Registered Office:
Newington House
237 Southwark Bridge Road
London SE1 6NP

Registered in England and Wales No: 3870728

Company:
UK Power Networks
(Operations) Limited

James Grayburn
RIIO-GD1
Ofgem
9 Millbank
London
SW1P 3GE

By email to: RIIO.GD1@ofgem.gov.uk

21 September 2012

Dear James

Consultation on the RIIO-GD1 and T1 Initial Proposals

Thank you for the opportunity to provide views on Ofgem's Initial Proposals for the RIIO-GD1 price control review.

This response should be regarded as a consolidated response on behalf of UK Power Networks' four electricity distribution licence holding companies: Eastern Power Networks plc, London Power Networks plc, South Eastern Power Networks plc, and UK Power Networks (IDNO) Limited.

I can confirm that this response is non-confidential and can be published via the Ofgem website.

The publication of the RIIO-GD1 and T1 Initial Proposals marks a very important milestone in the establishment of the RIIO framework. For UK Power Networks, who have participated in the development of RIIO from its origins in RPI-X@20, it has been an interesting journey and it is good to see many of the principles outlined 3-4 years ago being realised within these first RIIO price controls. Overall UKPN welcomes and is supportive of the move to the RIIO framework, particularly the increased focus on customers and stakeholders as it is important that the business plans reflect their requirements and those of the transition to the low carbon economy,

There is much within this consultation which is specific to the Gas Distribution industry, and we have left it to those who are more directly involved to comment on those issues. However there are also a number of more general observations that can be made, and specifically aspects that could have relevance to the RIIO-ED1 price control. We have focussed our contributions on those points.

In the attached pages, we have responded on a number of those more general issues, reflecting the structure of the Initial Proposals and the various appendices.

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I hope that you find these views of use. If you wish to follow up any of the points described in this letter, please do not hesitate to contact me on (07875) 112948.

Yours sincerely

Keith Hutton
Head of Regulation
UK Power Networks

Appendix 1

Cost Assessment

Firstly we would like to welcome the commitment to transparency shown by Ofgem in publishing a clear statement of the methodology applied to assess cost efficiency. In particular, the production of the 'Step-by-Step Guide' is a worthwhile innovation.

We are pleased to see that Ofgem has carried through with many of the proposals that were foreshadowed in RPI-X@20 including both the use of a diversity of assessment approaches, and also a greater consideration of future forecasts when setting allowances. This move away from a simplistic, mechanistic approach is welcome, particularly in the context of the uncertainties that now exist in the energy market.

Within this diversity of assessment methodologies UKPN notes and welcomes Ofgem's inclusion of TOTEX methodologies, The development of a methodology that is simple and provides a robust assessment process is an important enhancement to the DPCR5 process, We note, however, that the assessments of the efficient level of volumes and costs have been carried out independently. This implies a potential systematic over-estimation of potential cost savings as companies who have robustly justified the total business plan will be disadvantaged. We recognise that this has been mitigated to some extent by the inclusion of average costs (in some parts of the cost assessment framework) but believe that this issue needs to be properly addressed in future price controls under the RIIO framework

Secondly, we endorse the approach that Ofgem has adopted in respect to specific adjustment factors. It is our experience that there are significant differences in the operating conditions faced by the various utility companies operating across the UK. It seems self-evident to us that there are very different challenges to be faced in providing services in central London, as against, for example, the Highlands and Islands of Scotland. As such it is not only appropriate but essential that the cost assessment framework reflects this.

We believe that Ofgem is correct to place the responsibility for making the case for such adjustments fairly and squarely with the networks operators. Equally, when presented with that evidence, it is imperative that Ofgem takes note of this and acts upon it.

We consider that Ofgem's treatment of company specific factors is both rational and effectively analysed. The separation of factors into labour/contractor costs, which are essentially driven by the cost-of-living, and urbanity/sparsity which reflects the environment in which the companies operate is a useful one, and builds on the treatment developed in DPCR5.

Identifying where the London effect stops will always be slightly subjective, and whilst one could certainly argue that cost of living pressures extend well away from London and into the Home Counties, using the M25 as a proxy is a reasonable compromise.

