SP ENERGY NETWORKS

Network Planning & Regulation

By E-mail

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Date
2nd June 2016

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Dear Grant,

Informal Consultation - RIIO ED1 Financial Handbook- DPCR5 Close out

We welcome the opportunity to respond to Ofgem's DPCR5 Close out: Informal consultation on changes to the RIIO-ED1 Financial Handbook published on the 18th May 2016. Overall we support the majority of the proposed methodologies and believe the drafting reflects the significant effort invested by all parties in the working group to produce robust approaches for each area.

The appendix to this letter sets out some detailed comments on the drafting whilst this letter sets out our views on some points of principle. Our particular area of concern is the proposed approach to application of penalties to the fault rate secondary measure.

NOMs – Fault rate measure
We continue to support the proposals to review the DNOs' health and load index outputs including a review of the quality of these outputs. As set out at DPCR5 Final Proposals this should include a review of the fault rate secondary measure and DNOs should explain Material Changes, and reconcile the outturn performance relative to the original forecasts.

However, we believe that the proposal to introduce financial adjustments in relation to fault rates represents a divergence from the original DPCR5 policy intent which reflected the complexity and range of factors that can affect fault rates. The reasons for the changes in fault rate in some cases will be beyond the DNOs control, and the impact will not be able to be precisely explained.

For example:

- There may be an upturn in fault rates arising from environmental factors not affected by asset condition, e.g. 3rd party damages or damage from windborne materials
- Increased volumes of severe weather events may have had an effect on fault rates both during and following severe weather

The proposed approach for assessment of the fault rate component of NOMs Network Outputs provides DNOs with the opportunity to explain performance and allows the Authority to take into account the impact of external factors. However, the proposed approach to valuing a fault rate

outputs gap will not provide a clear linkage to DPCR5 intervention delivery. This failing results directly from the complexity of factors that can affect fault rates and provides further evidence to support the original DPCR5 policy intention not to apply financial adjustments to fault rates.

The approach converts differences in fault rates to fault volumes and then multiplies these by a 'standard' asset replacement volume to provide volumes of work. The 'standard' asset replacement volumes are a subjective assumption of the volume required to avoid a fault and implicitly assumes that each volume can be effectively targeted to avoid faults. The assumption of one plant item per fault is only acceptable, assuming that each one can be accurately targeted. This proposal is not supported by any analysis and we believe is flawed, particularly for linear assets.

For cable assets it is impossible to accurately identify the length of cable which if replaced could have avoided the fault. There is no current technology available to locate future cable failures before they occur so investment interventions are prioritised on cable fault history.

For overhead faults it is more complex as there are a wide range of components and environmental factors which could cause the fault. The methodology proposes that all overhead faults are treated as conductor failures but conductor failures only account for around 40% of damage faults. It is inappropriate to apply conductor 'penalties' to non-conductor faults such as damage from wind borne debris, damage from contact from birds, and failure of insulators or other fittings.

In addition to these issues the proposal does not take account of either the cost of faults or the intervention volumes achieved by the DNO during DPCR5. As we have previously indicated it is important that the penalty mechanism takes into account the relative economics of the impact of faults on customers and DNOs via the Quality of Supply mechanisms and the Efficiency Incentive Rates (for both fault costs and asset replacement costs) in order to ensure that any penalties are proportionate and balanced.

Overall the approach to valuing a fault rate outputs gap requires further work if financial adjustments are to be applied.

NOMs – Overall Assessment and Materiality

The consultation proposes a NOMs Materiality threshold value of 5% for HI and LI and 10% for fault rates. DPCR5 Final Proposals provided for the application of penalties where there was material and significant difference from the Agreed Network Outputs. We agree that 5% is a reasonable tolerance value, to represent material and significant variance for HI and LI and that variation beyond this level could lead to penalties. We also agree that a higher value is required for the fault rate component due to the variability of the measure associated with external factors. Our own analysis indicates that there has been a 6/12% (SPD/SPM) variation (one standard deviation) in fault rate over the past 14 years across all categories. This has been consistent over different time periods e.g. DPCR5. Therefore a threshold of between 12 to 24%, we would suggest 18%, would be more appropriate (two standard deviations) accounting for 95% of the population.

