

Decision on the proposed modifications to the RIIO-ED2 Electricity Distribution standard and special licence conditions

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We are taking three decisions on proposed modifications to the RIIO-ED2 Electricity Distribution licence. These changes are to clarify and, where necessary, correct and remedy, the standard and special licence conditions that were implemented for the electricity distribution network companies to give effect to our RIIO-ED2 settlement.

This document provides an overview of the responses that we received through our consultation as well as our consideration of these responses. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at <u>ofgem.gov.uk/consultations</u>.

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1. Introduction

Section summary

This section summarises what we are deciding on, the different licence conditions and the relevant stakeholders.

What are we deciding on?

- 1.1 Across October and November 2023, we published two consultations on proposed modifications to licence conditions of the electricity Distribution Network Operators (DNOs). We consulted:
 - jointly, on our proposal to make modifications intended to correct errors and generally improve the clarity to the electricity distribution licences; and our proposed approach to our redetermination of allocating NPgN's and NPgY's (collectively NPg's) total modelled costs following the Competition and Markets Authority's (CMA) Order¹ on the Energy Licence Modification Appeal 2023²; and
 - our proposal to remove the Provider of Last Resort (PoLR) provisions in Standard Licence Condition (SLC) 31F (Requirements relating to Electric Vehicle Recharging Points) of the electricity distribution licence³; and
- 1.2 Following consideration of consultation responses, we have now taken a decision in each of the areas.
- 1.3 Chapter 2 outlines our decision on the modifications to the Electricity Distribution Licence, which are intended to correct errors and generally improve the clarity of the licence.
- 1.4 Chapter 3 outlines our decision to remove the PoLR provisions in SLC 31F of the Electricity Distribution Licence (Requirements relating to Electric Vehicle Recharging Points) and the modifications giving effect to that decision.

¹

https://assets.publishing.service.gov.uk/media/650977fca41cc3000d5613d7/21 September 2023 Final Order - RIIO-2 ED2 Appeal - version for publication .pdf

² Statutory Consultation on Modifications to the Standard and Special Conditions of the Electricity Distribution Licence ³ Statutory consultation to modify Standard Licence Condition 31E of the Electricity Distribution Licence L

³ Statutory consultation to modify Standard Licence Condition 31F of the Electricity Distribution Licence | Ofgem

- 1.5 Chapter 4 outlines our decision following our reconsideration in the matter of the allocation of NPg's total modelled costs and the modifications to NPg's licence conditions to give effect to that decision.
- 1.6 The four modification notices are published alongside this decision document.
- 1.7 Within this document we provide an overview of consultation responses and supporting rationale for each of our decisions. Additionally, regarding the modifications which are intended to correct errors and generally improve the clarity of the licence, an issues log is published alongside this document summarising the changes made after the consultation.

Context and related publications

1.8 We are proposing changes primarily to the following electricity distribution network operator licences:⁴

Acronym	Group	Licensees (and acronym)
ENWL	Electricity North West Limited	Electricity North West Limited (ENWL)
NGED	National Grid	National Grid Electricity Distribution (West Midlands) plc (WMID)
Electricity Distribution ⁵		National Grid Electricity Distribution (East Midlands) plc (EMID)
		National Grid Electricity Distribution (South Wales) plc (SWALES)
		National Grid Electricity Distribution (South West) plc (SWEST)
NPg	Northern	Northern Powergrid: (Northeast) plc (NPgN)
	Powergrid	Northern Powergrid: (Yorkshire) plc (NPgY)
SPEN	SP Energy	SP Energy Networks: Distribution (SPD)
	Networks	SP Energy Networks: Manweb (SPMW)

Table 1: List of electricity distribution network operator licenses

⁴ Note that Standard Licence Conditions may apply to licensees other than those listed and some of the Associated Documents published alongside this consultation apply to other network licensees subject to the RIIO Price Control.

⁵ Western Power Distribution (WPD) became part of the National Grid Group following is acquisition in 2021. It was renamed National Grid Electricity Distribution (NGED) from 21 September 2022.

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SSEN	Scottish and Southern Energy Networks	Scottish and Southern Energy Power Distribution: Scottish Hydro Electric Power Distribution (SSEH) Scottish and Southern Energy Power Distribution: Southern Electric Power Distribution (SSES)
UKPN	UK Power Networks	UK Power Networks: London Power Networks (LPN) UK Power Networks: South East Power Networks (SPN) UK Power Networks: Eastern Power Networks (EPN)

1.9 There are two different types of licence conditions to which we are proposing changes. We have summarised these below.

Standard Licence Conditions (SLCs)

- 1.10 SLCs set out the duties and obligations applicable to all holders of a particular type of licence. All electricity distribution licences contain SLCs. The SLCs include some obligations related to Ofgem's performance-based price control model (**RIIO**) that do not adjust allowed revenue.
- 1.11 The SLCs are grouped into different parts/sections that either apply or do not apply according to the activities carried out by the licence holder.

Special Conditions (SpCs)

1.12 SpCs are conditions that apply to a particular licensee. However, the wording is often the same for all licensees of a particular type.

2. Modifications to the Standard and Special Conditions regarding clarifications and corrections

- 2.1 Ofgem became aware of certain issues within the electricity distribution licence following the issuing of new licenses prior to the start of the RIIO ED2 Price Control. Ofgem conducted a series of working groups with industry partners and identified changes required to clarify and correct the licences.
- 2.2 We issued a statutory consultation on 02 November 2023 regarding our proposed changes and stated that responses must be made on or before 30 November 2023. We further extended this deadline to 29 December 2023 to ensure that Independent Distribution Network Operators were given sufficient opportunity to respond.
- 2.3 We received six responses regarding our proposals to modify the electricity distribution licence in order to clarify and, where necessary, correct and remedy, the standard and special licence conditions. Licensees were broadly supportive of the collaborative approach taken by Ofgem and the opportunity they were given to input to these changes.
- 2.4 Respondents suggested a number of improvements and additions to our proposed changes that would further improve the drafting of the licence. We have compiled these responses into an issues log which has been published alongside this decision.
- 2.5 For the majority of issues raised we have agreed with the proposals and have implemented the changes. These new changes that have arisen after the consultation closed can be found as highlighted tracked changes on the Standard and Special Licence Conditions. Any proposed changes which were presented to Ofgem following the consultation which we have decided not to action are fully explained in the issues log.
- 2.6 We have therefore decided to modify the Standard and Special Licence Conditions to make these clarifications and corrections. The reasons for our decision on each modification are set out in the issues log published alongside this decision.

3. Modifications to Standard Licence Condition (SLC) 31F

Section summary

This section summarises the modifications that we are making to remove the PoLR provisions in SLC 31F (Requirements relating to Electric Vehicle Recharging Points).

Context

- 3.1 Ofgem introduced a new licence condition to enact the EU Clean Energy Package (CEP) at the start of 2021. The licence condition is "Standard Licence Condition 31F - Requirements relating to Electric Vehicle Recharging Points". SLC 31F is intended to limit the circumstances in which DNOs can own, develop, manage or operate electric vehicle charge points (EVCPs). It contains two exemptions from the general prohibition which in summary allow:
 - DNOs to own EVCPs to be used by their own fleets eg when DNO fleets become electrified (used only by the licensee in connection with distribution business, ie employee or visitor. Not accessible to the public); and
 - DNOs to operate EVCPs as a backstop where there is no other provider • following a tendering process and no other parties could do so at a reasonable cost or in a timely manner.
- 3.2 In our RIIO-ED2 Draft Determinations (DDs)⁶, we set out our proposal, with options, to manage Electric Vehicle (EV) Provider of Last Resort (PoLR) funding for DNOs. In response to this consultation, we found that the majority of DNOs and stakeholders who responded, questioned the need for EV PoLR provisions within SLC 31F.
- 3.3 In December 2022, we published our RIIO-ED2 Final Determinations (FDs)⁷ in which we decided that the introduction of a funding mechanism for EV PoLR activities was not in the interest of consumers and as such we decided not to include a funding provision for DNOs carrying out an EV PoLR role within the RIIO-ED2 price control. We set out that SLC 31F required further review and stated our intention to consult, in 2023, on whether the EV PoLR provisions contained in SLC 31F should be removed.

 ⁶ <u>RIIO-ED2 Draft Determinations | Ofgem</u>
 ⁷ <u>RIIO-ED2 Final Determinations | Ofgem</u>

- 3.4 In March 2023, we published an informal consultation seeking views on our proposal to remove the EV PoLR provisions in SLC 31F. We received five responses from four DNOs and one stakeholder.
- 3.5 In October 2023, we published a statutory consultation seeking views on our proposal to remove the EV PoLR provisions in SLC 31F. We have taken the responses to our consultations into consideration and have reached our decision.
- 3.6 This decision details the modifications that we have decided to make to the Electricity Distribution Licence in order to remove the EV PoLR provisions from SLC 31F.

