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RIIO-ED1
Ofgem
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23 November 2012

Dear Anna

Strategy consultation for the RIIO-ED1 Electricity Distribution Price Control Overview

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

We recognise the key challenges that the RIIO-ED1 will need to address. Distribution charges account for around 18 per cent of an average domestic customer's bill. Once transmission charges and the costs involved in implementing obligatory renewable, energy efficiency and social schemes are included, non-energy costs now make up around half of a typical consumer bill.

We are fully aware that consumers are already making a significant contribution towards transforming Great Britain (GB) into a low carbon economy. Hence, we have a role to play in ensuring that the necessary investments made by distribution network operators (DNOs) result in value for money. At the same time, DNOs are an important enabler in bringing low carbon technologies to the mass market. Their investment in their networks also strengthens security of supply. The careful balancing of network investments with 'affordability' is therefore the key challenge of RIIO-ED1.

The three main areas that we would therefore like to see addressed in the DNO business plans are:

- Longer notice of changes to network charges, in line with the report produced with CEPA¹ on managing volatility of networks charges.
- Efficient investment in network assets that represent value for money for both current and future consumers; and

¹http://www.ofgem.gov.uk/Networks/PriceControls/WebForum/Documents1/CEPA%20EDF%20volatility%20report_final%20260912.pdf

- An appropriate scheme that rewards innovation but is also balanced to incentivise good performance on elements such as reducing losses.

'Affordability' is a key issue to address given the increasing cost pressures that consumers face. DNOs need to balance the key elements of the price control and deliver affordability. DNOs' business plans should therefore provide strong justification for any investment ahead of need for longer term developments such as smart grids.

To achieve affordability, transparency and predictability of use of system charges and solutions to manage volatility of charges are essential for keeping costs down for consumers. EDF Energy produced a report with CEPA on managing volatility of network charges and several DNOs with whom we have discussed it (along with the wider industry) have been supportive of the arguments presented. Suppliers require greater visibility of DNO charges, which can be solved by DNOs publishing the detailed tariff rates much further in advance than they do now. Without this, customers face unpredictable and 'un-hedgeable' movements in charges. If customers are on fixed term retail contracts, then suppliers have to cover this financial risk of forecasting, usually by charging an additional premium.

The biggest area of risk is at the start of price control periods, where there is often a significant step-change in tariffs, and also the changes during the control period are subject only to three months notice of the new rates. DNOs are best placed to manage the impacts of such cost movements as they typically have a lower cost of capital than our customers (especially vulnerable customers, who are often exposed to very high marginal borrowing costs). To tackle volatility within and between price control periods DNOs should therefore smooth movements of charges by using their balance sheets where necessary to publish a transparent and stable set of future charges to manage cost recovery. As the report shows, this can be done in an NPV neutral way, at an overall lower cost to the end consumer. Such a smoothing mechanism could be readily accommodated in a price control package that enables DNOs to maintain investment grade credit ratings.

We have also been advocating Levelised network charges across the country so that domestic and small and medium sized enterprises (SME) consumers do not have to face the complexity of regional energy prices. We recognise that each DNO must have a bespoke price control settlement and have previously asked Ofgem to consider introducing an Ofgem managed "clearing house" to set stable national domestic charges for distribution (and transmission) costs. With this, it would be possible to develop a simpler energy market. We recognise that it will take time to implement the clearing house proposal, but we have the opportunity now, at the start of the RIIO-ED1 process, to debate the merits further with all stakeholders.

The Government's aim of moving GB to a low carbon economy, through the electrification of heat and transport with low carbon electricity, will require a significant investment in the DNO networks to support this increased load. At the same time we

agree with Ofgem and the Smart Grid Forum (SGF) that there are significant uncertainties around when the penetration of low carbon technologies (e.g. smart meters, electric vehicles, small scale electricity generation, heat pumps) on the DNO systems will have an impact. Similarly, the timing of the requirement for the development of smart grids is currently unclear. We therefore support Ofgem's decision to delay smart grid investments until RII0-ED2 to reflect these uncertainties. This will ensure that the costs to consumers are minimised and reduce the risk of stranded assets. At the same time we recognise that DECC has identified that smart grids could provide a cost saving in excess of £1 billion. It is therefore important that, in the longer term, the appropriate mechanisms are in place to ensure that this benefit flows back to consumers.