We note that the rest of the UK is being treated as if it was one homogeneous region. Our own research, as presented at DPCR5 and refreshed subsequently, shows different labour and contractor cost factors for each of the 14 electricity Distribution Network Operators (DNOs). This identifies two DNOs, outside of London and the South East, which were facing above-average cost pressures. Furthermore the majority of DNOs had below-average.cost factors with 7 companies below the 97% factor used in Ofgem's analysis. This has the effect of giving those companies an inherent and wholly inappropriate cost advantage, even allowing for the adjustments made to the cost bases of companies operating in higher-cost areas.

We strongly welcome Ofgem's recognition of the productivity impact faced by companies operating in urban and sparsely-populated areas. This is a real cost, but complex to measure, as it manifests itself in a range of different forms e.g. restrictions on working hours, the extent to which other utilities are present in the footway etc. Ofgem's approach whereby it has weighed up the evidence provided but then arrived at pragmatic adjustments which are easy to apply is a sensible one.

As a related matter, we also support Ofgem's decision to separate out TMA costs. Our experience shows that whilst there are still inconsistencies in the way this is being applied, the networks operators should be in a position to quantify much of this effect. In the spirit of the well-justified business plan, the companies should then be in a position to present this for Ofgem's consideration, and where the evidence is robust, Ofgem should then allow this expenditure.

Furthermore, we believe that Ofgem has adopted a sensible stance in recognising that there are certain supporting activities, such as reinstatement or transport, which are subject to the same urban challenges as direct tasks.

Thirdly, we note the new approach to the assessment of Business Support costs whereby the assessment process has been opened up to include other comparable companies, outside of the sector, and the adoption of standard benchmarks (provided by Hackett Group).

In principle, we support this as an approach. Whilst there are inevitably some peculiarities within the energy sector, many of these corporate functions are essentially similar to those found in other sectors..

In general, we approve of the selection of cost drivers, which are inherently more intuitive than those used in DPCR5. However, we think the Initial Proposals would have been improved if the logic behind the choice of drivers was explained in a little more detail.

We note the inclusion of the 'efficiency evidence additions' which appear to offer a mechanism through which companies can submit their own efficiency assessments/benchmarks for consideration. We approve of this innovation as it should encourage network operators to look outside their own organisation and sector, both in assessing their own performance and identifying opportunities to improve.

The one concern we have is that this assessment approach could drive you towards a view that lowest cost is, by definition, best. By way of example, the easiest way to achieve a reduction in our HR costs would be to limit or stop non-operational training, but is that a prudent approach in respect of the sustainability of the company or engagement of our employees? Equally a company could quite legitimately believe that a more sophisticated use of IT, or simply the wider deployment of technology, might support more efficient delivery of other direct and indirect activities. A benchmarking approach that favours lowest cost might effectively remove this as an option.

Hence, we would be concerned if Ofgem sought to apply a mechanistic approach to the assessment of Business Support costs, and was not receptive to those companies that wished to present a requirement for investment, in areas such as Training or IT, which it believed would show a benefit in other aspects of the business.

Financing

The Finance Group of the Energy Networks Association (ENA) has already made formal submissions to Ofgem in respect of the Financing elements of the price controls, including papers commissioned from Oxera in respect of Efficient Financing and First Economics on Relative Risk.

UK Power Networks was an active participant in these discussions and wholly endorses the conclusions.

Over and above this, we would like to emphasis the following points:

Firstly, we do believe that there is a change in risk under the RIIO framework. The move to an eight-year period in itself brings greater risk and we remain to be convinced that the uncertainty mechanisms proposed counterbalance the exposure to that systematic risk. We would also argue that the indexation of the cost of debt increases exposure to material risk

In addition, we question the assumption that all networks companies will be subject to the same level of risk. We would suggest that Ofgem needs to consider ‘Expenditure-to-RAV’ (i.e. opex + capex), particularly in the context of a regulatory framework that seeks to encourage companies to adopt more innovative approaches.

We also suggest that it would be a positive step if the framework through which risk is captured in the cost of capital was made more transparent. Networks companies would be greatly assisted in preparing their financial proposals if they knew how Ofgem was proposing to assess the efficiency of those proposals.

Finally, in respect of financing, we understand that one of the primary reasons behind the indexation of the cost of debt was to reduce the size of errors in fixing the cost of debt. This was previously addressed by setting allowances which were slightly ahead of the cost of capital in order to ensure that sufficient margin existed to cover any errors. The change to indexation deliberately seeks to minimise that margin, but in the process, removes the source from which debt issuance costs were met. In light of this, we suggest that Ofgem makes a specific allowance for debt issuance going forward.

