

RIIO-ED1 Closeout Team  
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Dear Anthony

## **UK Power Networks' Response to Ofgem's RIIO-ED1 Closeout Consultation on Proposed Adjustments**

Thank you for the opportunity to comment on the above consultation. This letter should be treated as a consolidated response on behalf of UK Power Networks' three distribution licence holding companies: Eastern Power Networks plc ('EPN'), London Power Networks plc ('LPN'), and South Eastern Power Networks plc ('SPN'). For the avoidance of doubt, all financial numbers presented in this response are in 2012/13 prices and are after the operation of the Totex Incentive Mechanism (TIM)<sup>1</sup>.

We can confirm we are in agreement with your stated position in the following areas:

- **Net to Gross** – we agree that, as LPN is subject to an adjustment under the Load Related Reopener, no additional Net to Gross adjustment needs to be undertaken;
- **Network Asset Secondary Deliverables** – we agree that all three networks have delivered ~104% of their respective output targets and thus no adjustment is required; and
- **Link Box Volume Replacement** – we agree that, as SPN has over-delivered on its target replacement link box volumes, no adjustment is required.

In the remainder of our response, we have focussed on the three areas where we do not agree with your minded-to position and/or have provided further information to support our positions.

### **Load Related Reopener**

You agree with our Performance Assessment Submission (PAS) that all three UKPN licensees (EPN, LPN and SPN) satisfied the Load Related Reopener test set out in CRC 3G. However, you disagree on the extent to which a number of the deductions we put forward meet the criteria for being innovative, in full or in part. We disagree with a number of these differences and thus we

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<sup>1</sup> Ofgem's consultation response presents financial adjustments inconsistently, with the Load Related Reopener presented as post-TIM, and High Value Projects and Street works adjustments presented pre-TIM.

disagree on the value of associated monetary benefits that need to be protected from the financial adjustment made as part of the closeout assessment.

#### Rejected innovative proposals

You rejected in full the innovative savings associated with the LPN Interconnection, Fun-LV and Loadshare projects. Whilst we believe these three projects do all demonstrate innovation, with benefits of reduced load expenditure and ultimately savings to customers on account of efficient network investment, we have decided not to challenge your stated position for these three areas.

As a result, the adjustment to our protected benefits is **-£10.0m** (-£5.4m in EPN, -£4.6m in LPN and -£0.03m in SPN).

#### Part-rejected innovative proposals

We are pleased to note you agree that all other proposals put forward by UKPN are innovative and thus benefits arising from these projects should be protected during the closeout assessment. However, we do not agree on the following two areas of contention, which could lead you to erroneously discount some of these benefits in your final decision:

##### **1. Innovation transitioning to 'business as usual' in period**

You suggest that three projects (Load Blinding Relays, Flexible Connections and Timed Connections) were innovative but transitioned to 'business-as-usual' activities in the 2020/21 regulatory year, and so you propose to discount any proposed benefits and associated savings from this point.

We disagree. The whole period to the end of RIIO-ED1 is the product of our innovation on these projects, and it was the prospect of both customers and company savings across the whole period that encouraged the innovation at the outset. Your minded-to position on this topic does not accord with the expectation or guidance of the RIIO framework. It amounts to retrospective regulation.

The move from the previous price control model (DPCR5) to the new RIIO model (Revenue = Incentives + Innovation + Outputs) was undertaken with the objective *"to encourage network companies to play a full role in the delivery of a sustainable energy sector, and to do so in a way that delivers value for money for existing and future consumers."*<sup>2</sup> This move was designed to give network companies greater certainty of outputs to be delivered. The longer duration of the RIIO price control (eight years rather than five years) contributed to encouraging an improved focus on driving innovation and the associated benefits for both customers and companies.

UK Power Networks is a performance-based business, and it is in our culture to strive to be the best-performing DNO group, delivering regulatory outputs for the lowest possible cost. This is evidenced by our performance over the RIIO-ED1 period where we were the most reliable network operator, delivering a 28% improvement in CIs<sup>3</sup> and 36% improvement in CMLs<sup>4</sup> in comparison to DPCR5, providing an industry leading BMOCs<sup>5</sup> score of 94%, all while being the lowest-cost DNO (8% cheaper than the average).

