



**Strategy Consultation for the RIIO-ED1 Electricity Distribution
Price Control issued 28th September 2012 (Ref 122/12)
SP Energy Networks Response to Annex – Uncertainty
Mechanisms**

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OVERVIEW

The 8 year period of RIIO-ED1 offers considerable certainty in clarity and levels of investment for those activities that are clearly defined and that are stable. SPEN welcome the extension of the period from 5 years to 8 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 simply has been an incentive that has rewarded higher forecasting. We believe that as many aspects of these charges are outside 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. 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 be 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.

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.

QUESTIONS RESPONSE

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1. CHAPTER ONE – INTRODUCTION

No questions posed.

2. CHAPTER TWO – PROPOSED APPROACH TO MANAGING UNCERTAINTY

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

By its very definition we believe that it is not possible to consider all criteria for uncertainty. We believe that the proposals from Ofgem are fair and afford the opportunity to deal with the level of uncertainty we face.

3. CHAPTER THREE – POTENTIAL VOLUME DRIVER AND REOPENER AND UNCERTAINTY MECHANISMS

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

We support the design of the uncertainty driver proposed here and believe that it has worked sufficiently well in DPCR5 to merit its inclusion in RIIO-ED1.

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

We support the decision to include the low carbon technologies in the general reinforcement expenditure. As we have presented at the Flexibility and Capacity Working Group meetings, we support the volume driver for such activities on an ex-ante basis as presented in your proposal.

This mechanism is likely to need to be calibrated differently for each DNO unless the mechanism is sufficiently granular.

We propose the following:

- Select a credible scenario to set ex ante allowance
- Select range and volumes of traditional solutions to deal with this (including mid-point clustering)
- Select efficient unit costs for traditional solution
- Agree list of triggers for mechanism (e.g. transformer will be overloaded / transformer is overloaded / cable is overloaded)
- Set ex ante allowance for first 4 years (to mid point)
- Allow revenue driver to immediately flex up if exceeded
- Allow revenue driver to flex down from midpoint review (NPV neutral)
- Encourage DNOs to innovate commercially and technically as a result of ERI mechanism (driver feeds into ERI)

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

There is currently insufficient information to allow us to fully determine the costs to the DNO associated with smart metering. We do believe, however, that there will be considerable investment required for asset modernisation of the LV services and for IT, Engineering and Administrative costs to allow the full benefits from smart metering to be integrated into the DNO systems. The latter will be difficult to forecast accurately and we believe an uncertainty mechanism, other than volume driver, will be required.

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

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

We believe that the proposal for the reopener is fair and will allow us the opportunity to deal with unknown proposals from Highway Authorities or Local Authorities. The timing of the reopener, halfway through RIIO-ED1, may present a difficulty if a significant change in Streetworks charges is imposed early in the RIIO-ED1 period.

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

We are experiencing investment requirements in site security and replacement of stolen equipment on an exponential basis. Accordingly, we believe that it will be difficult to accurately forecast levels of expenditure in this area. The opportunity for a reopener is, we believe, a fair method of dealing with the uncertainty in this area.

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

Due to the high potential for growth in this and the low carbon area, we feel that the trigger for reopener is not appropriate. If there is a volume driver and the volumes (measured at unit cost) materially exceed the allowance, then there should be an increase in the ex-ante allowances to accommodate such growth.

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

We believe that the high value projects mechanism is of very real value in dealing with uncertainty. The level of expenditure trigger for DPCR5 is, we believe, the correct level for mitigating risk whilst protecting customer interests. We believe that a level of £50M is too high for projects undertaken by a DNO and request that this value is revisited.

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

We support the proposal suggested by Ofgem and believe that it provides the necessary incentives to drive innovation for the DNOs.

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

If the question relates to the repair mechanism for the 'Established deficit' then we are consider the mechanism as proposed appropriate.

However, as detail in the response to the Financial Issues chapter 6 Question 7 we do not consider the treatment of the incremental deficit to be appropriate through totex (and the totex efficiency incentive mechanism). The materiality to shareholders and customers of potential uncontrollable changes due to unexpected movements in market conditions could lead to relatively large differences compared to initial forecasts.

