Appendix. 1

SSEPD's Response to Strategy Consultation Questions

OVERVIEW DOCUMENT

CHAPTER 3: Incorporating stakeholders' views

Question1: *Do you have any comments on our stakeholder engagement approach?*

We agree with Ofgem's objectives for stakeholder engagement.

We agree it is essential stakeholders are familiar with policy developments so they are able to contribute effectively to the price control review process. We would welcome the opportunity to work collaboratively with Ofgem in this education process.

If stakeholders are to contribute effectively to the price control process, we agree it is imperative that the views gathered from consumers are fully reflected. The methods for engagement set-out in Appendix 3 of the Strategy Consultation Overview document are appropriate, but without access to the full Ofgem stakeholder engagement plan it is difficult to offer further comment. We would suggest that Ofgem make their stakeholder engagement plan available to stakeholders, including DNOs, as soon as possible.

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

We consider it would be very useful if Ofgem held an overall communication plan which set-out how they plan to ensure stakeholders are familiar with policy developments (and thus enable stakeholders to contribute effectively to the price control review process).

The education element of this should be worked-up and delivered collaboratively with DNOs who are also working with similar groupings of stakeholders to ensure they are familiar with the process. In doing this, we can ensure we all work together to educate and engage stakeholders in the price control process and thereby reduce stakeholder fatigue.

CHAPTER 4: Form and structure of the price control

Question1: *Do you have comments on the form or structure of the price control?*

We agree with Ofgem's proposals on the form and structure of RIIO-ED1, and consider it logical for Ofgem to determine the RIIO-ED1 price control over a similar length of time to the RIIO-T1 and RIIO-GD1 price controls.

We note many uncertainties remain regarding how the sector and the needs of stakeholders may change during RIIO-ED1. Our main concern with setting the price control for this length of time is that sufficient and appropriate incentives and uncertainty mechanisms, where necessary, are incorporated into the overall price control package to facilitate change and drive the required improvements in performance. We provide specific views on how Ofgem should accommodate for this elsewhere in our response.

We agree with the price control process outlined by Ofgem and endorse a streamlined business plan assessment process. It is encouraging to note that Ofgem appear to have learnt from the experiences of the RIIO-T1 and RIIO-GD1 price control reviews and have modified their approach to RIIO-ED1 accordingly.

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

We agree with the proposal to amend the RIIO-ED1 timetable as indicated in Appendix. 5 of Ofgem's Overview document.

It is reasonable to allow DNOs additional time to prepare their business plans given that Ofgem propose a single stage assessment process. It is also sensible for Ofgem to allow additional time to assess non-fast tracked business plans.

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?*

We support initiatives to improve the predictability of network charges and reduce their volatility for our customers.

We support Ofgem's decision on proposed measures to mitigate network charging volatility arising from price control settlements.[1] As noted in our previous submission on this subject, we consider these measures will improve suppliers' ability to understand and forecast changes.[2]

We agree the RIIO framework, and the timeline for the preparation of business plans, will provide suitable transparency for the materiality of any changes to be taken into account from one price control to the next. We therefore do not agree it is necessary for Ofgem to fix DNOs' allowed revenues for the first year of RIIO-ED1. Ofgem's proposed approach of considering additional profiling or smoothing mechanisms following the submission of DNO business plans is sensible. The precise mechanism of how this can be achieved can then be established if it is required.

CHAPTER 5: Ensuring output delivery

Question1: *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 agree with the proposed outputs and consider they are sufficient and appropriate for the purposes of RIIO-ED1. Our general view is the proposed outputs will promote value for money and encourage development of solutions for a low-carbon energy future. We suggest it may be possible for Ofgem to consider combining the output categories of Customer Satisfaction and Social Obligations as these are closely aligned.

[1] *"Decision in relation to proposed measures to mitigate network charging volatility arising from price control settlement"*, Ofgem, 17 October 2012.

[2] *"Mitigating network charging volatility arising from the price control settlement"*, SSEPD, 11 June 2012.

However, we consider further incentive mechanisms should be adopted for RIIO-ED1. We are concerned the incentive mechanisms proposed by Ofgem do not go far enough in encouraging DNOs to change their behaviours.

Ofgem should recognise, and be congratulated on the fact, that previous price control periods have been incentive based regulatory frameworks. We strongly believe this has resulted in driving performance improvements across DNOs that would otherwise not have been achieved. RIIO-ED1 should not witness a diminishing of the overall level of incentives available to reward good performance or penalise poor levels of service to stakeholders.

In our view, DNOs should be incentivised to go beyond the minimum statutory requirements in the areas of safety and the environment. RIIO-ED1 presents a good opportunity to raise the bar of innovative DNO performance in these areas, and this opportunity should not be overlooked by Ofgem. The inclusion of such incentives could easily be accommodated by Ofgem through adjustments to the IQI mechanism for safety, or a discretionary reward for the environment and safety.

As noted in the summary of our response, we do not support the approach that Ofgem has taken towards losses reductions. 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 at this time 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.

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

As noted in our response to the previous question, we consider that further incentive mechanisms should be adopted for RIIO-ED1.

We also consider the Customer Satisfaction and Social Obligations primary outputs could be merged as a single output due to the close objectives that the outputs seek to achieve. We are comfortable if Ofgem should decide to retain these as separate primary outputs, but consider the combining of these is worthy of further consideration.

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

Please refer to our response to question 1 above.

CHAPTER 6: Assessing efficient costs

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

We consider the proposed approach to cost assessment is appropriate.

The discussions at the cost assessment working group (CAWG) have provided ample opportunity for stakeholders to provide their views and comments on the approach for cost assessment.

We consider further work and focus is now required to finalise the models and techniques that will be used and that actual data should be input to provide a clear understanding of how costs will be assessed and where DNOs stand in this process. This includes identification of appropriate cost drivers. Therefore, the overall approach has been appropriate but data input and analysis is now required to avoid a repeat of the lack of transparency in allowance setting in DPCR5.

Moving forward, we consider a 'middle-up' model is the most appropriate approach for RIIO-ED1. While we support the development of totex and disaggregated models, we consider development of these models to date indicates that these approaches should only be used as a sense check for RIIO-ED1.

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 deadlines which have recently been discussed at CAWG regarding completion of the models were deemed to be too late from an SSEPD perspective for finalising and providing transparency. However, we have been encouraged by Ofgem's indication that there is intention to provide an initial draft of the various models by the end of November, with a 'final' version being made available by March 2013. These timescales are much more realistic for incorporation into the DNO business plans.

As noted at the CAWG, it is important for all DNOs and Ofgem to understand the rankings of companies across all assessment models and the key drivers for efficient/inefficient performance.

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

We support the proposed use of proportionate treatment which enables companies to be considered for fast-tracking.

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

We agree with the proposed criteria for assessing business plans. We consider it important for Ofgem to require all business plans to be well justified, for historic performance of DNOs to be taken into account, and for DNOs to demonstrate how stakeholder engagement has informed their investment proposals for RIIO-ED1 and beyond.

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.

CHAPTER 7: Innovation

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

Innovation is a fundamentally important part of RIIO-ED1. We are committed to innovation being an integral feature of the future management of networks, and we consider this will happen with or without the need to deliver a low carbon economy.

We support the proposed Innovation Rollout Mechanism (IRM). This will provide funding to allow DNOs to convert innovative projects to business as usual solutions within the price control period. However, we are concerned that such funding will only be provided where

innovation will deliver low carbon or environmental benefits. We are concerned that this is too narrow and may prevent innovative approaches to operational or social issues being implemented as soon as possible. This may delay benefits being delivered to customers.

We have previously released a stakeholder consultation paper setting out our thoughts on the role of innovation in RIIO-ED1.[3] In our consultation paper we recognise and agree that DNOs have a key role to play in the transition to a low carbon economy. We also acknowledge DNOs face significant challenges in connecting potentially significant volumes of local carbon generation and low carbon demand in a timely and efficient manner.

We agree there is still considerable uncertainty regarding location, timing and impact of this going forward, but we have already seen significant change in some areas of our network that are facing real and significant challenges (e.g. Shetland and Orkney, but also in more urban areas). It is important to recognise that DNOs may be impacted differently because of the location or characteristics of their network and customers, and that there is unlikely to be a one size fits all solution.

We are currently making full use of existing innovation funding through the IFI and LCNF to help develop and trial innovative solutions to existing issues and challenges. By way of example, to date this has allowed us to connect an additional 25 MW of renewable generation in our SHEPD area. This has resulted in avoided network investment costs of £29.5m. We agree with Ofgem that the next decade will be critical.

We consider RIIO-ED1 and RIIO-ED2 will require even greater levels of innovation **and** delivery of innovative solutions as business as usual activities, rather than these being simply conceptual ideas and/or development projects. As we move into the era of smart metering and greater deployment of innovative smart grid solutions and technologies, the regulatory framework will also need to be more flexible to allow DNOs to adapt to changing circumstances and respond quickly to changing needs; particularly to address or remove legislative, commercial or regulatory barriers.

By its very nature innovation introduces an element of risk. While strong incentives are required to undertake innovative projects and deliver innovative solutions as business as usual, the regulatory framework also needs to recognise that in delivering innovation there is a risk. In the short term there could be a detrimental impact on performance or delivery of outputs. Where there is potential to deliver long-term benefits, the regulatory framework should not penalise innovative networks in the short-term. We believe consideration needs to be given to develop mechanisms to address both of these concerns.

Ofgem's Overview document suggests past and future innovation funding and performance will influence the efficiency incentive rate and frontier performance of DNOs. We are concerned this may be premature given the recent creation of the LCNF, and there may be insufficient evidence to make assumptions about efficiency and potential future performance.

We are also concerned that too much focus is placed on sharing learning. Proposed arrangements for the NIA in particular suggest an NIA Project must have the potential to develop learning that can be applied by all relevant network licensees and be demonstrated in the Project Eligibility Assessment (i.e. how the learning that will be generated could be used by all relevant licensees). This is a difficult hurdle to pass and very onerous to assess at the early stages of a project.

We consider most benefit can be delivered by focusing on real and immediate issues on our network. While we appreciate the recent inclusion in the governance arrangements of a provision to consider specific challenges on our own networks, they must be identified as part of a network's innovation strategy. These may be difficult to predict and clearly set-out in advance. Some of the projects currently delivering value to SSEPD may have struggled to meet this criterion and remove valuable opportunities to innovate that would otherwise have materialised.

[3] *"Our thoughts on a smarter grid"*, September 2012.

We also consider we require proportionate transitional arrangements to ensure projects initiated under existing arrangements, such as the IFI, can continue to deliver anticipated benefits. It is envisaged IFI projects will transfer to the NIA. However, the governance document indicated they will need to comply with all NIA requirements. We are concerned some projects may not be able to meet this requirement, meaning the full benefit and learning of funding to date will not be realised. We do not believe it is appropriate or necessary to apply new governance arrangements retrospectively.

Since the design and construction practices applied across electricity networks were established, science, commerce and industry have evolved considerably. However, we consider the regulated environment of the last 20 years has not incentivised companies to innovate in some of the most important areas, with innovation being limited to small incremental innovations broadly related to operational efficiency and network reliability.

It should also not be forgotten that innovation can help to avoid stranded network assets, accelerate network development and have a positively impact on a DNO's overall operational expenditure performance.

As a result, there is a significant pool of innovation waiting to be applied to the sector that will release significant cost savings, efficiencies in the use of the network and cost of connection both of new demand and generation. Our project on Orkney (Orkney RPZ) has demonstrated this, with a previously unimplemented project resulting in savings of £29m over the cost of conventional solutions. Put in simple terms, if repeated 15 times an active network management (ANM) project of this size would cover the entire cost of the LCNF fund.

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 note that Ofgem is proposing a combined allowance for electricity of between £60m and £90m (including £27m proposed for RIIO-T1). We also note that the LCNF currently provides £64m.

Given the focus under RIIO-ED1 on the transition to a low carbon economy, and the significant challenges we expect to face, we consider the funding requirements should tend toward the upper end of the range proposed by Ofgem of £90m. As the NIC is also to be open to other non-RIIO network licensees, we expect demand for funding to increase.

However, we consider it equally important for Ofgem to ensure that any funding through RIIO-ED1 should focus on the demonstrable deployment of innovation by DNOs. This will ensure that consumers and wider stakeholders will immediately benefit from this funding, which would not be the case were these funds solely dedicated to demonstration type projects.

We consider the innovation stimulus package proposed provides strong incentive to initiate projects and share learning, but we are concerned that the proposed arrangements for RIIO-ED1 seek to immediately claw-back any benefit and do not provide strong incentives or rewards to convert this into business as usual.

We will highlight a number of areas in our innovation strategy and business plan which will help justify the need for additional funding for projects that seek to deploy innovation projects as business as usual activities that will have immediate benefits for consumers and stakeholders.

If the arrangements for RIIO-GD1 and RIIO-T1 are applied to DNOs where innovation is likely to be crucial, any immediate benefits derived during an NIA project will be used to off-set innovation funding requirements. We believe benefits should be shared between networks and customers, possibly through the application of the efficiency incentive rate.

CHAPTER 8: Managing uncertainty

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

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

We agree that uncertainty mechanisms can have advantages and disadvantages for both consumers and DNOs. This is particularly relevant for RIIO-ED1 where a high degree of uncertainty is prevalent with regard to the uptake of innovative and low carbon technologies.

We recognise concerns about the potential impact of uncertainty mechanisms on the variability of tariffs and, in particular, the potential for volatility of these tariffs. However, we consider both can be addressed through notification periods and smoothing or profiling of revenues. It is important this is done in a way that provides the certainty and predictability that suppliers and customers desire. It should also ensure DNOs are not exposed to unnecessary risk by ensuring that, as far as possible, revenues are closely aligned to costs as and when they are incurred. Any additional risk should be taken into account, and the timing of reopeners and windows should take account of the profiling of costs and timing of events such as smart metering.

