Electricity North West
304 Bridgewater Place, Birchwood Park
Warrington, Cheshire WA3 6XG

Telephone: +44(0) 1925 846999
Fax: +44(0) 1925 846991
Email: enquiries@enwl.co.uk
Web: www.enwl.co.uk

Direct line: 01925 846892
Email:steve.johnson@enwl.co.uk

Hannah Nixon
Senior Partner Distribution
Smarter Grids and Governance: Distribution
Ofgem
9 Millbank
London
SW1P 3GE

29 April 2014

Dear Hannah

Statutory consultation on proposed modifications to electricity distribution licences

Thank you for the opportunity to comment on your proposed modifications to standard licence conditions for all licensees and to special licence conditions for Western Power Distribution.

Electricity North West has undertaken a detailed review of the draft conditions, Financial Handbook, Price Control Financial Model and Network Asset Workbook that were published on 28 March. It is clearly very difficult to assess whether the proposed conditions are acceptable or not in the absence of knowledge about the level of funding that we will have available to ensure that we can achieve compliance.

Our over-riding concern in assessing the acceptability of the proposed standard licence conditions is that we will be unable to assess whether the outcome of the RIIO-ED1 price control process will provide Electricity North West with an overall package that is sufficient to discharge our duties under the proposed new conditions, and without visibility of key guidance documents that outline the practical implications of the revised standards conditions.

It seems inequitable that we are faced with having to make an important decision as to whether to exercise our appeal rights in the absence of such key pieces of information.

As you will be aware from reviewing our plan, we have proposed alternative financing and uncertainty mechanisms that are needed to ensure that we are able to retain our investment grade credit rating and to ensure that the risks associated with the potential connection of a new nuclear power station in west Cumbria are managed. These mechanisms, combined with adequate cost allowances that fund the delivery of our proposed outputs and recognise our unique status as a single licensee group, are essential to allow us to deliver against our new RIIO-ED1 licence. If Ofgem continues with its proposed licence modifications in May, we will not have formal confirmation that our plan will be accepted at the time that we are forced to make a decision regarding our right of appeal.

We urge Ofgem to delay modifying the licences of all Distribution Service Providers until its Final Determination for slow track licensees has been published to allow companies that have not been fast tracked to make decisions as to whether to exercise their appeal rights based on full information.

Within this response, I highlight a number of the most significant concerns that we have with your proposed licence conditions. It is essential that these concerns are addressed prior to making any modifications to licence conditions.

We have also contributed fully to the Energy Networks Association's (ENA's) response to the consultation. The ENA's response is comprehensive and includes a wider range of issues that it is desirable are addressed prior to modification notices being served, along with a number of more minor typographical issues that should also be corrected. Please consider that the ENA's response also represents a component of Electricity North West's response to your consultation.

If you have any questions about our response please do not hesitate to contact me or Sarah Walls.

Yours sincerely

Steve Johnson
Chief Executive Officer

cc Anna Rossington
Jane Jellis
Tom Mackenzie

1. Significant concerns with proposed special licence conditions

1.1 Need for consultation with stakeholders regarding adjustments under CRC4C

As currently drafted, there is no requirement for the Authority to consult with stakeholders, including Distribution Service Providers other than WPD, on the proposed adjustments to be made under CRC4C (Price control update provisions for WPD). These adjustments have the potential to be material in quantum and to be complex to calculate. We therefore believe that wider consultation is required on these adjustments and for Ofgem to take account of representations received.

We also believe that it would provide greater clarity for stakeholders if the following potentially material adjustments that are expected to be made were included as Stipulated Values under Part A of this condition rather than within the general provisions under Part D:

- Updating WPD's attribution of qualifying expenditure to capital allowance pools for tax allowance purposes to the common basis to be used by all DNOs
- Updating of RPI assumptions within the PCFM to align with those of other DNOs
- Updating Network Innovation Allowance percentage

1.2 Change required to align basis of assessment of Network Asset Secondary Deliverables to Ofgem's published strategy

The current drafting of CRC5D refers (in paragraph 5D.6) to the assessment of a licensee's performance as being 'the licensee's delivered change as measured in accordance with the Network Asset Indices'. This wording suggests that the assessment is made against all three Network Asset Indices set out in paragraph 51.4.

Paragraphs 6.5 and 6.6 of Ofgem's reliability and safety decision (26f/13) make it clear that this assessment is to be based on the Risk Index. Paragraph 5D.6 should be updated to refer to 'Risk Index' rather than 'Network Asset Indices' to align with Ofgem's published strategy.

1.3 Definition of 'Ordinary Business Arrangement' precludes GB-wide roll-out of innovation

We note Ofgem has not enacted the ENA's request to amend the definition of Ordinary Business Arrangement to change "a licensee" to "the licensee" in the closing sentence.