The careful balancing of network investments with affordability is the key challenge of RII0-ED1. But, for Ofgem, there is the added challenge of determining how network costs should be managed through efficient retail pricing structures to ensure alignment with reforms proposed through the Retail Market Review (RMR).

Our detailed responses are set out in the attachment to this letter. Instead of preparing separate responses to the questions raised in the Supplementary Annexes, we have included answers to relevant questions here. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Mark Cox on 01452 658415, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'D. Linford', with a long horizontal flourish extending to the right.

Denis Linford
Corporate Policy and Regulation Director

Attachment

Strategy consultation for the RIIO-ED1 Electricity Distribution Price Control Overview

EDF Energy's response to your questions

CHAPTER: Three – Incorporating stakeholders' views

Q1. Do you have any comments on our stakeholder engagement approach?

We support the stakeholder engagement approach described in the consultation but the following areas could benefit from improvement:

- **Stakeholder events** - Although we understand Ofgem's need to cap numbers, the one representative per company stakeholder events can be problematic for a large organisation such as EDF Energy as no one individual covers all aspects of RIIO-ED1.
- **Email** – There has been limited email alerts from RIIO.ED1@ofgem.gov.uk. It will be useful to receive updates, where appropriate, from the various fora and working groups outlined in Appendix 3.
- **Working groups** - A short terms of reference of the working groups and an agenda of the next meeting will be useful. For example, looking at the website, it is not clear what the Innovation Working Group is considering and when they are meeting. There are no minutes or slide packs from that group either.

Q2. Do you have any views on how our engagement process or that of the DNOs could be made more effective?

We are pleased to see the focus on stakeholder engagement but there seems to be limited engagement aimed specifically at suppliers. We welcome DNO's individual efforts to engage with us on a bilateral basis but see value in an industry event i.e. where DNOs could engage with the 'supplier community' to understand our issues.

CHAPTER: Four – Form and structure of the price control

Q1. Do you have comments on the form or structure of the price control?

In terms of the scope of the price control, the consultation states that Ofgem will set allowed revenues to cover all aspects of a DNO's business except for excluded services and de minimis activities. Clarification regarding the scope of excluded services would be useful, especially in the light of new services DNOs might offer to transform GB into a low carbon economy e.g. Demand Side Response (DSR), storage and Distribution System Operator (DSO).

Q2. Do you agree with our proposed changes to the RIIO-ED1 timetable?

Substantial progress has been made on reducing the volatility to customers and suppliers with Ofgem's work on mitigating charging volatility. However, the RIIO-ED1 is currently one of the largest areas of volatility especially as final proposals will not be published for non-fast track companies until November 2014. This is only four months before the charges are applied.

Customers wishing to contract with supplier for periods longer than a year will see greater risks factored into their contracts. We would therefore like to see longer notice of changes to network charges, in line with the report produced with CEPA on managing volatility of networks charges.

Q3. Do you have a view on the materiality of potential changes in allowed revenues/charges between price controls? Do you have proposals to address this?

There are different drivers of volatility. Network revenues do not always flow into network charges. While Ofgem has to an extent tackled the challenges of volatility of charges within price controls, it does not solve challenges of volatility between periods. RIIO-ED1 will be a step change to the current price control DPCR5. We currently have no view of the materiality of the step change and according to the timetable we are unlikely to have a clear view until November 2014. In order to mitigate the uncertainty around the step change, agreeing the allowed revenues based on business plans submitted in July 2013 and a true-up phased over the first few years of RIIO-ED1 would be beneficial to both customers and suppliers. This could be implemented by DNOs smoothing charges, as advocated in the CEPA report.