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

We consider the uncertainty mechanisms proposed by Ofgem are generally appropriate.

However, we consider that an additional uncertainty mechanism should be considered for RIIO-ED1.

This should focus on allowing a single mid period review for submarine cables and the decommissioning of the embedded diesel power stations on Orkney and Western Isles, following completion of transmission reinforcements in our SHEPD area.

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

We consider the uncertainty mechanisms identified by Ofgem are appropriate and necessary for RIIO-ED1.

CHAPTER 9: Financing efficient delivery

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

We consider the proposed package of measures are broad enough to enable network expenditure to be effectively financed, providing they are appropriately calibrated for the specific needs of each DNO and as specified in their well-justified business plans.

We would particularly note that:

- The cost of equity should be set towards the upper end of Ofgem's indicative range (6.0% to 7.2% real post-tax). This should be at least 7.0% or higher and dependent on the level of risk included within each DNO business plan. This reflects risk relative to other recent regulatory decisions in RIIO-GD1 and RIIO-T1, as well as changes since DPCR5. This is

further covered in our response to the Financial Issues supplementary annex, Chapter 2, question 4.

- While we understand the rationale behind Ofgem's decision to introduce the cost of debt index, we believe there are some shortcomings in the practical application of the mechanism compared with the theoretical concept. As a result, we believe the cost of equity allowance should be increased to reflect the residual risk which shareholders are being asked to bear. This is further covered in our response to the Financial Issues supplementary annex, Chapter 2, question 3.

Our further comments can be found in our response to the Financial Issues questions further on in our consultation response.

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)?*

We note that Ofgem have set a cost of equity range of 6.0%-7.2%, which is consistent with that set in previous strategy papers for RIIO-T1 and RIIO-GD1.

We believe it is important to have a consistent regulatory message between price controls to ensure informed investment decisions by shareholders. We welcome the broad range provided by Ofgem, as it allows DNOs to set a cost of equity appropriate to the risk they wish to take within their well-justified business plans.

However, we consider there are a number of factors in RIIO-ED1 which make it riskier than other price controls in certain areas, and in particular there is much more uncertainty than under DPCR5 and RIIO-GD1 (and in some cases than under RIIO-T1).

The factors influencing risk include:

- Potentially higher cost-to-RAV ratio than RIIO-GD1 (both opex and capex);
- The level of incentives compared to DPCR5 and RIIO-T1;
- A longer price control period than DPCR5;
- Increased requirements for "smart" investment with uncertain costs and economic life compared with RIIO-GD1 and DPCR5;
- Increased economic asset lives compared with DPCR5;
- A greater proportion of allowances being set on an *ex-ante* basis, rather than determined within period and as compared to RIIO-T1;
- Different treatment of pensions with less certain full cost recovery, compared to DPCR5; and
- The issues raised above on the cost of debt index increasing risk compared with DPCR5.

As a result of these factors, we consider a cost of debt at the upper end of Ofgem's cost of equity range of at least 7.0% is appropriate fir RIIO-ED1.

These arguments are further elaborated in reports that have previously been submitted by the Energy Networks Association to Ofgem.[4]

[4] *"The Riskiness of the Electricity DNOs under RIIO Relative to Other Regulated Networks"*, August 2012, prepared by First Economics, *"Determining Efficient Financing Costs for RIIO-ED1"*, 3 September 2012, prepared by Oxera, and *"RIIO-ED1 consultation on strategy: Financial Issues"*, 16 November 2012, prepared by Oxera.

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

Further comments can be found in our response to the Financial Issues questions further on in our consultation response.

OUTPUTS, INCENTIVES & INNOVATION

CHAPTER 2:

Question 1: *We welcome respondents' views on the approach we have taken to develop the outputs framework.*

We support Ofgem's proposed outputs framework and the approach taken to develop it until now.

Question 2: *Do any of our proposed output measures present potential difficulties in ensuring the submission of accurate and comparable data?*

We consider the current known requirements do not pose any major issue in terms of submission of comparable data. However, there are several measures where the final proposals are undefined and more work is needed to agree:

- A valid metric for safety reporting aligned to HSE requirements;
- Consistent data for the Health Index of overhead lines and civil assets;
- The final format for criticality reporting proportionate to the cost of managing the data;
- Units of low-carbon connections and interventions/MW connected volume driver; and
- Output measures for Social Obligations.

Question 3: *Should we use a percentage of allowed revenue or £m set using basis points of return on regulatory equity (RORE) to set caps and collars?*

We consider using a percentage of allowed revenue is a far more transparent way of setting the benchmark, as long as it amounts to the same £m target. It also takes variability of RAV and therefore RORE out of the equation.

Question 4: *Are there any aspects of our proposed outputs framework where the reporting requirements are likely to lead to disproportionate regulatory costs?*

We continue to be concerned at the current level of granularity for collation and reporting of high volume low value works on assets for the RIGs submissions. This appears to be disproportionate to the benefit and we suggest that it would be appropriate to review the use of such low level data on an ongoing basis.

The use of the criticality assessment of assets is still under development. Our view is that if it is used solely to inform asset replacement priorities, there is no benefit in maintaining this information where no assets are being considered for replacement.

At this time we are unable to comment on outputs for Social Obligations as these have not been defined by Ofgem.

Our view is that cut-out fuse failures are generally caused by events within the premise which are outside of the DNO control, so should not be included within IIS. However, we would be happy for the guidance to clarify that fuse unit failures that required disconnection of the upstream network affecting several customers would be reported within IIS.

CHAPTER 3:

Question 1: *Do you agree that a specific output or incentive focussed solely on the connection of low carbon technologies is not necessary?*

A key challenge for RIIO-ED1 will be connecting new low carbon loads and generation to achieve national targets in an appropriate timeframe and at efficient cost, without causing network problems. However, we do not believe that outputs or incentives should focus solely on these activities during RIIO-ED1 as the boundaries between "low carbon" and conventional technologies are likely to become less clear.

The output measures and incentives should promote the evolution of innovative solutions to connecting demand and generation at lower cost, and recognise uncertainty until these options are fully developed as business as usual activities by DNOs.

Question 2: *Do you agree with our proposals on the level of detail DNOs will be required to submit on the different scenarios in their business plans?*

We agree with the general principle proposed by Ofgem, but clarification is needed to ensure DNOs submit their information in a format that is based on common scenarios and settings to ensure the results are consistent and comparable.

This applies to any data submitted to Ofgem by 20 December 2012 and subsequently in DNO business plans. Regarding the WS3 EATL model, the data population, system settings and associated scenarios to be used as a baseline need to be agreed between all parties. This issue has been raised on a number of occasions, specifically at the CAWG. Our understanding is that Ofgem have committed to provide guidance in sufficient time to allow DNOs to incorporate this as part of any data that is to be submitted by 20 December 2012.

Question 3: *Do you agree that an uncertainty mechanism is required to manage the uncertainty around the penetration of low carbon technologies?*

Uncertainty over 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%.

Question 4: *Do you agree with the three tier approach we propose to introduce for the recovery of the DNOs' costs during the smart metering roll-out?*

We consider the proposed three-tier cost recovery mechanism would work, with Tier 1 providing an *ex ante* allowance to cover the efficient costs that a DNO would normally incur (such as emergency call-outs and remedial work), Tier 2 funding any additional call-outs in addition to Tier 1, and Tier 3 including any additional costs to be funded by suppliers.

However, we believe there is a high level of uncertainty about the suppliers' roll-out profiles, and these costs make it difficult to set allowances and volume drivers in advance.

We consider an alternative option, aligned to RIIO-GD1, could be an up-front allowance to start the programme and annual reopener windows until there is sufficient certainty about costs to adopt the Tier 1-3 approach.

Based on a survey of 4099 properties in the SEPD area and 2565 properties in the SHEPD area between December 2010 and May 2011 (together with information provided by DECC on smart metering rollout profiles), we have been able to estimate costs associated with Tier 1 and Tier 2 for the remainder of DPCR5 and RIIO-ED1. We believe costs are likely to be in the order of £89m, split as follows:

SEPD	DPCR5	£10m
	ED1	£62m
SHEPD	DPCR5	£2m
	ED1	£15m

However, these costs only relate to the direct resolution of defects and do not include other costs associated with setting-up infrastructure, non-DNO complaint handling, additional customer service costs, handling smart meter data and/or DCC charges.

Question 5: *Should costs of load and generation growth for existing customers in profile classes 1-4 be socialised, until smart metering data is available?*

We broadly support Ofgem's proposal to encourage the take-up of low carbon technology by socialising some reinforcement/intervention costs. These proposals need to avoid any perverse outcomes such as:

- Developers requesting a low per household capacity and subsequently installing additional load and generation with the costs being socialised;
- Socialising high-cost schemes especially where low-carbon alternatives are available at lower cost; and
- Connecting cheaper "poor quality" devices which may affect other customers when better devices are available.

It is unclear whether smart metering will change the situation significantly as it is difficult to recover costs from customers who may have already connected high-demand low carbon devices

Question 6: *Should DNOs retain the ability to charge existing customers in profile classes 1-4 who install equipment which poses significant power quality issues for the network?*

We agree that DNOs should retain the ability to charge existing customers for equipment with significant power quality issues or financial impact, although we consider this option is unlikely to be used in practice.

Question 7: *If we socialise costs of existing profile classes 1-4 customers, will the use of system charging methodology need to be changed in order to protect IDNO margins?*

We consider the socialisation of costs for profile class 1-4 customers presents potential risks for IDNOs. If low carbon technologies cause reinforcement of the local network, the IDNO's 'margin' (i.e. the difference between the income received and 'boundary charge' from the host DNO) may not be sufficient to fund any necessary reinforcement works on the IDNO network.

CHAPTER 4:

Question 1: *What are your views on the primary outputs and secondary deliverables for reliability and safety? In particular:*
(a) Do you agree that these are appropriate areas to focus on?

(b) Are there any other areas that should be included?

We broadly support Ofgem's proposals. In particular:

- We agree it is not appropriate to create new incentives for short interruptions and that cut-out fuse failures should continue to be excluded from IIS;

- We support the reduction of the 18 hour EGS2 standard to 12 hours, but consider any related costs for events that cannot reasonably be managed by the DNO should be socialised across all customers. This is particularly important in our SHEPD area due to the design and security standards of our legacy networks, and as some parts of the network, such as the Scottish islands, cannot be accessed during severe weather conditions;

- We consider the WSC mechanism needs to be revised with an incentive scheme to encourage overall reductions in the number of interruptions experienced by customers as a whole. This should also include an allowance to fund improvements for the very worst served customers who typically are at extreme ends of networks and which may require considerable investment to improve reliability. The level of the current cap on cost per customer should also be reconsidered; and

- We support the aims of providing automatic payments to customers on the PSR.

CHAPTER 5:

Question 1: *Will our proposed approach ensure effective losses reduction actions?*

We do not support the approach that Ofgem has taken towards losses reductions. 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 at this time 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.

Question 2: *Will our proposed losses discretionary reward provide the required incentive on DNOs to reduce losses? Should this be awarded twice during ED1 or more frequently?*

Please refer to our response to the previous question.

Question 3: *Should DNO actions to identify and address electricity theft be encouraged through an approach outside of any losses reduction mechanism? Do you have any views on the proposed approach, or any alternate proposals, that we should consider?*

We welcome the proposals to incentivise suppliers to identify and reduce theft through a central service, while requiring DNOs to maintain current levels of support for tackling electricity theft until these new proposals are put in place.

We do not consider that theft is a 'real' loss of units across the network, as the network has actually delivered this energy to the point of supply where any theft occurs. Thus, we do not

believe it would be appropriate for DNOs to identify and address electricity theft outside of a proposed losses reduction mechanism.

Question 4: *Do you think that further guidance should be provided with regard to the use of the '10% allowance ' for undergrounding? If so, what form should this guidance take?*

We consider clearer guidance is required and that it has been a contributing factor in the under-utilisation of this allowance to date. While some degree of flexibility should be retained, further guidance in the form of examples of acceptable, and non-acceptable, uses would be of value.

Question 5: *Are National Scenic Areas (NSAs) sufficient to allow for effective use of the scheme in Scotland in the protection of visual amenity?*

Our key concern with regards to NSAs is that there was initially no provision for them within DPCR5. Given the amendments to the RIGs guidance and their inclusion in these, we now consider that issue resolved. However, we are keen to hear from other relevant stakeholders on this topic.

Question 6: *Do you agree with our proposals with regard to DNO assessment and stakeholder engagement within the undergrounding scheme?*

We agree that DNOs should be able to identify the relevant stakeholders and provide assistance where required. However, we feel this scheme will still need to be primarily driven by the stakeholder in order to ensure the most appropriate use of the funding available.

Question 7*: Do you agree with our proposed approach for BCF? Do you consider there are any additional elements that should be included within the BCF reporting scope?*

We consider the current scheme is a good foundation but that it can be improved upon.

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 DNOs remit which contribute to their 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 Western Isles 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.

Question 8*: Do you agree with our proposed approach to SF6 monitoring, reporting and management?*

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 there is currently no viable alternative to SF_6, leakage should be measured as a percentage of total volume, rather than an absolute level.

Question 9: *Do you agree with our approach for fluid filled cables?*

Yes.

Question 10: *Do you agree with our approach to noise reduction?*

The current reporting requirement is not onerous and we would support the continuation of this in RIIO-ED1. If it is not continued, Ofgem will be required to provide DNOs guidance on where these costs should be reported.

