

Chris Watts  
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LONDON

Your ref

Our Ref

Date

6<sup>th</sup> November 2014

Contact / Extension

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Dear Chris,

**A) RIIO-ED1 econometric models: SPM MEAV adjustments, 132kV assets and civils; and  
B) Ofgem proposed methodology to determine secondary deliverables**

Thank you for your letter dated 30<sup>th</sup> October. This has provided some assurances in relation to the Ofgem process in some areas.

**Identification of further qualitative or quantitative adjustments that may be needed**

Thank you for confirmation that your team (including engineering consultants) are doing further work. I note the following points from your letter setting out your planned activities:

- "...to consider appropriate costs for your 132kV assets, switchgear, civils etc in RIIO-ED1 including consideration of further evidence that you have provided."
- "...would raise SQs where we felt that additional information or clarification was needed."
- "...carrying out this work in a consistent manner across all areas including the 132kV circuit breaker, transformer replacement overhead line plans and civils."

As I have explained, our particular concerns on 132kV overhead lines (materiality £60M in disaggregated model), 132kV switchgear other (materiality c£3M in disaggregated model) and civils (materiality c£20m in disaggregated model) arose because we had received no supplementary questions in these areas. As at 6<sup>th</sup> November we have received supplementary questions only in relation to 132kV switchgear other.

You have highlighted that your team would have been in touch if you needed any additional information or clarification to make appropriate adjustments to the output of the cost models to reflect justifiable differences between DNOs. If you do need additional information or need guidance regarding interpretation of the extensive evidence we have provided, we will be happy to provide these.

I would also welcome a verbal outline of what and how adjustments have been made to the modelling, even if this was, as a minimum, similar in format to the meeting that took place with James Hope on 21<sup>st</sup> May 2014 ahead of the Draft Determination.

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**Adjustments to the SP Manweb MEAV used in the econometric modelling**

You state that you have reviewed NERA's report on the possible MEAV adjustments and have taken the points raised into account. However, you then state that it is clear to you that such an adjustment needs to be made to avoid distorting the cost benchmarking, and that you recognise that such an adjustment needs to be applied carefully to ensure that it does not result in arbitrary outcomes.

This raises two specific concerns:

- 1) Given the complexity of the SPM network design, and consequently the detail we had to prepare and present to you (including 2 independent expert reports), we are concerned that any such adjustment to MEAV can only be made in close collaboration with SPM engineering experts fully familiar with the special case; and
- 2) Another concern raised by NERA and emphasised in my letter, relates to the need to make MEAV adjustments to other DNOs in order to avoid discrimination, as clearly these will impact the regressions too.

Before I arrange access to engineering experts to ensure that this task is completed by Ofgem in full possession of information, I would ask that you confirm that Ofgem will be making similar adjustments to the MEAV of other DNOs, for example LPN and SHEPD.

**Ofgem identification of potential errors in their application of SPM special case**

On 4<sup>th</sup> November I received a call from your team explaining that they believe that they have identified approximately £35m of double counting (£15m BT21CN and £20m load) in the application of the SPM Special Case by Ofgem in their Draft Determination disaggregated model.

I have written to your team (by email on 4<sup>th</sup> November) to explain that in order for my Directors to accept the validity of this we must receive sufficient information to allow us to fully audit these adjustments and to confirm that these are indeed errors. For example, we must ensure that the proposed load adjustment is indeed a double count and not in fact outperformance of the benchmarking that should be retained in the model.

As at 6<sup>th</sup> November I have had no response from your team. I would appreciate if you can confirm that your team are progressing provision of this information in order for us to audit this prior to making any such adjustments. Please note that it is also our expectation that we will be able to fully audit the application of all elements of £128m special case in the final determination.

**Other information requested**

You identified in your letter that we had not provided an appropriate quantification of asset health movements for 132kV refurbishment. We have translated the information provided in our business plan annexes and BPDT commentary into the agreed format and provided to Mark Hogan in your team.

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## HI and Criticality Reconciliation

Thank you for meeting with us on 28<sup>th</sup> October to discuss our concerns with your proposed methodology to translate totex allowances into Health Index (HI) and Criticality scores, issued for consultation with DNOs on 16<sup>th</sup> October.

At this meeting we raised concerns regarding:

- the principal of a mechanistic calculation of HI and Criticality scores;
- a flaw in the model design that limited volume reductions only to those areas that had had volume reductions in the disaggregated model (resulting in only a c£0.5m secondary deliverables adjustment from a c£90M<sup>1</sup> gap to the final modelled allowances)
- a potential unintended consequence of creating imbalanced risk between DNOs depending on whether they have performed better in the disaggregated or totex models.

