

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

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OVERVIEW

We welcome the opportunity to comment on Ofgem's Strategy consultation for RIIO ED1 – Overview – reference 122/12 published on 28th September 2012. The main elements of our response are contained in the SP Energy Networks Executive Summary document.

QUESTIONS RESPONSE

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1. CHAPTER ONE – INTRODUCTION

No questions posed.

2. CHAPTER TWO – CONTEXT

No questions posed.

3. CHAPTER THREE – INCORPORATING STAKEHOLDERS' VIEWS

3.1 Question 1: *Do you have any comments on our stakeholder engagement approach?*

We support the approach Ofgem has taken to stakeholder engagement. We have no further comments at this time.

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

We support Ofgem's proposal of a non-prescriptive approach to DNO led stakeholder engagement. This allows DNOs to determine their own engagement activities with consumers and stakeholders in a manner which suits their business and stakeholders best. Through our engagement activities, we will seek to understand and, where appropriate, act on the information gathered.

4. CHAPTER FOUR – FORM AND STRUCTURE OF THE PRICE CONTROL

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

This is the first distribution price control featuring a revenue model as part of the contract. Our experience from RIIO-T1 suggests that sufficient time needs to be build into programme to test the model.

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

Our experience from RIIO-T1 is that the timetable allowed Ofgem and the DNO to clarify points, to the ultimate benefit of the stakeholder and customer. It is unfortunate that RIIO-ED1 timetable does not allow for this, but we appreciate the reasons for this change having been made.

4.3 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?*

The impact of profiling revenue in DPCR5, combined with the move to 45-year depreciation, may have a major impact. Ofgem are likely to need to profile the depreciation change or profile revenue entitlement as at DPCR5.

5. CHAPTER FIVE – ENSURING OUTPUT DELIVERY

5.1 *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?*

We broadly agree with the proposed outputs and incentives, but we believe that the success of these will lie in having a clear outputs contract with flexibility for appropriate reprioritisation. We believe that there is a convincing case that the IQI / EIR incentives are calibrated too strongly and that the proposed connections incentives are disproportionate.

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

We believe that the proposed outputs and incentive arrangements are proportionate and we view the extension of outputs and criticality arrangements as giving us the capacity to reprioritise to deal with emerging stakeholder priorities.

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

An effective outputs framework should recognise the full range of investments necessary to ensure the integrity of the network during RIIO-ED1. 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 RIIO-ED1 outputs framework and will continue to engage with Ofgem's RIIO-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 7 Reliability & Safety chapter 6 Health Indices). If developed correctly, this will allow DNOs to apply a risk-based re-prioritisation to asset investment, improving network safety to the benefit of the public, our staff and contractors.

We agree that any revenues associated with undelivered outputs that remain valid should be clawed back with a penalty. This treatment could also apply to any lower quality outputs that have been delivered on a pro rated basis. There are also, however, circumstances where the correct course of action is to reprioritise activities, 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 revenues that it has already received, but that this clawback might be subject to a reward to encourage companies to make these decisions if appropriate. Given the proposed strengthening of the Efficiency Retention Incentive, combined with an 8 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.

6. CHAPTER SIX – ASSESSING EFFICIENT COSTS

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

We welcome the consultative approach of the CAWGs and the stated objective that the ED-1 cost assessment and allowance setting is determined in a transparent way.

We strongly support the approach to developing alternative models to determine 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 modelling. 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 via the benchmark shortfall and via 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 regional or other factors are appropriately adjusted for in the modelling. Consistent with DPCR5 we will present SP Manweb'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 being developed for ED-1.

Late May is the advised timeline for the final cost assessment models / approach to be shared with the DNOs. We expect to work closely and constructively with Ofgem towards late May sharing views and interpretations of each models outputs at the regular CAWGs that are planned in late 2011 and 2012.

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

Having participated in RIIO-T1 successfully achieving fast track status, we support the proposed use of proportionate treatment, including recognition through the information quality incentive (IQI) mechanism¹. We are, however, concerned that the proposed shortened three-stage process for ED1 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 are also concerned with Ofgem's proposal for an additional reward for those companies achieving fast track status. We believe the benefits of fast track (as outlined in Annex Business Plans and Proportionate Treatment - section 3.3 Proportionate Treatment) are sufficient without the need for an additional reward.

