Ofgem Strategy Consultation for the RIIO-ED1 Electricity Distribution Price Control

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SP Energy Networks Response – Executive Summary

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INTRODUCTION AND OVERVIEW

SP Energy Networks (including the licensed distribution network operators SP Distribution and SP Manweb) welcomes the opportunity to respond to Ofgem's RIIO-ED1 Policy consultation document. We commend the open nature of the policy consultation document and recognise the efforts by the Ofgem team in enabling consultation on many policy areas earlier in the price control process.

Distribution Network Operators (DNOs) have a central role to play in the delivery of energy policy objectives in both a UK and European context. With peak demand forecast to increase by 20-90% by 2030, delivery of these objectives will require a significant change in approach and level of interaction with our customers, together with a balanced, supportive and forward-looking regulatory framework.

The RIIO-ED1 period will potentially see the largest transformation in technology and service that our industry has ever undertaken. Smart meters, customer adoption of low carbon products, smart network technologies and inevitable steps forward in communication, will allow DNOs and customers to interact dynamically in real time and harness entirely new forms of multimedia.

It is important that our plans reflect known stakeholder and customer requirements, whilst providing flexibility to meet future requirements. Our refined stakeholder engagement processes for RIIO-ED1 will be embedded into our normal business activities so that we can listen and respond to the wide range of stakeholders with whom we share dependencies.

For SP Energy Networks (SPEN), this price control review needs to take into account a number of themes impacting the context in which we and our stakeholders operate, these include:

- Continuing renewal of the UK's ageing distribution networks in an efficient manner, considering lowest lifetime costs and future customer requirements, whilst maintaining safety and security;
- Facilitating continued connection of high levels of distributed renewable generation;
- Facilitating connection of increasing levels of customer's low carbon products;
- Laying network foundations to efficiently manage the significant uncertainty that will face networks in future price controls under all industry and DECC energy scenarios;
- Allowing facilitation of a fundamentally different and proactive means of DNOs interacting with their customers by 2023 to meet the increasing demands of our customers on service, multimedia communication, and real time information.

Throughout the development of our RIIO-ED1 plans we will apply our Company's guiding principles:

SP Energy Networks is:

A customer service focussed company, trusted in the eyes of the communities we serve and the stakeholders we depend upon
– *Listening, learning and acting on the feedback we receive*
– *Taking a proactive approach to all customer management*

An engineering company with strong stewardship of our assets today as well as into the future
– *Investing strategically to ensure a safe, efficient, secure quality of supply is delivered for our customers of today and tomorrow*
– *Embracing innovation and enabling low carbon solutions*

A company that attracts and develops the skills for the future across our supply chain from within our local communities
– *Working with local colleges, contractors, universities and across sectors to recruit and train our future workforce*
– *Developing the new skills and behaviours to meet our changing landscape*
– *Leveraging our PowerWise Schools Program to make maths and science attractive*

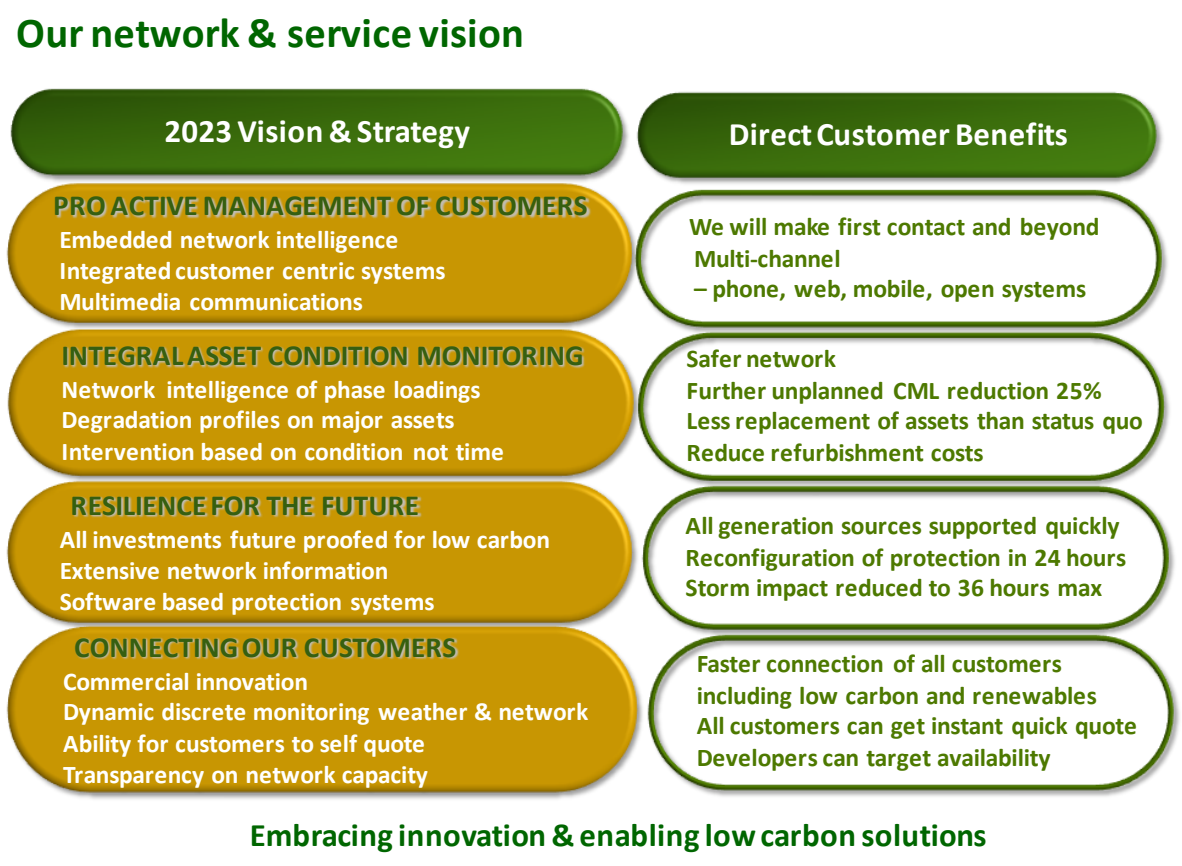
The RIIO-ED1 framework that we agree needs to consider the future in every facet of a DNO's activities as the legacy of our actions in this period will have an impact for many decades to follow.

