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Dear Maxine

**Consultation on the treatment of real price effects for RIIO-ED1 slow-track electricity distribution network operators**

Thank you for the opportunity to respond to your consultation on the Treatment of Real Price Effects (RPEs). The RIIO-ED1 Draft Determination for slow track companies demonstrates that there has been a change in the trajectory of the input price indices in aggregate since 2010-11. This indicates that there may be increased uncertainty in the forecast of RPEs and, therefore, it is appropriate to review whether the use of an ex-ante forecast continues to be appropriate, especially for an eight year price control period. The attached appendix contains answers to the specific questions raised in the consultation and our overall view is summarised below.

Given current market developments and the length of the RIIO-ED1 review, linking RPE allowances to some form of indexation might be an attractive de-risking approach for DNOs. However, care must be taken when changing approach to ensure the incentive properties of any mechanism continue to drive behaviours that are in customers' best interests. Furthermore, identifying an appropriate indexation mechanism which will sufficiently reflect our actual cost movements is a significant challenge.

**DNOs should manage the risks associated with RPEs**

It is clear that RPEs can in part be mitigated and managed by DNOs. Procurement contracts and framework agreements can be constructed to either transfer inflation risk down the supply chain or crystallise inflation risks faced by DNOs and their customers to provide greater cost and price certainty and reduce volatility. Therefore we believe it has been appropriate to allocate the RPE risk to network operators in recent price control reviews in a manner that creates a powerful incentive to manage this risk. An RPE index would have the effect of moving the risk associated with RPEs from DNOs to customers.

**Indexation is theoretically attractive, but simple, relevant and reliable indices are not available**

The indexation of RPEs, whilst attractive from a theoretical perspective, creates many practical issues which could create additional risk for customers. Previous attempts to create an appropriate index driver have not found metrics which track the costs of the relevant baskets of goods accurately. This creates a new risk of potential windfall gains and losses. The drive to avoid complexity and use single indices for each cost area increases this risk.

## **Indexation adds unwarranted volatility and complexity to price control settlements**

The RPE Index as proposed by Ofgem would create uncertainty and price volatility for consumers and would not mitigate the risks to the DNOs of in input prices changes over time. We therefore do not believe that the proposed RPE Index should be implemented.

## **An improved ex-ante allowance is the best available option**

We support managing the RPE uncertainty through ex ante allowances. This approach is consistent with the treatment used by other regulators, preserves incentive properties and avoids a potential source of charge volatility. However, there is an urgent need to correct the Draft Determination values to provide DNOs with sufficient protection from the potential for rapid input price inflation during the global economic recovery that is forecast to gather place during RIIO-ED1. It is also appropriate for Ofgem to recognise the increasing risks associated with managing RPEs over an eight year period within its wider cost of equity assessment.

Whilst we agree that when calculating RPEs Ofgem should utilise the most recent data available (which was not available when we submitted our plan), a number of errors and inappropriate assumptions have been made in the Draft Determination. The ENA commissioned NERA to review Ofgem's approach to constructing RPE indices and their assessment shows that our RPE allowance would have been £29m greater if the issues identified in their report were corrected. The ENA also commissioned Frontier Economics to determine what the RPE allowances for Slow-Track DNOs would have been in the Draft Determination if Ofgem had used the approach the Competition and Markets Authority (CMA) took in the Northern Ireland Electricity inquiry. They calculate that if Ofgem had adopted the approach used by the CMA our allowances would have been around £27m greater.

Ofgem's focus for RIIO-ED1 should be to ensure that appropriate levels of protection are in place for all parties.

If you have any questions regarding our response, please do not hesitate to contact me or a member of the team.

Yours sincerely

**Paul Bircham**  
Regulation Director

## Appendix 1 – Summary Responses to Questions

### Consultation Questions and Proposed Responses

1. *Do you think these criteria are appropriate and sufficient? If not, please explain why and justify any alternative assessment criteria.*

We believe that the assessment criteria proposed are appropriate. It is sensible that Ofgem has developed these criteria from its previous work on RIIO uncertainty mechanisms, ensuring consistency.