Question 11: *Do you agree with our assessment of the need for an additional environmental discretionary reward?*

No. We are disappointed Ofgem has not proposed a significant financial incentive to drive improvements in environmental performance through RIIO-ED1.

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.

We consider that if appropriate efforts are made in the remainder of DPCR5 to ensure the integrity of BCF data, a viable discretionary reward scheme could be in place for RIIO-ED1.

While the proposed mechanisms set-out in Chapter 3 encourage anticipation of the impact the low carbon future will have on the network, there currently exists no mechanism to reward best practice in regards to the direct environmental impact of the DNO business.

We agree that DNOs should be able to identify the relevant AONB stakeholders and provide assistance where required. While the proposed mechanisms set out in Chapter 3 of the Outputs and Incentives document encourage anticipation of the impact the low carbon future will have on the network, there currently exists no mechanism to reward best practice in regards to the direct environmental impact of the DNO business. We would propose that 'exceptional events' be removed from the BCF in the same way as the IIS. Given the proposed increases in statutory SF_6 regulation, we do not feel that it would be appropriate to increase this on a regulatory basis

We anticipate that the flooding prevention measures that have been proposed to date will be completed by the end of DPCR5 in both our licensed areas. As such we are not clear how it would be appropriate to introduce an incentive for DNOs in RIIO-ED1 that incentivises DNOs who have been unable to complete their works before the end of 2015.

CHAPTER 6:

Question 1: *Do you agree with our proposal to retain the Broad Measure of Customer Satisfaction (BMCS) and increase the maximum revenue exposure?*

We agree the BMCS should be retained and with the increase in the level of revenue exposure. 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 Strategy document, 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 Strategy document, 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; and

- 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.

Question 2: *We seek views on the approach to setting targets for the RIIO-ED1 period, including whether these targets should be fixed for the price control period or should be responsive to changes in industry performance.*

We consider targets should be set in advance for the period to provide more certainty for investment planning. They should also incentivise combined improvement for each DNO compared with current performance together with improvement compared to the frontier performers.

Question 3: *We seek wider stakeholder views on whether interruption customers that have been proactively contacted by the DNO via new methods of communication (e.g. social media) should be included in the customer satisfaction survey.*

We consider interruption customers that have been proactively contacted by DNOs should be included in the customer satisfaction survey. However, this should only be the case where the DNO communication process identifies appropriate contact details for the customer for the follow-up survey, and providing the process is robust enough to be auditable.

Question 4*: Should the provision of information to connections customers be taken into account when calculating the score of the customer satisfaction survey?*

We do not consider this should be separately scored as the provision of information will inevitably form part of the customers overall satisfaction score, and any shortcomings will be identified in the associated commentary.

***Question 5**: Should the number of unsuccessful calls be taken into account when calculating the score of the customer satisfaction survey?*

We do not consider there is any advantage to adding the number of unsuccessful calls into the CSS scheme. This is because past experience with the Ofgem telephony audit highlighted that common definitions, robust measurement and auditing of unsuccessful calls is difficult to achieve. Furthermore, we believe our customers will always get through to a SSEPD representative, if not at the first attempt, and have the opportunity to include their view of unsuccessful calls in the CSS score.

***Question 6:** What indicators should we use to measure complaints performance? How should these be weighted?*

We are of the view that the existing weightings are generally satisfactory,

***Question 7:** How should we calculate the BMCS complaints metric target for RIIO-ED1? How should we calculate the score at which the DNO incurs their maximum penalty exposure?*

We consider this should be addressed by the CSIWG.

***Question 8:** Do you agree with the proposed approach to assessing stakeholder engagement?*

The assessment of how meaningful and successful stakeholder engagement activities have been is open to subjectivity as detailed in paragraph 6.43.

To ensure that all DNOs are assessed in the same way, it would be useful if the minimum requirements, and pre-determined criteria that DNOs are to meet, was shared as soon as possible. In this way, while not influencing how and what issues DNOs engage with their stakeholders on, it would allow the submission to the independent panel to be structured in a way which mirrors the areas they are particularly interested in.

CHAPTER 7:

***Question 1:** Are there additional social issues that the DNOs should address?*

We do not consider there are other social issues that DNOs should address at this time.

We believe the arrangements for Social Obligations should be flexible enough to accommodate other social issues which may materialise during RIIO-ED1.

***Question 2:** Are there any specific outputs that the DNOs could be responsible for delivering?*

It is difficult to prescribe specific outputs until the arrangements for social obligations are finalised. However, we consider outputs could be related to delivery of specific projects (please refer to our response to question 3 below).

Question 3: *Should a separate funding allowance be provided to enable DNOs to carry out activities in response to social issues?*

We agree the social obligations mechanism should allow for DNO's, either independently or collaboratively, to identify suitable projects through stakeholder engagement and apply funding to deliver these.

Question 4: *Are DNOs adequately incentivised to engage with social issues as part of the BMCS Stakeholder Engagement Incentive?*

The proposed increase in the BMCS incentive for stakeholder engagement will incentivise consultation over social issues backed-up by additional funding for specific projects and deliverables.

CHAPTER 8:

Question 1: *Do you consider that our proposed package will drive the appropriate behaviour for connecting both demand connections and generation connections?*

We agree that many incentives have benefit and will support appropriate behaviours. However, others are still unclear and may drive perverse results unless carefully developed. Examples of those with an element of risk from this are the proposed inclusion of Major Connections in Average Time to Connect and the socialisation of reinforcement for all growth in profile classes 1-4.

Question 2: *Is it appropriate to remove the DG incentive?*

We support the removal of the DG Incentive as it is unlikely to be appropriate for the mixed nature and types of connections being seen on our networks into the future.

Question 3: *Do you agree that we should split the BMCS customer satisfaction survey into major and minor connections customers? If not, why not?*

We believe Ofgem should reconsider the inclusion of connections, both major and minor, within the BMCS scheme following review of the impact of competition and the number of customer contacts.

Question 4: *How should we set targets for the BMCS customer satisfaction survey?*

We believe that an element of any CSS incentives should be based on the improvement by that DNO compared to its historic performance, reflecting any external issues unique to the DNO. We also recognise that an individual DNO should be incentivised to improve towards the frontier performance. We therefore think it reasonable that any CSS incentive could apply a 50% weighting between these two elements in setting incentives.

Question 5: *We invite views on our proposals for the Long Term Development Strategy (LTDS), Distributed Generation (DG) Connection Guide and Information Strategy (IS).*

We see merit in the proposals for the LTDS. We are comfortable that the focus to provide good and timely information to connection customers has moved on from the DGIS to a more focussed major customer service score.

Question 6: *Are additional or alternative incentives required to encourage the DNOs to provide better information to connection customers upfront? If so, what would these measures and incentives be?*

No.

Question 7: *We seek stakeholders' views on the introduction of a new Average Time to Connect Incentive.*

We consider the development of the average time to connect incentive for smaller customers to be a positive step as we recognise how important timing, speed of service and cash flow are to our customers. We believe the incentive for this group reflects the level of risk for a new incentive and is fair.

We do not believe this should be extended to major customers, where time to connect is often dictated by their own needs beyond the influence of the DNO, without allowing appropriate exemptions and extensions to the incentive. This approach was supported by external stakeholders at the relevant Ofgem working group.

Question 8: *We seek views on which aspects of service should be measured, the approach used for target setting and whether any exemptions should be applied under the Average Time to Connect Incentive?*

We consider the average time to connect incentive should be simple for all stakeholders to understand, and should be the number of working days between the date that a customer accepts a quotation and the date at which all works are completed on site, as defined under the GSoPs SI and supporting Guidance.

We also consider the incentive should be based on improvement to historic performance by a DNO, rather than its performance relative to a group mean. This approach would drive improvement for all customers while recognising that many factors affecting the average time to connect are specific to an individual DNO network topology and geographic area.

Alignment with our GSoPs, applying the exemptions that are captured in the SI and supporting Guidance, would ensure that this incentive would align with existing standards.

Question 9*: Do you agree with our proposed approach for the treatment of connection customer contributions by the DNOs during RIIO-ED1?*

Yes.

Question 10: *Are additional incentives needed to encourage the DNOs to provide high-quality, timely non-contestable work? If so, what incentives should be applied?*

Although not directly an incentive, we consider a significant element of providing timely connections is the early reinforcement of higher-voltage networks, especially where we have robust intelligence to inform our business plans that the additional capacity will be required. This proposal would involve our investment plans being supported by appropriate key stakeholders such as local authorities, government bodies and developers. We foresee these costs to be recovered through the ECCR and changes to the CCCM.

Question 11: *We seek views on the financial exposure and scope of incentives for those market segments that have/have not passed the Competition Test.*

We consider that segments which pass the competition test should not be subject to regulation under RIIO-ED1.

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.

CHAPTER 9:

Question 1: *Do you agree with our proposed range for the efficiency incentive rate?*

We consider it is appropriate to maintain the efficiency rate at a level which strongly incentivises DNOs to ensure efficient delivery against costs – so a minimum of this level should be available. The combined efficiency rates under DPCR5 for SHEPD and SEPD were 59.4% and 56.2% respectively (compared with a 'headline' efficiency rate of 49%).

The nature of the work which DNOs undertake, being primarily high volume work with lower concentration risk on one-off projects than in other energy sectors, means that cost outperformance or underperformance is far more likely to result from systematic efficiencies or inefficiencies rather than aspects which are outwith the control of the DNO. This would imply a higher efficiency incentive rate than under RIIO-T1 (40%-50%), where there is a greater concentration of large projects, would be appropriate for RIIO-ED1.

Furthermore, we consider that a high efficiency incentive rate would provide an appropriate incentive to DNOs to provide "smarter" solutions to issues caused by decarbonisation of the economy. Without this, companies may be more inclined to utilise more expensive traditional solutions ahead of need which could result in stranded assets. This would suggest a higher efficiency incentive rate than under RIIO-GD1 (50%-60%) would be appropriate under RIIO-ED1.

These factors would suggest that a range of 60% to 70% would be more appropriate, and that the bottom end of Ofgem's proposed 50% to 70% range for RIIO-ED1 should not be applied, particularly in light of the actual DPCR5 rates.

Question 2: *Do you agree with our proposed approach to the calibration of the IQI?*

We do not agree with Ofgem's proposed approach to IQI calibration.

The purpose of the IQI allowance is to provide a financial incentive for DNOs to provide accurate forecasts of expenditure, and to then incentivise performance against these forecasts during a price control period.

It is probable, in our view, that any DNO whose business plan is 100% of Ofgem's baseline will be within the upper quartile of efficient companies. The proposed calibration of the IQI by Ofgem does not recognise this at present. Under previous price controls (and notably under the RIIO-GD1 and RIIO-T1 price control frameworks), providing expenditure estimates which match Ofgem's estimates would result in a financial reward. We agree this is appropriate as it encourages companies to appropriately balance the risks and rewards of their investment decisions and outperform against their forecasted expenditure. The proposed calibration of the IQI does not achieve this, as it provides no financial incentive for DNOs to meet their forecasted expenditure.

We believe the calibration of IQI should be consistent with that under RIIO-GD1 and RIIO-T1, ensuring that a consistent regulatory message is sent out to all sectors. The RIIO-GD1 Initial Proposals, for example, proposed a positive up-front IQI allowance being given to companies who submitted business plans at 114% of Ofgem estimates.

Question 3: *What are your views on the indicative IQI matrix?*

As noted in our responses to Questions 1 and 2 above, we do not agree with the indicative IQI matrix which Ofgem has proposed.

Question 4: *What do you consider are the appropriate rewards for fast-track companies compared to non fast-track companies? Should we have a differential between the two?*

We agree there should be a financial incentive in place for fast-tracked companies. The level of reward presented in RIIO-T1 (2.5% of totex) would seem an appropriate and consistent level to apply.

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.

Question 5: *Do you agree with our proposals for the same efficiency incentive rate to apply to all areas of expenditure that will be included within the IQI?*

We agree it is appropriate to have the same efficiency incentive rate for most areas of expenditure.

This is administratively simpler than previous approaches, is consistent with the approach taken in RIIO-T1 and RIIO-GD1, and makes for consistent decision making. Companies should be able to control their totex expenditure as easily as their business support costs, so there is no clear rationale for having different rates.

The exception to this is incremental deficit pension costs. We do not believe that it is appropriate to include incremental deficit costs as part of the efficiency incentive. There are components which will go to make up the incremental deficit which are outside the control of any DNO, and therefore it is not appropriate that these are subject to a sharing mechanism. Rather, if these are determined to be efficiently incurred, they should be fully reimbursed as a pass-through cost.

Question 6: *Do you agree with our proposed treatment of DNOs within a single ownership group? If you disagree with our proposals in these areas, please explain the basis for an alternative approach.*

We disagree with the proposal to have the same treatment for DNOs within a single group.

There is no clear rationale for doing so, and treating all members of an ownership group the same for IQI purposes is not consistent with other aspects of RIIO-ED1.

CHAPTER 10:

Question 1: *Do you agree that the cap on funding for the electricity NIC should be within the range of £60m and £90m for 2015-16 and 2016-17? Please provide evidence to support your suggested level of funding.*

We consider a level of £90m, which includes transmission, should be considered as a minimum.

To date, the appetite for LCN Fund Tier 2 funding has been strong, with the level of funding requested exceeding that available (£64m). As the LCN Fund has only recently been introduced, in addition to the challenges facing DNOs and the requirement for change, it will become more critical for an additional level of funding to be made available.

We also consider it equally important for Ofgem to ensure that the focus of future funding should be heavily weighted towards projects that result in immediate benefit to stakeholders. DNOs should be able to attract funding for implementing innovative projects as 'business as usual' activities rather than high-level conceptual development projects.

