement values set out in Appendix 1 of SpC 3.11 has been calculated on an inappropriate basis**

Without prejudice to DNOs’ view that the net to gross adjustment for Load Related Expenditure (SpC 3.11) should not be modified into the RIIO-ED2 licence, we note the following fundamental issue with the basis on which the key value against which the condition is intended to operate has been calculated.

Issue

We understand from correspondence with Ofgem that the values populated in Appendix 1 of SpC 3.11 for the baseline percentage of Gross Load Related Expenditure expected to be delivered via Specific Customer Funded Reinforcement have been populated based on DNOs’ submitted plans.

Ofgem has made a number of very significant changes to DNOs’ submitted plans in determining ex ante allowances for Load Related Expenditure activities. Most notably:

- normalising plans to Ofgem’s chosen System Transformation planning scenario; and
- making adjustments to allowances to reflect the outcome of the Access SCR for the first two years of RIIO-ED2.

Both of these changes will change the proportion of Gross Load Related Expenditure that is expected to be delivered via Specific Customer Funded Reinforcement.

These fundamental changes have not been reflected in the central value against which the condition is intended to operate. This means that the condition is currently drafted to operate against adjustment thresholds that are internally inconsistent with the basis on which Load Related Expenditure allowances have been set.

DNOs do not have details of the equivalent values that would be consistent with the way in which Load Related Expenditure allowances have been set. These cannot be identified or inferred from the cost assessment output files that Ofgem has shared with DNOs, because the ultimate allowances are not presented at a sufficient level of disaggregation.

### Consequence

The basis on which the baseline percentages have been calculated has the effect of proposing allowance adjustments in circumstances that are inconsistent with the way in which allowances have been set. This has the effect of creating an asymmetrical adjustment mechanism (because the baseline percentages are not consistent with the outcome assumed in setting ex ante allowances) creating the risk of an inappropriate reporting burden and inappropriate allowance adjustments.

DNOs do not have the data to calculate the materiality of the difference, but – based on the extent of changes required to normalise plans to System Transformation and to incorporate changes to reflect the outcome of the Access SCR - believe that the difference is likely to be material.

### Fix

If SpC 3.11 is to be modified into the licence, the baseline percentage of Gross Load Related Expenditure expected to be delivered via Specific Customer Funded Reinforcement in Appendix 1 of SpC 3.11, along with the Specific Customer Funded Reinforcement Percentage Band that is calculated relative to that percentage, must be populated with values that are internally consistent with the assumptions made in setting ex ante allowances for Load Related Expenditure.

Furthermore, DNOs must be provided with the Gross Load Related Expenditure and Specific Customer Funded Reinforcement values that are assumed in the calculation of the baseline percentage of Gross Load Related Expenditure expected to be delivered via Specific Customer Funded Reinforcement.

**G Net to gross condition adjustment basis is ambiguously drafted and may disallow some legitimate adjustments as well as allowing Ofgem to make adjustments in inappropriate circumstances**

Without prejudice to DNOs' view that the net to gross adjustment for Load Related Expenditure (SpC 3.11) should not be modified into the RIIO-ED2 licence, we also note the following issues with the condition.

We recognise that Ofgem has moved this condition to be subject to statutory modification. There is, however, some ambiguity and omission remaining in the drafting of the condition that merits correction even in the context of statutory modification, because they fundamentally call into question the purpose of the adjustment or the role of DNO evidence in the process.

### Issue

The drafting of 3.11.2 suggests that DNOs cannot justify that an adjustment is required.

## Consequence

This wording suggests that the adjustment is expected to operate asymmetrically, whereas our expectation is that it can operate both to increase as well as decrease allowances. It also suggests that adjustments can only be made if a DNO cannot explain why the percentage is materially different, whereas the DNO's explanation may actually show that an adjustment is required. This also contradicts the intent of paragraph 3.11.6(b).

## Fix

Change the text of 3.11.2 to read:

The effect of this condition is to adjust allowances where the actual percentage of Gross Load Related Expenditure provided by Specific Customer Funded Reinforcement during the Price Control Period falls outside the Specific Customer Funded Reinforcement Percentage Band and ~~either this is not justified by~~

- (a) the licensee has not adequately explained why the actual percentage of Gross Load Related Expenditure provided by Specific Customer Funded Reinforcement during the Price Control Period falls outside the Specific Customer Funded Reinforcement Percentage Band; or
- (b) the licensee has justified that an adjustment is required,

unless this has already been funded by other Load Related Expenditure mechanisms in the Price Control Period.