CHAPTER: Five – Ensuring output delivery

Q1. Do you consider that the proposed outputs and associated incentive mechanisms, taken together with other elements of the price control, will ensure that companies deliver value for money for consumers, and play their role in delivering a sustainable energy sector?

In principle, outputs-based regulation is an effective way of promoting efficiency. By defining what networks companies are required to deliver, companies should face powerful incentives to innovate and seek least-cost solutions to delivering the services required by customers. However, without any past performance, it is too early in the RIIO-ED1 regime to say whether they will ensure that companies deliver value for money for consumers.

Our additional answers to the questions posed in the Supplementary Annex: Outputs, incentives and innovation, provide additional points for consideration.

Q2. Do you consider that the proposed outputs and incentive arrangements are proportionate (eg do we have too many or too few)?

In general, they seem to be proportionate.

Q3. Do you have any views on the proposed outputs and incentives?

Customer satisfaction - We note that the success of the smart meter rollout is dependent on consumer engagement and a positive customer experience. We believe that the DNOs can play an important part in delivering a positive customer experience, and so should be incentivised to work with suppliers to co-operate and co-ordinate with the smart metering rollout. This would be facilitated best through the customer satisfaction output.

Environment - The Government's aim of moving GB to a low carbon economy through the electrification of heat and transport will require a significant investment in the DNO networks to support this increased load. But at the same time, we need to ensure that consumers do not pay unnecessarily high prices. So when DNOs include the costs of delivering outputs in their business plans it is particularly important that they set out the rationale for expenditure in the context of long-term strategy for delivery, which may be beyond the RII0-ED1 timeframe.

Conditions for connections: If the new Average Time to Connect output and incentive can encourage DNOs to move beyond the guaranteed standards and, at the same time, consider how they can plan and process connections more effectively to reduce the overall time taken, then this is to be welcomed. From a customer's perspective, it will be useful if DNOs can provide a firm connection date.

Social obligations: We agree that DNOs have a role in addressing social issues, including in partnership with other stakeholders. DNOs should coordinate partnerships and mobilise local networks and resources (charities, care agencies etc). This will help DNOs identify vulnerable consumers most at risk from the impacts of power outages and to provide information and support. Ensuring that this is carried out in a strategic manner will help minimise duplication with wider activity.

EDF Energy agrees that the co-ordinated sharing of information about consumers on industry Priority Services Register (PSR), and other information is key to targeting support. However, the objectives and rules associated with the PSR should be fully reviewed to ensure they support Ofgem's vulnerability strategy. This should explore areas where this can be improved so that it supports DNOs and suppliers in actions to assist vulnerable householders. This would benefit from data sharing with Government so that a robust database of vulnerable householders could be created allowing support to be provided in a consistent and coherent fashion. There have been a number of learnings since the PSR

was originally set-up and therefore this would be an opportune time to carry out a full review in consultation with DNOs, suppliers and consumer groups.

CHAPTER: Six – Assessing efficient costs

Q1. Is our proposed approach to cost assessment appropriate?

Since the onus is on DNOs to demonstrate the cost efficiency and long-term value for money of their business plans, Ofgem's proposal to use benchmarking of historical and forecast data as a means of informing its assessment of the DNOs' forecasts seems sensible.

Q2. Do you have views on our proposed use of proportionate treatment?

We support the concept of proportionate treatment. DNOs that produce high quality business plans should be able to benefit from being able to plan with greater certainty earlier in the process and focus on their business rather than the price control process. As recognised in the consultation, fast-tracked DNOs can also gain positive reputational advantage associated with the kudos of achieving a fast-tracked settlement or having lower-proportionate scrutiny. Therefore, we are somewhat bemused by the suggestion that the decision to fast-track could also be recognised in the way Ofgem sets the DNO's information quality incentive (IQI). In our view, this seems to suggest that DNOs are being rewarded for something they have already been rewarded i.e. fast-tracked.

Q3. Do you have any views on the criteria for assessing business plans?