The proposed definition of Ordinary Business Arrangement precludes use of the Innovation Roll-out Mechanism (IRM) when the innovation is being used by another licensee either inside or outside of the IRM which in turn may curtail the implementation of key innovations needed to support the move to a low carbon economy to one licensee per innovation.

1.4 Interaction between Load Related and Net: Gross conditions needs aligning

Conditions CRC3G (Revising the allowed level of Load Related Expenditure) and CRC5G (Net to gross adjustment for Load Related Expenditure) have the potential to make adjustments relating to the same activities, leading to the potential for a double count of adjustments.

This is recognised in the drafting of both conditions by allowing that if both mechanisms are triggered the combined effect of both will be included in the direction of load related variable values. However, this 'fail-safe' may work incorrectly as currently drafted because the adjustments under CRC5G are finalised in November 2023 and those under CRC3G in November 2024. We propose that this mismatch is corrected by ensuring that both adjustments are directed in November 2024. This will allow the safeguards that are currently included in the licence to operate correctly.

1.5 Potential changes required to CRC2D to reflect ongoing consultation regarding guaranteed standards payments during severe weather events.

We note that Ofgem's ongoing consultation 'Open letter consultation on potential changes to severe weather-related Guaranteed Standards of Performance (GSOP) following the December 2013 Storms' makes no reference to the potential need to amend CRC2D to implement changes. CRC2D sets out the maximum exposure to severe weather payments. In proposing to double payments, Ofgem has doubled the probability that companies are exposed to this level of payments; this is therefore a different risk profile to that included in companies' cost of equity assessment as part of their business plans.

In our response to this ongoing consultation, we will propose a variation on Ofgem's proposal that will see customers compensated at the same rate regardless of whether they were interrupted due to normal or severe weather and will ensure that companies are exposed to the same level of risk that was originally intended in Ofgem's RIIO-ED1 strategy by allowing companies to recovery the difference between the amount originally envisaged in Ofgem's strategy and the amount actually paid via DUoS revenues. If accepted, this would require consequential changes to CRC2D.

2. Significant concerns with proposed Financial Handbook

2.1 Ambiguity of detailed mechanisms associated with the annual iteration process

We remain concerned that the Financial Handbook does not, in many instances, include sufficient detail to ensure unambiguous interpretation of the mechanisms that must operate during the direction of Variable Values and MOD.

In particular, further work is required to ensure that full transparency is achieved as to whether adjustments are expected to over-write existing values in the PCFM or whether adjustments are intended to be added to the pre-existing values. In some instances, for example the basis of starting Variable Values for Totex Incentive Mechanism, the wording in the Financial Handbook is not consistent with the data populated in WPD's PCFM. In other instances, for example throughout adjustments in the pensions chapter, the processes seem to confuse calculations of 'over-write' values with 'delta' values inappropriately suggesting a hybrid calculation.

2.2 Further improvement required to pensions chapter

We acknowledge that the drafting of the pensions chapter within the Financial Handbook has progressed since your informal consultation, a number of issues require resolution:

- The handbook drafting fails to ensure the full recovery of any adjustments associated with DPCR4 close-out.
- The newly introduced drafting is, in some cases, unclear and can be interpreted in a number of ways.

The ENA's response on the Financial Handbook includes details of the required changes to address these issues.

2.3 Details of allocation of activities to tax pools required in handbook

We note that licensees' request to include details of the allocation of activities into the seven subdivisions to facilitate varying tax pool treatments has not been accepted.

While we welcome Ofgem's acknowledgement that '*If a change is made to the categories of costs included in each subdivision through the operation of a licence condition or otherwise, the Authority will consider whether it is appropriate also to make changes to the financial treatment of such cost category under the Annual Iteration Process,*' this is insufficient to protect licensees from potentially significant changes to the RIIO-ED1 framework.

The move to operate Totex Incentive Mechanism for RIIO price controls on a post-tax basis means that changes to tax allocations can have a potentially large effect on the incentive properties of the price control, with the potential for incentives to be rewarded on a different basis to the way in which allowances were made.

The inclusion of a simple table within the handbook allocating activities, based on BPDT definitions, to tax subdivisions would be sufficient to give licensees comfort that if significant changes were made to allocations that the DNO had recourse via CRC4A to seek a statutory consultation on the changes. Clearly, if the changes were not significant then the Financial Handbook could be changed via the self modification processes for the Financial Handbook.