## Issue

The circumstances under which the Authority may modify allowances under this condition (paragraph 3.11.9) do not allow Ofgem to take account of information provided to it under 3.11.7 and 3.11.8.

The same paragraph also does not allow Ofgem to take account of allowances that have already been reduced via the various load allowance adjustment mechanisms that operate at the end of RIIO-ED2.

## Consequence

The wording on 3.11.9 means that it is not clear that Ofgem is able to take account of the DNOs' evidence in deciding whether an adjustment can be made.

This could result in allowance adjustments being made in inappropriate circumstances. For example, the current wording of 3.11.9 would allow Ofgem to modify allowances in circumstances where a material change in connections funded proportion arises due to a change in work mix (such as a reduction in EHV general reinforcement being offset by an increase in connections related reinforcement) even if the net costs were unchanged.

## Fix

The wording of 3.11.9 needs to be better articulated to explain the circumstances that we think Ofgem has in mind. One option might be:

After the Price Control Period the Authority may modify the value of NGLREt where:



- the Actual Percentage of Gross Load Related Expenditure has fallen outside a Specific Customer Funded Reinforcement Percentage Band;
- either
  - the licensee has not adequately explained why the actual percentage of Gross Load Related Expenditure provided by Specific Customer Funded Reinforcement during the Price Control Period falls outside the Specific Customer Funded Reinforcement Percentage Band; or
  - the licensee has justified that an adjustment is required; and
- allowance adjustments have not already been made for the relevant Load Related Expenditure under Part K of Special Condition 3.2 (Uncertain Costs Re-openers) or through Special Condition 3.9 (Load Related Expenditure volume drivers) or [words to capture other end of RIIO-ED2 load closeout modifications see section A above].

### Issue

Sub paragraph 3.11.7(b) is written asymmetrically. It only considers the circumstances where connecting customers fund a greater proportion of Load Related Expenditure, and does not consider the circumstances where connecting customers fund a lower portion.

### Consequence

As drafted, it could be inferred from this sub paragraph that adjustments would only be expected if connecting customers have funded a greater proportion of Load Related Expenditure. Our understanding is that this mechanism would be expected to operate symmetrically.

Additionally, as Ofgem's decision to not include the additional costs associated with the outcome of the Access SCR for several years of the Price Control Period means that it is expected that connecting customers will pay a lower proportion for many projects, it also means that Ofgem has not required the information that is likely to be needed to explain any material change in the customer funded proportion.

### Fix

In section 8, we propose that paragraph 3.11.7 should be amended to remove the sub paragraphs to prevent an obligation being introduced that DNOs would be unable to comply with. That change would also resolve this issue.

However, if Ofgem opts to resolve the issue in section 8 using a different solution, sub paragraph 3.11.7(b) should be expanded to

reasons why reinforcement that was forecast to be funded through Load Related Expenditure at the outset of the Price Control Period has in fact been delivered through Specific Customer Funded Reinforcement or vice versa.

**H Submission requirements include some aspects that DNOs may be unable to comply with and others that do not have any clear role in Ofgem's allowance setting process**

### Issue(s)

The submission requirements for both the Load Related Expenditure Re-opener and the net to gross Load Related Expenditure adjustment need more consideration.

There are examples in both mechanisms of:

- Requirements that DNOs will be unable to meet because Ofgem has not provided sufficient detail of the assumptions made at FD; and
- Requirements that would be onerous to comply with without any clear benefit to or role in Ofgem's assessment of the allowance adjustment.