For the reasons stated in our covering letter, DNOs need to balance the key elements of the price control and deliver affordability. DNOs business plans should therefore provide strong justification for any investment ahead of need for longer term developments such as smart grids.

CHAPTER: Seven - Innovation

Q1. Do you have any views on the role of innovation in RIIO-EDI?

DNOs are likely to need to innovate if they are to ensure the delivery of a sustainable electricity sector and to demonstrate that their services represent long-term value for money for both existing and future consumers. However, we recognise that where commercial benefit of innovation is unclear, DNO may not have a strong motivation to pursue innovation in a timely manner. So in principle, we are supportive of the time-limited innovation stimulus package consisting of an annual competition (NIC) and limited funding allowance (NIA).

Q2. What should the funding threshold for the NIC be? Do you agree with our proposal to review it after two years to reflect learning from the LCN Fund?

The appropriate level of funding for the NIC is difficult to determine. We do not have a firm view on the maximum funding threshold for the NIC (currently proposed between £60m and £90m). Given that consumers are funding the vast majority of NICs, it is clear whatever the level of funding, benefits gained from projects funded through the innovation stimulus packages flow back to consumers.

We agree with Ofgem's proposal to review it after two years.

CHAPTER: Eight – Managing uncertainty

Q1. Do you have any views on the uncertainty mechanisms identified?

We acknowledge the need for new volume related uncertainty mechanisms to cater for low carbon connections and smart meter additional call-out costs.

While we support the new structure of RIIO, with additional outputs, incentives and reopeners, with the aim of driving down the cost of capital, this does introduce more uncertainty and potential for volatility. We believe in this context, solutions to stabilise networks charges can help counter this and keep costs down for consumers. They must also be managed in the most transparent way possible with advance notice of any impact to charges.

Ofgem states that it expects the use of uncertainty mechanisms to be rare. However, in practice, some uncertainty mechanisms will happen each year so we continue to have concerns over additional volatility they may cause. The consultation refers to guidance document published in October 2009 setting out the arrangements for responding in the event that a network company experiences deteriorating financial health. However, the guidance (published pre-RIIO) is not clear whether there is a limit on the number of times an uncertainty mechanism can be invoked by a DNO and what sort of notice period DNOs are required to provide. Further clarification would be welcome.

Q2. Are there any additional uncertainty mechanisms required?

We are not aware of any.

Q3. Are there any mechanisms that we have included that are not necessary and why?

We are not aware of any.

CHAPTER: Nine - Financing efficient delivery

Q1. Do you consider that our proposed package of financial measures will enable required network expenditure to be effectively financed?

In general, we believe that the proposed package of financial measures will enable required network expenditure to be effectively financed. However, in terms of the depreciation timescales, we believe that these should be more closely aligned with the lifetime of assets. Ofgem should consider whether the depreciation timescale for existing as well as new RAV should be 45 years. Ofgem should carefully consider the lifespan of 'new' assets, for example, where there is uncertainty over the pace of development or if based on technological advances, such as smart grids.

Additionally, Ofgem should enable DNOs to provide a solution to smooth movements in DUoS charges in a way that more efficiently allocates the risks and costs. DNOs' financeability could be maintained while providing headroom for volatility in charges reflected in the DNO's balance sheet.

Q2. Do you have any views on our proposed approach to assessing the cost of equity and the associated range of 6.0 - 7.2 per cent (real post-tax)?

No.

Q3. Do you have any views on the other elements of our financeability proposals?

No.

1. Additional answers from: Outputs, incentives and innovation

CHAPTER: Three – Driving sustainable networks

Smart Metering - The key points of our response are:

- It is expected that smart grids will deliver benefits in excess of £1 billion. It is important that these benefits are realised by customers, and the RIIO framework should support this.
- The rollout of smart meters will require co-operation between Suppliers and DNOs to improve the customer experience, this should be a factor in the customer satisfaction output.
- It is important to ensure that the DNO charging regime does not create a barrier to the connection of low carbon technologies (LCT).