Our decision-making process

- 3.7 Following the closure of the statutory consultation on 1 December 2023, we have assessed the feedback provided by respondents. We received eight responses from six DNOs and two stakeholders.
- 3.8 We have outlined the main points raised in stakeholder responses, within the statutory consultation, in the section below. We have also set out our decision in response to those points.

Our consideration of consultation responses

- 3.9 The six responses that agreed with our proposal to remove the EV PoLR provisions from SLC 31F of the Electricity Distribution Licence generally cited that their rationale was unchanged from that set out in response to our informal consultation.⁸ This included SSEN and NGED stating that they agreed with our proposal because there may now be other industry participants better placed than DNOs to act as EV PoLR.
- 3.10 SPEN and one other stakeholder disagreed with the proposal to remove EV PoLR provisions from SLC 31F of the Electricity Distribution Licence:
 - SPEN stated that "In order to meet the 2030 [installed charge points] target a rapid increase in EV charge points is required. There is a need for the EV PoLR backstop role, as an ultimate fall-back option where the market cannot proactively deliver the charging infrastructure needed for the transition to EVs."

⁸ Informal Consultation on removal of the EV PoLR provision from SLC 31F | Ofgem

- SPEN argued that if EV PoLR is left to existing market participants, then government needs to ensure that in any areas of low uptake of EVCPs the market needs to be incentivised to install EVCPs to ensure levelling up happens and that consumers need to have confidence to transition to meet net zero targets. SPEN also stated that it is unclear what the process would be if a local charge point operator were to go into administration and service was not taken up by another market participant.
- One other stakeholder argued that DNOs are the most efficient backstop. They believe that the existence of SLC 31F causes "no harm or offence", and that there is "little rational reason for removing it". They also argue that it is Ofgem's responsibility to prevent and rectify market failures. In addition, they argue that should EV PoLR provisions be removed it would take "significant regulatory effort to invoke a market solution" in the event of market failure.

Our Decision

- 3.11 In forming our decision, we have taken all responses to our statutory consultation into consideration and it is clear that there is strong support for removing EV PoLR provisions from SLC 31F, with six out of eight responses agreeing with our proposal to modify SLC 31F.
- 3.12 We have considered the points raised by SPEN and one other stakeholder, on our proposal to remove the EV PoLR provisions from SLC 31F. We disagree that there is a need for DNOs to act as a fall-back option where the market cannot proactively deliver the charging infrastructure needed to transition EVs.
- 3.13 To date there has been a large amount of government support put in place for EVCPs across the UK:
 - £2.5 billion of government funding has been committed to the EV transition, including £381m through the Local Electric Vehicle Infrastructure (LEVI)
 Fund⁹. The LEVI Fund will ensure local authorities in England have the capacity and skills to deliver tens of thousands of local charge points, benefitting residents without access to off-street parking.

⁹ Local electric vehicle infrastructure fund - Energy Saving Trust

- The government's EV Infrastructure Strategy¹⁰ is aimed at ensuring adequate charge points across the UK.
- New regulations for public charge points have been announced by $OZEV^{11}$. These new regulations aim to help improve EV user confidence in the charging network and subsequently the transition to net zero.
- Government is also supporting local authorities with capability funding to ensure strategies are in place.
- 3.14 Given the various UK Government workstreams, we are satisfied that the necessary support and incentives are available to support local authorities to address areas of low uptake of EVCPs. For this reason, we consider it more suitable for government or local authorities to invoke a market solution in the event of a market failure, if ever considered to be necessary.
- 3.15 We do not consider that DNOs are the most appropriate parties to own, develop, manage, or operate commercial EVCPs at reasonable cost, even as an EV PoLR. DNOs are less likely, than existing market participants, to have the business infrastructure required to successfully develop, manage, and operate commercial EVCPs. For example, in addition to the capital costs associated with developing EVCPs, DNOs would have to provide additional services that they may not currently be equipped to undertake, such as ongoing maintenance (including hardware and software), price setting, and EVCP customer service. These activities would likely see DNOs incur additional costs, which if DNOs were to be assigned as EV PoLR under SLC 31F, would be funded by the GB energy consumer.
- 3.16 We consider that existing market participants are best skilled and resourced to undertake EV PoLR activities, should the need arise. EVCPs are particularly valuable assets not only for their location but also for their backend systems, technology, and grid connections, therefore in the event of a market failure, it is highly likely other market players will acquire these assets and switch them over to their networks. Existing market participants are less likely to incur the additional cost burden that DNOs may incur in undertaking EV PoLR activities.
- 3.17 For the reasons outlined above and in our statutory consultation, our decision is that the EV PoLR provisions should be removed from SLC 31F.

¹⁰ UK electric vehicle infrastructure strategy - GOV.UK (www.gov.uk)
¹¹ The Public Charge Point Regulations 2023 (legislation.gov.uk)

- 3.18 We have decided to remove the following provisions from SLC 31F of the Electricity Distribution Licence:
 - SLC 31F.1 (b): Recharging Points;
 - SLC 31F.4 SLC 31F.12: Electric Vehicle Recharging Points; Provider of Last Resort (process);
 - SLC 31F.13 SLC 31F.17: Electric Vehicle Recharging Points; provider of last resort (review);
 - SLC 31F.18: Electric Vehicle Recharging Points: provider of last resort (general); and
 - SLC 31F.19 (c): Interpretation.
- 3.19 In addition, we will make the following edits to accommodate the changes to the SLC 31F:
 - Due to the deletion of the intervening paragraphs, paragraph 31F.19 will be re-numbered as paragraph 31F.4; and
 - In bullet point (a) in the re-numbered paragraph 31F.4, "and" will be inserted after "Transmission Licence;".

4. Modifications following our redetermination on the matter of the allocation of NPg's total modelled costs

Section summary

This section summarises the modifications that we are making to NPg's SpCs, providing a summary of our consultation position, a summary of the responses we received as part of the consultation, and sets out our decision and supporting rationale.

Reason and effect for modifications

- 4.1 The CMA Order remitted the matter of the allocation of NPg's total modelled costs back to us for reconsideration and redetermination.¹² We set out our proposed approach and sought views on this in our statutory consultation.¹³ Following a thorough review of the responses to this consultation, we have now decided on the modifications to NPg's licence conditions necessary to implement our redetermined approach.¹⁴
- 4.2 The effect of this modification is to change the allowances allocated to NPg's cost categories. Please refer to our statutory consultation document for more information on the background of NPg's appeal and a detailed summary of the CMA's Final Determinations.

Approach to redetermination

Principles for determining an approach to cost allocations for NPg

Summary of our consultation position

4.3 The CMA held that NPg's unadjusted submitted cost shares – the respective shares of Load Related Expenditure ("LRE")¹⁵ and all other cost categories in NPg's submitted costs – was an irrelevant input for the purposes of our allocation of NPg's total modelled costs between various cost activities in the RIIO–ED2 Price Control. The CMA remitted the matter back to us for redetermination. In

¹² Energy Licence Modification Appeal 2023, CMA Order on Order (publishing.service.gov.uk)

¹³ <u>Statutory Consultation on Modifications to the Standard and Special Conditions of the Electricity Distribution</u> <u>Licence | Ofgem</u>

¹⁴ To implement our proposed approach to allocate NPgN's and NPgY's total modelled costs, we will make incidental modifications to the licence conditions of NPgN and NPgY as well as the other DNOs to reflect NPgN's and NPgY's updated allocations.

¹⁵ LRE is the investment in electricity networks that responds to increases in demand to upgrade the capacity of

network, for example to connect LCTs or new generation.

developing our approach to redetermine the allocation of NPg's total modelled costs we proposed the following principles:

- (1) **Consistency with our statutory principal objectives**: Any approach and outcome should be consistent with our statutory duties, principally, to protect the interests of existing and future consumers.
- (2) Alignment with the fundamental basis of our cost assessment: The allocations process should align with and reflect as accurately as possible the basis of our cost assessment. This principle consists of two components:
 - (a) any allocations approach should take into account our overall cost assessment approach and how we set allowances; and
 - (b) that total modelled costs were not set by reference to a single, defined common decarbonisation planning scenario.
- (3) Consistency with the CMA's reasoning in its Final Determinations: This approach should reflect and address the comments that the CMA has made in its Final Determinations.
- (4) **Simplicity, transparency, and replicability**: The approach should be clear to understand, transparent and, as far as possible, replicable.¹⁶
- 4.4 We sought views on these guiding principles including whether they would provide a valuable framework for the reconsideration of our approach to allocating for NPg's total modelled costs.

Summary of responses

Q3. What are your views on the proposed principles? Do you agree that the principles provide a valuable framework for our consideration of an approach to cost allocations for NPg?