For example:

- SpC 3.11 does not set out the Gross Load Related Expenditure or the Specific Customer Funded Reinforcement values that are assumed in each DNO's baseline percentage of Gross Load Related Expenditure. Furthermore, it is unclear how the allowances for Access SCR costs have impacted the values. DNOs will need details of these in order to explain any material variance between actual and baseline assumptions. These should be added as appendices to SpC 3.11 so that they are readily accessible to DNOs for any 2028 reporting.
- 3.11.7(a) requires DNOs to provide a detailed explanation for any changes in the number of connection projects involving Specific Customer Funded Reinforcement relative to expectations at the start of the Price Control Period. This level of required explanation is not available to DNOs as it relates to customer behaviours. DNOs can provide the data about numbers of connections projects, but won't necessarily be able to explain why customer behaviour has changed.
- 3.11.7(b) requires DNOs to provide details of "why reinforcement that was forecast to be funded through Load Related Expenditure at the outset of the Price Control Period has in fact been delivered through Specific Customer Funded Reinforcement". However, DNOs can only provide this information if Ofgem provides details of the individual projects that it has assumed will be undertaken and which would be associated with connections in its FD allowances.
- 3.11.7(c) requires the DNO to provide details of changes in the licensee's use of contractors. We recognise that insource/ outsource decisions change the direct/ indirect cost boundary and therefore the level of gross LRE costs. However, without details of which activities Ofgem assumes are insourced or outsourced at FD, it is impossible for DNOs to quantify the effect of this on the Actual Percentage of Gross Load Related Expenditure. We also do not know how Ofgem would reflect this data in any allowance adjustment calculation.
- The requirements in appendix 9 of the RIIO-2 Re-opener Guidance and Applications Requirements are unclear about the level of data required for projects that will have already been undertaken. The submission requirements seem more suited to projects that are yet to commence. It is also unclear whether the requirements relate to all proposed projects (including those for which Ofgem has already been provided with EJPs) or just for new projects that materially contribute to the scope of the re-opener request.
- Appendix 9 of the RIIO-2 Re-opener Guidance and Applications Requirements requires DNOs to provide EJPs for secondary activities. As many secondary network activities will fall within the scope of the volume drivers, this requirement seems onerous for what may be an immaterial amount of expenditure.

### Consequence

The drafting of SpC 3.11.7 could result in a DNO's inability to provide data being deemed a breach of its licence.

In the case of the Load Related Expenditure Re-opener, the inability to provide the required data could potentially cause a re-opener request to be inappropriately disallowed or delayed.

The requirement to provide data that will not be helpful to Ofgem's analysis causes unnecessary costs to be incurred that consumers will ultimately share.

### Fix

More work is required to consider (a) what data Ofgem will require and (b) provide DNOs with more information about Ofgem's own assumptions at FD to allow them to comply with the requirements.

If SpC 3.11 is modified into the licence, the wording of paragraph 3.11.7 should be amended to prevent an obligation being introduced that DNOs would be unable to comply with (with all sub paragraphs removed):

Where the licensee's Actual Percentage of Gross Load Related Expenditure has fallen outside its Specific Customer Funded Reinforcement Percentage Band, the licensee must include a detailed explanation in the report required by paragraph 3.11.6 of factors relevant to the Actual Percentage of Gross Load Related Expenditure falling outside the Specific Customer Funded Reinforcement Percentage Band.

Further discussions should be held between DNOs and Ofgem during the Price Control Period to further agree submission requirements for both the Load Related Expenditure Re-opener and any report required under paragraph 3.11.6. Modifications to Appendix 9 of the RIIO-2 Re-opener Guidance will be required to achieve this, but we believe that these can be made during RIIO-ED2 provided that the modifications are made adequately prior to the first LRE Re-opener window. We include a number of examples of changes that are required to the RIIO-2 Re-opener Guidance document in our issues log.

### **I Legal status of documents/ modifications has not been consistently implemented, and document hierarchy is unclear**

#### Issue(s)

We recognise that Ofgem proposes changes to the legal status of some of the various documents or modifications associated with the suite of Load Related Expenditure uncertainty mechanisms from those previously consulted on. DNOs have different views on the acceptability of the proposed legal status changes and will share concerns directly. Without prejudice to some DNOs' views that the status should not change, the following issues relate to the enactment of the proposed change:

The change in legal status has not been enacted consistently across all documents. For example:

- SpC 3.9 sets out that the Load Related Expenditure Volume Drivers Governance Document has the status of a licence instrument that is part of SpC 3.9 (i.e. suggests it has the status of a licence condition), whereas paragraph 1.5 of the RIIO-ED2 LRE Volume Drivers Governance Document sets out that "this Governance Document is subordinate to the licence"; and
- Para 2.17 of the RIIO-ED2 LRE Volume Drivers Governance Document sets out that the LRE Volume Drivers Workbook "forms part of this LRE Volume Drivers Governance Document", suggesting that it also has the status of a licence condition. However, the same paragraph also states that it "will form part of the RRP's", suggesting that it therefore has the status of an Associated Document (i.e. a RIG)

The suite of documents does not set out the legal hierarchy between the various documents that should be followed in the event of a conflict between documents.