We note and welcome the recognition that uncertainty mechanisms can interact with financial resilience. The RIIO financeability principles produce an incredibly tight financial package and any risk of overspending allowances (as a result of inadequate RPEs) will place significant stress on financial ratios. This is particularly the case where networks are reliant on incentive mechanisms and outperformance to maintain appropriate financial ratio performance and credit ratings.

We agree that exposure to risk should be considered. DNOs are best placed to manage some of the risk, but must be appropriately compensated for this exposure.

These criteria provide an appropriate test for any revised treatment.

2. *Which of the RPE approaches (including the current approach of a fixed ex ante allowance, or any not explicitly discussed in this consultation) do you favour and why? Please justify with reference to the criteria.*

We support the current ex ante allowance treatment. This is because, despite some weaknesses, it best matches the evaluation criteria at the current time. The ex-ante approach has strong incentive properties and greater predictability and reduced volatility when compared to an index. The ex-ante approach is also less complex and less resource intensive.

We believe that any form of indexation will have implications for the current incentive properties within the price control. DNOs will be incentivised to de-risk their procurement approach by matching the contracting strategies to the index and therefore costs will undoubtedly follow the index more closely over time and it will effectively become a self-fulfilling prophecy. However, it will not be clear whether alternative procurement strategies could present improved efficiency outcomes as an area for innovation is likely to be stifled.

There are also significant risks of unintended consequences when developing an indexation approach. Numerous regulators and networks have attempted to find an appropriate mechanism without success. Indexes that do track the particular basket of goods utilised by DNOs tend to be too complex and simple indexes present the risk of significant windfall gains or losses. Furthermore, developing and implementing an indexation methodology will be time consuming for Ofgem and the DNOs and increase the complexity of the price control.

We also believe that indexation will introduce an additional source of volatility into price control revenues.

3. *If we use indexation with a deadband, at what value should the thresholds be set?*

As already stated, we do not support the use of indexation for RPEs.

We agree with Ofgem's analysis that the application of a deadband would limit the effectiveness of the uncertainty mechanism and increase its complexity. As we are concerned that the indexation mechanism will not provide effective protection, the overlay of a deadband will exacerbate the issue.

4. *If we use indexation, do you think the proposed indices are appropriate? If not please justify alternatives.*

One of our key concerns with the indexation uncertainty approach is the potential for windfall gains/losses from the use of inappropriate indices. We believe Ofgem's desire to use a single mechanism for each cost area potentially increases this risk. Our activities are extensive and varied and, therefore, the basket of goods that we procure is complex with many different cost drivers. We believe that many more indices would be required to develop an appropriate index for the "typical" DNO. Furthermore, it is not clear that the mechanism proposed would appropriately reflect the differences between DNOs or the variation between each individual DNO and the "typical" DNO.

We note that the majority of the indices proposed in the consultation have been used by Ofgem to develop the Draft Determination. The NERA paper on Ofgem's RPE calculation commissioned by the ENA sets out a number of issues with the indices used in the Draft Determination calculations. We agree with this analysis. In particular NERA demonstrate that it is inappropriate to use the general labour forecast to predict specialist labour cost movements.

Where the proposed index does differ from the Draft Determination is in relation to capex materials. The Copper, Aluminium and civils indices were selected in the Draft Determination as a proxy for the mix of components used by DNOs. Whilst these three indices represent an over-simplification, it is highly unlikely that the three could be appropriately represented by the use of the BEAMA basic electrical equipment index.

5. *Do you think that using a single mechanism covering all cost types is more appropriate than multiple mechanisms? If you think multiple mechanisms would be appropriate please justify which one you think should apply to each cost type.*

Ofgem should continue to use a single, ex ante allowance mechanism to address the RPE uncertainty.

We agree that our own labour costs are likely to be more predictable and controllable by the DNOs, however much of our incurred labour costs are in the form of contractor costs. The real benefit from the uncertainty mechanism is in the appropriate assessment of materials costs. However, we understand why Ofgem is keen to preserve the benefits of the move to a totex environment and support this intent. We are keenly aware that introducing different treatments for different cost types effectively starts to unwind the benefits of the aligned incentive approach and single sharing factor. There is evidence that artificial boundaries have distorted behaviours in the past.