4.5 We received three responses on this consultation question from three DNOs. One DNO recognised the work that we had carried out to make changes in light of the CMA's decision but did not feel best placed to comment on the detail. Nevertheless, it felt that the approach taken appeared to be pragmatic, noting

¹⁶ Note that while the redetermination of our approach only applies to NPg, we consider that any approach should not be entirely distinct from our approach to cost assessment for RIIO-ED2. is an important consideration that the approach should not be entirely bespoke to one DNO. We consider our approach should be replicable across all DNOs, in line with our approach to cost assessment which was applied consistently across all DNOs.

that the CMA did not provide specific direction as to how the re-assessment should be undertaken.

- 4.6 Another DNO commented that it had limited information available on which to provide a view on whether the principles were appropriate but suggested that any remedy needed to be cognisant of established RIIO-ED2 price control mechanisms.
- 4.7 The other DNO that responded challenged the ordering of our principles, arguing that Principle 3 was the most important and should appear higher in the list. It also argued that the Principle 1 and Principle 2 could be subsumed into Principle 3.
- 4.8 In relation to Principle 2, this DNO considered that further qualification was required. It added that the allocation methodology must allocate total modelled costs such that the split between LRE and all other cost categories would result in an appropriate level of LRE to fund the volume of load related work to which the total modelled costs correspond.
- 4.9 This DNO also commented that it is not necessary for the allocation methodology to seek to reflect the basis of our cost assessment. It argued they are separate steps in the process, with separate objectives, requiring separate solutions. It added that although totex benchmarking had been used in the process of setting total modelled costs, it was not necessary for the allocation methodology to 'use' the totex benchmarking in some way.
- 4.10 Finally, the DNO did not agree that Principle 2(b) should be a key guiding principle. It argued that the CMA was clear that it did not matter to its analysis and conclusions whether adjustments through the cost assessment were the result of any reference to a common decarbonisation planning scenario or not.

Our decision and supporting rationale

- 4.11 We appreciate the concern raised in response to the numbering of our proposed principles and whether this could imply a hierarchy of importance. We can clarify that we did not intend or propose for the numbering of the principles to provide any indication of their relative importance or precedence in our framework.
- 4.12 We have decided to maintain the principles in our reconsideration. We have decided that the principles will not be determinative of any approach or outcome, rather they are a valuable framework and reference to guide our thinking.

- 4.13 We note the concern with Principle 2 suggesting there is limited value in an alignment with the fundamental basis of our cost assessment and any allocation methodology does not necessarily need to reflect the totex benchmarking.
- 4.14 In the specific context of RIIO-ED2, our total modelled costs were produced as the result of a multi-step cost assessment process which is illustrated in Figure 1 below. Our cost assessment included two different benchmarking workstreams: totex benchmarking (which included three totex models, assessing DNOs' total costs) and disaggregated benchmarking (which included 36 disaggregated models, assessing DNOs' costs across 46 separate cost categories). A further separate step was a post-modelling adjustment applied to the outputs of our three totex models in our cost assessment, the Demand Driven Adjustment (DDA).

Figure 1: Simplified schematic of a component of the cost assessment process



- 4.15 We agree that alignment for alignment's sake is not sufficient justification for pursuing a particular approach. However, we remain of the view that there is value in considering the relationship between any redetermined allocations approach and the cost assessment approach particularly in relation to two issues:
 - NPg's total modelled costs were derived from a blended approach to cost assessment, both totex benchmarking and disaggregated benchmarking, followed by a separate post-modelling adjustment, the DDA (see Figure 1).

• How our overall cost assessment approach impacted the level of workload to which NPg's total modelled costs correspond.

Consideration of CMA's Final Determinations

- 4.16 The CMA remitted the matter of the allocation of NPg's total modelled costs for reconsideration and redetermination. The CMA, in part due to the complexity of determining an appropriate methodology, did not provide specific direction as to what approach we should take. In part to assist our redetermination, the CMA indicated some sources of information that it considered we wish to rely on in coming to an appropriate methodology.
- 4.17 The CMA indicated that any reconsideration and redetermination of the matter would not "*necessarily rely solely on the cost proportions derived from the disaggregated benchmarking*".¹⁷ The CMA also suggested that GEMA may wish to consider using one or a combination of the following sources in allocating NPg's total efficient modelled costs alongside the disaggregated benchmarking proportions" in redetermining our approach on allocations, and suggested considering the following:¹⁸
 - (a) The low scenario costs submitted by NPg (ie based on System Transformation FES); and/or
 - (b) NPg's submitted costs based on its decarbonisation planning scenario to be modified by GEMA by applying adjustments that are aligned with those applied in GEMA's benchmarking.
- 4.18 We considered and tested the following range of potential approaches and outlined our proposed positions in our consultation:
 - (a) relying solely on disaggregated benchmarking cost shares;
 - (b) utilising 'low scenario' costs submitted by NPg; and
 - (c) adjusting NPg's submitted cost shares to reflect our benchmarking approach.
- 4.19 We understand the CMA's Final Determinations, and recognise that our redetermined approach to allocating NPg's total modelled costs will need to appropriately account for the adjustments to NPg's LRE made within our cost

¹⁷ Paragraph 6.13 CMA's Final Determinations

¹⁸ Paragraph 6.13 CMA's Final Determinations

assessment for RIIO-ED2, and should consider the best available sources of information to underpin the allocation methodology.

Relying solely on disaggregated benchmarking cost shares

Summary of our consultation position

- 4.20 We did not propose to follow an approach of allocating total modelled costs by relying solely on the disaggregated cost shares. We explained that the disaggregated benchmarking captured interactions or linkages between activities directly in the modelling but would not sufficiently account for differences in DNO company structure and business models. We also explained that the sole reliance on disaggregated benchmarking cost shares would only reflect one aspect of our cost assessment (the disaggregated benchmarking) while excluding the other 50% which included both the totex benchmarking and the impact of the DDA, as illustrated in Figure 1.
- 4.21 We had previously considered the limitations with such an approach in detail in our RIIO-ED2 Final Determinations,¹⁹ and we noted that the CMA has also stated that it did not envisage that we would necessarily rely solely on the disaggregated cost shares.
- 4.22 Our proposed position was that while we did not consider there was sufficient justification in relying solely on disaggregated benchmarking costs shares taking account of the limitations, we remained of the view that there is value in using disaggregated benchmarking cost shares as part of a blended approach to allocations.

Summary of responses to our consultation

Q4. Do you consider there is merit in relying solely on the disaggregated benchmarking cost shares for the purpose of allocations, taking account of the significant drawbacks?

4.23 We received two specific responses to this consultation question from two DNOs. One DNO responded that it did not think there was merit in relying solely on the disaggregated benchmarking costs shares for the reasons that were set out in the RIIO-ED2 Final Determinations.

¹⁹ RIIO-ED2 Final Determinations paragraph 7.643

- 4.24 The other DNO that responded to this question considered that there was merit in relying solely on the disaggregated benchmarking cost shares for the purpose of allocations. It argued that the disaggregated modelled costs reflected our view of efficient costs at a granular cost category level and, therefore, represented a sensible basis on which to approach the allocation of total modelled costs.
- 4.25 The DNO added that it did not accept the drawbacks of relying solely on disaggregated benchmarking cost shares for the purpose of allocations. They also commented that even if there were drawbacks then this would not justify using cost proportions that were not relevant for the purposes of allocations. They explained that any approach which did not account for implicit adjustments in the totex benchmarking, was not a relevant input.

Our decision and supporting rationale

- 4.26 We have decided that we will not place exclusive reliance on disaggregated benchmarking cost shares. We remain satisfied that there is value in using disaggregated benchmarking cost shares as a source of information in allocating NPg's total modelled costs. We have decided that this value is best reflected as part of a blended approach alongside another source of information. We have decided that in NPg's circumstance there is justification for the disaggregated benchmarking cost shares reflecting additional value as a source of information as part of a blended approach. We outline our decision on the nature of this blended approach and the value of the disaggregated cost shares, particularly the weighting, below at paragraphs 4.71 to 4.77.
- 4.27 The modelled costs produced by the disaggregated benchmarking are a key input in the production of the total modelled costs and provide a view of cost allocation at a granular cost category level. We recognised this value as a source of information for the purposes of allocating total modelled costs across the sector at the RIIO-ED2 Final Determinations and used the cost proportions produced from our disaggregated modelling as part of a 50%/50% blended approach to allocations.
- 4.28 However, the disaggregated benchmarking produced modelled costs only represent one view of modelled costs. They are an important and useful source of information, but they are not wholly reflective of the total modelled costs that we produced, as demonstrated in Figure 1.
- 4.29 We are not persuaded that relying solely on the disaggregated benchmarking cost shares for the purpose of allocating NPg's total modelled costs is appropriate. We

also do not think that it would be correct to disregard the value of the submitted cost shares as another source of information. We understand the simplicity of a sole reliance on disaggregated benchmarking cost shares in allocating NPg's total modelled costs. Such an approach would not require additional steps to account for any adjustments made to NPg's LRE within the totex benchmarking, or through the DDA. However, we are not satisfied that any merits of relying solely on the disaggregated benchmarking cost shares are sufficient to justify an approach that disregards all other sources of information, and risks the overallocation of allowances to some cost categories.

