UK Power Networks
Delivering your electricity

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26 September 2014

Dear Maxine

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

Please find attached UK Power Networks' response to the above consultation. This response should be regarded as a consolidated response on behalf of UK Power Networks' three distribution licence holding companies: Eastern Power Networks plc, London Power Networks plc, and South Eastern Power Networks plc. For convenience, the three licensees are collectively referred to as "UK Power Networks" throughout. Our response is not confidential and can be published via the Ofgem website.

<u>Our recommendations on RPEs</u>

UK Power Networks strongly believes that costs will rise faster than general inflation over RIIO-ED1, in particular for our part of the country. Therefore we continue to believe that the right approach for both customers and companies is for Ofgem to set an ex ante allowance for RIIO-ED1 using a robust approach which reflects the cost pressures experienced by the sector. This will enable companies to then best manage the cost risk through the existing incentive framework, and without a negative cashflow impact.

However if Ofgem feels the need for additional protection for customers, we would accept a true up mechanism in addition to a robust ex-ante allowance, using an index that will be suitable to directly adjust DNO revenues in a manner that balances DNO exposure to risk, volatility of prices to customers and avoids unintended consequences. The true up would protect customers if the allowance does in fact turn out to be incorrect. Any such indexing would have to interact with the other revenue adjustment mechanisms in a well understood manner and our preference would be for an adjustment mechanism that operates with a two year lag.

<u>Our views on Ofgem's approach</u>

UK Power Networks understands that the greater uncertainty in the potential range of RPE outcomes perceived by Ofgem comes from the degree and timing of the recovery to trend and the wide variation between its and companies forecast of ED1 RPEs. It is apparent that Ofgem's analysis indicates that the starting position for ED1 RPE allowances shows a material divergence relative to the long term trend in RPEs. UK Power Networks, with its consultants, has identified a number of issues with Ofgem's analysis that are significantly magnifying the perceived level of

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uncertainty of future forecasts. This is primarily affected by the significant downward movement in general labour indices observed in 2013/14. Alternative approaches to assessing current and short term RPE, such as the benchmarking approach used by the CMA or updating the cost benchmarking to reflect DNO 2013/14 actual costs are available in setting RPE allowances, and these both show that the level of divergence is much lower than Ofgem's Draft Determination indicates.

UK Power Networks has submitted these consultant's reports as part of the ED1 Draft Determination consultation. Both of these reports indicate that the appropriate use of long term averages, in line with Ofgem's stated RPE methodology, significantly reduces the need for complex uncertainty mechanisms.

There is a strong case that some costs in the London and South East region (including LPN, EPN, SPN and SSE Southern) will grow faster than other areas. We have evidence that contractor price indices for the construction sector are forecast to grow 0.5% faster than the rest of the UK. UK Power networks believes that there should be recognition of any regional cost pressures in the ex-ante allowance and in any true-up mechanism, particularly as there are significant input price pressures on costs such as contractor tender rates that are subject to market pressures outside our control.

We have set out our views on Ofgem's specific questions in the attached.

Yours sincerely

Head of Regulation, UK Power Networks

Cc
Ben Wilson, Director of Strategy & Regulation and CFO, UK Power Networks
James Goldsack, Ofgem

Response to detailed questions

Criteria for assessing alternative uncertainty mechanisms

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

Ofgem have proposed the criteria below. We believe these cover the general criteria and believe issues such as financibility should be covered under unintended consequences.

Criteria	UKPN View
Exposure to risk	We agree that the aim of any mechanism must be to balance the risk to both customers and shareholders over the long term.
Impact on Incentives	Any mechanism must not be so volatile as to distort the efficiency incentives. There would be a complex interaction between any RPE adjustments and the totex incentive mechanism. However indexation does not in itself reduce incentives as management cannot control an index outcome, and are still incentivised to cut costs to outperform the index.
Volatility and predictability in network charges	We would agree that any unpredictable volatility of both charges and revenues is to be avoided.
Balance of charges between current and future consumers	Current costs are borne by both current and future customers through the fast /slow money split. We consider this to be of much lower importance than managing potential volatility.
Complexity and unintended consequences	Additional volatility should be avoided and it may have unintended consequences on financibility were there are sudden downward adjustments.
Resource costs	We agree that any approach should minimise complexity and ongoing costs.