With the rapid rate of improvement in telecommunications and network technology, customers and stakeholders have a right to expect proactive management. An example of this could be to expect that the DNO knows immediately when a customer loses supply and proactively contacts them having already despatched and diagnosed the fault.

Our objective is to agree a price control that fundamentally improves the service experience (in terms of reliability, resilience and quality) our customers can expect between now and 2023. It is also essential that we efficiently prepare for the challenges that the low carbon transition will present in 2030 and beyond.

To expand on our vision of network capability and improved service, we refer to figure1 extracted from our recent presentations to the Gas and Electricity Markets Authority (GEMA), which captures our view of what a DNO should be striving towards when it lays out its future network blueprint at RIIO-ED1.

The figure also highlights the associated customer benefits.



In considering the questions raised in Ofgem's consultation together with the challenge we face as an industry, we believe that the RIIO-ED1 package needs to exhibit:

- **Customer service metrics that reflect what customers want.** Our customers have told us that when they try to contact us they want us to answer every call, they want the choice of speaking to a person, they want accurate information and they want us to keep our promises.

- **A clear output contract with flexibility for appropriate reprioritisation**, reflecting the dynamic nature of asset risk management, in order to continue to protect the interests of the public, our customers, staff and contractors.

- **The opportunity for commercial and technical innovation** to facilitate low carbon transition. Our stakeholders in the urban and rural environments we serve are telling us they want us to be a proactive part of their economic growth plans and to engage with them to develop cost effective solutions that facilitate a move towards thriving low carbon economies.

- **Opportunities for effective future proofing** across all activities and not simply lowest unit cost. Investment decisions must incorporate potential future requirements, from accommodation and capacity for future use, to the potential functionality of the technology we install.

- **Symmetric and proportionate incentive mechanisms**. Incentive regulation has been an industry success, however, all mechanisms need to be linked to clear policy goals and to be balanced against incentivising the correct behaviours to deliver a sustainable future.

- **Workable and flexible uncertainty mechanisms.** The acid test of such mechanisms will be that they enable companies to anticipate and address future customer's needs.

- **Returns that reflect the overall balance of risk** and continue to attract UK and international investors to support the growing investment programme across energy production and infrastructure.

The package must also underpin the substantial recruitment and investment in staff that continues within the industry and which is required to realise the required policy objectives.

At a local level, addressing these factors in RIIO-ED1 will enable us to meet the requirements of our customers and stakeholders of today and tomorrow, and efficiently deliver a lasting legacy that we can be proud of as an industry.

At a national level, RIIO-ED1 will ultimately deliver not just a low carbon economy and a resilient distribution, but it should also act as a catalyst for real GDP growth at a time in which it is critical that the UK maintains its international competitiveness.

We now consider these points and Ofgem's key themes in more detail, before turning to the detailed responses to questions outlined by Ofgem in the accompanying annexes to this document.

RIIO-ED1 LEGACY

Considering the key objectives and themes raised in Ofgem's consultation, SPEN believe that a RIIO-ED1 package containing the following features will enable us to successfully deliver the network improvements required by today's customers and stakeholders and to prepare to meet the needs of the customers and stakeholders of tomorrow:

A clear output contract with flexibility for appropriate reprioritisation: The outputs contract should provide Ofgem and customers with confidence that DNOs are meeting their regulatory contracts in return for the returns they are receiving. This must include tests of output quality and proportionate penalties where DNOs deliver lower quality outputs than they have been funded for. There are clear benefits for stakeholders if the outputs package is extended to a greater proportion of DNOs' plans in conjunction with the inclusion of asset criticality. This allows DNOs to clearly demonstrate delivery and quality of outputs whilst also responding to new stakeholder priorities.

Commercial and technical innovation to facilitate the low carbon transition: The RIIO-ED1 process comes at a time when the UK is entering a key phase of preparation for transition to a low carbon economy. We welcome Ofgem's recognition that DNOs have a key role to play in facilitating this transition, and it is important that this recognition extends to ensuring that the RIIO-ED1 package, in conjunction with wider policy developments (for example the Electricity Retail Market Reform or Common Distribution Charging Methodologies), does not unnecessarily restrict the ability of DNOs to develop distribution system operator capabilities to more efficiently and effectively meet our future customers needs.

Cost effective future proofing across all activities: It is particularly important that when DNOs are carrying out any investment activities on their networks that the ED1 package supports cost effective future proofing. For example, this could mean simply ensuring smart network components can be retrofitted or selecting specifications that will deliver customer benefits over the lifetime of assets. It is important that this activity includes new connections activities and that effective future proofing is mandatory for all electricity connections providers.

Proportionate incentive mechanisms: Incentives must be calibrated to reflect the degree to which the incentivised activity is within the control of the DNO, and to reflect the relative scale of the activity in question, both in terms of a DNO's activities and their impact on customers.

Uncertainty mechanisms that deal with risk fairly and enable DNOs to address future customers' needs in a timely manner: It is important that uncertainty mechanisms deal fairly and promptly with factors that are materially uncertain and outside the DNO's control, and that they provide associated revenues in such a manner that they do not affect the financeability of the DNO.

Balanced risks and returns: In a time of ongoing wider economic uncertainty, many features of the DPCR5 package have provided a welcome degree of certainty to investors. It is important that this certainty is not materially undermined by the ED1 package.

Given the need to continue the renewal of the UK's distribution networks, with the additional challenges presented by low carbon transition, we are concerned that the cumulative effect of the proposals (including IQI, EIR, incremental pension costs, transmission exit charges, impact of smart metering roll out, high value project thresholds, removal of the DG mechanism) is to increase DNO risk relative to returns across the regulatory contract. The effect of these changes, plus delays to revenue entitlement relative to DPCR5 in a number of areas, may undermine DNOs' ability to meet the wide range of RIIO-ED1 challenges.

As a result, it is essential that company's financeability is well within the required credit statistics, in order to ensure that companies can efficiently access capital markets, to adequately deal with the increased uncertainty of obligations and associated cash flows.

