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Date

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Dear Joanna,

**RIIO-ED2 Statutory Consultation on proposals to modify the Special and Standard Conditions within the distribution licences held by SPEN**

This response is from SP Energy Networks (SPEN). SPEN owns and operates the electricity distribution networks in the Central Belt and South of Scotland (SP Distribution plc) which serves approximately two million customers, and North Wales, Merseyside, Cheshire and North Shropshire (SP Manweb plc) which serves approximately one and a half million customers. We welcome the opportunity to respond to the RIIO-ED2 Statutory Licence Drafting Consultation (the Licence Consultation) which follows our active participation in Ofgem RIIO-ED2 workshops, Licence Drafting Working Groups (LDWGs) and bilateral discussions.

On 27th October 2022 we provided a detailed response to Ofgem's informal consultation on the draft RIIO-ED2 Licence which was published 29th September 2022. That response listed over 300 issues covering various aspects of the proposed RIIO ED2 licence. We are pleased to see that many of those issues have been addressed. However, many issues remain and new ones have also emerged as a result of new detail in the licence drafting and population of the licence instruments and Associated Documents.

Given the volume of issues and the sheer scale of documentation published, where the issues relate to Associated Documents that are not subject to the licence modification time schedule, we would urge Ofgem to take more time to get these documents right and not necessarily publish these alongside the licence modification decision in February. Topic specific Working Group sessions should be arranged to allow the drafting to be improved in time for the start of RIIO-ED2. It is important that the issues identified are worked through effectively and are satisfactorily resolved to ensure that the final RIIO-ED2 suite of documents work together to deliver the intended policy in a way that is clear to all reading the documents and does not cause unintended consequences.

We have raised c.250 issues in the attached issues logs and attached 8 separate appendices. However, we would like to specifically highlight the issues below which we believe will either have a significant

financial impact on DNOs, cause unnecessary regulatory burden and confusion, or in some instances hinder the DNOs ability to help facilitate Net Zero. These can be grouped into the following broad categories:

1. Load related expenditure (LRE) conditions
2. Reopeners
3. Cost Assessment process
4. Finance
5. Allowance adjustment processes
6. Other deliverables

The issues raised and comments provided in this response to the RIIO-ED2 Statutory Consultation are given to enable Ofgem to make the necessary changes to the final licence changes and with a view to working with Ofgem to ensure that this publication, including its Associated Documents, operates fairly, consistently, transparently, proportionately, and cohesively. However, our comments are made entirely without prejudice to SPEN's rights of appeal, including those under the Electricity Act 1989 (EA89).

## 1. Load Related Expenditure (LRE) conditions

Ofgem has set out one of its objectives of the LRE mechanisms as “ensuring the networks are not a blocker to net zero by having sufficient funding to invest in network capacity and that low carbon technologies do not face installation or operational delays”. As part of our response to Ofgem's informal consultation on the draft RIIO-ED2 Licence, we submitted a c.30 page appendix of detailed changes that SPEN and all other DNOs believed were necessary in order for this objective to be realised.

Although the quality of drafting of the LRE conditions and associated guidance documents has improved since the informal consultation, a number of issues remain unresolved and some new issues have been introduced. Some issues also interact with each other, exacerbating the issue, meaning that the changes needed to resolve them are complex to enact. We welcome the fact that, when this updated set of issues was discussed with DNOs on the 10th January 2023, Ofgem acknowledged that it understands and agrees in principle with many of the issues. We call on Ofgem to ensure that the changes discussed are implemented in the final version of the licence and Associated Documents.

Appendices 1a and 1b contain the list of current issues and recommendations as drafted and agreed consistently across all DNOs. It is vital that this 'toolkit' of LRE conditions within the licence operate correctly together in the RIIO-ED2 period to enable DNOs to be responsive to changing network demand and avoid any risk of unfunded obligations or double-counted adjustments.

Within this toolkit, volume driver UMs will be essential in managing uncertainty at the lower voltage levels, which are driven by programmes of work rather than discrete projects of higher value. Given the need to make these 'automatic' to support companies, they must be explicitly linked to a unit cost allowance. This cost must be reflective of the work being undertaken and latest market data, given the inherent uncertainty ahead. We therefore believe it is essential that these are kept under review throughout the RIIO-ED2 period.

In addition, the administration of the LRE volume drivers set out in the LRE Volume Driver Governance document and associated workbook, will play a central role in enabling DNOs to invest confidently without the risk of clawback where activity is justified. The scale of activity means that administration of the volume drivers must not become overly burdensome whilst recognising interactivity with challenges around LCT notifications, the rollout of substation monitoring, and changes in underlying demand. As DNO performance in relation to the volume driver 'check metrics' in these areas may trigger an Ofgem decision to withhold some or all of DNO expenditure, it is vital that the operation of these metrics are kept under review throughout the period. This is particularly important as these metrics are new and untested.