No guidance has been provided on the population of the LRE Volume Drivers Workbook or the timing of any required data submissions. Ofgem has indicated that this will be made available to the DNOs at the same time that the modification notices are published. This will, therefore, not be available in time to allow DNOs to consider whether the LRE Volume Drivers Workbook is acceptable as a document that may have the status of a licence condition. DNOs should be given a proper opportunity to review and comment on that draft guidance prior to modification notices being published.

No change has been made to the definition of Associated Document to remove the volume driver documents for the scope of that term.

### Consequence

The inconsistency in articulation of the legal status of the various documents creates confusion about the status of the various documents, the process that would need to be followed to modify them and any appeal rights that would be afforded at any future modification.

The lack of a formal hierarchy means that we cannot fully assess the impact of the conflicts between the various documents that we have identified to date or any that are identified at a future date.

The LRE Volume Drivers Workbook requires data that DNOs have not routinely reported. It may be subject to differences in interpretation. This could result in different allowance adjustments being applied for different DNOs simply because of differences in interpretation.

### Fix

Confirm intended legal status of the various documents making up the suite of Load Related Expenditure uncertainty mechanisms, and draft consistently in all documents.

Include a formal legal hierarchy between the various documents, following the style used for the equivalent hierarchy in the PCFH (PCFH para 1.5). The scope of this hierarchy list should include SpC 3.2, SpC 3.9, SpC 3.11, Load Related Expenditure Volume Drivers Governance Document, RIIO-2 Re-opener Guidance and Application Requirements Document, LRE Volume Drivers Workbook, PCFM, Associated Documents including the PCFM Guidance, RIIO-ED2 Final Determinations.

Provide detailed guidance on how the LRE Volume Drivers Workbook is to be populated by DNOs. If the RIIO-ED2 LRE Volume Drivers Workbook is to have the status of a licence condition, the associated guidance must be available in time for DNOs to make a formal decision about the acceptability of the new condition.

If any of the various volume driver documents are to hold the status of a licence condition, explicitly remove the relevant documents from the scope of the defined term “Associated Document”, following the approach used for ED2 Price Control Financial Instruments.

## **J The scope of activities to be included within the volume driver remains unclear**

### Issue(s)



The drafting of the volume driver still is not clear as to whether connections are included or excluded. Likewise, it doesn't actually say that the relevant volumes must be within the scope of Load Related Expenditure (e.g. for circuit installed).

In the issues log, Ofgem says this has been clarified but we cannot see where this has occurred.

The scope is implied by virtue of the RRP data sheets that are referred to in the RIIO-ED2 LRE Volume Drivers Governance Document, but the wording doesn't actually limit the volumes to those activities.

### Consequence

There remains scope for differences in interpretation of the scope of this condition. Consequently, there is also scope for differences in interpretation of the scope of the Load Related Expenditure Re-opener.

### Fix

SpC 3.9 should explicitly set out the scope of the volume driver. For example:

The scope of the condition is confined to the activities set out in Appendix 1 and Appendix 2 of SpC 3.9 that are associated with the delivery of CV2 secondary reinforcement activities (as further defined in the RIGs).

### **K Incorporation of flexibility services into SpC 3.9 is ambiguously implemented, and contradicts some of the calculations in the LRE Volume Drivers Workbook**

The allowance calculations to incorporate flexibility services into the volume driver are not clearly written, are contradictory between SpC 3.9 and the RIIO-ED2 LRE Volume Drivers Workbook and can be subject to different interpretations.

DNOs discussed the confusion with the drafting of allowance adjustments related to flexibility services with Ofgem during the load policy meeting on 10 January 2023. Ofgem agreed to particularly revisit this area of drafting to ensure that it is aligned with policy intent.

### Issue

We understand from slide 3 of Ofgem's slide deck for 10 January meeting that "Flexibility ex ante allowances sit outside of the secondary reinforcement volume driver and therefore will not be automatically adjusted down."

