Ofgem Strategy Consultation for the RIIO-ED1 Electricity Distribution Price Control
Issued 28th September 2012 (Ref 122/12)
SP Energy Networks Response to Annex – Impact Assessment

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OVERVIEW

We welcome the opportunity to comment on Ofgem's Strategy consultation for RIIO ED1 – Annex Impact Assessment – reference 122/12 published on 28th September 2012.

QUESTIONS RESPONSE

Table of Contents

1. CHAPTER ONE – KEY ISSUES AND OBJECTIVES

No questions posed.

2. CHAPTER TWO - IMPACT OF RIIO-ED1 PROPOSALS

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

SPEN agree that Ofgem have identified the significant impacts that RIIO ED1 will have on customers, competition, sustainable development and safety.

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

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.

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

It is too early to identify any further areas for impact assessment at this time. As the DNOs develop their business plans, we expect the implications of RIIO-ED1 will become clearer, and therefore suggest a further IA at this time.

3. CHAPTER THREE – RISKS AND UNINTENDED CONSEQUENCES

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

We believe the IA has not given due consideration to the risk Ofgem's assessment of allowances is not proportionate, robust and accurate. This risk has the potential to greatly impact customers and the economy's recovery from recession and merits more thorough consideration in the IA. It would aid transparency if details of Ofgem's mitigation actions to ensure the proportional and accurate setting of allowances was provided.

We would like to see the implementation of indexation of debt based on a 10 year index as part of the implementation of RIIO quantitatively risk assessed in future IA. In paragraph 2.32 Ofgem have set out the proposed cost of debt approach under RIIO. This suggests the indexation approach to RIIO will allow the cost of debt to be set more closely to actual debt costs over time. A future IA should consider the impact on the longer term embedded debt in the DNOs. The DNOs' existing RAV values at the commencement of RIIO-ED1 are partially funded by debt, of which, as would be expected of prudently funded infrastructure companies, a proportion will be long-term in nature and have a greater maturity than 10 years. The cost of this debt will be different from the 10 year index due to the longer term nature of DNO financing and the impact of this RIIO approach should be quantified.

There is a significant level of uncertainty within the RIIO-ED1 price review, particularly associated with the connection and application of low carbon technologies, the setting of allowances which reflect the varying nature of different networks and the extended price control period of eight years. In the main, we believe the IA has captured these risks, but we would suggest further IA as proposed below:

We believe that the proposals for the inclusion of the incremental pension (post March 2010) funding and pension deficit in the totex efficiency incentive and the interaction of the proposed IQI matrix with the proposal to set allowances using upper quartile benchmarks would benefit from more detailed consideration under IA:

Incremental Pension Funding - In paragraphs 2.17-19 Ofgem sets out the intention to utilise uncertainty mechanisms to mitigate risk in areas of uncertainty. We believe an IA should consider the proposals to include incremental pension costs including ongoing funding and pension deficit in the totex mechanism. That many of the material inputs to pensions, including contribution rates and deficit calculations are outside the control of DNOs is reflected in paragraph 2.18, where it states that uncertainty mechanisms should only be deployed where network companies are unable to manage the uncertainty they face. We believe that the inclusion of an uncertainty mechanism for incremental pension costs would not undermine efficiency incentives or increase complexity, but would be in the interests of customers. Changes due to unexpected movements in market conditions could lead to relatively large variance from initial forecasts, potentially causing significant over or undercharging of customers during RIIO-ED1 and beyond

IQI / upper quartile benchmarks - We suggest that the next IA considers if the proposal for upper quartile benchmarking is appropriate for the proposed IQI matrix. 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 the DNO's allowance and Ofgem's view in the IQI process this will continue.

We estimate that use of the matrix in the September Strategy 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.

The relationship of the proposed IQI matrix and setting allowances at the upper quartile will make it almost impossible for a DNO who accurately forecast 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.

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 matrix / DPCR5 matrix.

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

Aggregate of uncertainty mechanisms / reopener thresholds - It would be appropriate for the next IA to quantitatively consider the appropriateness of the proposed thresholds across the suite of uncertainty mechanisms proposed for RIIO-ED1 and in aggregate. Many reopeners have a threshold set at a high level 1% of revenue which in several instances would require a greater than 100% increase in existing cost levels to activate the trigger.

The network operators are exposed to a suite of reopeners and the aggregate cost of several uncertainties not reaching trigger thresholds could be material. This would result in networks companies being exposed to funding a considerable level of uncertainty.

An IA considering this issue may find it appropriate to include an aggregate uncertainty accumulator to mitigate this risk to network companies.

4. CHAPTER FOUR – POST IMPLEMENTATION REVIEW

No questions posed.

5. CHAPTER FIVE – CONCLUSION

No questions posed.