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Dear Anna

Strategy Consultation for RIIO-ED1

Scottish and Southern Energy Power Distribution (SSEPD) welcome the opportunity to provide our views on Ofgem's Strategy Consultation for the RIIO-ED1 electricity distribution price control.

Key points

§ **Innovation.** Supporting innovation in the interests of improving the service we provide to customers is critical to the success of RIIO-ED1. Hence, we support the Network Innovation Allowance (NIA) and Network Innovation Competition (NIC) and believe that maximum funding opportunities should be available to innovative DNOs.

§ **Primary Outputs.** We support the primary outputs and secondary deliverables set out in the consultation document. We believe that the behavioural incentives should be strengthened: 70% sharing factor for the Information Quality Incentive (IQI) and 2.5% additional reward for 100 ratio cost submissions, changes to the Broader Measure of Customer Service (BMCS) and Interruptions Incentive Scheme (IIS), and a new Discretionary Reward Scheme (DRS) for environmental and safety improvements.

§ **Uncertainty mechanisms.** There is significant risk associated with changes in customers' behaviour during the longer RIIO-ED1 price control. The efficient allocation of risk – particularly in relation to expenditure on load – is essential to the calibration of the financial parameters.

Structure of our response

To assist Ofgem with the compilation and analysis of submissions, we provide below our high level summary response under the headings of Costs and Finance, Innovation and the six Primary Outputs.

A separate document sets out our detailed responses to the questions asked by Ofgem in the order they appear in the consultation.

We would of course be willing to discuss any aspect of our submission in further detail with Ofgem and other stakeholders, and we will continue to be constructive and proactive during the RIIO-ED1 work programme.

Yours sincerely

Aileen McLeod
Head of Regulation, Networks

SUMMARY OF RESPONSE

1. Costs and Finance

Cost Assessment

We support the progress in the development of cost assessment methodologies to date and Ofgem's proposed approach to developing totex, disaggregated and 'middle-up' models.

Moving forward, we consider a middle-up model will provide the strongest evidence of efficiency for RIIO-ED1 cost assessment. While we support the development of totex and disaggregated models, we consider that evidence from the development of these models to date demonstrates that these approaches should only be used as a sense check for RIIO-ED1. The challenges of developing totex models with sensible cost drivers for a suite of networks of different topology and age have been debated at length in previous price controls and, in our view, not resolved. Disaggregated models continue to suffer from comparability of cost allocation that distorts the results.

It is important that all models include regional factors for specific DNOs where these are materially significant and well justified, including sparsity and urbanity. In addition, the additional costs of embedded generation, submarine cables and the lower resilience of our long single networks in the West of Scotland need to be recognised in the cost assessment work.

We would welcome some debate around the methodology for determining real price effects and future productivity as part of the industry working groups, such that these can be factored consistently into the cost assessment methodology and DNOs' Business Plans.

The timescales for delivery of the various models are challenging. However, we are encouraged by Ofgem's most recent timetable for their delivery that should ensure DNOs can submit accurate cost forecasts for all scenarios by 1 July 2013.

Efficiency Incentive Rate and IQI calibration

There are two parts to the IQI mechanism that drive specific DNO behaviours:

(i) The additional penalty/reward element of the IQI matrix which incentivises DNOs to provide accurate forecasts of expenditure in their Business Plans; and

(ii) The efficiency incentive rate (sharing factor) which promotes the efficient delivery of outputs.

We note that the sample IQI matrix in the consultation document suggests that the additional penalty/reward element might be re-calibrated. **We strongly believe that there is no justification for re-calibration of the additional penalty/reward element of the IQI matrix.**

The primary purpose of the additional penalty/reward is to incentivise DNOs to submit accurate forecasts of expenditure. The IQI provides the appropriate incentive by rewarding DNOs for doing this where their forecasts match the views' of Ofgem's consultants. To remove or modify this, significantly effects the behavioural drivers of the incentive.