For the assessment of the package of NOMs the Authority has clarified that there is a single assessment based on the three components (HI, LI and fault rate). For each component a method of valuing a maximum outputs gap is proposed. These maximum values can then be adjusted based on the Authority's view of overall NOMs delivery. We support this approach to the overall NOMs Network Outputs Gap as the valuation of each component is not directly comparable. Therefore it is essential that the methodology provides the Authority with the discretion to apply appropriate penalties where necessary.

Treatment of Real Price Effects
The methodologies for the re-openers for Load Related Expenditure and for High Value Projects propose that expenditure is adjusted for the variation in Real Price Effects (RPE). We support this approach as the DPCR5 Final Proposals clearly allocated the risk of variation in RPEs to the DNOs. Therefore the impact of this variation needs to be adjusted for in assessing the two re-openers.

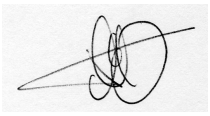
Profiling of Adjustments
Within the methodologies there are different proposals for the profiling of adjustments over DPCR5. We believe there should be consistent treatment of profiling between the re-openers and outputs gap assessments. For the Load-Related and HVP re-openers actual expenditure would be used for profiling, consistent with previous version of the handbook. However, for output gaps (NOMs and HVPs) it is proposed that allowances should be used for profiling. We believe that using actual expenditure is the most appropriate approach as it would ensure the fair and equitable treatment of double counting between outputs and the re-openers.

Performance Assessment
The proposal now provides details of the Authority's approach to Performance Assessment and provides an annex detailing the areas where a licensee may be required to provide information for each close out area. We fully support the proposed approach to Performance Assessment Submissions. Each close out area requires a proportionate response based on the Authority's analysis of the information already provided.

Conclusion
The proposed methodologies represent a significant development of the close out areas and reflect the extensive work undertaken in the past six months. We remain committed to working with Ofgem to finalise the methodology for the DPCR5 close out review that will be transparent, proportionate, and consistent, and which also demonstrates to stakeholders the significant customer benefits that have been delivered in this period.

If you have any queries on this response or any further questions, please do not hesitate to contact me.

Yours sincerely,



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Attachments: Detailed comments on drafting

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Question 1: Do you have any views on the proposed changes to the Financial Handbook?

We have set out some detail changes to the handbook and our specific areas of concern are highlighted in the sections below.

Chapter 15

Para 15.3 – The bullets refer to financial adjustments for Load Related Re-opener and for High Value Projects Re-opener. Should there not be additional bullets for Traffic Management permit costs and Flood Prevention adjustment as these are also detailed in this chapter.

Table 15.1 – Amend text for row 4 to 'Authority to provide the licensee with its Preliminary View'.

Para 15.9 – Paragraph should be updated to include reference to ongoing discussion between the Authority and licensee during the Performance Assessment to allow the Authority to obtain further information and clarifications as required.

Para 15.13 – Text references para 15.11, this should be changed to 15.12 as this is where the review of the consultation is detailed.

Para 15.127 – Amend the end of the sentence to '...of the adjustment set out in paragraph 15.152 below.'

Para 15.131 & Para 15.132 – Amend '... DPCR5 Load related Re-opener adjustment' to '... DPCR5 Load Related Re-opener Adjustment' using defined term.

Para 15.135 – The phrase 'for the purpose of that calculation' is not required as the start of the paragraph provides a clear scope.

Para 15.140 (a) – Amend 'low volume high cost' to 'LVHC' as the abbreviation is set out in para 15.125. It may also be worthwhile to include a definition of 'low volume high cost' in the glossary.

Para 15.140 (b) – Amend '... costs incurred by the licensee during the DPCR5' to '... costs incurred by the licensee during DPCR5'

Para 15.143 - This paragraph has only deleted text and should be removed. This will impact on all future paragraph numbers and may also impact paragraph references.

Para 15.147 – Amend '... subtract the total value of the LI Network Outputs Gap' to '... subtract the total value of the LI component of the NOMs Network Outputs Gap'

Para 15.187 – Amend '...using a three stage process:' to '...using the process below:' as there are four steps in the process.

Para 15.188 (a) – Delete 'activity and' as the re-opener only deals with changes in expenditure and activity level changes are dealt with through the HVP Network Outputs assessment highlighted in 15.188 (b)

Para 15.191 – Add ‘, as detailed in Annex C2.’ to the end.

