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Dear Chris

Consultation on close out methodologies for the DPCR5 Price Control

Thank you for the opportunity to comment on your proposals for the development of closeout methodologies for the DPCR5 price control, set out in your consultation of 29 September 2015.

We agree with the overall approach being proposed by Ofgem in these areas and have welcomed the opportunity to work with you in developing the detail of the methodologies. We believe that DNOs should be held to account for their delivery in DPCR5 and agree that the proposed methodologies are broadly fit-for-purpose. We have however identified a number of points of query and clarification in the detailed responses appended to this letter and look forward to working with Ofgem to turn the methodologies into appropriately drafted Financial Handbook chapters by the deadline of 31 March 2016.

It is important to note that these detailed methodologies are being developed after the price control period has closed and hence there is a risk that DNO performance will be judged after-the-fact on bases that were not evident during the price control period itself. To avoid the possibility of this, we encourage Ofgem to consider conducting a similar process for developing the RIIO-ED1 closeout methodologies following completion of the work for DPCR5.

Detailed responses to the specific questions posed in the consultation are appended to this response and reflective of the following principles which we suggest should be considered throughout the development process.

- Avoiding 'hindsight regulation'

Decisions taken during DPCR5 that affect outturn expenditure levels or delivery against targets need to be viewed based on the information and means of assessment that were available at the time, together with the lack of clarity over the exact nature of some of the output commitments at the start of DPCR5.

There are for example, numerous references throughout the document to the use of Cost Benefit Analysis (CBAs) as supporting evidence for changes in DPCR5 investment priorities. CBAs in their current form were only introduced relatively late in the DPCR5 period as supporting evidence for the RIIO-ED1 forecast submission. Qualitative assessment of DNO decision making within the DPCR5 period needs to take account of whatever evidence and justification DNOs provide, and not require retrospective application of a form of assessment not necessarily applicable nor available at the time.

- Not re-opening the DPCR5 price control

The closeout process should not change any of the fundamental bases on which the price control was set, nor introduce any new measures or sanctions not explicitly set out in the FP documentation and associated licence drafting. In this regard, we would welcome clarity on the proposed treatment of Real Price Effects. The consultation uses different wordings in a number of different places and often suggests (but does not explicitly say) that Ofgem plans to make some sort of generic assessment for some theoretical effect of RPEs being lower than allowances. The consultation states that Ofgem are 'giving further thought to how this can be done' and we would welcome further clarity on this.

In respect of Load Related Expenditure (LRE), the DPCR5 FP states that 'Real Price Effects (RPEs) cannot be used as a justification for expenditure being greater than or less than the baseline - the risk of RPEs exceeding the assumptions included in the baselines is for the DNOs to manage'. As such, RPEs are not included in the re-opener baseline and should not be adjusted for in the treatment of actual costs.

- Proportional information requirements

We support the principle of a two stage assessment process and proportionality of information requirements. The proposed Performance Assessment submission includes a high level of detail, even for companies who are comfortably over-delivered or not triggering re-opener mechanisms. We suggest that the 'Stage 1' data submission requirements are reduced to those sufficient to perform an appropriate initial qualitative and quantitative assessment. Only companies failing this first stage, or otherwise triggering more detailed scrutiny should then be required to submit the full range of proposed data.

We note that the proposed submission date of May 2016 is likely to clash with peak annual reporting activities. It is essential that the specification of these submissions is available as soon as possible to allow DNOs to complete and assure substantial components of this work prior to year-end. We suggest that DNOs should work with Ofgem to be able to issue the report specification in early January alongside the draft Financial Handbook sections.

- Consideration of interaction with other mechanisms

It is important that the closeout mechanisms are considered alongside the other mechanisms of the price control. Throughout the document Ofgem has not recognised the interaction with adjustments already made through RAV rolling Incentive (RRI) ie in calculating a penalty for non-delivery; the methodologies need to acknowledge that DNOs will already have shared 55% of the difference with customers. In developing the closeout methodologies it will be necessary to address this interaction.

The consultation also gives no mention to whether tax allowances should also be adjusted – we believe they should not as DPCR5 incentives were set on a pre-tax basis.

I trust these comments are useful. If you have any queries on this response, please contact me or Jonathan Booth at jonathan.booth@enwl.co.uk

Yours sincerely

Paul Bircham
Network Strategy & Technical Services

Chapter Two

Q1 Do you agree with the principles for the NOMs assessment?

Yes. The principles are consistent with those set out in the DPCR5 Final Proposals and it is appropriate to hold DNOs to account for their delivery and performance in these areas.

