Electricity North West Response to Ofgem's Strategy Consultation for RIIO–ED1

23 November 2012

Contents

Executive Summary

It is appropriate to recognise that this consultation is Ofgem's first attempt to apply the RIIO principles to the Electricity Distribution networks. Whilst the evolution from DPCR5 to RIIO-ED1 is not as significant as the other ongoing price control reviews, this is still a significant challenge for Ofgem.

From our perspective, Ofgem has followed a robust engagement process in discussing and developing the policy and business plan requirements included with the consultation. This level of engagement should be commended but must continue to ensure that RIIO-ED1 meets its objectives. Whilst we have detailed comments on all of the policy proposals set out in the documents, our over-riding concern is for the next stage of the process. The RIIO-ED1 strategy must consider the impact of the individual policy positions on the appropriateness of the overall package. It is clear that this has not yet been done and consequently, the balance between risk and reward in these proposals is not appropriate in its current format. As currently proposed, RIIO-ED1 represents a significant reduction in potential rewards combined with a significant increase in risk. This combination is unlikely to benefit customers in the short or long term and will increase the cost of financing future network investment.

To address these issues, we suggest that the following changes are made to the final policy package

- For Customers – To enable a further step change in quality of supply improvements we need to maintain the current strength of the Interruption Incentive Scheme (IIS) and not put an artificial cap on performance improvement. This will create the right conditions to stimulate more innovations and for investors to fund the required investment.
- For Innovation – The Low Carbon Network Fund (LCNF) has become an internationally regarded force for low carbon innovation. However, the job is far from finished and we must maintain funding for developing the transition to the low carbon economy and for other innovative improvements in performance for customers.
- For Investment – Our aging asset base must be replaced to reduce the risk of major power failures from increasing and prepare for future growth in electricity usage. Whilst efficient unit costs and investment targeting can restrict the rise in costs, the current investment levels must be maintained. The RIIO-ED1 framework must ensure DNOs remain able to raise finance to fund investment, including transition to new cost of debt index.
- For Efficiency – DNOs that set the benchmark for the industry should be encouraged and incentivised. The proposed Information Quality Incentive (IQI) will act as a penalty-only regime. A balance of 'carrot and stick' at the same levels as DPCR5 and RIIO-GD1 would maintain an incentive for all DNOs to bid keenly.

<u>For Customers</u>

We largely agree with the outputs and incentive mechanisms proposed in this consultation. Our position is that the individual mechanisms are appropriate but the combined effect of these mechanisms does not work as an acceptable package. We welcome the proposals on IIS, particularly the maintenance of the current incentive levels and setting of ex-ante targets. We disagree however with the proposed re-introduction of the IIS revenue cap as an artificial disincentive to improving customer performance. Any concerns over potential incentive earnings should be addressed at a more strategic level within the price control framework in the context of an overall

RORE analysis of the package. Our stakeholder engagement clearly indicates that our customers value improvements in reliability performance and the caps in the format outlined would act to inhibit further improvements. We are particularly conscious of our customers' increasing reliance on continuity of supply as the UK progresses towards the government's objective of decarbonisation of domestic heat and transport.

For Innovation

We also want to emphasise the importance of Innovation in the RIIO-ED1 settlement. The efficiency incentive encourages new thinking to reduce the costs of core activities, but it discourages trialling new solutions and services that are not yet core business requirements. Coupling a strong efficiency incentive with specific innovation funding from the Innovation Funding Incentive (IFI and Low Carbon Network Fund (LCNF) has been a considerable success. DPCR5 provided the industry with an opportunity to establish relationships and technologies to develop new solutions to traditionally investment driven activities. We have signalled the importance of this programme given the level of uncertainty in the future network requirements and the fact that whilst making a good start, we have not identified all the innovative solutions required yet. The down-grading of the innovation package proposed in RIIO-ED1 appears to be a backward step and we would argue that this position needs to be amended to ensure companies can continue to deliver for future customers.

Linking to this point, we do not agree that the key challenge for RIIO-ED1 is "being able to connect the new carbon loads". Whilst this will be an important element of the price control (and specifically for certain groups of our stakeholders), the main responsibility for RIIO-ED1 is the stewardship of the existing assets and improving service to existing customers. We must ensure that through the RIIO-ED1 period we prepare ourselves for the larger changes that are to come in RIIO-ED2 and that we facilitate the fledgling changes that do occur, but by building flexibility into the price control framework and innovating to maximise the use of existing assets we can minimise the charging impact for RIIO-ED1 customers.

For Investment

This continuing investment required in RIIO-ED1 places a continuing financing requirement on DNOs. Given the uncertainty of the future profiles of interest rates over the extended price review period, Ofgem has developed a logical uncertainty mechanism linking the cost of debt allowance to a simple trailing average of ten-year bond yields. However, the DNOs tend to be financed by the infrequent issue of long dated corporate bonds of a size required by bond investors to meet their requirements for "benchmark" issues. The profile of this existing position is that the sector only has a reasonably small amount of existing debt to refinance in RIIO-ED1 period and consequently a large part of the actual costs of debt are already fixed. Therefore it is generally accepted that the simple trailing average mechanism will not act as a reasonable proxy for distribution network companies during RIIO-ED1.

Ofgem must also recognise the potential impacts of the Office of National Statistics (ONS) consultation on the structure and composition of the RPI. As Ofgem has highlighted in this document, the indexation mechanism is an uncertainty mechanism to compensate companies for changes in costs during the price control. The ONS consultation has implications for the balance of funding of cost increases by allowances (Real Price Effects) or via uncertainty mechanisms (RPI).

We recognise the importance of price stability during and across price control periods. Our initial modelling suggests that there is scope for prices to reduce and that revenues can be stable across RIIO-ED1 (when compared to the end of DPCR5). The actual year-on-year change will largely depend on the revenue profiling approach adopted. This decision will be based on regional stakeholder discussions, investment profiles and financeability requirements.

For Efficiency

We agree that the Information Quality Incentive (IQI) continues to be an appropriate mechanism to incentivise sensible and accurate forecasting, but contend that the indicative matrix represents a material shift in the incentive properties compared to DPCR5. Our interpretation is that a non fast-tracked company is highly unlikely to have a baseline score <100 and hence will be in automatic penalty. This does not constitute a reward for fast-track but a penalty for slow track.

As a result, we agree that the IQI mechanism could be an appropriate mechanism for rewarding fast-track companies but are keen to ensure that the 'no worse off' principle is applied. We are keen to ensure that fast-track is a genuine reward and not just the lack of penalty being applied.

We agree with Ofgem's proposals to widen the range of efficiency rates as a stronger incentive to deliver sensible forecasts. It is important that Ofgem's analysis considers all aspects of efficiency: efficiency of outputs to be delivered, of associated volumes of work and unit costs of delivery. Therefore, we agree with Ofgem's approach of using a range of models to assess efficiency. It is important to note that Ofgem must not use the average results across all models as this may ignore key issues that may only be exposed in one type of model.

In resolving all of these issues, the key principle must be to establish a balanced package of risks and rewards that focuses on the services and performance that our customers require and enables DNOs to deliver and finance them sustainably. The resolution of these issues is the important final step for Ofgem in the development of a robust strategy document.

Our Answers to Questions in the Overview Document

Chapter Three

Question 1: *Do you have any comments on our stakeholder engagement approac*h?

We recognise Ofgem's very positive engagement with DNOs on all areas of the price control. Our view is that Ofgem's approach has led to a Strategy Consultation with very few surprises for industry participants. However, we do not observe any significant evidence of engagement with the investor community. This is key for the acceptability of the risk/reward balance contained in the business plans.

We have also noted the positive and timely engagement with DECC in the development of the policy framework and the business planning approach. We must, however, ensure that the views of national stakeholders are checked against the views of local stakeholders. Whilst we accept that this is primarily the responsibility of the DNOs, Ofgem must respect the views of local stakeholders when reviewing the acceptability of business plans. In comparison, we have seen significant engagement with the DG community. It is important to give an equal opportunity to all stakeholders.

Question 2: *Do you have any views on how our engagement process or that of the DNOs could be made more effective?*

Whilst Ofgem has made great improvements in the engagement process, we suggest that investor meetings need to be more prominent. The current strategy appears to be missing both debt and equity stakeholder views. . Many of the issues in this response build upon the interactions of policy positions rather than any one decision.

Ofgem must also recognise that the balance of responsibilities for stakeholder engagement (local vs. national) must be respected when making decisions for the regional networks. We cannot automatically prioritise national over local requirements if it is local communities which are paying the bills.

Chapter Four

Question 1: *Do you have comments on the form or structure of the price control?*

We fully support the adoption of an eight year price control period rather than the potential nine year control period discussed in earlier consultations. The extension of the price control duration under the RIIO principles increases the forecasting and operational risks associated with the price control. The impact assessment issued alongside this consultation recognises the implications of this change and it is important that the cost of capital reflects the increased risk profile.

Ofgem must also recognise the potential impacts of the Office of National Statistics (ONS) consultation on the structure and composition of the RPI. As Ofgem has highlighted in this document, the indexation mechanism is an uncertainty mechanism to compensate companies for changes in costs during the price control. The ONS consultation has implications for the balance of funding of cost increases by allowances (Real Price Effects) or via uncertainty mechanisms (RPI).
Finally, it is important to recognise the role of excluded services in the price control and make sure that a fair rate of return is allowed to companies who engage in these activities.

Question 2: *Do you agree with our proposed changes to the RIIO-ED1 timetable?*

We agree with the proposed changes to the timetable.

Question 3: *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?*

We recognise the importance of price stability during and across price control periods. Our initial modelling suggests that there is scope for prices to reduce and that revenues can be stable across RIIO-ED1 (when compared to the end of DPCR5). The actual year-on-year change will largely depend on the revenue profiling approach adopted. This decision will be set out in our Well Justified Business Plan based on regional stakeholder discussions, investment profiles and financeability requirements.

Chapter Five

Question 1: *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?*

The package of outputs and incentives needs to be carefully considered alongside the proposed RIIO-ED1 financeability package. Our concern that the reward package is not commensurate with the increased risk profile embedded within the RIIO principles. Using the RORE analysis developed in DPCR5 to assess the package, it appears that the RIIO-ED1 incentive and output package has significantly reduced in strength, thereby reducing the scope for efficient distribution companies to outperform the regulatory package. The weakening of potential outperformance has implications for the acceptability of the price control for investors. The increased number of discretionary reward mechanisms will also reduce the scope to build a business case for investments.

Question 2: *Do you consider that the proposed outputs and incentive arrangements are proportionate (eg do we have too many or too few)?*

It is important that Ofgem focuses on a small number of outputs within each category. This will ensure that stakeholders understand what they will receive for their money and provide clear guidance for the acceptability and objectives for network business plans. It is also important to recognise the appropriateness of each output to deliver the targeted objectives. We consider that the proposed balance included in the strategy consultation is appropriate for the RIIO-ED1 period.

Question 3: *Do you have any views on the proposed outputs and incentives?*

We largely agree with the outputs and incentive mechanisms proposed in this consultation. Our position is that the individual mechanisms are appropriate but the combined effect of these mechanisms does not work as an acceptable package. We suggest that a number of modifications can be made to correct these issues.

Our key messages in this area are

- We agree with the continuance of the IIS scheme but do not agree with the proposed re-imposition of a revenue cap on IIS earnings as an arbitrary restriction of the delivery of improvements in service to customers.

- We agree that Load Indices should be calibrated on a common scale, and that further work is required to look at the definition of common terms.
- We agree with the proposed extension of Health Indices to include Criticality, and propose that this is based on a metric calibrated in pounds.
- We favour the introduction of a Worst Served Customer incentive regime as a more appropriate incentive to drive improvements to such customers.
- We agree that Business Carbon Footprint, SF_6 and Fluid-Filled cables should remain reporting requirements and not be directly incentivised.
- We agree that IQI continues to be an appropriate mechanism to incentivise sensible and accurate forecasting, but contend that the indicative matrix represents a material shift in the incentive properties compared to DPCR5. Our interpretation is that a non fast-tracked company is highly unlikely to have a baseline score <100 and hence will be in automatic penalty. This does not constitute a reward for fast-track but a penalty for slow track.
- We agree with Ofgem's proposals to widen the range of efficiency rates as a stronger incentive to deliver sensible forecasts.
- We agree that the IQI mechanism could be an appropriate mechanism for rewarding fast-track companies but are keen to ensure that the 'no worse off' principle is applied. We are keen to ensure that fast-track is a genuine reward and not simply the absence of a penalty.

We have provided a detailed analysis of each of the proposed outputs and incentives in the "Outputs, Incentives and Innovation" chapter of this response.

Chapter Six

Question 1: *Is our proposed approach to cost assessment appropriate?*

It is important that Ofgem's analysis considers all aspects of efficiency: efficiency of outputs to be delivered, of associated volumes of work and unit costs of delivery. Ofgem must ensure that the range of models used to assess company plans consider all aspects of efficiency. We therefore agree with Ofgem's approach of using a range of models to assess efficiency. It is also important that Ofgem does not use the average results across all models as this approach may ignore key issues that may only be exposed in one type of model.

Ofgem must not dictate DNO operating and delivery structures; the regulatory framework must allow scope for companies to innovate in delivery. These differences in delivery structures can make a big difference to where costs are reported. Ofgem's approach must be neutral to where costs are reported and avoid treating ostensibly the same costs differently. It is also important that the comparative analysis must reward innovative solutions that can be used to set benchmarks for others rather than penalise them.

Our detailed response to this question is contained within the "Tools for Cost Assessment" chapter of this response.

Question 2: *Do you have views on our proposed use of proportionate treatment*?

We welcome the introduction of proportionate treatment for well justified business plan assessment. This approach to focus on the weaker areas of the plans will benefit all parties during the price control review. . Our detailed response is included in the "business plans and proportionate treatment" chapter of this response.

Question 3: *Do you have any views on the criteria for assessing business plans?*

We support the assessment criteria objectives of ensuring DNOs demonstrate that their plans are appropriate to stakeholder needs, developments in economic and low carbon activity and long-term customer value. The assessment criteria must ensure that the Well Justified Business Plan remains relevant to the DNO, its employees, customers and stakeholders.

Chapter Seven

Question 1: *Do you have any views on the role of innovation in RIIO-ED1?*

The RIIO-ED1 period will see significant developments in the movement towards a low carbon economy. It is important that innovation funding available during this price control prepares the network companies for RIIO-ED2 and RIIO-ED3 deliverables. The discussions in previous price controls recognised the benefits of developing the commercial and technological capability of the networks to respond to the future challenges but also recognised that innovation reduces costs for future customers at the expense of current customers. We recognise that innovation places an increased cost burden on our customers but believe that this is appropriate and will deliver benefits for current and future customers over the medium and long term.

Question 2: *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 RIIO-ED1 innovation funding should be maintained at the DPCR5 level. The proposed reductions in the consultation document could have significant implications for RIIO-ED2 deliverables (and subsequent periods). The NIC funding should initially be set consistent with DPCR5 levels but we also agree that the levels should be reviewed following a review of the LCN Fund. Reducing the level before the review places inappropriate constraints on innovation at a time when we need to improve efficiency of delivery.

Chapter Eight

Question 1: *Do you have any views on the uncertainty mechanisms identified?*

It is important that Ofgem works with companies to put the most appropriate uncertainty regime in place for RIIO-ED1. We have identified a number of areas where Ofgem should modify the proposed approach to ensure an efficient allocation of risks between customers and companies. We agree with Ofgem's comments to carefully consider the implications of the ONS decision on calculating RPI. This proposed change will reduce the effectiveness of the cost indexation approach and require additional RPE allowances to cover anticipated cost growth. We also agree that the scope of the mid-point review must be very tightly constrained in order to prevent the perception that this adds asymmetric risk to DNOs.

We have discussed with Ofgem our concerns with the proposed High Value Project (HVP) mechanism for RIIO-ED1. The HVP should include associated indirects and should allow for outputs to be varied. It is also important that the networks should not be exposed to a materiality threshold for any HVPs added during the period. It is inappropriate to ask DNOs to fund 20% of a >£50m project.

Question 2: *Are there any additional uncertainty mechanisms required?*

Ofgem should reinstate the DG incentive mechanism to provide customers and networks with appropriate uncertainty mechanisms to deliver appropriate DG reinforcement protection. . Our positions in this area are fully described in the uncertainty section.

Question 3: *Are there any mechanisms that we have included that are not necessary and why?*

All of the mechanisms included in the consultation are required in RIIO-ED1 with the exception of Critical National Infrastructure (CNI) where the requirements are sufficiently mature to be included within an ex-ante allowance.

Chapter Nine

Question 1: *Do you consider that our proposed package of financial measures will enable required network expenditure to be effectively financed?*

The proposed balance of risk and reward has significantly changed since DPCR5. Many of the financial measures proposed in the consultation increase risk for investors without providing appropriate compensation. The adoption of the RIIO principles requires rebalancing the current incentive package to ensure that it retains its existing strength. Our concern is that the risk-reward package proposed may not attract the level of equity investment to ensure timely and efficient finance is available to deliver the network outputs. If the financeability mechanisms in this consultation place additional risk on the deliverability of the outputs or fails to provide an efficient company with sufficient revenues to finance its functions, they should be reviewed.

Several of the proposed mechanisms may not provide sufficient revenues within the price control period to allow companies to finance their functions (eg cost of debt index). This also increases the risk profile for investors and may create inefficient financing requirements for customers.

Question 2: *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)?*

Ofgem must ensure that that the allowed cost of capital for RIIO-ED1 reflects the significant change in risks for the network companies. Some of these additional risks associated with the RIIO principles (increased exposure to cost of debt, increased operational risk due to longer price controls etc) have been discussed during the RIIO-GD1 and RIIO-T1 price control reviews. Ofgem must also recognise the emerging risks associated with the introduction of consumer redress and the modification of the RPI index which will increase the risk of the costs being unfunded. There are also the additional risks created by the removal of the National Grid exit charges pass through mechanism and the DG connection uncertainty mechanisms.

We therefore agree that the upper quartile end of the published range is likely to prove appropriate for the balance of risks in the price control package and reflecting the overall reduction to some elements of the estimated RORE components.

Question 3: *Do you have any views on the other elements of our financeability proposals?*

Our concerns with the cost of debt mechanism have been discussed in great detail with Ofgem over the past months. We note the recent Fitch report on National Grid's

credit rating which highlighted a number of key messages for Ofgem. Our particular concern is that Fitch relied on the non regulated businesses to support the BBB investment grade credit rating. This situation suggests that the financeability package embedded within the RIIO-ED1 package is not sufficient to maintain an investment grade credit rating and customers could be exposed to increased financing costs as a result. Our detailed commentary on this issue is contained in the “financial issues” chapter of this response.

Outputs, Incentives and Innovation

Overview

We agree that the connection of new low carbon loads is a key challenge for RIIO-ED1; however it is likely that the majority of investment in the period will continue to be driven by the requirements of the existing, ageing asset base and care will need to be taken to ensure that stewardship of the existing asset base and improving service to existing customers are not marginalised in comparison to the challenges of a low carbon economy.

We agree with the majority of the proposals outlined in the document for outputs in RIIO-ED1. In many cases these represent a sensible development of mechanisms in place for DPCR5. Where new outputs are considered, their associated frameworks need to be carefully designed to ensure consistency with the approach taken to cost assessment. We also suggest that a greater degree of comparability is required compared to a number of the DPCR5 mechanisms in order to ensure a comparable basis for assessment.

We consider that both the mechanism for and the level of subsidy of low carbon connections is a decision for Ofgem and DECC. We recognise the rationale of Ofgem's proposal to treat all Low Carbon Technologies in exactly the same way and that there are problems with the existing DG Incentive. However, it is important to recognise that the drivers of changes in demand and generation technologies are different and that they are likely to be most prevalent at different scales and voltage levels. This leads to the need for different designs in Low Carbon Technology uncertainty mechanisms for demand and generation.

In terms of Safety, we agree that the output should be compliance with HSE requirements and that no financial incentive should be applied.

We also agree with the continuance of the IIS scheme as the primary reliability output, including the setting of ex-ante targets and maintenance of incentive rates at broadly at their current levels. We do not agree, however, with the proposed re-imposition of a revenue cap on IIS earnings as an arbitrary restriction of the delivery of improvements in service to customers. In terms of worst-served customers, we favour the introduction of an incentive regime as a more appropriate incentive to drive improvements to such customers.

We agree that Load Indices should be calibrated on a common scale and that further work is required to look at the common definition of terms. We favour the proposal to manage the resultant risk within a band, rather than deliver a prescribed delta as this is more consistent with treatment of the costs, and enables account to be taken of changes in external drivers

We agree with the proposed extension of Health Indices to include Criticality, and propose that this is based on a metric calibrated in pounds. The criticality framework also needs to be commonly defined between DNOs in terms of the categories and factors used. Any subsequent presentation in matrix form should be taken as illustrative and not represent a deterministic link to investment. The ultimate form of 'contract' should remain a 'delta' in risk from the position that would have pertained without the associated investment.

We agree with the proposed risk measure for flooding, and suggest that an equivalent should also be introduced for pinch points.

We agree that Business Carbon Footprint, SF_6 and Fluid-Filled cables should remain reporting requirements and not be directly incentivised

We support the continuance of the DPCR5 undergrounding scheme based on current eligibility criteria. We suggest that the amounts available under the undergrounding scheme should be reviewed once the further studies being undertaken as part of RIIO-T1 are concluded. We also suggest that consideration is given to setting undergrounding funding eligibility on an Area rather than DNO basis for those areas that cover more than one licensee.

We agree that IQI continues to be an appropriate mechanism to incentivise sensible and accurate forecasting, but contend that the indicative matrix represents a material shift in the incentive properties compared to DPCR5. Our interpretation is that a non fast-tracked company is highly unlikely to have a baseline score <100 and hence will be in automatic penalty. This does not constitute a reward for fast-track but a penalty for slow track.

As a result, we agree that the IQI mechanism could be an appropriate mechanism for rewarding fast-track companies but are keen to ensure that the 'no worse off' principle is applied. We are keen to ensure that fast-track is a genuine reward and not just the lack of penalty being applied. We agree with Ofgem's proposals to widen the range of efficiency rates as a stronger incentive to deliver sensible forecasts. It is important that incentives rates for performance incentives are calibrated against the efficiency incentive rate to ensure that companies are incentivised to deliver performance improvements as well as efficiency improvements.