## 2. Re-openers:

The RIIO-ED2 period faces unprecedented levels of uncertainty, and the new regulatory framework has been designed to manage this in part via 16 reopeners and 24 reopener windows. It is essential that robust processes and adequate resources are in place to ensure these reopeners operate smoothly. Lessons should also be learned from the Transmission sector which is 2 years ahead of Distribution as we are aware Ofgem has already experienced resourcing challenges in this area.

### 2.1. Starting points

Most of the re-openers in SpC 3.2 require that the DNO provides evidence that the allowances being applied for are not included within ex ante (non-variant) allowances that are provided in the Final Determination. However, the values that DNOs need to consider cannot be inferred from the cost assessment output files that Ofgem has shared with DNOs, so we believe that the relevant ex ante allowance values for each re-opener need to be formally recorded and provided by Ofgem. Further detail can be found in Appendix 2.

### 2.2. Efficiency requirements

Each of the eleven DNO-instigated reopeners which can be modified by direction now specify that a modification will only be made "where the modification to allowances is efficient". As Ofgem is aware, in the RIIO-T2 CMA appeal, the CMA confirmed in their Final Determination that, in order for a licence condition which permits "self-modification" to be lawful, the condition must specify the (a) time, (b) manner and (c) circumstances in or under which a modification can be made.

No detail is provided in the condition as to the methodology which Ofgem will apply when assessing "efficiencies". This should be expanded upon in the drafting of the licence condition itself to ensure it meets the requirements of section 7(5) EA89 and to ensure licensees can understand how Ofgem will make this efficiency assessment. Where it is not possible for Ofgem to provide the required clarity in the licence drafting, the self-modification power should be removed so that any modification to the licence needs to be by way of statutory modification under s.11A of the EA89.

We have a particular concern about this in relation to the OT and IT Cyber Reopeners. As with the other Reopeners, no detail is provided in the licence conditions as to how the "efficiency" assessment provided for at SpC 3.2.49(f) and SpC 3.2.57(f) respectively, will be conducted. We consider that it would not be possible for Ofgem to add the required level of detail into the licence drafting for these

Ofgem has responded to these concerns raised in a SQ by referring to Appendix 4 to the RII0-2 Reopener Guidance and Application Requirements Document but this information is about the detail required from licensees, rather than setting out any details about Ofgem's assessment processes. The fact that Ofgem instigated re-openers will now be made under s11A of EA89 is welcome, but does not address the issue in relation to licensee triggered reopeners. The self-modification powers in these reopeners should therefore be converted to statutory modification under s.11A EA89.

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Ofgem's Cost Assessment process has materially improved since RIIO-ED1, and SPEN have been a strong supporter of the Cost Assessment process developments which have been discussed and

debated throughout the RIIO-ED2 price control process and via the Cost Assessment working groups. Whilst the Cost Assessment working groups were extensively attended, and the theory and application was debated, it was not possible for DNOs to understand the full results of the Cost assessment process that Ofgem applied, or some of the implications of the interplay with regulatory mechanisms which were being developed as part of other working groups, until the algebra was fully outlined within the FD and the licence drafting which is currently being consulted upon. Having now had the chance to undertake that assessment of Ofgem's final decision, we have identified several areas where we consider Ofgem to have made errors in the cost assessment process which need to be corrected before the final licence modifications.

### 3.1. EV optioneering allowance

Via the SQ process, we made Ofgem aware that we were unable to understand the basis of the c.30% reduction in the value of EV Optioneering UIOLI set in our licence, compared to that submitted in our business plan. Ofgem provided an explanation and we can now understand some of the reduction is a result of a conversion of Gross to Net and efficiency challenges, another part was a result of an error in the PCFM interface file, but we still believe that 19% of the reduction is an error. Ofgem indicated that it has adjusted this allowance for 'Non Price Control Allocation'. Such an adjustment would indicate that these costs are funded elsewhere eg customer funded or innovation. We do not believe this to be the case so would request the 19% reduction is removed.

### 3.2. MEAV methodology

At Draft Determination (DD), SPEN were encouraged to see developments had been made to the MEAV calculation approach since RIIO-ED1, which recognised enhancements and improvements in data quality during RIIO-ED1. As of Final Determination, SPEN were disappointed to see that the MEAV calculation has been amended since DD and now excludes certain Protection Asset categories (Batteries, and Pilot Wire). SP Manweb (SPMW) have the largest proportion of these assets, and are therefore the most affected DNO, though Ofgem did not engage or consult with SPEN on this change prior to FD. We note Ofgem state this change was partly made due to comments received from NGED (FD, para 7.118), but also note this DNO group is least impacted.