Q2 Do you agree with our approach to assessing performance on Health Indices?

Yes in principle. The document makes clear that the HI Output is a delta between the 'with' and 'without' investment scenarios agreed at the time of the FP and that the Output is to be treated as an overall deliverable within which variation against original forecasts is encouraged where this delivers a more efficient solution. We agree with Ofgem that an assessment of Material Changes is appropriate and also that the process of converting to 'Adjusted Network Outputs' in light of Material Changes prior to assessment envisaged in the FP is an unnecessary complication.

In terms of the weightings for the proposed mechanism, these were subject to significant discussion with Ofgem in 2010 and 2011 and we are happy with the overall principles applied. We suggest that the base weightings should be those reflective of these discussions, ie the DPCR5 FP unit costs, as these are the basis on which we built our own subsequent tracking and assessment process, consistent with what we believed was Ofgem's preferred method at the time. We have separately highlighted to Ofgem that there is an error in the unit cost weighting applied to 33kV Tower assets.

In terms of the results of the quantitative analysis, we note that the specification of the Performance Assessment submission outlined in Appendix 2 suggests that DNOs should justify why further interventions were not undertaken if 'the number of risk points is higher'. This seems to confuse a delta target with an absolute one as the risk points may be higher (than target? than start point?) either due to Material Changes (which are being reviewed separately) or because they were always forecast to be so. This confusion is also evident in the requirements of A2.15 where reference is made to the asset risk delta being 'worse' than assumed at DPCR5. If this relates to a shortfall in the delta, then it is already covered by the other points; if it refers to the reported absolute level of risk being worse (higher?) than forecast, then this seems to be confusing the nature of the Output target.

We also note a proposed requirement to explain why HI5 assets have not been replaced. In DPCR5, HIs are only defined at a high level and DNOs have exercised considerable discretion in terms of interpreting the definition. Some DNOs use the HI5 category to highlight their very worst assets whereas others have lower qualification criteria. Some DNOs use the HI5 category to deterministically drive interventions whereas others use it as a trigger for intervention to be considered but not necessarily required. The requirement as set out is potentially very onerous and unhelpful without an understanding of how each DNO has interpreted and defined its HI scales.

Q3 Which of the two approaches to valuing the Health Indices outputs gap do you consider to be more appropriate?

We suggest that both proposed approaches are workable but would prefer the more holistic approach indicated in option 2. The principle of the HI Output measure is that it acts on the overall network risk. Disaggregating into asset type specific movement variances and then applying asymmetric unit cost treatment to 'over-' and 'under-' delivery on a line-by-line basis seems to both run counter to the principle of the HI Output measure and introduce a measure of cherry picking when aggregated back up.

We note Ofgem's comment in 2.26 that this represents a more significant deviation from the FP than Option 1 but we suggest that it is entirely in line with the proposal for assessing LI outputs gap valuation outlined in section A2.34.

Q4 Do you agree with our approach to assessing performance on Load Indices and valuing any associated Outputs gap?

We agree with the overall approach for assessing performance on LIs and agree that the appropriate measure is an absolute view of loading risk. We note however that it is entirely based on a substation specific basis as written. The LI reporting requirement in the NADPR RIG made provision for reporting on both a substation and a Group basis and we have made extensive use of the Group-based reporting to highlight where loading issues and solutions may apply to an area of network and not a specific substation. We suggest that this should also be taken into account in the assessment.

We note Ofgem's proposal in section 2.30 that DNOs should provide justification of changes in their reinforcement programme. This is potentially extremely onerous and needs to take account of the fact that LIs (unlike HIs) must account for a major factor outside of the DNO's control, ie load and demand movements. It also needs to consider that LI investment decisions are often taken cognisant of a longer time period than the five years of a single price control review.

We agree in principle with the weightings proposed in Appendix 2 but note that these were the subject of much less discussion and testing with Ofgem in the early part of DPCR5 compared to their HI equivalents. We highlight that assigning a weighting of '1' to the LI1 band results in a false zero in the assessment. As the vast majority of customers are fed by both EHV and 132kV substations, this results in a minimum risk point score of 2x the DNO's number of customers (even if there was no load on the network at all). If concepts such as a 5% materiality threshold are to be applied to the risk points score, we propose that this will be more appropriately implemented by assigning a weighting of '0' to the LI1 category.

In terms of assessing whether there is an outputs gap for LIs, we note that the qualitative assessment set out in A2.29 includes some vague requirements (such as 2 & 3) which should be further clarified. We also note however that criteria 5 is appropriate for judging delivery against an absolute target (but not for a delta – see comment above).