Without prejudice to the fact that not all DNOs agree with this policy, if ex ante allowance are not to be included within the opening variant load values, the policy creates a mis-match between the allocation of ex ante allowances and the operation of SpC 3.9.

The formula at paragraph 3.9.4 calculates the full allowance for flexibility services, and neither checks whether the original ex ante allowance has been exceeded nor removes the ex ante funded allowances from the amount allowed through the volume driver.

## Consequence

The effect of this is to double count the ex ante allowances for flexibility services in both non variant load allowances and the recalculated volume driver allowances.

## Fix

If flexibility services ex ante allowances are to be included in non variant allowances, with any further allowances provided only once the total (recalculated) flexibility services allowance exceeds the allowance provided ex ante, consequential changes should be made to SpC 3.9.

## Issue

The algebra in SpC 3.9 used to calculate the unit cost for flexibility services contracts contradicts the calculations in the LRE Volume Drivers Workbook. For example:

- SpC 3.9 sets out that the unit cost calculation uses WACC for year t (presumably the year in which the flexibility contract commences) and sets out that WACC is defined in the PCFH (which will calculate different annual WACC values) whereas the LRE Volume Drivers Workbook is populated with just one WACC value that is used in all years of RIIO-ED2.
- SpC 3.9 provides no constraint to the forecast number of years of reinforcement deferral, whereas LRE Volume Drivers Workbook seems to constrain the maximum number of deferral years to 5 years.

## Consequence

It is unclear whether the algebra for calculating flexibility services unit costs in SpC 3.9 or in the RIIO-ED2 LRE Volume Drivers Workbook should be followed to calculate allowances associated with flexibility services.

## Fix

To address the difference in how WACC is applied to unit cost calculations:

- We assume that the annual WACC values calculated via the PCFH methodology should be used to calculate unit costs. With the WACC for the year in which the flexibility contract commences being used to calculate the unit cost (i.e. no need to forecast future changes in WACC – because the investment decision would be made based on the prevailing WACC).
- To achieve this, no change is needed in SpC 3.9, but the RIIO-ED2 LRE Volume Drivers Workbook would need to be evolved to
  - include 5 cells that would be populated with the annual WACC values for each year (to align with PCFH);
  - replicate the flexibility unit cost calculations (currently cells K89: O95) to create 5 annual sets of unit costs (so all unit costs for flexibility contracts let in 2023-24 would be based on the 2023-24 WACC, etc); and
  - update the formula for the unit cost calculations to point to the annual unit costs.

To address the difference in the definition of the number of years deferral that can be included in the unit cost calculation:

- Confirm Ofgem's policy intent here.
- Ensure that both SpC 3.9 and the RIIO-ED2 LRE Volume Drivers Workbook implement that policy in an internally consistent manner, either by adding additional "Contract length"

columns/ different formulaic structure in the RIIO-ED2 LRE Volume Drivers Workbook or by amending the definition of “n” in SpC 3.9.

#### Issue

It is not clear in SpC 3.9 nor the RIIO-ED2 LRE Volume Drivers Workbook whether a flexibility contract that runs for a number of years should only be counted once, presumably in the first year of the contract, or in each year that the flexibility contract is put in place.

#### Consequence

Different interpretations could lead to the unit cost for any one project being allowed multiple times.

#### Fix

This should be clarified in the RIIO-ED2 LRE Volume Drivers Governance Document, ensuring that the “counting” of any contract is applied internally consistently with the calculation of the associated unit cost.

#### Issue

No reporting mechanism has been provided in the RIIO-ED2 LRE Volume Drivers Workbook to capture the data required by paragraph 5.8 of the RIIO-ED2 LRE Volume Drivers Governance Document (reporting of information for each asset where flexibility has been used to defer investment).

#### Consequence

As this data will be required to be captured from 1 April 2023, and data capture systems put in place to achieve this, DNOs need sight of Ofgem’s proposed format in order to capture data in the required format.

#### Fix

Ofgem should provide DNOs with sight of any standard reporting requirements and guidance as soon as possible.

If this data is to be reported in the RIIO-ED2 LRE Volume Drivers Workbook, the reporting requirements and associated guidance would need to be incorporated in time for the early February modification notice being issued. Otherwise, a full licence modification process would be required to incorporate the additional requirements would not fall within the self-modification rules set out in Part C of SpC 3.9.