As mentioned in our covering letter, we agree with Ofgem and the SGF that at this point in time there are significant uncertainties regarding the penetration of low carbon technologies on the DNO systems and the requirement for the development of smart grids in the RIIO-ED1 period. We therefore support Ofgem's decision to delay smart grid investments until RIIO-ED2 to reflect the uncertainties. This will ensure that the costs to consumers are minimised and reduce the risk of stranded assets.

We also do not believe that at this time the DNOs have made a business case for RIIO-ED1 investments to support smart grid realisation in RIIO-ED2. In particular we note that the SGF has identified that DSR will only be provided by the Industrial & Commercial market in the RIIO-ED1 period and it is not clear what the asset lives of smart DNO technologies are. We therefore believe that further work is required in this area to ensure that costs to consumers are minimised.

Low Carbon Technologies - As previously noted, the realisation of the Government's low carbon target is dependant on the rollout of low carbon technologies. It is therefore important to ensure that any charging regime implemented by the DNOs does not create a barrier to the uptake of these technologies. We would also note that the development of customer specific DUoS tariffs needs to be balanced against the need for simple and transparent tariffs that are easy to compare. Ofgem should consider this trade off when policy decisions are being made in this area.

We are also concerned about the impacts of increasing amounts of generation directly connecting to DNO networks (generation/DSR). This has implications for transparency of settlement arrangements and for the system operator's ability to manage power flows to the grid. Greater transparency and visibility of connections is therefore essential to efficiently manage the costs.

Q4. Do you agree with the three tier approach we propose to introduce for the recovery of the DNOs' costs during the smart metering roll-out?

When approaching the smart metering rollout, our objective is to ensure that the smart metering installations are right first time. This is driven by the fact that suppliers will be responsible for any subsequent call outs as a result of a faulty installation and there are costs associated with this. We therefore disagree with any suggestion that the rollout of smart meters will increase the costs of the DNO emergency service provision as a result of a faulty or unsafe installation.

However, the smart meter rollout will represent a unique opportunity to visit and inspect the wiring at a large proportion of domestic properties in a short period of time. It is therefore likely that the rollout of smart meters may identify unsafe connections that require emergency rectification by the DNOs. This should be funded to ensure that the risk to life or injury is minimised. The smart meter rollout will also identify connections that require rectification by the DNO. We believe that the following high level principles should be followed when funding this work:

1. Where the installation of a smart meter brings forward work that the DNO would normally expect to undertake and be funded for, such as replacing assets at the end of their economic life; then this should be funded through the price control mechanism.
2. Where the installation of a smart meter requires a reconfiguration of the connection, such as the relocation of the cut-off; then this should be funded through the price control mechanism.
3. Where the installation of a smart meter identifies a sub-standard connection, then the DNO should be exposed to the cost of rectifying this on the assumption that a standard connection and maintenance has been funded through previous price control mechanisms.

EDF Energy believes that the funding arrangements proposed by Ofgem support the first two principles, but clarity is required over the approach to the third principle above. We also note that suppliers have undertaken smart metering testing and trialling and it could be expected that these may have identified the prevalence of these issues within the test area. This information may help to support an appropriate revenue driver and funding mechanism for these issues.

Finally we note that the success of the smart meter rollout is dependent on effective customer engagement and experience. An aborted smart meter installation as a result of rectification work by a DNO that is not co-ordinated with suppliers would not be conducive to a positive consumer experience. We therefore believe that the DNOs should be incentivised to work with suppliers to identify opportunities to minimise the disruption to customers and improve customer experience. We believe that this would best be developed through the customer satisfaction output.

Q5. Should costs of load and generation growth for existing customers in profile classes 1-4 be socialised, until smart metering data is available?

EDF Energy supports the socialisation of costs for customers in profile classes 1-4. In particular we note that a targeted cost base approach would require the development of individual customer based charges. Although cost reflective, this would be very costly and complex for both suppliers and DNOs to administer, and outweigh any benefits that may be achieved.

