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By electronic copy to RIIO.ED1@ofgem.gov.uk

Dear Steve

### **Consultation on a potential RIIO-ED1 Mid-Period Review (MPR)**

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 distribution licence holding companies: Eastern Power Networks plc, London Power Networks plc, and South Eastern Power Networks plc.

The three points below summarise our position on Ofgem's consultation regarding the potential MPR in RIIO-ED1. We have provided further detail in Appendix A and the answers to your consultation questions in Appendix B.

#### **Preserving regulatory certainty**

Ofgem clearly recognised in formulating its RIIO-ED1 strategy decision that it is not appropriate to use a short term view of performance data when evaluating an eight-year price control. The scope for an MPR is clearly defined to only take account of significant external factors which would result in a change in the needs of customers. The RIIO-ED1 Strategy Decision states<sup>1</sup>:

*"Other than in these circumstances, the mid-period review will not be used to adjust the output measures or output incentives that were set at the price control review." and "is not intended to be an opportunity for either Ofgem or the DNOs to conduct a mini price review."*

Narrative, such as the above, issued by Ofgem set a legitimate expectation that the MPR would not be used to construct two four-year price controls, and this was an important factor in UK Power Networks' acceptance of the RIIO-ED1 final determination in December 2014.

The stability of the regulatory regime underpins investor confidence. To depart from this expectation undermines the regulatory certainty that Ofgem has established over three decades. This very point is acknowledged in Ofgem's decision regarding the MPR in the Gas Distribution and Transmission price controls. The uncertainty created by extending the scope of an MPR will lead to a higher perceived risk of investing in energy networks and consequently

<sup>1</sup> [https://www.ofgem.gov.uk/sites/default/files/docs/2013/02/riioed1decuncertaintymechanisms\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2013/02/riioed1decuncertaintymechanisms_0.pdf)

result in a higher cost of capital. This increase, in the context of the three network price controls (Electricity Distribution, Gas Distribution and Transmission), has been quantified by Ofgem to potentially raise costs to customers to between £390m and £1,900m over the next set of price controls<sup>2</sup>.

### **The current framework already caters for uncertainty**

The RIIO-ED1 framework is comprehensive, reflecting customers' expectations through a robust package of incentives and protecting their interests with uncertainty mechanisms. For example, through the Totex Incentive Mechanism, UK Power Networks' customers will have £182m<sup>3</sup> returned to them in period as a result of our performance in the first two years. Furthermore, mechanisms such as the load related reopener have the potential to return an additional c.£40m<sup>4</sup> to customers if the requirement for load related reinforcement does not materialise as forecast.

Notwithstanding the above, the GB regulatory framework is internationally recognised and held in high regard based on the results it has delivered for customers. These include:

- Delivering a 25% reduction in the number of supply interruptions and 40% reduction in the duration<sup>5</sup>;
- Increasing customer satisfaction scores to 86%, equivalent to the leading retailers in the UK<sup>6</sup>;
- Reducing the number of safety incidents to an all-time low across the industry<sup>7</sup>; and
- Reducing the average domestic customer bill by 5.5% (since 2013)<sup>8</sup>.

We recognise and value this framework and believe that it aligns the interests of consumers and shareholders. We believe this is a view shared by Ofgem, who have acknowledged that network companies are delivering well for customers and providing the services the energy system needs.

### **The RIIO-ED1 process has already been legally assessed and upheld**

In developing the RIIO-ED1 framework, Ofgem extensively consulted on its approach, holding some 60 working groups and events on all aspects, including incentives. The process involved the review and evaluation of all submitted evidence and responses over a 2.5 year programme to set RIIO-ED1, along with consulting on the final arrangements with all stakeholders.

This process provided ample opportunities for stakeholders to raise concerns and challenge approaches to setting targets at the appropriate stages of the review in order that these views be taken into consideration. Ofgem's Strategy Decision<sup>1</sup> is clear on this:

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<sup>2</sup> [https://www.ofgem.gov.uk/system/files/docs/2016/05/mpr\\_decision\\_document\\_final.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/05/mpr_decision_document_final.pdf)

<sup>3</sup> UK Power Networks Response to RIGs 2016-17 submitted to Ofgem, 31 July 2017

<sup>4</sup> Reflects additional monies that could be returned to customers by the load relater reopener mechanism from the first two years of RIIO-ED1