Using 'low scenario' costs submitted by NPg

Summary of our consultation position

- 4.30 We explained that this approach would rely on NPg's System Transformation view of LRE to approximate a low decarbonisation scenario view of submitted cost shares, alongside the disaggregated benchmarking cost shares. We did not propose to rely on low scenario' costs submitted by NPg because of our concerns with such an approach to allocating total modelled costs.
- 4.31 We considered that any 'low scenario' costs would have limited relevance for the purposes of allocating total modelled costs because it would not reflect the results of our cost assessment, specifically the totex benchmarking produced modelled costs. Accordingly, we explained:
 - that NPg's submitted costs against its own forecast decarbonisation planning scenario were used as an input to our cost assessment, not its 'low scenario' costs;
 - the specification of our three totex models and how they sought to control for differences in DNOs' own forecast decarbonisation planning scenario;
 - that two of our three totex models (models 1 and 2) included a RIIO-ED2 dummy variable which sought to capture the average step up in expenditure across RIIO-ED2, to deliver wider decarbonisation targets; and
 - that totex model 3 was specified on DNOs forecast data only.
- 4.32 As a result, the use of low scenario submitted cost shares to allocate total modelled costs would bear little resemblance to the assessment of NPg's costs through our totex benchmarking. We therefore considered it inappropriate to rely on NPg's System Transformation view of LRE to try to approximate a 'low scenario' view of submitted cost shares for the purposes of allocations. We

explained that such an approach would be inconsistent with the foundations and purpose of our cost assessment process.

Summary of responses to our consultation

Q5. Do you consider there is a justification for us relying on the 'low scenario' costs submitted by NPg alongside the disaggregated benchmarking cost shares, for the purposes of allocations?

Q7. Do you agree with our view that it would not be appropriate to utilise the low scenario LRE costs submitted by NPg as part of an approach to allocations?

- 4.33 We received two responses from two DNOs to the three consultation questions in this section of our consultation. On consultation question 5 and 7, the first DNO argued that it would find it difficult to envisage a scenario where the final total modelled costs can be held constant, but the underlying inputs that gave rise to that result are materially changed. As such they did not consider that there was merit in relying on the 'low scenario' costs submitted by NPg.
- 4.34 The other DNO that responded to these questions commented that relying on 'low scenario' costs submitted by NPg, alongside the disaggregated benchmarking cost shares, would be consistent with the CMA's Final Determinations and would therefore be an appropriate approach.

Q6. Do you agree with our view that (a) our totex models adequately control for differences in decarbonisation planning scenarios across DNOs, and (b) there are no observable or measurable adjustments within our totex benchmarking produced modelled costs for LRE that would materially impact the balance of totex? (c) If not, how do you think we could observe and measure any implicit adjustments that may be being made?

- 4.35 On consultation question 6, the first DNO responded that the overall outcome of the price control had been accepted, recognising the approach that we had taken through our cost assessment.
- 4.36 The other DNO noted in their response to this question that the CMA found in its Final Determinations that the implicit adjustments present within the totex benchmarking were "*material*" and "*sizeable*" and disproportionately reduced LRE relative to other cost categories. They argued that the disaggregated benchmarking cost shares could be a suitable proxy to estimate the approximate scale of the implicit adjustments that they consider are present within the totex benchmarking. They considered that the other sources of information that could

be used to estimate the impact of implicit adjustments were the 'low scenario' costs submitted by NPg, and NPg's submitted costs modified by applying adjustments that are aligned with those applied in our cost assessment.

4.37 This DNO also commented on the question of whether there were any other suitable proxies that could be used to account for any implicit adjustments that may be present within the totex benchmarking, such as by reconsidering the weights that we place on cost shares. They argued that submitted cost shares adjusted solely with reference to the DDA are, based on the CMA's findings, an irrelevant input. However, if we were to reduce the reliance on the submitted cost shares adjusted solely with reference to the DDA, there will be a reduction in the impact of the error; albeit they argue the magnitude of the error may remain material.

Our decision and supporting rationale

- 4.38 We have decided not to rely on the 'low scenario' costs submitted by NPg for the purpose of allocating NPg's total modelled costs.
- 4.39 We did not develop our suite of totex models as part of our totex benchmarking to benchmark DNOs against a particular decarbonisation planning scenario. Instead, they were explicitly designed to control and allow for differences between DNOs' forecast decarbonisation planning scenarios. The totex benchmarking produced modelled costs for each DNO, including NPg, are a function of each individual DNO's own forecast decarbonisation planning scenarios.
- 4.40 We are not satisfied that there is sufficient supporting justification for any reliance on the 'low scenario' costs submitted by NPg for the purposes of allocating their total modelled costs. Nor are we satisfied that such an approach would result in the 'best available decision'. Our cost assessment relied on an underlying input, the submitted costs from NPg, to produce total modelled costs. We agree that it is challenging to envisage a situation where the final total modelled costs can be held constant, but the underlying inputs that gave rise to that result are materially changed. This presents a fundamental issue, and we are not persuaded that NPg's 'low scenario' is an appropriate source of information to rely on in allocating NPg's total modelled costs.
- 4.41 Hypothetically, if we were to alter our approach to cost assessment and adjust the input to our benchmarking ie by adjusting NPg's submitted costs based on its own baseline decarbonisation planning scenario to reflect its 'low scenario'

submitted costs, then it may be relevant to use 'low scenario' submitted costs to allocate total modelled costs. This is not a plausible option. It would necessitate a redetermination of our entire cost assessment for RIIO-ED2, which was not the subject of appeal.

Adjusting submitted cost shares

Summary of our consultation position

- 4.42 We proposed adjusting NPg's submitted costs shares to best reflect the adjustments that were applied in our benchmarking. We proposed that these adjusted submitted cost shares would be used alongside the disaggregated benchmarking cost shares, for the purpose of allocations.
- 4.43 We summarised our assessment of the impact of the adjustments that were applied at each discrete step of our cost assessment (as illustrated in Figure 1):
 - Step 1a Totex Benchmarking The modelled costs for NPg produced by the totex benchmarking were £3,225m (NPgN £1,366m, NPgY £1,859m)²⁰ compared to NPg's submitted costs²¹ of £3,209m (NPgN £1,378m, NPgY £1,831m). Our totex benchmarking did not include any explicit adjustments at the level we can observe. We explained that we did not identify any implicit adjustments that were observable, quantifiable or measurable at the individual cost level, or how the impact of such adjustments could be reliability or robustly estimated. We noted that our assessments had not yet identified any evidence to suggest that any adjustments implicit in our totex benchmarking would materially impact LRE and the balance of the total modelled costs.
 - Step 1b Disaggregated Benchmarking The modelled costs for NPg produced by the disaggregated benchmarking were £2,910m (NPgN £1,249m, NPgY £1,661m)²². Our disaggregated benchmarking made targeted, explicit adjustments to certain cost categories that could be directly observed, quantified, and measured at a cost category level. These adjustments were captured by virtue of the 50% weight we attached to the disaggregated benchmarking-produced modelled costs when calculating total modelled costs, and the 50% weight we attached to the allocation based on the disaggregated

²⁰ Presented on a gross costs basis before the application of the catch-up efficiency challenge

²¹ Normalised submitted costs on a gross basis, and after reclassifications and exclusions.

²² Presented on a gross costs basis before the application of the catch-up efficiency challenge.

benchmarking cost shares when allocating DNOs' total modelled costs to cost categories.

- Step 2 DDA Through the DDA we made targeted and explicit adjustments that could be directly observed, quantified, and measured at the total modelled costs level (NPg, £170m, NPgN £67m, NPgY £103m)²³. We explained that the key difference between the DDA at Step 2, and the adjustments carried out through our disaggregated benchmarking at Step 1b, was that the DDA was applied at the total modelled costs level. Therefore, we did not have sufficient information to assess or estimate its precise impact as a volume adjustment as if the DDA was applied at a more granular cost category level.
- 4.44 While we recognised that there was insufficient evidence to conclude that the DDA would solely impact LRE, we proposed our view that there was a reasoned and sufficient basis to assume that the DDA would predominately impact LRE. We recognised that any adjustment to LRE shares in the submitted cost shares to account for the impact of the DDA would need to rely on some reasonable assumptions, including the specific size and weight of the adjustment to the individual LRE cost categories.
- 4.45 With the lack of underlying evidence of implicit adjustments and the difficulty in observing any implicit adjustments, the scale of magnitude of adjustments to NPg's LRE reflecting in disaggregated benchmarking already sufficiently captured by virtue of a 50% weighting, we proposed an adjustment to NPg's submitted costs shares to reflect the explicit adjustment made at the total modelled costs level ie the DDA.