It is the stability of the regulatory regime that provides the confidence to invest and strategise how we run our network and our business, maximising the value achieved from every pound we spend and pushing the frontiers on innovation and efficiency. This is not just for the benefit of our customers, but for all homes and businesses across Great Britain.

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<sup>2</sup> [https://www.ofgem.gov.uk/sites/default/files/docs/2011/03/t1decision\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2011/03/t1decision_0.pdf)

<sup>3</sup> Customer Interruptions

<sup>4</sup> Customer Minutes Lost

<sup>5</sup> Broad Measure of Customer Service

The methodology for the Load Related Re-opener at RIIO-ED1 closeout under CRC 3G is clear.<sup>6</sup> Step 4 is “Assessment of expenditure avoided through innovation” and explains how the “Authority will take into account efficiencies generated by the licensee through the use of Innovative Solutions not already factored into the licensee’s Business Plan.”

“Innovative Solutions” is defined in Annex A of the RIIO-ED1 Regulatory Instructions and Guidance, copied below for ease of reference:

*“....only solutions that meet one of the following criteria can be defined as Innovative Solutions:*

- *has been trialled by any DNO as part of an LCNF, NIC, NIA, or IFI innovation project during DPCR5 or RIIO-ED1.*
- *was considered a smart solution as part of the RIIO-ED1 smart solutions assessment.*
- *involves the application of technology, systems or processes not in widespread use at the beginning of RIIO-ED1 to provide long term direct benefits to distribution network customers through:*
  - *improving the utilisation or provision of network capacity for demand or generation (including demand side solutions)*
  - *improving the management of asset condition to reduce lifetime costs*
  - *increasing the DNO’s ability to manage network performance, safety or security, or*
  - *improving the level of service provided to network customers.*

*Direct benefits can include improvements in economic performance, environmental benefits, safety, quality of service, reliability, and/or resilience.”*

The innovation projects Load Blinding Relays, Flexible Connections and Timed Connections all fall within the above description, as confirmed within your consultation.

However, we are unable to understand the rationale or valid basis that allows you to deem that in 2020/21 the projects transitioned to business-as-usual (and thus are no longer “Innovative Solutions”).

It is not stated in any guidance, licence or closeout methodology that this is as a route Ofgem can take, nor is any precedent set within the DPCR5, RIIO-T1, GT or GD closeout assessments. Continuing with this stance of deeming an innovative solution no longer as innovative, after the fact and following eight years of reporting within the E6 Innovative Solutions Regulatory Reporting would represent a departure from the stable regulatory regime Ofgem has sought to create. Such an approach would diminish the confidence of network companies in their ability to retain benefits associated with innovation and would disincentivise them from innovating in future price controls.

All this is despite:

- (a) Ofgem’s duty in section 3A(5A) of the Electricity Act 1989 to have regard to “*the principles under which regulatory activities should be transparent, accountable, proportionate, consistent ...*”; and
- (b) the fact that Ofgem is undertaking a designated regulatory function in making this closeout determination for the purposes of section 3A(1A)(c) of the Electricity Act 1989 and therefore Ofgem must protect the interest of consumers in the fulfilment of the regulatory objective in Article 36(f) of the Electricity Directive of “*ensuring that system operators ... are granted*

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<sup>6</sup> [Decision on the closeout methodologies for RIIO-ED1 \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/consult/condocs/riioed1/riioed1decisions/riioed1decisiononcloseoutmethodologies.pdf)

*appropriate incentives, in both the short and long term, to increase efficiencies in system performance”*

We respectfully request you to reconsider your approach to this topic and not to discount the consequences of innovation as if it were ‘business as usual’.

## **2. Estimating the value of the counterfactual reinforcement**

In addition to this, and in particular for the Load Blinding Relays project, you requested we gave further thought on the calculated cost of traditional reinforcement costs.