For the RIIO-GD1 and RIIO-T1 price controls an additional reward of 2.5% was allowed for companies who matched their forecasted expenditure with Ofgem's consultants (for fast tracked and non-fast tracked companies). We do not consider there is any justification for changing the IQI calibration, as it has worked well historically and we would strongly encourage the continuation of this approach for RIIO-ED1.

We believe there is a strong justification for the efficiency incentive rate to be increased to a maximum of 70% in ED1. This appropriately reflects the acute risks faced by DNOs in RIIO-ED1 over consumers' behaviour, and sharply incentivises DNOs to implement innovation and seek efficiency improvements for which they may be rewarded. In particular, it encourages DNOs to find 'smart' solutions rather than expensive, conventional options.

We also consider that any IQI assessments should be undertaken against the most recent submission of DNO data that is available for comparison.

Uncertainty Mechanisms

The need to recognise and allocate risk is the biggest issue for SSEPD leading into RIIO-ED1.

The risk associated with changes in customers' use of energy over the next decade makes it difficult to accurately predict load expenditure on our networks. Therefore, we welcome the proposal of a load related reopener with a threshold of 20%. However, we consider the scope of this reopener should encompass all ex-ante load allowances. In addition, we believe there is merit in considering how this reopener can be linked to outputs to avoid the perverse incentive of protecting inefficient expenditure.

Uncertainty over, for example, the growth of low carbon technologies means a form of volume/revenue driver beyond a prescribed ex-ante output is required; and we welcome recognition of this in the consultation document. The scope of this mechanism needs to be inclusive of distributed generation (DG), low carbon technologies (LCTs) and changes in customer usage. There is a real risk that the unit cost for this uncertainty mechanism is set incorrectly given the limited data currently available. Hence, we believe the load reopener should apply to this volume/revenue driver and the threshold should also be 20%.

We consider the uncertainty mechanisms proposed by Ofgem are generally appropriate for risks identified to date. We have identified one further uncertainty mechanism that should be considered for RIIO-ED1. This should focus on allowing a single mid period reopener for submarine cables and the decommissioning of the embedded diesel power stations on

Orkney and the Western Isles, following completion of transmission reinforcements in our SHEPD area.

We consider the criteria proposed for justifying the appropriate use of additional uncertainty mechanisms is appropriate.

Financeability Issues

As we explain in our detailed response, RIIO-ED1 is more risky than DPCR5 and RIIO-GD1. Some, but not all, of this incremental risk can be efficiently allocated through uncertainty mechanisms. Hence, it is important that the cost of equity and gearing are calibrated based on residual risk after uncertainty mechanisms are defined.

A cost of equity of at least 7.0% is required, and possibly higher than 7.0% depending on the allocation of risk in RIIO-ED1. We therefore consider the proposed range of up to 7.2% is appropriate at this stage.

We are also of the view that gearing should be set in the range of 60% to 65%. New evidence on associated costs will need to be revisited to determine an appropriate cost of debt index.

We agree with Ofgem's proposals to set depreciation at 45 years for new assets, with provision for one price control period (eight years) of transition for this to take effect.

We also consider the capitalisation rate should be bespoke for each DNO and be based on historic and future business requirements.

Further clarity from Ofgem on how they intend to address the individual cash-flow effects of reopener items that are being proposed would be welcomed. Our view is that a cumulative effect threshold needs to be set.

2. Innovation

We are committed to innovation continuing to be an integral feature of the future management of networks that will happen regardless of the speed of delivering a low carbon economy.

We recognise that there is uncertainty regarding the location, timing and impact of changes to consumers' demand moving forward, but we have already seen significant change in some areas of our network that are facing real and significant challenges (e.g. remote constrained networks such as Shetland and Orkney, but also in more urban areas in the south of England with high solar penetration). In response to our customers' requirements, **RIIO-ED1 and RIIO-ED2 will require even greater levels of innovation and, importantly, delivery of innovative solutions rather than these being simply conceptual ideas and/or development projects. Therefore, to facilitate this, the NIC should be at the top of the**

range proposed by Ofgem of £90 million. Without such investment now, the future decarbonisation challenges will be greater and, in all likelihood, more costly in time and money.