As part of the RMR, EDF Energy has called for a flat national charge for transmission and distribution for domestic consumers and SMEs. The flat national charge would eliminate the postcode lottery of networks charging. Currently, domestic and SME customers can do little to affect these costs, which are a significant proportion of the bill (c18%). A uniform charge would also facilitate the comparison of national prices in the media, rather than giving a GB average of the best deals. The introduction of a customer specific networks tariff goes against this principle of simplicity and transparency and would make it more difficult for domestic customers to compare tariffs between suppliers.

Finally we also note that the issue of access to data will also need to be considered if the DNOs are to develop customer specific networks charges. It is not clear from the customer protection and engagement work that DECC has been undertaking that DNOs will have access to this data without customer permission. There may be a disincentive on the customer to provide permission for access to this data if it results in an increase in their costs. This may also have a negative impact on the customer experience and request for some of the smart metering functionality to be withdrawn if it is perceived that the smart meter has resulted in an increase in their costs. We therefore believe that further consideration is given to these issues.

Q6. Should DNOs retain the ability to charge existing customers in profile classes 1-4 who install equipment which poses significant power quality issues for the network?

The impact of customers installing equipment that poses significant power quality issues is currently being considered by the SGF. We would also note that in general, this equipment would not qualify for either FITs or RHI and so would not be installed under an accredited scheme. Given the above, and the fact that this is being connected to the DNOs network, we also believe that the DNO should have a role in ensuring that suitably accredited equipment is connected to their system. This would avoid the issues associated with the connection of this equipment and associated investment, and also improve the experience of the customer.

CHAPTER: Five – Environmental impacts

Q1. Will our proposed approach ensure effective losses reduction actions?

Losses are important as there is an environmental and economic cost associated with them. Irrespective of whether the causes of losses are technical or caused by other reasons such as theft, they are paid for by the users of the network. As a result, DNOs need to be strongly incentivised to reduce the losses on their networks. The RIIO ED1 proposals allow DNOs to set out their actions and they can be rewarded through the discretionary award for good performance but there is no cost for poor performance. We would argue that the incentive needs to be balanced.

Q2. Will our proposed losses discretionary reward provide the required incentive on DNOs to reduce losses? Should this be awarded twice during ED1 or more frequently?

Awarding the discretionary award each year would ensure that the DNOs maintain the momentum for improving losses performance. Limiting the award to twice throughout the price control may mean that we see a flurry of activity close to the award period rather than it being a sustained performance.

2. Additional answers from: Business plans and proportionate treatment

CHAPTER: Three – Business plan assessment - process

Q1. Do you have any comments on the timing and stages of the assessment process?

The fast tracking companies provide adequate notice of allowed revenues but the non fast tracked companies do not.

Q3. Do you think the additional reward for fast tracking is appropriate?

In principle, it seems odd to reward companies for providing business plans. We would argue that the opportunity for fast tracking is a reward in itself.

CHAPTER: Five – Guidance on presentation and structure

Q3. Should we set a page limit for the executive summary of the plan? How long should it be? Are there other areas where we should consider setting page limits?

DNOs should be encouraged to make the executive summary as succinct as possible. Perhaps an example would provide better direction than setting a limit.

Q5. What should be the common metric, calculation and assumptions for determining the impact of the DNOs' proposal on consumer's bills?

£/Customer/Year for the duration of ED1 with year on year percentage increase would be reasonable.

3. Additional answers from: Uncertainty mechanisms

CHAPTER: Two – Proposed approach to managing uncertainty

Q1. Are there any additional criteria that we should take into account to guide the appropriate use of uncertainty mechanisms?

Any uncertainty mechanism increase volatility to customers and suppliers. This should be taken into consideration with regards to transparency and notice periods.

CHAPTER: Five – Mid period review of outputs

Q2. Do you agree with the indicative process and timetable? If not, how could the process and timetable be improved?

The timetable suggests that notice of any changes to allowed revenues following the mid-period review will be in November 2018. This is not enough notice to factor additional charge into contracts for suppliers.

**EDF Energy
November 2012**