Counterfactual costs (or deferred costs of reinforcement) have been used, minus any unqualifying expenditure, to quantify the value of allowances to protect from the closeout assessment.

It is our view that if reinforcement expenditure has been deferred out of period, then the full value of the deferred expenditure should be acknowledged in the closeout assessment as a benefit. As RIIO-ED1 has demonstrated, forecasts and predictions for load growth can vary considerably from what transpires in reality, and thus it is not appropriate to dilute the value based on a hypothesis that the need to reinforce the site may materialise again in the near term. Finding innovative ways to avoid traditional and costly reinforcement should be commended, with the full value of the benefits protected to encourage network companies to seek out these opportunities, leading to the efficient operation of the network and its capacity.

The below Innovative Solutions all use the cost of the counterfactual to assist with valuing the amount to protect at closeout:

- Load Blinding Relays
- Flexible Connections
- Timed Connections
- Load Blinding Relays for Busbar Protection
- Flexibility Savings

Values that have been used all refer to evidence, decisions and estimations that have been captured across the RIIO-ED1 period. During our closeout engagement we have provided considerable information and evidence to Ofgem across a six-month period to explain the basis of this evidence and the calculation of the associated benefits. With the exception of Load Blinding Relays, this approach has been consistent, with counterfactuals based upon estimates provided by UKPN Network Planners using information at the time. This has been sufficient for you to accept the cost of the counterfactuals used in the basis of protecting the savings for flexibility, Load Blinding Relays for Busbar Protection and also for the remaining innovative proposals up to 2020/2021 as per point 1 above.

For Load Blinding Relays, as a result of further analysis undertaken during the Supplementary Questions (SQ) period, we identified that some of the costs used to determine the reinforcement costs at sites were a mixture of estimates from Network Planners (as above) and in other instances, a £/MVA value was used and applied to the capacity released from the Load Blinding Relay. Subsequently, we opted to be consistent across this innovative solution and apply the same £/MVA value (£51,672) across all sites where Load Blinding Relays were used. This was because:

- a) we could not ask Network Planners to reliably cost up traditional reinforcement costs for historic works given network constraints and costs will be different now to that when the solution was deployed; and
- b) using the £/MVA value provides a conservative valuation of the cost of reinforcement, i.e. by only applying to the capacity released it is a lower value than would be applied to any



additional capacity released by a true counterfactual solution. For example, our counterfactual approach would value 12MVA of capacity released at £620,064 (12MVA x £51,672), but the true counterfactual cost would require the installation of a new 20MVA transformer, which depending on the circumstances at the site, could cost significantly more than the value we have proposed. By opting for the lower value, it means the value protected from the closeout assessment is less than it otherwise would have been.

Furthermore, for reference, under the RIIO-ED2 Load Related Expenditure Volume Driver, the £/MVA value used for Ground Mounted Transformers is between £54,904 and £56,210 (in 2012/13 prices), i.e. further demonstrating our estimate is conservative. Ultimately, we are seeking recognition and therefore benefit for deploying this innovative solution, but we are doing so in such a way that customers are benefiting from an increased share of the savings due to our use of a conservative estimation.

Given the above, we trust that the further information provided is helpful to you in reaffirming our approach and that you do not seek to make any post consultation amendments to the methodology used to define the counterfactual costs. Proposing that the design of a new valuation method at this late stage would not allow for sufficient consideration and risks an unfair process.

### Conclusion on Load Related Reopener

In summary, for the above reasons, we agree with your rationale for discounting £10.0m of associated benefits from the LPN Interconnection, Fun-LV and Loadshare innovation projects. We however disagree with any reduction to the associated benefits for the Load Blinding Relays, Flexible Connections and Timed Connections innovation projects. Thus, we believe the associated discounted benefits of £26.6m should be reinstated and accounted for in your overall Load Related Reopener decision. By doing this, the total UKPN value to be returned to customers as part of the Load Related Reopener would be £49.9m.<sup>7</sup>

### High Value Projects

In our PAS document on High Value Projects, we proposed that, for any project not fully completed within the RIIO-ED1 period, the closeout assessment should take into account the forecasted expenditure for completion of the project within the RIIO-ED2 period, so as to assess whether the full project cost would be materially lower than the original allowance. This would determine whether allowances should be returned to customers. Applying this analysis, our proposal was that, of the UKPN DNOs, only LPN should return allowances to customers, on the basis that the need to undertake the West End project had been deferred until the RIIO-ED4 period.