We consider the calibration of the NIA should appropriately recognise past performance as well as the proposals put forward by DNOs as part of their business plans. DNOs with a strong record in research and development should be strong candidates for an NIA at the top end of the range.

We support the proposed Innovation Rollout Mechanism (IRM) which will provide funding to allow DNOs to convert innovative projects to business as usual solutions within the RIIO-ED1 price control period. However, we are concerned that such funding will only be provided where innovation will deliver low carbon or environmental benefits. This is potentially too narrow, and may prevent innovative approaches to operational or social issues being implemented as soon as possible. This may delay real benefits being delivered to customers.

3. Primary Outputs

Safety

Protecting the safety of our employees and the general public is essential to the way we work.

We are disappointed Ofgem has not included consideration of incentivising improvements in safety performance through RIIO-ED1.

Ofgem have, correctly in our view, identified safety as one of RIIO-ED1's primary outputs. However, we find it slightly unusual that no associated regulatory activity has been directly attributed to this primary output.

We acknowledge and agree with Ofgem's view that safety is the primary responsibility of the Health and Safety Executive (HSE), but also believe that RIIO-ED1 presents a real opportunity for Ofgem to target increased safety behaviour and performance across DNOs. This could be achieved by:

(i) allowing an uplift to the IQI mechanism of, for example, +0.1% for Business Plans that demonstrate a commitment to safety (or -0.1% penalty for those that do not), and/or

(ii) a DRS for exceptional approaches to safety (this might be a joint scheme with exceptional environmental performance).

At a minimum, a commitment to safety should be part of the well justified business plan assessment and, without demonstrating this, a DNO should not be eligible for fast tracking.

Customer Satisfaction

We welcome the focus on customer service for RIIO-ED1. Our customers' expectations of the level of service we provide will increase and that this will be aided by the availability of new communication tools such as social media.

We support Ofgem's proposal to continue the BMCS for the duration of RIIO-ED1. There a number of improvements to the BMCS that we would support:

§ As proposed in the consultation, the potential reward and penalty ranges of the BMCS should be widened and, additionally, we strongly believe that the incentive should be symmetric.

§ Also as proposed in the consultation, the targets should be set up-front, based in performance to date and driving improvement. The current approach to target setting was developed when there was no data to set individual improvement pathways, now this data is available it should be used to avoid 'group set back'.

§ The weightings of the BMCS categories should more accurately reflect the number of customer contacts. In particular, the current weightings appear disproportionately weighted to the connections component of the BMCS given the significantly higher number of contacts for interruptions.

§ The separation of the connections element of the BMCS should be reconsidered once the consequences of the development of competition have been fully considered. Specifically, the number of customers and customer contacts in each category should be used to calibrate the incentive.

Our proposed BMCS structure is shown in the table below:

BMCS revenue exposure		**OFGEM ED1 Proposals**	**DPCR5**	**SSEPD % of BMCS Contacts**	**SSEPD Proposal**
Connections	Minor	+0.5/-0.5	+0.32/-0.2	3.4%	+0.5/-0.5 (split to be reviewed)
	Major	0/-0.5	-	3.2%	
Interruptions		+0.3/-0.3	+0.32/-0.2	91.3%	+0.75/-0.75
General Enquiries		+0.2/-0.2	+0.16/-0.1	2.1%	+0.25/-0.25
Total exposure		**+1.0/-1.5**	**+0.8/-0.5**		**+1.5/-1.5**

We expect RIIO-ED1 will result in an increased need for DNOs to become more responsive to their customers' needs. We therefore consider it important for Ofgem to recognise that the components of the BMCS may change during RIIO-ED1, and perhaps accommodate for this by including within the scope of the mid-period review.

We support the continuation of the complaints and stakeholder engagement outputs and incentives.

