

26 September 2014

Ms Anna Rossington
RIIO ED1
Ofgem
9, Millbank
London
SW1P 3GE

Dear Anna

RE: Draft Determinations for the Slow-Track Electricity Distribution Companies

I am writing on behalf of Energy Networks Association (ENA), the voice of the networks. ENA is the industry body for UK and Ireland gas and electricity transmission and distribution networks, essentially, the 'wires and pipes' that deliver this vital service to our homes and businesses.

ENA members welcome the opportunity to respond to the consultation on the Draft Determinations for the Slow-Track Electricity Distribution Companies and this response is made on behalf of these companies.

The Distribution Network Operators (DNOs) welcome the introduction of the RIIO Model (Revenue = Incentives + Innovation + Outputs) and agree that this model provides companies with strong incentives to meet the needs of consumers and the challenges of delivering a sustainable energy sector at a lower cost. The process thus far between the DNOs and Ofgem has been transparent and our members believe that RIIO-ED1 will deliver real benefits for consumers.

There are elements of the proposed Draft Determinations however where Ofgem has made inappropriate assumptions that have material adverse effects on companies' abilities to operate sustainable businesses. Further work is needed to ensure that the Slow-Track DNOs receive a settlement that truly allows them to deliver benefits to consumers and to operate in an equitable way. These areas are:

1. The assessment of Real Price Effects (RPE)

We consider the revised methodology adopted for RPE in the Draft Determinations is not yet fully justified as it contains a number of anomalies:

- There is an inconsistency between long-term forecasts and reliance on third party sources in the short-term;
- Missing data from long-term average growth rate calculations;
- Exaggerated adjustment for the "RPI-effect"; and
- Method for extrapolating trends ignores mean reversion in macro indices.

We have commissioned NERA to review these issues and we attach their Review of Ofgem's Draft Determination of Real Price Effects for RIIO-ED1, with this letter. They estimate, taking account of the issues above, that RPEs in RIIO-ED1 should be around 0.85% per annum higher than those included in the Draft Determination (£274m higher for Slow-Track DNOs).

ENA has also commissioned Frontier Economics to carry out a piece of work to analyse the proposed Real Price Effects as set out in the Draft Determinations. They estimate that RPE allowances for Slow-Track DNOs would have been £343m higher than those in the Draft Determination if Ofgem had used the approach the Competition and Markets Authority (CMA) took in the Northern Ireland Electricity inquiry once this approach is aligned with the ED1 basis for uplifting allowed revenues using annual average RPI inflation. The final version of their report, CMA RPEs methodology in NIE inquiry applied to GB DNOs is attached to this response as appendix.

2. Smart Grid and Smart Metering Benefits

All DNOs accept the importance of ensuring that the benefits of innovation projects are fully included in DNOs' plans. However, Ofgem's approach to calculating the level of Smart Grid and Smart Meter benefits that should be embedded within companies' plans includes a number of errors. Its approach to assessing the level of benefits included in DNOs' plans is inconsistent and inappropriately dismisses crediting a number of innovative approaches incorporated in companies' plans. We commissioned EA Technology Limited to review Ofgem's approach to applying smart grid and smart meter benefits in the Draft Determination. We attach their report, DNO RIIO-ED1 Business Plan Smart Grid Related Expenditure Assessment, which identifies a number of material issues with Ofgem's approach.

3. The Allowed Cost of Debt including the "Halo" effect and the indices used

We are pleased that Ofgem has recognised that a debt index based on 20 years' data better reflects DNOs' debt profiles. However, Ofgem's decision to delay applying this 20 year index until 2025 results in DNOs' allowances being based on a sub-optimal index for the full RIIO-ED1 period. Ofgem's own analysis shows that use of its proposed index will, on average, under-provide for DNOs' debt costs. Ofgem's justification of its approach based on an assumption that DNOs can systematically outperform the index is flawed as Ofgem's analysis ignored differences in maturity of debt.

DNOs do not consider that there is any headroom in the 6.0% Cost of Equity and urge Ofgem to set the Cost of Debt allowance to cover the expected outturn. Even if Ofgem considers that there is headroom, it maintained its commitment to remaining within the 6.0% to 7.2% range in its February equity returns decision, citing investor certainty as an important reason. By underfunding the Cost of Debt Ofgem is effectively going back on this commitment, which will be damaging to long term investor sentiment.

We attach a report by NERA titled A Response to Ofgem's Proposals on the Cost of Equity and Debt for RIIO ED1, commissioned by DNOs that highlights the issues with Ofgem's approach.

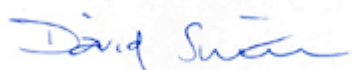
4. The RPI Formula Effect

While we can appreciate Ofgem's reasoning behind this technical adjustment to the cost of equity and RPE calculations, there remains considerable uncertainty over its scale, how it would actually feed into real world capital and labour markets, and the impact of future changes by ONS to price data gathering routines (such as those planned for 2015 which are deliberately targeted to reduce the RPI formula effect). A more cautious approach and a smaller adjustment would be warranted – which we note was also the recommendation of Ofgem's consultants during the cost of equity consultation.

We attach a report by NERA titled Review of Ofgem's Estimate of the RPI Formula Effect that demonstrates why an adjustment of 15 basis points would be more appropriate.

I trust that you find these comments useful. We would like to meet with you and the relevant members of your team to discuss the various consultant reports further.

Yours sincerely



David Smith
Chief Executive

Attachments:

- NERA Review of Ofgem's Draft Determination of Real Price Effects for RIIO-ED1
- Frontier Economics - CMA RPEs methodology in NIE inquiry applied to GB DNOs
- EA Technology Limited - DNO RIIO-ED1 Business Plan Smart Grid Related Expenditure Assessment
- NERA - A Response to Ofgem's Proposals on the Cost of Equity and Debt for RIIO ED1
- NERA - Review of Ofgem's Estimate of the RPI Formula Effect