Summary of responses to our consultation

Q8. Do you agree with our view that the most appropriate way to adjust submitted cost shares to reflect our cost assessment is by making adjustments based on the explicit DDA adjustments?

4.46 We received two specific responses from two DNOs to consultation question 8. The first DNO commented that, based on its understanding of the approach, it agreed that at this stage in the process our proposed approach appears to be appropriate.

²³ Presented on a gross costs basis, before the application of the catch-up efficiency challenge.

- 4.47 The other DNO did not agree with our view. It argued that the CMA was clear in its Final Determinations that there are material and sizeable adjustments to the share of LRE in the totex models and that this was why the CMA found our approach to be wrong in law. This DNO continued by stating that any approach to allocation must take into account of all the adjustments to the share of LRE in NPg's submitted costs made by us, including but not limited to the implicit adjustments contained in the totex models.
- 4.48 Finally, it commented that the approach that makes adjustments based solely on the DDA would be insufficient, as it would ignore what it considers are the material and sizeable implicit adjustments contained in the totex models.

Our decision and supporting rationale

- 4.49 We have decided to adjust NPg's submitted cost shares to reflect the adjustments made within our cost assessment, specifically the impact of the DDA, in our approach to allocating NPg's total modelled costs.
- 4.50 We consider that this approach gives sufficient weight to the sources of information that accounted for the basis of the RIIO-ED2 cost assessment. We also think that this addresses the fundamental nature of our error in relying on NPg's (unadjusted) submitted cost shares. This error as explained in our consultation,²⁴ was that following the adjustments to NPg's submitted costs during our cost assessment, in particular to LRE, NPg's submitted costs shares were no longer relevant as a source of information for the allocation of NPg's total modelled costs.
- 4.51 We have considered the challenge raised in response to our proposal that adjusting solely for the impact of the DDA would be insufficient. This challenge suggests that adjusting solely for the DDA would ignore any implicit adjustments to NPg's LRE that may exist within our totex benchmarking. We have given a great deal of consideration to this concern, and we explain our considerations in the next section.

Accounting for implicit adjustments

Possible implicit adjustments in the totex benchmarking

4.52 In this section we address the possible presence of LRE-related implicit adjustments within our totex benchmarking and respond to feedback to our

²⁴ Statutory Consultation, paragraphs 4.6.

consultation, as noted at paragraph 4.36, that suggested that the CMA had found that such implicit adjustments made within the totex benchmarking were sizeable.

- 4.53 The CMA stated in its Final Determinations, "...[W]e infer from the evidence that the adjustments which GEMA made to LRE within totex benchmarking were sizeable and proportionately larger than the adjustments applied to other major cost categories. Therefore, in our view, GEMA effectively rejected NPg's submitted LRE in its totex benchmarking (and disaggregated benchmarking) ... In its response to the Provisional Determination, GEMA discussed how the adjustments in totex benchmarking could be assumed to impact the relative proportions of LRE and non-LRE categories in the total efficient modelled costs, and on the degree to which adjustments to LRE were reflected in its blended approach.".^{25,26}
- 4.54 The CMA in its Final Determinations also refer to "workload adjustments [that] were applied in the disaggregated benchmarking and the DDA [that] was applied in the totex benchmarking alongside implicit volume adjustments within the totex models".²⁷
- 4.55 We accept that the workload adjustments within our disaggregated benchmarking and the DDA together gave rise to "*sizeable"* reductions to the proportion of NPg's LRE in the total modelled costs, relative to its submitted costs. The magnitude of the workload adjustments within the disaggregated benchmarking were reflected in the modelled costs and cost allocation by virtue of the 50% weighting on the disaggregated benchmarking modelled costs and disaggregated benchmarking cost shares. The scale of adjustments to NPg's LRE made through the DDA were not reflected in our decision at RIIO-ED2 Final Determinations to allocate NPg's total modelled costs. As discussed in the previous section, in consideration of the CMA's Final Determinations, we have identified a methodology for quantifying and estimating the impact of the explicit DDA on the submitted cost shares. This methodology was set out in our consultation,²⁸ and is summarised at paragraphs 4.95 to 4.100.
- 4.56 The questions that remain are:

 $^{^{\}rm 25}$ CMA Final Determinations, paragraph 4.126 and 4.127.

²⁶ Note, that in our response to the Provisional Determination, which the CMA referred to at paragraphs 4.127 of its Final Determinations, we said the following, "[g]iven the nature of the composite growth variable used in totex models 2 and 3, and the way in which the DDA was derived and applied, we might expect that adjustments to NPg's totex would be focused on LRE.".

²⁷ CMA Final Determinations, paragraph 4.122.

²⁸ Statutory Consultation, paragraphs 4.49 to 4.54.

- is there relevant evidence to assess the scale of any potential implicit adjustments in our totex benchmarking, specifically such adjustments that would affect the share of LRE in the total modelled costs relative to the submitted costs; and
- if there is relevant evidence, how should we take such evidence into account in our approach to allocations.
- 4.57 We are not persuaded by the consultation response that suggests that the CMA specifies that any implicit volume adjustments were sizeable. While the CMA in its Final Determinations stated that there were "*implicit volume adjustments within the totex models*", we have not found evidence to support that any such implicit adjustments are "*sizeable*".
- 4.58 We accept that some form of implicit adjustments may exist within our totex benchmarking that might impact the submitted cost shares in some way. The models only assess and produce modelled costs at the totex level, so there will always be some uncertainty regarding any potential implicit adjustments, and how they might affect different components of totex to varying degrees.
- 4.59 Overall, the totex benchmarking in RIIO-ED2 was found to explain variation in totex well; the benchmarking was considered robust in terms of the size and statistical significance of the parameter estimates; and the adjusted R-Squared measures and the broader robustness tests. The models were therefore considered appropriate for modelling totex and in capturing the forecast step change in expenditure expected in RIIO-ED2.
- 4.60 As described in our consultation,²⁹ the models were specified in such a way as to capture variation between DNOs in terms of forecast decarbonisation planning scenario and associated levels of network reinforcement and LRE. The models included scale variables such as MEAV³⁰ and total network length which captured aspects of forecast workload. They also contained variables that are directly related to LRE such as the volume of Low Carbon Technologies (**LCT**s) connecting to the networks, capacity released, and a dummy variable that captured the sector wide cost increase in expenditure over the forecast period, driven largely by delivery of decarbonisation and net zero targets.

²⁹ Statutory Consultation, paragraphs 4.27 to 4.30.

³⁰ Modern Equivalent Asset Value (MEAV), which is the estimated cost of replacing all of the assets on the network with a new asset with the same service capability as the existing asset. We put a value on the DNO's current and future network assets, in today's prices/values, to use as a measure of the scale of DNO networks.

- 4.61 Unlike the disaggregated benchmarking, where a net negative adjustment of £299m to NPg's submitted costs was driven overwhelmingly by explicit workload adjustments to secondary reinforcement volumes, we <u>did not</u> change the volumes of the cost drivers in the process of calculating the totex benchmarking produced modelled costs.
- 4.62 The totex benchmarking models were designed and specified in a different way to the disaggregated benchmarking models. Given this, and the fact that the totex benchmarking produced modelled costs are higher than the disaggregated benchmarking produced modelled costs (in fact, there is a net positive modelling adjustment relative to submitted costs, as shown in Figure 2), it is not a reasonable assumption that any adjustments that are implicit within our totex benchmarking would necessarily be of the same scale as the explicit adjustments made within our disaggregated benchmarking. The reasonable conclusion is that the totex benchmarking produced modelled costs could contain a level of LRE that is higher than the result of the disaggregated benchmarking, and closer to the level of NPg's submitted costs under their own decarbonisation planning scenario.



Figure 2: Overall net adjustments within totex and disaggregated benchmarking

4.63 We recognise that this does not rule out the presence of implicit adjustments within the totex benchmarking. Rather it demonstrates that there is no evidence from the totex benchmarking process that any implicit adjustments to NPg's LRE are as "*sizeable"* as the explicit workload adjustments applied in the disaggregated benchmarking, or in the DDA. In the wider context of our RIIO-ED2 cost assessment approach, we remain satisfied that the specification of our totex models adequately controls for differences in decarbonisation scenarios and associated LRE. However, while our analysis has not identified any sizeable

implicit adjustments (nor do we accept that the CMA has determined that any implicit adjustments are necessarily sizeable), we accept this does not preclude the existence of some LRE-related implicit adjustments within our totex benchmarking.

4.64 We accept that an approach of solely adjusting the submitted cost shares to account for the DDA, gives rise to the potential that any additional implicit adjustments within our totex benchmarking would not be accounted for.