The Network Innovation Competition (NIC) funding should initially be set consistent with DPCR5 levels and agree that the levels should be reviewed following a review of the Low Carbon Network Fund.

We support the increase the level of incentive for the Broad Measure of Customer Satisfaction and strongly support the move to fixed targets for all of this incentive. The existing arrangements have only been recently introduced and we therefore advocate that they remain largely unchanged at this point in time. We support changes to the treatment of Ombudsman complaints.

We have identified few (if any) real social outputs that we consider DNOs should be responsible for delivering but would support the creation of a potential funding allowance that could be utilised in the future if such outputs are identified over the RIIO-ED1 period.

We support Ofgem's proposals for the Long Term Development Statement, DG Connections Guide and Information Strategy. We do not think additional incentives are appropriate for the provision of information to connections customers but do support the introduction of average time to connect incentive. We fully support Ofgem's proposals for the treatment of market segments that have not passed the Competition Tests. These ensure appropriate incentives are retained to support the development of competition.

Our Answers to Questions in the Outputs, Incentives and Innovation Document

Chapter Two

Question 1: *We welcome respondents' views on the approach we have taken to develop the outputs framework.*

The six output categories set out as part of the RIIO framework remain appropriate and careful thought and design is now required in order to make them meaningful for RIIO-ED1. In overall terms, the expansion of output frameworks to cover more of the DNOs' activities is appropriate and these discussions have been generally well facilitated through the Ofgem-run workshops. As stated in our overall response, the fact that there are very few surprises in the consultation is testament to the effectiveness of the process Ofgem has managed.

Through our participation in the Working Groups, we observe that these have often worked best when there was an Ofgem proposal for stakeholders to respond to. We also observe that there has been a limited input of ideas from some stakeholders to date.

Question 2: *Do any of our proposed output measures present potential difficulties in ensuring the submission of accurate and comparable data?*

Many of the proposed output measures will bring additional data requirements. There is a potential tension between the need to maintain appropriate asset and network data to populate outputs and a form of Inspection and Maintenance cost benchmarking which could be set by companies not taking the requirement seriously.

The key secondary deliverables for reliability and availability (Risk Indices and commonly-defined Load Indices) are still in the early stages of development. For Risk Indices in particular, there is a tension between constraining the framework to currently-reported data and increasing the data requirements on DNOs to populate a more robust arrangement.

A number of areas (eg social obligations) are still subject to further development which may increase the data requirements on DNOs, or require the production and submission of new data which may not benefit from a process of normalisation and standardisation.

Question 3: *Should we use a percentage of allowed revenue or £m set using basis points of return on regulatory equity (RORE) to set caps and collars?*

RORE should be used to set caps and collars as makes it more stable for the DNO rather than having variable incentive strength.

Question 4: *Are there any aspects of our proposed outputs framework where the reporting requirements are likely to lead to disproportionate regulatory costs?*

We do not believe that there are any areas of the proposed outputs framework that will bring disproportionate costs in terms of the reporting requirements for Electricity North West. This is in part due to our capturing of appropriate data on aspects of asset performance as routine process. It may be that not all companies are as well positioned, however, and consideration needs to be given to this in comparative efficiency assessments.

Chapter Three

Question 1: *Do you agree that a specific output or incentive focussed solely on the connection of low carbon technologies is not necessary?*

We agree that it is difficult to differentiate between different technologies and hence a specific output is not required.

Question 2: *Do you agree with our proposals on the level of detail DNOs will be required to submit on the different scenarios in their business plans?*

We agree that it is appropriate for DNOs to provide their specific "best view" scenario as proposed. We note that DECC is intending to update its scenarios and that over time these will continue to evolve. From a pragmatic point of view this will necessitate utilisation of the latest forecast at a point in time for our plans.

Question 3: *Do you agree that an uncertainty mechanism is required to manage the uncertainty around the penetration of low carbon technologies?*

We agree that uncertainty mechanisms are required. We have proposed some changes to the DG Incentive that will provide the most appropriate funding mechanism for Ofgem, customers and DNOs.

We consider that the IQI incentive creates an incentive for DNOs to submit a "low" bid in their Well Justified Business Plans. Indeed any DNO that takes a counter view runs the risk of appearing inefficient and having these costs disallowed. This creates a shareholder exposure if there is a significant level of reinforcement actually required. Alternatively a DNO may consider that they can recover these costs through the current connections charging methodologies and charge DG customers for this reinforcement. Our experience in DPCR5 is that DG developers are sensitive to reinforcement costs and simply prioritise their focus on alternative sites once reinforcement charges have been identified. Our over-riding concern is that there is not the same level of modelling developed for low carbon technologies and our confidence in developing a forecast that is both acceptable to us and Ofgem is low. An uncertainty mechanism is therefore our favoured solution.

For Demand Connections we have proposed a volume driver that reimburses DNOs where they are required to intervene to address network problems that have been caused by clusters of Low Carbon demand technologies.

Question 4: *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?*

We generally support these proposals as an effective way of ensuring efficient delivery of the requirements. However, the scope of the proposed smart metering reopener must be expanded to include all of the costs that DNOs may incur following smart meter roll-out including: on site costs associated with smart meter roll-out, cut-out inspection once suppliers cease to inspect, costs of purchasing data from DCC, data management and storage costs, costs of extra activities driven by new information eg responding to LV voltage alarms.

Question 5: *Should costs of load and generation growth for existing customers in profile classes 1-4 be socialised, until smart metering data is available?*

We support Ofgem's proposals for the socialisation of costs for existing customers in profile classes 1-4.

We think the decision on the approach once smart metering data is available is a policy decision for Ofgem and DECC. The level of subsidy provided through DECC incentives will have a large impact on the attractiveness and therefore take up of low carbon technologies. It is unclear to us what arrangements Ofgem would propose once smart metering data was available.

Whilst we appreciate the issues that Ofgem has identified in relation to socialisation, we are concerned that introducing any "carve outs" that result in some customers having to pay costs but not other customers creates an artificial boundary. This will create a disincentive for customers to notify us of their installation or to seek routes to circumvent the "carve out". We have made (on behalf of the ENA) proposals to DECC that certain types of equipment that have higher adverse impacts on the network receive a lower level of subsidy and we think this is a much more effective way of creating the right incentives for customer behaviour.

Question 6: *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?*

We see merit in retaining the current provisions set out in the current connections charging methodology which work well and ensure that customers who significantly affect power quality face the costs of addressing the problem.

We recognise that we may need to differentiate between different types of equipment that may have similar disruptive effects. For example, for the connection of industrial-type equipment in a domestic property, it may be appropriate to charge. However the installation of different low carbon technologies may be better incentivised by removing certain types of equipment from the Renewable Heat Incentive.

Question 7: *If we socialise costs of existing profile classes 1-4 customers, will the use of system charging methodology need to be changed in order to protect IDNO margins?*

If socialised expenditure becomes significant then adjustments can be made to customer contribution assumptions in the charging model which would increase IDNO margins to reflect the additional expenditure.

Chapter Four

Question 1: *What are your views on the primary outputs and secondary deliverables for reliability and safety? In particular: (a) Do you agree that these are appropriate areas to focus on? (b) Are there any other areas that should be included?*

We agree that the appropriate areas have been focused on. Further details can be found in our response to the Reliability & Safety document but in summary terms our views are as follows;

- We agree that the Safety outputs should be compliance with HSE requirements and that no financial incentive should be applied.
- We agree with the continuance of the IIS scheme, setting ex-ante targets and maintaining the incentive rates broadly at their current levels.

- We do not agree with the proposed re-imposition of a revenue cap on IIS earnings as an arbitrary restriction of the delivery of improvements in service to customers.
- We agree that Load Indices should be calibrated on a common scale, but further work is required to assess the viability of common terms. We favour the proposal to manage resultant risk within a band, rather than deliver a prescribed delta as this is more consistent with treatment of the costs, and enables account to be taken of changes in external drivers.
- We agree with the proposed extension of Health Indices to include Criticality, and propose that this is based on a monetised metric.
- We favour the introduction of a Worst Served Customer incentive regime as a more appropriate incentive to drive improvements to such customers
- We agree with the proposed risk measure for flooding, and suggest that an equivalent should also be introduced for pinch points.

Chapter Five

Question 1: *Will the proposed approach ensure effective losses reductions actions?*

We support the proposed change to an incentive mechanism which recognises those aspects of losses performance over which a DNO has control. The previous mechanism was so hampered by data issues that it did not drive any meaningful loss reduction behaviour. The proposed requirement to set out a loss reduction strategy appears sensible but will be dependent on the detail of the associated Cost Benefit Analysis. In terms of setting out the forecast costs of the DNO's proposed strategy, it will be important to set out clearly how these costs are to be captured, particularly where they represent an increment on other costs, in order to ensure that new reporting boundary issues are not inadvertently introduced.

Question 2: *Will our proposed losses discretionary reward provide the required incentive on DNOs to reduce losses? Should this be awarded twice during RIIO-ED1 or more frequently?*

In overall terms, we support the introduction of the proposed discretionary reward on losses; however clarity will be required on its interaction with the IQI efficiency incentive. In the case of a DNO securing greater loss improvements than forecast within the original funding, how is the outperformance rewarded? Similarly, if the target loss reduction is achieved for reduced expenditure, are such efficiencies subject to the IQI sharing factor? The efficiency sharing factor, discretionary reward and allowed revenue for loss reduction initiatives need to be considered together.

In terms of timing of the award, we suggest that a biennial basis may be more appropriate, to reflect the timescale over which most initiatives will be implemented, and ensure that the losses issue remains on the agenda throughout the price control period.

Question 3: *Should DNO actions to identify and address electricity theft be encouraged through an approach outside of any losses reduction mechanism? Do you have any views on the proposed approach, or any alternative proposals that we should consider?*

DNO costs for tackling electricity theft should generally be covered through charges to electricity suppliers or the recovery of costs from customers through theft in conveyance charges as allowed for under Schedule 6 of the Electricity Act. DNOs should be able to make a reasonable return on these activities but this should be

assessed over a number of years to reflect the potential volatility year to year in the level of theft detected and revenues recovered. Where a DNO revenue protection team discovers theft which is a supplier responsibility then the supplier should be obliged to pay the distributor its published costs associated with dealing with the issue in accordance with the Revenue Protection Code of Practice. This can be progressed through normal code governance arrangements. Transaction charges to third parties and costs recovered under Schedule 6 should both be treated the same from a regulatory perspective.

Question 4: *Do you think that further guidance should be provided with regard to the use of the 10% allowance for undergrounding? If so, what form should this guidance take?*

We understand that the '10% allowance' refers to the ability to deploy a small proportion of the undergrounding entitlement on undergrounding lines outside of the boundaries of Designated Areas at the request of stakeholder partner organisations. Typically, this would be where a line crosses the Designated Area boundary, but the visual impact is best mitigated by undergrounding the whole length of line, including that portion outside the Designated Area boundary. This provides useful flexibility in particular, limited, circumstances.

We work with stakeholders representing three areas shared with other DNOs. Feedback from these stakeholders suggests that consideration should be given to allocating entitlement on a Designated Area basis rather than by DNO, such that overall prioritisation decisions can be made, rather than separate ones by DNO. The 10% rule is relevant in these circumstances as work will still be undertaken within the boundaries of the Designated Area.

Question 5: *Are National Scenic Areas (NSAs) sufficient to allow for effective use of the scheme in Scotland in the protection of visual amenity?*

We agree that National Scenic Areas (NSAs) in Scotland should be afforded equal status with the current AONB and National Park areas for the purposes of the undergrounding scheme. We understand that the density of lines in such areas is relatively low, and that the companies involved will need to demonstrate they are accounting for the potential double-count where areas carry dual designations.

Question 6: *Do you agree with our proposals with regard to DNO assessment and stakeholder engagement within the undergrounding scheme?*

We agree that eligible funding should be applied pro-rata based on numbers of customers and length of lines in Designated Areas, as was the case in DPCR5. We suggest that an updating of the values for inflation may be sufficient for RIIO-ED1, but cognisance should be made of the results of the further RIIO-T1 studies, to ensure there is not a disproportionate treatment between distribution and transmission lines.

We agree that companies should retain discretion in terms of their assessment process and be mindful of the overall environmental impact of any proposed scheme. As stakeholder endorsement is vital to the success and eligibility of these projects and due to the sensitivity of the landscapes within which the work is undertaken, our experience is that these issues are exhaustively tested on a scheme-by-scheme basis before construction work commences.

We have found that the stakeholder consultation process is very successful but share the observation that some areas are better able to access resources than others. Some areas can also call on active 'Friends' or similar volunteer organisations which can conduct much of the initial survey and prioritisation work.

We would be happy to outline in a policy how stakeholders can contact us for assistance; however this would largely be a formalisation of existing practice. Part of the resourcing issue comes when stakeholders have to manage and prioritise two or three separate schemes due to their areas overlapping a number of DNOs. This could be mitigated by setting allowances on a Designated Area basis as outlined earlier.

Question 7: *Do you agree with our proposed approach for BCF? Do you consider there are any additional elements that should be included within the BCF reporting scope?*

We agree that is it appropriate for Business Carbon Footprint (BCF) to remain a reporting requirement only at this stage due to issues regarding commonality of reporting. We are happy to report annually on carbon reduction initiatives. We already undertake a number of carbon reduction activities as part of our existing Corporate and Social Responsibility (CSR) activities.

Question 8: *Do you agree with our proposed approach to SF6 monitoring, reporting and management?*

We agree that SF_6 emissions should remain a reporting requirement only, as it is included in the overall calculation of BCF and hence it would be inconsistent to single one BCF component out for differential treatment, particularly given the relatively low volumes installed on DNO networks. It is appropriate to require DNOs to ensure that their reporting arrangements are fully compliant with international standards.

Question 9: *Do you agree with our approach for fluid filled cables?*

We support the maintenance of the fluid-filled cable (FFC) reporting requirement and will provide forecast data as part of the Well Justified Business Plan.

Question 10: *Do you agree with our approach to noise reduction?*

Consistent with other areas, we will set out our policy on managing noise in our RIIO-ED1 submission and are likely to include associated expenditure forecasts. It appears counter to the proposals in other areas to remove the reporting requirement entirely as companies are likely to incur expenditure in relation to justified noise complaints and will need to report such expenditures somewhere. We agree that the current reporting requirement is not particularly meaningful; however it could be amended to require companies to include their activities in a narrative form, perhaps akin to the proposed reporting requirements for the new losses incentive scheme.

Question 11: *Do you agree with our assessment of the need for an additional environmental discretionary reward?*

We agree that the proposed RIIO-ED1 framework includes a wide range of incentives and requirements on the DNOs to facilitate the transition to a low carbon economy. We also agree that the main impacts of DNO's own activities (visual amenity, oil, SF_6 noise etc.) are covered off in specific requirements. There may be other areas however that would benefit from recognition in an Environmental Discretionary

Reward with a scope set to avoid duplication with other mechanisms. Examples could include waste management and other aspects of DNO operations.

Chapter Six

Question 1: *Do you agree with our proposal to retain the Broad Measure of Customer Satisfaction (BCMS) and increase the maximum revenue exposure?*

We agree that the Broad Measure of Customer Satisfaction (BMCS) has been a useful tool to improve customer satisfaction and we agree that it is appropriate to increase the maximum exposure to the incentive. We note that Ofgem's approach has significantly increased the downside exposure for DNOs with only a modest increase in reward opportunity for the customer satisfaction survey element. Whilst the Stakeholder Engagement element has increased, as it is a subjective measure, our perception is that maximum reward is unlikely to be gained.

Question 2: *We seek views on the approach to setting targets for the RIIO-ED1 period, including whether these targets should be fixed for the price control period or should be responsive to changes in industry performance.*

We strongly support the move to fixed rather than relative targets for the BMCS customer satisfaction survey and note that Ofgem has changed the RIIO-GD1 regime in this way.

Relative targets have been a useful mechanism to create a sense of "competition" between the DNOs and have driven improvements in customer satisfaction across all the DNOs. This competitive element engenders an environment which discourages the sharing of best practice. Feedback from many stakeholders, most pronounced at the recent DG Forum in London, is that customers want consistent approaches across the DNOs that reflect best practice. A move away from relative targets will remove a current perceived barrier to discussing and sharing best practice across DNOs which we believe to be in the best interests of customers overall now that levels of performance are generally much improved.

Fixed targets make evaluation and justification of new initiatives easier and business cases simpler to develop and accept. Note that fixed targets do not imply "easier", simply that the DNO knows the threshold, however stretching, that it needs to meet to gain a reward. We propose that fixed targets are set at the upper quartile position during DPCR5. The actual date that targets are set needs consideration for practical reasons so that these can be specified and encapsulated into licence conditions. We consider an adjustment at the mid-point review to reflect any further improvements achieved by DNOs in the first four years of RIIO-ED1 an appropriate mechanism.

We consider that customers' expectations will change over time and that the performance of a DNO to maintain a level of scoring will need to continually improve. Fixed targets are therefore self correcting as the achievement of a fixed target requires continuous improvement by the DNO.

Question 3: *We seek wider stakeholder views on whether interruption customers that have been proactively contacted by the DNO via new methods of communication (eg social media) should be included in the customer satisfaction survey.*

There is already adequate incentive for DNOs to carry out proactive communications and note that most companies are carrying out this to some degree, including

ourselves. Many of the methods of communication used are non specific and therefore do not feel appropriate to be explicitly considered in the customer satisfaction survey. For simplicity, we would therefore not advocate adding these types of contact into the survey.

Question 4: *Should the provision of information to connections customers be taken into account when calculating the score of the customer satisfaction survey?*

The additional measures are unnecessary and we observe that there are many initiatives already being undertaken by DNOs to provide better information to customers. We therefore consider that there are existing incentives that drive this appropriate behaviour such as customer satisfaction scores, Competition Tests, complaints and improving efficiency.

Segregating provision of information as a separate "killer question" in the customer satisfaction survey for example presupposes that this is the one of the most important drivers of satisfaction and remains so throughout RIIO-ED1. We consider that the simplicity of the single "killer question" futureproofs the scheme rather than focuses on a single component of what drives customer satisfaction.

Question 5: *Should the number of unsuccessful calls be taken into account when calculating the score of the customer satisfaction survey?*

It would be appropriate to take unsuccessful calls into account for the interruptions element of the customer satisfaction survey. We can see that this would ensure that there is no perverse incentive to reduce the flow of calls a DNO receives during interruptions to allow them to provide an enhanced experience for the smaller number of customers that get through. If two DNOs had exactly the same level of customer satisfaction but very different levels of unsuccessful calls, it seems appropriate to adjust the scores downwards for a DNO with significantly higher levels of unsuccessful calls.

We do not think it appropriate to apply such an adjustment to connections or general enquiries. Connections in particular is measured based on all customers receiving the service eg a quotation, irrespective of how they contacted the DNO. We have developed on-line quoting for example and it would seem inconsistent to scale our satisfaction score based on the number of unsuccessful calls. Any contact issues the customer has will be taken account of in the score they give us. Similarly general enquires are not so subject to the coincident high volumes of calls and therefore the adjustment does not seem appropriate.

Question 6: *What indicators should we use to measure complaints performance? How should these be weighted?*

The current approach appears to work with the exception of the Ombudsman complaints element which should be assessed against the total number of complaints received by the DNO, not just those referred to the ombudsman for resolution. The use of the total number of Ombudsman complaints does reduce the current disproportionate financial consequences of an Ombudsman finding against us but does mean that a DNO's individual performance is impacted by the approaches of other DNOs.

Question 7: *How should we calculate the BMCS complaints metric target for RIIO-ED1? How should we calculate the score at which the DNO incurs their maximum penalty exposure?*

The approach used in gas was for 1.75 standard deviations from the mean and it would seem appropriate to replicate this in electricity.

Question 8: *Do you agree with the proposed approach to assessing stakeholder engagement?*

The proposed approach is satisfactory as it is difficult to produce more robust approaches where the actions being taken by DNOs could differ significantly. The additional rewards should assist in DNOs looking to invest in this key area. We would expect Ofgem to provide assessment criteria so that DNOs are clear how the assessment will be made in advance of making their submissions.

Chapter Seven

Question 1: *Are there additional social issues that the DNOs should address?*

The key social issues have been addressed specifically in this chapter or through the proposals on theft which include assisting agencies such as the police in addressing issues such as cannabis farms.

Question 2: *Are there any specific outputs that the DNOs could be responsible for delivering?*

This area is so diverse it is difficult to produce specific measure and an assessment approach is likely to be more appropriate. Any significant expenditure in this area is likely to create cross subsidy issues and therefore a clear policy position from Ofgem is essential.

We note that Ofgem is also developing a Vulnerable Customer Strategy and there are implications of minimum requirements for Priority Service Register customers. Whilst we welcome this work it is important that any such obligations or expectations are identified in time so that DNOs can incorporate them into their Well Justified Business Plans next year.

Question 3: *Should a separate funding allowance be provided to enable DNOs to carry out activities in response to social issues?*

We consider this would be an appropriate mechanism to fund activities that require expenditure to address social issues. As discussed in the Strategy Consultation, an approach similar to the Network Innovation Allowance would seem an appropriate mechanism to deliver this. Whilst there may be limited specific activities currently identified, such a mechanism would provide a degree of “future proofing” for the RIIO-ED1 period.

Question 4: *Are DNOs adequately incentivised to engage with social issues as part of the BMCS Stakeholder Engagement Incentive?*

We recognise that the proposed increase in the Stakeholder Engagement incentive does give additional scope to incentive DNOs to engage with social issues. The strength of the incentive limits a DNOs involvement to *engagement* and does not encourage investment in more innovative activities. A scheme as identified in Question 3 could provide this balance.

Chapter Eight

Question 1: *Do you consider that our proposed package will drive the appropriate behaviour for connecting both demand connections and generation connections?*

We consider that changes to the DG Incentive are required as outlined in our answer to question 2 below.

Question 2: *Is it appropriate to remove the DG incentive?*

We do not think it is appropriate to remove the DG Incentive. There are three key features of the existing DG Incentive;

- To provide an incentive for the connection of DG.
- To allow the recovery of operations and maintenance costs.
- To act as an uncertainty mechanism for the associated reinforcement.