POLICY CONSULTATION - HIGH LEVEL COMMENTARY

The annexes (1 to 8) attached set out our detailed responses to the specific questions posed in the consultation documents, however, we would like to draw particular attention to certain aspects of the strategy consultation:

Areas where the proposed policies have the potential to bring significant benefits for our customers and stakeholders include:

- **An engineering-based mechanism to optimise network losses is a positive step forward for the industry and our stakeholders**
- **Asset risk is by definition dynamic. Extension of the outputs contract to a much greater proportion of DNO plans with greater scope for reprioritisation provided by asset criticality will benefit stakeholders.**
- **Retention of the broad measure of customer satisfaction, with refinement to use absolute targets and to include a measure of lost calls from customers, will provide a platform for the industry to deliver world class customer service levels.**
- **Consistency across price controls for measuring quality of supply performance and setting unplanned targets will continue to deliver world leading performance.**
- **A consistent measure of network loading risk (Load Index) across DNOs should enable greater consistency in general load driven reinforcement triggers and a consistent assessment of the impact of the low carbon scenarios.**
- **Continuation of innovation funding mechanisms will enable the industry to build on the excellent foundations laid during DPCR5.**
- **The potential for companies to build 'future ready' investments into their plans where need and benefit are proven.**
- **Uncertainty mechanisms to manage known risks of unknown scale and timing.**
- **Retention of reputational environmental incentives will drive improvements in performance.**
- **Retention of the undergrounding mechanism for areas of visual amenity and extension to AONB equivalent areas in Scotland**
- **Refinement of the worst served customer mechanism**

Areas where we believe the policy proposals require further development and have significant potential to have detrimental consequences for customers and stakeholders include:

- **The stronger incentive for companies to embed greater risk into plans and bid more aggressively, to the detriment of the industry and our stakeholders, resulting from:**
  - **a. Higher up front rewards (IQI incentive and relative allowance) for underbidding;**
  - **b. Higher efficiency incentive rates for underbidding;**
  - **c. Lower regulatory scrutiny for fast tracked companies;**
  - **d. Upper quartile unit costs for DNOs who out bid the majority of these.**

  Equivalent levels of underbidding and overbidding should be subject to the same levels of regulatory suspicion and scrutiny.

- **The cost assessment process should place as least equal weighting on top down totex modelling as disaggregated bottom up, as otherwise there are risks of cherry picking.**

- **The balance of the package increases the risk held by DNOs and delays cash flow across a number of incentive and uncertainty mechanisms relative to DPCR5.**

- **ED1 relative returns will need to be internationally competitive at a time of unprecedented demand for funding of infrastructure investment;**

- **Gearing needs to be lower than at DPCR5 levels to reflect the increased risk under ED1;**

- **Credit ratios consistent with an A rating are necessary to ensure access to financial markets;**

- **Cost of Equity will need to be higher than DPCR5 levels to reflect the higher RoRE levels we forecast will be necessary in RIIO-ED1;**

- **The proposed connections incentives (as part of the customer service incentive) are disproportionate, as they are calculated as a percentage of Allowed Revenue, whereas the relevant activity relates to <10% of a DNOs turnover.**

- **Several material known risks are currently excluded from uncertainty mechanisms.**

- **A robust challenge process is necessary to test the quality of outputs delivered.**

- **The ED1 package must enable all DNOs to future ready every new asset (connections, asset replacement and reinforcement), where there is a benefits case.**

- **The DPCR5 distributed generation mechanism should be retained and refined to include totex expenditure to allow DNOs to satisfy the needs of these important stakeholders.**

- **Pre-planned outage target setting should apply consistently to future price controls.**

The annexes attached set out our detailed responses to the specific questions posed in the consultation documents, however, we would like to provide more detailed comments on the points above, following the structure of the consultation for ease of reference.

1. OUTPUTS, INCENTIVES & INNOVATION

OUTPUTS:
Asset risk is, by definition, dynamic over time, therefore the output contract should include:

- **Greater flexibility for reprioritisation based on criticality;**
- **A greater proportion of our activities;**
- **A test of output quality and penalties for substandard outputs.**

INCENTIVES:
Should reflect the degree to which they are within the influence of DNOs and the relative value that can be delivered for customers and stakeholders.

INNOVATION:
We welcome the proposal to maintain the innovation funding mechanisms. The wider ED1 package should also fully enable and reward the rollout of commercial and technical innovation where this delivers customer or stakeholder benefits.

1.1 The Outputs-led Framework

Assuming that there is sufficient assurance surrounding the quality of an output delivered, the outputs contract should provide customers and Ofgem with confidence that DNOs are meeting their regulatory contracts in return for the returns they are receiving.

There are clear benefits for stakeholders if the outputs package is extended to a greater proportion of DNOs' plans in conjunction with the inclusion of asset criticality. This would allow DNOs to clearly demonstrate delivery of outputs whilst also responding to new stakeholder priorities.

An effective outputs framework should recognise the full range of investments necessary to ensure the integrity of the network during the ED1 period. We do not believe the framework established for DPCR5 achieves this outcome. For example, the current framework does not give recognition for investment in all asset types (e.g. low ground clearances on overhead lines, or investment to replace ageing rising mains and laterals). We would like to see this rectified in the ED1 outputs framework and will continue to engage with Ofgem's ED1 working groups to help inform policy decisions.

We welcome proposals on the further development of the asset health index to include asset criticality (we have provided a detailed response on asset criticality in Annex 2 Reliability & Safety Chapter 6 Health Indices). If developed correctly, this will allow DNOs to apply a risk-based re-prioritisation of asset investment, improving network safety for the benefit of the public, our customers, staff and contractors.

We agree that any revenues associated with undelivered outputs that remain valid should be clawed back with a penalty and that this treatment should also apply to any lower quality outputs that have been delivered on a prorated basis. However, there are circumstances where the correct course of action is to reprioritise activities in order to delay investments, or where outputs are no longer required for valid reasons. In these circumstances, it would seem appropriate that a company should lose the majority of revenues that it has already received, but that this claw back might be subject to a reward mechanism to encourage the correct behaviours. Given the proposed strengthening of the Efficiency Retention Incentive, combined with an eight year price control with annual allowed revenue model iterations, and the uncertainties of the transition to a low carbon economy, we do not believe that DNOs should have to fund the catch-up of undelivered outputs for the period of the next price control.

