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By email only to: chris.watts@ofgem.gov.uk

10 November 2015

Dear Chris

Consultation on close out methodologies for the DPCR5 Price Control

Thank you for the opportunity to respond to the above consultation. This letter should be treated as a consolidated response on behalf of UK Power Networks' three licensed distribution network operators (DNOs): Eastern Power Networks plc, London Power Networks plc, and South Eastern Power Networks plc. Our response is not confidential and can be published on your website.

In principle we believe that Ofgem's approach will deliver an appropriate adjustment, however we feel that there is not yet sufficient detail in some methodologies, in particular the assessment of efficient expenditure and how this interacts with output performance. We look forward to the opportunity to work further with Ofgem and the other DNOs to finalise the detail of these methodologies in the working group.

Where possible, we have provided specific responses to the questions asked by Ofgem in the consultation document and these are outlined in the appendix to this letter. In addition we make the following general observations:

- Ofgem should continue to strive to ensure that its efficiency test looks at the overall cost of delivery of the outputs, as this is the basis on which price controls are set. Ofgem should ensure that the reopener processes do not create a perverse incentive to spend inefficiently to avoid future reopeners. We believe that Ofgem needs to set out how it will ensure this is documented in the close-down methodologies in the handbook.

- We should be working to ensure the reporting burden of the DPCR5 close-down process remains as efficient as possible, especially given the timing coincidence with the preparation of the main regulatory reporting (RRP) return.

- With regard to the load-related reopener, we are supportive of the view that efficiencies through synergies with LVHC connections should be treated as efficient behaviour, as this reduces costs for connectees and the generality of customers. The assessment of net to gross costs must also allow for this for the same reasons.

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- Assessment of efficient expenditure and allowance adjustments should be against the benchmarks used to set allowances for the DPCR5 period. The DPCR5 close-down process should not attempt to reassess efficient levels of expenditure ex-post or use ED1 benchmarks to make adjustments to DPCR5 allowances. Furthermore, the cost assessment methodology to set the DPCR5 revenue allowances was very different to that used in the RIIO-ED1 review process and it will not be possible to apply it retrospectively.

- In Paragraph 1.10, Ofgem states that the impact of Real Price Effects (RPEs) will be discounted from any adjustments made under the load-related and HVP reopeners. RPE allowances of 0.4 per cent were made net of ongoing efficiencies so both should be accounted for if adjusting allowances on the same basis as they were set. The approach to how this will be accounted for when the impact of RPEs is assessed should be developed with the DNO working group.

We hope that you will find our comments helpful. If any part of our response requires further explanation or clarification, please do not hesitate to contact me.

Yours sincerely

Keith Hutton
Head of Regulation
UK Power Networks

Copy: Paul Measday, Regulatory Returns & Compliance Manager, UK Power Networks

Appendix

With reference to the questions presented in the consultation document, we have the following responses.

CHAPTER: Two

Question 1: Do you agree with the principles for the NOMs assessment?

We broadly agree with the principles but note the need for more clarity in certain areas, as mentioned below, before we can provide more specific comments.

Question 2: Do you agree with our approach to assessing performance on Health Indices?

We broadly agree with the approach outlined in the consultation with the following further comments:

Allowances should be made for situations where risk on the network is being managed by innovative solutions where justified by an appropriate assessment. This will avoid delivery of NOMs hindering the use of innovative technologies that deliver long-term benefit to customers.

We agree with the proposal to identify and explain the effects of material changes (or lack thereof) affecting the overall HI risk position. We do not feel that this impacts the assessment of the delivery of the HI delta or any outputs gap.

Question 3: Which of the two approaches to valuing the Health Indices outputs gap do you consider to be more appropriate?

The health index has been developed as a consistent way to value the risk of asset health across asset categories. Therefore we suggest that the top-down method of valuing any outputs gap is the most suitable. This will ensure DNOs are not discouraged from improving their approach to asset management to reduce risk in the optimal way based on the information available to them.

However we suggest that, rather than actual expenditure, the allowed expenditure for asset replacement and refurbishment which impacts risk points should be used to value any outputs gap, as it is neutral to an individual DNO's delivered cost per risk point. For example, if a DNO had under-delivered its risk points but had low expenditure against those delivered, the outputs gap would be valued lower than the allowed costs and would not produce the intended penalty.

Question 4: Do you agree with our approach to assessing performance on Load Indices and valuing any associated outputs gap?

We agree with the approach to assessing performance and valuing any outputs gap.

We believe that allowances should be made for situations where risk on the network is being managed by innovative solutions where justified by an appropriate cost benefit assessment. This will avoid delivery of NOMs hindering the use of innovative technologies that deliver long-term benefit to customers.

Question 5: Do you agree with our approach to assessing fault rate performance?

We agree with the approach to assessing performance.

Question 6: Do you agree with our proposal not to make any financial adjustments associated with fault rate performance?

We agree with this proposal as fault rates were not intended to be incentivised.

Question 7: Do you agree with the changes we have made to the assessment approach from DPCR5 FPs and the NADPR RIGs?

