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Dear Maxine

RIIO-ED1: Draft Determinations consultation for the slow-track electricity distribution companies

Thank you for the opportunity to respond to your consultation. Our business plan is the result of nearly three years of work with our stakeholders, employees, investors, suppliers and contractors. The Draft Determination largely concludes that our plan represents a good deal for the customers of the North West.

We have identified a small number of very significant issues with the published Draft Determination. In combination, these have a disproportionate effect on the revenue that Ofgem proposes for Electricity North West, rendering it an unacceptable package for the acknowledged most efficient company to be offered.

Overall, the Ofgem cost assessment methodology appears to be generally robust. The process of developing cost assessment tools for the RIIO-ED1 process is transparent and open and has enabled useful dialogue between DNOs and Ofgem. Our assessment of our costs is aligned with the results from the modelling and we are pleased that Ofgem addressed the issues identified with the fast track assessment in developing the models used for Draft Determination. However, we have identified a small number of very material issues that need to be addressed in the Final Determination. The correction of the five biggest errors will further improve the assessed efficiency of our plan by around £60m. We will continue to work with you to make the necessary corrections to the cost assessment models.

We recognise and agree that smart solutions will create an efficiency opportunity for the industry with stretching levels of smart grid solutions and smart metering efficiency savings incorporated into our business plan. However, we are concerned that Ofgem's calculation of the benefits contained multiple errors which have overestimated the potential impacts. We are particularly concerned that some assumed benefits have been applied to inappropriate activity types such as unbundling of services, a number of innovative solutions that we included in our plan were inappropriately not credited in Ofgem's assessment of benefits in our plan and an error in the allocation of GB wide benefits between the DNOs has the effect of incorrectly applying an extra £17m of benefits to Electricity North West. We have raised these issues with you separately and will work with Ofgem to incorporate appropriate efficiency challenges in the Final Determination.

The adjustment to allowances based on the real price effects (RPE) adjustment is also concerning. Whilst we agree that 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 applying the adjustment. We commissioned NERA and Frontier Economics to review Ofgem's approach to setting RPE allowances. Their analysis identified a number of issues with the construct of Ofgem's RPE indices and demonstrated that Ofgem's approach provides much lower allowances than the Competition and Markets Authority did in their recent assessment of efficient costs for Northern Ireland Electricity. The issues in Ofgem's analysis place significant delivery cost risks on the business. We are also concerned that the frontier shift and RPE assumptions for RPI are now misaligned as a result of the reduction for the "formula effect" in the RPE calculation. This effect is exacerbated by Ofgem's cherry picking of its own stringent RPE assumptions whilst accepting DNOs' stretching frontier shift assumptions. The Real Price Effect adjustment represents a significant and inappropriate adjustment to our business plan which must be appropriately addressed before the Final Determination.

The proposed financeability package remains our most significant concern with the Draft Determination. Your consultation recognises that the proposed package requires amendment to improve financial resilience. The Ofgem team acknowledges that its preferred financeability solutions will not provide the appropriate financial resilience in isolation. We have separately written to GEMA proposing a suite of adjustments which are fair to customers and investors.

We are proud of our business plan and recognise that it represents a considerable challenge for us to deliver its combination of outputs and efficiency. We are also pleased that Ofgem's Draft Determination recognises the relative efficiency of our plan. All in all, our customers will receive leading performance, the largest price reduction and the lowest DNO bill by the end of the price control. However, a small number of very fundamental changes need to be made to Ofgem's proposals to ensure that the Final Determination provides a great deal for customers, efficient yet achievable deliverables and appropriate financial resilience to ensure long-term sustainability.

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

Yours sincerely

Steve Johnson
Chief Executive Officer

Appendix 1 - Consultation Questions

Overview

Chapter Two: Summary of assessment

Question 1: Do you think our assessments for each of the five criteria are appropriate?

We agree with Ofgem's assessment of the slow track business plans against the five criteria.

The assessment process for fast track suggested that we were very close to achieving the fast track status. The subsequent modifications and supporting evidence submitted as part of our March plan has been reflected in the cost efficiency assessment metric.

Ofgem's assessment of our financeability position (amber) reflects the fact that whilst our business plan was submitted with a specific financial package designed to achieve an appropriate degree of financial resilience, some of the measures taken were inconsistent with Ofgem's (amended) policy requirements. However, in our particular situation, compliance with all of Ofgem's policy positions would not provide sufficient revenues to finance our activities. We have separately written to GEMA, setting out our proposals for financing which we believe can be reflected in the Final Determination.

Chapter Four: Assessment of efficient expenditure

Cost assessment – Overall

We consider that, overall, Ofgem has taken a reasonable approach to cost assessment; however there continue to be a small number of calculation errors and misunderstandings that have a very material effect on the modelled efficiency of our plan. We have discussed these issues with the Ofgem team, and made it clear that they need to be resolved before the Final Determination is made.

In considering the cost assessment process, we acknowledge that all modelling approaches have advantages and disadvantages and there is no 'perfect' model. In this context it is reasonable that Ofgem should use a range of models, supplemented by qualitative assessment to assess companies' plans, and apply judgement in determining a balanced and proportionate suite of models.

We raised a number of challenges to the assessment approach and models used for the fast track decision which highlighted some fundamental flaws and errors. We note that Ofgem has made a number of important and appropriate changes in response to our feedback. We are pleased that the suite of models now demonstrates clearly that our plan is efficient and represents a good deal for customers. We also note that there are aspects of many models where other approaches would have been equally valid, and that would have assessed us as being slightly more efficient, but in the round we accept the overall cost assessment approach adopted by Ofgem.

