

## Appendix 2 - 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.

This document focusses on drafting issues or areas where the policy is unclear with implications for drafting clarity where all DNOs are in agreement. It does not cover aspects of policy that DNOs may disagree with or individual company points. To assist Ofgem in identifying any company specific issues, DNOs have developed a common issues log that captures the commonly agreed issues. Any issues that are not commonly agreed are identified separately in DNOs' individual issues logs.

Where we have identified further, less material issues we will include these in issues logs in our responses to the statutory consultation. This note is, therefore, not an exhaustive list.

**1. 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.
  - 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.

## **2. 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.

**3. 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.

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.

#### **4. 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<sub>i</sub> 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<sub>i</sub> 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:

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

#### **5. 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 the 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.

**6. 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.

**7. 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:

- (a) the Actual Percentage of Gross Load Related Expenditure has fallen outside a Specific Customer Funded Reinforcement Percentage Band;
- (b) either
  - 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; and
- (c) 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 1 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.

**8. 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.

## **9. 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.

#### 10. 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).

#### 11. 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 PCFM);
  - 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.

### **12. 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  $LRE_t$ .

**13. 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."

#### **14. 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 than 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.