If projects are not of sufficient quality this amount does not have to be spent, but we believe it should be provided for and geared towards making innovative solutions business as usual for all DNOs. We will be submitting details of our proposed innovation strategy as a key part of our Business Plan in July 2013, and we expect other DNOs to do likewise. We consider that before any projects are approved they should also be reviewed by other DNOs for duplication of learning and the potential for future collaborative working.

We will also be providing comments on NIC funding in response to the licence drafting and governance document consultations.

Question 2: *Do you agree that the level of funding for the rest of the ED1 period should be reviewed in 2016 following a review of the LCN Fund?*

We welcome Ofgem's review of the LCNF in 2016 and as suggested, believe this should help inform future funding requirements going forward.

We also consider a review at that stage is appropriate as indications are that the requirements for smart grid solutions are likely to be more dominant towards the end of the RIIO-ED1 period. It is essential the level of funding matches the level of challenge and change faced by DNOs. We believe Ofgem should review the rate of conversion to business as usual and incentivise this behaviour through the allocation of funds.

Question 3: *What are your views on the information DNOs should provide in their innovation strategies? How can DNOs best demonstrate that their approach to innovation is sufficiently well justified and robust?*

We consider the information suggested for inclusion in DNO innovation strategies is appropriate and covers many key areas.

As noted in our response to question 1 above, DNOs should be expected to demonstrate how their approach to innovation is being implemented as business as usual. We consider this is the best benchmark to ascertain whether a DNO is serious about their approach to innovation.

A DNO's strategy should also be focused on particular issues or priorities on its network, demonstrate how it builds on previous innovation and lessons learned, and how this fits in with the DNOs overall business plan. It should also be based on extensive but relevant stakeholder engagement.

In addition, given the potential benefits of increased collaboration between DNOs and stakeholders, we believe it would be helpful if innovation strategies also highlighted any particular areas where collaboration may be required or helpful.

Question 4: *Do you agree that it would be valuable for DNOs to consult and update their innovation strategies regularly during the price control period?*

We agree innovation strategies should change as our understanding of the issues, challenges and potential for smart solutions develops. However, we would not expect strategies to be amended or consulted on every year, but as required following ongoing reviews by the DNO.

Question 5: *Are there any aspects of the innovation framework for ED1, which you think should differ from the arrangements from RIIO-RIIO-T1 and RIIO-GD1? If yes, please explain why.*

We consider the RIIO-T1 and RIIO-GD1 arrangements are suitable for RIIO-ED1.

However, we believe consideration should be given to the differences across the DNOs, the extent to which smart technologies are already developing on individual networks, and the impact of individual network constraints.

Although most of the WS1/3 DECC scenarios predict no significant changes until RIIO-ED2 or RIIO-ED3, we are already seeing significant penetration of renewable generation and low carbon demand on some parts of our network.

We have already started to manage demand side response and storage, with smart solutions being trialled and implemented to a significant extent. In some cases the greatest value for customers is likely to be delivered from projects focused on real and current issues on specific networks, and in these cases learning is most likely to be turned into business as usual well ahead of RIIO-ED2.

RELIABILITY AND SAFETY

CHAPTER 2 – Overview of Reliability and Safety

Question 1: *What are your views on the primary outputs and secondary deliverables for reliability and safety? In particular:*
(a) Do you agree that these are appropriate areas to focus on?
(b) Are there any other areas that should be included?

We are supportive of Ofgem's proposals for primary outputs and secondary deliverables for reliability and safety. We support the increased consistency proposed for measuring both LI and HI on a comparable basis between DNOs and the introduction of a criticality measurement for informing asset replacement decisions.

However, we are concerned that proposals to create an overall risk index for each asset is unnecessary for items which are not due for intervention, although development of these proposals is still under discussion.

CHAPTER 3 - Safety

Question 1: *What are your views on the proposed primary output and secondary deliverables relating to safety?*

The proposed safety output of compliance with statutory and legislative obligations is an existing duty for all DNOs, and we therefore support this being an appropriate primary output.

The secondary outputs of asset health, criticality and risk index to an extent repeat reliability outputs, which we agree with subject to our comments regarding their effective application (please refer to our responses below on health indices).

Question 2: *Are these appropriate areas to focus on and are there any other areas that should be included?*

We consider these activities are appropriate as safety metrics.

Question 3: *Do you agree with our proposal not to place a financial incentive on the primary safety output?*

No. 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:

- 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

- 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.

Question 4: *Do you agree with our proposal to create an incentive framework for secondary deliverables for electricity distribution safety?*

Please refer to our response to question 1 above. We do not support an incentive in the area of the proposed secondary deliverable.

CHAPTER 4 – Interruptions Incentive Scheme

Question 1: *Do you agree with our proposal to align the IIS incentive rates with those proposed as part of RIIO-T1?*

We consider the existing mechanism works well and it is not necessary to align this with the incentive rates in RIIO-T1. This is because the distribution networks and their effect on customer interruptions are generally quite different to that of the transmission network.

However, we do not consider this will have a material impact if done as described in the Strategy Consultation document.

Question 2: *What are your views on applying the efficiency incentive rate to the IIS incentive rates?*

Please refer to our response to question 1 above.

Question 3: *Do you believe we need to introduce a rolling incentive mechanism for IIS, along the lines of the shrinkage rolling incentive proposed in RIIO-GD1, and if so outline your views on the merits of this approach for the IIS?*

We would welcome further clarification from Ofgem of how this mechanism would be applied to IIS. The proposal appears to offer benefits of smoothing-out changes to IIS rewards or penalties by spreading these over the following eight years, and would also reduce the impact on DUOS charge volatility year-on-year. Our preference would be for option B of the RIIO-GD1 proposals with the rolling period continuing into the following price control period rather than a true-up in the first year.

Question 4: *What are your views on the level of revenue exposure and do you believe we need to reintroduce a cap on outperformance?*

We consider the existing mechanism works well in maximising the incentives for DNOs to improve network performance, and that the proposed cap will only reduce this incentive and may cause DNOs to stop looking for further improvements when they reached the capped position.

Question 5: *Do you agree with our proposal to set separate planned and unplanned interruptions and minutes lost targets under the IIS?*

Yes. We understand and support the proposal to separate planned and unplanned targets.

Question 6: *Do you have a preference amongst the options which we have outlined for planned interruptions and minutes lost target setting in RIIO-ED1?*

We prefer the proposal to set rolling targets based on three years performance with a two-year lag.

Question 7: *Do you have a preference amongst the options which we have outlined for unplanned interruptions and minutes lost target setting in RIIO-ED1?*

We prefer to have the targets set up front and based on the existing methodology.

However, in the absence of any QoS funding, and as network performance is governed by a series of factors (both historical and geographical), we believe it would be more appropriate for the proposed improvement targets to be set at the same level for all DNOs and voltages (e.g. 1%). This would avoid any complication with changing improvement factors if a DNO's performance improves or deteriorates, so they change position relative to the benchmark.

Question 8: *Do you agree with our proposals on exceptional events?*

We agree the thresholds for weather-related exceptional events should remain unchanged.

The proposal to replace exceptional event days with an average period performance is a complication. Although we appreciate the underlying intention, we believe this is unnecessary taking into account the relatively low number of days affected, issues with part-days and the impact that storms can have on the days following an event which reduces performance as legacy incidents occur.

We note the proposal to review the thresholds for one-off events although we believe the current level is reasonable. We agree with the removal of the 5,000 customer exemption for EGS2 and that customers will receive GS payments at the 12 hour threshold, with costs being recovered by the DNO providing the incident passes a fair and independent exceptional event audit.

Question 9: *Do you agree with our proposed approach to smart electricity meters?*

We believe it is unlikely smart meters will have any material impact on network performance during RIIO-ED1, or that any change in performance can be attributed solely to smart meters. We suggest there is no requirement for rebasing during RIIO-ED1, and any impacts will be better understood when preparing for RIIO-ED2.

Question 10: *Do you agree with us not incentivising short interruptions in RIIO-ED1?*

Yes.

CHAPTER 5 – Load Indices

Question 1: *What are your views on our proposals on load indices (LIs)?*

We are supportive of Ofgem's proposals, and agree it is not effective to extend LI's into the general low-voltage network at this time.

Question 2: *Do you agree with our proposed common LI bandings?*

We agree with the proposed common LI bandings.

Question 3: *Of the two options outlined for determining the LI deliverable, which do you think is the most appropriate?*

We agree that Option 2 is the more appropriate, but the methodology needs to recognise the scope for investment ahead of need under controlled circumstances.

Question 4: *Where significant numbers of substations that predominantly cater for demand arise, do you agree that the development of a Distributed Generation (DG) index for generation-dominated substations would be feasible and appropriate to implement at the mid-period point of RIIO-ED1?*

The concept of Load Index is to monitor background slow load growth related to the loading of substations, to manage risk and need for investment in these areas.

Our 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.

Furthermore, our experience in this area is that the required network reinforcements required are more often related to voltage rise and not to overload, and this would not be picked-up by monitoring DG Load Index.

As a consequence we do not believe a DG Load Index would provide any benefit in informing DNOs or Ofgem of investment requirements in the foreseeable future. Our view is that Ofgem should review this position around the mid period of RIIO-ED1, but not commit to introducing such a feature at this time.

CHAPTER 6 – Health Indices

Question 1: *What are your views on our proposals for health indices (HIs)?*

We are supportive of the Health Index mechanism as a methodology to align asset condition and investment in replacement and refurbishment.

Question 2: *Do you agree with our proposals to introduce criticality into the HI framework?*

We support the assessment of criticality when determining asset intervention decisions and Ofgem's view in paragraph 6.17 that:

"Information on the consequences of asset failure should be useful to DNOs in prioritisation of asset interventions and in demonstrating to us how asset management decisions have been prioritised efficiently".

However, on the basis criticality is being used for this purpose we do not believe it is necessary or effective to collect and maintain criticality information for low-value high-volume assets, or assets in good condition not being considered for intervention. Furthermore, the extension of criticality to these assets on a consistent and comparable basis would be difficult to achieve in time for business plan submissions in July 2013.

We believe it is appropriate to understand the benefits of extending criticality into an overall ‘Risk Index’ for all low-volume high-value assets following further development and consideration.

Question 3: *Do you agree with our proposals for applying financial consequences in the case of material under or over delivery?*

Yes, we agree the proposals appear reasonable.

Question 4: *Do you agree with our proposals to require greater consistency in the types of assessments that the DNOs should feed into the calculation of the asset health indices?*

We agree with this proposal to introduce greater consistency and comparability into Health Index assessments.

Question 5: *What are your views on the suggestion that we would mandate DNOs to develop and maintain HIs in specified asset classes?*

We support the development of HI across specific asset classes where appropriate and effective, although we do not believe this would apply to individual high-volume assets on lower-voltage networks. We also believe it is more effective to maintain the health index of overhead lines on the basis of an overall circuit assessment rather than individual components.

CHAPTER 7 – Guaranteed Standards

Question 1: *What are your views on our proposals for the guaranteed standards?*

We agree the reduction of EGS2 from 18 to 12 hours is in the interests of our customers. We have two further suggestions which would benefit customers by simplifying the guaranteed standards:

- Simplify the time-banding of EGS2 compensation to a single payment of £50/£54 at 12 hours and a further £100/£108 at 24 hours only rather than increment the payment every 12 hours.

- Remove weather-related exemptions from EGS2 but allow DNO's to recover for these payments on a sliding scale for Exceptional Events.

We consider an allowance should be made for efficient levels of guaranteed standards recognising that this is an alternative to increased investment.

Question 2: *Do you feel that we should conduct a mid-period review of the guaranteed standards?*

We consider a mid-period review of the guaranteed standard payments would be appropriate.

Question 3: *Do you agree with our proposal to remove the potential double exemption of one-off exceptional events under the IIS and the guaranteed standards?*

We agree that DNOs should be allowed to pass-through guaranteed standard payment costs for exceptional events.

Question 4: *Do you agree with our proposal to remove all of the Highlands and Islands customer exemptions?*

We agree with this proposal provided the DNO is allowed to pass-through guaranteed standard payments for severe weather circumstances, as these are outside our control and the alternative is a very costly investment programme.

We therefore consider an allowance should be made for efficient levels of guaranteed standards recognising that this is an alternative to increased investment.

Question 5: *What are your views on our proposal to reduce the normal weather standard from 18 to 12 hours, the associated changes to payment levels and options for funding?*

We agree that customers value better restoration performance and, although the change to a 12 hour EGS2 standard will be challenging, we agree it is an appropriate move. On the basis that the compensation threshold is reduced by six hours we consider it is reasonable to keep the payments at or about the existing level.

We consider that, to avoid confusion over exemptions primarily in severe weather, payment should be made at 12 hours under all circumstances with companies able to pass-through compensation costs for exceptional events, on a sliding scale to maintain the incentive to focus on rapid supply restoration.

Question 6: *Do you agree with our proposal to keep non-domestic customers in the guaranteed standards?*

We consider it is appropriate to keep profile-classes 1-4 in the interruptions guaranteed standards but not major customers, for whom the payment level is not consistent with the impact on their business and they should be in an informed position to make other arrangements for supply continuity.

Question 7: *What are your views on the feasibility and practicality of making payments to all customers automatic?*

We consider that identifying the premises affected by a qualifying interruption should be much simpler following the rollout of smart meters, but the difficulty of ensuring that any compensation payment is directed to the right person remains.

Prior to the smart-meter roll-out automatic payments would be achievable but costly and labour-intensive without investment in real-time customer-network models. We are consulting with customers on options for automatic compensation payments.