Question 1: Do you agree with our totex benchmarking?

Containing overall costs is the key to reducing prices for customers. Our Business Plan is the result of nearly three years of work and innovation with our stakeholders, employees, investors, suppliers and contractors and we are pleased that the Draft Determination largely concludes that our plan represents a good deal for the customers of the North West.

We have looked at the basis of Ofgem's totex assessment and our analysis shows that whatever functional form or drivers are used, our plan remains at or within Upper Quartile. Furthermore, although we note that many other totex model constructs are available, we are confident that our plan benchmarks at or better than benchmark in all the models we have tested. This confidence is boosted by the knowledge that more reliable cost driver data is available than at fast track, and we support the role of Ofgem's Data Assurance Guidance (DAG) in achieving this.

We agree that using two totex models with an equal weighting is a sensible and pragmatic approach. We also consider that Ofgem now has better quality data available to balance the weighting of totex and disaggregated models appropriately, and agree with the proposed weights.

Question 2: Do you agree with our disaggregated benchmarking?

We acknowledge that Ofgem has to apply judgement in determining a balanced and proportionate suite of models and, subject to the comments in the next paragraph, we think that the overall balance is about right. There are aspects of many models where other approaches would have been equally valid that would have assessed us as being slightly more efficient, but in the round we accept the overall cost assessment approach adopted by Ofgem.

In terms of the results of the assessment, we have identified the need to resolve a small number of very material errors, issues or misunderstandings which have distorted results and need to be corrected. These are outlined in later sections of our response and have been discussed with the Ofgem team.

Question 3: Do you agree with our forecast of RPEs?

Our business plan was based on actual unit rates with significant efficiency targets and included a realistic assumption about how our future costs will vary relative to RPI, also taking account of the steps we will have taken to mitigate the effect of RPEs to keep costs lower and more stable for customers. Whilst we agree that Ofgem should utilise the most recent data available to calculate RPEs (which was not available when we submitted our plan), a number of errors and inappropriate assumptions have been made in applying the RPE adjustment.

We commissioned NERA to review Ofgem's approach to constructing RPE indices and the analysis identified a number of issues including:

- Inappropriate short term wage forecasts
- Failure to use longest available data set for specialist labour
- Estimation techniques that ignore mean reversion in long term growth rate calculations
- Exaggerated adjustment for RPI formula effect

NERA assesses that our RPE allowance would have been £29m greater if the issues identified in their report were corrected. Their report is appended as Appendix 1 of our submission.

We note that in its calculation of the notional company cost type split, Ofgem fails to take account of the fact that UKPN had included a 'hybrid' general and specialist labour split. This had the effect of giving all companies too little specialist labour RPE allowance. Correcting this will further increase our RPE allowances. We understand that Ofgem has recognised this as an error and will correct it in the Final Determination.

We 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. Frontier Economics estimate that the allowances would have been £343m higher than those

in the Draft Determination if Ofgem had used a similar approach, once it is aligned with the RIIO-ED1 basis of uplifting allowed revenues using annual average RPI inflation. If Ofgem had adopted the approach used by the CMA, our allowances would have been around £27m greater. This increase would be even greater if applied based on Ofgem's cost type split for a notional company. The Frontier Economics report is appended as Appendix 2 of our submission.

The issues in Ofgem's analysis place significant delivery cost risks on the business. The Real Price Effect adjustment represents a significant and inappropriate adjustment to our business plan which must be appropriately addressed before the Final Determination.

We are also concerned that the frontier shift and RPE assumptions are now misaligned in Ofgem's proposals for two reasons. Firstly, the reduction for the "formula effect" in the RPE calculation should be extended to reduce frontier shift by the same margin to ensure consistency in the calculation of allowances. Frontier shift adjustments effectively target DNOs with an improvement in costs relative to RPI. If Ofgem believes that a formula effect means that RPI is over-recording inflation, it follows that DNOs' ability to outperform RPI in frontier shift has reduced correspondingly.

Secondly, Ofgem's approach of using its own RPE assumptions whilst accepting DNOs' stretching frontier shift assumptions cherry picks from two different modelling approaches. Ofgem should apply its own calculation of frontier shift to allowances based on latest available data. We expect that this would result in a less stringent frontier shift assumption being applied to DNOs.

Question 4: Do you agree with our assessment of potential smart savings?

Overall, we agree that there are significant benefits that arise from smart and that these need to be accounted for in all DNOs' business plans. The benefits are of a magnitude that it would be inappropriate to merely rely on the efficiency incentive and sharing factor to share them with customers. We also note and welcome that Ofgem recognises most of the considerable benefits included in our business plan.

We commissioned EA Technology Limited to review Ofgem's approach to approach applying smart grid and smart meter benefits in the Draft Determination. Their report is appended as Appendix 3.

We note that there are quite wide differences between DNO business plans in the assumptions used to underpin reinforcement forecasts, particularly forecasts of the take-up in electric vehicles, heat pumps and PV. These differences are clearly illustrated in section 3.2 of the EATL report (see Appendix 3). Given that there are such wide differences between DNO assumptions of reinforcement expenditure and smart benefits, Ofgem must carry out more benchmarking and relative comparison of DNOs' plans and recognise these issues in its assessment of the opportunity for further savings from each slow track DNO.

The Ofgem assessment requires further work as there are a number of errors and misunderstandings we observe that materially distort the results of the analysis to date. There are errors in both Ofgem's bottom-up build of savings and in the top-down cross-check subsequently applied.