<sup>5</sup> [https://www.ofgem.gov.uk/sites/default/files/docs/electricity\\_distribution\\_company\\_performance\\_2010-2015.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/electricity_distribution_company_performance_2010-2015.pdf) and the 2015-16 annual report: [https://www.ofgem.gov.uk/system/files/docs/2017/02/riio-ed1\\_annual\\_report\\_2015-16.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/02/riio-ed1_annual_report_2015-16.pdf)

<sup>6</sup> Since the introduction of the Broad Measure of Customer Satisfaction in 2012-13

<sup>7</sup> <http://www.energynetworks.org/assets/files/events/SHE/2014/Presentations/Thursday%2009.00-09.15%20-%20David%20Smith,%20Energy%20Networks%20Association.pdf> since records of incidents were recorded in 1989/90

<sup>8</sup> Based on Ofgem's consumer count weighted averages included in: [https://www.ofgem.gov.uk/system/files/docs/2017/02/riio-ed1\\_annual\\_report\\_2015-16.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/02/riio-ed1_annual_report_2015-16.pdf)

*“The submission of business plans is the key opportunity for DNOs to propose the outputs they believe are required for RIIO-ED1. Stakeholders should provide their views on the DNOs plans and our proposals for each DNO at the appropriate stages of the review.”*

Furthermore, a referral to the Competition and Markets Authority (CMA) on parameters within RIIO-ED1, including Broad Measure of Customer Service and Interruptions Incentive Scheme, was made following the Final Determination. Ofgem robustly defended these challenges and the CMA upheld Ofgem’s approach and decision, finding them to have used sound and correctly applied principles. Therefore, any extension to the scope of the MPR would directly contradict Ofgem’s position in defending the appeal by British Gas Trading Ltd.

## **Conclusion**

UK Power Networks fundamentally disagree with any departure from Ofgem’s previously stated policy decisions. A legitimate expectation was firmly set through the extensive consultation and dialogue leading up to UK Power Networks’ acceptance of Ofgem’s RIIO-ED1 Final Determination in 2014. Subsequent to our acceptance, Ofgem has given no grounds to alter our understanding on how the MPR would be approached. This message was consistent across all levels of Ofgem until the publication of the MPR consultation in December 2017. We believe there is no legal basis for the extension of the MPR scope, therefore the expectation created over a period of time should be maintained for the benefit of electricity consumers. Notwithstanding the current media attention on the MPR, we strongly believe that the scope as defined in the Strategy Decision should be maintained and we agree with Ofgem’s analysis that the potential issues identified do not warrant an MPR.

Yours sincerely



**Basil Scarsella**  
**Chief Executive Officer**

UK Power Networks

Copy Suleman Alli, Director of Safety, Strategy and Support Services

James Hope, Head of Regulation and Regulatory Finance

## Appendix A – Further reasoning

### Performance to date

The RIIO-ED1 framework is comprehensive, reflecting customers' expectations through a robust package of incentives and protecting their interests with uncertainty mechanisms. This framework, along with previous price controls, has facilitated the delivery of significant improvements in the quality of service customers receive at lower cost, with the table below demonstrating the progress made since 2010:

Industry position	UK Power Networks position
Delivered a 25% reduction in the number of supply interruptions that customers experience <sup>5</sup>	Delivered a 40% reduction in the number of supply interruptions that customers experience <sup>9</sup>
Delivered a 40% reduction in the duration of supply interruptions <sup>5</sup>	Delivered a 49% reduction in the duration of supply interruptions <sup>9</sup>
Increased customer satisfaction scores to an average of 8.6 out of 10 <sup>6</sup>	Increased customer satisfaction scores to 8.6 out of 10 <sup>9</sup>
Reduced the average domestic customer bill by 5.5% (since 2013) <sup>8</sup>	Lowest Cost DNO – annual domestic charges are 14% lower than the industry average <sup>9</sup> , equivalent to around £6.50 a month.
Reduced the number of safety incidents to an all-time low across the industry <sup>7</sup>	Industry leading performances with an 80% reduction in lost time injuries <sup>9</sup>

### Sharing of benefits with customers

The RIIO-ED1 framework has mechanisms to ensure that the benefits of this performance are shared with customers:

- £182m returned to customers in period as a result of our performance in the first two years<sup>3</sup>; and
- c.£40m potential return for customers should the load related reinforcement not materialise as forecast.<sup>4</sup>

### Regulatory certainty

The positive track record of stable regulation since privatisation has unquestionably delivered a better experience and value for customers, with electricity transmission and distribution licensees reducing the operating cost base by 60% in the first 15 years since privatisation<sup>10</sup> and a reduction of over 65% in the number and duration of customer interruptions<sup>11</sup>. Changing the framework by modifying the scope of the MPR would remove this stability and damage confidence in the regulatory regime, creating significant uncertainty and risk for markets and investors. Increasing regulatory risk in this way would lead to higher financing costs and, ultimately, increased costs to the consumer.