1.2 Driving Sustainable Networks

It is essential that we consider future customer's needs in every facet of our activities, and if it is cost effective to do so, we should both be enabled and incentivised by the RIIO-ED1 package to future proof the investments we are making on behalf of our customers.

We welcome Ofgem's recognition that DNOs have a key role to play in facilitating the transition to a low carbon economy. It is important that this recognition extends to ensuring that the ED1 package, in conjunction with wider policy developments (for example the Electricity Retail Market Reform or Common Distribution Charging Methodologies) do not unnecessarily restrict the ability of DNOs to develop distribution system operator capabilities to more efficiently and effectively meet our future customers needs.

It is particularly important that when DNOs are carrying out any investment activities on their networks that the ED1 package supports cost-effective future proofing. For example, this could be simply ensuring smart network components can be retrofitted or specifications that will deliver customer benefits over the lifetime of assets that in some cases will be >80 years. It is important that this activity is not restricted to asset replacement but also includes new connections activities and effective future proofing is not just required but mandatory for all electricity connections providers.

1.3 Environmental Impacts

We support strongly the proposal to introduce an engineering-based losses mechanism which has the potential to deliver significant and tangible benefits for stakeholders.

We welcome the retention of the undergrounding mechanism in Areas of Outstanding Natural Beauty, the extension to cover the equivalent areas in Scotland, and the retention of a reputational incentive for Business Carbon Footprint.

SPEN share Ofgem's commitment in encouraging DNOs to fully contribute to the achievement of GB carbon targets. The measures proposed strive to offer the necessary incentives to further build on our reputational incentive to be the leading Network Operator in the UK. We believe that there could be further improvements in the losses incentive (as outlined in our detailed question response to Annex 1 Outputs, Incentives and Innovation Chapter 5 environmental Impacts). We are committed to working with Ofgem through the working groups to arrive at a suitable framework that allows all of the DNOs to work together to realise our aim of carbon emission reduction.

1.4 Customer Satisfaction

We support the continuation of the Broad Measure of Customer Service including:

- **Absolute rather than relative targets; and**
- **Inclusion of lost customer calls; and**
- **More appropriate weighting of ombudsman complaints; and**
- **Consistency in interpretation and reporting across DNOs;**

However, we believe there is clear evidence that the current proposals are disproportionately weighted to connections activities.

Our customers have clear expectations of the level of service they wish to receive from us, now and in the future. They tell us they want us to:

- Answer every call and communicate proactively; Always have the option to speak to a person;
- Provide good, accurate information and keep them informed;
- Restore supplies quickly; Limit or stop multiple interruptions;
- Keep our promises.

We fully support Ofgem in driving the industry to high levels of customer service via the Broader Measure of Customer Service (BMCS) introduced in DPCR5 and believe it is an essential framework to drive improvements in customer service across all DNOs. We believe it is essential for Ofgem to ensure that all DNOs are reporting customer contacts on a consistent basis and applying equal standards of reporting across all contact channels.

We have been actively involved in Ofgem's Customer and Social Obligations working group and broadly agree with the changes to the incentive for customer satisfaction for interruptions and general enquiries. However, we feel that the proposed percentage increase for Connections is disproportionate when compared to the volume of work undertaken in this area. We also believe that sustainable improvements in customer service can be best achieved by fixing targets for the full price review period based on absolute scores rather than mean DNO performance. This approach will encourage DNOs to share best practice, which will benefit all customers in the long term.

We have made significant investments in technology to improve the service we provide to customers, making it easier for them to contact us. Further investment is also planned for 2012/13 to deliver additional improvements and enable customers to contact us in a variety of different methods. We feel strongly that as the BMCS is intended to measure all aspects of our service, the customer satisfaction scores should include all customers; therefore, the inclusion of Unsuccessful Calls within BMCS is essential in providing a fair and standard measure across all DNOs and should be measured for all categories. We also feel that the BMCS should include inbound contacts via phone, email, text, web chat and online where we have given customers a specific contact channel. We envisage social media being part of our communication strategy to engage customers and seek their views, however, we do not see this as a specific contact channel to be included in the incentive.

In our view, the current measure and weighting of Ombudsman Complaints under DPCR5 are treated disproportionately to the total number of complaints received. We would like to see this mechanism revised with a greater focus on direct customer compensation. We would also like to see a reduced weighting on Day 1 complaints to ensure the incentive drives the right behaviour in terms of quality of response to our customers.

1.5 Social Obligations

A multi-agency approach supported by a discretionary incentive mechanism will allow DNOs to develop their social obligation services in response to customer needs.

We take our social obligations very seriously and we are acutely aware that a significant proportion of fuel poor customers exist within our operational areas Throughout our involvement with Ofgem's Customer and Social Issues working group, we have maintained that vulnerable customers should be the main focus of DNOs, however, as the role of the DNO develops within the ED1 period, we would consider participating in a multi-agency approach to identifying appropriate energy solutions for customers.

1.6 Connections

We recognise that our connections activities have a major role to play in facilitating the transition to a low carbon economy, as well as contributing to economic growth, and we will continue to focus significant resources into providing the highest level of service for our customers in this area.

The proposed levels of new connections incentives appear disproportionate relative to the entirety of a DNO's activities. As proposed this is calculated as a % of allowed revenue when the activity relates to <10% of a DNOs turnover, only a subset of which DNOs are allowed to make any profit.

In addition, a time to connect incentive might include aspects that will be difficult to compare across DNOs, given the differences in:

- **The topography in which DNOs operate;**
- **The types of connecting customers (e.g. >1/3rd of GBs renewable generation has connected to SPEN networks)**
- **Levels of competition (e.g. SP Distribution facilitates the highest level of connection competition in the UK. The 50% delivered by competitors tend to be higher volume, lower cost connections typically in urban and suburban areas).**

SPEN have been actively involved in the ED1 consultation process via the Connections working group and have extensive experience of competition in connections within SPD and SPM distribution licensed operating areas. We believe Ofgem's proposal for ED1 contains elements that are disproportionate. Whilst the focus on improvements to customer service has been welcomed within the industry, Ofgem's proposals have the potential to provide a disproportionately higher level of risk in the connection of both demand and generation connections. In addition, we are concerned that if the targets for the BMCS remain relative rather than absolute, then there is the risk that some DNOs could face significant penalties for what may be only marginally poorer performance than others.