The load scenario assumed by the DNO is material to the quantification of the discount; as lower growth scenarios with higher clustering of demand growth will tend to have lower opportunity for smart solutions. This has not been taken into account in Ofgem's calculation of the smart discount to apply to reinforcement. We also note that Ofgem has over-estimated the total discount to apply to reinforcement, although the derivation of this figure is not transparent to us. Furthermore, Ofgem wrongly applies the smart discount to all aspects of reinforcement, including some cost areas such as service unbundling and harmonics where no smart benefit should be assumed. Overall, more use of comparison of benefits

assumed by the best performing DNOs would aid in the derivation and justification of robust estimates of the benefits of smart to apply to reinforcement.

When we turn our attention to where there are benefits from smart technologies in other cost areas, we also find that Ofgem's approach is too broad brush and ignores DNO work mix. Whilst we agree that the benefits of smart grids can extend beyond reinforcement, the Ofgem approach results in savings being assumed across all activities including some activities where no savings should be expected, such as flood protection, safe climbing and wayleave payments. This is because Ofgem's calculation is effectively tied to its own erroneous calculation of reinforcement benefits and is magnifying the effect of the errors in the reinforcement calculation. Again, greater reference to the benefits assumed in the plans of the leading DNOs would serve to assist Ofgem in deriving an appropriate level of benefit and applying it to the correct work types.

Unfortunately, the errors in the bottom-up build of savings are not highlighted by Ofgem's top down cross-check of the quantum of smart grid benefits because of two major issues:

- Firstly the assumption that half of LCNF project benefits accrue to the DNO cost base is incorrect for two reasons. Firstly, many of the Tier 2 projects benefits are in fact competitor technologies and there are several solutions targeting the same elements of the cost base. Secondly, many of the benefits included in LCNF projects accrue to parties other than DNOs such as direct customer benefits, suppliers or transmission network operators. It is therefore inappropriate to add these benefits together and whilst a 50% factor has been included, this is not sufficient to derive the probable benefit accruing in RIIO-ED1 correctly.

- In addition, the Ofgem top-down cross-check effectively assumes that all projects will be successful and will deliver assessed benefits – this is an overly optimistic assumption. We expect Ofgem to deploy a more scientific approach to working out what activities smart benefits should be expected to improve and a more robust approach to calculating the appropriate smart discount.

The same issues are also observed in Ofgem's bottom up assessment of the quantum of benefits that can be derived from smart meters. The impact assessment on which Ofgem's analysis is based relies on inappropriate assumptions about the level of smart meter penetration that is required to support smart solutions. The assumption that full power outage benefits are available to DNOs from commencement of the roll-out, that most solutions can be supported at 30% smart meter penetration and that load related savings are available at 80% penetration are all flawed and overstate the benefits that will be released in RIIO-ED1.

Whilst we are pleased that Ofgem recognises the significant double count between smart meter benefits and other smart benefits and has taken account of this, the bottom up calculation is effectively tied to 1½ times the reinforcement benefit, amplifying the errors discussed above.

Overall we conclude that the level of benefits across GB that Ofgem has assumed in the Draft Determination as missing from the DNOs' plans is grossly overstated. The EATL report in Appendix 3 reaches the same conclusion.

There are two further issues that exacerbate the problems with the Draft Determination and cause particular issues for Electricity North West:

- Ofgem wrongly dismisses some benefits included in DNOs' plans as being Business-as-Usual, rather than smart. Some innovative solutions have been dismissed due to a lack of specification in Ofgem's data request. For example our new oil regeneration solution will result in massive cost savings which have been reflected in our plan. This new approach has been wrongly dismissed as a Business-as-Usual approach because it has been confused with traditional oil replacement. Had we included a

traditional solution our efficient cost allowances would have been much higher, clearly indicating the benefit of our approach over that in other DNOs' plans.

- In allocating its derivation of the benefits of smart between the DNOs, Ofgem has made multiple and very material errors. In particular Ofgem fails to correct for the differences in work mix, especially reinforcement. This factor alone leads to Electricity North West being given a £17 million greater reduction than is indicated by Ofgem's own analysis. There is a 40% challenge applied to our low reinforcement forecasts which contrasts with much lower 12% reductions applied to other companies with much bigger reinforcement programmes. Ofgem's justification of its apportionment approach based on 'allowing DNOs to determine how they achieve these savings' is fundamentally flawed as it ignores its own derivation of the areas where greatest savings are expected to be made ie reinforcement.

Overall, we find nothing in Ofgem's analysis that provides compelling evidence that our plan was anything other than efficient. We believe we have included some of the most substantial levels of smart benefits of any DNOs in a business plan that is one of the most efficient overall. As such our business plan is a useful reference guide for Ofgem to help determine the levels of smart benefits it should be able to observe in the plans of others.

We have provided detailed calculations to the Ofgem team that explain how corrections for many of the errors in the allocation of benefits between DNOs can be achieved. We remain committed to working constructively with Ofgem to resolve these issues and derive a more accurate forecast of the levels of smart benefits that should be included in each DNO's plan.

Question 5: Do you agree with our approach to combining the cost assessment models?

All modelling approaches have advantages and disadvantages and there is no 'perfect' single model. Consequently, we agree that Ofgem should use a range of models, supplemented by qualitative assessment to assess companies' plans.

There is also no 'perfect' combination of models and so Ofgem has to apply judgement in determining a balanced and proportionate suite of models. We believe that this has been achieved in the cost assessment completed for the Draft Determination by applying equal weighting to disaggregated and totex models.

Question 6: Do you agree with our design of the IQI?

