

28 February 2014

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By email only

Dear Hannah

Re: RIIO-ED1: Informal consultation on licence drafting — Charge Restriction Conditions (Part 2) and Financial Handbook

Thank you for the opportunity to respond to the above consultation dated 31 January 2014. I am responding on behalf of the fourteen electricity distribution licensees who are Distribution Services Providers.

This response is not confidential and can be published on the Ofgem website.

We have set out our main comments in Appendix 1 to this letter. Appendix 2 contains a track changed version of the Financial Handbook, Appendix 3 is a track change of the Charge Restriction Conditions (CRCs) that form part of this consultation and Appendix 4 is a log of the relevant CRC track changes where it may not be obvious as to the reason for the change, plus more significant issues.

I hope the above and attached provide constructive feedback on the current state of the draft DNO RIIO-ED1 licence conditions and Financial Handbook and we look forward to working with Ofgem to progress these. With this in mind we are happy to discuss the contents of our response with Ofgem should any points require clarification.

Yours sincerely



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Chief Executive

Cc: Sarah Walls, ENWL
John France and Tony Sharp, Northern PowerGrid
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Appendix 1

A) Licence Conditions

1. Legacy condition requires further work

We have identified a number of significant issues with the legacy adjustment condition. For example, the condition introduces terms related to RAV and revenue adjustments but uses them interchangeably with words describing allowed and actual costs. On occasion, the condition uses defined terms for RIIO-ED1 adjustments and uses them in relation to DPCR5 adjustments, resulting in changes to policy intent. We are also unsure as to Ofgem's logic for excluding workforce renewal and high-value low-cost connections adjustments from the DPCR5 RAV rolling incentive.

Ofgem has recently confirmed to DNOs that it proposes to delay publishing the statutory consultation for legacy adjustments to allow further work on this condition and associated Financial Handbook chapters to be undertaken. We support this decision.

2. Issues in theft condition

We are concerned that Ofgem's policy intent relating to DNO obligations in respect of the theft of electricity is unclear in the drafting, in particular in the area of DNOs' legal powers under the Electricity Act. We have provided alternative drafting that we hope will clarify the matter. Given that it is Ofgem's policy that suppliers have the main responsibility for theft of electricity, it is important that DNOs are clear exactly what they are responsible for under their licence.

In addition, we note that CRC5D, in combination with the associated handbook chapter, has the effect of treating costs and revenues associated with theft in conveyance activities in the same way as all other distribution costs. We are therefore unclear as to why a separate condition is required.

B) Financial Handbook

3. Financial Handbook Summary

We have reviewed the Financial Handbook and provide our detailed comments in Appendix 2 of this response. We identify four broad themes, which we discussed with Ofgem on 19 February:

- Conflict with licence
- Precision of Financial Handbook
- Important practical and process issues
- Governance of Financial Handbook and PCFM

We believe it is important that these are addressed as part of the work to finalise the Financial Handbook to ensure an accurate and usable document for Ofgem, DNOs and stakeholders. Furthermore it is notable that there are a number of chapters that provide less detail than the licence conditions – this, coupled with the lack of calculations in some places (e.g. the smart metering chapter), leads to a document that requires the user to refer to other sources to understand the intent. Finally, we believe that users of the Financial Handbook would benefit from precise cross-references to cell references in the RIGs.

We provide more detail on these issues below.

4. Issues on previous draft Financial Handbook not addressed

We note that the feedback provided to Ofgem by the DNOs (in the form of a track changed draft of the Handbook) as part of the LDWG process has not been fully incorporated into the Financial Handbook that accompanied this consultation. DNOs did not receive any feedback from Ofgem on why so many of the points had not been incorporated into the version now being consulted on. We have since met with Ofgem and discussed the importance of the points we raised with them.

We have repeated in this response any of the points that were previously raised but not yet dealt with. There is substantial work still to be completed on the Financial Handbook.

5. Conflict between licence conditions and Financial Handbook

In a number of instances, the Financial Handbook currently interacts with the wording in the licence condition in a way that creates inappropriate consequences, for example it provides an alternative presentation of the 'emergency MOD' procedure, it generally fails to include the consenting arrangements outlined in the licence to allow flexibility in reporting timescales in certain circumstances and fails to set out which party is required to undertake the task set out in the Financial Handbook. Additionally, it sets out a few instances of activities that DNOs 'must' undertake, effectively enforcing additional licence obligations on DNOs. Given that the Financial Handbook itself has the status of a licence condition, these circumstances need to be addressed to avoid conflicting drafting of process, to ensure that safeguards set out in the licence condition are acknowledged in the Financial Handbook and to avoid "double jeopardy" for DNOs.

6. Financial Handbook does not explain how to run the model

According to the CRC definitions, the Financial Handbook includes specific information and advice about the operation of the Annual Iteration Process and the ED1 Price Control Financial Model and the ED1 Price Control Financial Methodologies. These documents "together comprise a complete and documented explanation of the methods, principles, and assumptions that the Authority will apply for the purposes of determining the PCFM Variable Values that are to be used in the Annual Iteration Process".