Regarding the valuation of any Outputs gap, the proposal set out in 2.37 appears to be lacking a number of steps. It is not appropriate for instance to compare weighted profiles against 'risk points removed' to create the denominator into which the numerator of actual spend is applied to derive unit costs. We suggest further work is required to set out the steps of this approach more clearly.

Q5 Do you agree with our approach to assessing fault rate performance?

Yes. We agree that an overall quantitative assessment is appropriate in the first place, supplemented by a narrative in the Performance Assessment submission. We note that the discussion in Appendix 2 only presumes an explanation of where fault rates are higher than forecast. We suggest that understanding of this area would be increased by widening the scope to include categories where fault rates have materially improved compared to forecast.

Q6 Do you agree with our proposal not to make any financial adjustments associated with fault rate performance?

Yes. We agree that it is not feasible to make a link between fault rate performance and investment levels.

Q7 Do you agree with the changes we have made to the assessment approach from DPCR5 FPs and the NADPR RIG?

Yes.

Chapter Three

Q1 Do you agree with the principles for the load-related re-opener assessment?

We agree in principle with the approach to the load-related re-opener, however are concerned over the risks of inappropriate efficiency assessment and potential for re-opening the basis of the original price control settlement. As per our introductory comments, the proposed methodology needs to take account of other existing price control mechanisms and avoid potential double jeopardy with other closeout mechanisms.

The principles should also more clearly set out the principle of the 'deadband' within which the RAV Rolling Incentive operates and within which no additional adjustments should be made. This principle is correctly referenced in the detailed methodology but would be usefully included in the high level principles too.

Note that the document makes reference to the materiality threshold as being 'one per cent of DPCR5 base revenue' (3.7). It is of course one per cent of 2010-11 revenues as stated in A4.35.

The load related reopener baseline figure for Electricity North West is slightly different to the value we expected. We believe the value should be £104.5m.

We suggest that the 'expectation' set out in 3.18 that 80% of load-related expenditure should comprise general reinforcement should be removed. There may be network-specific reasons why a DNO's expenditure make up in this area may differ from this typical percentage.

Q2 Do you agree with our approach to assessing expenditure on low volume high cost (LVHC) connections?

By their nature, LVHC connections are extremely variable in unit cost as acknowledged in section 3.5 of the consultation. The proposed benchmarking using median unit costs for LVHC proposed in A3.15 therefore needs to be used with great care for LVHC connections which are by their nature 'lumpy' and job specific.

We also note the repeated references to potential adjustments to LVHC for changes in the net:gross ratio which were not noted in the FP (they were only flagged for HVLC and ED1 LRR). Should these be used, the checks should use total gross load as the denominator in the test as this will be a better test of whether there has been a DUoS to connectee shift.

In explaining variances to the baseline, it should be noted that LVHC activity is completely externally driven and will not have been itemised in detail at the time of the FP due to its reactive nature. The nature of the variance explanation will necessarily be at a higher level than that for LI-related General reinforcement for example.

Q3 Do you agree with our approach to assessing expenditure on general reinforcement?

As noted in the consultation, general reinforcement comprises LI, non-LI and secondary network elements. Much of the proposed approach focuses on LI-related aspects which will be a variable component of companies' LRE expenditure and needs to be considered in parallel with the NOMs assessment. The high level ratio analysis using techniques developed at DPCR5 and RIIO-ED1 needs to be used with caution as this is biased towards capacity construction where this may not be the most efficient solution to solving load issues and again risks re-opening decisions made at the time of the DPCR5 FP.

We agree that secondary network reinforcement will be largely qualitative in nature due to the lack of relevant supporting information either at the FP or in subsequent RRP reporting.

Where companies have changed their investment programme in light of new information and changes in external factors, these decisions need to be viewed based on the information

available at the time and not a hindsight view formed up to six years after the decision was made. They also need to be referenced to the assumptions that underpinned the original FP settlement and not an ex-post view as to what constitutes efficient delivery.

Q4 Do you agree with our approach to assessing avoided reinforcement?

We welcome the broadening of the innovation offset beyond DSR schemes as this is reflective of the effort invested in innovative demand management techniques over DPCR5. Further discussion is required on further defining qualifying investments and technologies in this area.

Q5 For non-DNO interested parties; do you have any evidence you can provide that would support our assessment of the load-related re-opener?

Not for us to answer.

Chapter Four

Q1 Do you agree with the principles and general approach set out in this chapter?