### **L Important wording changes needed in the description of the circumstances under which a Load Related Expenditure Re-opener adjustment may be made**

#### Issue

Sub paragraph 3.2.77(g) inappropriately requires DNOs to submit evidence “including evidence of the efficiency of the Load Related Expenditure”.

Similar wording is included in paragraph 3.19 of the Re-opener Guidance and Application Requirements Document which requires the submission of “evidence to justify why the level of costs is efficient”.

### Consequence

DNOs have had considerable discussion with Ofgem at LDWG regarding the fact that such a requirement is not appropriate, for example it is very likely that there will be situations where it is difficult to show independent evidence or conduct analysis to prove that the modification to allowances is efficient which Ofgem have accepted and rectified in all other places. (An example relevant to the Load Related Re-opener is that DNOs would be unlikely to be able to provide evidence of the efficiency of expenditure associated with increased New Transmission Capacity Charges as the costs would be incurred by the relevant Transmission Licensee).

As a consequence, such wording remaining in the condition could lead to a re-opener application being inappropriately disallowed.

For all other Parts of SpC 3.2 such wording (or equivalents) has been removed by Ofgem.

### Fix

In line with other Parts of SpC 3.2, this requirement should be removed. This would leave paragraph 3.2.77(g) reading:  
provides such detailed supporting evidence as is reasonable in the circumstances

The second sub bullet of paragraph 3.19 of the Re-opener Guidance and Application Requirements Document should be amended to read  
why the level of costs is efficient. Please note, the efficient level of costs will be determined at the time of any determination of a Re-opener application.

The RIIO-2 Re-opener Guidance already defines specific requirements for submissions.

### Issue

Sub paragraph 3.2.75(c) sets out that one of the criteria to be met for the Load Related Re-opener to be used is that the expenditure “is not provided for by ex ante allowances”.

This wording is too loose.

### Consequence

This requirement could potentially be incorrectly interpreted to refer to all totex ex ante allowances or all Load Related Expenditure allowances.

Also, given that DNOs may have previously had allowance adjustments made under the re-opener, it is not clear that it includes any allowances previously made under the Load Related Re-opener (which could have awarded ex-post allowances for some years).

### Fix

Sub paragraph 3.2.75(c)(i) should be amended to read



is not provided for by the sum of (a) ex ante allowances for activities within the scope of the Load Related Re-opener (as set out in Appendix X) plus (b) any previously directed values of  $LRE_t$ .

**M Amendments to the various transmission connection point charges definitions have fundamentally changed the boundary between Load Related Expenditure and Pass-through in a way that is not consistent with our understanding of Ofgem's policy**

### Issue

Ofgem's definitions of New Transmission Capacity Charges and Transmission Connection Point Charges have fundamentally changed the boundary between pass-through and Load Related Expenditure compared to RIIO-ED1.

The RIIO-ED1 equivalent terms (New Transmission Capacity Charges, Pass-through Transmission Connection Point Charges, Transmission Connection Point Charges) limited the portion of Transmission Connection Point Charges that was included with Load Related Expenditure to those aspects that are (in whole or in part):

- a) energised after the start of the price control; and
- b) pursuant to a requirement of the licensee for the provision of new or reinforced connection points between the GB Transmission System and the licensee's Distribution System.

All other Transmission Connection Point Charges were funded via pass-through.

The wording of the RIIO-ED2 definitions does not include any equivalent parameter to limit the costs to fall within Load Related Expenditure to those arising due to the DNO requesting a new or reinforced grid connection point. It would, for example, include Transmission Connection Point Charges due to all TO assets that are replaced due to age/condition and energised during in RIIO-ED2.

The RIIO-ED1 defined terms also included the wording "in whole or in part" allowing that, pursuant to a DNO's requirement for a reinforced grid connection point, where the TO identifies the need to replace existing assets – and where those assets are not reinforced – it is only the assets that are either new or reinforced that are included within Load Related Expenditure. Ofgem's proposed use of "projects energised" would result in the costs associated with all impacted assets being treated as Load Related Expenditure.

### Consequence

This is a fundamental change in policy that was not signalled by Ofgem.