In practice, we have seen that the incentive properties have been reduced by the perfectly rational behaviours of DG developers. Where there is reinforcement required that will be chargeable to them they choose to develop alternative sites. This means that there is limited DG related reinforcement carried out and the enhanced rate for this investment is not realised. Should the DG Incentive be stopped then another mechanism for the recovery of the operations and maintenance costs will need to be developed. However it is the last of these three features that gives us most cause for concern. We consider an appropriate uncertainty mechanism is essential as outlined in our response to Question 3 of Chapter 3. We have previously proposed to Ofgem that the simple removal of the cap and collar aspects of the DG Incentive should remove the current deficiencies of the scheme and provide an adequate incentive for DNOs.

Question 3: *Do you agree that we should split the BMCS customer satisfaction survey into major and minor connections customers? If not, why not?*

We support the principle that Ofgem has proposed that major customers in market segments that have passed the Competition Tests should not form part of an incentive regime that provides additional revenue to a DNO funded by DUoS customers.

Splitting the BMCS into major and minor customers is therefore necessary to support this principle. We do have a concern that some of the market segments can be very small. If a DNO has not passed the Competition Tests in market segments with small volumes of customers then we would have concerns about the BMCS still applying. This could result in DNO revenues being impacted by very small sample sizes. Where an individual customer may be aware that they constitute a large proportion of the survey basis, there is a risk that they may be less objective in their responses to the survey.

Question 4: *How should we set targets for the BMCS customer satisfaction survey?*

We strongly support the move to fixed rather than relative targets for BMCS customer satisfaction survey and note Ofgem has changed the gas regime in this way.

Relative targets have been a useful mechanism to create a sense of “competition” between the DNOs and have driven improvements in customer satisfaction cross all the DNOs. This competitive element engenders an environment which discourages the sharing of best practice. Feedback from many stakeholders, most pronounced at the recent DG Forum in London, is that customers want consistent approaches

across the DNOs that reflect best practice. A move away for relative targets will remove a current perceived barrier to discussing and sharing best practice across DNOs which will be in the best interests of customers overall now that levels of performance are generally much improved.

Fixed targets make evaluation and justification of new initiatives easier and business cases simpler to develop and accept. Note that fixed targets do not imply "easier", simply that the DNO knows the threshold, however stretching, that it needs to meet to gain a reward. We propose that fixed targets are set at the upper quartile position during DPCR5. The actual date needs consideration for practical reasons so that these can be specified and encapsulated into licence conditions. We consider an adjustment at the mid-point review to reflect any further improvements achieved by DNOs in the first four years of RIIO-ED1 an appropriate mechanism.

Question 5: *We invite views on our proposals for the Long Term Development Strategy (LTDS), Distributed Generation (DG) Connection Guide and Information Strategy (IS).*

We support the proposals to retain the LTDS and DG Connection Guide and to remove the obligation to produce the Information Strategy whilst recognising that this is still a key requirement in delivery of good customer service.

Question 6: *Are additional or alternative incentives required to encourage the DNOs to provide better information to connection customers upfront? If so, what would these measures and incentives be?*

The additional measures are necessary. We observe that there are many initiatives already being undertaken by DNOs to provide better information to customers. We therefore consider that there are existing incentives that drive this appropriate behaviour such as customer satisfaction scores, Competition Tests, complaints and improving efficiency.

Segregating provision of information as a separate "killer question" in the customer satisfaction survey for example presupposes that this is the one of the most important drivers of satisfaction and remains so throughout RIIO-ED1. We consider that the simplicity of the single "killer question" future proofs the scheme rather than focusing on a single component of what drives customer satisfaction.

Question 7: *We seek stakeholders' views on the introduction of a new Average Time to Connect Incentive.*

We agree that an incentive to shorten the average time to connect over the RIIO-ED1 period has merit and is a key element of customer requirements.

We are particularly encouraged by the statement in paragraph 8.33 regarding strategically investing in network reinforcement. Our perception to date is that Ofgem may disallow such investments in the future should they not be utilised and therefore expose DNOs to unnecessary financial risks. Such investment which can be justified on an ex ante basis should not be challenged on an ex post basis with the full benefit of hindsight. This is a significant and welcome change that will enable DNOs to meet more effectively to meet their obligation under section 9 of the Electricity Act.

Question 8: *We seek views on which aspects of service should be measured, the approach used for target setting and whether any exemptions should be applied under the Average Time to Connect Incentive?*

We agree that it is appropriate to split the measurement into the two key elements of average time to produce a quote and average time taken from quotation acceptance to completion of works.

For minor customers, where there are likely to be reasonable volumes, this can generally be measured as a simple elapsed time. We support Ofgem's point that some exemptions would be appropriate where customers request timescales that are considerably longer than the average. These could be specifically identified and presented to Ofgem for review. We would consider more minor delays, whether caused by the customer or not to be included in the measurement. Whilst this may have the affect of worsening our measured performance we believe it more closely aligns to customers' perception of elapsed time.

For major customers whilst the same principle applies, the smaller volumes mean that the simplicity of this approach may not be appropriate. Generally for these customers it is alignment to their programme that is more important.

The individual targets for DNOs are more appropriate. There are differences between DNOs both from a network perspective and other factors such as Traffic Management Act access across different local authorities that can have a bearing on the performance of DNOs. As currently there is little comparative data on a consistent basis there is a risk that some DNOs could benefit unduly from previous strategies, for example previous over-investment resulting in capacity could benefit a DNO compared to a more targeted DNO.

Question 9: *Do you agree with our proposed approach for the treatment of connection customer contributions by the DNOs during RIIO-ED1?*

This approach is appropriate but as stated in our response to Question 7, the imperative is to remove the perceived level of risk associated with proactive and strategic reinforcement.

Whilst we do accept its appropriateness, we note it is another example where the overall package removes an out-performance opportunity for the DNO and adds to the reduction in the attractiveness for investors.

Question 10: *Are additional incentives needed to encourage the DNOs to provide high-quality, timely non-contestable work? If so, what incentives should be applied?*

No additional incentives are necessary. The safeguards identified in 8.55 together with the complaints incentive, licence obligations and the requirement to comply with competition law provide adequate incentive.

Question 11: *We seek views on the financial exposure and scope of incentives for those market segments that have/have not passed the Competition Test.*

We consider that the proposals look balanced and provide appropriate incentives for DNOs to pass the Competition Tests.

We do have a concern that some market segments are very small (perhaps with one project per annum) and that some of the mechanisms proposed may not work adequately for them. For example, calculation of an average time to connect for one project may not be appropriate.

We reiterate our view that Ofgem should reconsider its view regarding Guaranteed Standards of Performance for market segments that have passed the Competition Tests. These impose an additional administrative burden on DNOs compared to their competitors and Ofgem should be mindful that they are not creating an anti-competitive situation in a market that they have deemed competitive.

We also propose that Ofgem reviews and standardises the approach to standards relating to connections. Standard Licence Condition 15 requires DNOs to meet a performance of 90% against a number of activities. In some cases the volumes of these activities are low and a single failure to meet the standard can result in a licence breach. In opening up activities to competition and making more contestable this has exacerbated the situation. Lowering the number of non-contestable activities, for example by making jointing to mains cables contestable has increased our exposure of a licence breach for a single failure. We would advocate moving to standardise the whole regime for SLC15 and the Connections Guaranteed Standards of Performance covered by SLC15A. In addition the requirement to provide connections offers in three months in SLC12 is superfluous and inconsistent with SLC 15A.

Chapter Nine

Question 1: *Do you agree with our proposed range for the efficiency incentive rate?*

We support the widening of the efficiency rate range for the IQI mechanism as a more appropriate incentive for accurate forecasting. In particular, those companies close to baselines of 100 will have to work harder to identify efficiencies than those companies away from 100 who receive additional allowances under the mechanism. This needs to be recognised in the setting and calibration of efficiency rates.

Question 2: *Do you agree with our proposed approach to the calibration of the IQI?*

RPEs should be excluded from the IQI assessment. This is an uncertainty mechanism which should not be subjected to additional efficiency adjustments on top of the separate RPE assessment and productivity offsets.

Question 3: *What are your views on the indicative IQI matrix?*

We do not agree that the illustrative IQI framework is appropriately calibrated as it represents a material change from the DPCR5, RIIO-GD1 and RIIO-T1 precedents. Whilst we agree that the IQI mechanism is a potential vehicle for introducing rewards for fast-tracking, it needs to be clear that these are rewards compared to the outcomes DNOs would expect from a traditional price review process. At present the IQI proposal appears as an effective penalty for slow track (compared to DPCR5), rather than a reward for fast-track (as a fast-track company will only earn rewards commensurate with those 'typical' of DPCR5.

Question 4: *What do you consider are the appropriate rewards for fast-track companies compared to non fast-track companies? Should we have a differential between the two?*

We agree that the IQI matrix is an appropriate method of rewarding fast-track companies. One of the features of IQI is that it gives allowances above 100% to companies who do not achieve the 100 baseline point in recognition of the fact that comparative models are imperfect and may under-estimate required allowances. Similarly, companies whose plans are deemed below 100 receive allowances greater

than their plan. At DPCR5, some DNOs were recompensed for their plans by receiving allowances above those requested.

If the intention of the fast-track process is to give the DNO the allowances requested, a DNO does not have recourse to this risk management and so would need to be recompensed in other ways, such as a revenue reward based on totex.

The illustrative matrix includes the possibility of non fast-tracked companies achieving baselines of 90. This would lead to substantial additional allowances and a strong efficiency factor. The matrix needs to be carefully designed so as not to appear more lucrative for companies to deliberately aim for slow track (eg by submitting competitive but non-compliant bids) in order to unlock the rewards available at this point on the scale.

Question 5: *Do you agree with our proposals for the same efficiency incentive rate to apply to all areas of expenditure that will be included within the IQI?*

We agree that all expenditure areas should be included within the scope of the IQI framework, in order to remove any remaining boundary issues on cost classification. However, the expenditure associated with uncertainty mechanisms should not be included in the IQI assessment to avoid companies being unduly rewarded or penalised for differences in forecasts of uncertain items.

Question 6: *Do you agree with our proposed treatment of DNOs within a single ownership group?*

We agree that the proposed treatment of DNOs within a single group is appropriate.

Chapter Ten

Question 1: *Do you agree that the cap on funding for the electricity NIC should be within the range of £60m and £90m for 2015-16 and 2016-17? Please provide evidence to support your suggested level of funding.*

We suggest that the funding level for the electricity NIC should be set at £90m for 2015-16 and 2016-17. We agree that it is appropriate to conduct a review of the effectiveness of the projects undertaken under the LCN Fund and to use the results of this review to inform the appropriate levels beyond 2016-17. Until that point, funding levels should be consistent with those currently in place for DPCR5 and those planned for RIIO-T1. As noted in the document, projects are only funded in any case if they pass strict criteria applied to a competitive process and there is no requirement for Ofgem to disburse the entire annual allocation. As such, the limit is somewhat arbitrary as only high quality projects will be approved in any case.

Question 2: *Do you agree that the level of funding for the rest of the RIIO-ED1 period should be reviewed in 2016 following a review of the LCN Fund?*

We agree that it is appropriate to review the effectiveness of the initial LCN Fund projects after a few years of operation and to use the results of this review to establish appropriate funding levels thereafter. We anticipate that low carbon issues will not have been ‘solved’ by 2016 and that there will be an enduring need to allow large-scale innovation to take place. As well as reviewing the effectiveness of previous projects, the discussion on funding levels should also take into account issues such as smart metering roll-out which will by then be in progress.

Question 3: *What are your views on the information DNOs should provide in their innovation strategies? How can DNOs best demonstrate that their approach to innovation is sufficiently well justified and robust?*

As the future needs are uncertain, it is important that DNOs have a strong history of innovation and improvement, ie to show that they have the right culture and expertise to make business changes. DNOs should include the approach to innovation taken over recent years and demonstrate how they have addressed the needs perceived at the time the innovation was undertaken and how customers have benefitted from the outcome of innovation strategies.

In terms of future innovation, there are differences between those elements funded under NIA and those under NIC. By definition NIA projects will contain more speculative research in to asset management, life extension, service performance and the adoption of new technologies in response to LCTs. Whilst these elements must be linked to stakeholder value drivers we do not believe it is in the interest of stakeholders to overly constrain innovation. We support the proposals outlined including the pre- registration of NIA projects.

NIC projects must by definition demonstrate strong stakeholder engagement and a linkage to clear business needs. The competitive nature of the funding mechanism necessarily precludes open disclosure of future projects however it is appropriate to encourage stakeholder involvement and collaboration.

Question 4: *Do you agree that it would be valuable for DNOs to consult and update their innovation strategies regularly during the price control period?*

It would be appropriate for DNOs to update their innovation strategies during the price control period as part of the wider effort to publicise and disseminate learning from research efforts. It is appropriate to allow companies an element of discretion in this process as it can be reflective of their particular stakeholder requirements.

Question 5: *Are there any aspects of the innovation framework for RIIO-ED1, which you think should differ from the arrangements from RIIO-T1 and GD1? If yes, please explain why.*

We have not identified any material requirement for changes.

Reliability and Safety

Overview

In overall terms, we consider that the right primary outputs and secondary deliverables are being considered for RIIO-ED1, a number of them representing the sensible evolution of DPCR5 frameworks.

We agree that the primary Safety output should relate to legislative compliance, and that no financial incentives should be applied.

In terms of Reliability and Availability, we welcome the proposals on IIS, particularly the maintenance of the current incentive levels and setting of ex-ante targets. We disagree however with the proposed re-introduction of the IIS revenue cap as an artificial disincentive to improving customer performance. Concerns over potential incentive earnings should be addressed at a more strategic level within the price control framework in the context of an overall RORE analysis of the package. Our stakeholder engagement clearly indicates that our customers value improvements in reliability performance and the caps in the format outlined would act to inhibit further improvements. We are particularly conscious of our customers' increasing reliance on continuity of supply as the UK progresses towards the government's objective of decarbonisation of domestic heat and transport.

With respect to arrangements for Worst-Served Customers, we prefer an appropriately calibrated incentive scheme to replace the DPCR5 arrangements.

We agree with the principles of a common LI framework, but suggest that the requirement for common terms requires further work. We agree that LIs should be measured in terms of performance within a defined band but highlight the need to consider how the proposed LI monitoring regime interacts with the LRE re-opener.

We agree with the proposal to extend HIs into Criticality and consider that this should be on the basis of a common framework quantified as a monetised value. We suggest that the RIIO-ED1 contract should continue to be set as a risk delta and agree that it should be subject to a symmetrical incentive regime that rewards outperformance as well as penalising under performance.

We agree with the proposals on resilience and suggest delivery is assessed (and penalised or rewarded) on a similar basis to the proposed HI regime. We also propose an additional factor – pinch points – for the proposed resilience measures.

Our Answers to Questions in the Reliability and Safety Document

Chapter Two

Question 1: *What are your views on the primary outputs and secondary deliverables for reliability and safety? In particular: (a) Do you agree that these are appropriate areas to focus on? (b) Are there any other areas that should be included?*

We agree that these are the appropriate areas to focus on and our detailed comments follow.

Chapter Three

Question 1: *What are your views on the proposed primary output and secondary deliverables relating to safety?*

The proposed areas are appropriate; however see our detailed responses below.

Question 2: *Are these appropriate areas to focus on and are there any other areas that should be included?*

We agree that these are the appropriate areas to focus on, and that the requirements should be framed in such a way that does not restrict them to a pre-defined list of applicable legislation so that any new legislative requirements are also included.

Whilst to some extent much of our asset replacement programme is pursuant to ensuring safety compliance, companies should be encouraged to outline in their Well Justified Business Plan those specific programmes of work they are required to achieve or maintain safety compliance.

Question 3: *Do you agree with our proposal not to place a financial incentive on the primary safety output?*

We agree that it is inappropriate to place financial incentives on the primary safety output as this area is regulated by the Health and Safety Executive (HSE). Failure of DNOs to comply with the primary safety output will result in enforcement action being taken by another agency.

Question 4: *Do you agree with our proposal to create an incentive framework for secondary deliverables for electricity distribution safety?*

We agree that issues of asset-related (rather than operator or behavioural) safety are adequately covered in the proposed definition of Risk Indices (RIs), although this is dependent on the final form of this mechanism. As these are part of a wider risk framework, it is probably not helpful to describe them as 'secondary deliverables for electricity distribution safety' as the RIs are not safety-specific. As the RIs will have financial incentives attached to them, there is a risk that this statement is contradictory to the decision not to place a financial incentive on safety.

Chapter Four

Question 1: *Do you agree with our proposal to align the IIS incentive rates with those proposed as part of RIIO-T1?*

The DPCR5 level of incentive rate has been sufficient to drive companies to make significant improvements in the quality of supply for customers. As such, we support its retention at broadly the current level as customers have indicated to us that reliability and availability of supply remain their top priorities. We understand that the ENS rate referred to is broadly consistent with the current DPCR5 rate.

Question 2: *What are your views on applying the efficiency incentive rate to the IIS incentive rates?*

We agree that IQI rates should not be applied to the IIS scheme. The current rates, howsoever derived, are appropriate and adequate to drive further improvements. The application of IQI would simply reduce the rates and hence the rate and extent of future improvements. As there is no funding of improvements through allowances in either DPCR5 or proposed for RIIO-ED1, in effect customers and shareholders share the cost of any upfront investment, with companies making a further return based solely on the subsequent delivery of improved service to customers.

The future incremental service improvements are likely to require higher investment levels than in previous periods and hence any diminution of the incentive rate would be likely to cause a significant reduction or cessation of such return-based investment.

Question 3: *Do you believe we need to introduce a rolling incentive mechanism for IIS, along the lines of the shrinkage rolling incentive proposed in RIIO-GD1, and if so outline your views on the merits of this approach for the IIS?*

We believe a rolling incentive mechanism whilst viable would be an unnecessary complexity compared to maintaining an ex-ante target regime for the RIIO-ED1 period. Clarity of targets and rates for the whole period is preferable to enable companies to plan the implementation of enduring improvement initiatives. It may be necessary to look at establishing the principles for target-setting as part of the mid period review, such that there is no unintended disincentive to invest in the latter part of RIIO-ED1 due to a lack of clarity regarding target-setting in RIIO-ED2

Question 4: *What are your views on the level of revenue exposure and do you believe we need to reintroduce a cap on outperformance?*

The re-introduction of a cap on IIS revenue exposure is a retrograde step and would be counter-productive. Revenues earned under the scheme only accrue because of real, tangible benefits in terms of improved performance delivered to customers. These improvements will also be delivered against an ever-tightening set of targets. Our stakeholder engagement clearly indicates that our customers value improvements in reliability performance and the caps in the format outlined would act to inhibit further improvements. We are particularly conscious of our customers' increasing reliance on continuity of supply as the UK progresses down the road to decarbonisation of domestic heat and transport.

Any concerns regarding potential returns should be addressed at the overall RORE level, and take into account the proposed removal of a number of other incentive schemes from the current DPCR5 framework.

Question 5: *Do you agree with our proposal to set separate planned and unplanned interruptions and minutes lost targets under the IIS?*

We agree that it would be appropriate to separate planned and unplanned target-setting as the former are far less comparable between DNOs than the latter based on current data. Experience suggests that they are also a function both of companies' network investment programmes, and also their approach to mobile generation etc. As such, the trade-offs between planned interruptions and the use of mobile generation or live line techniques is already encapsulated in the IQI incentive. It is also difficult for DNOs to appropriately forecast levels of planned interruptions in advance, whilst a number of other factors (eg IQI sharing factors) remain unknown.

Question 6: *Do you have a preference amongst the options which we have outlined for planned interruptions and minutes lost target setting in RIIO-ED1?*

We agree that a rolling approach for planned target-setting would be appropriate as this would effectively allow DNOs to find their own appropriate economic level in RIIO-ED1, based on their programmes of work and stakeholder feedback. We also observe that investment programmes naturally flex over the medium term to respond to changing investment needs and the rolling mechanism provides an automatic and symmetrical means of allowing for such variations in the scope of plans.

Our view is that it is difficult to assess customer tolerance of planned interruptions in a way that can be easily translated to the planned investment programme. Our experience of alternative mechanisms for planned target setting is also that they can produce inefficient behaviour or boundary issues that may inhibit efficient and necessary investment.

Question 7: *Do you have a preference amongst the options which we have outlined for unplanned interruptions and minutes lost target setting in RIIO-ED1?*

We agree that setting targets for RIIO-ED1 up front gives appropriate clarity to customers and DNOs on the levels of performance that the former can expect and the latter are charged with delivering. It is appropriate to include some form of anticipated performance improvement in the target-setting methodology as companies deliver improvements through technological and operational innovation. It may be appropriate to apply the glidepaths from 12-13 onwards as it will not be feasible to update the target-setting methodology for 12-13 actuals in the time available for Well Justified Business Plan assessment.

Rolling targets are feasible, but give greater uncertainty over future revenues, and add complexity to the regulatory arrangements. We believe that whilst targets offer clarity of deliverables for customers, it is the interplay of incentive rates caps and collars within the overall regulatory incentive package that both funds and drives improvements. Certainty in these areas is of primary importance.

Question 8: *Do you agree with our proposals on exceptional events?*

It is important to note that investment levels for hardening of networks to withstand extreme events, for example ETR 132, have historically been limited and hence network operators have only a limited ability to prevent or reduce the affect of such events on their networks.

We agree therefore that it is appropriate to maintain the existing severe weather exceptional event mechanism and update the thresholds to reflect current performance. These thresholds have appropriately identified those events which are genuinely exceptional to current performance.

We also agree that the one-off mechanism should be retained and that it would be appropriate to replace the current GS exemptions with an automatic payment and claim back arrangement.

Question 9: *Do you agree with our proposed approach to smart electricity meters?*

It is currently unclear what specific benefits will accrue to DNOs from the use of smart meter data and in particular how such data may affect either a companies' view of performance, or the appropriate interventions it needs to make.

Our understanding is that the so called 'last gasp' functionality if implemented would be likely to result in an increase in reported CMLs particularly on certain types of faults and in certain scenarios. As such, it would seem appropriate to include a rebasing mechanism in the licence to cover this eventuality once the materiality has been established.

Question 10: *Do you agree with us not incentivising short interruptions in RIIO-ED1?*

We agree that it is appropriate to continue to exclude short duration interruptions (SDIs) from the incentive scheme. Installing remote control and automation technology has improved customer service significantly at relatively modest cost and customers have indicated that short interruptions are less disruptive than interruptions over three minutes, and hence not a priority for investment.