We are in general agreement with the principles set out in this chapter. HVPs were separated out at the time of the DPCR5 review as they were considered to have a different risk profile in terms of their scope and timing compared to the rest of the forecast investment programme. They were also considered in many cases to be more difficult to comparatively benchmark than the other elements of the programme and hence tended to be assessed on a bespoke basis.

This needs to be remembered when discussing the nature of efficient delivery. Efficiency assessment for closeout should always be primarily against the basis on which the projects were allowed rather than an ex-post view generated from subsequent comparator data. Otherwise, this could lead to the circumstance where a company delivers the forecast outputs at the allowance and is subsequently deemed to have delivered inefficiently based on an efficiency model designed after-the-fact. This would effectively constitute a re-visiting of the basis on which the DPCR5 price control allowances were set.

In particular, we caution strongly against the use of comparative unit costs for assessing BT21CN delivery. Section 4.23 makes reference to the use of unit cost assessment against DPCR5 benchmark costs for asset replacement. This is appropriate for Asset Replacement HVP Projects as this is the basis on which allowances were set in this area. It was not however the basis of allowances for BT21CN due to the varied nature of the projects proposed by DNOs, driven largely by the completely different legacy communications networks in each area. It was acknowledged that it was not appropriate to use comparative unit costs in setting allowances in this area and it is not appropriate to use them in ex-post efficiency analysis either. Section A4.23 appears to reiterate that Ofgem proposes to use a benchmarking approach that was deemed unsuitable at the time the DPCR5 allowances were set.

The proposal also includes a number of references to the provision of the supporting evidence used at the time of the DPCR5 review. This will be useful in establishing the baseline from which any project variations must be accounted for, but should not be used as a basis to re-open the originally established need for the allowed projects.

We agree that it is appropriate to ensure that there is no double jeopardy between the expenditure and outputs mechanisms when assessing HVPs; however the flow chart in 4.16 does not appear to show this as it suggests that an outputs gap resulting from expenditure triggering the adjustment threshold would be adjusted for twice. We welcome further clarity from Ofgem on its expected interaction between the two mechanisms.

As per the comment under the LRE re-opener, the document makes reference to the materiality threshold as being 'one per cent of DPCR5 base revenue' (4.6). It is of course one per cent of 2010-11 revenues as stated in A4.35.

Q2 Do you agree with the changes we have made to the assessment approach from DPCR5 FPs?

We agree that the proposals have added clarity to the structure of this closeout mechanism compared to the references in the FP.

Q3 Do you have any suggestions as to how we can assess outputs under the individual project categories set out in this document?

We agree that, where possible, the assessment of HVP output delivery should be consistent with the approach adopted for NOMs closeout. This will be possible for Asset Replacement and General Reinforcement projects. For HVP projects undertaken under other drivers, this will inevitably require a bespoke assessment of individual projects as proposed in section 4.19 onwards.

In completing this assessment, it is important that Ofgem should not seek to re-open the price control by re-visiting the original justification of and allowance for HVPs included in the re-opener baseline.

We also agree that the benefit of innovative solutions should be accounted for. As per our comments above, the definition of innovative solutions requires further work in this context. It is implied but not stated that the avoided investment due to innovative solutions would be included against the HVP baseline in a manner similar to that proposed for the LRE re-opener.

Q4 For non-DNO interested parties, do you have any evidence that would help with our assessment of HVPs?

Not for us to answer.

Chapter Five

Q1 Do you agree with our proposed methodology for adjusting DNO's allowances to account for permitting costs?

We agree in principle with the methodology set out in the consultation. We note however the reference to the use of comparative information to assess permit costs. As acknowledged in 5.16, DNOs do not have any control over the permit costs which are set by the Local Authorities. Comparative analysis is therefore not appropriate in this regard. We note that paragraph A5.16 seems to contradict the principle set out in Paragraph 5.6 5; the statement in A5.16 is a much more appropriate approach.

We note that the statement in 5.15 regarding the exclusion of permitting penalties is in conflict with the Financial Handbook (at 15.86 (iv)).

We also note that Ofgem plans to require all licensees to submit data relating to permit costs and permit condition costs in May 2016. Ofgem already collects considerable data from all DNOs in this area in annual submissions.

Q2 For wider stakeholders and non-DNO interested parties, do you have any information or evidence which would assist us in carrying out the TMA reopener assessment?

Not for us to answer.

Q3 Do you agree with our proposal to settle the TMA reopener mechanism early as part of the 2016 annual iteration?

This seems a sensible proposal to us.