2.4 Inappropriate mechanism to adjust for rail electrification

We are concerned that the proposed handbook states (in 12A.8) that '*It should be noted that there is no provision to revise allowed levels of Totex expenditure for the licensee (upwards or downwards) in respect of outturn levels of diversion work activity – only in respect of the level of additional contributions*'. Our understanding of this statement is that there are a number of credible situations where WPD can keep this allowance and it is therefore funded (subject to efficiency sharing factor) by WPD's customers. Examples of such potential situations are if

(a) some or all of the funded projects are cancelled
(b) some or all of the funded projects do not start
(c) the outturn costs are lower than forecast
(d) project phasing delays some costs into ED2
(e) WPD delays billing for contributions into ED2

We therefore do not believe that this arrangement is in the interests of WPD's customers. We also do not consider that this mechanism is consistent with our interpretation of Ofgem's statement in its fast tracking decision that "*We consider that, from a public policy perspective, these costs should not be borne by energy consumers, but should be recovered from rail customers*" and "*We will ensure that WPD's licence enables us to remove them from the settlement should it be decided that another party will fund them".* We urge Ofgem to review this drafting to ensure that WPD's customers are appropriately protected.

WPD's approach in this area is in stark contrast to our own proposed approach to funding of costs associated with rail electrification and the network costs associated with a potential nuclear power station in west Cumbria. In the case of rail electrification, we have made no provision for overhead line diversions in our plan as we assume that these costs will be recharged to Network Rail. We do not believe that including an uncertainty mechanism with the advanced funding of these costs would be in our customers' interests and therefore have not included this in our plan. In the case of the potential connection of a new nuclear power station in west Cumbria, at present, no firm commitments on the timing of the connection works or the route for the transmission circuits have been made and we therefore propose to include an uncertainty mechanism that will mean that our customers will only be asked to pay for this investment once it is certain that the investment is required.

Notwithstanding our view that the most correct approach is to amend the drafting, if Ofgem opts to retain the current drafting for rail electrification adjustments it is essential that Ofgem adopts a cost assessment approach that is consistent with its decision and takes account of these costs. It is essential that rail electrification costs are included in WPD's cost base for slow track cost assessment for both bottom up and totex analysis. In the case of bottom up analysis this should be assessed as being 'unnecessary' volume of work and disallowed so that it is not treated as a cost to be funded by customers.

To do otherwise results in two risks. Firstly this results in inappropriately tough benchmarks for slow track companies as a result of this inconsistent treatment. Secondly this would create an inappropriate 'no worse' off adjustment for WPD for which they already have an outperformance opportunity built into their allowances.

3. Significant concerns with proposed Price Control Financial Model (PCFM)

A number of issues remain with the formulae within the Price Control Financial Model. These are predominantly of a minor nature. We believe that these issues are best addressed at a meeting of the PCFM Working Group. We note that Ofgem has called a meeting of the PCFM Working Group on 30 April and will raise the majority of the issues that we have found at that meeting.

We have identified two particularly material issues

3.1 Inappropriate revenue adjustment for Excluded Services 7 (ES7) revenues

The calculation of revenues in the PCFM includes an automatic adjustment to DUoS revenues based on companies' forecast levels of ES7 revenue. This adjustment fails to recognise the new differentiation in CRC5C of this legacy category into Directly Remunerated Services (DRS) 8 and 9. A specific incentive relating to DRS8 is included in CRC5C and recognised in the Financial Handbook. The effect of this issue is to penalise companies that plan to undertake the activities that Ofgem is seeking to incentivise as it enacts a punitive revenue adjustment as well as requiring the licensee to share any profits with customers.

This issue does not have a material effect on WPD's proposed Opening Base Revenues, as it does not include forecast activity in these areas, but it constitutes a very material issue in our PCFM that must be corrected prior to Ofgem's Draft Determination for Electricity North West.

3.2 RPI in WPD model

We note that the PCFMs for WPD's licensees include an RPI assumption of 2.8% per year. This is a lower rate of RPI than has been mandated for other licensees (3.1%). The RPI assumption used in the PCFM has a significant effect of the level of tax allowances calculated for the licensee, with lower RPI assumptions leading to higher tax allowances. The combined effect of this difference across WPD's licensees is to increase their tax allowances by £16.4m over the RIIO-ED1 period relative to the allowances they would receive based on a RPI forecast of 3.1%.

The Financial Handbook explicitly sets out that RPI assumptions used for tax purposes will not be changed as part of the annual iteration process: *'The PCFM refers to RPI forecast values set at the outset of the Price Control Period'.* There is no explicit adjustment to RPI assumptions included within CRC4C.

It is essential that Ofgem either updates PCFMs for the WPD licensees to align assumptions with those of other DNOs or explicitly acknowledges in Part A of CRC4C that an adjustment can be expected prior to the RIIO-ED1 period commencing.

4. Significant concerns with proposed Network Asset Workbook

4.1 Lack of ‘credit’ for 33kV and 132kV plant refurbishment in Network Asset Workbook

We note that WPD’s Network Asset Workbooks take no account of WPD’s proposed refurbishment of a number of items of 33kV and 132kV plant. As these asset classes are included in WPD’s proposed asset health movements due to Asset Replacement, the exclusion of the health index movement due to refurbishment of these assets from the Network Asset Workbook could result in WPD being given a reward under CRC5D at the next price control of the 102.5% of the cost of the refurbishment despite this movement already being funded in its opening base revenues.