We believe that the Distributed Generation Incentive Mechanism (DGIM) should remain, possibly within a revised form, to allow DNOs to make targeted investments to facilitate ease of connections in generation-rich areas and for multiple speculative projects.

The Average Time to Connect incentive proposals are welcomed by SPEN for minor customers, although we have concerns that these incentive proposals may not deliver the desired behaviours for major customers. Whilst 'quicker feels better' for minor customers, major customers often want to be connected at the right time rather than sooner.

SPEN do welcome the proposed change in the treatment of customer contributions. The ability for the DNO to consider investment ahead of need, without the threat of such investment being deemed inefficient is welcomed. We also welcome the proposed standard load index categories as this will allow greater consistency in general load driven reinforcement triggers across the industry, which is a concern that our stakeholders have raised in meetings with us and Ofgem.

1.7 Efficiency Incentives and IQI

We are concerned that the proposed calibration of the Information Quality Incentive (IQI) and Efficiency Incentive Rate (EIR), in combination with the lower scrutiny for fast track companies, results in a clear incentive for companies to adopt an overly aggressive and optimistic approach to their ED1 bid in an effort to obtain additional rewards whilst minimising regulatory scrutiny.

Given the recent experiences of the West Coast mainline tender process, we are confident that this is not the intended consequence of this package of policy changes and would suggest that these incentives should be accompanied with mechanisms that appropriately assess and deal with risk. Given the consolidation in the industry, an individual company's approach to risk could have material effect on all others, which may only be understood after the event.

Consequently, there is also a strong regulatory case that the business plan of any company whose bid is materially below the Ofgem vision of efficiency should be subject to at least regulatory scrutiny comparable to that of a company who has materially overbid, and we seek further clarity in the Policy Decision document on how Ofgem intend to deal with this risk if not through a more balanced calibration of the IQI and EIR incentives.

IQI is now an established part of the price control process, having been used in DPCR5, RIIO-T1 and now RIIO-ED1. We believe that the IQI mechanism incentivises accurate forecasting of expenditure, and are supportive of its inclusion as part of the ED1 process. There is an interaction between the cost assessment process and the outcome for DNOs under IQI. Historically, the overwhelming majority of IQI ratios have been well in excess of 100. If upper quartile benchmarking is used to form both the DNOs' allowances and Ofgem's view of the IQI process this will continue.

The relationship of the proposed IQI matrix and the setting of allowances at the upper quartile will make it almost impossible for a DNO who accurately forecasts their costs to earn their allowed return on equity. At the highest level, quartile benchmarking ensures that 75% of DNOs will have negative additional income. This fraction can only increase as weighting is given to any disaggregated results.
We believe that the proposed matrix is consistent with mean rather than upper quartile benchmarking. If Ofgem wish to use an upper quartile benchmark, the proposed matrix must be replaced with a positive additional income matrix similar to the revised RIIO-GD1 or DPCR5 matrix.

We believe that the mean benchmark is inherently more robust than a quartile benchmark, and shareholders would only accept the proposed matrix on the basis of mean benchmarking.
We estimate that use of the matrix in this policy consultation, together with a quartile benchmark (or with a distribution of IQI ratios similar to those at GD1 and DPCR5) reduces the expected return on equity by around 100bp relative to DPCR5.

It seems logical to extend the Efficiency Incentive to a broader range of costs. We note that the proposed rate for ED1 is around 5% higher than the effective rate at DPCR5. We estimate this provisionally as an increase in risk of 15-20bp, and would expect that this be taken into account when setting gearing and cost of equity.

1.8 Encouraging Innovation

We are strongly in favour of the Ofgem proposals on Innovation Funding and welcome the three components - NIC, NIA and IRM.

We recognise the importance of an innovation strategy which outlines our approach not only to the NIA and NIC, but also how innovation forms an integral part of our overall business plan and an essential element of our business as usual activities. Our parent company, Iberdrola, is the only electricity company to have been included in the ranking of the top 1000 companies in R&D investment worldwide, drawn up by U.S. consultancy firm Booz & Company. We favour a "think big, start small, scale fast" approach in delivering technically advanced projects which can deliver significant benefits to our customers, stakeholders and the wider industry.

2. RELIABILITY AND SAFETY

We strongly support the proposals for improved reliability and safety of the network, and in particular, the introduction of a Risk Index Framework, which we believe will benefit our customers and stakeholders.

Further work is required to define a common banding for load index across the DNOs, which may deliver greater consistency for stakeholders operating across network areas and ensure that the relative impact of the low carbon scenarios can be better understood.

Changes to guaranteed standards for supply restoration may require greater use of portable generators, which will require the industry to consider the safety implications of such a move for the public, our staff and contractors.

The long term reliability and safety of our network is a fundamental part of our asset management policy. We welcome the continued focus within ED1 on the delivery of primary outputs and secondary deliverables and we will continue to work with Ofgem to ensure the comparability of output measures and assessment of risk.

Safety of our network for members of the public, staff and contractors is a key primary output and compliance with HSE legislation is an essential requirement for which financial incentives are unnecessary. We support the continued opportunity to be rewarded for improved reliability of our network as measured through the Interruptions and Incentives Scheme (IIS) mechanism.

Separating planned and unplanned interruptions targets will provide more transparency between performance under fault conditions and performance during outages required to carry out necessary network investment. We support upfront target setting for both planned and unplanned interruptions to reduce the level of uncertainty in our business plans, and agree that the level of revenue exposure is appropriate. We do not believe it is necessary to incentivise short interruptions but do believe a simplified worst-served customer scheme is required to improve the performance for customers who experience a high volume of interruptions.