We agree with the changes as they are in line with the approach set out in the document.

CHAPTER: Three

Question 1: Do you agree with the principles for the load-related reopener assessment?

We broadly agree with the principles for the load-related reopener assessment but note the need for greater clarity on the points below before we can provide more specific comments.

Given that load growth has in general been less than forecast, Ofgem should focus on assessing whether this has resulted in lower costs for DNO and 'windfall' benefits or outperformance of the LI secondary deliverable.

We believe that Ofgem should ensure that the reopener processes do not create a perverse incentive to spend inefficiently to avoid future reopeners. Ofgem needs to set out how it will ensure this is reflected in the close-down methodologies.

Question 2: Do you agree with our approach to assessing expenditure on low volume high cost (LVHC) connections?

We do not feel there is sufficient clarity in Ofgem's intended approach to dealing with the proportion of costs recovered through connections charges to agree with Ofgem's proposed approach at this stage.

Question 3: Do you agree with our approach to assessing expenditure on general reinforcement?

We broadly agree with Ofgem's intended approach to assessing expenditure on general reinforcement although do not feel there is yet sufficient detail for the financial methodologies on how the assessment of efficient costs and output delivery will be undertaken.

DNOs carry the risk during the price control on specific project costs subject to the totex incentive. In assessing the close-down adjustment, we believe that Ofgem should be seeking to assess the proportion of the underspend that should not be subject to the totex incentive.

We also believe that Ofgem should also ensure that the totex incentive is sustained between price controls. Deferral of costs from DPCR5 to RIIO-ED1 incurs an 8 per cent penalty (shareholders retained 45 per cent in DPCR5 but must fund 53 per cent in RIIO-ED1) and the reopener assessment must not recover revenues that should be subject to the totex mechanism. The methodologies must set out how this will be achieved.

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

We agree with the approach set out in the document but also note that this assessment must take account of reinforcement on an overall basis. The requirement of the level and location of reinforcement will have changed over the DPCR5 period and this should be reflected in the assessment.

Question 5: For non-DNO interested parties, do you have any evidence you can provide that would support our assessment of the load-related reopener?

Not applicable.

CHAPTER: Four

Question 1: Do you agree with the principles and general approach set out in this chapter?

We agree with the principles set out in this chapter. We feel that more detail is required to make specific comments on the approach but have provided comments below where possible.

Question 2: Do you agree with the changes we have made to the assessment approach from DPCR5 FPs?

As above, we agree with the changes made which are in line with the principles set out in this chapter.

Question 3: Do you have any suggestions on how we can assess outputs under the individual project categories set out in this document?

We welcome Ofgem's intention to take into account the status of High Value Projects when assessing efficiency of expenditure. In particular, projects which are in-flight and committed to delivering the outputs originally outlined in the DPCR5 submission which have no further funding allowed for in the RIIO-ED1 settlement must be assessed to ensure that they are still properly funded and the totex incentive is allowed to work across price controls (subject to the 8 per cent penalty that arises for deferring expenditure arising from the change in sharing factors).

As experience has been gained regarding the mitigation of the BT21CN project, solutions which are more cost effective on a whole-life basis have been identified. Where such solutions have been adopted following a whole-life CBA, the resulting reduction in costs should be treated as efficient.

Question 4: For non-DNO interested parties, do you have any evidence that would help with our assessment of HVPs?

Not applicable.

CHAPTER: Five

Question 1: Do you agree with our proposed methodology for adjusting DNOs' allowances to account for permitting costs?

We agree with the proposed methodology but note that relevant data has already been submitted as part of the DPCR5 RRP returns and that DNOs' data was investigated by Ofgem in the RIIO-ED1 price control negotiations, where Ofgem decided to allow DNO specific permitting condition costs. During this process we demonstrated that we had made every effort to harmonise the approach to conditions between local authority permitting schemes and that the differences were outside of our control.

We believe that Ofgem should use the learning from RIIO-ED1 to make the DPCR5 close-down process more efficient. At this stage we do not understand Ofgem's proposal to collect further and as yet unspecified data in May 2016 as Ofgem should have the necessary data from annual returns and RIIO-submissions. Ofgem should be consistent with the decisions made for the RIIO-ED1 price control, where it decided to use individual licensee permitting conditions.

We have the vast majority of established permitting schemes and presented evidence (which Ofgem accepted) that the differences were not within the licensee's control. The situation has not changed since the RIIO-ED1 assessment. Ofgem should avoid unnecessary additional burden on all companies while they are preparing their annual returns and this is disproportionate to the size of any likely adjustments.

Question 2: For wider stakeholders/non-DNO interested parties – Do you have any information or evidence which would assist us in carrying out the TMA reopener assessment?

Not applicable.

Question 3: Do you agree with our proposal to settle the TMA reopener mechanism early as part of the 2016 annual iteration?

We agree with this proposal as we believe SPN will be the only DNO to trigger this mechanism. An expedited settlement is therefore appropriate.