

Appendix 8 – Misallocation of allowances

On 17th December 2020, Ofgem published the Sector Specific Methodology Decision (SSMD), including an associated annex (Annex 2) which outlined decisions with regards to the RIIO-ED2 Cost Assessment Methodology. Within this, Ofgem outlines that the document provides limited decisions, and instead directs most decisions to future working group engagement: ‘In our Consultation we set out proposals across several areas relating to our Cost Assessment process. In this chapter we summarise the responses received and our proposed approach. In most areas we are not making decisions at this stage and our Cost Assessment approach will continue to be developed through an ongoing programme of engagement ahead of the submission of the final DNO Business Plans in December 2021’.

Whilst the Cost Assessment working groups were numerous, and well-attended by SPEN and other DNOs, and the methodology and application was debated, DNOs could not foresee the interplay with other regulatory mechanisms which were being developed as part of wider working groups until the detail was articulated fully in the Final Determination (FD) documentation and the Licence Drafting. Therefore, we have only been able to identify the error set out below since the FD and statutory consultation were both available in December 2022.

Cost Allocation at DD and FD

At the end of the Cost Assessment process, the result is one overall totex value, which is an overall level of efficient totex for each DNO for the RIIO-ED2 period. This is the value which will be awarded as ex ante allowances for the RIIO-ED2 period. For publication in the Final Determination and for the PCFM and BDPTs for the RIIO-ED2 Price control period, this 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 via Ofgem’s cost allocation methodology.

At Draft Determination (DD), Ofgem allocated costs equally across all cost tables, which meant that, irrelevant of the level of efficiency or inefficiency at a disaggregated cost table level, all cost tables received the same magnitude of reductions. In SPEN’s case, this reduction was 14% across all tables.

We considered this logic flawed because it did not align with a true representation of the efficient/inefficient cost tables. Over time, this would have resulted in a further deviation from the ‘efficient’ level of costs across all DNOs, which would introduce further deviation in the benchmark level of costs in future price control negotiations. We raised this in our DD consultation response and discussed this during a bilateral meeting with Ofgem on 27th July 2022. We understand that other DNOs also challenged the allocation methodology.

At Final Determination (FD), Ofgem changed the allocation methodology, allocating overall totex to the individual Cost and Volume (CV) tables using a ratio of 50:50 as follows:

- 50% Disaggregated Model output ie allocating 50% of overall totex using the percentage allocation calculated by Ofgem’s ‘bottom up’ cost assessment modelling; and
- 50% DNO plan input ie allocating 50% of overall totex using the percentage split within each individual DNO’s business plan data templates (BPDTs).

Although this change at FD was an improvement on the DD allocation methodology, it has caused a different error. Specifically, this FD allocation rule allocates too much of the overall totex allowances to load related expenditure and a disproportionately low level of totex has been allocated to non-load related expenditure.

The issue

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) and this has unintended consequences for the levels of allowances awarded in specific areas. This inconsistency between two fundamental 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 (non-load) whilst too much has been apportioned in others (load).

This error has arisen as a result of Ofgem taking the following steps:

- 1. Ofgem's Approach to Cost Assessment submission and normalisation:** In their Cost Assessment methodology, DNOs were asked to submit their business plans using the DNO view of Low Carbon Technology (LCT) uptake instead of Ofgem providing a common scenario. Ofgem then normalised these plans by assuming a lower level of LCT uptake based on Ofgem's 'System Transformation' scenario. This reduced DNO totex allowances on the basis that a smaller volume of activity was required and awarded an overall level of "efficient" totex on the basis of System Transformation only.
- 2. Ofgem's approach to cost allocation:** Ofgem has then, as part of the final step in the Cost Assessment process, allocated DNO totex allowances using a 50/50 blend of percentages based on:
 - Ofgem's view of efficient costs per table that were identified under the 'System Transformation' scenario; and
 - DNOs submitted views, which are based on a higher LCT uptake.

By using the DNO business plan submission breakdown at this stage, there is a more significant proportion of allowance allocated to Load Related Expenditure (because DNO plans had requested more allowance here based on an assumption of higher LCT uptake) and a reduced level of totex allocated in other areas that should have received it, like non-load and indirect costs.

The impact

The allocation rule would not have as significant an impact if it wasn't for the interaction with the increased use of uncertainty mechanisms (volume drivers and reopeners) in RIIO-ED2.

- **Volume drivers and variant allowances:** The concept of splitting the PCFM allowances between 'variant' and 'non-variant' pots was only marginally used in RIIO-ED1. In contrast, in RIIO-ED2 a significant amount of load related and PCB expenditure is set via a volume driver mechanism which is classified as a 'variant' in the PCFM. In practice this means that any allowance that is allocated to a variant row of the PCFM at FD, gets overwritten by the actual volumes delivered x Ofgem's efficient unit cost. If Ofgem has incorrectly attributed too much of overall totex into a variant row in the PCFM that should have been allocated to a non-

variant row, then if the variant row gets overwritten by a reduced volume of units then the totex allowance that should have been allocated elsewhere is effectively lost.

- Load reopener and non-variant allowances: DNOs also have allowances for load related expenditure which are marked as non-variant within the PCFM. To manage LCT uncertainty, Ofgem has introduced a Load Related re-opener in RIIO-ED2 which means that if the non-variant load expenditure is spent, DNOs can request further allowance if justified. If Ofgem has incorrectly attributed too much of overall totex into the non-variant row in the PCFM then Ofgem is effectively asking DNOs to spend allowance that should have been allocated to other activities before applying for further allowance under the load reopener. This is at odds with the policy set in the FD.

In summary, Ofgem has set an overall level of efficient totex which has then effectively been reduced in some areas because of the allocation methodology and the interaction with the Uncertainty Mechanisms. If this is left unchanged, it will have an impact across our wider plan. For SPEN, we estimate that this error, if left unchanged, results in a disconnect in our allowances across cost categories by 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.