Question 8: *Do you agree with our proposal to make payments to Priority Service Register customers automatic?*

We consider that automatic payments for interruptions GS failures to PSR customers are achievable from the commencement of RIIO-ED1.

CHAPTER 8 – Worst Served Customers

Question 1*: What are your views on the proposed options that we have outlined for the worst served customers scheme? Please include what you see as the pros and cons of each of the options, whether you have a preferred option and why.*

We support the continuation, with modification, of the current WSC mechanism.

We consider that option one, a continuation of the existing scheme, is appropriate to address the needs of the very worst served customers on the basis of DNO's proposing their own investment proposals and planned performance improvements.

While the IIS interruption mechanism addresses the average level of interruptions for customers, it does not target improvement for customers whose supply reliability is poor but not necessarily at WSC levels. Option two would address this area, but needs to incorporate a mechanism for mitigating the impact of extreme weather-related exceptional events.

Option three is a penalty-only mechanism, and overlaps with other existing EGS, and we do not support this option.

In our view, the best solution is a combination of options one and two to fund improvements for very worst-served customers and to drive improvement for other customers who suffer from an unreliable supply.

The current WSC definition does not take any account of duration, and we consider it would be appropriate to develop a revised definition taking both number and duration of interruptions into account. For example, this could include comparison of the impact of a series of interruptions not exceeding 1-3 hours with a sequence exceeding 12 hours.

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 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.

CHAPTER 9 – Resilience

Question 1: *What are your views on our proposals for network resilience?*

We support Ofgem's proposals for resilience.

- We have no current plans for HILP although the recent events in the US may prompt us to revisit this.

- We anticipate completing the majority of flood mitigation works in accordance with ETR138 before the start of RIIO-ED1 but new techniques for flood risk prediction may generate additional requirements.

- Our plans for Black Start are well advanced and we will have mitigated this risk for a significant number of substations by the end of DPCR5.

Question 2: *Do you think that our proposals cover the right areas or are there other areas that you think we should be considering?*

We consider Ofgem's proposals generally cover the right areas. Two other areas that may be worthy of further consideration are:

- Resilience of light-construction overhead lines in much of our Highlands and Islands area which were installed in the period from the 50s to the 80s and are below the current design standards required for the prevailing weather. These can provide issues for SHEPD during severe weather events such as gales and blizzards, and

although we address these as part of our routine refurbishment programme, we have no specific programme agreed for upgrading them; and

- The lack of interconnection to provide alternative supplies for many GSP sites and the consequences of a catastrophic event at a GSP.

TOOLS FOR COST ASSESSMENT

CHAPTER 2:

Question1: *Do you consider our overall approach to cost assessment appropriate and what changes, if any, would you propose?*

The discussions at the cost assessment working groups (CAWG) have provided ample opportunity for stakeholders to provide their views and comments on the approach for cost assessment.

We consider further work and focus is now required to finalise the models and techniques that will be used and that actual data should be input to provide a clear understanding of how costs will be assessed and where DNOs stand in this process. This includes identification of appropriate cost drivers. Therefore, we consider the overall approach has been appropriate, but data input and analysis is now required to avoid a repeat of the lack of transparency in allowance setting in DPCR5.

The deadlines which have recently been discussed at the CAWG regarding completion of the models were deemed to be too late from our perspective, but we have been heartened to hear from Ofgem at the November visit to SSEPD that there is intention to provide an initial draft of the various models by the end of November, with a 'final' version by March 2013.

These timescales are much more realistic for incorporation into the well justified business plans. As noted at the CAWG, it is important for all DNOs and Ofgem to understand the rankings of companies across all assessment models and the key drivers for efficient / inefficient performance.

Question 2: *Do you think Ofgem should take into account poor historical performance in its assessment of business plans, and if so, how?*

We consider historic performance should be taken into account when assessing business plans to test the DNO forecast performance of DNOs. Considerable historic data sets are available to test historic versus forecast performance this should at least be acknowledged by DNOs in their business plans.

DNOs with poor historic performance in cost assessment and efficiency in previous price control periods (i.e. DPCR3, DPCR4 and DPCR5) should be required to fully justify why they believe their forecast costs and performance would differ from their previous performance. If this justification was not compelling then historic inefficient performers should not be considered for fast tracking.

CHAPTER 3:

Question1: *Do you agree with the use of totex benchmarking for RIIO-ED1 and what are your reasons?*

We are supportive of the use of totex benchmarking for RIIO-ED1 to enable a viable alternative to disaggregated modelling.

However, as previously expressed to Frontier Economics, DNOs and Ofgem the current model being developed for totex essentially presents analysis on such high level drivers (customer numbers/peak load) without any associated outputs. This means that a perceived 'poor performing' DNO has no indication of why they are performing poorly or how they can improve. Moreover, in its current form we believe the model essentially identifies the constraints that a DNO cannot address. We have been heartened by recent discussions with

Ofgem who have indicated that the totex model should contain a range of potential cost drivers, such as network length, MEAV, other Network Scale Variables.

In our view, this highlights that SSEPD have considerably constraints (particularly within SHEPD's network) which we overcome to be highlighted as one of the strongest performing DNOs in the disaggregated modelling. The disaggregated modelling, while not perfect, does enable DNOs to relate the analysis to outputs and clearly identifies areas for improvement.

Our preference is for Ofgem to develop a 'middle-up' costs assessment model for the purposes of RIIo-ED1, and then to use totex and disaggregated models as a sense check only.

Question 2: *Do you agree with the use of a capital expenditure as opposed to capital consumption approach for measuring total costs?*

We agree with the use of capital expenditure as opposed to capital consumption for totex as it is a simple measure of the amount of cash invested, and is not subject to the historical vagaries of historical RAV addition / depreciation policies.

Question 3: *Do you agree with using a similar approach to the top-down model used in RIIO-RIIO-GD1, considering the adjustment for regional factors, the use of a composite cost driver, and the use of the upper quartile (UQ) to determine efficient costs?*

We agree with adjusting for selective, well-justified, regional factors, for example London density, and Highlands and Islands sparsity, but not for a sliding scale of sparsity / density across many DNO's. For the avoidance of doubt we will be proposing a Highlands & Islands sparsity adjustment as part of our well justified business plan.

We are also supportive in principle of a composite cost driver, assuming such a supportable driver can be produced, and we would also support the use of upper quartile to determine efficient costs as has been proposed in both RIIO-T1 and RIIO-GD1 price control reviews.

Question 4: *Do you believe it is appropriate to use a middle-up totex model and if so, do you agree with following the principles of the RIIO-GD1 approach?*

While we consider a middle-up model should be used for RIIO-ED1, due to lack of visibility of what constitutes a middle-up model, and the challenging timescales proposed by Ofgem for its development (i.e. by Christmas 2012), it is difficult to comment in specific terms.

The group activity level proposed would be supported by ourselves, with more discussion required as to the exact specification. Our response to question 1 in Chapter 2 of this section on Tools for Cost Assessment regarding visibility and deadlines are particularly relevant for this area of work.

Question 5: *What level of disaggregation do you believe is appropriate for the middle-up model to provide a useful comparator to the top-down totex model?*

On the basis that the totex model cost drivers are by definition at a high level (customer numbers, MEAV and network length), the level of disaggregation being proposed appears it may bridge the gap between the totex and disaggregated model. In paragraph 3.24, the group activity level proposed would be supported by SSEPD. However, care must be taken if further disaggregation is brought into this model, as this may overlap with the disaggregated model approach.

Question 6: *How do you believe lumpy expenditure should be treated in totex modelling?*

We consider, like all expenditure, lumpy investment should be justified with outputs as this is the critical factor. Whether it is flat or lumpy is not a critical factor in our view.

CHAPTER 4:

Question 1: *Do you believe it is appropriate to use a bottom-up, disaggregated model to compare with the totex model results?*

In principle, and as per our previous response on the totex modelling approach, we agree with the approach of having a range of models to compare and assess DNO expenditure and performance for the purposes of RIIO-ED1.

Question 2: *Do you agree with our approach to the disaggregated, bottom-up model?*

In principle, we agree with the approach to disaggregated modelling to date.

However, since the first version of this model we have raised key questions regarding the selection of activity drivers and the justification of deviation from the Ofgem DPCR5 activity driver approach. To date we have received no response or justification on these important matters.

Additionally, we can see the drawback at setting allowances at this very low-level of detail given the inconsistencies that still exist between DNOs across a range of categories. To this end, while we have not yet had sight of the middle-up model, if developed in a suitably robust fashion, this may be a more realistic level to set allowances at.

CHAPTER 5:

Question 1: *Do you agree with our proposed approach to how the specific building blocks that make up load related expenditure interact as well as which categories are proposed to be included in a load related reopener?*

From a cost assessment perspective, in principle we agree with the proposed approach. However, please refer to our previous comments in our summary response at the beginning of this paper regarding the need for working groups to develop these proposals further.

Question 2: *Which of the three options set out for assessing connection-related costs within the price control do you feel is the most appropriate and why? Please reference the following in your answer: d) the gross cost assessment adjusted for net-to-gross ratio or just on the Distribution Use of system (DUoS) funded reinforcement costs*
e) the most appropriate cost driver for connection reinforcement costs: Meter Point Administration Numbers (MPANs) or number of connection projects
f) the most appropriate approach for assessing cost of low volume high cost (LVHC) connections.

We consider that, although all three options have merits, the most consistent and appropriate seems to be Option 3 that applies a £/MW for LVHC projects and using Option 2 as a volume driver mechanism for HVLC projects.

We believe it is sensible and consistent to use a £/MVA based on general reinforcement (while ensuring the MVA is the additional capacity installed rather than applied for) for primary reinforcement associated with LVHC projects. We support using the market segmentation defined in DPCR5 and costs on this basis for HVLC projects to provide a secondary reinforcement driver.

In response to the three specific points we also support:

d) Distribution Use of system (DUoS) funded reinforcement costs;

e) Number of connection projects segmented by DPCR5 defined market segments; and

f) Low volume high cost with a unit cost benchmarked across the DNOs.

Question 3: *Which of the three options set out for assessing wayleaves and diversionary-related costs within the price control do you feel is the most appropriate and why?*

We consider Option 2 is the most appropriate as *ex ante* baselines set based on historical cost data and forecast developments in the number of claims over time.

However, as discussed at the CAWG we would expect an assessment of efficient delivery to ensure Customers are not paying more for this activity based on DNO specific historic costs.

Question 4: *For all general reinforcement, is it feasible for the DNOs to provide specific scheme lists based on commonly agreed demand scenarios in RIIO-ED1?*

It is feasible for DNOs to provide specific EHV/132kV schemes as provided for DPCR5 under the load index submission.

However, this is a forecast at a specific point in time and would therefore allow DNOs to explain where they deviate from this forecast rather than penalty for not delivering LI improvement where the demand has not materialised.

Question 5: *For all general reinforcement, do you think that reinforcement specifically relating to generation should be separately assessed from demand-related reinforcement?*

We agree the assessment should be separate for primary network reinforcement. However, this may prove problematic for secondary networks.

Question 6: *Do you agree with our proposed modelling approach to cost assessment of n-1 reinforcement schemes, specifically in relation to the two proposals for the Load Index (LI) delivery as outlined in Chapter 4 in the "Supplementary annex – Reliability and Safety•?*

Please refer to our previous responses to questions on load indices that are raised withiin the Reliability and Safety supplementary annex.

Question 7: *Do you agree that expenditure on secondary network reinforcement is no longer highly correlated with localised economic growth?*

No. Secondary network reinforcement is correlated to localised economic growth. However, we accept that the volume of activity is lower than for the primary network.

Question 8: *Do you believe that it is feasible and appropriate to set definitions and unit cost(s) for the following: d) the conversion of wayleaves to easements and injurious affection payments;*
e) load related interventions on the secondary network; and
f) fault level reinforcement?

Our response to the above questions are as follows:

d) Yes in principle by voltage;

e) No there is too much diversity regarding specific scheme solutions; and

f) No this is low volume/high volatility activity which will be significantly affected in the future by DG.

Question 9: *What is the most appropriate funding mechanism for load related expenditure on the secondary network?*

We consider the most appropriate funding mechanism is an *ex-ante* approach with an associated volume driver for lower voltages and a £/MW driver for higher voltages.

CHAPTER 6:

Question1: *Do you agree with our approach for assessing NLRE in the companies ′ business plans?*

In principle we agree with the approach for assessing NLRE. However, as discussed at the CAWG in order to avoid similar issues encountered in DPCR5 early transparency regarding the assessment will be required.

Similarly in terms of the age based model, this model was shared with the transmission operators for RIIO-T1, and therefore it would seem sensible for DNOs to have early visibility of this model to enable them to use the output as part of their business plans.

In terms of the cost benefit analysis (CBA) requirements, significant further guidance is required to ensure the use of CBAs are appropriate and proportionate to the materiality thresholds of specific expenditure items. Without further guidance, Ofgem may find they are inundated with unnecessary CBAs at the time business plans are submitted in July 2013.

Question 2: *In light of our proposals, do you agree with our selection of risk removed as the primary output of the mains replacement programme?*

The only reference to risk removed seems to relate to load index. We do not understand the relevance of the question to mains replacement programmes?

Question 3: *Do you agree with our approach to remove non-modelled costs in RIIO-ED1?*

In principle we agree, providing early transparency and data is provided regarding how these will be modelled.

Question 4: *Do you agree with our proposed approach for assessing the DNOs ′ plans for expenditure on Legal and Safety? If not, what changes would you propose?*

In principle we agree, again providing early transparency and data is provided regarding deviations from the DPCR5 approach i.e. for site security being benchmarked.