We also agree that the investment levels required to materially reduce SDIs would be beyond those supported by our stakeholders.

Chapter Five

Question 1: *What are your views on our proposals on load indices (LIs)?*

We agree that the LI measure is an appropriate high-level indicator of the loading and utilisation of the network. We welcome the increased commonality of the banding and also agree that whilst it is feasible to extend LI measures to the secondary network, there is no strong driver to do so at this time. We do foresee that such secondary network metrics could be required for RIIO-ED2 investment planning and would support their continued development.

We observe that any commonality of LI banding does not in itself allow comparison across DNOs. This would require corresponding clarity in the accompanying definitions of capacity and demand. These are much more complex issues and are deeply embedded in a company's historic design policies. Whilst certain aspects such as the treatment of demand side response in LI calculations can be resolved relatively easily, we consider that there are significant issues in terms of defining common terms and that this requires further debate.

When considering LIs it is also important to note that LIs extend to interconnected groups of feeders and substations and hence the use of the term substations in this context only partially encompasses the scope of LI driven investment plans. As there are in theory a much larger set of interconnected groups than substations, care must be taken to avoid the potential to distort any overall LI based measure of load risk by the inclusion or exclusion of these groups. To avoid this we would recommend that the LI substations and groups considered be clearly baselined in any reporting.

Question 2: *Do you agree with our proposed common LI bandings?*

We agree that common bandings between DNOs are appropriate, but the band criteria need to be set such that they are meaningful. Our DPCR5 experience for example suggests that care needs to be taken with the LI=4 band, to ensure it is sufficiently wide to capture emerging load issues. As the current LI data does not (for us, anyway) simply translate into the proposed new bands, we suggest further work is required to validate the proposed bands.

Question 3: *Of the two options outlined for determining the LI deliverable, which do you think is the most appropriate?*

We suggest that the proposal to manage within a band is the most appropriate as the overall loading risk is subject to factors outside of the DNO's short-term control, eg demand changes. Delivering a pre-defined delta may not be appropriate in the context of other investment drivers, particularly if demand changes significantly from original forecasts.

The mechanism will also need to take appropriate account of efficient mitigation actions which may not reduce either the MD or the FC (and hence the LI as proposed), eg demand side response measures. This has the potential of incentivising new capacity which may not be the most efficient solution to demand issues. When judging the efficiency of a DNO's proposals, care will also need to be taken that the load modelling method for assessing general reinforcement costs outlined in the Cost Assessment annex does not conflict with the assessment approach taken to the corresponding LI outputs.

Consideration will also need to be given as to the interaction of the LI outputs mechanism with the proposed load-related re-opener, particularly in terms of ensuring the incentive properties are consistent (eg if a company is going to undershoot the LI collar but also trip the LRE re-opener and hence return monies to customers, what is the appropriate response to incentivise?).

Question 4: *Where significant numbers of substations that predominantly cater for demand arise, do you agree that the development of a Distributed Generation (DG) index for generation-dominated substations would be feasible and appropriate to implement at the mid-period point of RIIO-ED1?*

It is apparent from the UK Fourth Carbon budget targets that the de-carbonisation of generation will drive significant amounts of DG into DNO networks within the RIIO-ED1 period. In many ways this represents a greater technical challenge than the RIIO-ED1 plans for de-carbonisation of heat and transport.

We agree that the appropriate treatment of this DG contribution to reliability measures such as LIs has yet to be fully understood and hence it would be inappropriate to construct a DG Index at this stage.

We are leading the evolution of P2/6 through the ENA to allow appropriate and efficient inclusion of both DSR and DG and we agree that it would be feasible to construct a DG index for implementation at the mid-point review.

Chapter Six

Question 1: *What are your views on our proposals for health indices (HIs)?*

We are supportive of the proposals on HIs, in particular the use of a monetised metric to assess Criticality and the combination of Health and Criticality into Risk Indices. We are keen to ensure that the resulting framework is commonly specified for all DNOs and appropriately designed to operate over the period of RIIO-ED1. We consider that it forms an appropriate basis for calibrating the RIIO-ED1 risk deliverable and offers the potential for an associated incentive scheme on delivery.

Question 2: *Do you agree with our proposals to introduce criticality into the HI framework?*

We agree that the introduction of criticality represents a sensible evolution of the current DPCR5 HI metric, and more appropriately reflects the risk-based investment prioritisation processes of DNOs. We also believe that it will give a more representative investment 'delta' for RIIO-ED1 contract management.

Question 3: *Do you agree with our proposals for applying financial consequences in the case of material under or over delivery?*

We agree that the HI regime is approaching a level of maturity that would enable a symmetrical outputs incentive to be designed, and to replace the punitive downside only DPCR5 arrangements.

Question 4: *Do you agree with our proposals to require greater consistency in the types of assessments that the DNOs should feed into the calculation of the asset health indices?*

We agree that there should be greater consistency in the assessments that DNOs feed into the HI calculations. Such assessments should not be defined by the 'lowest common denominator' amongst DNOs in terms of current data and approaches and that the principles of the framework should be designed commensurate with a mechanism that will last for ten years, rather than what companies may be able to 'cobble together' in a few months.

To this extent, it may be necessary to require or mandate additional requirements or capabilities on DNOs to enable the operation of the metric from 2015.

Question 5: *What are your views on the suggestion that we would mandate DNOs to develop and maintain HIs in specified asset classes?*

We would urge caution on the mandating of asset classes to which the assessments made be applied. There is a risk that spurious or specious assessments will be made for the sake of completing a matrix without appropriate consideration of the overall framework. However, it is in companies' interests to seek to roll out these approaches as far as reasonably practicable and Ofgem should place a high evidence hurdle on those DNOs which are not forthcoming with risk projections for certain asset types.

Chapter Seven

Question 1: *What are your views on our proposals for the guaranteed standards?*

Our stakeholder engagement confirms that guaranteed standards provide an appropriate and material recompense to customers for service level failures. We support their limitation to this scope and the avoidance of any compensatory component.

As such, we support the proposals for guaranteed standards which are substantively the same as for DPCR5. The payment rates should be set adjusting for inflation forecasts to the middle of RIIO-ED1.

Question 2: *Do you feel that we should conduct a mid-period review of the guaranteed standards?*

Guaranteed Standards are tried and tested and are not subject to the same level of uncertainty as some of the newer incentive mechanisms. As such, we do not feel that a mid-period review is necessary. Adjusting the payment rates taking account of forecast inflation rates to the middle of the RIIO-ED1 period further removes the need for a mid period review.

Question 3: *Do you agree with our proposal to remove the potential double exemption of one-off exceptional events under the IIS and the guaranteed standards?*

We agree that this is appropriate and would make the arrangements clearer for customers.

Question 4: *Do you agree with our proposal to remove all of the Highlands and Islands customer exemptions?*

We agree that this is appropriate.

Question 5: *What are your views on our proposal to reduce the normal weather standard from 18 to 12 hours, the associated changes to payment levels and options for funding?*

We support this proposal as it is line with feedback from our own customer research. We believe that the caps on exposure are appropriate as well. Our customer feedback has suggested that a lower level of compensation at 12 hours would be appropriate, but the level that a DNO wishes to expose itself to under the proposals from Ofgem is their choice to make. Therefore we support the payment levels proposed by Ofgem and agree that it is appropriate to inflate these for the RIIO-ED1 period.

This will represent an increase in costs for DNOs. An efficient level of compensation should be funded in cost allowances.

Question 6: *Do you agree with our proposal to keep non-domestic customers in the guaranteed standards?*

We agree with the proposals to keep non-domestic customers within the guaranteed standard regime and not to reflect consequential losses in the level of payments as proposed. Any move to reflect consequential losses in payments would constitute a significant change to DNO risk profiles.

Question 7: *What are your views on the feasibility and practicality of making payments to all customers automatic?*

Any requirement for automatic payments should be linked to a DNOs ability to identify those customers who are off supply and will clearly be improved when smart meter data is available. If a customer has called a DNO to report that they are off

supply it could be argued that this customer should receive an automatic payment if they subsequently qualify for a GS payment.

However, we agree that it would be appropriate to wait until the national smart meter roll-out is complete before introducing a requirement to make automatic payments.

Question 8: *Do you agree with our proposal to make payments to Priority Service Register customers automatic?*

We agree that this would be appropriate, since even without full phase connectivity a DNO should be able to identify if a low voltage feeder has a PSR customer on it and should be proactive in making contact with that customer to check if they have been affected, so that appropriate action can be taken, if necessary.

Chapter Eight

Question 1: *What are your views on the proposed options that we have outlined for the worst served customers scheme? Please include what you see as the pros and cons of each of the options, whether you have a preferred option and why.*

Overall, we welcome the retention of a worst served customers (WSC) scheme as these customers receive a significantly worse performance than average and the IIS scheme does not necessarily incentivise improvements in service to these customers. We believe that a weighted incentive regime is a more appropriate mechanism than the current DPCR5 arrangements. The current logging-up regime is based on implementing investment-led solutions over a long timeframe within a set of restrictive criteria. Experience in DPCR5 to date shows that whilst it is possible to develop suitable investment business cases, these investments are overly difficult to identify and the success criteria difficult to achieve. In particular, the £1000 per customer cap acts to limit any material improvement for such customers.

The current scheme could even be considered perverse in terms of setting an arbitrary qualification criteria – there is no incentive to improve performance for customers marginally under the threshold; indeed there could be an incentive for additional interruptions to enable them to qualify for the WSC scheme.

In our view option 2 - namely a weighted scale - not only avoids the very binary and arbitrary qualification criteria, but credits any intervention options, not just network investment. Companies would be incentivised to find the most efficient mix of investment and operational management solutions for those customers, and also react to emerging performance issues, rather than waiting for a sustained level of poor performance to be endured before triggering action.

In our view this would enable a greater number of customers in the middle to upper performance bands to benefit from service improvements.

Chapter Nine

Question 1: *What are your views on our proposals for network resilience?*

We agree that there is currently no driver for investment to mitigate the impact of High Impact, Low Probability (HILP) events but the option should be left open for any subsequent guidance from government to be incorporated in the price control framework.

We also agree that future flood risk proposals could be measured and assessed in a manner similar to that used at DPCR5 in terms of risk removed from customers. Such a measure would need to take into account the customers at risk from a particular site and the degree of risk mitigated.

In terms of timely delivery, we suggest that this is important, but may not lend itself to the mechanistic application of an incentive. It may be possible to include it in the annual reporting in a manner akin to that proposed for HIs in DPCR5 (ie % progress vs. % spend with a minimum qualifying threshold on both); alternatively, it may be appropriate to subject it to the same assessment regime as that proposed for HIs in RIIO-ED1, ie under or over-delivery is penalised or rewarded through revenue adjustments or a roll forward of liabilities into RIIO-ED2.

Question 2: *Do you think that our proposals cover the right areas or are there other areas that you think we should be considering?*

Flooding and Black Start are important components of resilience but we are unsure of the merit of attempting to combine them in an overall metric. We also suggest that companies may look to remove some of the risk posed by network 'pinch points' following risk assessments in light of the Dartford incident. Such a programme could be assessed in terms of the approach suggested for flooding in terms of numbers of customers at risk, risk removed etc. This area could form the third component of a 'resilience scorecard'.

Tools for Cost Assessment

Overview

The RIIO-ED1 cost assessment approach must build on the lessons learned from RIIO-GD1 and DPCR5. One of the key issues is to ensure that Ofgem's analysis considers all aspects of efficiency: efficiency of outputs to be delivered, of associated volumes of work and unit costs of delivery. It is therefore important that the range of models used during RIIO-ED1 is appropriate to assess all aspects. We therefore agree with Ofgem's approach of using a range of models to assess efficiency (including totex, middle-up and disaggregated). It is important to note that Ofgem must not use the average results across all models as this may ignore key issues that may only be exposed in one type of model.

The table below illustrates the benefits and issues of using each modelling approach.

Model type	Pros	Cons
Totex	• relatively immune to trade-offs between activities and reporting differences • avoids "cherry picking" between different modelling approaches • simple to understand and replicate	• not able to include many cost drivers, leading to a less intuitive relationship between cost drivers and costs • difficult to normalise for inherited characteristics of network, previous spend and performance levels • does not easily differentiate between efficient delivery of work and non-delivery
Middle-up	• allows trade-offs between activities to be modelled with more detailed cost drivers than possible at totex level	• needs to be carefully specified to avoid simply duplicating analysis in totex or disaggregated models
Disaggregated	• provide a more intuitive assessment of costs against logical cost drivers • allows results of separate analysis of some activities (eg by consultants) to be incorporated back into results of assessment	• can be distorted by differences in cost and cost driver reporting • trade-offs between activities not always recognised in results

Ofgem must not dictate DNO operating and delivery structures; the regulatory framework must allow scope for companies to innovate in delivery. However, the differences in delivery structures can make a big difference to where costs are reported (and therefore where they are assessed). Ofgem's analysis approach must be neutral to where costs are reported and avoid treating ostensibly the same costs differently. At the same time, the comparative analysis must reward innovative solutions that can be used to set benchmarks for others rather than penalise them.

Total expenditure analysis and middle-up model

We agree that totex modelling should be one of the models included in Ofgem's modelling toolkit. Totex modelling has particular advantages including being relatively immune to trade-offs between activities and reporting differences, avoiding "cherry picking" between different modelling approaches and being simple to understand and replicate. However, these advantages are countered by a number of disadvantages including inability to include many cost drivers, leading to a less intuitive relationship between cost drivers and costs, and difficulty normalising for inherited characteristics of network, previous spend and performance levels. Crucially, totex models do not easily differentiate between efficient delivery of work and non-delivery and should therefore only be used in conjunction with other models that test the efficiency of outputs delivered and solution efficiency.

We agree with the principle of including a middle-up model in Ofgem's toolkit. It will be important to develop a middle-up model that measures different aspects of efficiency to those assessed in other models. Our analysis suggests that the key efficiency test that is absent from emerging totex models and from emerging disaggregated models is any test of the efficiency of outputs delivered and efficiency of investment volume targeting. We recommend that middle-up model is developed to test these key components of efficiency.

Disaggregated model

We agree that a bottom-up, disaggregated model should be used as part of Ofgem's assessment toolkit. We also agree that disaggregated models can provide a more intuitive assessment of costs against logical cost drivers and believe that both unit cost based and regression based models are appropriately included in the toolkit.

Disaggregated models have a number of key disadvantages. In particular, the results of disaggregated models can be distorted by differences in cost and cost driver reporting – either due to legitimate reporting differences because of different operating and delivery structures or due to reporting inconsistency or errors. Great care must be taken when aggregating the results of disaggregated models to avoid 'cherry picking' to create an impossibly low cost target. We broadly support the direction of the ongoing development of a disaggregated, bottom-up model, but comment on specifics in the relevant questions/ chapters.

We agree that for activities where no logical cost drivers exist, such as IT and property costs, benchmarks for these activities should be based on assessment by specialist consultants.

Network Investment – Load Related Expenditure

Ofgem will need to be careful to ensure approaches to assess efficient expenditure in this document are consistent with the approaches to assess appropriateness of outputs in the Reliability & Safety document. In particular, we are keen to ensure that there is not an inappropriate incentive to add capacity to solve load issues, without the acknowledgement of more innovative approaches. Ofgem's proposed approach, as currently drafted, does not appear to give appropriate credit to companies that use innovative techniques such as demand side response and inter-connection to mitigate load issues.

Network Investment – Non-Load Related Expenditure (NLRE)

The RIIO price controls have been developed to revolve around the outputs delivered for customers and stakeholders. The prime method of assessment should therefore be how well a company articulates the outputs from its proposed investment plan and demonstrates the efficiency of its proposed costs in achieving them. In overall terms, we agree with the evolutionary approach set out for NLRE assessment. However, fundamental to the RIIO settlement is the linking of investment to the outputs expected from that investment. As such, we would expect that the primary means of corroboration of company forecasts will be with reference to the outputs the investment will deliver, rather than a theoretical age-based model which actually contains no outputs at all.

We agree with the overall approach to increase the application of output-based metrics beyond those used in DPCR5. We also agree that a number of areas are best dealt with on a case-by-case basis, and that unit cost analysis is not universally applicable due to the difficulties of isolating comparable unit costs in some areas.

Network Operating Costs

We agree that Ofgem's proposed approach represents a broadly sensible evolution of DPCR5 approach for these activities.

Closely Associated Indirect Costs

We agree that it is sensible to differentiate between Closely Associated Indirect costs associated with supporting the delivery of direct activities and those that contain substantially fixed costs. It is important that analysis recognises not only that costs in Group B do not vary much with size of capital programme, but also that they contain some fixed costs that can be shared by DNOs in the same ownership group (for example control room and call centre costs).

We agree that it is sensible to consider non-operational capex as part of the same assessment methodology as associated indirect costs to avoid any differences in DNO ownership strategy distorting results. We agree that capex should be smoothed to avoid lumpy profiles which can unduly influence the results of modelling. Similarly, we agree that financial treatment of both types of costs should identical to avoid any distortion.

We are concerned that Ofgem's proposal to treat contractor costs differently from insourced costs for WFR and TMA risks creating an inappropriate incentive to insource activities. Unless separate unit costs are calculated for insourced and outsourced direct activities, this approach is inconsistent and hence inappropriate.

Business Support Costs

We have significant concerns with Ofgem's approach to assessing the efficiency of business support costs in the RIIO-GD1 and RIIO-T1 reviews. Firstly, many of the cost drivers chosen are not exogenous (eg end users, revenue, employees, spend) and hence all may advantage inefficient companies. The significant difference between the GDNs' costs and external benchmark costs (sometimes by a factor of 100%) suggests that the benchmarks are non-comparable and hence the baselines are inappropriate.

We are also concerned that the approach undertaken in RIIO-GD1 fails to recognise and take into account the very material issue of recognising the fixed costs that are shared by companies in the same ownership group. All comparative analysis must

take into account the fixed costs that can be shared across ownership groups; calculating unit costs will not achieve this.

We agree that IT and property costs should be subject to external review – these are complex areas of expenditure that do not lend themselves to simple cost drivers. The external review must recognise that utilities incur different types of costs in these areas to other companies and that external comparators and benchmarks may not be relevant.

We agree that it is sensible to consider non-operational capex as part of the same assessment methodology as associated indirect costs to avoid any differences in DNO ownership strategy distorting results. We agree that capex should be smoothed to avoid lumpy profiles which will unduly influence the modelling results.

Regional and company specific adjustments

We agree that adjustments for regional factors should be kept to a minimum and only enacted if strong evidence of a distorting factor is found and a robust mechanism for an adjustment is available.

RPEs and ongoing efficiency

Ofgem has recognised that DNOs are exposed to substantial real price effects (RPEs) in its recent price control review. These RPEs occur as a result of the mismatch between the revenue indexation methodology and the real growth of network costs in areas including specialist labour costs, materials and contractor costs. The impact of the cost growth in these areas must be taken into account in the assessment of business plans. The ongoing consultation by the Office of National Statistics to modify the construction of RPI could exacerbate the current issue and will require higher RPE allowances for RIIO-ED1.

We agree with Ofgem's position that RPEs associated with potential reopeners should be assessed separately.

We do not expect that frontier shift rates for DNOs will be as substantial as those determined for GDNs given that GDNs have only relatively recently been separated and hence not subject to competitive pressures for as long a period as DNOs.

Data assurance and compliance

We fully support Ofgem's proposal to introduce an additional licence condition and associated guidance to improve data assurance and compliance. The proposals have an important role to play in ensuring consistency of data assurance across DNOs and improving the comparability of reported data used to assess company performance. We will also fully support the data assurance trial in DPCR5.

Ofgem needs to make sure the new data assurance licence condition is enforceable and needs to ensure that costs associated with delivering good data assurance are not 'benchmarked out'.

Our Answers to Questions in the Tools for Cost Assessment Document

Chapter Three

Question1: *Do you agree with the use of totex benchmarking for RIIO-ED1 and what are your reasons*?

We agree that totex modelling should be one of the models included in Ofgem's modelling toolkit. Totex modelling has particular advantages including being relatively immune to trade-offs between activities and reporting differences, avoiding "cherry picking" between different modelling approaches and being simple to understand and replicate. However, these advantages are countered by a number of disadvantages including inability to include many cost drivers, leading to a less intuitive relationship between cost drivers and costs, and difficulty normalising for inherited characteristics of network, previous spend and performance levels. Crucially, totex models do not easily differentiate between efficient delivery of work and non-delivery and should therefore only be used in conjunction with other models that test the efficiency of outputs delivered and solution efficiency.

Question 2: *Do you agree with the use of a capital expenditure as opposed to capital consumption approach for measuring total costs?*

We agree that capital expenditure should be used in totex modelling. Whilst capital consumption measures are theoretically more appropriate, we believe that the practical issues associated with calculating a comparable capital consumption construct from inconsistent data sets outweigh the potential benefits of its use. We also believe that the output of capital expenditure models can be more intuitively understood when assessing companies' forecasts.

We believe that some smoothing of the capital expenditure measure may be required to normalise for natural year on year variations in capital expenditure.

Question 3: *Do you agree with using a similar approach to the top-down model used in RIIO-GD1, considering the adjustment for regional factors, the use of a composite cost driver, and the use of the upper quartile (UQ) to determine efficient costs?*

We agree that only controllable costs should be included in the totex model and that uncertain costs should be excluded.

We are concerned that the wide range of normalisation adjustments applied to data in the RIIO-GD1 totex model may distort the results of models. Ofgem must be confident that the adjustments correct for material exogenous factors and that they are based on robust data. In particular, we do not agree that there is evidence that regional salary distortions occur outside of central London.

Care must be taken when using composite drivers to determine an appropriate weighting between drivers. Where results using composites differ from those using free weighted drivers it will be important to understand whether those differences arise from an inappropriate composite construct.

Great care must be taken in determining an 'efficient cost' value from totex models. Given the simplicity of totex models, the risk that apparent 'inefficiency' may actually be due to un-modelled factors is high in totex models. In particular, it is unlikely that a totex model could be developed for RIIO-ED1 that includes comparable output

measures as cost drivers. This means that part of modelled 'inefficiency' will in fact arise from differences in output delivery. We would be very concerned if Ofgem sought to set allowances at upper quartile without any adjustment for differences in output delivery.