You have however provisionally decided that the use of RIIO-ED1 allowances to complete in-flight projects in the RIIO-ED2 period should not be factored into the closeout assessment (para. 4.17). In doing so it then follows that both LPN and SPN have materially underspent and, as a result, an additional £8.5m should be returned to customers above what we had already proposed. We disagree, for the following reasons:

1. **It is in direct opposition to the precedent set by Ofgem's DPCR5 closeout decision** – Ofgem allowed DNOs who had in-flight projects that were clearly going to be delivered to *"retain the forecast spend required to finalise these projects and exclude[d] the associated*

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<sup>7</sup> The accompanying 'UKPN – Final Closeout Positions – LRR\_HVP\_Streetworks' spreadsheet captures the revised movements and final values to be returned to customers/awarded to UKPN. We have also replicated Ofgem's file for the adjustments to aid Ofgem in viewing the final positions in comparison to its own presentation of numbers in its minded-to position – this is titled 'DATAFILE\_MASTER\_UKPN'

*underspend from our [their] assessment”.*<sup>8</sup> We are entitled to expect consistency from Ofgem in its treatment of the RIIO-ED1 closeout and we have not been forewarned of a change in approach.

2. **It is inconsistent with the RIIO-ED1 licence and published closeout methodology** – Special condition 3F.8(a) refers to closeout adjustments to uncertain cost activities, such as High Value Projects, including those proposed by the Authority after the end of the RIIO-ED1 period (3F.11), being “*based on information about the actual or forecast level of efficient expenditure*”. Similarly, Step 1, paragraph D3 of the closeout methodology says that Ofgem’s initial analysis will be based on the “*actual or forecast level of High Value Project Costs*”. In both instances the word “forecast” emphasises that RIIO-ED1 allowances forecasted to be spent in the RIIO-ED2 period are relevant within the RIIO-ED1 closeout.
3. **UKPN did not request any RIIO-ED2 allowances to complete RIIO-ED1 HVPs** –We relied on the expectation and understanding set out in points 1 and 2 above. Our RIIO-ED2 Business Plan did not request any allowances to complete any in-flight HVPs from the RIIO-ED1 period. This was highlighted to Ofgem in our RIIO-ED2 Business Plan Data Template Commentary, submitted in December 2021, with relevant extract below:

*“Two projects are anticipated to complete in the first years of RIIO-ED2, however, these projects are part of RIIO-ED1 HVP continuation and were funded in RIIO-ED1. The costs in RIIO-ED2 are not part of the RIIO-ED2 ex-ante plan given the precedent set by the DPCR5 close-out process, where for similar projects the Ofgem decision was to retain the DPCR5 price control funding, with well progressed projects completing in RIIO-ED1 without any additional funding.”*

We were very clear with our expectation that RIIO-ED2 funding would not be used to complete inflight RIIO-ED1 HVPs. It Ofgem were not of this view, this should have been communicated to us at the time. If you continue with your minded-to approach of not factoring our forecasted spend into the closeout assessment it will leave these HVPs materially underfunded.

4. **There is currently no defined mechanism to recover this forecasted expenditure** – You have suggested that any RIIO-ED2 expenditure on RIIO-ED1 HVPs should be dealt with during the RIIO-ED2 closeout. The RIIO-ED2 closeout methodology is yet to be defined. This puts UKPN at risk of being underfunded to complete these projects. Additionally, it prolongs the assessment process for projects that were submitted to Ofgem over 15 years prior.