Question 5: *Do you agree with our proposed approach for assessing the DNOs ′ plans for expenditure on ESQCR? If not, what changes would you propose?*

While we agree in principle that ESQCR expenditure should fall away during RIIO-ED1, there will be DNOs (e.g. SHEPD) who have agreed a phasing of resolution that involves

expenditure in RIIO-ED1. These costs could be included in business as usual categories and be justified, providing there is recognition that business as usual costs could be higher to accommodate the inclusion of these legitimate costs.

Question 6: *Do you agree with our proposed approach for assessing the DNOs' plans for expenditure on flooding? If not, what changes would you propose?*

We agree with Ofgem's proposed approach for mitigating flood risks identified during DPCR4. However, we recognise there may be new requirements for flood mitigation work arising from new or improved flood risk mapping techniques during RIIO-ED1.

Question 7: *Do you agree with our proposed approach not to fund Quality of Service (QoS) improvements during RIIO-ED1?*

We do not disagree with the proposed approach providing all DNOs are treated equally. However, we are not clear how DNOs are expected to fund the year on year improvements in IIS performance for the full eight year RIIO-ED1 period.

Question 8: *Do you agree with our proposed approach to change Black Start and Rising and Lateral Mains (RLM) from reopener mechanisms to ex ante allowances?*

We agree with Ofgem's proposals.

Question 9: *Do you agree with our approach to assessing enhanced physical site security costs?*

We agree with this approach as this will be based on the industry discussions and sites identified by DECC.

CHAPTER 7:

Question1: *Do you think that our proposals for the Trouble Call are proportional given the materiality of the area and do you have any preference between the options? Please separate your response by the following categories: low and high voltage overhead faults; low and high voltage underground faults; EHV and 132kV faults; ONIs (formerly non-QoS faults); third party cable damage recovery; pressure assisted cables; and submarine cables.*

For low and high voltage overhead faults and low and high voltage underground faults, we agree with re-using the DPCR5 approach in principle but at this stage we agree with Ofgem's statement regarding the level that this goes down to being dependent on the quality of data provided.

For EHV and 132kV faults we believe that the method which provides the most robust statistical result should be employed.
For ONI's, we would be comfortable with re-using the DPCR5 approach, benchmarked on average or UQ.

We are comfortable with the proposal to use the maximum of forecasts and historical averages for 3rd party cable damage.

For pressure assisted cables we feel further work is required as from analysis that we have conducted and shared with Ofgem it would appear this continues to be a boundary issue.
For submarine cable, given that this predominantly impacts SHEPD, we feel that further bi-lateral work is still to be done, particularly given the interaction with asset replacement, and we would look to address this in our well justified business plan.

Question 2: *Do you agree with our approach to assessing Severe Weather 1 in 20 Events and do you have any preference between the options?*

We agree in principle with Ofgem's approach to 1 in 20 events to re-use the DPCR5 approach.

Question 3: *Do you agree with our proposed approach for assessing the DNO's plans for expenditure on Inspection and Maintenance (I&M)? If not, what changes would you propose?*

While we agree with benchmarking costs at the upper quarter level for unit costs, the proposal for volumes to take the minimum of DNOs' own forecast costs and industry average of actual historical volumes needs further clarification. If this is to be interpreted as DNOs' own forecast volumes and industry average volumes, we understand the rationale for this process.

In DPCR5, we understand how allowances were set but we cannot understand how allowances would be set for RIIO-ED1 using a combination of DNOs' own costs and industry average volumes. For this to be our preferred approach, there would have to be consistency across DNOs for I&M volumes. At the moment it would appear there could be different policy arrangements which result in boundary issues for volumes.

We anticipate there will be a further clarity on this issue when the models are released either in December 2012 or January 2013.

For submarine cable, given this predominantly impacts SHEPD, we consider further bi-lateral work is still to be done particularly given the interaction with Asset Replacement. We would look to address this in our well justified business plan.

Question 4: *Do you agree with our proposed approach for assessing the DNO's plans for expenditure on Tree Cutting? If not, what changes would you propose?*

Our understanding is that 'Spans Managed' has been removed from the CV14 in the RRP therefore the approach being suggested could not be followed at the current time. However analysis on forecast expenditure associated with spans cut and spans inspected would seem sensible.

Question 5: *Do you agree with our approach to assessing NOCs Other and do you have any preference between the options? Please separate your response by the following categories: dismantlement, remote location generation, and substation electricity.*

We agree that dismantlement costs should be assessed separately as per DPCR5
For remote location generation we broadly agree with taking the DPCR5 approach of using historic costs.

For substation electricity we are comfortable with Ofgem's approach in SEPD, but given the generally colder weather in the North of Scotland, we feel that a higher allowance should be given for SHEPD for additional heating and lighting costs in this area.

We are broadly supportive of a calculated consumption rate being applied, as we already utilise a methodology in order to produce our usage figures for the Business Carbon Footprint. However, we would ask Ofgem to be mindful that we employ different consumption rates depending on the location of the substation, as those in SHEPD will be subject to increased heating and lighting requirements during the winter months.

CHAPTER 8:

Question1: *Do you agree with our proposed approach to assess CAIs? In particular, do you agree with our groupings of activities?*

We are in broad agreement with the categorisation used in Table 8.1 across CAI's. In our experience System Mapping would be more inclined towards the fixed Group B categories, in that we would require a step-change in activity before we would experience substantial movement. We welcome the fact that both WFR and TMA will be considered separately in RIIO-ED1.

Additionally, we are supportive of analysing the non-op Capex element of indirect costs alongside their indirect element i.e. CAI Vehicles & Transport alongside non-op Capex Vehicles & Transport.

As mentioned at Ofgem's visit to SSEPD, we feel that the current RRP reporting requirement for Vehicles & Transport, whereby companies which substantially insource (including their own related parties) and therefore have to show Vehicle costs within CAI could be unfairly assessed via regression analysis against companies which predominantly outsource, and therefore retain these costs within their Direct activities. We are keen to further explore this boundary issue with Ofgem.

Question 2: *Are there any views as to which cost drivers would be most appropriate?*

We were broadly supportive of the cost drivers of the cost drivers used in Final Proposals at DPCR5, where MEAV was used in conjunction with NI. The initial drivers proposed by WPD in the disaggregated model include MEAV and these are reasonable, although further work is required for system mapping (i.e. length of total underground cable and operational training) where total number of direct employees could be used in the first instance.

Question 3: *Do you believe our approach to assessing Workforce Renewal is appropriate? In particular, do you believe it is appropriate to consider Workforce Renewal allowances both in isolation and also as part of wider training and do you believe Workforce Renewal should include or exclude the training of contractors?*

We welcome the fact that WFR will be considered separately in RIIO-ED1, at least in part using the model being currently developed by all DNOs and EU Skills. Looking at how this fits in with a company's wider training programme is likely to be beneficial for both DNOs and Ofgem.

We do not believe WFR should include the training of contractors, as there is no guarantee these resources will be available to the industry in future given the fluid nature of the contracting market. We consider this is down to individual companies to manage on an insource/outsource basis.

CHAPTER 9:

Question1: *Do you agree with our general approach to assessing BSCs? If you disagree with any particular areas can you please specify what these are and your reasons?*

While we agree with the assessment of BSCs against other network companies and against external BSC benchmarks in theory, we had several specific issues with the approach taken within RIIO-GD1.

We were concerned that other network companies were excluded from benchmarking, that unrelated companies within the same overall Company Group (i.e. SHETL / SHEPD / Scotia

Gas) were regressed together, and are concerned about the selection criteria of using either external benchmark or GDN benchmark figures on a category by category basis, with an unachievable overall total benchmark figure for BSCs.

We do agree with the proposal to potentially seek advice from external consultants in specialist areas such as IT and property, and including network policy within CAI.

Question 2: *With regards to the non-fast-track benchmarking, for those DNOs that report lower than the benchmark costs which of the three options for setting cost allowances to you think is most appropriate and why? The options are: increasing allowances to the benchmark level of costs, giving the DNO their submitted level of costs, and taking an average between the benchmark and the submitted costs.*

Our preferred option is to increase allowances to the benchmark level, as we consider there should continue to be a reward for cost efficiency.

Question 3: *Do you agree with the cost drivers set out for each of the categories of Business Support Costs? If not, can you please suggest an alternative?*

For finance & regulation (excluding Insurance), CEO and property categories where the suggested metric is 'Cost as a % of base revenue' SSEPD are comfortable with this approach provided that SHEPD base revenue includes the Assistance for Areas with High Electricity Distribution Costs element.

For HR & Non-op training, we would prefer the metric to be Total Number of Employees rather than purely direct employees.

For IT &T costs, we feel that key to successful benchmarking in this area is identification of fixed costs, which Ofgem have acknowledged needs further work at the CAWGs. Excluding these fixed costs, we are comfortable with the metric of Cost per end user proposed.

Question 4: *Do you agree with the proposed use of expert review to assess IT&T and property costs?*

We agree with the proposal to potentially seek advice from external consultants in specialist areas such as IT and property.

CHAPTER 10:

Question1: *Do you agree with our approach to regional and company specific adjustments?*

We disagree with the Ofgem minded position of not replicating any DPCR5 adjustments.

We agree that the onus should be placed on the licensee to justify any proposed adjustments in the submitted business plans, and we firmly believe that there is a sparsity issue for our Highlands & Islands area that we look forward to exploring further with Ofgem.

Question 2: *Which regional and company specific adjustments do you think we should consider in RIIO-ED1? Please give a rationale for your suggestions.*

We believe that an adjustment for living and working in and around London and SHEPD should be the only adjustments considered in RIIO-ED1.

This is because SHEPD has:

- 25% of the UK land mass with only 2.5% of UK customers;
- 3 times UK average km/customer cable length;
- 10% of our customers are island based;
- coastline of 15,000km means resultant switchgear and plant corrosion; and
- Additional factors, such as submarine cables, severe weather events, Private Mobile Radio.

CHAPTER 11:

Question1: *Are there any additional analytical techniques that we should consider beyond those we have used at past price control reviews to assess RPEs and ongoing efficiency?*

For RPEs we would intend to commission an economic study either ourselves or via the ENA. This would consider a range of available economic forecasts & evidence that will allow to a view to be taken on the appropriate level of RPEs. This external expert view is preferable to an individual Ofgem or DNO view.

We fully support the requirement for DNO's to strive for ongoing efficiency. Our own internal plans and targets look to achieve an ongoing efficiency and cost reduction target of approximately 0.5% p.a. Evidence of efficiency levels in other regulated sectors in the UK should also be examined. Less reliance would be placed on efficiency levels in other non-network industries which will be at different levels of efficiency depending on history and current market and economic conditions.

Question 2: *Are there any additional data sources that we should be aware of to assist with our analysis of RPEs and ongoing efficiency? Are there some that you think we should rely more on than others?*

Please refer to our response to the previous question.

BUSINESS PLANS AND PROPORTIONATE TREATMENT

CHAPTER 3:

Question 1: *Do you have any comments on the timing and stages of the assessment process?*

SSEPD agrees with Ofgem's proposals for the timing and stages of the assessment process.

Question 2: *Do you agree with the three stage assessment process for RIIO-ED1?*

We agree with Ofgem's proposed three stage assessment process.

In our view, it is entirely appropriate for Ofgem to focus their efforts on areas that are likely to produce the greatest value to stakeholders. We consider it important for Ofgem to assess the quality of DNO business plans, their record of efficient output delivery (i.e. delivery of outputs at the lowest possible cost) and proposals to improve past performance where this has previously been problematic. We also welcome the opportunity to present our business plans to the Authority.

We also agree that Ofgem should award a lower level of attention to well prepared and well justified business plans that should lead to a DNO being considered for fast tracking. In our view this aligns with better regulation principles and suitably incentivises DNOs to prepare good quality, well articulated business plans in the first instance.

We also support Ofgem's proposal to create a licence drafting working group following the publication of the Strategy Decision. Given the timelines for completing the RIIO-ED1 process, it will be important to ensure the policy rationale is underpinned by suitable licence conditions that achieve the policy objectives. We are familiar with the timetable that was adopted for RIIO-T1 and RIIO-GD1, and consider a similar approach would be appropriate for the RIIO-ED1 process.

Question 3: *Do you think the additional reward for fast tracking is appropriate?*

We consider it important to ensure that any DNO who is fast tracked is not disadvantaged. Such an outcome would clearly be contrary to the intended purpose of acknowledging and recognising well prepared business plans.

We acknowledge that a DNO is able to withdraw from being fast tracked at any point during the assessment process, although in reality we think it extremely unlikely that any DNO will want to do this having already been approved for fast tracking.

Therefore, the question of an appropriate level of financial reward for fast tracking is an important one. Our initial view is that an allowance of 2.5% of totex is an appropriate reward for being fast tracked. That said, we consider the IQI matrix should be calibrated to enable a potential reward of 2.5% to be awarded to non-fastracked companies who are in the upper quartile of efficiency, and as was the case with the RIIO-T1 and RIIO-GD1 price control reviews.

CHAPTER 4:

Question 1: *Does the categorisation of the assessment criteria remain appropriate?*

We consider both the assessment criteria, and the way this has been categorised, is appropriate for RIIO-ED1. We also consider the explanation of the criteria provided by Ofgem

is extremely useful and is an improvement on the guidance that was provided under the previous price controls for RIIO-T1 and RIIO-GD1.

Question 2: *Are there any criteria which we should add or amend in the context of RIIO-ED1?*

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

CHAPTER 5:

Question 1: *Is there anything else, in the context of the presentation and structure of the business plan, which we should provide guidance on?*

We consider the guidance provided by Ofgem to date is helpful, and we do not have any further questions at this time.

