

Ofgem RIIO ED1 Team

(by email to)

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Your ref

15/12

Our Ref

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Date

2 April 2012

Contact / Extension

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Open letter consultation on the way forward for the next electricity distribution price control review – RIIO-ED1

Please find attached SP Energy Networks (SPEN) detailed response to Ofgem's consultation dated 6th February 2012.

We wholeheartedly agree that accommodating low carbon technologies in a timely and cost effective way should be a key feature of RIIO-ED1 and are committed to playing our full part in the transition to a low carbon economy.

Given the variety of innovative solutions which may be proposed to address the future challenges, consideration could be given to assessment of whole life costs rather than simply the capital unit cost as is currently undertaken. We shall work with Ofgem to develop a robust approach for assessing efficient costs, including totex analysis.

DPCR5 introduced outputs and incentives in a variety of areas. In general we believe these are appropriate for refinement and development for application in RIIO-ED1 as follows:

- Network performance incentives – retain IIS mechanism and further develop health indices and load indices
- Customer Service incentives – retain guaranteed standards, revise broad measure to include 'lost calls' as this group of customers are currently excluded and develop leading measures of connections competition
- Environment – retain existing measures but remove transmission exit charges incentive and revise losses mechanism to be engineering based until smart meter roll out allows reintroduction of a settlement based mechanism

On balance, we would prefer a nine year price control period for RIIO-ED1, subject to the development of adequate uncertainty mechanisms that would mitigate the additional risk of a longer price control period. This would alleviate resourcing issues for Ofgem and groups with multiple licences.

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We welcome the continued emphasis on stakeholder engagement and we shall be building on our experience of RIIO-T1. We shall be adapting our approach to allow effective representation from the much larger numbers and range of stakeholders for distribution. We commit ourselves to working closely with Ofgem and stakeholders to reach early agreement on delivery of a successful outcome to RIIO-ED1, including development of appropriate social obligations.

We strongly recommend the approach taken by Ofgem as part of the RIIO framework in making use of stakeholder engagement groups such as the PCRf and the CCG, and urge that sufficient time is allowed for effective feedback to DNOs from both groups, perhaps including additional meetings of the CCG.

The following attachment includes greater detail on these points and the questions raised in the open letter, if you have any queries regarding these please do not hesitate to contact us.

Yours sincerely,



Jim McOmish
Distribution Policy Manager

SP Energy Networks Response - Ofgem Open letter consultation on the way forward for the next electricity distribution price control review – RIIO-ED1 (Ref 15/12)

Executive Summary

We wholeheartedly agree that accommodating low carbon technologies in a timely and cost effective way should be a key feature of RIIO-ED1. We are committed to playing our full part in the transition to a low carbon economy.

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Low carbon technologies and smart grids

Ofgem: Do you agree that ensuring that DNOs accommodate low carbon technologies in a timely and cost effective way should be a key objective of RIIO-ED1? Do you have any thoughts on how we could address this?

We agree that this is a critical feature of the RIIO-ED1 price control and should feature in investment decisions for new connections, load related investment and asset replacement to a certain extent. As per the approach taken in RIIO-T1, we believe that companies business plans should be developed from an 'industry' best view of existing technology with the flexibility developed around that. Given the high uncertainty over the uptake of low carbon technology, and the development of alternative solutions to address the challenges that this creates, flexibility within the business plans will be required to allow DNOs to apply the most appropriate solution as they are developed. A number of LCNF projects are addressing some of these issues and many of the solutions that are being trialled will only be proven over the course of DPCR5 and the early years of RIIO-ED1, not before many of the incentives for RIIO-ED1 are finalised. The RIIO-ED1 process should be careful not to pre-empt the outcome of such demonstration projects until the learning has been fully understood and disseminated for all parties to benefit.

We believe a key consideration for the accommodation of these technologies will not only be the development of the technology on the network but also the commercial arrangements which accompany it. Some of the barriers which may currently exist should be actively examined through the LCNF activity rather than developing new arrangements for the purposes of RIIO-ED1 which are not tested and proven. Given the variety of innovative solutions which may be proposed to address the future challenges, consideration could be given to considering a whole life solution cost rather than the capital unit cost as is currently undertaken. This could examine the net present value of such solutions and consider the trade-off between ongoing opex versus capital intensive solutions e.g. demand side management versus new assets.