Using a proxy to account for any implicit adjustments

- 4.65 In our consultation we sought views on whether there were any suitable proxies, such as reconsidering the weights on cost shares, that could be used to account for the unobservable nature of implicit adjustments. In response, and as noted at paragraph 4.36, one DNO argued that the disaggregated benchmarking cost shares, or the 'low scenario' costs submitted by NPg could be used as proxies to estimate the approximate scale of the implicit adjustments that they consider are present within the totex benchmarking.
- 4.66 We are not persuaded that NPg's "low scenario" costs have relevance as a source of information for the purposes of allocations. We have explained our reasoning at paragraphs 4.38 to 4.41. As such, we are not placing any reliance on those costs in considering a suitable proxy.
- 4.67 A source of information that could provide some indication of implicit adjustments is the disaggregated benchmarking. While there remains insufficient evidence to support the proposition that implicit adjustments within our totex benchmarking would be of the same scale as explicit adjustments within the disaggregated benchmarking, we considered whether the disaggregated cost shares could have any value in determining a proxy. In the absence of alternative sources of information, it is plausible that disaggregated benchmarking does have some value in highlighting circumstantial evidence of possible changes to submitted costs in this instance.
- 4.68 If no adjustment was made to submitted cost shares to account for any implicit adjustments in the totex benchmarking, this would be consistent with the assumption that there is a similar, or even equal likelihood of implicit adjustments that would increase the share of LRE or would decrease the share of LRE. The disaggregated benchmarking provides a source of information that the likelihood, or probability distribution, may be tilted towards the existence of implicit adjustments in the totex benchmarking that would reduce the share of LRE.

- 4.69 While we are satisfied on the available evidence that there is no basis to change submitted cost shares to try to capture all possible implicit adjustments, we recognise in this case that there is additional value in relying on the disaggregated benchmarking as a source of information to assess the likelihood and scale of implicit adjustments in the totex benchmarking that would reduce the share of LRE.
- 4.70 We considered that the best reflection of this additional value would involve increasing the weight of the disaggregated benchmarking cost shares, relative to the submitted cost shares (adjusted for the DDA). This approach is consistent with a view that it is more likely that implicit adjustments reduce rather than increase the share of LRE (ie that the probability distribution is not symmetrical around no change in LRE). This increase in weight for the disaggregated benchmarking cost shares, relative to the 50% weight assigned in our statutory consultation, will act as a proxy for any implicit adjustments within our totex benchmarking.

Determining the size of the proxy adjustment

- 4.71 There is no single, definitive approach to say what additional weight should be placed on the disaggregated benchmarking cost shares in determining the size of the proxy. Instead, it will require an exercise of regulatory judgement, taking into account the best available information, and considering a plausible range of adjustments.
- 4.72 From our cost assessment, we can directly observe, or have explicit evidence of the following outcomes:
 - The size of the totex benchmarking produced modelled costs;
 - That any implicit adjustments to LRE and non-LRE within the totex benchmarking must broadly cancel each other out, as NPg's totex benchmarking produced modelled costs are at a similar level to NPg's submitted costs, as shown previously in Figure 2;
 - The size of the DDA;
 - The size of the disaggregated benchmarking produced modelled costs; and
 - The overall net adjustment applied to NPg's costs in the disaggregated benchmarking is driven by a downwards adjustment on LRE, particularly secondary reinforcement and primary reinforcement, and a smaller positive adjustment on non-LRE, as illustrated in Figure 3 below.

4.73 In addition, we have separately taken a view of the impact of the DDA on the submitted cost shares and how this impacts the level of LRE and non-LRE in the totex benchmarking produced modelled costs, as noted at paragraph 4.55.





4.74 Information on modelled costs and changes in cost shares has been revealed from the disaggregated benchmarking and from the DDA analysis. This includes the fact that there is a £145m difference between the totex benchmarking produced modelled costs, post DDA, and the disaggregated benchmarking produced modelled costs, as shown in Figure 4.

³¹ For the purposes of this exercise, LRE is referring to primary and secondary reinforcement cost areas <u>only</u>. These are the LRE categories with explicit workload adjustments applied in the disaggregated benchmarking that drive the net adjustment to the disaggregated benchmarking produced modelled costs, and therefore are of most interest in respect of any implicit workload adjustments within the totex benchmarking.





- 4.75 Table 2, below, shows the results of different scenarios that we have considered for how these pieces of information can be combined to adjust the cost shares produced by the disaggregated benchmarking to calculate possible changes in cost shares driven by unobservable implicit adjustments in the totex benchmarking. We take the average of these estimated cost shares and the disaggregated benchmarking cost shares. We then calculate the implied weightings on the adjusted submitted cost shares (post DDA) and the disaggregated benchmarking cost shares that are required to produce that same average cost share.
 - Scenario 1 As we observed at paragraph 4.72, and as shown in Figure 3, the overall net adjustment from the disaggregated benchmarking is driven largely by a downwards adjustment on LRE. Our assumption for the purpose of this scenario is that the £145m difference between the totex benchmarking produced costs, post DDA, and the disaggregated benchmarking produced modelled costs, is driven completely by a difference in LRE. The impact of this on implied cost shares is shown in Figure 5.
 - Scenario 2 As per Scenario 1, but rather than assuming that the difference is driven completely by LRE, our assumption is that the difference is driven by both LRE and indirect costs. This results in approximately 91% of the £145m

³² All costs provided on a gross basis.

difference being attributable to LRE ie ± 133 m, and ± 12 m to non-LRE for the indirects. This is consistent with our assumptions for the impact of the DDA on submitted cost shares, and for the indirects scaler, which we set out in our consultation,³³ and describe again at paragraph 4.97.

Scenario 3 – In Figure 3 we can observe the adjustments in LRE and non-LRE from the disaggregated benchmarking (which produce a net change in overall costs). Our assumption then for the purpose of this scenario is that the £145m difference between the totex benchmarking produced modelled costs, post DDA, and the disaggregated benchmarking produced modelled costs, is driven by the same gross adjustments (pro-rated to the size of the net change in overall costs) ie that the net adjustment is driven by a slight increase of £31m in non-LRE, and a larger decrease of £176m in LRE.



Figure 5: Calculating disaggregated benchmarking implied LRE cost share³⁴³⁵

³³ Statutory Consultation, paragraph 4.51.

³⁴ The split of LRE and non-LRE for the totex benchmarking produced modelled costs, post DDA, is determined using the adjusted submitted cost shares.

³⁵ As per Figure 3, for the purposes of this exercise, "LRE" is only considering primary and secondary reinforcement LRE cost categories.

Step	Description	Scenario 1	Scenario 2	Scenario 3
1	Totex benchmarking produced modelled costs, post DDA (Gross)	3,055	3,055	3,055
2	Adjusted submitted LRE cost share	363	363	363
3	Adjusted submitted LRE costs share (2) / (1)	11.9%	11.9%	11.9%
4	Disaggregated benchmarking produced modelled costs (Gross)	2,910	2,910	2,910
5	Disaggregated benchmarking produced LRE	152	152	152
6	Disaggregated benchmarking LRE costs share (5) / (4)	5.2%	5.2%	5.2%
7	Allocation to LRE using 50%/50% blend of (3) and (6)	8.6%	8.6%	8.6%
8	Difference between totex post DDA and disaggregated (1) - (4)	145	145	145
9	Amount to allocate to LRE	145	133	177
10	Add back to disaggregated benchmarking produced LRE (5) + (9)	297	285	329
11	Calculate revised LRE (10) as % of submited costs (1)	9.7%	9.3%	10.8%
12	Implied cost allocation for LRE (i.e., average of (6) and (11))	7.5%	7.3%	8.0%
13	Calculate weighting of adjusted submitted costs share to achieve (12)	33.8%	30.7%	41.6%
	Calculate weighting of disaggregated benchmarking cost share to			
14	achieve revised allocation (12)	66.2%	69.3%	58.4%

Table 2: Implied disaggregated benchmarking cost shares and associated proxies³⁶

- 4.76 The results of this analysis suggest that increasing the weighting of the disaggregated cost shares to between approximately 58% and 70% would reflect the possible proxies for any implicit adjustments to LRE within the totex benchmarking.
- 4.77 This analysis, while limited by the extent of the information we have available, provides a reasonable range for adjustments to cost shares to reflect any possible implicit adjustments.

Our decision on the size of the proxy adjustment

4.78 We have decided to aim towards the upper end of this range, and increase the weight on the disaggregated benchmarking cost shares to 70% (with the adjusted submitted cost shares weighted at 30%) for the purpose of allocating NPg's total modelled costs. This approach assumes a higher level of estimated implicit adjustments within our totex benchmarking, from the range of options presented. By aiming up, we have sought to reflect the fact that Scenarios 1 and 2 assume that LRE is the main driver of the difference between disaggregated modelled costs and totex benchmarking modelled costs (post DDA). This

³⁶ As per Figure 3, for the purposes of this exercise, "LRE" is only considering primary and secondary reinforcement LRE cost categories.

assumption is based on the observed outcomes of the cost assessment. However, it remains uncertain whether implicit adjustments would follow a similar pattern. We acknowledge that on balance, this may create a risk that the cost shares in the middle of range are too low to fully account for unobservable implicit adjustments in totex benchmarking. This risk may be greater, although unquantifiable, than the risk of the cost shares in the middle of the range being too high.