Question 2: *Should we require DNOs to conform to the proposed document structure (set out in figure 4.1), some other prescribed structure, or let the DNOs structure the plans as they see fit?*

We agree that some level of prescribed structure to DNO business plans would be beneficial to all interested parties. This will improve the ability of stakeholders to better understand what a business plan offers them, and will also allow interested parties to compare and contrast where necessary.

The proposed high level structure proposed by Ofgem appears to be appropriate, but we would caution against any further level of prescription as this may fetter the ability of DNOs to distinguish their plans and represent these in a way that best represents the needs of their stakeholders.

Question 3: *Should we set a page limit for the executive summary of the plan? How long should it be? Are there other areas where we should consider setting page limits?*

We do not consider there is a need for Ofgem to prescribe a maximum number of pages for any aspect of a DNO's business plan. If a DNO wishes to be fast tracked, it will be essential for them to structure their business plan in such a way as to make it easy for stakeholders, including Ofgem, to understand. If a DNO makes any aspect of their business plan too long or too short, this will detract from the overall readability of their business plan and this will reduce the possibility of being fast tracked.

Question 4: *Do you agree with the information that we are proposing should be required in each DNO's executive summary? What other information would be useful.*

We agree with the components proposed by Ofgem for inclusion in each DNO's executive summary. In addition, we would also suggest that each DNO should include:

- a brief overview of who they are and the customers they serve; and
- a brief explanation of how innovation will influence their plans and maximise benefits for stakeholders.

Question 5: *What should be the common metric, calculation and assumptions for determining the impact of the DNO's proposal on consumers' bills?*

We consider the impact of DNOs' proposals on customers' bills should be based on the CDCM model. This should be used to demonstrate the effect on a typical domestic customer's bill averaged across the eight year period of RIIO-ED1.

CHAPTER 6:

Question 1: *Do you agree with our proposed approach to cost benefit analysis?*

We support the use of cost benefit analyses (CBAs) for the purposes of RIIO-ED1.

The proposed approach suggested by Ofgem appears appropriate and draws on the experiences of the RIIO-T1 and RIIO-GD1 price control reviews.

Question 2: *Do you agree with our proposed approach to have a threshold level of expenditure to determine whether cost benefit analysis is required?*

We agree it is important to have a proportionality threshold level applied to the use of CBAs. There are numerous options for establishing such a proportionality threshold. Our view is that the application of a simple monetary threshold may not be the most appropriate. We note that a threshold of £500k was determined as appropriate for RIIO-GD1. However, a similar threshold for RIIO-ED1 could, we believe, lead to an unnecessarily high number of CBAs for Ofgem to appraise.

We consider it would be more appropriate for Ofgem to set the RIIO-ED1 threshold as a percentage of category spend (i.e. where individual projects or programmes exceed this level then a CBA should be required). Additionally, CBAs should be required where a DNO proposes to deviate from standard industry practices and it may not be appropriate to apply any financial thresholds to these instances. For instance, where a DNO proposes to refurbish rather than replace assets a CBA should be required to demonstrate the impacts to stakeholders of the actions a DNO is proposing to take.

Question 3: *What level of expenditure do you believe should be used as the threshold for determining when cost benefit analysis should be provided as part of the business plan submission?*

Please refer to our response to the previous question.

Question 4: *Have we identified all of the relevant parameters to ensure consistency in how cost benefit analysis is undertaken?*

We agree with Ofgem that many uncertainties exist for RIIO-ED1 regarding the useful life of assets. A good example of this is where the implementation of innovation as business as usual may not yet be accurately quantified. However, what is certain is that consumers will require electricity for many, many years to come

This was different for RIIO-GD1 (i.e. 16 years), as the longer term future of gas is less certain and the CBAs needed to reflect that uncertainty. Because this degree of uncertainty does not exist for RIIO-ED1, we consider it appropriate to calculate payback periods over a period of 45 years. This would be commensurate with the depreciation life cycles also being proposed by Ofgem for RIIO-ED1.

Question 5: *What are your views on the levels the parameters should be set at?*

Please refer to our response to question 2 above.

UNCERTAINTY MECHANISMS

CHAPTER 2:

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

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

We agree that uncertainty mechanisms can have advantages and disadvantages for both consumers and DNOs. This is particularly relevant for RIIO-ED1 where a high degree of uncertainty is prevalent, especially with regard to the uptake of innovative and low carbon technologies.

We recognise concerns about the potential impact of uncertainty mechanisms on the variability of tariffs and, in particular, the potential for volatility of these tariffs. However, we believe both can be addressed through notification periods and smoothing or profiling of revenues. It is important that this is done in a way that provides the certainty and predictability that suppliers and customers desire. It should also ensure DNOs are not exposed to unnecessary risk by ensuring that, as far as possible, revenues are closely aligned to costs as and when they are incurred. Any additional risk should be taken into account, and the timing of reopeners and windows should take account of the profiling of costs and timing of events e.g. smart metering.

CHAPTER 3:

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

We support the continuation of the mechanism established during DPCR5.

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

We support the general proposal of a mixture of *ex ante* allowance and volume/revenue driver.

Uncertainty over 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%.

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

We are concerned the proposed smart meters volume driver focuses on costs associated with the roll out of smart meters only i.e. costs related to DNOs being called out to premises. We assume this means callouts to rectify any defaults identified during rollout and any additional emergency callouts after a meter has been installed. Ofgem has proposed a unit cost should be set based on benchmarked data provided in the business plans based on current call out rates.

We have carried out an extensive survey to quantify the potential impact of smart meter rollout on network activities. We believe this provides a reasonable cost estimate but are conscious that Ofgem's Initial Proposals for RIIO-GD1 indicated Ofgem was concerned there is still significant uncertainty regarding unit costs. There have been very low volumes of activity up to now; given concerns around SMETS1 and data security, Supplier rollout volumes under the Foundation Stage have been low and have focused on simpler jobs with no network issues and without full account of new processes or procedures for reporting or rectifying issues or Service Level Agreements. As such costs may not be certain for some time yet and we do not believe current experience would provide a good benchmark. For this reason, Ofgem proposed a reopener mechanism for RIIO-GD1.

We also believe it is important that full account is taken of DNOs set-up costs in relation to developing and implementing internal systems, processes and procedures to receive, handle and process data related to network issues, additional callouts and smart metering data. We are concerned the proposed uncertainty mechanism for smart meters does not take account of these costs and there may be considerable uncertainty around these costs for some time yet. While we aim to set out our initial view of requirements in relation to all aspects of smart metering costs in our business plan, if sufficient uncertainty still exists in relation to rollout profiles and timescales etc. an additional uncertainty mechanism may be required to recover set up costs e.g. through a re-opener to ensure all efficiency incurred costs are recoverable.

We agree with Ofgem's proposed approach to DCC related costs, with all "mandated" service costs being pass through items. Further clarification and discussion may be required around what is deemed to be "mandated" once services and associated costs are more fully understood. In particular, how optional costs that a DNO may decide to procure as part of an alternative solution would be treated, particularly if over the longer term they are required to deliver a new innovative approach and improved efficiency.

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

We are concerned that this is an area of high uncertainty and potentially high cost. In addition, taking into account the period of the review extending out to 2023, the proposed arrangements present cash flow risk. We would suggest that two reopener windows are necessary during the period of RIIO-ED1.

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

We support Ofgem's proposals in this area.

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

We support Ofgem's proposals in this area. 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.

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

We do not support the proposed threshold of £50 million for HVP. This is because it does not in any way reflect the differing requirements for DNOs to draw on this area of expenditure,

and there is no explanation provided to support this proposal. We are not aware of any issues with the current mechanism (20%) and would suggest this continues into RIIO-ED1.

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

We broadly support the proposed arrangements to introduce an innovation rollout mechanism at the two reopener windows to provide additional funding to roll out innovative solutions that would otherwise have to wait until the next price control period. However, we believe DNOs should be able to show how the innovation achieves any of the outputs, not just environmental, and set-out relevant outputs or other end products against which the relevant adjustment will be assessed. We do not consider it is necessary to commit to deliver enhanced outputs.

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

We agree with Ofgem's approach to the pension deficit repair mechanism reopener every three years.

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

We consider the uncertainty mechanisms proposed by Ofgem are generally appropriate. However, we consider that one further uncertainty mechanism should be considered for RIIO-ED1.

This should focus on allowing a single mid period review for submarine cables and the decommissioning of the embedded diesel power stations on Orkney and Western Isles, following completion of transmission reinforcements in our SHEPD area.

CHAPTER 4:

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

We are comfortable with the proposed approach to index revenues to RPI on the same basis as RIIO-T1 and RIIO-GD1.

However, we note with concern the ONS's proposed changes to the measurement of RPI, which is generally expected to result in a fall in RPI. This would have a consequent impact on the revenues of the DNOs. We consider this is of concern to all network companies and support previous correspondence from the Energy Networks Association (ENA) to Ofgem on this issue[5].

Very few of our costs are explicitly linked to RPI (our salary costs are influenced by general inflation and increases are not necessarily tied to RPI) so the fall in revenues and static level of costs could potentially lead to financeability issues in RIIO-ED1. We believe that Ofgem should seek a remedy to any potential change in the RPI measure, such that DNOs are no worse off than they would be under the current measure of RPI.

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

[5] We understand the ENA will be forwarding a response to Ofgem on this issue on 27 November 2012. We support this response.

While we understand the rationale behind Ofgem's decision to introduce the Cost of Debt index, we consider there are some shortcomings in the practical application of the mechanism compared with the theoretical concept. As a result, we believe that cost of equity allowance should be increased to reflect the residual risk which shareholders are being asked to bear. This is further covered in our response to the Financial Issues paper (Question. 3).

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

We support Ofgem's view that licence fees and business rates should continue as pass-through items.

However, we note that the Finance Issues supplementary annex indicates Ofgem are minded to switch off the pass-through mechanism from 1 April 2015, and until companies can demonstrate they have taken reasonable steps to minimise rates arising in the next revaluation exercise. We consider we have been able to demonstrate such reasonable steps in the past, and would expect to continue to do so.

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

We consider it is appropriate to maintain the tax trigger approach adopted in previous price controls, and agree that a fixed 'deadband' amount should be set in advance of the price control, to ensure clarity and consistency of operation.

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

We support Ofgem's views on disapplication of the price control in circumstances where financeability becomes a significant issue.

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

We are not aware of any additional mechanisms that are required at the present time.

CHAPTER 5:

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

We agree with the scope of the mid-period review of outputs proposed by Ofgem. However, this should also include a mid-period review of a losses mechanism and the BMCS.

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

We agree with the indicative timetable proposed.

As noted by Ofgem, it is important to provide as much certainty as possible on the timing of a mid–period review but appreciate only indicative timings can be provided at this stage in the consultation process. We would expect Ofgem to provide more certainty on these timings as part of their Strategy Decision in February 2013.

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?*

We understand the timeline for making any licence changes is the same as that included in previous Ofgem consultation documents for RIIO-GD1.[6] If this is the case, we agree this timeline and process would also be appropriate for RIIO-ED1.

[6] *"Consultation on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Uncertainty mechanisms"*, Ofgem, 17 December 2010; Figure 7.1; page 37.

FINANCIAL ISSUES

CHAPTER 2:

Question 1: *Is our approach for setting the allowed return appropriate, particularly in the context of an eight-year price control?*

We believe that Ofgem's approach to setting allowed return is appropriate. However, we think it is important the Ofgem continues to monitor developments in the sector, such as the debt issuance 'halo effect' and the impact of any unwinding of quantitative easing on the risk free rate, to ensure that the parameters used for setting return are not fixed too early on in the process, leaving DNOs with a package that is not appropriate to their financing requirements.

Question 2: *What considerations do we need to take into account when setting the notional gearing level?*

We believe that the primary consideration when setting gearing should be financeability concerns. This is particularly appropriate given the use of cost of debt index and the historic low interest rates which will be reflected in this. Ofgem need to be cognisant of the risk appetite of those providing debt and equity finance, and the level of gearing which markets would be considered acceptable, particularly given the current economic climate. Finally, we believe that regulatory precedent is also important to ensure clarity of decision making of investors between price controls and across network types. The would suggest that a gearing range of 60%-65% would be appropriate.

Question 3: *Is our proposed mechanism for annually updating the cost of debt assumption based on an index appropriate?*

Whilst we understand the rationale behind Ofgem's decision to introduce the cost of debt index, we believe that there are some shortcomings in the practical application of the mechanism compared with the theoretical concept. These issues can be found in reports submitted by the Energy Networks Association to Ofgem.[7]

In summary, our concerns centre on:

- Using a Cost of Debt index in a situation where the actual debt structure of the company is significantly different, being mainly longer term debt which will refinance in one or two tranches, rather than evenly over ten year. This presents significant refinancing risk which is not eliminated by the index, and arguably is exacerbated as any 'headroom' which was provided in a fixed cost of debt allowance under previous price controls is no longer present. It is not realistic to expect DNOs to change their actual debt profile to mirror that of the index, particularly in the short term;

- The difference between actual and notional debt structures gives a mismatch between movements in actual borrowing rates and the index, resulting in lower allowances when interest rates fall than our actual debt costs, increasing pro-cyclicality of the sector. We therefore believe that Cost of Equity (under the CAPM model) should increase to make explicit recognition of this pro-cyclicality. Ofgem note that there is no clear evidence that there is a link between rising interest rates and economic growth, but we believe that current economic circumstances, including any unwinding of quantitative easing, would suggest it is highly likely;

[7] *"The Riskiness of the Electricity DNOs under RIIO Relative to Other Regulated Networks"*, August 2012, prepared by First Economics, *"Determining Efficient Financing Costs for RIIO-ED1"*, 3 September 2012, prepared by Oxera, and *"RIIO-ED1 consultation on strategy: Financial Issues"*, 16 November 2012, prepared by Oxera.