Question 4: *Do you believe it is appropriate to use a middle-up totex model and if so, do you agree with following the principles of the GD1 approach?*

Please see our response to Question 5

Question 5: *What level of disaggregation do you believe is appropriate for the middle-up model to provide a useful comparator to the top-down totex model?*

We agree with the principle of including a middle-up model in Ofgem's toolkit. It will be important to develop a middle-up model that measures different aspects of efficiency to those assessed in other models so that the middle-up model adds to the toolkit rather duplicating analysis already undertaken in other components of the toolkit.

Our analysis suggests that the key efficiency test that is absent from emerging totex models and from emerging disaggregated models is any test of the efficiency of outputs delivered and efficiency of investment volume targeting. We recommend that the middle-up model is developed to test the efficiency of these key components of efficiency.

Question 6: *How do you believe lumpy expenditure should be treated in totex modelling?*

Some smoothing of lumpy expenditure such as capex (through simple averaging) may be required to normalise for natural year on year variations in capital expenditure.

Chapter Four

Question 1: *Do you believe it is appropriate to use a bottom-up, disaggregated model to compare with the totex model results?*

We agree that a bottom-up, disaggregated model should be used as part of Ofgem's assessment toolkit. We agree that disaggregated models can provide a more intuitive assessment of costs against logical cost drivers. We believe that both unit cost based and regression based models are appropriately included in the toolkit.

Disaggregated models do have a number of key disadvantages. In particular, the results of disaggregated models can be distorted by differences in cost and cost driver reporting – either due to legitimate reporting differences because of different operating and delivery structures or due to reporting errors.

Great care must be taken when aggregating the results of disaggregated models to avoid 'cherry picking' to create an impossibly low cost target.

We agree that for activities where no logical cost drivers exist, such as IT and property costs, benchmarks for these activities for these activities should be based on assessment by specialist consultants.

Question 2: *Do you agree with our approach to the disaggregated, bottom-up model?*

We broadly support the direction of the ongoing development of disaggregated, bottom-up models, but comment on specifics in relevant questions.

Chapter Five

Question 1: *Do you agree with our proposed approach to how the specific building blocks that make up load related expenditure interact as well as which categories are proposed to be included in a load related reopener?*

We broadly agree with the approach, subject to comments in specific questions below.

Question 2: *Which of the three options set out for assessing connection-related costs within the price control do you feel is the most appropriate and why? Please reference the following in your answer:*
d) the gross cost assessment adjusted for net-to-gross ratio or just on the Distribution Use of system (DUoS) funded reinforcement costs
e) the most appropriate cost driver for connection reinforcement costs: Meter Point Administration Numbers (MPANs) or number of connection projects
f) the most appropriate approach for assessing cost of low volume high cost (LVHC) connections.

We consider that it is much more appropriate and logical to use Distributed Use of System funded reinforcement costs.

Both proposed drivers have weaknesses and could lead to inconsistencies if used to compare costs between companies. In the DPCR5 settlement we considered that we were disadvantaged in the unit cost calculation where number of MPANs was the driver as we completed little new housing work compared to other DNOs. Similarly using number of projects as a driver would generally disadvantage DNOs that have largely underground networks; in more overhead DNOs, even the connection of a single domestic customer could require a pole mounted transformer change. This would be categorised as a LV end connection involving HV work. The unit cost of this work would be relatively low and therefore the average unit cost for this category in an overhead DNO will be relatively lower than that of an underground DNO. In practice it is the connected capacity that influences the amount of reinforcement and therefore a volume driver based on the capacity connected needs consideration.

Reinforcement costs associated with Low Volume High Cost (LVHC) connections should continue to be treated as general reinforcement.

Question 3: *Which of the three options set out for assessing wayleaves and diversionary-related costs within the price control do you feel is the most appropriate and why?*

Due to the materiality of the costs involved, it is appropriate to continue to set ex-ante allowances for diversions. These costs are generally trend-based and it will be for DNOs to indicate in their Well Justified Business Plans what their view of future trends will be. Diversions due to NRSWA are entirely driven by external requirements and some of these can be 'lumpy' in nature as they relate to major infrastructure works, however the overall volumes of work will be broadly consistent through time.

Question 4: *For all general reinforcement, is it feasible for the DNOs to provide specific scheme lists based on commonly agreed demand scenarios in RIIO-ED1?*

It is realistic for DNOs to provide specific scheme lists for the first part of RIIO-ED1 as this coincides with the typical planning period for such schemes. However, as the planning horizon will cover ten years at the time of forecast, it is unlikely to be practical to make projections beyond the mid-point review on the basis of specific scheme proposals. Demand modelling will indicate the numbers of sites likely to require reinforcement, and typical costs will be available based on those schemes planned for the early part of RIIO-ED1 so it is likely that DNO forecasts will be a mix of specific project proposals and estimated costings.

Question 5: *For all general reinforcement, do you think that reinforcement specifically relating to generation should be separately assessed from demand-related reinforcement?*

Reinforcement specifically related to generation does need to be assessed separately. We consider that the IQI incentive creates an incentive for DNOs to submit a "low" bid in their Well Justified Business Plans. Indeed any DNO that takes a counter view runs the risk of appearing inefficient and having these costs disallowed. This creates a shareholder exposure if there is a significant level of reinforcement actually required. Alternatively a DNO may consider that they can recover these costs through the current connections charging methodologies and charge DG customers for this reinforcement. Our experience in DPCR5 is that DG developers are sensitive to reinforcement costs and simply prioritise their focus on alternative sites once reinforcement charges have been identified. Our over-riding concern is that there is not the same level of modelling developed for low carbon technologies and our confidence in developing a forecast that is both acceptable to us and Ofgem is low. An uncertainty mechanism is therefore our favoured solution.

Question 6: *Do you agree with our proposed modelling approach to cost assessment of n-1 reinforcement schemes, specifically in relation to the two proposals for the Load Index (LI) delivery as outlined in Chapter 4 in the „Supplementary annex – Reliability and Safety "?*

We believe it is appropriate to set ex-ante allowances for n-1 schemes and relate them to a projected LI position which should be monitored in terms of performance within a target band (as set out in the Reliability & Safety annex). Care will be needed to ensure that the proposed LRE re-opener and Outputs monitoring process do not create contradictory incentives.

Question 7: *Do you agree that expenditure on secondary network reinforcement is no longer highly correlated with localised economic growth?*

We agree that secondary network reinforcement expenditure will increasingly be dominated by the uptake of Low Carbon Technologies, rather than local economic growth patterns. Economic growth will still be a driver, but it is likely to be relatively smaller in scale.

Question 8: *Do you believe that it is feasible and appropriate to set definitions and unit cost(s) for the following: d) the conversion of wayleaves to easements and injurious affection payments; e) load related interventions on the secondary network; and f) fault level reinforcement?*

Whilst it may be feasible, we do not believe it is appropriate to set unit costs for the conversion of wayleaves and injurious affection payment as these will be significantly influenced by a number of factors outside of the DNO's control.

It may be possible to develop unit costs for fault level reinforcement as this type of work generally requires the replacement of switchgear whose rating is producing the fault rate issue. As such, the solutions tend to be fairly uniform and hence could be unit costed.

It would be possible to unit cost reinforcement interventions on the secondary network at the level of 'problems solved' as there is an established model to do this (through Smart Grid Forum's Workstream 3 model).

Question 9: *What is the most appropriate funding mechanism for load related expenditure on the secondary network?*

For Demand Connections we have proposed a volume driver that reimburses DNOs where they are required to intervene to address network problems that have been caused by clusters of Low Carbon demand technologies. To ensure there is an efficiency incentive, the average unit cost of an intervention should be determined and fixed ex-ante, creating scope for a DNO to be rewarded for developing innovative solutions that reduce the average cost of all interventions compared to this unit cost. The penetration thresholds that require an intervention on any particular circuit type are modelled by the Transform model developed by Workstream 3 of the Smart Grid Forum. Ex-ante estimates of the average cost of each intervention can also be derived from this model. To count the number of interventions required a DNO would be required to identify the number of units of each Low Carbon Technology connecting to its network and their location. DNOs have been discussing this notification issue with DECC and it is likely that notification can be achieved by the process of registration for subsidies such as the Renewable Heat Incentive via the Microgeneration Certification Scheme.

This revenue driver can be integrated with the General Reinforcement reopener. The revenue driver will effectively change the allowance for reinforcement expenditure and the 20% threshold for triggering the reopener can be calculated on this new allowance. This will mean that all reinforcement expenditure, whether for conventional load growth reasons or low carbon technologies will be captured together, avoiding the creation of new boundary issues. If the revenue driver unit cost is set too low, DNOs' risk will be limited to the first 20% by the reopener mechanism. Where DNOs are able to out-perform the revenue driver unit cost they will effectively share with customers up to the first 20% of any out-performance.

This proposal is similar to, but slightly simpler than, Option 2 considered in the strategy document. There is no need for a true-up mechanism as all intervention costs are included with all other general reinforcement. There is no need to define an intervention; DNOs will count the number of circuits where the clustering of low carbon technologies passes an ex-ante determined threshold for the relevant generic circuit type. This means that DNOs are effectively incentivised to solve problems on the network, rather than to intervene in a particular way. There will be one unit cost per intervention threshold breached, therefore, if a DNO chooses to intervene by simply monitoring the network and no other intervention is subsequently required, the DNO is likely to out-perform the unit cost. However, if further intervention is later required this will also be captured in the reinforcement expenditure and overall the DNO may under-perform the unit cost. Customers keep all of the benefits of efficiency above a 20% reduction.

Chapter Six

Question1: *Do you agree with our approach for assessing NLRE in the companies' business plans?*

In overall terms, we agree with the evolutionary approach set out for NLRE assessment. Fundamental to the RIIO-ED1 settlement however is the linking of investment to the outputs expected from that investment. As such, we would expect that the primary means of corroboration of company forecasts will be with reference to the outputs the investment will deliver, rather than a theoretical age-based model which actually contains no outputs at all.

The assessment should focus on;

- The level of outputs that the company forecasts to deliver, including its rationale for selecting this quantum, and
- The costs forecast as required to achieve these outputs, and whether they are appropriately efficient and take account of innovative approaches.

We do not agree that an age-based model necessarily sets the 'outer edge' for company forecasts as this is largely a function of the unit costs selected. Whilst it is true that companies will consider a range of interventions other than full replacement at end-of-life and hence deliver lower solution costs than models have previously suggested, this could be reflected by using the unit cost of intervention rather than replacement in the model.

We would also expect that cost benefit analysis will make a key contribution in assessing the appropriateness of a company's volume forecasts.

Question 2: *In light of our proposals, do you agree with our selection of risk removed as the primary output of the mains replacement programme?*

This appears to be a question related to RIIO-GD1. In terms of the asset replacement programme, we agree that risk removed is an appropriate target, when articulated as a delta from the network position that would result if no investment were to be undertaken. This will need to be against the proposed Risk Index for RIIO-ED1, which will need to be calibrated in such a way as to allow total risk to be assessed.

Question 3: *Do you agree with our approach to remove non-modelled costs in RIIO-ED1?*

We agree that under the current RIG requirements, all costs are reported against a relevant activity and hence all costs should be able to be modelled. This modelling will not necessarily require unit costs, depending on the nature of the activity being assessed.

Question 4: *Do you agree with our proposed approach for assessing the DNOs' plans for expenditure on Legal and Safety? If not, what changes would you propose?*

We agree that the assessment of Legal & Safety forecasts will be best assessed through individual review. These areas are almost all in response to a legislative driver and many programmes will run on into RIIO-ED1, allowing a comparison of historic and forecast costs. Where companies identify a new driver, this should be articulated in terms of the emerging work requirements and efficient costs.

Care will need to be taken in the area of site security as this category covers many different potential interventions and there is no consistent and common definition of a 'unit'. Companies should not be penalised for implementing more robust and successful (but expensive) security on the basis of a simple unit cost analysis.

Question 5: *Do you agree with our proposed approach for assessing the DNOs' plans for expenditure on ESQCR? If not, what changes would you propose?*

We are aiming for compliance with ESQCR requirements (as defined in the RIG) by 2015, hence will not be putting specific expenditures in our RIIO-ED1 forecast. Companies will however need to provision for the ongoing emergence of isolated compliance issues and their resolution. This may mean for example that Troublecall or Asset Replacement costs increase slightly due to the dealing of compliance issues under this category rather than as a separate building block.

Question 6: *Do you agree with our proposed approach for assessing the DNOs' plans for expenditure on flooding? If not, what changes would you propose?*

Initial surveys will have been completed for flooding sites prior to the commencement of RIIO-ED1; however ongoing surveys will be required as the base flooding data is constantly being refined by the Environment Agency (for example following new flood protection schemes and new modelling information) and this will be being used in company assessments during RIIO-ED1 to prioritise programmes.

In terms of the proposed unit cost benchmarking, there should be an adequate data set built up through reporting in DPCR5 to allow this analysis. Care will need to be taken to ensure that solutions of equivalent robustness are being compared, and that solutions which have multiple benefits are appropriately recognised.

Question 7: *Do you agree with our proposed approach not to fund Quality of Service (QoS) improvements during RIIO-ED1?*

We agree that Quality of Service (QoS) improvements should not be funded from ex-ante allowances; however we emphasise that the associated incentive rate will need to be sufficient to continue to incentivise the re-investment of efficiencies in QoS improvements to the benefit of customers.

Question 8: *Do you agree with our proposed approach to change Black Start and Rising and Lateral Mains (RLM) from reopener mechanisms to ex ante allowances?*

We agree that these areas have reached sufficient maturity within DPCR5 to be treated as ex-ante. Companies should have an appropriately clear view of the required volumes and associated efficient costs to be able to forecast this activity into RIIO-ED1.

Question 9: *Do you agree with our approach to assessing enhanced physical site security costs?*

We agree that, where these requirements are known in advance of RIIO-ED1, these should be funded as an ex-ante allowance.

Chapter Seven

Question1: *Do you think that our proposals for the Trouble Call are proportional given the materiality of the area and do you have any preference between the options? Please separate your response by the following categories: low and high voltage overhead faults; low and high voltage underground faults; EHV and 132kV faults; ONIs (formerly non-QoS faults); third party cable damage recovery; pressure assisted cables; and submarine cables.*

In general, those fault categories with high annual volumes can be assessed on a unit cost basis. Care will be required to ensure that an unachievable cherry-picked target level is not derived by identifying upper quartile costs for individual fault activities and simply summing them. It is clear from the 2011-12 returns that there is still further work to do based on company interpretations of 'betterment' and the extent to which such costs may in fact be subsidising Troublecall costs.

Those categories which are lower in their volumes and more erratic in their trends (such as submarine cables and 132kV faults) do not lend themselves to unit cost analysis. We suggest that, for consistency, the same data set as is proposed to be used for IIS target-setting at these voltages is used, together with a long-run average unit cost.

Question 2: *Do you agree with our approach to assessing Severe Weather 1 in 20 Events and do you have any preference between the options?*

No options are presented in the paper to discuss. We are happy that the DPCR5 approach, updated for inflation, is used in this regard.

Question 3: *Do you agree with our proposed approach for assessing the DNOs' plans for expenditure on Inspection and Maintenance (I&M)? If not, what changes would you propose?*

We are concerned that there is currently insufficient commonality in the scope of I&M volumes for the resultant unit costs to be appropriate for benchmarking. We are also concerned that low volumes (particularly of maintenance) do not necessarily represent good asset management practice and that companies may make sub-optimal decisions in this regard. We would prefer more weight to be placed on the assessment of such costs across replacement, refurbishment and I&M, and also would point Ofgem to the results of cost benefit analysis which may suggest that enhanced maintenance regimes are commensurate with a lowest whole-life cost approach for some asset classes.

Question 4: *Do you agree with our proposed approach for assessing the DNOs' plans for expenditure on Tree Cutting? If not, what changes would you propose?*

We highlight that the notion of 'Spans Managed' has been removed from the RIG reporting requirement which simply requires 'Spans Inspected' and 'Spans Cut'. As such, two forms of analysis are required;

- A unit cost assessment of spans cut, and
- An overall assessment of the costs of tree management (including inspections and cuts) as a function of the scale of a DNO's exposure (ie spans affected by trees).

This will require a common interpretation of 'spans affected by trees' as the 2011-12 returns ranged from 8% to 92% in this regard. Supplementary analysis will also need to be undertaken on return intervals to check that companies with apparently very

low overall management costs are not achieving this simply by not undertaking activity.

Question 5: *Do you agree with our approach to assessing NOCs Other and do you have any preference between the options? Please separate your response by the following categories: dismantlement, remote location generation, and substation electricity.*

We suggest that dismantlement, due to its relatively small size, should continue to be a bilateral discussion, with the onus on the DNOs to set out their plans and policies in this regard.

We broadly agree with Ofgem's proposed approach to setting substation electricity allowances. Two further checks should be included in the approach to determining allowances: firstly Ofgem should check that reported unit prices are not based on fixed price deals that cannot currently be achieved in market and secondly, that units per substation and unit costs are not unduly distorted by possible reporting errors. Reporting data for 2010-11 and 2011-12 include some data that we believe is materially erroneous.

Chapter Eight

Question1: *Do you agree with our proposed approach to assess CAIs? In particular, do you agree with our groupings of activities?*

We agree that it is sensible to differentiate between Closely Associated Indirects (CAIs) associated with supporting the delivery of direct activities and those that contain substantially fixed costs. It is important that analysis recognises not only that costs in Group B do not vary much with size of capital programme, but also that they contain some fixed costs that can be shared by DNOs in the same ownership group (for example control room and call centre costs).

We agree that it is sensible to consider non-operational capex in same assessment as associated indirect costs to avoid any differences in DNO ownership strategy distorting results. We agree capex should be smoothed to avoid lumpy profiles unduly influencing results. Similarly, we agree that financial treatment of both types of costs should beneficial to avoid any distortion.

We agree that workforce renewal and TMA costs should be separately assessed. However, we are concerned in both cases that Ofgem's proposal to treat contractor costs differently risks creating an inappropriate incentive to insource activities. Unless separate unit costs are calculated for insourced and outsourced direct activities this approach is inappropriate.

It will be necessary to ensure that TMA forecasts are undertaken on a basis that is consistent with uncertainty mechanisms to avoid risk of either double counting or missed funding.

Wayleave costs should be separately assessed and not included with Engineering Management and Clerical Support. Wayleave costs vary for a number of reasons, including local land usage that is not appropriately included in comparative modelling.

We agree that network policy should be considered a CAI for RIIO-ED1. There can be a trade-off between use of network policy and, for example, network design and engineering where some companies may invest in network policy to establish

detailed common policies where others may develop bespoke designs for each project.

We agree that analysis must be undertaken both before and after reallocation to non-distribution businesses and that a review of DNOs' allocation bases should be undertaken to test that costs to be funded by DUoS customers are efficient.

We agree that the impact of part-funded connections must be taken into account in allowance setting. The extent of part funded connection work undertaken by ICPs can have an impact of DNOs' ability to recover their costs. A mechanism should also be introduced to ensure that DNOs are not unduly disadvantaged if volumes of part funded connections undertaken by ICPs is higher than assumed as part of the RIIO-ED1 allowances.

Question 2: *Are there any views as to which cost drivers would be most appropriate*?

The selection of cost drivers for the assessment of Closely Associated Indirects is complex. These activities are related, to a greater or lesser extent, to the scale of the company and to the amount of direct work being undertaken by the company. This results in the immediate cost drivers being endogenous to the DNO. Assessment based on endogenous cost drivers should be used with caution as it can result in companies being rewarded for inefficient behaviours in their direct work programme – and companies that invest in indirect activities to better targets their direct activities being penalised. Analysis of these activities is further complicated by the fact that different operating structures can lead to these costs being reported differently by different DNOs.

We will continue to work with Ofgem, through the Cost Assessment Working Group to develop models to assess the efficiency of these costs.

Question 3: *Do you believe our approach to assessing Workforce Renewal is appropriate? In particular, do you believe it is appropriate to consider Workforce Renewal allowances both in isolation and also as part of wider training and do you believe Workforce Renewal should include or exclude the training of contractors?*

DNOs face significant workforce renewal challenges due to large increase in forecasted employee retirements because of the numbers of staff recruited during the 1960s, 1970s and 1980s.

The focus for DPCR5 has been largely on replacing existing skills and increasing volumes of operational staff; DNOs have made good progress in addressing these challenges during DPCR5 but will need to continue to do so during RIIO-ED1. Additionally, RIIO-ED1 has revealed new challenges, in particular the requirement to recruit new skill-sets to address low carbon networks. The requirement for ongoing funding is certain but the scale is unclear and likely to change throughout RIIO-ED1 period.

The workforce renewal allowance setting and spend calculation mechanism must be consistent with comparative efficiency assessment methodology and should not unduly influence companies' resourcing or delivery strategies. We are concerned that by excluding contractor costs from allowances Ofgem has created a distorting incentive to insource activities. Analysis and modelling must cover both in-sourced and contracting requirements.

Chapter Nine

Question1: *Do you agree with our general approach to assessing BSCs? If you disagree with any particular areas can you please specify what these are and your reasons?*

We have significant concerns with Ofgem's approach to assessing the efficiency of business support costs in GD and T1 reviews. Firstly, many of the cost drivers chosen are not exogenous (eg end users, revenue, employees, spend) and hence all may advantage inefficient companies. The significant difference between the GDNs' costs and external benchmark costs (sometimes by a factor of 100%) suggests that the benchmarks are incomparable and hence baselines inappropriate.

We are also concerned that the approach undertaken in RIIO-GD1 fails to recognise and take into account the very material issue of the fixed costs that are shared by companies in the same ownership group. All comparative analysis must take into account the fixed costs that can be shared across ownership groups; calculating unit costs will not achieve this.

We agree that it is sensible to consider non-operational capex in same assessment as associated indirect costs to avoid any differences in DNO ownership strategy distorting results. We agree capex should be smoothed to avoid lumpy profiles unduly influencing results.

We agree that analysis must be undertaken both before and after reallocation to non-distribution businesses and that a review of DNOs' allocation bases should be undertaken to test that costs to be funded by DUoS customers are efficient.