Managing risk, volatility and uncertainty should be the primary objectives and in doing so will minimise the risk of unintended consequences.

Alternative RPE mechanisms

Question 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.

UK Power Networks continues to believe that a fixed ex ante allowance is the right approach for both customers and companies. Ofgem should consider an adjustment mechanism if it believes that its forecast of RPEs is sufficiently uncertain that this is necessary when considered in the round with the other incentive and other uncertainty mechanisms. We set out our reasoning below.

An ex ante allowance creates certainty in cash flow for DNOs over the period and thereby eliminates any additional price volatility issues for customers. It also removes the need to understand the complex interactions with the other incentive mechanisms, in particular the totex incentive mechanism. The uncertainty Ofgem perceives arises from the recent short term RPE movements seen in some of the indices, particularly general labour. Ofgem has the tools and visibility of sector costs during the current period to assess the risk and set an ex ante allowance based on long term average of suitable indices. We have, with our consultants, identified a number of options including the CMAs approach and using the 13/14 outturn data for Ofgem to assess and set robust RPE allowances.

Setting an ex ante allowance is also consistent with Ofgem's overall approach as ongoing efficiencies are included in the benchmarked costs and adjusted through the totex incentive mechanism.

If Ofgem believe that further protection is required for customers, an adjustment mechanism should be designed using an index consistent with that used to set allowances. Any such adjustment mechanism should be aligned with the other RIIO-ED1 revenue adjustment mechanisms, for example two years in arrears.

We suggest Ofgem use the same index as they use for setting the ex –ante allowance. Short term indexes may be volatile and are unlikely to be predictable which creates risk for suppliers, consumers and shareholders, the differences observable between general labour indices and benchmark sector wage increases in 2013/14 and 2014/15 are a clear example of the potential volatility of indices in the short term.

A possible alternative would be to set an RPE index based on a longer term average RPE index and then adjust for long term index movements on a regular basis. This would be much less volatile and would still allow observed values to flow through over time.

We prefer a rolling mechanism to specified adjustment windows within RIIO-ED1 as uncertainty in forecasts is likely to persist over shorter timeframe, for example RPEs may be lower than forecast over the first four years and then much higher under certain reversion to trend assumptions.

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

Deadbands in a purely short term indexation approach create a number of potential problems and would amount to efficient revenue being withheld from companies. They may be appropriate in an adjustment mechanism around a properly calculated ex-ante allowance. The size of any deadband should be set to reduce short term volatility in revenue changes, and would depend on the length of the data time series used in any index used in an adjustment mechanism.

Selection of input price indices

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

The set of indices proposed by Ofgem is not unreasonable, however the general labour should reflect private sector wages and exclude the public sector which is subject to government austerity measures, for example the ONS Private Sector Average Weekly Earnings.

We do not understand the rationale for the index to be any different from that used to set the ex ante allowances. We question the benefits of reducing the set of indices as larger set of inputs is likely to be less volatile and sensitive to changes in the formulation of any specific index.

We would also ask Ofgem to consider whether regional factors should be included in their assessment of real price changes, particularly where there are independent indices for factors such as contractor prices which are analogous to output purchasing price indices for materials and equipment. We believe that including contractor cost indices appropriately is necessary given the significant proportion of DNO expenditure subject to contractor pricing.

Question 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.

We do not believe that there is sufficient evidence that the additional complexity and uncertainty of adjusting revenues at the level of individual cost types is necessary, but Ofgem should ensure that its overall mix is representative of the make-up of DNO costs.