- There is no explicit allowance for issuance costs within the cost of debt index. Ofgem has commented that this is counterbalanced by historical evidence showing that the DNOs and other network companies have been able to issue debt at below the debt trailing average, the so-called 'halo effect'. However, recent evidence suggests that this 'halo effect' is shrinking and will continue to do so as network companies make up an increasing proportion of the index, and may no longer be sufficient to compensate for debt issuance costs. Ofgem state that they will "keep this matter under review" – we believe that they should explicitly state at what point it will be formally reviewed and what actions will be taken; and

- The cost of debt index does not remove debt risk even in the extreme case where companies' actual debt matches the index, as there is still potential for intra-year variations resulting in a mis-match.

All of these factors would suggest that an additional allowance should be put in place to cover off these risks, or Cost of Equity should be increased to recognise the debt risk which shareholders are otherwise taking on. We would favour the latter approach.

Question 4: *Does our range for the cost of equity capture the DNOs probable cost of equity in RIIO-ED1?*

We note that Ofgem have set an cost of equity range of 6.0%-7.2%, which is consistent with that set in previous strategy papers for RIIO-T1 and RIIO-GD1.

We believe that it is important to have a consistent regulatory message between the price controls to ensure informed investment decisions by shareholders, and we welcome the broad range provided by Ofgem as it allows DNOs to set a cost of equity appropriate to the risk they wish to take on in their well-justified business plans.

However, we would contend that there are a number of factors in RIIO-ED1 which make it riskier than other price controls in certain areas, and in particular there is much more uncertainty than under DPCR5 and RIIO-GD1, and in some cases than under RIIO-T1.

The factors increasing risk include:

- Potentially higher cost-to-RAV ratio than RIIO-GD1;

- Increased level of incentives from DPCR5 and RIIO-T1;

- Longer price control than DPCR5;

- Increased requirement for "smart" investment with uncertain costs and economic life compared with RIIO-GD1 and DPCR5;

- Increased economic asset lives compared with DPCR5;

- Potential uncertain impact of Smart metering leading to higher risk than all other sectors;

- A greater proportion of allowances being set on an ex-ante basis, rather than determined within period, compared to RIIO-T1;

- A different treatment of pensions with less certain full cost recovery, compared to DPCR5; and

- The issues raised above on the cost of debt index increasing risk compared with DPCR5.

As a result of this, we believe that a cost of debt at the upper end of Ofgem's cost of equity range, at least 7.0%, is appropriate.

These arguments are further elaborated in reports submitted by the Energy Networks Association to Ofgem and as referenced in footnote 7 of this response.

Question 5: *Is the ex ante approach to the cost of raising notional equity appropriate for RIIO-ED1?*

We support Ofgem's approach in this area, on the basis of simplicity of application and consistency with other price controls.

CHAPTER 3:

Question 1: *Have we identified the correct equity and credit metrics?*

We believe that Ofgem have identified the most appropriate metrics.

Question 2: *Do the rating agency credit metric levels quoted provide the most appropriate levels?*

The credit metric levels quoted are consistent with those adopted in previous RIIO price controls for the A to BBB range. However, we believe that it is appropriate that our DNOs should be financed such that there is no impact on our current A-/A3 credit rating. This allows us to continue to raise debt effectively and finance the business without placing undue requirements on equity funding.

CHAPTER 4:

Question 1: *Do you agree with our approach for the calculation of the percentage of totex allowed into RAV?*

Of the proposed capitalisations approaches, we consider the first (treating assets with a life of three years or less as fast money, with indirect costs following the asset to which they relate) as unnecessarily complex. We would support the view that historical and projected actual capitalisation rates should be used, with a degree of flexibility applied where there are financeability concerns.

Question 2: *Do you agree with our revised approach to Totex and with the costs that are included and excluded?*

We are broadly in agreement with Ofgem's approach and the majority of costs which are included or excluded. However, we note that Ofgem propose to include Incremental Deficit costs within their totex assessment. Whilst we agree that this is a valid approach to assessment of efficiently-incurred costs, we do not believe that it is appropriate to include Incremental Deficit costs as part of the Efficiency Incentive. There are components which will go to make up the Incremental Deficit which are outside the control of any DNO and therefore it is not appropriate that these are subject to a sharing mechanism. Rather, if these are determined to be efficiently incurred, they should be fully reimbursed as a pass-through.

Question 3: *We invite views on whether the definition of related parties should exclude captive insurance companies and whether our proposed approach is proportionate.*

We agree with Ofgem's proposed treatment of excluding captive insurance companies from the definition of related parties.

CHAPTER 5:

Question 1: *Do you agree with modelling tax under the ASB proposed accounting frameworks for financial reporting in the UK with any changes to be subject to the tax trigger?*

Whilst we understand the rationale behind Ofgem's proposed treatment, we are concerned that Ofgem are adopting an approach that may not happen to the anticipated timescales. It may be a more sensible approach to model on the basis of the current approach applying throughout RIIO-ED1.

Question 2: *We invite views on the calibration of the dead-band.*

We believe that it is appropriate to maintain the tax trigger approach adopted in previous price controls, and agree that a fixed 'deadband' amount should be set in advance of the price control, to ensure clarity and consistency of operation.

Question 3: *Do you agree that clawback of the tax benefit of excess gearing in DPCR5 should be spread over the eight years of the RIIO price control? If not, which alternative option do you prefer?*

We agree with Ofgem's view of spreading the clawback over the duration of RIIO-ED1.

Question 4: *Do you agree that the revenue adjustment for tax clawback should be applied annually as part of the annual iteration process?*

We agree with Ofgem's approach on this matter, which is consistent with other aspects of the annual iteration process.

Question 5: *Do you agree with our treatment of expenditure for tax modelling including the cash flows of corporation tax payments?*

We do not consider there is likely to be a material difference between modelling cash flow for tax on an 'as-due' basis and on the year they arise. Therefore we are supportive of Ofgem's approach.

Question 6: *Do you agree with modelling of expenditure subject to capital allowance and capital allowance pool balances?*

We do not consider there is any good reason to have capital allowances determined on a common basis for each DNO – setting capital allowance allocations for each individual company would not be significantly more onerous for Ofgem, and would result in more accurate tax allowances. We therefore do not agree with Ofgem's approach.

Question 7: *Do you agree with our proposal for funding business rates?*

We support Ofgem's view that business rates should continue as pass-through items. However, we note that the Finance supporting paper indicate that Ofgem are minded to switch off the pass-through mechanism from 1 April 2015 until companies can demonstrate that they have taken reasonable steps to minimise rates arising in the next revaluation exercise. We believe that we have been able to demonstrate such reasonable steps in the

past, and would expect to continue to do so. In addition, the Government has recently announced their intention to defer the next rates valuation date to April 2017. If this happens, we would expect the current arrangements are extended to that date, as DNOs will have no opportunity to influence the level of business rates from 2015 through to 2017.

CHAPTER 6:

Question 1: *Do you agree that the fast money true-up adjustments for DPCR5 should be spread over the eight years of the RIIO-ED1 price control if they exceed £1m per DNO? If not, which alternative option do you prefer?*

We are comfortable with any true up of fast money adjustments for DPCR5 being spread over the 8 years of RIIO-ED1, if it exceeds £1m for a DNO and as long as this is on a NPV neutral basis.

Question 2: *Do you agree with our proposals for the basis for the first and subsequent reset adjustments?*

We are supportive of the basis of the reset adjustments; we note that much of the Pensions proposals are predicated on Ofgem's Pensions Deficit Allocation Methodology ("PDAM") which is yet to be issued in final form. We therefore cannot comment conclusively on Ofgem's proposals until the PDAM is finalised and agreed.

Question 3: *We invite views from interested parties on how we conducted the latest pension reasonableness review, with a view to understanding what elements of the review were conducted well, what could be improved and what should be done differently in future reviews.*

We have a number of concerns over the way in which the first GAD efficiency review was undertaken. Our understanding of the GAD review was that Ofgem would use this review to assess the efficiency of the NWO schemes in comparison with other schemes in the sector but also in comparison with other DB schemes in the UK from outside the NWO sector.

The final GAD report was very factual in nature and concentrated almost exclusively on comparing individual actuarial assumptions and characteristics of NWO's schemes. It offered no opinion from GAD as to the relative efficiency of the individual schemes and did not draw any meaningful comparisons with schemes from outside the sector. As a result we believe Ofgem were able to select individual assumptions made by different schemes that appeared to be different from other NWO assumptions and propose adjustments to funding levels. This was initially done without apparently considering whether the overall performance of schemes was efficient and whether individual assumptions used were appropriate for the particular scheme. In order to assess efficiency of a scheme it is not appropriate to look at any one assumption in isolation and compare across schemes. The danger with this approach is that an overall assessment is not being carried out and an incorrect conclusion on what is deemed to be efficient is arrived at.

In addition, Ofgem appeared to change their view during the course of the efficiency review and moved from attempting to assess whether industry schemes were efficient, to assessing whether the assumptions used were "reasonable". This was not communicated to DNOs and, in our view, this gave Ofgem more scope to propose adjustments to funding levels.

For future reviews Ofgem should attempt to get an external review performed that compares assumptions and performance of schemes not only within the sector but also with other comparable DB schemes. This review should offer an external view on whether the performance and overall management of the schemes are efficient and reasonable.

Question 4: *We invite views on which of the options for pension scheme administration costs and Pension Protection Fund levies we should adopt; and, if our preferred approach were adopted, the methodology itself, and the level of the de minimis thresholds.*

In principle we support the approach adopted for RIIO-GD1 and RIIO-T1 with an allowance being set for PPF Levy and scheme admin costs and a true up and reset of allowances every 3 years subject to efficiency.

However, while we accept there should be some form of *de minimis* threshold, the proposed level for RIIO-T1 and RIIO-GD1 of £1M per annum is too high, particularly given the uncertainty around the future levels of the PPF levy and the fact the PPF Levy is not totally within the control of individual companies. This proposed level of threshold is material and will potentially penalise DNO Groups that have more than 1 DB scheme. Our view is that a more appropriate threshold should be £500k per scheme.

Question 5: *Do you agree that companies must demonstrate a robust approach as to how their de-risking strategies, especially if aggressive, are protecting future scheme funding and that they should clearly demonstrate the benefits that they expect to flow to consumers?*

We agree that Trustees, and to a lesser extent companies, should be able to demonstrate a robust and sensible approach to de-risking strategies. Any de-risking should form part of a long term funding strategy agreed between the scheme trustees and the sponsoring company.

Ofgem should monitor these strategies but as long as the de-risking can be demonstrated to be sensible and part of the efficient long term objectives and strategy of the scheme then no further regulatory intervention is required. There should be ongoing dialogue between Companies and Ofgem to outline and explain the funding strategy of each scheme.

Question 6: *Do you agree that the costs of contingent assets be funded if clearly demonstrated to be in consumers ′ interests?*

As long as it can be demonstrated the use of contingent assets provides the same or similar benefits to consumers as traditional funding, we consider this type of funding is acceptable. The use of contingent assets should be considered on a case by case basis and agreed in advance between Ofgem and each individual company.

Question 7: *We invite views on whether the revised guidance to our pension principles and the methodology is comprehensive and adequate for DNOs and stakeholders to understand how the principles will be applied in RIIO controls and for network companies to prepare their business plan.*

We consider the pension principles which are in place are still appropriate, and are comprehensive. However, as mentioned previously, we were concerned with the change in emphasis adopted by Ofgem in the recent GAD efficiency review. There was a shift away from assessing whether costs were efficient, to assessing whether the costs were reasonable. This was not our initial understanding of the original pension principles, which was that pension costs would be funded if they were “efficient and economic”. As a minimum the concept of reasonableness requires to be defined.

CHAPTER 7:

Question 1: *We invite views from interested parties on the proposed annual iteration process.*

We consider the annual iteration process provides an appropriate mechanism to see correction of under/overspend and other items on a quicker basis than waiting until the end of the price control, particularly given the longer 8-year control period under RIIO.

However, we are concerned that, under the current process, Ofgem have allowed for two weeks from notification of the variable values to direction of the MOD term. We do not believe that this gives the DNOs sufficient time to adequately consider whether the variable values are appropriate and to assess the impact on revenues, and believe that four weeks should be allowed.

IMPACT ASSESSMENT

CHAPTER 2:

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

We consider the other potential impacts of RIIO-ED1 have been suitably identified for the purposes of this Strategy Consultation. However, we would expect this impact assessment to be updated and included with the publication of Ofgem's Strategy Decision document in February 2013.

We have noted in our response to earlier questions that Ofgem should consider more robust incentives to promote delivery of safety outputs under RIIO-ED1. We remain of the opinion that incentives in this regard could be improved, and this is also reflected by an apparent lack of clarity on the impacts of health and safety within the impact assessment. We would therefore encourage Ofgem to better explain how safety impacts upon stakeholders and to incentivise this accordingly as part of the wider RIIO-ED1 package of incentives.

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

We consider there are no additional impacts that need to be considered for RIIO-ED1 at this time.

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

We consider low carbon uncertainty will remain a significant risk during RIIO-ED1, and that Ofgem should seek to better quantify these impacts as part of a future impact assessment.

CHAPTER 3:

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

We consider that all of the major potential risks associated with RIIO-ED1 have been identified.

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

There may be additional risks associated with RIIO-ED1 that become apparent as the policy development process evolves. These should be appropriately recognised and described in subsequent impact assessments, the next one of which should be released with the release of Ofgem's Strategy Decision in February 2013.