4.79 We acknowledge that this approach has limitations. We accept that we are exercising a degree of judgement in determining how best the possibilities of any implicit adjustments within our totex benchmarking are reflected. However, in being presented with a range of various alternative approaches, we have sought to test the availability and suitability of the evidence before us in coming to our decision. We are satisfied that this approach reasonably captures the likely magnitude of any implicit adjustments in this case.

Cross-checks

- 4.80 We have performed a series of cross-checks to assess whether our decision to increase the weight of the disaggregated benchmarking cost shares to 70% (and the adjusted submitted cost shares to 30%) drives plausible outcomes in terms of the allowances that are allocated across the different cost categories for NPg.
- 4.81 These cross-checks are intended to check for the risk of any potential over- or under-funding, by comparing NPg's allocations against the rest of the sector, and the sector median. While this analysis cannot say whether NPg have, or have not, been over- or under-funded, it does help to highlight whether NPg are outliers, as a result of the approach that we have taken. This is useful because, broadly speaking, we might expect DNOs to carry out the same balance of work, in managing their networks and delivering their outputs.
- 4.82 The analysis, which is provided in Appendix 1, focuses on Primary and Secondary Reinforcement cost areas, as well as Closely Associated Indirects, as we consider these to be most relevant, given their sensitivity to the different approaches to allocations.
- 4.83 Overall, the redetermined approach reduces the overall spread, and improves the consistency of the percentage of allowances allocated to the different cost categories that we tested. In instances where NPg could perhaps be considered an outlier, in terms of percentage of allowances allocated to certain cost

categories, our analysis highlights that under our remedied approach they are now more consistent with the sector median.

4.84 We are satisfied that this analysis represents a reasonable cross-check, and that there is no evidence of any over- or under-funding as a result of our redetermined approach to allocations.

Our decision on the redetermination of our approach

Summary of our decision

- 4.85 At the RIIO-ED2 Final Determinations, we decided on an approach that utilised the two sources of data available to us to determine the methodology to allocate total modelled costs. These two sources of information were the DNOs' submitted costs (the unadjusted submitted cost shares) and the outputs from our disaggregated benchmarking (the disaggregated benchmarking cost shares). The approach taken was to use both equally weighted as part of a blended allocations approach.
- 4.86 The CMA determined that, since material adjustments were made to NPg's LRE across our cost assessment, our decision to rely on the proportions derived from NPg's unadjusted submitted costs when allocating NPg's total modelled costs was wrong. The CMA reasoned that this was because adjustments to NPg's submitted costs through our cost assessment meant that there was a materially higher share of LRE in NPg's submitted costs relative to the total modelled costs that we produced. The unadjusted cost proportions derived from NPg's submitted costs were therefore no longer a relevant source of information to rely upon when allocating NPg's total efficient modelled costs to cost categories.
- 4.87 Our reconsideration and redetermination of our approach to the allocation of NPg's total modelled costs has involved a consideration of alternatives to relying on NPg's unadjusted submitted cost shares as a relevant input.
- 4.88 Our first consideration was whether sole reliance on the disaggregated benchmarking cost shares would address the nature of our error and whether such an approach would represent the best available decision as part of our redetermination. While such an approach could address the nature of our error as the disaggregated benchmarking cost shares would reflect the scale of adjustments made to NPg's LRE in the disaggregated benchmarking, for the

reasons set out in our consultation³⁷ and as set out at paragraphs 4.20 to 4.29, we are not pursuing this approach and nor do we consider such an approach to be in consumers' interests. We are satisfied there remains value in using the disaggregated benchmarking cost shares as a source of information, and as part of a blended approach to allocations.

- 4.89 Secondly, we considered whether the 'low scenario' submitted costs that NPg provided would be a suitable source of information that could be used as part of a blended allocations approach alongside the disaggregated benchmarking costs shares. While the 'low scenario' submitted costs do represent an additional source of information in which to consider, for the reasons set out in our consultation³⁸ and as set out at paragraphs 4.30 to 4.41, we are not pursuing this approach nor do we consider such an approach to be in the interests of consumers.
- 4.90 Thirdly, we considered whether NPg's unadjusted submitted cost shares could be adjusted to reflect the explicit DDA that was made as a post-modelling adjustments to the outputs of our totex benchmarking, as part of our cost assessment. As set out at paragraphs 4.49 to 4.51, we determined that this would be appropriate for addressing any adjustments that impacted the share of LRE in NPg's total modelled costs as a result of the explicit DDA.
- 4.91 Following the review of feedback to our consultation, we further considered whether adjusting solely for the DDA would be sufficient in addressing the magnitude of adjustments to LRE within our cost assessment. Specifically, the possibility of such adjustments that may be implicit within our totex benchmarking. As set out at paragraphs 4.52 to 4.64, we accept that solely adjusting the submitted cost shares to account for the DDA, gives rise to the potential that any unobservable implicit adjustments within our totex benchmarking would not be accounted for.
- 4.92 In response, we considered whether there were suitable proxies that could be used to account for any additional adjustments implicit within our totex benchmarking and as explained at paragraphs 4.65 to 4.70, produced a range of proxy adjustments, based on increasing the weight on the disaggregated benchmarking cost shares.

³⁷ Statutory Consultation, paragraphs 4.20 to 4.23.

³⁸ Statutory Consultation, paragraphs 4.24 to 4.38.

- 4.93 Our decision is to use a blended approach, weighting NPg's adjusted submitted cost shares at 30%, and NPg's disaggregated benchmarking cost shares at 70%, for the purpose of allocating NPg's total modelled costs.
- 4.94 We are satisfied that this approach:
 - acknowledges the value in using the disaggregated benchmarking cost shares as part of allocating NPg's total modelled costs;
 - acknowledges the value in using a range of sources of information on cost shares for the purposes of determining an allocations approach, alongside the disaggregated benchmarking cost shares;
 - takes account of each of the guiding principles;
 - addresses any material distortion from relying on unadjusted submitted costs shares for the effective allocation of NPg's total modelled costs to different cost categories;
 - addresses the concerns raised that reflecting the DDA in NPg's submitted cost shares would not account for any implicit adjustments within the totex benchmarking that impact the share of LRE in the totex benchmarking produced modelled costs; and
 - on balance, results in the correct outcome, taking account of the limitations with the available evidence to quantify a plausible magnitude of any implicit adjustments impacting the share of LRE in NPg's total modelled costs within the totex benchmarking.

Implementation of our decision

Summary of our consultation position

- 4.95 We proposed to adjust NPg's submitted cost shares to reflect the explicit adjustment of the DDA. We proposed that the following three cost categories were the most relevant for reflecting the impact of the DDA:
 - LRE: Primary Reinforcement;
 - LRE: Secondary Reinforcement; and
 - Closely Associated Indirects.
- 4.96 We identified Primary Reinforcement and Secondary Reinforcement as most relevant because the capacity released variable in totex models 1 and 2 captured RIIO-ED2 forecast workload from the primary and secondary reinforcement cost

activities and was directly adjusted in the derivation of the DDA. We proposed that it was reasonable to conclude that these were the two most relevant cost categories when considering which components of LRE were impacted by the DDA. Furthermore, we stated that this conclusion was supported by the fact that the derivation of the DDA across all three totex models was anchored on adjusting the LCT cost driver – a key cost driver for LRE, particularly secondary reinforcement.

- 4.97 We also proposed to adjust cost shares for Closely Associated Indirects in line with the treatment of the indirects scaler.³⁹ We explained that as a logical consequence of adjusting NPg's submitted cost shares for secondary reinforcement, we assumed the DDA impacts a component of indirects. The reason being that there is an assumed relationship between LRE and closely associated indirect costs, with the variant ex ante allowance for the indirects scaler calculated as 10.8% of the ex ante allowance set for the secondary reinforcement volume drivers.
- 4.98 We did not propose to include the three other LRE categories (Connections, Fault Level Reinforcement and New Transmission Capacity Charges (NTCC)) in our approach. We were not satisfied that the impact of the DDA, and the cost drivers used to derive it, were sufficiently relevant for these cost categories.
- 4.99 We proposed to adjust NPg's submitted cost shares via the following steps:
 - Step 1: Sum up submitted costs for Primary Reinforcement, Secondary Reinforcement, and a component of Closely Associated Indirects (calculated as 10.8% of submitted secondary reinforcement costs). Calculate the size of each cost category relative to this total – for NPg this equates to:
 - (1) Primary Reinforcement ~ 11.5%;
 - (2) Secondary Reinforcement ~ 80%; and
 - (3) Closely Associated Indirects ~ 8.5%.
 - Step 2: Apportion the £167m DDA using the % shares listed above and use the resulting allocation to adjust submitted costs for Primary and Secondary Reinforcement, and CAIs.