In the FD, Ofgem give two reasons for the exclusion of Battery and Pilot Wire assets: data quality issues, and for consistency with SPMW special factor adjustments. In DD, Ofgem amended their RIIO-ED1 approach by including Rising and Lateral Mains, and Protection Assets on the basis that data quality issues should have been resolved (DD, para 7.119). SPEN strongly supported these changes as it demonstrates an overall improvement and increased accuracy within the MEAV calculation, even in the case where some DNOs have less precise data for these asset classes. However, at FD Ofgem has removed the protection asset classes, in part due to concerns on Data Quality following feedback received from NGED (FD, para 7.120).

SPEN are confident of sufficient data quality for these asset types, consistent with the type and level of information held on other NARM and Non NARM Asset classes within the MEAV calculation, and support their ongoing inclusion within the MEAV calculation. We are not aware of Ofgem undertaking any additional engagement to confirm whether any data quality issues actually exist in this area, or any evidence being presented demonstrating that some DNOs continue to have insufficient information to inform MEAV calculations in relation to these asset classes.

### 3.3. Allocation of allowances

For the PCFM and BDPTs for RIIO-ED2 each DNOs' overall "efficient" totex value, must be allocated back to the individual cost tables for the purposes of future price control delivery and reporting. This is done by Ofgem via a cost allocation methodology. We are concerned that Ofgem has adopted a cost allocation approach which is inconsistent with the way it has identified the efficient level of totex (which is ultimately apportioned using the allocation methodology). This has unintended consequences for the levels of allowances awarded in specific areas when considered alongside other Price Control mechanisms such as Uncertainty mechanisms. This inconsistency between two parts of the cost assessment process has resulted in an error in the apportionment of totex as there is a shortfall of totex being apportioned in some areas whilst too much has been apportioned in others. For SPEN, we estimate that this error, if left unchanged, results in a disconnect in our allowances across cost categories worth up to £50m. We are committed to working with Ofgem and the other DNOs to agree on a solution to fix this error ahead of the final licence modifications. Further detail can be found in Appendix 8.

## 4. Finance

### 4.1. SoLR

In RIIO-ED2, Ofgem has removed the Materiality Threshold and licence drafting around SoLR costs in SLC 38B, which allowed us to amend tariffs out with the 15 month notice period for SoLR costs in excess of this threshold, protecting us from significant cashflow risk. Although we understand that we still have the right to apply for a derogation from the 15 month notice period under the DCUSA we believe the proposed ED2 licence drafting increases risk and uncertainty to DNOs as there is no explicit reference to this within the licence and/or no clear process set out anywhere on how the DCUSA derogations process interacts with the SOLR process and wider allowed revenue. Reliance on the DCUSA process only significantly reduces the DNOs protections in this area as the DCUSA can be more easily amended than our licence. We understand this is not Ofgem's policy intent so we do not think this should be a controversial addition to make to our licence.

We believe the drafting that appears in the current SLC 38B should continue to apply during ED2 as this confirms that after receipt of a Valid Claim the licensee has the right to request a derogation to increase its Use of System Charges and there is no threshold to trigger this. In addition, a process should separately be documented to explain the steps involved in both applying for and assessing a derogation request. We welcome Ofgem's issues log response, which agreed that this would be useful and would now urge Ofgem to action this. Further detail can be found in Appendix 3.

### 4.2. RPE inconsistencies

There are inconsistencies in how Real Price Effects (RPEs) are applied to the allowances of certain RIIO-ED2 mechanisms. The inconsistencies specifically relate to how RPEs are reflected in DNOs' actual and forecast costs, which have the potential of leading to a double counting of RPEs within the final RPE allowance modification process in the ED2 PCFM for the relevant allowances. An issue has been identified in 4 areas, specifically: re-openers; Use It Or Lose It (UIOLI) mechanisms and Evaluative Price Control Deliverables (PCDs). Appendix 4 outlines the issue in more detail and provides suggested solutions.

## 5. Allowance adjustment risks:

It is essential that DNOs understand the full suite of regulatory mechanisms and processes whereby Ofgem has the ability to adjust the level of allowances that DNOs receive. We have already set out

specific load and reopener concerns separately, but there are also other areas where we have identified inconsistencies and/or missing detail.