We therefore believe that the Financial Handbook should set out the steps required to generate the variables that it describes, and how to run the Annual Iteration Process. This should include detailed descriptions that would enable any user to replicate these steps, which may involve worksheet and cell references for inputting data, instructions on how to run macros and references to where output values are displayed. The Financial Handbook does not currently include all this information and it therefore does not meet the definition from the licence quoted above. Without this detail it is not clear for DNOs or other users as to the precise working of the Financial Handbook, and this could lead to disagreements or disputes in the future.

7. Financial Handbook cross-referencing and calculations not clear

In addition to this, where data referred to in the Financial Handbook is obtained from sources other than the Price Control Financial Model, clear and specific references, including cell and worksheet/table references where appropriate, should be included in the Financial Handbook to enable users to replicate the calculations.

For clarity, it would be helpful to have a summary worksheet at the front of the RIGs data tables that sets out the values used in Financial Handbook calculations and performs any calculations set out in the Financial Handbook. This would make it easy to reference values and enable DNOs and Ofgem to check understanding of how calculations will work in advance of the Annual Iteration Process.

8. More timescale/process detail required

The Financial Handbook does not, in many cases, set out clear processes, timescales and/or accountabilities. Where these are absent, there is a risk that the calculation or task in question is not completed either in an appropriate timescale or by the relevant party, which may lead to inadvertent licence breaches or a non-calculation of a PCFM variable value. It is envisaged that the Financial Handbook acts as a "how to" for the PCFM and it should be possible for persons unfamiliar with the complex working of the PCFM to gain an understanding of how, when and by whom values are calculated by reading the Financial Handbook. In its current form, the Financial Handbook does not facilitate this understanding and we would urge Ofgem to improve the current draft so that this objective might be met.

9. Inappropriate governance arrangements for Financial Handbook and PCFM

We are concerned that the governance arrangements currently drafted for the Financial Handbook and PCFM are not sufficiently robust for such important mechanisms. In particular, we ask Ofgem to consider amending the arrangements to ensure that a process exists for companies to raise issues with the PCFM and force a meeting of the PCFM Working Group to be held. We also require that minimum notice periods are established for meetings of the PCFM Working Group, that the levels of attendance required for a quorate meeting are reviewed and that formal minutes are kept and published for all meetings.

10. Absence of appropriate safeguards for licensees against failures in Annual Iteration Processes

Licensees have raised concerns with Ofgem on a number of occasions that a very substantial component of revenues will rely on successful operation of Ofgem's Annual Iteration Process. We remain concerned that the 'emergency MOD' process set out in CRC4B could result in licensees receiving a shortfall in revenues in circumstances where the Annual Iteration Process would enact changes to revenues, due for example to successful reopener processes or increases to tax rates.

Whilst we acknowledge that this shortfall would be redressed in the subsequent year's iteration process, licensees could face substantial financial pressures in the intervening period. It is equally the case that the process would delay price cuts for consumers in the opposite circumstance.

We are also concerned that there are no safeguards in place to address potential circumstances where the Authority fails to direct, or incorrectly directs, variable values. Whilst all licensees will allocate resources to checking draft variable values once issued, we remain concerned that Ofgem will have a very short period of time to make any consequential corrections across all licensees (including gas distribution and transmission) before it is required to direct those variable values and MODt. Licensees believe that there is a significant risk that errors or omissions may occur, given the experience of operating the iteration process in other sectors to date. As many of the variable values can result in changes to base revenues of millions of pounds, a process needs to be introduced to address material errors and omissions in variable values included in calculation of MODt.

11. Issues in process for directing variable values for established pension deficits

We have a number of concerns regarding the process set out for assessing and directing variable values associated with pension deficit recoveries. For example, the process allows only one month between DNOs' pension deficit allocation methodology information being provided to Ofgem and Ofgem's reasonableness review being completed. The process allows no time for DNOs to be consulted on this important, complex and often very material adjustment.

We also note that the process erroneously refers to undertaking an Annual Iteration Process in November 2014 and also fails to recognise that revenues for all DNOs will have been fixed by July 2015 and that therefore adjustments will be required for this important component of the price control package in November 2015.

12. Missing chapters

We note that there are no chapters in the Financial Handbook that cover:

- CRC4C (Price Control update provisions for Fast-Track licensees); and
- CRC 5G (Net to gross adjustment for Load Related Expenditure).

We are concerned that the absence of these results in a lack of clarity for Ofgem, licensees and other stakeholders in these areas. Accordingly we look forward to receiving a draft of these in the near future.

13. Decision to freeze 2015/16 DUoS prices is not reflected in Financial Handbook

Consideration needs to be given as to how the decision to freeze 2015/16 DUoS prices is reflected in the Financial Handbook. This needs to be considered in conjunction with the debate on CRC2A and the setting of charges and the rebate determined by the Secretary of State. We suggest a separate chapter would be appropriate to explain how this will work.