We support the use of the IQI matrix in setting allowances for RIIO-ED1. It remains relevant in the RIIO framework that companies are incentivised to request the allowances that they believe they need for the each regulatory period.

We also agree that Ofgem should move the 'start to earn point' so that companies that are assessed to be within the UQ are rewarded for offering efficient plans. However, the incentive properties of the IQI matrix issued with the Draft Determination fail to recognise that the efficiency incentive rate is a post-tax value, whereas the additional income is awarded pre-tax. This means that the current matrix has effect of inappropriately rewarding some companies for requesting more allowances than they need. It is essential that this is corrected for Final Determination.

There are two potential corrections for this: either 'gross up' additional income for tax within the IQI matrix or include additional IQI allowances in the activities included in the calculation of tax allowance in the Price Control Financial Model (PCFM). The latter option would allow for the tax allowances to be adjusted as part of any tax trigger event. We have forwarded details of the required correction to the Ofgem team.

Chapter Five: Assessment of efficient finance

Question 1: Do you agree with our cost of equity proposals?

Ofgem has made a number of errors in "translating" the Competition and Market Authority's (CMA's) cost of equity decision for Northern Ireland Electricity (NIE) across to the DNOs and in its overall cost of equity decision.

The CMA's use of short-run evidence is less relevant for what Ofgem should assume for RIIO-ED1. The RIIO-ED1 period runs for a much longer period (2015-2023) than NIE's regulatory period, which runs from 2013-2017, and which has already been running for 18 months. The RIIO-ED1 price review period starts three years later and finishes six years later than NIE's, by which time the current exceptional period of low interest rates is unlikely to remain in place, with the market expecting the economy to return close to long-run normal conditions. Moreover, it is implausible to reduce the "margin for error" relative to the CMA's NIE decision when the regulatory period is longer and thus more uncertain with regard to actual outturn rates than the NIE RP.

Ofgem uses a debt beta of 0.1 for the DNOs which is higher than the CMA's assumption of 0.05 for NIE. Ofgem's debt beta assumption of 0.1 for the DNOs is not explicitly justified but it appears to be based on the assumption that a higher gearing of 65% compared to NIE's 45% gearing assumption warrants the use of a higher debt beta. At the same time Ofgem assumes that the DNOs are able to achieve a *better* credit rating (A/BBB) than NIE (BBB+). In practice this set of assumptions is empirically flawed as companies with weaker credit ratings exhibit higher debt betas.

In light of the above, Ofgem's estimate of the cost of equity of 6.0% appears to reflect a misplaced direct translation of the CMA's NIE decision that fails to recognise:

- The significantly longer regulatory period compared to NIE and the uncertainty and expected risk-free rate trajectory associated with it;
- The impact that assuming a higher credit rating than the CMA did for NIE has on the debt beta; and
- The impact that a new and untested framework has on asset beta.

This analysis is explored in more depth in a report prepared by NERA (see Appendix 4).
We believe that the appropriate cost of equity for the RIIO-ED1 period obtained from a consistent translation of the CMA decision that takes account of the specificities of the two cases lies upwards of 6.4%. By concluding on a cost of equity of 6.0%, Ofgem chooses an estimate that does not allow any margin for error (headroom) over the RIIO period, thereby not providing any buffer against under-recovery on other elements, eg the cost of debt.

We also commissioned NERA to provide further analysis of Ofgem's approach to setting the cost of equity and debt at RIIO-ED1 and specifically to look at Ofgem's arguments that the cost of equity in the draft determination contained headroom. The NERA analysis shows that these arguments are incorrect and there is no additional headroom (see Appendix 5).

While we can appreciate Ofgem's reasoning behind its technical adjustment to the cost of equity and RPE calculations for RPI formula effect, 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). NERA have provided a detailed analysis of Ofgem's approach to adjusting its allowances for both the cost of equity and real price effects (RPE) for the "RPI formula effect" (see Appendix 6). We support this report and the conclusion that 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.

Question 2: Do you agree with our cost of debt proposals?

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 ignores differences in maturity of debt. Ofgem's justification of the existence of alleged headroom in its cost of equity allowance that can be used to 'top up' its cost of debt allowance is also flawed. We asked NERA to consider both of these issues (see Appendix 5). Their analysis supports our view that Ofgem's justification of setting a cost of debt allowance that systematically under-provides for average DNO costs is unjustified. We urge Ofgem to set the cost of debt allowance to cover the expected outturn.

Question 3: What are your views on our assessment of financeability?

In preparation for and subsequent to the announcement of the Draft Determination, we have undertaken extensive engagement with the Credit Rating Agencies. As a result we have observed that all Credit Rating Agencies have indicated their concerns with the sector wide deterioration in interest cover observed. We have specifically addressed Ofgem's invitation to change our determination and improve financial resilience in a separate letter.

Question 4: Do you agree with our proposals to modify the three financial policies?

<u>Directly remunerated services - Adjustments for top up and standby</u>

We agree with Ofgem's approach to adjusting DPCR5 closing RAV for income received during DPCR5 top up and standby (ES4).

We support Ofgem's proposed amendment to our licence to specify that top-up and standby charges are only directly remunerated if they relate to an agreement for the recharge of direct expenditure.

<u>Directly remunerated services – Adjustments for Value Added Services</u>

Ofgem has not correctly reflected the adjustment for Value Added Services in our Price Control Financial Model. It has adjusted for total revenue, rather than net revenue, resulting in an asymmetrical penalty being applied. The marginal costs associated with delivering these activities must be included within net totex allowances in order to achieve the desired symmetrical properties set out in CRC5C.