We agree that the impact of part-funded connections must be taken into account in allowance setting. The extent of part funded connection work undertaken by ICPs can have an impact of DNOs' ability to recover their costs, in the case of business support costs this will affect the extent to which fixed costs are recovered from connections customers as opposed to DUoS customers. A mechanism should also be introduced to ensure that DNOs are not unduly disadvantaged if volumes of part funded connections undertaken by ICPs is higher than assumed as part of the RIIO-ED1 allowances.

We are concerned that the proposal to not benchmark insurance costs will inadvertently reward companies that are risk averse.

Question 2: *With regards to the non-fast-track benchmarking, for those DNOs that report lower than the benchmark costs which of the three options for setting cost allowances to you think is most appropriate and why? The options are: increasing allowances to the benchmark level of costs, giving the DNO their submitted level of costs, and taking an average between the benchmark and the submitted costs.*

Before making any decision as to the level of allowance to be made, it is essential that Ofgem seeks to understand why companies are forecasting at very different levels to benchmarks. Very different levels can suggest that the benchmarks are inappropriate.

Once Ofgem has convinced itself that benchmarks are comparable and that differences are not due to fundamental differences, if it opts to set companies with higher forecasts at benchmark it is only appropriate that companies with lower

forecasts are also set at benchmark. To do anything else would be extreme cherry picking.

Question 3: *Do you agree with the cost drivers set out for each of the categories of Business Support Costs? If not, can you please suggest an alternative?*
The selection of cost drivers for the assessment of Business Support Costs is complex. These activities are generally related, to a greater or lesser extent, to the scale of the company and contain substantial fixed costs. This results in the immediate cost drivers of these activities being endogenous to the DNO, for example numbers of employees. Assessment based on endogenous cost drivers should be used with caution as it can result in companies being rewarded for inefficient behaviours elsewhere in the company. Analysis of these activities is further complicated by the fact that different operating structures can lead to these costs being reported differently by different DNOs.

We will continue to work with Ofgem, through the Cost Assessment Working Group to develop models to assess the efficiency of these costs.

Question 4: *Do you agree with the proposed use of expert review to assess IT&T and property costs?*

We agree that IT and property costs should be subject to external review – these are complex areas of expenditure that do not lend themselves to simple cost drivers. It must be recognised that utilities incur different types of costs in these areas to other companies and that external comparators and benchmarks may not be relevant.

Chapter Ten

Question1: *Do you agree with our approach to regional and company specific adjustments?*

We agree that adjustments for regional factors should be kept to a minimum and only enacted if strong evidence of a distorting factor is found and robust mechanism for adjustment is available.

Ofgem must be confident that the adjustments correct for material exogenous factors and that they are based on robust data. In particular, we do not agree that there is evidence that regional salary distortions occur outside of central London. Salaries across utilities are comparable because of a common history, the specialist nature of many of the skills required and competition between companies to attract staff, often from each other.

Question 2: *Which regional and company specific adjustments do you think we should consider in RIIO-ED1? Please give a rationale for your suggestions.*

We agree that there should be very few normalisation adjustments applied prior to comparative modelling.

For the few regionally specific activities that are only incurred by a few companies, eg island generation, it is more appropriate to remove these costs from models and separately assess their efficiency than to seek to make normalisations within models.

Chapter Eleven

Question1: *Are there any additional analytical techniques that we should consider beyond those we have used at past price control reviews to assess RPEs and ongoing efficiency?*

Ofgem must recognise that the RPEs could be much more significant if the RPI construct changes. Ofgem must assess the impact of the change in RPI construct as part of determining appropriate RPE allowances. This will result in greater RPE allowances but Ofgem must recognise that this represents a switch from indexation based funding to ex ante rather than any overall increase in funding for companies.

Question 2: *Are there any additional data sources that we should be aware of to assist with our analysis of RPEs and ongoing efficiency? Are there some that you think we should rely more on than others?*

Ofgem has identified the most appropriate cost modelling techniques to assess the allowances. Ofgem must be mindful that the DNOs are best placed to understand the real cost movements for the RIIO-ED1 period. It is therefore important that the assessment of RPEs should not be included within the IQI assessment as different DNOs may have different RPE requirements.

Business Plans and Proportionate Assessment

Overview

We support Ofgem's objectives of making the Well Justified Business Plan (WJBP) relevant to the DNO, its employees, customers, stakeholders and investors. We recognise the need to ensure comparability and transparency across all DNO plans but would ask Ofgem to balance this with the flexibility to ensure that individual DNOs' plans meet their local needs.

The assessment process is robust and the assessment criteria are appropriate. We are encouraged by the approach Ofgem proposes to adopt but would seek to ensure that Fast Track treatment is clearly differentiated from Proportionate Treatment in terms of providing real, additional value to those DNOs selected for Fast Track. Furthermore, we believe an IQI reward should be available to efficient bids that are not selected for Fast Track.

We support Ofgem's objectives of making Well Justified Business Plans transparent and comparable. The structure proposed is appropriate and further prescription of content, format and length (subject to this being stated within a range) for the Executive Summary and Overview would not pose a problem. We urge Ofgem to allow DNOs flexibility in compiling the core content, as this is where the DNO can develop the detail of a WJBP that is appropriate to its specific network and stakeholder requirements.

Whilst we endorse the objective of Cost Benefit Analysis (CBA) - ie to ensure DNOs deliver best value solutions for customers current and future – we are concerned that the model proposed does not yet reflect all the financial or engineering realities DNOs would normally use to assess investments. The use of a discount rate which does not reflect DNO WACC is an issue, as is the uncertainty around treatment of non-monetised criteria. We believe an appropriate and robust CBA methodology can be developed and we look forward to working with Ofgem to deliver this.

Our Answers to Questions in the Business Plans and Proportionate Assessment Document

Chapter Three

Question 1: *Do you have any comments on the timing and stages of the assessment process?*

Generally, the process is robust and we are encouraged by the drive to give DNOs certainty over their settlement at the earliest possible time. Ofgem has set a clear and ambitious schedule for completion of the various stages of the assessment process. We support this and would urge all parties involved to commit the requisite level of resources to ensure the schedule is maintained.

We are encouraged by the diversity exhibited in the range of comparative modelling techniques which Ofgem propose to use. We look forward to working with Ofgem to develop robust, fair and comprehensive models.

Question 2: *Do you agree with the three-stage assessment process for RIIO-ED1?*

We broadly agree but we would seek assurance that the IQI Reward would be available to all DNOs whose Well Justified Business Plans merit it, whether selected for Fast Track or Proportionate Treatment.

Question 3: *Do you think the additional reward for fast tracking is appropriate?*

A Fast Track reward is essential if the RIIO regime is to operate in the way Ofgem intends it. The reward must be a genuine reward and Ofgem must clearly demonstrate that, when the Fast Track reward is discounted, the DNO's settlement is no worse than it would have been under Proportionate Treatment.

Chapter Four

Question 1: *Does the categorisation of the assessment criteria remain appropriate?*

We support the inferred assessment criteria objectives of ensuring DNOs demonstrate that their plans are appropriate to stakeholder needs, developments in economic and low carbon activity and long-term customer value.

Question 2: *Are there any criteria which we should add or amend in the context of RIIO-ED1?*

We believe the criteria are appropriate as stated.

Chapter Five

Question 1: *Is there anything else, in the context of the presentation and structure of the business plan, which we should provide guidance on?*

The structure as laid out is a reasonable foundation, which DNOs should be capable of adapting to.

Question 2: *Should we require DNOs to conform to the proposed document structure (set out in figure 4.1), some other prescribed structure, or let the DNOs structure the plans as they see fit?*

DNOs should be compelled to conform to the proposed structure, as it provides a basis for developing broadly comparable and transparent plans. A significant revision to the published structure in February may result in substantial rewriting of business plans at a time when companies' focus should be on enhanced stakeholder engagement.

We recognise that Ofgem may wish to prescribe certain common content which all DNOs must provide. We support this in principle but would welcome the opportunity to work with Ofgem, other DNOs and stakeholders to ensure any common content meets the needs of all parties involved in preparation, development and assessment of Well Justified Business Plans.

Question 3: *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?*

Ofgem could set out guidance on "expected lengths" rather than prescribed limits and we suggest that this approach would be more constructive. Ofgem must balance the needs of readers with the needs of DNOs to develop plans for their business. Artificially limiting content beyond key summary or consolidated sections could be unhelpful.

Question 4: *Do you agree with the information that we are proposing should be required in each DNO's executive summary? What other information would be useful.*

The proposals are broadly consistent with the information we would expect to see in an Executive Summary.

Question 5: *What should be the common metric, calculation and assumptions for determining the impact of the DNOs' proposal on consumer's bills?*

The common unit of measurement across customer bills is £0.00p/kWh. It would seem appropriate to use this in business plans. There are issues, however, with the way in which suppliers apply cost increases to unit prices, standing charges and discounts (payment method or multi-fuel), and this may dilute comparability. If this method is chosen, we would suggest all DNOs state price impact on the average standard tariff for a single fuel electricity supply and using Ofgem's typical medium consumption figure of 3,300kWh per annum (official Ofgem value in use from Jan 2011).

The alternative is to determine the £0.00p or % impact on a typical annual electricity bill. This also has limitations, however it may be more appropriate given that media analysis typically expresses energy bill changes in this manner and it is one with which customers may be more familiar.

Chapter Six

Question 1: *Do you agree with our proposed approach to cost benefit analysis?*

Whilst we endorse the aims of Cost Benefit Analysis (CBA) in terms of ensuring DNOs deliver the best long-term value for customers, the process proposed is not necessarily consistent with the economic realities DNOs would price into an investment decision.

The broad application of the STPR discount rate (3.5%) cannot fully account for individual DNO (and project) risk profiles. Furthermore, it is not consistent with DNO WACC, which is a fundamental parameter in determining the overall value of an investment.

The CBA methodology must recognise DNOs' overarching responsibility to ensure the reliability and availability of the network as a whole. In this context, CBA may be applied to the policies, engineering standards and risk assessment methodologies which underpin this responsibility. DNOs clearly exercise discretion in what mix of interventions – eg replacement, refurbishment, life extension etc. – is deployed to manage overall network resilience. It would therefore be appropriate to ensure CBA is applied (subject to a materiality test) in those circumstances where there is genuine optionality.

We are keen to ensure that the CBA methodology delivers best value for customers overall and look forward to working with Ofgem to develop a robust and transparent process.

Question 2: *Do you agree with our proposed approach to have a threshold level of expenditure to determine whether cost benefit analysis is required?*

In general we support the introduction of a materiality test however a purely financial metric may not always be appropriate. For example, some significant aspects of DNOs' programme are mandated by statute, it would be inappropriate to require DNOs to undertake a CBA to justify inclusion of such work in their plans. It would more appropriate to ensure CBA is applied (subject to a materiality test) in those circumstances where there is genuine optionality. We suggest application at an Asset Category level, for major projects and in relation to the DNOs' investment plans as a whole.

Question 3: *What level of expenditure do you believe should be used as the threshold for determining when cost benefit analysis should be provided as part of the business plan submission?*

Please refer to the response to Question 2 above.

Question 4: *Have we identified all of the relevant parameters to ensure consistency in how cost benefit analysis is undertaken?*

Whilst the process is comprehensive, we remain concerned by the lack of consistency between STPR and WACC. We are also keen to ensure that assessment processes can be applied as objectively to the value of non-monetised criteria as they can to monetary criteria.

Question 5: *What are your views on the levels the parameters should be set at?*

The discount rates must reflect the DNO's WACC. Furthermore, there must be sufficient flexibility to alter this in relation to specific projects, particularly in relation to financing low carbon scenarios.

Uncertainty Mechanisms

Overview

The level of risk that DNOs are required to manage as a result of changing external circumstances and the proposals within Ofgem's Strategy Consultation is likely to be significant in RIIO-ED1. These risks are, of course, limited at their maximum level of consequence by the opportunity to seek a disapplication of the price control or where they reach a level that demonstrates that there are persistent constraints on financeability. However, the level of risk that DNOs must bear below these thresholds is significant and growing as the number of different risks increases.

In a few areas, the risks that DNOs have, historically, been exposed to are diminishing. As an example, we perceive greater certainty around our obligations in relation to securing Critical National Infrastructure. As some councils start to implement the Traffic Management Act to its full effect we are learning more of the likely operational and cost effects, although the timing of implementation is still uncertain. We also do not believe that customers are exposed to the same level of risk resulting from inaccurate connections forecasts as was the case in DPCR5. Unfortunately, these examples are in the minority and, as the strategy consultation demonstrates, the majority of the uncertainties apparent in DPCR5 remain. In the interests of reducing the potential for price volatility, wherever possible we have proposed the removal of uncertainty mechanisms that are no longer needed or provide very limited real risk reduction for DNOs.

It is now clearer that the implications of the banking collapses of 2008 that were a significant dislocation for consideration in setting DPCR5, have lead to profound and long-term damage to the global economy. The results are greater fragility and more volatility in the economy. Forecasts of economic activity currently indicate a long and difficult road to recovery and, perhaps more importantly for this debate, a much wider range of uncertainty around any "central" forecast.

A significant new uncertainty for DNOs is the rate of take up of low carbon technologies particularly by domestic customers. Experiences with the effect of the Government's feed-in tariff for Photo Voltaic cells has shown that stimulus packages can have a rapid and dramatic effect on behaviour and uptake rates. DNOs face greater uncertainty in terms of the impact on both generation and demand technologies connected to their networks. This leads to the need for Low Carbon Technology uncertainty mechanisms for demand and generation.

The need for adjustments for the Relative Price Effect between the inflation that DNOs experience and the Retail Price Index (RPI) persists. The basket of goods that is used to calculate RPI does not closely match the equivalent DNO basket. The DNO basket of goods tends to have a heavier weighting to oil and construction commodities which, in a more volatile global economy have exhibited considerable swings and remained higher in overall terms. The proposed changes to the calculation of RPI are likely to make a significant difference in the level of inflation above the new RPI calculation experienced by DNOs, exacerbating this effect.

The other implication of a RIIO price control is that the length of time that DNOs are exposed to these uncertainties is greater, providing a greater opportunity for change to occur and potentially requiring DNOs to finance the effect for longer. We therefore agree that getting the right uncertainty regime in place is more important with an extended, eight year, price control period.

The mid-period review does not provide a significant remedy for this increased risk exposure, as it is perceived as an asymmetrical mechanism. To address this perception Ofgem has, quite rightly, stated that it will prescribe the characteristics of the review as tightly as possible.

Another RIIO principle that is likely to change DNOs risk profiles is the increased exposure to debt cost risk that results from the introduction of the new cost of debt index in current market conditions. Very low debt costs over recent years mean that the index is being introduced at an unprecedentedly low level. This does not therefore cover the costs of efficiently raised historic debt and potentially lag ongoing debt costs if the start to increase.

The total risk exposure in a price control period, measured by potential reduction in cash-flow, has previously been usefully demonstrated by the calculation of a range for potential Returns on Regulated Equity (RORE). This is a very useful calibration and it would be appropriate to continue the approach from DPCR5 into RIIO-ED1. The DNOs and Ofgem should work together to develop such a model to enable the transparent calibration of risks.

We agree that DNOs should have an incentive to manage all the costs that they can exercise some control over. We also agree that customers' bills will be lowest if they collectively share the risks that might lead to higher costs rather than requiring DNOs to price those risks and turn them into certain cost increases. Appropriate risk sharing between customers and DNOs is essential to maintain the low costs of capital and finance that have been achieved by the stable regulatory regime. There should be a balance between reopeners, volume drivers and pass-through mechanisms to deal with uncertainties during the extended price control period. One of the key determinants of choosing the right uncertainty mechanism is the materiality of the uncertainty considered. Whilst each of these uncertainties can be dealt with by an uncertainty mechanism, as discussed in the consultation, the total exposure to incremental risks from multiple uncertainties below the materiality threshold for any mechanism is potentially growing. There is a limit to the amount of unfunded costs companies can sustain and remain financeable at a low cost of capital.

Our Answers to Questions in the Uncertainty Mechanisms Document

Chapter Two

***Question 1**: Are there any additional criteria that we should take into account to guide the appropriate use of uncertainty mechanisms?*

It is entirely appropriate for Ofgem to evaluate the justifications and drawbacks of each uncertainty mechanism, how to minimise the drawbacks and whether the benefits outweigh the drawbacks. During such an evaluation we have identified two distinct stages. Firstly the degree of control a DNO will have over the uncertainty being considered leads to a decision on whether an uncertainty mechanism of an incentive is required. Customers' bills will be lower if they collectively share the risks that DNOs have no or very limited control over and that might lead to higher costs rather when compared to requiring DNOs to price those risks and turn them into certain cost increases.

Secondly the magnitude/materiality of the risk will determine the type of uncertainty mechanism. As there is a limit to the amount of unfunded costs companies can sustain and remain financeable at a low cost of capital the magnitude of all of the potential risk exposures must also be considered.

Chapter Three

***Question 1:** Do you have any views on the design of the proposed high-volume low-cost connections volume driver?*

There has been a need for an uncertainty mechanism associated with high volume connections activity in DPCR5 given the direct correlation between connections volumes and the economic activity. Recent and ongoing recession has lead to a high degree of observed volatility in volumes of new connections. The current recession has depressed volumes to the extent that the downwards reopener may be triggered in DPCR5. This protection for customers is important.

Going forward into the RIIO-ED1 period, current forecasts show a depressed level of activity and a slow economic recovery – however, if this forecast is overly pessimistic an equal protection may be required for companies. There are two aspects of uncertainty to address. First the volume of connections work and, of that, the volume that requires reinforcement. For those that do require reinforcement, the amount of reinforcement is relevant. The volumes of connections are predominantly driven by economic conditions. In addition there is also a concern that changing levels of demand may mean that historic data is less useful in assessing future levels. We use an average domestic maximum demand of 1.1kVA at present in all our connections design work, but if heat pumps and electric vehicles are widely adopted then it is likely that this will need to substantially increase in the future. When and by how much is the question. The amount of reinforcement needed is impacted by this ADMD consideration plus whatever innovations we develop to maximise the use of the existing asset base and enable greater connection without reinforcement. Arguably a volume driver removes the incentive to innovate if it is only based on the number of jobs with reinforcement.

***Question 2:** Do you have any views on the design of the proposed low carbon technologies volume driver?*

We welcome the low carbon technologies (LCT) volume driver as the uptake of LCT represents a significant new uncertainty in RIIO-ED1 period.

The scale of the uncertainty is very significant. Early, indicative modelling carried out for our RIIO-ED1 business planning and consistent with our submission to Ofgem in July 2012 showed that the various DECC scenarios could have a profound effect on DNOs' reinforcement requirements, with a subsequent knock-on challenge to resources and, therefore, all other activities. For Electricity North West alone reinforcement can vary by over 400% changing investment by over £300m between base economic growth and high Electric Vehicle and Heat Pump penetration scenarios. £300m would represent approximately 30% of our total network investment programme.

It is currently very difficult to forecast which of the DECC scenarios is most likely to be closest to the eventual path. As technologies and markets develop different options can become more affordable and, therefore, popular. Whilst heat pumps and electric vehicles put similar demands on the network for more capacity, the location and clustering of each technology will have a significant impact on the number and size of resulting reinforcement schemes. The rate of progress towards 2030 targets is also unclear and the extent to which progress is made to these targets within the RIIO-ED1 period is dependent, primarily, on the scale and timing of market stimuli deployed by Government. DECC is currently unable to determine what the form and effect of its complete package of stimuli will be.

If companies were required to make a best forecast of the level of activity required with the information currently available and that forecast was subsequently utilised to determine an ex-ante expenditure allowance, with the risk of variations from this forecast to be carried by the DNO during the RIIO-ED1 period, two outcomes that have a negative impact on customer will occur. Firstly, forecasts would have to anticipate that there was considerable success towards achieving the stated targets, resulting in high levels of reinforcement. Secondly, investors would have to estimate the maximum exposure possible and determine a risk premium appropriate for carrying the potential exposure to even higher investment requirements. This would effectively crystallise for customers a large proportion of the risk that high reinforcement is required, leading to higher prices. This approach would also create an incentive on DNOs to stall and frustrate the deployment of low carbon technologies. The positive customer benefit is that there would be a very strong incentive on DNOs to innovate and improve efficiency such that capacity was provided at the least possible cost.

The alternative is that a revenue driver is implemented that enables DNOs to change revenues only to the extent that the actual costs of reinforcement have been incurred. This will remove from customers the burden of high up-front payments and a higher cost of capital. However, the customer downside of a revenue driver is the potential for it to remove efficiency incentives for DNOs to minimise the actual costs and innovate to find novel ways of increasing capacity at low cost. This downside can be addressed through the design of the revenue driver.

Therefore, we conclude that the customer interest is best served by a carefully designed revenue driver that includes an efficiency incentive. We propose that this can be achieved by a volume driver that reimburses DNOs where they are required to intervene to address network problems that have been caused by clusters of Low Carbon demand technologies. To ensure there is an efficiency incentive, the average unit cost of an intervention should be determined and fixed ex-ante, creating scope for a DNO to be rewarded for developing innovative solutions that reduce the

average cost of all interventions compared to this unit cost. The penetration thresholds that require an intervention on any particular circuit type are modelled by the Transform model developed by Workstream 3 of the Smart Grid Forum. Ex-ante estimates of the average cost of each intervention can also be derived from this model. To count the number of interventions required a DNO would be required to identify the number of units of each Low Carbon Technology connecting to its network and their location. DNOs have been discussing this notification issue with DECC and it is likely that notification can be achieved by the process of registration for subsidies such as the Renewable Heat Incentive via the Microgeneration Certification Scheme.

This revenue driver can be integrated with the General Reinforcement reopener. The revenue driver will effectively change the allowance for reinforcement expenditure and the 20% threshold for triggering the reopener can be calculated on this new allowance. This will mean that all reinforcement expenditure, whether for conventional load growth reasons or low carbon technologies will be captured together, avoiding the creation of new boundary issues. If the revenue driver unit cost is set too low, DNOs' risk will be limited to the first 20% by the reopener mechanism. Where DNOs are able to out-perform the revenue driver unit cost they will effectively share with customers up to the first 20% of any out-performance.