### 5.1. Cyber PCD and UIOLI references

During the overall RIIO-ED2 consultation process, Ofgem considered whether it was appropriate to include a Use It or Lose It (UIOLI) mechanism in respect of the Cyber resilience Price Control Deliverables (PCDs). The outcome was that Ofgem removed the Cyber resilience UIOLI mechanism from both the informal consultation and statutory consultation version of the licence. However, Appendix 4 to the RIIO-2 Price Control Deliverable Reporting Guidance and Methodology Document which covers Cyber Resilience Operational Technology (OT) and information technology (IT) reporting contains references to Ofgem applying a UIOLI mechanism or a form of UIOLI mechanism for PCDs funded under Cyber Resilience OT plans and Cyber Resilience OT Re-opener applications. There is, therefore, a significant conflict between the licence and Appendix 4. This not only causes confusion but also risks double counting between adjustments for PCD non-delivery and adjustments for underspend via UIOLI. Further detail can be found in Appendix 5.

### 5.2. Manifest Errors

There are 4 special licence conditions which give Ofgem the powers to make a licence modification at any time to correct manifest errors. Such modifications would not be required to go through the statutory modification process. Although we can accept the principle of Ofgem having the ability to make obvious, indisputable changes to tidy up the licence, we are concerned that the absence of a definition of manifest errors is a risk to DNOs revenue. We therefore support the inclusion of the following definition which we believe is also being proposed by several other DNOs: "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".

## 6. Other Deliverables:

### 6.1. Smart Optimisation Output

The Smart Optimisation Output outlines that its aim is to promote and enable effective collaboration between the licensee and its local stakeholders and communities, leading to better decision making and more coherent local energy planning. It has two principal deliverables as set out in SpC 9.13 a Part 1 Collaboration Plan and Part 2 System Visualisation Interface. The requirement for these activities has only recently come to light, and there has been very limited discussion on this with no detailed Working Group sessions to ensure that the content of the Guidance document is understood by all DNOs. As it stands, the 'Core requirements' section of the Guidance document could result in very different interpretations from each DNO. Whilst we agree with the purpose, and strategy of the document, we have concerns that the lack of DNO wide discussion, and the unrealistic timescales, could undermine the realisation of the strategy in a meaningful and useful manner.

We firmly believe that Ofgem should not finalise the Guidance document until Ofgem and DNOs have been able to work together to ensure the interface requirements are clearly articulated and understood by all. Once this process is complete, a realistic set of deliverables and deadlines can be set reflecting interactions with other working groups such as the Data and Digitalisation working groups, the Open Networks working groups and publications such as the DSAP. Further detail can be found in Appendix 6.

## 6.2. Polychlorinated Biphenyls (PCBs)

We are pleased that Ofgem has recognised the need to include a RIIO-ED2 regulatory mechanism designed to fund DNOs for the work required to comply with environmental legislation changes relating to certain PCB contaminated assets. However, we believe that the unit cost Ofgem has set out in our licence will not allow us to undertake this activity in a way which is in the best long term interests of our customers. The unit cost allowed is aligned with the cost of installing the smallest size of Pole Mounted Transformer (PMT), whereas our CBA demonstrated that a touch-it-once approach is in the best interest of customers. This approach, when applied to our load/utilisation forecast for each PMT would involve us upsizing a significant amount of the PMTs that require replacement to enable Low Carbon Technologies (LCTs) and avoid early replacement of these assets. Indeed the unit cost set out in the licence will not even fund a like for like replacement in all but the smallest of PMTs. Further detail of our concerns and suggested solutions can be found in Appendix 7.

Where the issues we have raised in this letter will impact the licence, we trust Ofgem will give these due consideration and make changes prior to the publication of licence modification decision. For issues relating to Associated Documents, we are keen to continue working with Ofgem and the other DNOs to develop and improve the drafting for the start of RIIO-ED2. The majority of these documents do not need to be subject to the same statutory time pressures and we believe that it is more important to improve the content than publish at haste.

Yours sincerely,



Stephanie Anderson

Head of Network Regulation and Policy



*Documents included within this submission:*

- *RIIO ED2 Statutory Licence Consultation Response Covering Letter.pdf*
- *Issues Logs (zip folder):*
  - *Special Licence Conditions*
  - *Standard Licence Conditions*
  - *Associated Documents*
- *Appendix 1a – Common Load Conditions FINAL.pdf*
- *Appendix 1b – Common Load condition issues log.pdf*
- *Appendix 2 – Ex ante values and reopeners – FINAL.pdf*
- *Appendix 3 – SoLR - FINAL.pdf*
- *Appendix 4 – RPE inconsistencies FINAL.pdf*
- *Appendix 5 – Cyber PCDs and UIOLIs – FINAL.pdf*
- *Appendix 6 – SOO - FINAL.pdf*
- *Appendix 7 – PCBs – FINAL CONFIDENTIAL.pdf*
- *Appendix 8 – Misallocation of allowances - FINAL.pdf*