Para 15.193 - Text references para 15.11, this should be changed to 15.10 as this is where the preliminary view is detailed.

Para 15.195 - sub para (a states that values are adjusted to common 2015/16 time value basis. We believe this should be 2012/13 time value basis consistent with the other calculations.

Para 15.204 - Text references para 15.11, this should be changed to 15.10 as this is where the preliminary view is detailed.

Para 15.212 - Text references para 15.11, this should be changed to 15.10 as this is where the preliminary view is detailed.

Para 15.220 – Amend ‘then the steps set out in paragraph 15.220(i) to 15.220(viii) will be carried out...’ to ‘then the steps set out below will be carried out...’ as it simplifies the reference.

Para 15.220 – sub para (iii) and (iv) reference sub para (i). However at this step the post double counting value from sub para (ii) may be used. The referencing needs to be reviewed to make this clear.

Para 15.220 – sub para (vi) states that values are adjusted to common 2015/16 time value basis. We believe this should be 2012/13 time value basis consistent with the other calculations.

Para 15.225 – The text ‘...but this is without prejudice to any requirement for the licensee to restate values referred to in paragraph 15.220 for any other purpose.’ is inconsistent with the drafting for the Load Related Re-opener. It should be deleted to provide consistency.

Chapter 16

Table 16.1 – Amend text for row 4 to ‘Authority to provide the licensee with its Preliminary View’.

Para 16.9 – Paragraph should be updated to include reference to ongoing discussion between the Authority and Licensee during the Performance Assessment to allow the Authority to obtain further information and clarifications as required.

Para 16.13 – Text references para 16.11, this should be changed to 16.12 as this is where the review of the consultation is detailed.

Para 16.67 – Amend ‘...tthe DPCR5 NOMs...’ to ‘...the DPCR5 NOMs...’

Annex A1 NOMS Failure to Deliver Outputs

Overview

Para 1.4 - Amend ‘...paragraph 1.2above.’ to ‘...paragraph 1.2 above.’

Para 1.7 - This paragraph indicates that consideration will be given to any interventions carried out as part of a DPCR5 High Value Project in determining whether a NOMs Network Outputs Gap has arisen. High Value Projects are outside the scope of NOMs and should be assessed independently. The impact of HVPs should be excluded from both the agreed and the delivered network outputs, this will ensure there is no double count between the close out areas.

Para 1.17 – Amend '...and whether:' to '...and whether overall:' to clarify that the NOMs outputs assessment is across all 3 metrics.

Para 1.18 – As drafted this paragraph indicates the gap calculation to be a prescriptive summing of the values from each component. During development it was agreed that the values from each component should provide a maximum value which the Authority can adjust based on their view of overall delivery. This is reflected in the drafting of paragraphs 1.68 to 1.70. This paragraph should be updated to be consistent with this.

Health Indices

Para 1.22 – Amend 'If following a Performance Assessment...' to 'If following an assessment...'. This is required as use of the defined term, 'Performance Assessment' is not appropriate at this stage (Initial High level Analysis).

Para 1.23 – Amend '..paragraph1.20(iii).' to '..paragraph 1.20(iii).'

Para 1.28 (i) – As this paragraph refers back to the rebasing of network outputs in para 1.27 (i) and para 1.27 (ii) we don't believe that use of the term 'Agreed Network Outputs' is correct. We think this step is assessing whether the Adjusted Network Outputs are reasonable or whether the reasoning for not adjusting is appropriate. The para should be redrafted to reflect this.

Load Indices

Para 1.34 – Amend 'This Initial High Level Analysis will include, but is not be limited to' to 'This Initial High Level Analysis will include, but is not limited to'

Para 1.34 (iii) – This section states that a high level analysis of Material Changes will be undertaken as part of the LI Initial High Level Assessment. This type of analysis can be particularly complex due to network specifics requiring background information when interventions result in both demand and capacity being transferred between Demand Groups. We would welcome the opportunity to provide support with this assessment.

Para 1.42 – Amend '... in determining a LI Adjusted Network Outputs' to '... in determining the LI component of the Adjusted Network Outputs'.

Para 1.43 – Amend '... against both its LI Agreed Network Outputs and its LI Adjusted Network Outputs' to '... against both its LI component of the Agreed Network Outputs and its LI component of the Adjusted Network Outputs'.