Changes in Transmission Connection Point Charges due to TO initiated work, or where the assets are not for a new or reinforced connection point, would not meet the scope of the Load Related Re-opener in 3.2.75, leaving DNOs exposed to the full cost of meeting these costs (as no ex ante allowance has been made for those aspects of Transmission Connection Point Charges at FD). This would clearly be an unacceptable situation.

Given that Ofgem did not signal this change and no allowances have been provided, we think it is probable that the effect is unintended.

### Fix

Assuming that this change is unintended, changes are required to the RIIO-ED2 defined terms to set the boundary between Load Related Expenditure and pass-through back to the RIIO-ED1 boundary.

Amend the wording of the new ED2 terms to read

- Transmission Connection Point Charges: "means the sum of: (a) charges payable by the licensee that are levied by a Transmission Licensee as connection charges by direct reference to the number or nature of connections between the licensee's Distribution System and the GB Transmission System, and includes any associated Transmission Use of System Charges and any Remote Transmission Asset rentals payable by the licensee; and (b) charges payable by the licensee to another Electricity Distributor in respect of units transported from that Electricity Distributor's Distribution System; less any charges under (a) and/or (b) that meet the definition of New Transmission Capacity Charges"
- New Transmission Capacity Charges: "means those elements of Transmission Connection Point Charges that are attributable (in whole or in part) to connection assets first becoming energised on or after 1 April 2023 pursuant to a requirement of the licensee for the provision of new or reinforced connection points between the GB Transmission System and the licensee's Distribution System."

### **N The scope of the review of the LRE Volume Drivers during RIIO-ED2 introduces regulatory uncertainty during the early years of the Price Control Period**

#### Issue

DNOs recognise that the LRE Volume Drivers are new mechanisms for RIIO-ED2 and agree that it is sensible to review their effectiveness after a few years' operation.

The scope of the review of LRE Volume Drivers that is set out in chapter 5 of the RIIO-ED2 LRE Volume Drivers Governance Document is currently only defined at a high level. More work will be required during the early years of RIIO-ED2 to define the scope of this review more closely. We accept that the scope will be informed by the experience of operating the volume driver mechanism during the first few years of RIIO-ED2 and note that any changes that arise as a result of the review will be subject to the statutory modification process set out in S11A of the Electricity Act 1989.

The expectation that SpC 3.9 may be modified during RIIO-ED2 creates some uncertainty regarding how allowances may be calculated for activities undertaken during the first years of RIIO-ED2. In particular:

- Chapter 5 of the RIIO-ED2 LRE Volume Drivers Governance Document does not make it clear that the any modifications that arise as a consequence of the review will only apply going forward i.e. for Regulatory Years after the review has concluded. The chapter could be read as posing a risk of retrospective modifications to the licence. Our understanding, based on Ofgem's response to issues log entry 133, is that any changes that arise as a consequence of the review would not act retrospectively.
- The phrasing of the second bullet of paragraph 5.7 could be read to suggest that one outcome of the review might be reductions in the caps that apply to the volume drivers. Any such reduction could result in expenditure that DNOs had expected to be funded via the volume driver no longer being funded. We do not believe that Ofgem intends that the

review could reduce the caps, i.e. this aspect of the review would only allow for increases to the caps.

### Consequence

The potential for changes to be made as part of the review of LRE Volume Drivers that could affect allowances for activities undertaken during the first years of RIIO-ED2 undermines regulatory certainty and could result in delays to investment during the early years of RIIO-ED2.

### Fix

An additional paragraph should be introduced in chapter 5 of the RIIO-ED2 LRE Volume Drivers Governance Document (as a new paragraph 5.6) setting out that:

Any changes agreed as a result of the review of LRE Volume Drivers will be enacted on a forward-looking basis. No changes will be made to allowances for volumes that have already been delivered.

An additional sentence should be added to the second bullet of paragraph 5.7 of the RIIO-ED2 LRE Volume Drivers Governance Document setting out that:

No reductions to the volume driver caps will be made as a result of the review of LRE Volume Drivers.

Additionally, discussions will be required between Ofgem and DNOs during RIIO-ED2 to further refine the scope of the review of LRE Volume Drivers. The outcome of these discussions may require changes to the RIIO-ED2 LRE Volume Drivers Governance Document. It is possible that the changes to the scope of the review may need to be made under S11A of the Electricity Act 1989.