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

We agree with the proposed criteria for assessing business plans in RIIO-ED1 and we would like to emphasise the strong requirement for the assessment process and its outcomes to be completely

¹ Our comments on the proposed IQI mechanism for ED1 are outlined in our response to supplementary annex – Outputs, Incentives & Innovation.

transparent across the DNOs². The process should enable customers and stakeholders to gain full visibility of the assessment outputs, building the credibility of the regulatory process.

7. CHAPTER SEVEN – INNOVATION

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

We strongly support the incentivisation of innovation within RIIO-ED1, continuing the competitive funding mechanism for innovation which carries an element of uncertainty. We also agree that innovation should be built into our business plans and that appropriate funding should be provided where the business case is justified. Additionally, we support the inclusion of innovation as a significant feature of our business-as-usual plans where justified by cost benefit analysis.

7.2 *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?*

We are strongly in favour of the approach that Ofgem has taken to the NIC and recognise that the continuation of a competitive fund is conducive to incentivising innovation. Based on the uptake and continued interest in the LCNF Tier 2 to date, and the level of interest that has already been expressed by Transmission Owners in the NIC for the RIIO-T1 period, we are in favour of the allowance being set at the upper limit of £90m for 2015-17.

The reasons for this are two-fold: Firstly, the Tier 2 limit of £64m has remained the same throughout the DPCR5 period, thus decreasing in real terms. The continuation of a similar threshold means a marginal decrease over time. Secondly, the selection process for NIC projects allows for an assessment of whether or not they provide value for money. Given the uncertainty over the variety of ideas and scale of projects, we do not perceive any potential negative effects in setting the cap at the upper limit (£90m) as the selection process will ensure that those projects with the potential to create the greatest value for money will be progressed. Should the projects that are proposed not provide adequate value, Ofgem are not obliged to award the full amount of money.

8. CHAPTER EIGHT – MANAGING UNCERTAINTY

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

We welcome the retention of uncertainty mechanism provision in RIIO-ED1, however, we believe that there is a requirement to include additional areas as discussed in our response to Question 2 below.

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

Yes - we believe that there is clear evidence that the ED1 uncertainty mechanisms should include additional risks. Specifically, these include:

- Transmission exit point charges
- Smart metering costs
- Black start costs

² Our detailed views on the criteria for assessing business plans are contained in our response to supplementary annex – Business Plans and Proportionate Treatment

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 simply has 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 risk in relation to transmission exit charges relate to 1) National Grids charging methodologies, and 2) to 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, this means 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 SP Distribution 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 out with the control of a DNO that 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 DNO's 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 across the ED1 period. As a consequence this uncertainty also extends to the proposed IT systems and business 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 - Work is continuing by DNOs in consultation 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

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

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

We believe that all of the uncertainty mechanisms included are necessary.

9. CHAPTER NINE – FINANCING EFFICIENT DELIVERY

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

To allow each DNO to effectively finance its expenditure it may well be necessary to allow the details of the package, for example gearing and capitalisation percentages, to vary across DNOs. We shall set out appropriate values in our well justified business plan.

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.

In addition, an explicit allowance is required for the issuance costs of debt, as Ofgem have over-estimated the apparent headroom in the iBoxx index.

9.2 *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)?*

It is essential that the cost of equity as estimated from the Capital Asset Pricing Model (CAPM) is cross-checked against alternative models, including the Dividend Growth Model (DGM) and the Inter-temporal Capital Asset Pricing Model (ICAPM).

International comparisons of allowed returns for regulated utilities should be with private sector companies, as state-owned companies often benefit from lower costs of finance, as risks are effectively transferred to tax payers.

The absence of clarity surrounding the assumed gearing makes it impossible effectively to assess the cost of equity. Nevertheless, we believe it is inappropriate to rule out an equity beta of at least unity, as, for example, would result from, say, an asset beta of 0.4 with assumed gearing of 60%.

The cost of equity will also reflect the residual risk that falls on shareholders which arises from the mis-match between the allowed cost of debt, as indexed, and the DNO's actual cost of debt. There will be significant potential mismatch, due to DNOs' high financing requirements during RIIO-ED1.

We propose that the relative risk of RIIO-ED1, compared with DPCR5 and other network companies, is assessed through risk modelling of the underlying cash flow volatility. This will provide an indication of the degrees of differences in risk between sectors and in changes of risk for DNOs between DPCR5 and RIIO-ED1.

Initial analysis suggests that electricity DNOs are relatively more risky than GDNs, with:

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

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

Our detailed views on financial issues (including pensions, tax and RAV) are set out in our response to the Supplementary annex on Financial Issues.

10. CHAPTER TEN – NEXT STEPS

No questions posed.