There is significant risk if incremental deficit movements are managed through the totex efficiency incentive mechanism. Customers could easily be significantly over/under charged over the course of RIIO-ED1 and beyond. Therefore we propose it would be more appropriate to fund these costs via a specific ex ante allowance (i.e. not part of totex) with true up, following an efficiency review, as part of the three yearly reset process.

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

We believe the following additional mechanisms should be considered:

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.

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.

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

Other than those mention above, we believe that Ofgem has captured the requirements for dealing with uncertainty. One additional comment we would offer is in the timing of reopeners that have been set at 4 year intervals. We believe, through joint agreement with the DNOs and Ofgem, that there could be a mechanism for a shorter period window for consideration of re-openers.

4. CHAPTER FOUR – POTENTIAL INDEXATION, PASS THROUGH AND TRIGGER MECHANISMS

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

We agree with the proposed RPI indexation of allowed revenues mechanism.

In due course we look forward to receiving your consideration of any potential implications of the ONS consultation on its methodology for calculating RPI.

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

We are concerned that the proposed cost of debt indexation mechanism:

- Will not cover the embedded cost of DNOs' debt;
- Does not match the profile and frequency of debt issuance by DNOs;
- Fails to allow for the issuance cost of debt;
- Inadequately accounts for the inflation risk premium;
- Increases the risk borne by equity;
- Exposes customers to the risk of increases in interest rates; and
- Contributes significantly to the volatility of charges.

Our concerns are set out more fully in our answer to Question 3 of Chapter 2 of the Financial Issues appendix.

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

We agree with the proposed continuation of the policy of pass through of Ofgem licence fees and business rates.

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

We agree with the proposal to maintain a tax trigger mechanism. We have made some specific comments on the operation of the deadband in our response to Question 2 of chapter 5 of the "Financial Issues" Annex:

We agree the materiality of the proposed dead band calibration level is at an appropriate values to adjust for changes to taxation. However, once the dead band threshold is breached we believe that

the whole of the tax trigger effect should be adjusted, not just the amount in excess of the dead band limit.'

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

We note that the process currently set out in Electricity Distribution licences, which provides for a licence modification referral by the Authority to the Competition Commission, is no longer applicable as a result of changes to the licence modification process set out in the Electricity Act in response to the Third Energy Package.

We acknowledge the reference to consideration of a request from the licensee to reopen its price controls. However, this is couched in terms of a scenario in which the licensee is unable to finance its activities. There also needs to be consideration of circumstances in which continuation of part of the price control is no longer appropriate in its existing form, even though there may be no immediate threat to the licensee's ability to finance itself. The existing licence provisions are not tied to the financeability criterion, and we do not believe that the ED1 provisions should be either. Consideration should be given to a mechanism, perhaps analogous to those proposed in the case of financial instruments, whereby in certain circumstances the licensee may trigger a formal licence modification process to disapply all or part of the price controls.

We shall be responding separately to the informal licence drafting consultation on disapplication conditions.

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

We believe there are additional mechanisms not captured in Ofgem's strategy consultation:

Incremental Pension Deficit:

We believe a mechanism is required that removes the incremental pension deficit from the totex efficiency incentive mechanism.

There is significant risk if incremental deficit movements are managed through the totex incentive mechanism. The materiality to shareholders and customers of potential uncontrollable changes due to unexpected movements in market conditions could lead to relatively large differences compared to initial forecasts.

Customers could easily be significantly over/under charged over the course of RIIO-ED1 and beyond. Therefore, we propose it would be more appropriate to fund these costs via a specific ex ante allowance (i.e. not part of totex) with true up, following an efficiency review, as part of the three yearly reset process.

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.

5. CHAPTER FIVE – MID PERIOD REVIEW OF OUTPUTS

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

We agree that mid period reviews should be limited in scope to new material factors that were unknown at the time of the submission of company's RIIO-ED1 plans.

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

We are concerned that the process set out may lead to significant uncertainty around prices and perhaps the need to issue two sets of indicative prices in December 2018. As a consequence, we believe that this process should start a month earlier.

5.3 *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?*

Any license changes should be implemented at an appropriate time to respect stakeholders' entitlement to appeal the result and should take into account the timing risk that an appeal would introduce.