Question 3: *Do you have any views on the design of the proposed smart meters volume driver?*

Where a smart meter is installed by a Meter Operator, the Meter Operator will undertake a detailed inspection of the meter, the cut-out and associated installation. Whilst we are not able to collect condition data on our cut-out assets by visiting every premise in our Distribution Services Area, we currently have in place a programme of cut-out changes required to address issues when they are identified by Meter Operators. The roll-out of smart meters is currently in its very early stages and there is limited data on the rates of call outs that are likely to occur. However, it is very likely that with a great many more meter changes being undertaken, the rate of call-outs will significantly increase. Other DNOs have undertaken survey work, in some instances as part of smart meter trials, of the number of defects at supply points. While there is uncertainty over the likely impact on call out rates and costs, the survey results show that 5-10 defects are found for every 100 supply points. Of these, more than half may be emergencies or defects that prevent installation of the smart meter. While lower estimates are also plausible, and responsibility for some of the costs included may not fall on the DNO, the potential for significant additional costs is clear.

The scope of proposed smart meter reopener must be expanded to include all of the costs that DNOs may incur following smart meter roll-out including: on site costs associated with smart meter roll-out, cut-out inspection once supplier cease to inspect, costs of purchasing data from DCC, data management and storage costs, costs of extra activities drive by new information eg responding to LV voltage alarms.

We also note that the so called 'last gasp' functionality if implemented would be likely to result in an increase in reported customer interruptions, particularly on certain types of faults and in certain scenarios. As such, it would seem appropriate to include a rebasing mechanism in the scope of the smart meter reopener.

We agree that DCC licensing costs should be pass-through.

Question 4: *Do you have any views on the design of the proposed street works reopener?*

We support the continuation of the street works reopener as proposed in the Strategy document, but with a number of changes to the detail of the mechanism. This reopener has been in place for two price control reviews and already proved to be very valuable to customers, as the implementation of charging for street works has not followed anticipated timetables and customers have avoided paying unnecessary upfront charges for this activity. Whilst we have seen a significant increase in streetworks charges from local councils and highways agencies during the DPCR5 period to date, as yet this has not been sufficient to exceed the materiality threshold and trigger the reopener.

We propose changes to the scope of the reopener, the regularity of the reopener window and the materiality threshold.

Scope of reopener

We are actively engaged with all the Highway Agencies controlling our operating area and have developed very positive working relationships with most of them. However, these relationships are put under increasing strain by the restrictions in local council funding that have resulted from the current economic recession and need for austerity and the fact that in response, some councils have turned to road based charging as a means to supplement their income. This has lead to a very hard-line implementation of all associated regulations that is having an impact on the costs of all activities where DNOs must work in the highway. A key example is the significant increase in core sampling of reinstated roadways. Cores are being taken from almost every resurfaced roadway rather than on a sample basis as Highway Agencies have found that they can charge DNOs punitive costs for any core found to contain air pockets. Reinstatement works that are fit for purpose and would previously have met all requirements and served road users well are now routinely failed on a technicality, rather than fitness for purpose test. This is adding to cost of reinstatement for every street opening, either through associated fines or increased costs for higher specification back-fill materials.

As a result of this change in practice from Highway Agencies we propose that the streetworks reopener be maintained and that the definition of relevant streetworks be expanded to cover the costs of all reinstatement activities, including core sampling costs and fines.

Reopener window

The purpose of a reopener is to adjust a DNO's revenue to allow it fund efficient costs so that the DNO does not carry these costs for long periods of time, adding to risk and financeability challenges and thereby increasing the cost of capital. A reopener window ensures that there is a fixed point in time when this recalculation will occur to provide a number of benefits, including:

- Giving transparent notice of the potential for the reopener to change a DNOs revenues and reducing charge volatility
- Ensuring sufficient data on actual costs has been collected
- Minimising the regulatory costs and burdens of analysis of reopener submissions by co-ordinating all DNO submissions
- Ensuring DNOs have an incentive to minimise costs wherever possible due to the cash flow implications of carrying the costs for a defined period

Decisions on the number and timing of reopener windows are an important consideration. Too few windows and DNOs are still facing the risks that lead to the decision to introduce the reopener; too many and the benefits of reduced price volatility and an efficiency incentive are eroded. In DPCR5 a reopener was introduced after two and a half years to avoid the DNOs having to carry the costs for five years. The proposal to not introduce a reopener window until 2019, requiring DNOs to carry these risks for four years plus the reopener deliberation period effectively undermines all the risk reducing intent and extends the DNO risk back to almost pre-DPCR5 levels. It also means that companies have no opportunity to seek funding for streetworks schemes implemented in or after 2019. All of the benefits listed in the bullet point list above could be gained from having three reopener windows in an eight year price control review at the end of years 2, 4 and 6. This would strike the right balance between reduce price volatility, incentive for efficiency and reduced cost of capital as achieved in DPCR5.

Level of materiality threshold

The level of the materiality threshold should be maintained at the level agreed as part of the DPCR5 price control review to ensure that risk does not increase.

Question 5: *Do you have any views on the design of the proposed enhanced physical site security reopener?*

We are not aware that there is likely to be a significant new requirement from Government to change physical site security for key DNO assets. This is a different situation from that apparent during the development of the DPCR5 price control, where concerns were raised about the need to harden key assets and to change black start arrangements and standards. Therefore, we agree that ex-ante forecasts can be made of requirements to enhance site security and DNOs no longer require a reopener to deal with this issue.

Question 6*: Do you have any views on the design of the proposed load related expenditure reopener?*

We understand that a number of DNOs may trigger the DPCR5 reopener on load related expenditure and our own experience is that the level of our load related expenditure is around 20% lower than anticipated when forecasts were made for the DPCR5 price control. The three key drivers of this are:

- reduced electricity demand as a result of the economic downturn;
- reduced connections activity as a result of the economic downturn; and,
- reduced cost of reinforcement through innovative solution development utilising Demand Size Response or network reconfiguration and the linking of numerous schemes.

Therefore, the DPCR5 reopener may operate in customers' interests during the current price control period.

The risk of a significant variation in load related expenditure requirements from best forecasts at the time of the price control review will remain during for RIIO-ED1. Current forecasts anticipate a very slow economic recovery affecting reinforcement and connections during RIIO-ED1. If economic recovery were to be faster and greater than currently forecast DNOs could face a risk of significantly greater reinforcement requirements. This indicates that the reopener mechanism should be retained, but designed such that it will only be utilised if the change in reinforcement expenditure is significant. Our indicative forecasts as provided to Ofgem in July 2012

show that the levels of reinforcement expenditure required in RIIO-ED1 are at a similar level to those in DPCR5, although there is a shift from the primary network to the secondary network. Therefore, the current 20% threshold in the DPCR5 mechanism would be appropriate to ensure that only a very material risk would trigger the reopener mechanism.

Question 7: *Do you have any views on the design of the proposed high value projects reopener?*

Very large projects are subject to much greater uncertainty than a higher volume of smaller projects due to key external influences such as planning consents and the intrinsic complexity of large schemes. Therefore, the requirement for a High Value Projects reopener remains valid in RIIO-ED1 – allowing protection for both companies and customers. We also support the proposal to raise the threshold for defining a High Value Project to ensure that this uncertainty mechanism is only used for projects subject to this level of uncertainty and thereby limit the potential for revenue volatility.

We agree that the mechanism should cover both known and unknown High Value Projects. It is also essential that the mechanism covers not only the direct costs associated with the project, but also is expanded to include the associated indirect costs and the associated outputs.

We also propose that Ofgem should revisit its proposal to apply a 20% deadband to high value projects. This is inappropriate for two reasons. Firstly, the level of deadband has not been reviewed to take into account the change in size of high value projects. Secondly, it is inappropriate to apply a deadband to projects that are identified mid period. The incentive effect of applying a deadband to a project identified mid period would be to drive the DNO to carry a proportion of the costs of the project, rather than to carry the risk that the forecast is inaccurate. The risk of having a proportion of each unknown High Value Projects unfunded would have a significantly detrimental impact on financeability and the cost of capital. It is inappropriate to discriminate in how the projects are treated purely on the basis that the High Value Project is unknown or the costs are unforecastable at the time of setting ex-ante allowances. The need to ensure that it is only used when the project has a significant impact on the financing of the DNO has already been achieved by setting a much higher threshold before a project is considered eligible for being treated under the uncertainty mechanism.

The proposal to not introduce a reopener window until 2019, requiring DNOs to carry these risks for four years plus the reopener deliberation period, effectively undermines the risk reducing intent and increases DNO risk. A reopener window ensures that there is a fixed point in time when this recalculation will occur to provide a number of benefits, including:

- Giving transparent notice of the potential for the reopener to change a DNO's revenues and reducing charge volatility
- Ensuring sufficient data on actual costs has been collected
- Minimising the regulatory costs and burdens of analysis of reopener submissions by co-ordinating all DNO submissions
- Ensuring DNOs have an incentive to minimise costs wherever possible due to the cash flow implications of carrying the costs for a defined period

All of the benefits listed in the bullet point list above could be gained from having three reopener windows in an eight year price control review at the end of years 2, 4 and 6. This would strike the right balance between reduce price volatility, incentive

for efficiency and reduced cost of capital as achieved in DPCR5. As High Value Projects will often be triggered by external events, this potential frequency for the reopener windows is much more appropriate.

Question 8: *Do you have any views on the design of the proposed innovation roll out mechanism reopener?*

We recognise the issues described in the consultation document related to changes and innovations to enable environmental solutions. In the DPCR4 and DPCR5 periods we have rolled out the use of Demand Side Response (DSR) at a small scale where there has been a commercial driver to do so. It could be argued that the wider environmental benefits of Demand Side Response are such that a more holistic roll out triggered by DNO actions could have stimulated a DSR market to become much more developed than it has to date. This example may not exactly meet the criteria proposed for the innovation roll-out mechanism, but is indicative of the fact that innovative solutions, for which the innovation roll-out mechanism is designed, do exist and do require support. For this support to be effective it should apply to any qualifying scheme.

The introduction of a materiality threshold is a disappointing complication. This will drive DNOs away from small projects that may have big intangible benefits to customers. Whilst we have a regulatory framework with many incentives to stimulate a range of positive behaviours, the efficiency incentive is still by far the over-riding concern of all DNOs and, as pointed out in the consultation document, companies are very unlikely to direct management effort into higher cost activities. The removal of the materiality threshold is much more likely to make this mechanism a success. Alternatively, the mechanism could be adjusted such that funding is made available for 100% of additional costs incurred, rather than just costs that exceed the materiality threshold.

Question 9: *Do you have any views on the design of the proposed pension deficit repair mechanism reopener?*

We support this mechanism – see our response to the Financial Issues Annex for more detail.

Question 10: *Are there any additional mechanisms that we should be considering? If so, how should these be designed?*

We have not identified the need for any additional mechanisms to those already discussed in the consultation document.

Chapter Four

Question 1: *Do you have any views on the proposed RPI indexation of allowed revenues mechanism?*

We have significant concerns about the potential implications of the current Office for National Statistics (ONS) consultation for Improving the Retail Prices Index (RPI) published on 8th October. The mostly likely outcome of consultation by the Office for National Statistics will be a significant change to the methodology for calculating RPI which will in turn systematically reduce the level of RPI compared to historic methods of calculation. A realistic scenario suggests a potential 0.9% reduction to RPI outside any movements in the underlying economy and this would represent a significant

reduction in future revenues. It will be necessary to assess the impact of the change in the RPI construct as part of determining appropriate RPE allowances.

Investors (both debt and equity) typically require a nominal return, so any reduction in the underlying return through price protection will need to be adjusted through a higher real return. Furthermore, future Regulatory Asset Value may fall compared to historic norms and in global investment market will reduce the attractiveness of investment in all index-linked UK utility assets. Any significant change to how RPI is calculated is, therefore, likely to be perceived as adding to regulatory uncertainty and therefore the cost of equity.

The change to the RPI mechanism proposed increases DNOs short-term cashflow risk. This is similar in effect to proposals to add a two year lag to all other uncertainty and incentive mechanisms and to increase implementation time for the under or over recovery mechanism to two years. All these proposals will increase transparency and notice of price changes and should therefore reduce supplier risk and result in price reductions of end customers. However, it must be recognised that a reduction in risk for suppliers is only possible because the risk has been transferred to distributors. This may be an efficient decision as DNOs will have a lower cost of financing than electricity suppliers. However, the cost of financing is not negligible and there will be a cost incurred by DNOs. This additional risk and associated cost must be recognised within the estimation of the cost of equity.

Question 2: *Do you have any views on the proposed cost of debt indexation mechanism?*

At the beginning of RIIO-ED1 a DNO's opening RAV will be made up of the investments made in the preceding 20-years given depreciation lives up to that point; ie since 1995. It is therefore logical and reasonable that this investment will have been largely funded by debt raised at various times over this 20-year period.

The extent to which this historic debt is considered "efficient" is subjective, but Ofgem should recognise that the sterling debt capital markets have been the major source of funding for all UK utilities since privatisation and debt investors' demand has been for long term (20 years to 30 years or longer) fixed rate bond issues of "benchmark" size.[1]

It is therefore reasonable, and we believe efficient, that a DNO's debt portfolio in 2015 will be made up of a number of long-term bonds or loans that have been issued over the previous 20-year period, at the prevailing market rates at time of issue.

Over this period the market has seen two "downward steps" in prevailing nominal rates (we quote both 10-year government bond and bank base rate as illustrations), firstly from the 7%-8% range in the mid 1990s to the 4%-6% range which largely prevailed until the reaction to the credit crisis post 2009 with the step down to the all time low rates currently prevailing of 0.5%-2%.

[Commercially sensitive data has been deleted]

This means that the actual weighted average cost of debt will differ materially from the simple 10-year trailing average; which assumes 1/10th of existing debt is refinanced every year.

[1] The benchmark size measure has been for the bond to be included in bond indices, such as the iBoxx indices selected by Ofgem, which are used to measure investment managers' relative performance. The minimum size has increased over time to approximately £250m.

Indeed as Ofgem stated in the DPCR5 proposals, the limitations of an index are well recognised:

"constructing an appropriate benchmark index would involve a wide range of equally arbitrary assumptions, in addition to being fraught with technical difficulties. The issue of materiality depends heavily on the assumptions used for the construction of the index and in particular the choice of the benchmark, the sensitivity of the index to actual movements in rates, and whether it would be applied only to new debt or also to embedded debt. Overall, although there seem to be some potential benefits, we believe that these are outweighed by de-incentivising DNOs to manage interest risk."[2]

However, we recognise that for an eight year price review period there are equally risks attached to a single spot allowance and that a suitable trailing average may give DNOs a better match to actual costs. The practical issue is, against the background of the long-term reduction in rates as illustrated above, a simple ten-year trailing average will give no weighting to previously prevailing higher rates whilst for the reasons set out above it is reasonable that a DNO's actual costs of debt will be made up of a proportion of fixed rate debt raised efficiently more than 10-years ago. This effect will be exacerbated should current all time low rates prevail well into RIIO-ED1 as this will mean the trailing average continues to fall.

We note in the FTI Consulting report published by Ofgem as part of the T1 and GD1 Initial Proposals, FTI comment:

"In general, an average based on 10 years of data will reflect rates over the course of an economic cycle, and no adjustment would be required for low (or high) rates in any one period. However, we recognise that recent interest rates have been at historically low levels that may be unrepresentative of a normal economic cycle.

Depending upon the future pattern of interest rates, the inclusion of these rates in the index may, therefore, not reflect the efficient costs of debt for a network company over the 2013/21 Price Controls"[3]

We agree with this view and, based on a range of modelled scenarios for future interest rates, expect to show in our RIIO-ED1 business plan that the simple 10-year trailing average allowance will not provide a fair and reasonable coverage of actual efficiently incurred debt service costs during RIIO-ED1.

For the avoidance of doubt, it is worth stressing that early repayment of existing longer term debt by refinancing with current low price debt is not a practical option for network companies. The redemption premium costs and related increase in the notional amounts to be funded would off-set the apparent benefits of lower interest coupons.

Question 3: *Do you have any views on the proposed pass through of Ofgem licence fees and business rates?*

We agree that these costs are predominantly outside of the control of DNOs and that pass-through of these costs should continue. We do acknowledge that there are a number of actions undertaken by networks to minimise these costs on behalf of customers (examples can be found in our financial issues section) but ultimately we have very little control over these costs and therefore pass through remains the most appropriate funding mechanism. We are also aware that the revaluation will now take place in 2017 rather than 2015. This misalignment also lends itself to the pass through mechanism.

[2] Paragraph 5.11 to 5.13 DPCR5 Consultation 5 December 2008.
[3] Paragraph 2.23 (4) of the Cost of capital study for RIIO-T1 and GD1 price controls report by FTI Consulting 24 July 2012.

Question 4: *Do you have any views on the proposed tax trigger mechanism?*

We agree with Ofgem's proposal to continue to use the tax trigger mechanism as this protects customers and DNOs against non controllable movements in taxation rates and is consistent with the incentive based approach. During DPCR5 to date there have been a number of downwards revisions to the corporate tax rate and customers have benefitted from revenue reductions to reflect lower tax costs.

Question 5: *Do you have any views on the disapplication of the price control process?*

The disapplication process effectively bounds the total level of risk that DNOs must carry during a price control review as a result of changing external circumstances. It is quite appropriate that the level of risk that DNOs must bear below this threshold is significant. Removing this ultimate level of protection would, however, leave investors facing potentially unbounded risk which would have a significant impact on the cost of equity to the detriment of customers. We strongly support the retention of the disapplication option.

It must also be recognised that DNOs are facing a growing number of different risks. It is now clearer that the implications of the banking collapses of 2008 that were a significant dislocation for consideration in setting DPCR5, have lead to profound and long-term damage to the global economy. The results are greater fragility and more volatility in the economy. Forecasts of economic activity currently indicate a long and difficult road to recovery and, perhaps more importantly for this debate, a much wider range of uncertainty around any "central" forecast.

A significant new uncertainty for DNOs is the rate of take of low carbon technologies by electricity customers, particular domestic customers. Experiences with the effect of the Government's feed-in tariff for photo voltaic cells have shown that stimulus packages can have rapid and dramatic effect on behaviour and uptake rates. DNOs face greater uncertainty in terms of the impact on both generation and demand technologies connected to their networks. This leads to the need for Low Carbon Technology uncertainty mechanisms for demand and generation.

Whilst each of these uncertainties can be dealt with by an uncertainty mechanism, as discussed in the consultation, the total exposure to incremental risks from multiple uncertainties below the materiality threshold for any mechanism is potentially growing. There is a limit to the amount of unfunded costs companies can sustain and remain financeable at a low cost of capital.

Question 6*: Are there any additional mechanisms that we should be considering? If so, how should these be designed?*

A modified DG incentive mechanism should be included for RIIO-ED1.

Chapter Five

Question 1: *Do you agree with the scope of the mid-period review? If not, what changes to the scope are needed?*

The mid-period review is an important safeguard for customers because there is a realistic chance that the requirements of customers from DNOs will change in the five years between publication of Ofgem's requirements for DNOs business plans in

February 2013 and the start of the mid-point review process in January 2018. The mid-period review does not provide a significant remedy for this increased risk exposure, as it is perceived by investors as an asymmetrical mechanism. To address this perception Ofgem have, quite rightly, stated that they will prescribe the scope of the review as tightly as possible.

Question 2: *Do you agree with the indicative process and timetable? If not, how could the process and timetable be improved?*

The indicative timetable aligns with our experience of how long similar reviews will take.

Question 3: *Do you have views on when we should make licence changes as a result of any actions taken at the mid-period review? If a threshold to make a licence change is seen as appropriate, what should this be?*

As explained in the consultation response, the need for licence changes will be dependent upon the particular changes being contemplated by the mid-point review

Financial Issues

Overview

We recognise the conflicting pressures on Ofgem to ensure that customer bills are efficient whilst ensuring that companies are financeable. To achieve this, Ofgem must identify the real and credible issues from a broad debate, which is often supported by lengthy and learned economic finance theory.

At the heart of the debate is the trade off between allowing an appropriate cost of capital with appropriately financeable networks, given the uncertainties concerning what needs to be financed over the next ten years, and the very real hardships that many families are facing in the UK over this period as a result of the rising costs of energy.

In the development of our business plan for the RIIO-ED1 period, we are committed to demonstrating an appropriate balance between these pressures to identify and justify a fair and reasonable package for customers and finance providers.

There are several factors that contribute to this challenge. Firstly there are very likely to be a great many competing demands for the scarce commodity of capital. In the UK alone there is the estimated £200 billion estimated by Ofgem in its Project Discovery review for the energy industry over the period to 2020. The UK water industry will also continue to be a large borrower in the capital markets and there is an increasing requirement for housing stock to be funded by Housing Associations directly from the debt markets rather than relying upon high levels of government funded grants and conventional bank lenders. Additionally the Government's aspirations for new infrastructure (such as roads) to be funded by pension funds and similar investors, places further competing demands on the electricity networks to maintain their historical position as long-term stable borrowers and to continue to benefit from the arguable "halo" effect identified by Ofgem.

Secondly, although we currently operate in an environment of all time low interest rates, the distribution operators are very long-term businesses entrusted with the efficient stewardship of assets that have useful lives of many decades and financing structures that reflect this. The debt that has been raised to finance the investment in the networks since privatisation will, in practice, never be repaid. Instead it is and will be repeatedly re-financed and therefore forms a significant part of the long-term capital structure of the companies.

Consequently it is not possible for companies to efficiently finance themselves over the relatively short term of a price control period and so they will carry a blend of interest rate costs into subsequent reviews.

The proposed balance of risk and reward has significantly changed since DPCR5. Many of the financial measures proposed in the consultation increase risk for investors without providing appropriate compensation. The adoption of the RIIO principles requires rebalancing the current incentive package to ensure that it retains its existing strength. Our concern is that the risk-reward package proposed may not attract the level of equity investment to ensure timely and efficient finance is available to deliver the network outputs. If the financeability mechanisms in this consultation

place additional risk on the deliverability of the outputs or fails to provide an efficient company with sufficient revenues to finance its functions, they should be reviewed.

Several of the proposed mechanisms may not provide sufficient revenues within the price control period to allow companies to finance their functions (eg cost of debt index). This also increases the risk profile for investors and may create inefficient financing requirements for customers.

Electricity North West's key objective from any price control settlement is to secure sufficient revenues to deliver the level of service and outputs required by our customers at an efficient cost whilst meeting key financeability metrics and providing our investors with appropriate returns for their investment. Whilst the mechanics behind the revenue setting are important in terms of understanding how revenues have been calculated, the ultimate decision on the acceptability of a price control will be based on the sufficiency of revenues to deliver investments for customers and returns to debt and equity investors whilst maintaining appropriate financeability metrics.