³⁹ RIIO-ED2 Final Determinations, paragraphs 7.521 to 7.527.

- Step 3: Calculate adjusted submitted cost shares for every cost category as a percentage of the adjusted submitted totex.
- 4.100 Following these steps, we proposed to place a 50% weight on NPg's submitted cost shares adjusted to reflect the DDA and a 50% weight on the cost shares from the disaggregated benchmarking.

Summary of responses to our consultation

Q9. Do you agree with our methodology for implementing our proposed approach?

4.101 We did not receive any specific responses from stakeholders on our methodology for implementing our proposed approach, although one DNO did comment that they did not have any observations at this time, in light of their objection to our proposed approach.

Our decision and supporting rationale

- 4.102 We have decided to retain the methodology for adjusting NPg's submitted cost shares to reflect the impact of the DDA, as described in our consultation. We will adjust NPg's submitted cost shares in the cost categories of Primary Reinforcement, Secondary Reinforcement and Closely Associated Indirects. We remain satisfied that these three cost categories remain the most relevant for the purposes of reflecting the DDA.
- 4.103 However, in light of our reasoning outlined in paragraphs 4.52 to 4.79, we have decided to reduce the weight on these adjusted submitted cost shares to 30% and increase the weight on the disaggregated benchmarking cost shares to 70%.

Impact of proposed modifications

Impact on allowances

4.104 The effect of the proposed modified allocations approach on NPg's totex allowance is to reduce the variant ex ante totex allowances by £86m and increase the nonvariant ex ante allowance by £77m. This is broken down by licensee in Table 3 below. Table 3: Changes to NPg's non-variant and variant totex allowances as a consequence of our redetermination of the allocation of total modelled costs

	NPgN RIIO-ED2	NPgN RIIO-ED2	NPgN change +/-	NPgY RIIO-ED2	NPgY RIIO-ED2	NPgY
	FDs	Remedy		FDs	Remedy	change +/-
	£m	£m	£m	£m	£m	£m
Non-variant allowances						
Load related capex	79.1	72.7	-6.3	129.5	124.0	-5.4
Non-load related capex - asset replacement	178.5	184.4	5.8	208.2	212.5	4.3
Non-load related capex - other	98.2	101.4	3.2	125.0	133.0	8.0
Faults	120.1	120.4	0.3	214.2	221.6	7.4
Tree cutting	18.3	18.5	0.2	25.7	25.5	-0.2
100% 'revenue pool' expenditure	30.7	31.9	1.2	36.8	39.3	2.5
Controllable opex	349.2	368.1	19.0	450.6	487.7	37.1
Total non-variant allowances	874.1	897.5	23.4	1189.9	1243.7	53.8
Variant allowances						
Network Asset Risk Metric Expenditure	138.7	143.6	4.9	161.0	163.5	2.5
Secondary Reinforcement (SRVD)	53.9	35.5	-18.4	116.0	76.1	-39.9
Low Voltage Services (LVSVD)	28.3	18.6	-9.7	47.9	31.4	-16.4
Visual Amenity Projects	5.1	5.4	0.3	4.7	4.7	0.0
Worst Served Customers	0.9	0.9	0.0	3.0	3.1	0.1
Other variant allowances	29.5	26.7	-2.9	37.7	31.5	-6.2
Total variant allowances	256.3	230.6	-25.7	370.1	310.3	-59.8
Total allowances (excl. RPEs)	1130.5	1128.1	-2.4	1560.1	1554.0	-6.1

Special Licence Conditions

modelled costs.

Special Condition 3.1 Allowed Network Asset Risk Metric expenditure			
(NARMt)			

Type of change	Amendment to existing licence condition

- 4.105 The reasons for amending this condition are to correct the baseline allowed NARM expenditure values (as detailed in Table 3 above) included in Appendix 1, as a consequence of our reconsideration of the allocation of NPg's total modelled costs.
- 4.106 The effect is to update the values to reflect the redetermination of our approach to allocating total modelled costs to individual cost categories.

Special Condition 3.2 Uncertain Costs Re-openers				
Type of change Amendment to existing licence condition				
4.107 The reasons for amending this condition are to correct the Load Related				
Expenditure ex ante non variant allowances in Appendix 2 (as detailed in Table 3				
above), as a consequence of our reconsideration of the allocation of NPg's total				

4.108 The effect is to update the values to reflect the redetermination of our approach to allocating total modelled costs to individual cost categories.

Special Condition 3.4 Use It Or Lose It Allowances			
Type of change	Amendment to existing licence condition		

4.109 The reasons for amending this condition are to correct the Worst Served Customers expenditure cap (WSCCSC) and Visual Amenity Projects expenditure cap (VAPCAP) allowances in Appendix 1 and Appendix 2, as a consequence of our reconsideration of the allocation of NPg's total modelled costs (detailed in Table 3 above).

4.110 The effect is to update the values to reflect the redetermination of our approach to allocating total modelled costs to individual cost categories.

Special Condition 3.9 Load Related Expenditure volume drivers (SRVDt and LVSVDt)

Type of change	Amendment to existing licence condition

4.111 The reasons for amending this condition are to correct the Secondary Reinforcement Volume Driver (SRVD) and Low Voltage Services Volume Driver (LVSVD) ex ante allowances (as detailed in Table 3 above), and caps for the Price Control Period in Appendix 3, as a consequence of our reconsideration of the allocation of NPg's total modelled costs.

4.112 The effect is to update the values to reflect the redetermination of our approach to allocating total modelled costs to individual cost categories.

Price Control Financial Model (PCFM)

- 4.113 We have updated the RIIO-ED2 Price Control Financial Model (PCFM) to reflect the changes to NPg's totex allowances. The copy updated is 'Version 1', originally published on 27/02/2023, prior to the start of the RIIO-ED2 price control.
- 4.114 The changes made to the PCFM are as follows:
 - Non-variant totex allowances (cells AR15:AV21) in the 'NPgN' and 'NPgY' input tabs.
 - Variant totex allowances (cells AR24:AV63) in the 'NPgN' and 'NPgY' input tabs.
- 4.115 The changes to PCFM only reflect changes to implement our proposed redetermination of the allocation on NPg's totex allowances. They do not include any changes to NPg's allowances related to the Annual Iteration Process (**AIP**) updates. We intend that any consequential amendments related to NPg's AIP in 2023 will be reflected in NPg's AIP in 2024.

Appendices

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Appendix 1 Cross-checks on cost categories

Primary and Secondary Reinforcement

A1.1 In Table 4 below, we show the allowance allocated to Primary and Secondary Reinforcement cost categories for each DNO group, at RIIO-ED2 Final Determinations, and then under our redetermined approach. At RIIO-ED2 Final Determinations, NPg had the highest percentage of their allowances allocated to this cost category. Under our redetermined approach they are much closer to the sector median (excluding NPg). This is illustrated in Figure 6, where the overall spread of allowances allocated to these cost categories is reduced, relative to the RIIO-ED2 Final Determinations position.

Table 4: Allowance allocated to Primary and Secondary Reinforcement cost categories, by DNO group

	RIIO-ED2	RIIO-ED2
	FDs	Remedy
ENWL	5.3%	5.3%
NPg	10.6%	7.3%
NGED	8.2%	8.2%
UKPN	6.5%	6.5%
SPEN	7.9%	7.9%
SSEN	6.0%	6.0%
Median (excl. NPg)	6.5%	6.5%

Figure 6: Allowance allocated to Primary and Secondary Reinforcement cost categories, by licensee



Closely Associated Indirects

A1.2 In Table 5 below, we show the allowance allocated to Core Closely Associated Indirects cost category for each DNO group, at RIIO-ED2 Final Determinations, and then under our redetermined approach. Under our redetermined approach, NPg have moved closer to the sector median (excluding NPg). The overall spread of allowances allocated to this cost category, as illustrated in Figure 7, has broadly stayed the same, relative to the RIIO-ED2 Final Determinations position.

Table 5: Allov	wance allocat	ed to Core Cl	osely Associated	l Indirects cost	category, by D	NO
group						

	RIIO-ED2	RIIO-ED2	
	FDs	Remedy	
ENWL	19.1%	19.1%	
NPg	17.0%	17.9%	
NGED	16.7%	16.7%	
UKPN	22.4%	22.4%	
SPEN	16.0%	16.0%	
SSEN	18.1%	18.1%	
Median (excl. NPg)	18.1%	18.1%	

Figure 7: Allowance allocated to Core Closely Associated Indirects cost category, by licensee