#### Other points to note

In paragraphs 4.30 – 4.34 of the consultation, you highlight that you did not comply with the licence requirement to undertake and notify any HVP financial adjustments as part of the closeout process in the period 1<sup>st</sup> – 31<sup>st</sup> December 2023. You refer to a number of mitigating factors and set out your reasons for continuing with the assessment despite this non-compliance.

We agree that it is in customers’ interests to continue with the assessment, and we submitted our PAS document on this basis and in good faith. However, we do want to highlight to you that we are making a concession and furthermore we do expect that you will follow the licence, guidance and regulatory precedent when undertaking the assessment, in line with the reasoning presented above.

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[https://www.ofgem.gov.uk/sites/default/files/docs/2017/06/dpcr520close20out20public20consultation20final1\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2017/06/dpcr520close20out20public20consultation20final1_0.pdf) (para. 2.20), confirmed in [DPCR5 Closeout: decision on adjustments to allowances | Ofgem](#).

If you continue to pursue your minded-to position, we will be compelled to report any RIIO-ED2 expenditure on RIIO-ED1 HVPs on load or asset replacement tables as part of our annual regulatory submissions. This would also mean claiming any associated benefit from doing so within the RIIO-ED2 period (i.e. NARMS<sup>9</sup> risk points). However, if, as we suggest, you reconsider your position and factor forecasts into the RIIO-ED1 closeout assessment, we would then restate our submission in future years and place RIIO-ED2 expenditure on RIIO-ED1 HVPs on the HVP regulatory reporting tables.

### Conclusion on High Value Projects

In summary, for the above reasons, we disagree with Ofgem's stance of disallowing forecasted expenditure from the HVP closeout assessment. We put forward both our RIIO-ED2 Business Plan and our HVP PAS document on the legitimate expectation that the licence, associated guidance and regulatory precedent set in prior controls would be followed. For Ofgem to maintain its minded-to position on this topic would leave UKPN materially underfunded to complete affected projects and (as with the minded-to position on the Load Related Reopener) would signal a change to retrospective regulation.

We respectfully request you reconsider your position on this topic, ultimately reassessing the closeout with forecasts included. This would result in the total figure to be returned to customers by UKPN as part of the HVP closeout assessment being set at £10.9m.

### Specified Street Works Costs

In our PAS document for street works, we proposed an additional £0.85m<sup>10</sup> of allowances for EPN based on having delivered greater volumes of work than was originally funded through the 2019 reopener. Our request was based on recalculating the unit cost for works, using the same methodology Ofgem had used in 2019, but updating it using revealed costs from across the period from UKPN and other DNOs, and thus removing the applicability of the 3% efficiency challenge Ofgem had placed on the unit cost from 2019 onwards.

You have in your approach, like we had, looked to update the unit cost of work based on revealed data. However, your approach contains two errors, which lead you mistakenly to a conclusion that UKPN should have no additional allowance:

1. **Permit variation volumes have been removed from the calculations** – In Ofgem's 2019 street works reopener decision<sup>11</sup> (four years into RIIO-ED1), volumes and costs associated with both permits and permit variations were utilised in the derivation of the efficient unit cost.

This was on the basis of DNOs and Ofgem both recognising that permit variations were sometimes a necessary work activity, for example when changing a schedule of works to meet customer requirements or at the request of Local Authorities working to minimise the impacts of street works activities.

Ofgem then, to calculate the awarded allowance as part of the 2019 reopener, used the calculated unit cost and applied it to the actual volumes of permit and permit variations for the first four years of RIIO-ED1, but then applied it only to the forecasted volumes of permits for the final four years of RIIO-ED1. This was based on Ofgem recognising (as highlighted above) that whilst "*some level of permit variations are outside the DNOs*"

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<sup>9</sup> Network Asset Risk Metric

<sup>10</sup> Our PAS document presented the claim pre-TIM at £1.59m. This equates to £0.85m post-TIM.

<sup>11</sup> [RIIO ED1 Reopener Decision Specified Streetworks Costs \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/rpr/regulation/2019/07/riio-ed1-reopener-decision-specified-streetworks-costs)

control", their expectation going forward was for DNOs to work to minimise these going forward.