This methodology is not correctly reflected in the Financial Handbook issued for WPD. Two corrections are required:

- The handbook needs to reflect the intended symmetry of this incentive by including marginal costs associated with Value Added Services as well as associated income to actual totex expenditure.
- If Ofgem intends to make an ex ante adjustment for any companies that have forecast income from disposals, it must ensure that a 'true-up' is included in the financial handbook and PCFM to ensure that companies are not disadvantaged for forecasting this activity.

<u>Capital allowance pools</u>

We accept Ofgem's decision to roll forward regulatory tax pool calculations at the end of the RIIO-ED1 period policy change, but observe that it will create a mis-match between the statutory tax computations and the regulatory tax allowance in future RIIO periods.

We also accept Ofgem's proposal to use DNO-specific attributions of qualifying expenditure to capital allowance pools. This is more appropriate than calculating generic tax pool allocations which could have penalised some DNOs merely for differences in work mix or the timing of activities.

Disposals

We are pleased that Ofgem has recognised that its previous policy for treatment of disposals provided no incentive to DNOs to achieve income from disposal of redundant assets. The revised proposals provide an appropriate balance between incentivising DNOs to dispose of assets and ensuring that customers share in any profits made.

It is not clear in Ofgem's proposals whether the new policy will only apply to sale of operational assets or whether it will also be extended to sale of non-operational assets and sale of scrap. It would be helpful for this to be clarified.

Ofgem did not make changes for this policy change in our Price Control Financial Model and our RAV additions are understated by £6.4m as a consequence. This must be corrected for in our Final Determination.

This policy change will also require a change to the Financial Handbook. If Ofgem intends to make an ex ante adjustment for any companies that have forecast income from disposals, it must ensure that a 'true-up' is included in the financial handbook and PCFM to ensure that companies are not disadvantaged for forecasting this activity.

Chapter Six: Uncertainty and risk

Question 1: Do you agree with our acceptance of the DNO specific uncertainty mechanisms?

We agree with the proposals. Ofgem has conducted an appropriate review of the company specific uncertainty mechanisms throughout the fast track and slow track Draft Determinations. The proposed specific mechanisms included in the Draft Determination provide appropriate levels of protection for customers and companies.

Question 2: Do you agree with our proposal to give all DNOs an uncertainty mechanism for rail electrification?

We support Ofgem's proposal to extend the rail electrification uncertainty mechanism to all of the slow track companies. We agree that the uncertainty associated with the rail investment programme (in terms of timing, location and scale) is best addressed through the proposed reopener. We do not think however that Ofgem should apply a materiality threshold as no baseline allowances have been included in the Draft Determinations and the proposed efficiency test should ensure that only efficiently incurred costs are remunerated.

Cost assessment

Normalisations and other adjustments

Question 1: Do you agree with our approach to regional labour cost adjustments?

We broadly agree with Ofgem's approach to regional labour cost adjustments. We recognise that higher labour costs are incurred in the South East, and London in particular, than in other parts of the country and we agree that adjustments should only apply to activities or parts of activities that need to be located in the licensee's operating area.

However, we note that Ofgem has applied regional adjustments to all contractor costs. As contractor costs may include an element of material costs and will include indirect costs that need not be located within the licensee's operating area and contractor margin, this is likely to overstate the required regional labour adjustment and therefore inappropriately advantage companies operating in the South East and London.

Question 2: Do you agree with our approach to adjusting for company specific factors?

We are disappointed that, despite recognising that issues associated with differences in scale exist, Ofgem has failed to take account of the additional costs that we incur relative to other DNOs because of our status as a single licensee. We have presented detailed evidence to Ofgem as part of our business plan showing that we incur more than £10m of additional costs each year relative to licensees that belong to an ownership group with two DNOs. Ofgem's failure to take account of this results in our allowances being reduced by some £80m.

Question 3: Do you agree with the costs excluded from our totex assessment?

We broadly agree with Ofgem's approach of excluding costs that are only incurred by some DNOs, where requirements for expenditure differ greatly between DNOs or where costs are mainly assessed qualitatively in disaggregated models rather than totex models.

We are pleased that insurance costs have been included in the totex models. Ofgem's fast track approach penalised companies that reduce overall costs by managing insurance costs, particularly through 'self insurance'.

We agree that non-controllable costs should be excluded from cost assessment.

Load-related expenditure

Question 1: Do you agree with our approach to assessing primary reinforcement and n-1 primary reinforcement?

We agree that the combined process of assessing each scheme through a quantitative 'unit-cost' assessment and a qualitative review of scheme papers is an appropriate approach.

Question 2: Do you agree with our approach to assessing secondary reinforcement (both low carbon technology (LCT) reinforcement and non-LCT reinforcement)?

We agree that the approach to assessing reinforcement allowances is generally appropriate and recognises the role of the Transform model in assessing future network reinforcement requirements due to LCT penetration.

Question 3: Do you agree with our approach to assessing transmission connection point (TCP) charges?

We agree with Ofgem's approach of appointing consultants to carry out an engineering review in this complex area due to the need to consider the complexities of each site. We are pleased that the consultant's review supports our submission.

Question 4: Do you agree with our approach to assessing connections?

We agree that the approach to assessing connections allowances is appropriate.

Asset replacement, refurbishment and civils

Question 1: Do you agree with our approach to assessing asset replacement costs?

We are broadly happy with Ofgem's approach in this area, particularly the modelling changes since Fast Track (including an expansion of 'modelled costs' over 'unmodelled costs') and the greater focus on qualitative adjustments where we have provided additional justification. However we have found a number of errors in Ofgem's modelling which we expect to see corrected in the Final Determination. We have provided Ofgem with the details of these errors so will not repeat them here.