Environment

Our customers care about the environment and the impact DNOs have on their surroundings. This was recognised in DPCR5 and should be built upon for RIIO-ED1.

While we support the suggested outputs, we are disappointed Ofgem has not proposed a significant financial incentive to drive improvements in environmental performance through RIIO-ED1.

We agree with Ofgem's proposal to include environmental activities as a primary output. However, we believe financial incentives should be attributed to achieve the objectives of this primary output, and in particular we strongly believe that a DRS would drive behavioural change and demonstrate to customers the importance of the environment to DNOs. As with safety, we consider RIIO-ED1 presents a real opportunity for Ofgem to incentivise improved environmental behaviour and performance across DNOs beyond the minimum statutory requirements. We would propose that a DRS should be considered to drive appropriate behaviours. Such as scheme could also be combined with driving improved safety performance, and would not place any obligation on Ofgem to apportion rewards where DNO performance has not been exceptional.

As we have expressed previously, we do not support the approach that Ofgem has taken towards losses reductions. Losses remain the most significant environmental impact of the electricity distribution networks. We have previously stated our position that the DPCR5 losses mechanism should be activated, and consider a strong financial incentive in RIIO-ED1 is the most effective approach for reducing losses across distribution networks.

We acknowledge there is potential volatility in settlement data to calculate losses incentives. This will change as better quality data becomes available during RIIO-ED1 from the installation of smart meters. However, Ofgem's proposal does not satisfactorily explain or demonstrate how this will better incentivise behaviour to reduce losses. We consider the proposed fund is weak, especially when compared to the environmental impact of losses. Our preference is for Ofgem to examine the possibility of adopting a DPCR5 type approach. At a minimum, Ofgem should leave open the opportunity to introduce a new losses scheme as part of a mid period review, especially as improved data is likely to be available at that time.

We consider the current Business Carbon Footprint (BCF) scheme is a good foundation but that it can be improved on. We propose that 'exceptional events' be removed from the BCF in the same way as the IIS. There is currently no mechanism for the inclusion of other activities within the DNO's remit which contribute to its carbon footprint, but which are less easily measured (such as waste aggregate and recycling). In addition, there is no method by which to exclude the impact of a one-off, unpredictable, event. SHEPD have a number of fixed

diesel stations on the West coast of Scotland which experience increased demand during storms. This causes an increase within the fuel consumption section of the BCF which detrimentally affects the footprint of SHEPD as a whole.

We agree with Ofgem's proposed approach to fluid filled cables. Regarding Ofgem's proposals for SF_6, and given the proposed increases in statutory SF_6 regulation, we do not consider it would be appropriate to increase this on a regulatory basis. However, given that there is currently no viable alternative to SF_6, leakage should be measured as a percentage of total volume, rather than an absolute level.

Conditions for Connections

A lot of work has already been done by DNOs in recent years to facilitate competition and improve service in connections. We agree it will be an important objective of RIIO-ED1 to ensure customers are offered a choice of timely, cost effective connections.

Competition in connections should be promoted as far as possible. Segments which pass the Competition Test should not be subject to price regulation under RIIO-ED1 and should have reduced service regulation.

Evidence submitted to date demonstrates that some segments might not pass the Competition Test for reasons beyond the control of individual DNOs. This could arise for a variety of reasons, for instance a low volume of work activities in certain areas. We note Ofgem's intention to review this in 2014, but believe that a policy position needs to be put in place for ED1 that can be adopted by all DNOs in their Business Plans.

We propose that a category 'Excluded RMS by default' is adopted for segments that might not pass the Competition Test through no fault of the DNO. The regulatory arrangements are summarised in the table below.

	GSoP	**Allowed Margin**	**Time to Connect Incentive**	**Application of Broader Measure**
Excluded RMS	Yes	Regulated	Yes	Yes
Excluded RMS by default	Yes	Regulated	Yes	Yes
Competitive RMS	Yes	Unregulated	No	No

We understand Ofgem's rationale for not having specific regulation of contestable elements of competitive RMS. However, subject to the views of ICPs and IDNOs, we believe there is an option to include these within, for example, the BMCS or through a time to quote incentive.