A reduction in the Guaranteed Standards from 18 hours to 12 hours will require a review of our working practices (for example involving greater use of portable generators). Such a review must carefully consider the safety risks associated with any proposed changes and how we ensure the continued protection of the public, our staff and contractors. Moving to an automatic payment to all customers, whilst desirable, is not easily achieved in practice.

We are supportive of the development of the Health Index framework into a Risk Index framework, although further work is required to develop a common methodology across DNOs and the extension to additional categories will be subject to the availability of the necessary data. Extension of health indices to ESQCR clearances and Internal Mains are appropriate in ED1.

Load index methodologies differ between DNOs and although we support a common banding for Load Index, further work is required to understand the assessment of the parameters used. Consideration of network risk is required to avoid unnecessary investment ahead of need balanced against providing adequate capacity in a timely manner when required. During ED1, it is likely that more generation-dominated substations will appear and a DG Index may be appropriate at the midpoint review. Uncertainty around the quantity and demand profiles associated with the uptake of low carbon technologies could result in reinforcement which can't be accurately forecast, but this can be catered for through the proposed volume driver.

We are supportive of the proposed measures of network resilience to assess whether DNOs are adequately investing to manage the impact of increasingly unpredictable disruptive events, such as flooding and Black Start. We would also consider an additional metric measuring OHL network resilience under storm conditions.

3. TOOLS FOR COSTS ASSESSMENT

Efficiency frontier and allowances should be set at the Median rather than upper quartile considering the interaction with the IQI matrix and efficiency incentive;

Disaggregation at an intermediate level provides a valuable check on the highest level assessment. However, there is greater sensitivity to normalisations and insourcing/outsourcing choices;

Therefore, we propose that by far the greatest weight must attach to benchmarking at the highest level, and would suggest a minimum ratio of 4:2:1 in weightings between Total: Intermediate: Low Level models.

We welcome the consultative approach of the Cost Assessment working group and the stated objective that the ED1 cost assessment, and allowance setting, is determined in a transparent way. We strongly support the approach to developing alternative models to establish appropriate allowances and the inclusion of forecasts data rather than over-reliance on historic data. Comparison of the disaggregated approach to the middle and totex models will facilitate important testing to ensure the calculated allowances are valid and reasonable.

We believe median would be the appropriate efficient frontier for allowance setting and encourage Ofgem to also consider this approach. The inherent data consistency issue in disaggregated benchmarking across the 14 DNOs is too great to support upper quartile as valid or equitable for modelling the efficiency frontier. If the output from cost assessment is to feed directly into the Ofgem view in the IQI Mechanism, the benchmarking must be relative to the mean (the regression line), rather than the quartile.

For a predictable outcome across cost assessment and IQI, a mean benchmark is essential to inform the Ofgem view and the overall RoRE impact should be calibrated via the IQI additional income term. Use of a quartile benchmark to form the Ofgem view in the IQI process leads to a double penalty for the average DNO through both the benchmark shortfall and IQI. To do otherwise, with the proposed IQI matrix, will result in the majority of DNOs (who finish behind the quartile) earning much less than their allowed return on equity even if they spend to allowance.

An area of the modelling that we will work to develop is the determination and exclusion from the modelling of atypical costs and non-modelled costs. It is crucial to the modelling that as far as is practical the DNO costs are presented on the same basis and that appropriate adjustments are made for regional or other factors..Consistent with DPCR5, we will present SPM's integrated network configuration as a company-specific adjustment.

Only when the application of the overall approach, and how the output and findings of the three proposed models are brought together, will we be able to develop an informed opinion on the appropriateness of the cost assessment model being developed for ED1.

Through our participation in the Cost Assessment working groups, we will continue to work closely with Ofgem to shape the cost assessment models and approach until the final version is shared with DNOs in May 2013.

We believe that there is a clear and robust hierarchy of levels at which quantitative benchmarking can be carried out. Given this hierarchy, we do not believe that an unweighted average of the output of aggregated and disaggregated models is justifiable.

Totex benchmarking at a whole-group or whole-DNO level is likely to give the most reliable quantitative estimate of realistic efficiency for actual businesses, immune to cherry-picking, cost allocation inconsistency and insourcing/outsourcing choices. This is the preferred level.

Disaggregation at an intermediate level provides a valuable check on the highest level assessment. There is greater sensitivity to normalisations and insourcing/outsourcing choices. Drivers tend to have poorer statistical properties, and the greater dispersion of DNOs around the benchmark in individual cost categories makes regression (with a maximum of 14 units, even if pooled over several years) much more sensitive to the position of individual DNOs. This is a particular problem where DNOs at extremes of size lie any distance from the regression line.

Extreme disaggregation exacerbates the problems present at the intermediate level. It becomes harder to find a complete set of drivers across all cost categories which are statistically useful predictors of cost. While very low level drivers may offer intuitive comfort, they are unable to capture the intrinsic (non-efficiency) differences between networks. Many candidate drivers vary materially from year to year and are under the control or influence of the DNO.

For these reasons, we believe that by far the greatest weight must be attached to benchmarking at the highest level, and would suggest a minimum ratio of 4:2:1 in weightings between Total:Intermediate:Low Level models.

4. BUSINESS PLANS AND PROPORTIONATE TREATMENT

4.1 Business Plan Assessment – Process

We are concerned that proposed changes to the assessment process successfully used in RIIO-T1 and GD1 will lead to more, rather than less, regulatory scrutiny.

We do not consider it necessary for fast track companies to receive additional financial reward beyond those provided by appropriately calibrated IQI/EIR mechanisms.

We agree with Ofgem's view that regulatory scrutiny should be proportionate to the quality, robustness and justification of the DNO's business plan. However, we are concerned that the proposal to shorten the assessment process from that used in RIIO-T1 and GD1, removes the opportunity for DNOs to fine-tune their business plans based on initial Ofgem feedback. We believe this undermines the principle of focusing regulatory attention where it is likely to produce greatest value and may lead to a reduction in the number of DNOs achieving fast track status. We consider this to be a retrospective step in the RIIO framework, leading to greater, rather than less, regulatory scrutiny.