One area where we disagree with Ofgem's approach is that of batteries. We believe that the replacement of batteries should be assessed as a whole, covering the interaction between Protection, Black Start and BT21 Century work due to classification and definitional issues in this area.

Question 2: Do you agree with our approach to assessing refurbishment costs?

We are pleased that Ofgem acknowledges the trade-off between asset replacement and refurbishment volumes and has included a mechanism in the DD to allow for this. Unfortunately, errors in the application of these tests result in incorrect adjustments to our woodpole refurbishment volumes which we have advised Ofgem of.

We do not agree with Ofgem's approach to assessing refurbishment unit costs. There are major issues of scope and output linkage which we tabled at our bilateral meeting. This results in no clear standard scope against which to assess forecast costs and the inappropriate application of benchmarked unit costs. We have presented efficiency analysis at our bilateral meeting that takes account of the impact of investment in driving movements in Health Indices (HI).

We propose that refurbishment reporting is changed in the RIIO-ED1 RIGs to overcome this issue and look forward to working with Ofgem in this regard.

Question 3: Do you agree with our approach to assessing civil works costs?

As with refurbishment, we believe that civil work is a very difficult area to benchmark because of the wide interpretations of scope that are apparent from the submissions. As a result, Ofgem's civil costs models generate huge offsetting adjustments for volumes and unit costs that make the individual assessments meaningless. We believe that greater use should be made of qualitative adjustments to recognise the disparity in the scope of activities.

As with refurbishment, we believe that significant further work is required on definitions and guidance to prevent such issues recurring in the future.

Question 4: Do you agree with our approach to assessing high value projects (HVPs)?

Whilst we have no HVPs which were assessed using this approach, we will continue to work with Ofgem to develop suitable arrangements to cover the work in connecting the nuclear power station at Moorside.

Non-core expenditure

Question 1: Do you agree with our slow-track approach for assessing:

- **operational IT&T costs**
- **diversions costs**
- **ESQCR costs**
- **legal and safety costs**
- **quality of service (QoS) costs**
- **flooding costs**
- **BT21C costs**
- **environmental costs**
- **black start costs**
- **rising and lateral mains (RLM) costs?**

We largely agree with the approach to assessing these costs, but have the following observations:

- Operational IT&T costs: Whilst we agree with the approach of using specialist consultants to assess this area, we were disappointed that the consultants did not seem to understand our plans and their linkage with the rest of our submission. It is also evident that there are issues of cost classification that affected their initial findings. We raised this at our bilateral meeting and welcome Ofgem's plan to re-engage consultants to further review our plan.

- ESQCR costs: We agree with Ofgem's approach to ESQCR costs, but recognise that there are issues regarding the reporting of future spending particularly the distinction between ESQCR and Legal and Safety work. We are working with the Cost & Volumes Working Group to propose an alternative reporting structure.

- Legal and Safety: We do not believe that simple unit cost medians work where there are significant variations in work scopes, for example Safe Tower Climbing where we have supplied additional information on the content of our programme. We welcome Ofgem's qualitative adjustments in this area but believe that they should fully reinstate our forecasts.

- Flooding: We are pleased to see that Ofgem has continued to adopt a risk-based approach to assessing the unit costs of flooding which reflects the approach set out in the industry guidance for this area (ETR138).

- BT21C costs: We believe that there is a categorisation issue in the allocation of costs between BT21C and operational IT&T costs, particularly where companies are in different phases of their BT21C projects. For early movers, the costs of replacing assets with relatively short asset lives which were installed as part of the BT21C project will begin to show up in the Operational IT&T costs towards the end of the RIIO-ED1 period.

- Black Start: As noted in our comments on asset replacement, we believe that costs of all batteries including those for Protection, BT21C and Black Start, should be assessed as a whole.

- CNI: We recognise that our proposed expenditure was disallowed based on the list of critical sites that DECC shared in the summer. As discussions are ongoing with DECC and we still anticipate being required to do some of the planned work, we believe that our forecasts should be reinstated for the Final Determination. Should requirements materially change, this will need to be covered by a re-opener mechanism.

Network Operating Costs

Question 1: Do you agree with our approach to assessing Troublecall and occurrences not incentivised (ONIs) costs?

There are significant issues of activity definition and classification in the area of ONIs and data consistency needs to be worked on for the RIIO-ED1 RIGs.

Question 2: Do you agree with our approach to assessing the costs of tree cutting (ENATs 43-8)?

We generally do not consider work volumes to be a reliable cost driver; however in the case of ENATs 43-8 tree-cutting, it would appear to be adequate if coupled with a qualitative assessment of the appropriateness of company proposed volumes. Most companies are forecasting steady state volumes through RIIO-ED1 (unlike the patterns observable in DPCR5); hence any distortions are likely to be small.

Question 3: Do you agree with our approach to assessing the costs of severe weather – atypical, inspections and maintenance, NOCs other, and tree cutting (ETR 132 activity)?

- Severe weather atypical: We do not agree that Ofgem's approach to setting benchmark costs for severe weather is appropriate for a slow track approach where all companies receive the same cost of equity. This 'lower of' approach reduces allowances for companies that proposed lower costs and effectively includes an incentive for proposing higher costs. We suggest that for the Final Determination Ofgem should set allowances based on the average costs proposed by DNOs for the RIIO-ED1 period; this would be more consistent with its approach in other areas of cost assessment.