In your consultation on closeout, you have again derived the unit cost by including the volumes and costs associated with both permits and permit variations in the first four years of RIIO-ED1, and excluded permit variations in the final four years, whilst updating permits to include the revealed actuals rather than the forecasts used in the 2019 reopener. However, when calculating the resulting allowance associated with street works activities, you have applied this blended unit cost against only the volume of permits for the full eight years of RIIO-ED1, i.e. you have omitted the volumes associated with permit variations from the first four years of the price control period.

Omitting allowances associated with permit variations in the first four years of RIIO-ED1 is inconsistent with both the design and intent of the 2019 reopener. This is, at best, a simple error in Ofgem's application of the street works methodology, or, at worst, another example of retrospective regulation.

2. **The 3% efficiency challenge has been retained from 2019 onwards** – Putting the above point aside, you have ultimately generated an efficient unit cost based on the revealed cost information from all DNOs across an eight-year price control period i.e. the calculated unit cost should be a fair reflection of the amount of allowances required to deliver the work prescribed. Despite this, you have retained a 3% year-on-year efficiency on this unit cost post-2019. This is contradictory.

Ofgem initially set this 3% efficiency challenge as a result of the 2019 Street Works reopener based on the expectation that DNOs would find efficiencies subsequently. UKPN disagreed with this strongly at the time and repeated the following arguments in our PAS documents, stating that:

- It was not in line with the approach taken for setting the RIIO-ED1 price control;
- There was no evidence of the level of efficiency included in Ofgem analysis;
- It was inconsistent with the approach for gas distribution; and
- It failed to account for differing levels of maturity.

As can be seen through the data received from all DNOs, the 3% efficiency challenge was unrealistic. In fact, the average unit cost year on year varies significantly, suggesting costs are more volatile than predictable. It does not make sense to calculate a new efficient cost using data across the whole price control period, and then arbitrarily apply a 3% challenge, when (firstly) there has been no evidence provided to state why this is appropriate and (secondly) the actual data revealed by DNOs demonstrates this 3% challenge was not achievable. Even if DNOs had demonstrated a 3% year-on-year improvement post-2019, your methodology would have still applied a 3% efficiency on revealed performance – this is in effect a double application of the efficiency challenge and one that would leave DNOs always underfunded.

### Conclusion on Specified Street Works Costs

In summary, for the above reasons, we disagree with your minded-to position of not allowing any additional allowances for street works activity. In response to our provided rationale, we have utilised Ofgem's closeout methodology but updated it to include permit variations as an applicable work activity in the first four years of RIIO-ED1 and removed the 3% efficiency challenge. This would result in an award of £1.12m post-TIM of additional allowances for UKPN's qualifying street works activity in its EPN licence area. However, given your proposed adjustments were to award the lower of that requested through the PAS documents or the value calculated from your closeout methodology, we propose our claim remains at the originally submitted £0.85m.



### **Conclusion on RIIO-ED1 closeout position**

In conclusion, we are in agreement with your consultation positions with regard to: Net to Gross; Network Asset Secondary Deliverables; Link Box Volume Replacement; and adjustments to our Load Related Reopener clawback amount on account of three rejected innovation projects.

However, we do not agree on how further reductions have been made under: the Load Related Reopener on account of Innovative Solutions becoming BAU; the removal of RIIO-ED2 forecasted spend from the closeout assessment of High Value Projects; or the methodology used to calculate additional allowances for street works activity.

Our proposed adjustments to Ofgem's stated consultation result in positive movements of £26.6m on Load, £8.5m on HVPs and £0.85m on street works. Factoring these assessments into the overall closeout position, this puts the total proposed value to be returned to customers as part of closeout at £60.0m.

We thank Ofgem for its current level of engagement with regard to the RIIO-ED1 Closeout and would be happy to discuss any of the above in greater detail. If you have any questions on our response or would like more information, please do not hesitate to contact James Hope in the first instance.

Yours sincerely



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