We do not consider it necessary to provide additional reward for fast track companies over and above the advantages outlined within Ofgem's strategy consultation. We believe the direct benefits of fast track status plus the reward achieved through an appropriately calibrated IQI incentive (e.g. rewarding companies for bids that match the efficient view) would provide sufficient reward.

4.2 Cost Benefit Analysis

We are in agreement with the ED1 proposals on Cost Benefit Analysis (CBA) and intend to develop our internal CBA processes in line with the guidance provided through the Ofgem Cost Assessment working group. This will form an integral part of our business plan.

We fully support Ofgem's proposal for the use of a consistent Cost Benefit Analysis model across the DNOs. We have committed to undertake a more comprehensive review once the model has been fully developed. We wholly agree that there should be a threshold level for CBA. For large projects, the benefits are clear, however, we prefer to aggregate large volume activities (e.g. RMU replacement) and carry out CBA at a programme level. This allows us to undertake analysis on activities which, on an individual basis, have a low expenditure. We would promote this approach for consideration at the Cost Assessment working group and look forward to working with Ofgem and the other DNOs in developing a suitable approach for ED1.

5. UNCERTAINTY MECHANISMS

We welcome the proposal to continue to manage uncertain costs through uncertainty mechanisms that deal fairly with risk.

These are essential features of ED1 to enable companies to address future customer's needs in a timely manner, and should function in such a manner that they maintain DNOs financeability.

We believe that there is clear evidence that the ED1 uncertainty mechanisms should include additional risks than proposed, and these include:

a) Transmission exit point charges
b) Smart metering costs
c) Black start costs

There are also strong arguments for an uncertainty mechanism to deal with real price effects

It is important that uncertainty mechanisms deal fairly and promptly with factors that are materially uncertain and outside DNOs' control, and provide associated revenues in such a manner that they do not affect DNOs' financeability.

The eight year period of ED1 offers considerable certainty in the clarity and levels of investment for those activities that are clearly defined and that are stable. We welcome the extension of the period from five to eight years and agree that the benefits in resource and finance planning far outweigh the disadvantages of dealing with those activities for which there is a low level of clarity. We are, however, entering a period where the level of uncertainty in how our networks will be required to perform is such that uncertainty mechanisms are a vital part of mitigating risk. We are committed to working with Ofgem to develop a series of uncertainty mechanisms that provide a method for mitigating risk whilst at the same time ensuring best value for our customers.

Transmission exit charges:
We agree with the proposal that transmission exit charges should not be subject to an incentive mechanism as at DPCR5, as this has simply been an incentive that has rewarded higher forecasting.

We believe that the relationship between DNOs and the TSO, and the price-controlled nature of the Transmission Network Owners, means that there is a strong efficiency challenge to the provision of new Grid Supply Points. In addition, the biggest risks in relation to transmission exit charges relate to:

- National Grid charging methodologies; and
- The age of connections that we are being charged for.

In the case of SPD and SPM, when National Grid changed to a shallow charging methodology, our combined exit charges dropped from around £100m p.a. to c£20m p.a.,

It would seem entirely disproportionate to expose DNOs to such a change or to a windfall gain if National Grid reduced its charges to DNOs.

Secondly, the majority of the boundary points between National Grid and DNOs utilise assets that are over 40 years old, meaning that the DNOs are only paying Operation and Maintenance charges for these sites and are not paying capital return or depreciation charges. However, if connection assets fail, or need replaced based upon condition then the associated charges faced by the DNO will be significantly higher.

This is a risk that is disproportionately higher for SPD relative to other DNOs, due to the 132kV boundaries in Scotland. For example, SPD has 83 GSPs whereas SPM has only 18. It would seem unreasonable to introduce a mechanism that disproportionately impacted one industry party.

We believe that as many aspects of these charges are outside the control of a DNO this should return to being a pass-through charge, and that the current pass-through treatment for wheeling charges between DNOs should be extended to transmission exit charges.

Smart Metering Costs:
It is becoming clear that potential smart metering costs will not be known across a number of potential cost categories prior to DNOs finalising their business plans for submission in July 2013.

In particular, the costs DNOs will face for the set up and operation of the new licensed entities will not be known with any certainty until the tender processes are complete, and even then, the nature of the regulatory arrangements are such that there are likely to be unknown but regulated costs that DNOs will face throughout the ED1 period. As a consequence, this uncertainty also extends to the proposed IT and business systems DNOs will establish to utilise smart metering data.

We believe these uncertainties are best addressed by a pass-through mechanism and reopener respectively.

Black Start costs:
DNOs are continuing to consult with DECC about the completion of a common specification for black start resilience, and in particular what this might mean for communications systems. Until these activities are complete, it is not possible to accurately forecast the costs involved in this area, which could be significant, depending upon the agreed solution.

We believe this uncertainty is best addressed by a reopener mechanism.

Real Price Effects:
In relation to paragraph 9.26 of the Outputs, incentives and innovation paper we do not believe that the forecast of RPEs should be included in the IQI Mechanism. Our appendice providing the response to the Cost Assessment annex provides greater details about the degree of uncertainty.

Any business which (accurately) forecast RPEs higher than the Ofgem forecast would be exposed to an unjustified loss of additional income simply because of the inherent uncertainty in forecasting. RPEs are not comparable with the wider IQI process, where it is possible to form an absolute (if still uncertain) view of efficient cost and how forecast cost relates to this.

We believe that RPE risk should not form part of the IQI mechanism, and should be dealt with via an appropriate and distinct uncertainty mechanism.

6. FINANCIAL ISSUES

ED1 relative returns will need to be internationally competitive to support UK DNOs ability to finance their investment programmes at a time of unprecedented demand for the funding of infrastructure investment;

Gearing needs to be lower than DPCR5 levels to reflect the increased risk from higher expenditure to RAV, IBoxx debt indexation and longer duration of cashflows;

Credit ratios consistent with an A rating are necessary to ensure access to financial markets and mitigate risk of contagion from the continuing sovereign debt crisis. BBB investment grade credit rating will be suboptimal and will increase the overall WACC; and

Cost of Equity will need to be higher than DPCR5 levels to reflect the higher RoRE levels we forecast will be needed in ED1 associated with the higher risks from areas such as the proposed IQI / efficiency incentive, the longer price control period and incremental pension funding risks.