Para 1.44 (i) - Amend '... demonstrate the Actual LI Risk Points are was qualitatively equivalent' to '... demonstrate the Actual LI Risk Points are qualitatively equivalent'

Step 3 Heading – Amend '... Assessment of the delivered of the LI component of Qualitatively Equivalent Network Outputs' to 'Assessment of the delivered LI component of Qualitatively Equivalent Network Outputs'.

Para 1.46 (i) (ii) – The text references para 1.19, this should be changed to 1.33 as this is where the LI test is set out.

Para 1.46 (ii) – Amend 'the result from paragraph 1.45 does not meets' to 'the result from paragraph 1.45 does not meet'.

Fault Rate

Para 1.47 – The section proposes a NOMs Materiality threshold value of 10% for fault rate. We agree that a higher value than that applied to HI and LI is required for the fault rate component due to the variability of the measure associated with external factors. Our own analysis indicates that there has been a 6/12% (SPD/SPM) variation (one standard deviation) in fault rate over the past 14 years across all categories. This has been consistent over different time periods e.g. DPCR5. Therefore a threshold of between 12 to 24%, we would suggest 18%, would be more appropriate (two standard deviations) accounting for 95% of the population.

All NOMs components –Authority's determination

Para 1.61 – Amend '...no DPCR5 Revenue Adjustment...' to '...no DPCR5 NOMs Revenue Adjustment...'

Para 1.63 – This section states that the DPCR5 asset replacement allowance will be used to profile any NOMs Network Outputs Gap. This creates an inconsistency between the gap and the allowance as NOMs is a composite of a section of the EHV & 132kV General Reinforcement allowance and a section of the Asset Replacement allowance. However, we can understand using the Asset Replacement allowance as it is the most readily available value and is a greater contribution to NOMs than general reinforcement. Therefore the impact from the inconsistency should be minimal. During development of the methodology using actual expenditure to profile the gap was discussed. This approach would provide consistency with the approach for Load Related and HVP re-openers and ensure the treatment of double counting between NOMs and Load Related Re-opener was fair and equitable. We believe that using actual expenditure is the most appropriate approach.

Para 1.64 (ii) – Amend '...and multiplied again by the licensee's...' to '...and separately by the licensee's...'

Para 1.64 (ii) – Amend '...to convert it into monetary values in £.' to '...to convert the volumes of work into monetary values in £.'

Para 1.65 (v) - Amend '... to calculate a total monetary value of the HI component' to '...to calculate a total monetary value of the LI component'

Para 1.66 – The process detailed in this section does not fully reflect the model discussed through working group meetings. There is an additional step required between sub para (i) and sub para (ii) to covert the fault volumes calculated in (i) into the volumes of work required in (ii).

Para 1.68 – Amend '...Network Outputs for each Regulatory Year of DPCR5 to obtain...' to '...Network Outputs to obtain...' as the preceding paragraphs only provide total values for DPCR5, not discreet values for each year.

Annex A2 NOMS Risk Point Methodologies

Health Indices

Para 1.3 – Amend '...delivered through Interventions during...' to '...delivered through asset replacement and refurbishment Interventions during...' as this clarifies the interventions being used.

Para 1.5 – States that 3 different unit costs are used in the risk point methodology. However, only the DPCR5 Allowed unit costs are used in the methodology.

Para 1.6 (B) - The Licensee DPCR5 outturn unit cost is used in the HI component of the NOMs Network Outputs Gap valuation (Annex A1 para 1.64) and should be appropriately referenced.

Para 1.6 (C) – The Licensee DPCR5 FBPQ unit cost is not used in the HI methodologies and should be deleted.

Load Indices

Para 2.3 (ii) – Amend 'the Authority will sum the LI Risk Points across Demands Groups to derive voltage level total and the overall LI Risk Points' to 'the Authority will sum the LI Risk Points across Demands Groups to derive the overall LI Risk Points' in line with Para 2.5 (ii).

Para 2.7 – This section proposes sensitivity analysis of alternative LI weightings for licensees which have a different view of which LI Band an over-firm Demand Group should be assigned. The methodology should set out how the sensitivity analysis will be used to inform the outcome of the quantitative analysis.