We are comfortable with Ofgem's proposals for an average time to connect incentive for excluded RMS and excluded RMS by default. However, specific exception provisions need to be included to appropriately allow for factors such as transmission constraints and/or customers' requests for specific dates.

We understand the basis for the proposal to socialise connection costs for domestic retrofit LCTs. However, any mechanism for socialising costs will need to provide the correct economic indicators to customers to avoid perverse incentives in connecting particularly disruptive loads or under-designed networks. For example, this could include developers requesting a low per household capacity and subsequently installing additional load and generation with the costs being socialised.

Social Obligations

We recognise that as a DNO we are an essential service provider and a key member of the communities we serve. We welcome opportunities to develop our social obligations that build upon our stakeholders' ideas.

We support Ofgem's proposal to encourage DNOs to make automated guaranteed standards payments to Priority Service Register customers. We consider this could be a realistic proposition for the commencement of RIIO-ED1. We support Ofgem's intentions of deriving greater value from a commonly held DNO database for vulnerable customers.

We support Ofgem's proposed approach for stakeholder engagement to support appropriate actions for fuel poor and vulnerable customers and the promotion of public safety initiatives. We also consider Ofgem should create a separate fund (similar to the NIA to support the development and implementation of projects that will improve the well being of fuel poor and vulnerable customers.

Reliability and Availability

Consultation responses from our stakeholders to date has emphasised that reliability is consistently their number one priority. We therefore agree this should be an important focus of RIIO-ED1.

We support the continuation of the IIS during RIIO-ED1 as reliability is a priority for our customers. We agree with the proposal to separate the targets for planned and unplanned interruptions. Our preference is for planned targets to be set on a rolling basis, and for unplanned targets to be set prior to the commencement of RIIO-ED1. We are broadly supportive of the proposed approach, and consider the incentive rate should not be adversely affected by any alignment with RIIO-T1, the application of the efficiency incentive rate or the need to change any of the exclusions.

We strongly support a specific Worst Served Customer (WSC) mechanism to be developed for the West coast and Highlands of Scotland given the unique circumstances our network faces in that part of the country.

We recognise there is a need to have in place an effective WSC mechanism. We agree the current mechanism could be improved, and we support a combination of Ofgem's proposals in this regard for our SEPD area and the central and East Coast of Scotland. However, we

remain of the view these mechanisms will not provide sufficient incentive or associated funding to address the worst of the WSC in our remote communities served by our long radial networks in the Highlands and Islands.

We note Ofgem's proposal to lower the threshold for the application of guaranteed standards payments from 18 to 12 hours, and to apply this across all networks. We recognise the need for this and believe the removal of the exemption that currently applies to the Highlands and Islands is workable. It is important to recognise that networks are designed with an implicit level of interruptions. This is higher in the West coast of Scotland and the level of guaranteed standards payments will be higher as a direct result. We therefore consider an allowance should be made for efficient levels of guaranteed standards recognising that this is an alternative to increased investment.

We support Ofgem's proposals for primary outputs and secondary deliverables. We support the increased consistency proposed for measuring both Load Indices (LI) and Health Indices (HI), and for comparing across DNOs.

We understand the rationale for the introduction of criticality measurement for informing asset replacement decisions where the need for interventions has been identified. Our view is that a risk index to identify criticality from flooding and black start will be much more effective at a site level rather than for individual assets.

We are broadly supportive of Ofgem's proposals in relation to LIs. Our view and experience of DG driven reinforcements is that they are "lumpy and unpredictable" and any proposed DG Load Index would not have provided any value in forecasting which parts of the network were likely to require reinforcement. It is not clear to us that any DG Load Index would provide any benefit in informing DNOs or Ofgem of investment requirements in the foreseeable future.