- Inspection and maintenance: We agree that it is not practical to conduct volume analysis on individual asset types due to the materiality of the volumes involved, differing company practices and lingering issues on the definitional boundary between maintenance and refurbishment. MEAV is a reasonable overall indication of asset base size and its use is consistent with other areas of cost assessment.

  For the unit costs assessment, we agree that the scope of work is perhaps better defined than for activities such as refurbishment, and that the use of the median can accommodate definitional issues at an activity level to give an overall view of cost efficiency.

- NOC other: We agree with Ofgem's approach to setting allowances for dismantlement and substation electricity.

- ETR132 tree cutting: We agree with the approach to assessing ETR132 tree cutting costs but highlight that DNOs will have a range of approaches to risk reduction in this area (as evidenced by the exclusion of NPg data from the assessment) and hence further discussions may be required with DNOs on a bilateral basis.

Question 4: Do you agree with our approach to assessing smart meter costs?

We agree with this approach, particularly that the use of lower quartile unit costs is appropriate due to the uncertainties on unit costs prior to programme commencement.

We are disappointed that Ofgem has reduced our proposed expenditure on smart meter IT. Our investment in smart meter IT is needed both to appropriately manage and store the data received from smart meters, but also to ensure it can be used to deliver the benefits that

arise once smart meter data is available. The benefits included in our plan associated with smart meter roll out are amongst the largest of all DNOs. The IT costs included in our plan are consistent with those benefits. It seems wholly inappropriate to set our allowance for smart meter IT based on the costs proposed by a company that claims to have not included any smart meter savings within its plan.

Whilst we recognise that it is possible that these costs might be funded in the future via the pass through mechanism, this approach simply delays the cash flows we receive to fund this important area of activity.

Closely Associated Indirects, Business Support and Non-op Capex

Question 1: Do you agree with our overall assessment of closely associated indirect (CAI) costs?

We agree with Ofgem's overall approach to modelling closely associated indirect costs. We believe that the changes to Ofgem's models since the fast track decision generally improve the robustness of the models. In particular, the move to modelling a number of these activities in aggregate is sensible and results in Ofgem's models being less sensitive to differences in companies' operating structures or to reporting boundaries that can exist between these activities.

We agree with Ofgem's approach to undertaking separate assessment of wayleaves, operational training and streetworks costs associated with permit schemes. Different DNOs can incur quite different levels of efficient expenditure in these areas and it is important that the drivers of this expenditure are specifically modelled.

Question 2: Do you agree with our approach to assessing:

- **the eight aggregated categories of CAI costs**
- **vehicles and transport (for both CAI costs and non-operational capex)**
- **operational training and workforce renewal**
- **assessing streetworks costs?**

We agree that it is sensible to model network design, project management, system mapping, EMCS, stores, network policy, control centre and call centre within one aggregated model. Whilst it is the case that the immediate drivers of each activity and the level of fixed costs within each activity vary slightly, they are all broadly linked to the delivery of work on DNOs' networks. We believe that the advantages of avoiding cherry picking due to differences in companies' operating structure and removing distortions due to reporting boundaries more than outweigh any benefits that might have resulted from more complex modelling arrangements.

We are pleased that Ofgem has opted to retain the use of an exogenous cost driver for this area of activity. Some of the alternative endogenous drivers proposed by other DNOs might have rewarded inefficient behaviour. We support the move away from the weighted MEAV used as a cost driver at fast track towards using a more holistic MEAV. We agree with Ofgem that MEAV is the most appropriate exogenous scale driver to use as a proxy for network scale as it reflects both substation assets and linear assets; work on all assets is supported by closely associated indirect activities. We agree with Ofgem's decision to exclude a small number of asset classes from its MEAV calculation where very big differences in reporting exist.

We agree with Ofgem's approach of setting benchmarks for workforce renewal based on number of leavers. We also agree that it is appropriate for Ofgem to set benchmarks for operational training based on the size of the current workforce. The consistency of some of the non-retirement leaver data reported in this area needs to be resolved via the development of the reporting rules for RIIO-ED1. We support Ofgem's approach of using wider headcount data available from annual returns to undertake its analysis.

Ofgem's approach to assessing the efficiency of streetworks costs for slow track companies has developed appropriately from its fast track models. In particular, we strongly support Ofgem's approach of modelling non-permitting aspects of streetworks within general cost assessment models for the associated activities. We do not believe that non-permitting costs should vary materially between companies for any reason other than volumes of work. The approach Ofgem now adopts provides appropriate efficiency incentives on DNOs to propose and manage efficient levels of streetworks costs in these areas.

We agree that it is appropriate for Ofgem to assess DNOs' permitting costs separately. The extent to which Highways Authorities have implemented permitting schemes varies across the country and including permitting costs within wider cost models could distort results and penalise companies that incur higher permitting costs due to the decisions of the Authorities in their operating areas. Ofgem's approach has limited ex ante allowances to those schemes for which companies had 12 months of data at the time that they submitted plans. This means that we do not receive any allowance for the permitting scheme implemented in Greater Manchester in April 2013. This approach has the effect of removing around £4m of certain, efficient costs from our ex ante allowances.

Question 3: Do you agree with our approach to assessing business support costs (BSCs)? Please consider the four aggregated areas and IT&T costs separately.

The changes that Ofgem has made to its approach to assessing business support costs have corrected a number of very material issues in Ofgem's approach to business support modelling for fast track. The move to a more transparent modelling approach is appropriate as it allows companies to better understand the drivers of any modelled efficiency or inefficiency.