We also believe that the structure of the new cost of debt index has at least two unintended and unhelpful consequences:

(a) The ten year trailing average is shorter than the typical age of the DNOs' debt, and therefore "overreacts" to changes in interest rate and potentially reverses the interest rate sensitivity of the networks. We would prefer an index that "trombones" to a twenty year trailing average; and

(b) The average tenor of the bonds that make up the index is less than 20 years. This together with the lack of an allowance for new issue costs creates an incentive for networks to issue debt of short tenor, say 10-15 years, even though our assets are remunerated over 45 years. This increases refinancing risk, does not match bond investors' desire for longer tenors, and is inconsistent with raising index linked debt which needs to be long tenor to get investor interest. We would prefer to see an index made up of longer tenor bonds, or adjusted for the impact of a longer tenor risk free rate.

Real Price Effects

We are pleased that Ofgem have continued to specifically develop indices for both real price effects (RPEs) and ongoing efficiency assumptions. With respect to labour indices the assumption that these should return to long run average levels of growth is appropriate. However, it is not clear why Ofgem's assumption that the real labour RPE growth would be the same across both the gas and electricity sectors is valid, especially given the forecast growth in renewable generation and the associated infrastructure. It would be useful if Ofgem could set out in more detail to support the rationale underpinning this assumption.

In addition, the assumption that there should be no difference between directly employed and contractor real wage growth may not always be valid. Network companies will employ a range of specialist contractors whose skill sets may be more effectively bought in when required, e.g. tunnelling contractors. A general assumption on real labour RPE growth may not be valid for such contractors but we would expect a network company to explicitly justify why this would be the case.

We note that Ofgem have not allowed any real price effects for either electricity or transport related costs, on the basis that these form a relatively small part of the cost base. Historically these cost items have risen significantly faster than RPI. We accept that due to the external factors which impact on these costs it is difficult to predict the future RPE impact. Therefore, if these costs are to be excluded from the RPE assessment it would also seem sensible to exclude them from the cost base to which ongoing efficiency improvement is applied

Customer Service

The broad structure and design of the Customer Service incentive scheme is familiar to us from DPCR5. With this in mind, we offer the following comments on the detail, drawn from our experience of the evolution of that scheme:

(a) Customer survey:
We support Ofgem's proposal of having a targeted absolute level of performance, however, we consider it appropriate to introduce a mechanism to allow the targeted level to be recalibrated, if it was seen that customer satisfaction scores were converging and outperforming the targeted score. We believe that the weightings applied should bear some relationship to work volumes in that category. That aside, we note the difference when compared to the electricity distribution scheme (specifically the lack of a "General Enquiries" category and a larger weighting on interruptions) but are comfortable with the levels. As for the target and penalty/reward levels, we support the methodology and justification behind their calculation but are unable to comment on the actual values proposed as we have not had sight of the detailed model used to derive them.

(b) Complaints metric:
We support Ofgem's proposed weightings of 10% (complaints settled within 1 working day (wd)), 30% (complaints 31 wd), 50% (repeat complaints) and 10% (Ombudsman findings). We would however support a further reduction on the weighting on the Ombudsman findings as both DNOs and GDNs are finding that this element of the incentive is very volatile and large

financial penalties are possible based on only one Ombudsman decision against the network company.

Furthermore, to ensure a balanced and fair incentive we believe that the "Ombudsman findings" calculation must have the denominator of "total complaints" to avoid an undue weighting on a network company that only has a small number of Ombudsman cases. We also believe that consideration should be given to the total volume of complaints, such that there is a "penalty factor" applied if complaint volumes exceed a ratio/scaling for the size of the network company. Finally, we also support the exclusion of exemptions, as they introduce ambiguity and complexity in application and making comparisons.

(c) Stakeholder Engagement:
We support the proposed approach for Stakeholder Engagement, and welcome Ofgem's development of a clear and robust stakeholder engagement assessment framework in the DPCR5 incentive. It is important that a similar framework is implemented for RIIO-GD1, and this should be done in sufficient time that the GDNs understand fully the assessment process before they make their first submission under the incentive. We also support openness in the decision making and welcome the publication of feedback and notes to support industry learning.