A critical part to the creation of the business plans will be determining a common set of scenarios for the DNOs to build upon, while also recognising the regional differences that will drive different approaches i.e. Scotland's target for 500MW of renewable energy to be derived from local communities by 2020. This has partly been undertaken by WS1 of the Smart Grid Forum but we believe further work is required to ensure these scenarios are comprehensive and realistic, for example, this work does not address underlying demand growth assumptions.

Review of DPCR5 mechanisms

Ofgem: Which of the DPCR5 outputs and incentives do you consider to be fit for purpose, or require minimal amendment, for RIIO-ED1?

Safety, Reliability and Availability - We supported the development of network outputs (Health indices and Load indices) for DPCR5 and believe that, with further development, will continue to be appropriate for RIIO-ED1. In particular we focus should be given to extension of the indices towards risk measures through inclusion of asset criticality and development of an overall asset health output.

The IIS mechanism is well established and understood by all stakeholders and requires minimal amendment for RIIO-ED1. The target setting mechanism requires review with focus on the incentive rate and the balance between CI and CML. The Worst Served Customer mechanism requires refinement as the definition is too narrow and the incentive rate too low to provide for improvements in this area.

Customer Service - Although the broad measure customer satisfaction is only being introduced in 2012/13 there remain concerns that the mechanism is calibrated on data that is not statistically significant. We suggest further analysis of actual performance is necessary before deciding how the mechanism needs to be refined for RIIO-ED1. There is a clear requirement to refine the mechanism to reintroduce a measure of 'lost calls' to the incentive mechanism as this group of customers are excluded from the current measure.

The guaranteed standards for customer service remain appropriate and should be retained, with a review of the appropriate values.

Connections - The guaranteed standards introduced for DPCR5 require some refinement to avoid gaming by speculative developers. In addition, we believe more refined measures of competition should be developed by Ofgem through their annual reporting processes. For example, 'connections won' is a stronger measure of the current levels of competition than 'connections delivered', which is a measure which lags by, perhaps, several years.

Environment – We believe the existing mechanisms generally work well but there are a few areas which require modification for RIIO-ED1. Facilitating transition to a low carbon economy will be a major focus of RIIO-ED1.

We do not believe that transmission exit charges incentive mechanism is effective or appropriate and should be discontinued.

The DNO and Supplier industry working group, formed in 2011 to assess the effectiveness of the DPCR4 losses incentive mechanism, concluded that the current losses incentive mechanism is fundamentally flawed and that settlement data are not appropriate for measuring distribution losses. An engineering output based losses mechanism should be implemented to replace the current mechanism until smart metering has been rolled out to effectively all customers in a DNO's area. The years immediately following this could be used to measure and set targets for reintroduction of a settlement based mechanism at an appropriate point. This would avoid windfall gains / losses and ensure that the incentive targets can be set appropriately.

Assessing efficient costs

Ofgem: We welcome respondents' views on how we can improve the cost assessment, particularly with respect to the expenditures that will be proposed in RIIO-ED1.

We support Ofgem's intention to adopt a toolkit approach for assessing efficient costs for the RIIO-ED1 price control and we look forward to developing a robust and pragmatic suite of measures alongside the other DNOs and Ofgem.

We are pleased that Ofgem intend to include a review of the DPCR5 approach as part of its deliberations and that avoiding over-complication will be one of its key objectives for ED1. In our opinion, the very detailed benchmarking performed by Ofgem in DPCR5 led to many DNO's being unable to determine a clear line-of-sight from Ofgem's benchmarking results through to final allowance setting. This was a major weakness which the Cost Assessment Working Group should focus on avoiding again.

We also found that the mechanistic allowance setting in DPCR5 was unduly influenced by the large scale DNOs/Groups relative position to the remaining data points, which resulted in a skewing of the regression analysis and was not statistically robust. This is further compounded now that two Groups own half of the DNO's; how they partition their costs will have a disproportionate influence on any cost regressions. To get round partitioning issues, Ofgem needs to consider benchmarking at a group level while recognising that disaggregated efficiency comparators do not readily lend themselves to only six data points (i.e. group level). Therefore the full toolkit afforded to Ofgem will need to be utilised to inform the decision making process rather than relying solely on any single regression output to mechanistically set an expenditure allowance.