We welcome Ofgem's commitment to ensuring that DNOs are able to finance themselves. It is essential that DNOs are able to attract and retain funding from investors in a global capital market. DNOs are predominantly financed by international companies, global infrastructure funds and sovereign wealth funds. All of these allocate capital across countries and sectors on the basis of relative returns.

There are unprecedented demands for the funding of infrastructure investment. The OECD report on Infrastructure to 2030, published in 2006/07, estimated global infrastructure requirements to 2030 to be in the order of US$50 tn. The International Energy Agency also estimated that adapting to and mitigating the effects of climate change over the next 40 years to 2050 will require around US$45 tn or around US$1 tn a year.

In the UK, DECC has acknowledged the need for £200 bn of investment in our energy infrastructure by 2020. Npower has published the Future Report that projects that up to £330 bn of investment will be needed by 2030.

Analysts and rating agencies have already warned that too low a return would fail to attract sufficient funding, given the increased risks and the unprecedented increase in investment requirements. Furthermore, new regulation recently approved and to be implemented in the coming years will affect sources of finance (debt and equity) for infrastructure, potentially limiting their availability. Proposed EU legislation, following the review of the Directive on Institutions for Occupational Retirement Provision (IORP Directive), could apply the Solvency II approach to occupational pension schemes, which would have an impact also on infrastructure investment. Basel III will affect in particular long term bank lending. In addition, the Volker Rule and the EU Directive on Alternative Investment Fund Managers (AIFM) will have consequences on infrastructure funds and fundraising in the future.

We are concerned that, for the electricity DNOs, indexation of the allowed cost of debt is expected to increase the risk of error in estimating the cost of debt. This is because of the relatively infrequent need for DNOs to issue debt results in a profile vastly different from that implicit in the construction of the index as the average of daily yields.

We propose that Ofgem use a longer weighted average of yields, starting from January 1998 (from when the iBoxx yields become available), which continues to expand in length, until it becomes a 20 year trailing average. This would smooth out movements in interest rates and more closely match the maturity of DNO debt.

Nevertheless, it is essential that residual risk arising from debt indexation is fully reflected in the cost of equity, as shareholders bear the residual risk. Moreover, RoRE analysis should include the risk of a mismatch between the actual and the allowed cost of debt.
Furthermore, initial analysis suggests that electricity DNOs are relatively more risky than GDNs, with:

- Higher capex/RAV
- Higher opex/RAV; and
- Higher totex/RAV ratios

The "cash flow risk", as measured by totex/RAV is expected to be similar to RIIO-T1 and substantially higher than RIIO-GD1.

While the theoretical debates about the impact of the longer duration of cash flows in RIIO may continue, we are clear that a longer price control period and the increase in the assumed lives of new assets will increase the risk compared to DPCR5. Simply, risk will be higher as respectively more unanticipated developments will occur over a longer time period than a shorter one and the period capital will be invested will increase substantially. NERA have estimated that the increase in asset lives will increase the risk premium by 50bps.

Similarly, Oxera have estimated the term premium component to be 70bps.

Furthermore, the longer price control period means that the allowed return is locked in for more years, increasing the required return. In US regulation, an allowance is made for this through an additional "stay-out" premium.

In addition, considering the entire strategy consultation, the RoRE analysis will also need to reflect additional risk from the Investment Quality Incentive (IQI) from the higher range for the totex efficiency incentive rate. Also, as proposed in the strategy document, the incentive will now include 'incremental' (post-31 March 2010) ongoing pension contributions and the 'incremental' pension deficit funding. Considering these issues, investors will be seeking a higher Cost of Equity for electricity DNOs than that proposed for GDNs and that allowed for DPCR5 and at the upper end of Ofgem's proposed range.

Ofgem will need to take cognisance that international demand for infrastructure investment will drive competition for equity infrastructure investors. ED1 relative returns will need to be internationally competitive to support UK DNOs' ability to finance their investment programmes.

We require a package of financial measures that maintains our investment grade credit rating with sufficient certainty, in the face of the risk of contagion from the continuing sovereign debt crisis or adverse changes in the RPI. We do not consider that a package with potential requirements for dividend cuts would be consistent with utility investors' requirements for income.

We consider a BBB investment grade credit rating to be suboptimal and this will increase the overall WACC. Furthermore, low investment grade rated companies face the risk that financial markets will become effectively closed to them in periods of capital market disruption. This risk should be mitigated by the initial credit metrics and gearing assumption, which should be consistent with an A rating. To ensure an adequate credit rating, we propose a lower level of gearing than that assumed for DPCR5.

7. IMPACT ASSESSMENT

We believe there are additional risks that have not been adequately identified or mitigated in Ofgem's Impact Assessment and would welcome a further review of the Impact Assessment ahead of the Policy Decision in February 2013.

We have reviewed Ofgem's Impact assessment and whilst we agree with the majority of the areas of risk identified and mitigating actions, we are concerned that there are a number of areas of the proposed ED1 strategy that may result in significant risk for the DNOs. Our areas of concern are detailed in our response to Annex 7 – Impact Assessment. These areas are summarised as follows:

- The assessment of allowances is not proportionate, robust and accurate;
- The difference between the IBoxx and the DNOs embedded debt;
- Consideration of the connection and application of low carbon technology;
- Inclusion of incremental pension funding and deficit within efficiency Incentive;
- Suitability of upper quartile benchmarking considering the revised IQI matrix;
- Aggregate of uncertainty mechanisms / reopener thresholds.

8. ANNEXES

Our detailed response to the Policy Strategy and answers to the questions posed by Ofgem are contained within the following Annexes:

- SP Energy Networks Response to Annex – Overview
- SP Energy Networks Response to Annex – Outputs, Incentives and innovation
- SP Energy Networks Response to Annex – Reliability and Safety
- SP Energy Networks Response to Annex – Tools for Cost Assessment
- SP Energy Networks Response to Annex – Business Plans and Proportionate Treatment
- SP Energy Networks Response to Annex – Uncertainty Mechanisms
- SP Energy Networks Response to Annex – Financial Issues
- SP Energy Networks Response to Annex – Impact Assessment