Fault Rate

Para 3.8 – As highlighted earlier we do not agree with the use of 'standard' asset replacement in the calculation of the fault rates output gap. This is due to the subjective assumption of the volume required to avoid a fault and implicitly assumes that each volume can be effectively targeted to avoid faults. However, if this approach is used we do not agree with the values proposed in this table. For cable assets we would propose that 'standard' repair lengths provide a useful guide and values of twice the 'standard' should be used, assuming this length would have avoided that fault occurrence. This would provide 30m for LV; 40m for HV and 100m for EHV and 132kV. For overhead line suggest using average span lengths which based on our network would be 40m for LV; and 75m for HV and EHV.

Annex B Load Related Re-opener Assessment Methodology

Para 1.8 – Amend '... load related reopener in DPCR5' to '... Load Related Re-Opener in DPCR5'

Para 1.21 (i) – This section states that a cost efficiency assessment will be undertaken implying a unit cost efficiency assessment which is explicitly excluded in Para 1.17. We propose to amend 'cost efficiency as defined in paragraph 1.13...' to 'efficiency as defined in paragraph 1.13...'

Para 1.25 – Amend 'The licensee should provide...' to 'The licensee may provide...'.

Para 1.32 – Table 1. We are unclear on the source of the values in the table and it would aid transparency if Ofgem could clarify the values through supporting information. Additionally the value detailed for 2012/13, 1.080, is inconsistent with the value for the same year detailed in Annex C1 para 1.30, 1.081. They should be amended to be the same.

Annex C1 HVP Re-opener Assessment Methodology

Para 1.30 – Table 1. The values in this table for Load related should be consistent with those in table 1 of Annex B (para 1.32).

Annex C2 HVP Outputs Review Methodology

Para 1.2 – 'Step 2: Performance Assessment Submission and Performance Assessment' should be amended to 'Step 2: Performance Assessment' to be consistent with the other Annexes.

Para 1.25 – This section states that the HVP allowances will be used to profile any HVP Network Outputs gap. This creates an inconsistency between the profile for the gap and the profile for the HVP Re-opener, which is based on actual expenditure. We believe that using actual expenditure is the most appropriate approach as it would ensure the treatment of double counting between HVP Network Outputs and the HVP Re-opener was fair and equitable.

Annex D TMA Permit Costs Methodology

We have no comments on this Annex.

Annex E Performance Assessment Submission

Para 1.1 – The references to Annex C1 para 1.6 and to Annex C2 para 1.6 should be to para 1.5 in each case.

2 – The heading NOMs – Health Indices is duplicated and one should be deleted.

Para 2.1 – Sub paragraphs (vii) and (viii) refer to 'HI categories (EHV)', these should be amended to 'HI categories (EHV & 132kV)' to clarify the scope.

3 – The heading NOMs – Load Indices is duplicated and one should be deleted.

Para 3.2 (i) – LI Risk Points were not set out in the Agreed Network Outputs. We propose to amend '... impact these have had on outputs as reflected in the LI Band Profile or LI Risk Points set out in the Agreed Network Outputs' to '... impact these have had on Agreed Network Outputs as reflected in the LI Band Profile or LI Risk Points derived from the Agreed Network Outputs'.

Para 3.6 (i) - The methodology for rebasing the LI component of the Agreed Network Outputs due to Material Changes proposes to make an adjustment based on substation capacity. The methodology

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should include reference to hours at risk in the rebasing as it is a key differentiating factor between the higher LI Bands.

Para 3.6 (i) – Limits the scope of Material Changes to substation capacity with changes to forecast demand being captured through the Load Related Re-Opener. As the quantitative assessment for the LI component of NOMs Network Outputs will be driven by the LI Risk Point analysis consideration should also be given to licensee's explanation of changes affecting customer numbers associated to Demand Groups.

Appendix 1 Glossary

Fault Rate Point(s) – after the definition the text 'Has the meaning given in the Glossary for DPCR5 RIGs' appears. This appears to be an error and should be deleted.

Network Output Measures (NOMs) - The definition needs reworked as NOMs includes fault rates but 'forecasts without intervention' were not produced for fault rates for DPCR5. Suggest wording is amended to read 'Metrics provided by each licensee to report the status of distribution asset utilisation and distribution asset health, to forecast the change in those measures, and to illustrate how such network risks will be managed through planned interventions over DPCR5.

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