Cost of Debt Index

Given the uncertainty of the future profiles of interest rates over the extended price review period, Ofgem has developed a logical uncertainty mechanism linking the allowance to a simple trailing average of ten-year bond yields. Implicitly this is likely to act as a reasonable proxy for the likely bond coupons of a network company that has financed itself in equal amounts each year over the preceding ten-years and has a refinancing and incremental debt requirement of one tenth of the total each year.

However, in reality and for the reasons set out above, the DNOs, including Electricity North West, tend to be financed by the infrequent issue of long dated corporate bonds of a size required by bond investors to meet their requirements for "benchmark" issues, of c£250m+. The profile of this existing position is that the sector only has a reasonably small amount of existing debt to refinance in the RIIO-ED1 period and consequently a large part of the future costs of debt are already fixed.

Therefore it is generally accepted that the simple trailing average mechanism will not act as a reasonable proxy for distribution network companies during RIIO-ED1. It is possible that companies can change their funding profiles to try and better match the ten-year trailing average by the start of RIIO-ED2, although this approach may not be in the long term interest of customers.

This issue is referred to as "embedded debt" and Ofgem is quite right to point out that it is not a new issue for network companies as they cross over price reviews. However, the significant new factor is the scale of the recent reduction in interest rates and the related forecast levels for the simple trailing average allowance.

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Our Answers to Questions in the Financial Issues Document

Chapter Two

Question 1: *Is our approach for setting the allowed return appropriate, particularly in the context of an eight-year price control?*

Taking a long term view of the components of the CAPM is sensible. Ofgem needs to provide a clearer quantitative methodology for assessing the relative risk factors that determine the equity beta beyond its preferred method of just assessing the percentage of the planned capex to the opening RAV.

In respect of the uncertainty mechanism for the cost of debt allowance, Ofgem needs to accept that the levels of the simple 10-year trailing average during RIIO-ED1 will not be sufficient to cover efficiently incurred debt costs where a company's issue profile does not match the assumptions behind the index.

Ofgem's willingness to consider alternative mechanisms on a transitional basis is welcome, but the hurdle test needs to recognise that debt issued in the capital markets is by implication "efficiently priced" at the time of issue. Any shortfall in allowances for debt costs will ultimately fall on equity investors who will require compensation for this in the cost of equity. Regardless of whether adjustment is made as transitional adjustment to debt indexation methodology or as compensation in cost of equity, this will represent an "additional" cost to customers for funding of efficiently incurred costs. It is likely that no amount of stakeholder engagement will prove a compelling case for this from the customers' perspective

Question 2: *What considerations do we need to take into account when setting the notional gearing level?*

Firstly, the relative risk of the price control review, based on a more developed methodology, as referred to under the response to Question1.

Secondly, based on the financeability assessment of the size of the equity wedge that is necessary to ensure the businesses are financeable under the range of possible investment scenarios that may develop during RIIO-ED1.

Finally there needs to be a check that networks can indeed debt finance themselves to the assumed level during the RIIO-ED1 period and maintain solid credit ratings at the targeted levels. Credit Rating Agencies include pension deficits in their assessment of debt and given the growth in these since the DPCR5 determination will have caused further pressure on these key ratios.

Question 3: *Is our proposed mechanism for annually updating the cost of debt assumption based on an index appropriate?*

We recognise that given the extended price control period some kind of mechanistic setting of the cost of debt allowance is attractive. However as we have shown, and indeed Ofgem recognised in 2008, there is no index that satisfactorily matches the debt profile of companies which issue at irregular dates and in relatively large amounts - a practice which is followed by all UK utilities and is by implication "best practice" to secure the best relative value in execution and minimising the costs of carry.

Therefore, on the basis that Ofgem is indeed anchored to the simple 10-year trailing average mechanism, it needs to accept the need to provide a transitional allowance during RIIO-ED1, given the scale in the reduction in interest rates in recent years and the likely levels of the allowance through RIIO-ED1. This is because the network companies' interest costs are substantially fixed for the RIIO-ED1 period.

In the longer term companies may choose to alter their financing policies to better mirror the core mechanism to minimise their risk of future shortfalls but we continue to question the long-term benefits to consumers given this is driving inefficient behaviours by network companies.

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Indeed as Ofgem stated in the DPCR5 proposals, the limitations of an index are well recognised:

"constructing an appropriate benchmark index would involve a wide range of equally arbitrary assumptions, in addition to being fraught with technical difficulties. The issue of materiality depends heavily on the assumptions used for the construction of the index and in particular the choice of the benchmark, the sensitivity of the index to actual movements in rates, and whether it would be applied only to new debt or also to embedded debt. Overall, although there seem to be some potential benefits, we believe that these are outweighed by de-incentivising DNOs to manage interest risk."

However, we recognise that for an eight year price review period there are equally risks attached to a single spot allowance and that a suitable trailing average may give DNOs a better match to actual costs. The practical issue is, against the background of the long-term reduction in rates as illustrated above, a simple ten-year trailing average will give no weighting to previously prevailing higher rates whilst for the reasons set out above it is reasonable that a DNO's actual costs of debt will be made up of a proportion of fixed rate debt raised efficiently more than 10-years ago. This effect will be exacerbated should current all time low rates prevail well into RIIO-ED1 as this will mean the trailing average continues to fall.

We note in the FTI Consulting report published by Ofgem as part of the T1 and GD1 Initial Proposals, FTI comment:

"In general, an average based on 10 years of data will reflect rates over the course of an economic cycle, and no adjustment would be required for low (or high) rates in any one period. However, we recognise that recent interest rates have been at historically low levels that may be unrepresentative of a normal economic cycle.

Depending upon the future pattern of interest rates, the inclusion of these rates in the index may, therefore, not reflect the efficient costs of debt for a network company over the 2013/21 Price Controls"

We agree with this view and, based on a range of modelled scenarios for future interest rates, expect to show in our RIIO-ED1 business plan that the simple 10-year trailing average allowance will not provide a fair and reasonable coverage of actual efficiently incurred debt service costs during RIIO-ED1.

For the avoidance of doubt, it is worth stressing that early repayment of existing longer term debt by refinancing with current low price debt is not a practical option for network companies. The redemption premium costs and related increase in the notional amounts to be funded would off-set the apparent benefits of lower interest coupons.

Question 4: *Does our range for the cost of equity capture the DNOs " probable cost of equity in RIIO-ED1?*

Ofgem must ensure that that the allowed cost of capital for RIIO-ED1 reflects the significant change in risks for the network companies. Some of these additional risks associated with the RIIO principles (increased exposure to cost of debt, increased operational risk due to longer price controls etc) have been discussed during the RIIO-GD1 and RIIO-T1 price control reviews.

It is now clearer that the implications of the banking collapses of 2008 that were a significant dislocation for consideration in setting DPCR5, have lead to profound and long-term damage to the global economy. The results are greater fragility and more volatility in the economy. Forecasts of economic activity currently indicate a long and difficult road to recovery and, perhaps more importantly for this debate, a much wider risk range around any "central" forecast.

A significant new risk for DNOs is the rate of take up of low carbon technologies particularly by domestic customers. Experiences with the effect of the Government's feed-in tariff for Photo Voltaic cells has shown that stimulus packages can have a rapid and dramatic effect on behaviour and uptake rates.

Ofgem must also recognise the emerging risks associated with the introduction of consumer redress and the modification of the RPI index which will increase the risk of the costs being unfunded. There are also the additional risks created by the removal of the National Grid exit charges pass through mechanism and the DG connection uncertainty mechanisms.

We therefore agree that the upper quartile end of the published range is likely to prove appropriate for the balance of risks in the price control package and reflecting the overall reduction to some elements of the estimated RORE components.

Question 5: *Is the ex ante approach to the cost of raising notional equity appropriate for RIIO-ED1?*

Yes we agree this is appropriate, on the basis that the financeability modelling and the level of regulatory gearing will determine the potential need for raising notional equity.

Chapter Three

Question 1: *Have we identified the correct equity and credit metrics?*

We agree that the six credit metrics fairly assess the key aspects assessed by the rating agencies, cashflow, interest cover gearing and debt servicing.

The equity metrics, measuring theoretical returns on regulatory equity should not be the primary assessment for assessing the stability of actual cash paid returns to equity.

We have previously suggested that Ofgem should include standard equity ratios such as dividend cover but we note in the Gas and Transmission Initial Proposals the use in the financeability modelling of an assumption of annual equity dividends based on

5% of regulatory equity. This excludes any allowance for incentives generating higher returns (other than IQI).

Ofgem should adopt the same approach for RIIO-ED1 as although equity investors take a long-term view they often represent pensions funds which require annual dividends to fund liabilities. The comparative data on equity beta is all based on listed companies that pay annual dividends and if Ofgem assumes that the DNOs cannot maintain annual dividends then a higher equity beta would be commensurate.

The report issued by Fitch on the National Grid credit rating reflected on the challenging RIIO financeability principles and noted that it had to rely on non-regulated earnings to support the current credit rating. We do not believe that this situation is appropriate for long term sustainable businesses and in the case of the DNO's generally and specifically Electricity North West there are no material non-regulated revenue streams to supplement regulated revenues.

Question 2: *Do the rating agency credit metric levels quoted provide the most appropriate levels?*

We accept that the published metrics reflect the rating agencies' current guidance. However, we note that the final shape of the RIIO-ED1 package could reasonably lead to the agencies demanding stronger ratios to maintain the same credit ratings. For example Fitch has said it is not ambivalent to the change in regulatory asset lives and the historic 20-year term has been a factor in allowing the levels of gearing at the relative rate bandings.

As the shape of the package develops over the next few months it is important for Ofgem to maintain its dialogue with the rating agencies and sense check any updated levels of the targeted metrics before completing its financeability assessment.

Chapter Four

Question 1*: Do you agree with our approach for the calculation of the percentage of totex allowed into RAV?*

Whilst we accept the economically pure attraction of a single totex allowance into RAV this is likely to represent a further erosion of fast money allowances alongside the change in asset lives, potentially exacerbating financeability issues for DNOs. It is therefore important that Ofgem remains open to utilising phased changes in capitalisation as a key part of networks building a blend of transitional changes to ensure robust financeability.

Question 2: Do you agree with our revised approach to Totex and with the costs that are included and excluded?

We agree that the scope of 'totex' costs should be expanded to include more cost categories. The DPCR5 treatment goes some way towards removing some of the boundary issues and potential cost distortions of previous prices controls, but further equalisation of rules will ensure that DNOs have no perverse incentive to deploy solutions that fail 'lowest whole life cost' tests because of differences in regulatory treatment.

We have a number of specific comments on proposed RAV addition rules:

- We disagree with the proposal that traffic management costs should not be included within totex. These activities are integral components of the cost of working in the highway and should be treated in the same way as other costs of undertaking work to avoid boundary issues. We recognise that they should be separately reported to ensure the correct operation of any reopener.
- It is important to recognise that in some instances streetworks fines incurred by DNOs may be efficiently incurred costs and should be included within totex.

Question 3: We invite views on whether the definition of related parties should exclude captive insurance companies and whether our proposed approach is proportionate.

We have no specific comments on this proposal.

Chapter 5 – Taxation

Question 1: *Do you agree with modelling tax under the ASB proposed accounting frameworks for financial reporting in the UK with any changes to be subject to the tax trigger?*

We agree with modelling tax in line with generally accepted accounting principles as this is also the basis for the preparation of tax returns. The one caveat is that there can sometimes be more than one interpretation of particular accounting standards, so until we know whether there will be any contentious standards giving rise to differing accounting interpretations and taxation results, it is difficult to comment further.

Question 2: *We invite views on the calibration of the dead-band*

The dead band appears to work well in DPCR5 and we would consider the same approach in RIIO-ED1 to be appropriate. The proposed dual trigger basis represents an unnecessarily complex trigger mechanism and propose that Ofgem maintains its current approach of having a single trigger based on % revenue. This trigger takes account of all potential tax changes. It will be necessary to clearly understand the detailed trigger mechanism as part of developing the price control financial model.

Question 3: *Do you agree that clawback of the tax benefit of excess gearing in DPCR5 should be spread over the eight years of the RIIO price control? If not, which alternative option do you prefer?*

We believe this is consistent with the DPCR5 methodology, upon which companies may have determined financing strategies. We would agree with the approach of spreading the clawback over the remaining RIIO-ED1 period, once any adjustment relating to the last year of DPCR5 is known (after the RIIO-ED1 period commences).

Question 4: *Do you agree that the revenue adjustment for tax clawback should be applied annually as part of the annual iteration process?*

Whilst we believe this represents best value for consumers we do have concerns about the scale of the combined annual adjustments through the iteration process and the impact on price volatility for consumers We agree with the proposal for the clawback to be annual and that customers would be unfairly treated if they had to wait until the next price control period for such price adjustments.

Question 5: *Do you agree with our treatment of expenditure for tax modelling including the cash flows of corporation tax payments?*

We would welcome the approach to model cash flows in the same year that the tax charge arises to reduce unnecessary complications. There needs to be careful consideration of the transition from DPCR5 rules to RIIO-ED1 rules, where ordinarily a DNO would only receive half of the final year of DPCR5 in the first year of RIIO-ED1. There should be a compensating adjustment to reflect the change in treatment from DPCR5 to RIIO-ED1.

Question 6: *Do you agree with modelling of expenditure subject to capital allowance and capital allowance pool balances?*

We agree with resetting the capital allowance pools based on the submitted data for 31 March 2015 as this would be the fairest approach for customers. We also agree that the fairest approach to setting capital allowances is on an industry average basis. The document refers to resetting the tax pool balances at 01 April 2015 once the "*2014-15 data is available and has been reviewed and moderated for any issues".* It was not clear to us whether this means the 31 March 2015 RRP data being available or the submitted tax computation data, presumably the former as a number of DNOs do not have submitted tax computations for a 31 March period end. Furthermore, it was not clear what was meant by a moderation of the data for any issues. Clarity on these points would be welcome.

Question 7: *Do you agree with our proposal for funding business rates?*

We note that since the publication of the Strategy Document it has been announced that the 2015 Rating revaluation has been postponed to 2017 and Ofgem may need to reconsider its methodology in the light of this postponement as it makes a material difference to the mechanism it is proposing to capture the costs of Business Rates. From a practical point of view it means that the rates charge to the business will remain the same for 2015-16 and 2016-17, in real terms.

Overall we agree that the proposed approach is sensible. Noting that in previous rating revaluations Ofgem has allowed 100% rates as a non controllable cost, but only if it was satisfied that the company had fully engaged with the Valuation Office Agency in pre-discussion on the appropriate methodology for arriving at Rateable Value. Such engagement in the past has satisfied Ofgem that the exercise produced a rateable Value that was a fair and reasonable one which ensured pass through. We fully expect that all DNOs will actively engage with the Valuation Agency and that Ofgem will be assured that customers' interests have been represented in the process.

Chapter 6 – Pensions

Question 1: *Do you agree that the fast money true-up adjustments for DPCR5 should be spread over the eight years of the RIIO-ED1 price control if they exceed £1m per DNO? If not, which alternative option do you prefer?*

Yes we agree that fast-money true-ups should be spread over the eight years of RIIO-ED1, subject to adjustment for the time value of money to compensate for delayed cash flows.

Question 2: *Do you agree with our proposals for the basis for the first and subsequent reset adjustments?*

We agree with your proposals for the basis for the first and subsequent adjustments.

We note that Ofgem has not discussed or proposed any position on incremental allowances. This is an important gap in the pensions funding and should be discussed with the industry ahead of the final strategy publication in February.

Question 3: *We invite views from interested parties on how we conducted the latest pension reasonableness review, with a view to understanding what elements of the review were conducted well, what could be improved and what should be done differently in future reviews.*

We welcome the ongoing dialogue with Ofgem on this issue and recognise the opportunity to explain more of the detail and background to our current funding position. Ultimately, many of the key decisions on pension funding and investment strategy rest with trustees. Our concern is that Ofgem's approach to benchmark individual assumptions, rather than looking at pension funding and investment outcomes in the round, risks 'cherry picking' individual assumptions rather than assessing the efficiency of overall assessment. The trustees and their advisers will always be guided more by the Pension Regulator rather than Ofgem, which creates a tension between trustees and their sponsor. We do not believe this tension has caused too many problems in the past but can see that it could cause decisions being made for the wrong reasons in future by either side. We suggest that for future Ofgem reviews, more meetings are held with companies, probably to include trustees, to discuss negotiation outcomes and strategies agreed so that Ofgem (and their advisers – eg. GAD), understand the full range of views in this area.

Question 4: *We invite views on which of the options for pension scheme administration costs and Pension Protection Fund levies we should adopt; and, if our preferred approach were adopted, the methodology itself, and the level of the de minimis thresholds.*

We agree that it is appropriate to introduce consistent policies for the treatment of PPF levy and administration costs across licensees in all sectors. We also agree that Ofgem's proposal to true-up and reset these allowances every three years, subject to a review for efficiency and a deminimis threshold is appropriate, subject to a deminimis threshold of £1m. It is important that efficient pension costs are appropriately funded through the price control. We are pleased that Ofgem has acknowledged that single networks may face proportionally larger costs due to the fixed costs associated with pension administration. This should be taken into account in setting ex ante allowances.

. . .

Question 5: *Do you agree that companies must demonstrate a robust approach as to how their de-risking strategies, especially if aggressive, are protecting future scheme funding and that they should clearly demonstrate the benefits that they expect to flow to consumers?*

Whilst all DNOs may put a robust strategy in place, it is impossible to demonstrate which approach will give the best outcome for customers in the future. We agree that companies should be able to explain their thinking, their negotiating position with the trustees and how this position reflects the most appropriate settlement for customers. Ofgem must recognise that there will be differences of opinion between the company and their pension trustees and both parties are governed by different regulators. It is therefore important to ensure that the DNOs can demonstrate where the approaches diverge and how this change will affect customers.

Question 6: *Do you agree that the costs of contingent assets be funded if clearly demonstrated to be in consumer's interests?*

Yes, together with other similar initiatives that reduce inefficiencies and spread long term costs across the different generations of customers and possibly beyond 2025

Question 7: *We invite views on whether the revised guidance to our pension principles and the methodology is comprehensive and adequate for DNOs and stakeholders to understand how the principles will be applied in RIIO controls and for network companies to prepare their business plan.*

As we have already discussed, the main remaining area of uncertainty relates to the practical implementation of the Established and Incremental deficits principle and how the Incremental costs will be fairly and logically treated as part of the Totex total costs of employment allowance.

Chapter 7 – Annual iteration process

Question 1: *We invite views from interested parties on the proposed annual iteration process.*

We consider the mechanism is now sufficiently detailed and understood. We have concerns about the scale of the total value of annual adjustments (Tax clawback, efficient underspend or timing differences in investment programme, cost of debt allowance, triennial pension true up etc) on the stability and predictability of consumer prices.

Impact Assessment

Overview

The Impact Assessment (IA) document considers the impact of implementing the new regime under the RIIO-ED1 price control review but fails to recognise or discuss any of the interactions between the various elements of the framework, or the relative impact compared to DPCR5. We have raised this issue with members of the Ofgem team and understand that this will be the focus for the final development of the Strategy Publication.

The Impact Assessment explicitly recognises the increased risk under the RIIO model resulting from the extension of the price control duration. Ofgem's proposed application of uncertainty mechanisms to mitigate this impact should recognise that they are managing an increased risk, rather than reducing overall risk (compared to DPCR5). The IA also fails to recognise potential under/overestimation of allowances and RPEs as the increased duration increases the chance that the forecasts/allowances are wrong. Combining this probability with an increased sharing factor places increases the exposure risk for the networks.

The introduction of the RIIO financeability principles represents a significant movement for investors away from a previously stable set of financeability parameters. It is important that the IA recognises the impact of the RIIO principles correctly. Whilst the RIIO financeability principles provide clarity for future treatment, they also represent an increase in risk for the networks with a lower package of available rewards. This is unlikely to provide investors with an appropriate risk/return package when compared with other investments.

We are also concerned that the specified set of risks included in the IA fails to recognise the potential risk that Ofgem underestimates cost allowances or revenues to finance the network for the price control period.

We also note that the discussion on the cost of RIIO fails to recognise cost of compliance. Ofgem is (quite correctly) requiring compliance assurance for RIIO-ED1 and this should be recognised in the IA.

Our Answers to Questions in the Impact Assessment Document

Chapter Two

Question 1: *Have we correctly identified the impacts that RIIO-ED1 will have on consumers, competition, sustainable development and safety?*

Ofgem has recognised the impacts of the individual policy decisions but failed to understand the impacts on the collective package. There is a possibility that the combination of the policy decisions could create perverse incentives for customers

We also suggest that the final impact assessment should recognise the impact of RIIO–ED1 on the average customer bill.

There are also questions on the impact of the RIIO-ED1 incentive mechanisms. A number of mechanisms introduced in earlier price controls have been modified in the strategy document (Losses, Transmission exit point charges, Broad customer satisfaction etc) without being recognised in the IA. Some of these mechanisms will have an impact on charge volatility, the returns package and customer willingness to pay and should therefore be reviewed for proportionality and potential effectiveness.

Question 2: *Are there any additional impacts that RIIO-ED1 may have?*

The IA fails to include any discussions or even recognise the impacts on debt and equity investors. A number of significant modifications have been introduced in RIIO-ED1 which will, on an individual policy and as a package, increase risk for reduced outperformance opportunities. It is important that Ofgem assesses the implications of the package from an investor perspective to ensure that efficient, timely investment finance is available to deliver the agreed outputs.

Question 3: *Are there any specific areas in which we should seek to quantify the impacts of implementing RIIO-ED1 in a later IA*

We have included our answer to this question in questions 1 and 2.

Chapter Three

Question 1: *Have we correctly identified the risks associated with implementation of RIIO-ED1?*

The IA fails to recognise the risks associated with the package and that incentive mechanisms could interact with each other to create unintended consequences. The IA fails to recognise that implementation of RIIO will reduce both current and future cash flows. Ofgem must assess both the short and long term financeability implications of its policy positions and determine if this is an efficient outcome for future customers.

Question 2: *Are there other risks that implementation of RIIO-ED1 may have?*

We have included our answer to this question in Question 1.