Our recent Transmission Business Plan submission provided us with a first opportunity to implement the new RIIO model. There were many key learning points for us (and Ofgem also); demonstrating and evidencing cost efficiency within the plan was one of these. For ED1 there is likely to be an even larger and varied range of submissions across the DNO groups, that may not be easily comparable; each plan is likely to have a range of scenarios which need to be considered within the context of the submission. It is important for ED1 then that Ofgem ensure an appropriate balance is struck between a qualitative assessment of well-justified business plans and reliance on mechanistic cost regressions. In particular relative benchmarking must be used with caution; each plan should be assessed on its own merits.

Disparate plans (scenario types/styles/contexts) and complex scenarios do not readily lend themselves to a disaggregated cost benchmarking approach that doesn't account for the interplay and trade-off of capex and opex costs very well and where a mechanistic allowance setting is the goal. We believe that more reliance should be placed on a Totex benchmarking approach that aligns more philosophically with the RIIO allowance setting methodology and is consistent with the RIIO framework. Totex benchmarking removes cost play offs/trade-offs and the need to identify a wide range of individual suitable cost drivers, that help in simplifying the process and are relatively transparent.

We look forward to developing a robust methodology with Ofgem through the Cost Assessment Working Group.

Smart meters

Ofgem:

“Whilst suppliers will be responsible for procuring and installing the smart meters, we expect that the DNOs will incur costs from additional call-outs as operational issues for which they are responsible are uncovered during installation.”

“We also expect that the meter replacement will uncover issues affecting the accuracy of the data used for balancing and settlement. We will need to consider how this affects the losses incentive which uses settlements data as an input. However we expect that once smart meters are rolled out there will be a significant improvement in the measurement of losses.”

The open letter does not explicitly ask a question on smart meters but we believe this should be a key consideration because of the potential impact, and also the benefit which DNOs could achieve from Smart Meters. A number of relevant points are raised which should be considered including the additional costs which DNOs will need to incur as well as issues uncovered as a result of data accuracy.

Consideration will also need to be given to the likely costs for DNOs of establishing suitable IT systems and other process changes in order to manage these new data streams for them to be of longer term benefit. DNOs are also likely to incur costs associated with the provision of data and DCC operational charges. Both of these will be the source of longer term benefits to customers, but many of these will not be achieved until the rollout of smart meters has reached a critical mass which is likely to be at least mid way through RIIO-ED1.

Length of price control

Ofgem: Do you think the ED1 price control period should last for eight or nine years?

We see merit from a resourcing perspective, for both Ofgem and parties with multiple licences (e.g. DNOs with GDN or Transmission licences), of extending the price control to 9 years. The concern that 9 years is inappropriate due to uncertainty over that period is potentially equally applicable to 8 years. On balance, our preference is for the ED1 price control to last 9 years.

We believe that development of effective uncertainty mechanisms (e.g. revenue drivers, focused reopeners, trigger mechanisms etc) should mitigate the additional risk rising from an additional year.

Business plans and proportionate treatment

Ofgem: We welcome feedback on the business plans and proportionate treatment process for RIIO-T1 and GD1 and any improvements we can make for RIIO-ED1.

In our view one of the important benefits of RIIO, is the potential for proportionate feedback depending on the quality of the business plan. If a business plan is well-justified, demonstrating appropriate stakeholder engagement with a clear strategy, then such a plan need not require the same degree of regulatory oversight as a plan that does not demonstrate these qualities. Ofgem should have comfort that the use of a strong outputs-led framework under RIIO, with network revenues linked to actual annual investment, allows for a proportionate approach to be applied to qualifying network companies without any risk to the cost and quality of service.

Enhanced Stakeholder Engagement

Ofgem: We welcome feedback on the company stakeholder engagement processes used in RIIO-T1 and GD1, and also welcome any feedback on the consultations being initiated by the DNOs.

Ofgem's focus on stakeholder engagement in RIIO-T1 has significantly influenced our strategy, commitment and activities in this area and we welcome the continued emphasis in ED1. However, stakeholder engagement respect of our distribution activities will be significantly different from our Transmission engagement for two main reasons. Firstly, the numbers of distribution stakeholders and secondly the different issues they are likely to raise.