I do recognise your point at our meeting that our ED1 licence will set global Health Index and Criticality targets. However my concern remains that these global targets are derived from the line by line asset replacement and refurbishment volumes, and that any penalty or reward for variance from these global targets may be assessed using the line by line volumes and unit costs.

You also highlighted at our meeting that no other DNOs had raised the same issues, although you had not yet met with UKPN. The table below, extracted from Ofgem's Draft Determination, explains why only UKPN is likely to raise the same concerns, as the remaining companies will either be unaffected or experience windfall benefits.

Extracted from table 2.3, Page 10 of Draft Determination Cost Assessment		Disagg. Activity- level analysis (£M)	Modelled costs post UQ, pre RPEs, pre smart (£M)	Difference	% of disagg. totex
ENWL	ENWL	1800	1810	10	1%
NPg	NPGN	1219	1246	27	2%
NPg	NPgY	1659	1696	37	2%
WPD	WMID	1869	1831	-38	-2%
WPD	EMID	1917	1953	36	2%
WPD	SWALES	1019	1019	0	0%
WPD	SWEST	1520	1431	-89	-6%
UKPN	LPN	1702	1701	-1	0%
UKPN	SPN	1672	1691	19	1%
UKPN	EPN	2591	2521	-70	-3%
SPEN	SPD	1519	1553	34	2%
SPEN	SPMW	1752	1662	-90	-5%
SSEPD	SSEH	1126	1092	-34	-3%
SSEPD	SSES	2311	2343	32	1%

<sup>1</sup> This gap is at totex level, a subset of this will relate to secondary deliverables

As discussed on the 28<sup>th</sup> October, we have commissioned NERA to complete some further analysis on Ofgem's proposed approach. NERAs report is attached to this letter.

Please note that the NERA report refers throughout to reconciliation to the output of the disaggregated modelling. **For clarity, this reference does not mean that SPEN accept the output of the disaggregated modelling.** We have communicated extensively (as above) that the output of this model, as well as the totex models, must be subject to qualitative adjustments. The secondary deliverables reconciliation described would be made post these adjustments.

The key findings of NERA's report are as follows:

- There is a flaw in the model design limiting volume reductions to those areas where Ofgem's view of volumes is below that of the DNO in the disaggregated modelling. NERA have proposed a revision to the model in the attached report that will improve the model outputs;
- However, even with this improvement the effect of the model is to create asymmetry of risk in the favour of DNOs who do better in the totex modelling than the disaggregated modelling, and unduly discriminate against those DNOs that perform less well in the totex modelling;
- To avoid discriminating against some DNOs, whilst offering others windfall gains, further adjustments are needed to the final values of allowed totex to reflect the outputs of the qualitatively adjusted disaggregated model;

I would be happy to arrange to meet with you and NERA to discuss their findings and the range of potential solutions to resolve the unintended consequences of the proposed approach. Please let me know if this would be helpful.

On reviewing the NERA report SPEN would draw your attention to the following additional points:

- Whilst the report sets out a view of potential asymmetry for companies (table 1), this is calibrated by Health Index costs derived by the disaggregated model. However, this analysis makes no adjustment for companies forecasting volumes below Ofgem's view (e.g. we have previously discussed NPG's 132kV OHL programme).  
As such, some DNO windfall gains will be much larger than detailed in table 1.
- Alternative solutions to resolve this asymmetry (not identified by NERA) include:
  - Further reductions to secondary deliverables for companies performing better in the disaggregated model than the totex model; or
  - Increases to the secondary deliverables of companies that perform better in the totex models than the disaggregated models (ensuring that such an adjustment does not penalise companies for efficient unit costs);

However, we do not believe these alternatives deliver the right outcome for stakeholders.

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**Conclusion:**

There are a number of material concerns set out in this letter. As such I believe that it would be prudent to arrange a face-to-face meeting to discuss these in order to avoid any material misunderstandings.

I propose that we would meet at your London offices, at your convenience, in the next few days, and plan to be accompanied by Scott Mathieson.

I would appreciate if you could confirm your availability for a meeting and in the meantime please do not hesitate to contact me if you have any questions regarding this letter.

Yours sincerely



Jim McOmish  
Head of RIIO-ED1 Programme  
SP Energy Networks

(Attachments: NERA – Review of Ofgem’s approach to setting secondary deliverable obligations)

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