We strongly support Ofgem's change to reverse its inappropriate approach to modelling fixed costs for fast track. This approach created a material adverse adjustment for smaller DNOs. We are disappointed however, that Ofgem did not accept that an adjustment should be made for the fixed costs we incur as a single licensee. The failure to recognise these additional efficient costs results in our total allowances and IQI position being artificially worse than should be the case for an efficient single DNO.

We are pleased that Ofgem has included insurance costs in its business support models. This revised modelling approach ensures that Ofgem's approach is neutral to companies' approach to risk mitigation through insurance or via other means and also recognises companies that have managed their insurance costs down to a very efficient level.

We support Ofgem's change to use an exogenous cost driver to assess the efficiency of companies' business support costs. Ofgem's previous approach introduced the risk that companies could be rewarded for proposing inefficient plans or because they have a more in-sourced organisation structure than others. We agree that MEAV is the most appropriate cost driver to use for assessing business support costs as the variable aspects of these activities will scale with the size of the network operated by the DNO.

Question 4: Do you agree with our approach to assessing non-operational capex costs? Please consider each of the two categories of IT&T and property and small tools, equipment, plant and machinery (STEPM) separately.

We agree with Ofgem's approach of modelling the non-operational capex and indirect costs associated with managing vehicles within one model. Companies will make operational decisions regarding whether to own or lease vehicles and it is important that Ofgem assesses the level of efficient overall vehicle costs in a way that is not skewed by companies' purchasing decisions.

We support Ofgem's approach of basing allowances for IT non operational capex on a combination of quantitative modelling and qualitative assessment by its consultant. Ofgem's

weighting of 25% on quantitative and 75% on qualitative seems appropriate given the extent to which companies' expenditure will vary for company specific reasons or to support other aspects of performance. We are disappointed, however, that Ofgem's consultant does not seem to have considered the trade-off between IT & Telecom costs and non-operational IT capex, and has not made a positive adjustment to our proposed expenditure in this area to recognise the efficiency of our plan relative to that of other DNOs.

Whilst we agree with the modelling parameters used in Ofgem's other non-operational capex models, the 'lower of' approach to setting efficient cost allowances for property non operational capex and small tools and equipment gives us no credit in the upper quartile assessment for the efficiency of our plan in these areas. Ofgem should set allowances for all companies based on the outcome of its efficiency models.

Real Price Effects (RPEs) and ongoing efficiency

Question 1: Do you agree with our approach to assessing ongoing efficiency?

See our answer to question 3 of Overview, chapter 3.

Detailed figures by company

In a number of instances, we do not believe that Ofgem's calculated values for licence terms are correct. This appears to arise when Ofgem's calculations of detailed values for inclusion in the licence have not taken account of Ofgem's cost assessment process and therefore the proposed terms for use in the licence are inconsistent with the way in which totex allowances have been set.

Some of these incorrect calculations are also replicated in our PCFM and need correcting in both our final PCFM and licence.

We set out below details of the values that have been incorrectly calculated, and also describe the effect of these.

CRC3E – Smart Meter Roll-out Costs

- We do not understand how Ofgem has derived its SMAE values in the PCFM and in licence values. The values quoted do not appear to take account of Ofgem's efficiency assessment.

The effect of this is to distort the allocation of total values between categories that are treated differently in the annual iteration process. In our case, because our proposed smart meter Roll-out Costs were assessed as being very efficient, it has the effect of providing us with totex allowances that are slightly too high.

- Ofgem's proposed Allowed unit cost of smart meter interventions has not been adjusted for Ofgem's view of an efficient unit cost. We believe this should be adjusted to the efficient unit cost of £331.

The effect of this is to allow companies who proposed unit costs that were deemed inefficient to recover costs at that inefficient level. Conversely, companies such as Electricity North West that proposed unit costs that were deemed efficient are given no credit for those efficient costs.

CRC3G – Revising the allowed level of Load Related Expenditure

- Ofgem appears to have incorrectly calculated its opening level of Load Related Expenditure (total and annual) included in our PCFM based on its disaggregated cost models, without factoring in its totex models or its RPE or smart grid adjustments.
- The values proposed for our licence are different to those included in our PCFM. We do not recognise the source of those numbers, but can confirm that we believe them to be too high.

This approach has three effects. Firstly, it results in other totex allowances within the PCFM being too low. Secondly, it results in calculations in the licence that are inconsistent with values in the PCFM and therefore will not have desired effect. Finally, it results in the uncertainty mechanism operating against values that are inconsistent with that load related allowances that have been set. In particular, if companies deliver the level of smart grid savings that Ofgem expects within reinforcement, the subsequent adjustment will remove from DNOs an element of allowances that were not given in the first place, effectively double counting Ofgem's smart grid adjustment.

CRC3H – Allowed expenditure on improving services to Worst Served Customers

- The allowed expenditure value suggested for us is slightly lower than we had expected.

This has the effect of allowing us slightly less expenditure than we had anticipated in this important area that is valued by customers and stakeholders.

CRC5G – Net to gross adjustment for Load Related Expenditure

- We cannot replicate Ofgem's calculation of Baseline Percentage of Gross Load Related Expenditure. Our calculation suggests a slightly higher percentage of 8% would be correct.

The effect of this issue is to distort the intended effect of the mechanism by setting the trigger points for upward and downwards adjustments at too low a percentage, meaning that inappropriate adjustments may be made and appropriate adjustments may be missed.

- We cannot replicate Ofgem's calculation of Baseline Specific Customer Funded Reinforcement. Our calculations suggest a lower value.

This may lead to any adjustments made under this condition being too large.