The focus in RIIO-T1 was the scale of investment required to connect renewable generation and the impact connecting these generators has on the environment, visual amenity and cost to consumers. Much of the debate was dominated by government targets and the challenge to achieve these at acceptable cost. The challenge for stakeholder engagement was to identify key groupings, clarify the issues they face and understand how to trade off opposing requirements. The number of interested stakeholders runs into hundreds which allows engagement to be facilitated through dedicated workshops, one-to one meetings, and the building of long term relationships.

Distribution stakeholders include millions of domestic and business consumers. It will be imperative to develop mechanisms that can capture information from large numbers of individual stakeholders, supplemented by identifying and working with key representative groups. The use of online forums, analysis of trends from behavioural data and feedback through representative groups is likely to provide the intelligence we need to inform our business plans. We will establish forums with key stakeholders that provide enduring processes for facilitating effective stakeholder engagement over the ED1 price control period.

Our current engagement has highlighted our distribution stakeholders to be concerned about their supply quality, reliability and cost. In particular, the opportunity to manage their demand, source low cost electricity and achieve environmental benefits are recurring themes. In response to this, we are already committed to work with the Scottish Government to support their target of 500MW of community and local energy schemes. We are taking forward a project which links in local wind farm developer, energy efficiency assessments and will incorporate Dynamic line rating and active network management systems. We have also undertaken some other innovative projects which have looked at whole village scale energy monitoring and dynamic line rating projects in North Wales, increasing power flows when wind and temperature conditions allow.

We look forward to building on our stakeholder engagement to better understand the needs and aspirations of our stakeholders and ensure our ED1 investment plans meets those needs and delivers real benefit to all our stakeholders.

Ofgem: Have these stakeholder engagement groups been useful in RIIO-T1 and GD1? Are there any improvements that we could make for RIIO-ED1?

These groups have provided significant influence and benefits to the RIIO-T1 stakeholder engagement process and formulation of our business plans. They effectively represented a broad range of stakeholders and were able to understand and respond to our investment plans to bring effective challenges that led to improvement in our plans and clearer outcomes for stakeholders.

We strongly recommend the approach taken by Ofgem as part of the RIIO framework in making use of stakeholder engagement groups such as the PCRf and the CCG.

Price Control Review Forum

We have found these forums useful in terms of:

- Providing a communication channel to the stakeholder community,
- Providing feedback on how other companies are managing the process,
- Providing feedback from Ofgem on their priorities and milestones
- Understanding concerns and issues from stakeholders

We gained more value from this Forum when it focused on the four transmission companies, rather than when it also included the gas distribution companies, as more time was available to focus on transmission issues. This probably would not be as much of an issue for ED1, but having seven+ companies presenting to the Forum could limit the time for feedback, which from the networks businesses' perspective, is an important benefit of this Forum.

Consumer Challenge Group

Our experience with the CCG in reviewing our RIIO T1 transmission business plan was very positive with a strong focus on stakeholder engagement, sustainability and innovation. In particular they considered:

- Our level of engagement with stakeholders, and also to understand what areas could be improved, and lessons learned,
- Ensure that we had considered and addressed the future proofing of our plan, and
- Assess our commitment to innovation, environment and sustainability.

We also received practical advice on the layout of our Business Plan; for example they noted that although we have provided the information necessary to justify our Plan, as envisioned by the RIIO framework, perhaps more thought should have gone in to the Plan layout to support the reader.

We have taken the feedback we received from the CCG to heart, and intend to ensure that our stakeholder engagement plans for ED1 are based on effective and targeted communications. We only met with the CCG on one occasion in the RIIO T1 process. For RIIO ED1, we suggest that more than one meeting with each company would be worthwhile; perhaps a first meeting to discuss the companies' plans three to six months before they submit their individual business plans, and then a second meeting around three months after their plans have been submitted, and ensuring that feedback from the CCG aligns with the decision making process for the fast-track timetable.

Working Groups

We consider the working groups were essential to the RIIO-T1 process but our overall experience was that it was not consistently clear how stakeholder views, were taken into consideration. It is important to the success of RIIO ED1 that working groups inform policy effectively, and that Ofgem's consideration of the views of all stakeholders in their policy development process is transparent.