14. Inconsistent use of defined terms, capitalisation and interchangeable use of 'Authority' and 'Ofgem'

There is currently within the draft Financial Handbook an inconsistent combination of:

- terms with initial capitals that are not defined either within the Financial Handbook glossary or within SLC1 or CRC1B;
- terms without initial capitals that either are defined or ought to be defined or ought to be changed to something that is defined; and
- terms that sometimes appear with initial capitals and sometimes do not.

It is crucial to the usefulness, meaningfulness and correct application of the Financial Handbook that ambiguity and uncertainty should be avoided by adequate provision of definitions and by correct signposting of those definitions through appropriate and consistent use of initial capitals.

Similarly, whilst the interchangeability of 'Ofgem' and 'the Authority' is acceptable in many contexts, it is important that such interchangeable usage should not introduce inaccuracy (as in references to determinations being made by Ofgem) or ambiguity (as in the usage within the Financial Handbook of 'Ofgem's website' or 'its (meaning Ofgem's) website', which cannot but imply an intention to refer to something different from the defined term 'Authority's Website' within the licence.

15. Should not allow a precedent of the Financial Handbook/licence being in GDN/ET/GT as a reason for not updating the ED version

We note that during the LDWG meetings Ofgem has expressed a desire to align ED licence and Financial Handbook drafting with that of GD/ET. Whilst this may appear to Ofgem to simplify the process and provide an element of consistency, we do not consider this is appropriate. The DNO group is separate with its own governance forum and processes and as such should be the driver for changes. We believe that, if there is a case for alignment, efforts should be made to move the GDN/ET licence conditions and Financial Handbook to match the ED ones rather than leave all sets of documents incorrect or suboptimal.

Chapter 7 onwards

16. Less detail in Financial Handbook than licence

We were disappointed that the current draft of the Financial Handbook, from Chapter 7 onwards, contains significantly less detail than the licence. As previously mentioned, it was envisaged that the Financial Handbook would be a "how to" for the PCFM and would set out processes, timescales and accountabilities for the various calculations and tasks that require completion. At present, Chapters 7 onwards do not add anything to the information set out in the licence and we would urge Ofgem to address this deficiency in the next draft of these chapters.

17. Inconsistency of Financial Handbook with Ofgem's published policy

In a number of instances, the Financial Handbook is written in a way that contradicts Ofgem's published policy. For example, the Financial Handbook states that no adjustment will be made to allowances associated with ex ante funded High-Value Projects, whereas Ofgem's strategy decision sets out the circumstances where changes may be made. The Financial Handbook also fails to recognise Ofgem's policy that streetworks costs will be funded as fast money. We also note that the Financial Handbook contains an inaccurate précis of Ofgem's pensions principles that could cause confusion for licensees and stakeholders. It is essential that the Financial Handbook is drafted in a way that is consistent with Ofgem's published policies.

18. Absence of methodologies for adjustments that will be enacted in early RIIO-ED2

Currently the Financial Handbook explicitly does not include the methodologies for adjustments associated with RIIO-ED1 performance that will be enacted during RIIO-ED2. For example, it does not set out how closing adjustments for the Load-Related Expenditure reopener, High-Value Project reopeners or net: gross adjustments will be made in early RIIO-ED2. It also does not set out how the more routine adjustments to efficiency-sharing and logging-up arrangements will be enacted for performance in the final two years of the price control period.

Whilst we fully understand that these variable values will be calculated and directed during the RIIO-ED2 period, these represent very important components of the RIIO-ED1 policy framework. We anticipated that the Financial Handbook would outline these methodologies, in the same way that the licence sets out the principles associated with each adjustment.

19. No informal opportunity for DNOs to comment prior to consultation

We are disappointed that we were not given the opportunity to review and comment on drafts of these chapters prior to Ofgem's consultation. We believe that a number of the issues we identify in this response could have been resolved prior to consultation if we had been given the opportunity to comment.

C) General Points

20. Unavailability of Regulatory Instructions and Guidance (RIGs), Associated Documents (ADs), the Price Control Financial Model (PCFM) and Financial Handbook

As outlined in our response to Ofgem's Part 1 consultation, which ended three weeks ago, to fully understand some of the conditions and to be able to check them DNOs need to be able to see them in combination with all supporting documents. The lack of chapters 13 to 16 (on legacy price control adjustments) serves to emphasise this point and we repeat our proposition that conditions that are affected in this way should be subject to a further consultation (preferably prior to the fast-track statutory licence modification or alternatively before the slow-track statutory licence modification) once the relevant Associated Documents (ADs), RIGs, Price Control Financial Model (PCFM) and Financial Handbook are available to allow a thorough review.

21. Status of Legacy Workbook unclear

We are concerned that there is no formal legal status given to the Legacy Workbook, even though this has a significant effect on allowed revenues. The Financial Handbook is not in a sufficiently advanced state to provide the governance of the Legacy Workbook that licensees had expected. If not corrected we require the Legacy Workbook to be recognised in CRC4A and in the Financial Handbook with an associated process for modifying the Legacy Workbook.