Current financial parameters such as the Cost of Capital are underpinned by regulatory certainty and given the significant sums invested in energy networks (£25billion from 2015-

<sup>9</sup> [http://www.ukpowernetworks.co.uk/internet/en/about-us/documents/UKPN\\_AR\\_2016\\_2017.pdf](http://www.ukpowernetworks.co.uk/internet/en/about-us/documents/UKPN_AR_2016_2017.pdf)

<sup>10</sup> Ofgem (2006), Transmission price control review – third consultation paper

<sup>11</sup> First Economics (2017) – Making the case for Private Ownership

2023<sup>12</sup>), a small increase in the cost of capital would have a significant impact on consumers. Companies would be less likely to invest in new efficient processes/strategies with high upfront costs if there is an increased risk that the benefits will not materialise due to unexpected changes in the regulatory settlement.

### **Legal precedent (CMA appeal)**

A referral to the Competition and Markets Authority (CMA) on parameters within RIIO-ED1, including BMCS and IIS, was made previously by one of the key advocates of an MPR. Ofgem robustly defended the arrangements it had in place for RIIO-ED1 with the CMA upholding Ofgem's approach and decision, finding them to have used sound, correctly applied principles. The CMA determined "*GEMA's design of the schemes is not flawed such that the schemes are likely to lead to significant rewards for DNOs, without these being justified by any substantive improvements in performance.*"<sup>13</sup>. This evidences Ofgem's methodology was based on sound evidence and principles which were applied correctly at the time of setting price control parameters.

### **Regulatory precedent**

Ofgem ruled against extending the scope when considering an MPR for the RIIO-1 Transmission and Gas Distribution licensees. In coming to this decision, an impact assessment was undertaken to provide an illustration of what could be expected from the perceived increase in investment risk that an MPR scope extension would cause. This assessment showed that increased uncertainty could lead to an increase in cost of capital:

*"a 10 to 50 basis point increase in the cost of capital across the three RIIO sectors for an eight-year regulatory period could increase costs to consumers by £390m to £1.9bn"*<sup>14</sup>

We believe that both the precedent of sticking to the original scope set by the RIIO-GD1 and RIIO-T1 MPR decision and this impact analysis suggest that an extension of scope is not in the best interests of consumers in the long term. In other words, any perceived short-term gain would be to the detriment of long-term interests of consumers.

### **MPR as currently defined**

We strongly believe that there is no basis for an MPR as currently defined. The mechanisms within its current form provide the right incentives and controls to protect consumers and performance to date provides evidence to this effect. We are in agreement with Ofgem's view that potential factors arising to date do not warrant an MPR. The arguments against the current framework have already been tested and successfully defended by the CMA. Changes at this stage seriously jeopardise the benefits that regulatory certainty has and will continue to deliver through significant investment and improved performance.

The consultation clearly sets out the scope and definition of the MPR and should not be considered an opportunity to re-open the price control<sup>15</sup>. An MPR is designed to tackle material changes to existing outputs that can be justified by clear changes to government policy, and new outputs that may be needed to meet the needs of consumers and other network users. The RIIO-ED1 Strategy Decision says "*Other than in these circumstances, the mid-period review will not be used to adjust the output measures or output incentives that were set at the*

<sup>12</sup> <http://www.energynetworks.org/news/press-releases/2017/september/energy-network-companies-totally-reject-inaccurate-claims-about-network-company-profits.html>

<sup>13</sup> [https://assets.publishing.service.gov.uk/media/5609588440f0b6036a00001f/BGT\\_final\\_determination.pdf](https://assets.publishing.service.gov.uk/media/5609588440f0b6036a00001f/BGT_final_determination.pdf)

<sup>14</sup> [https://www.ofgem.gov.uk/system/files/docs/2016/05/mpr\\_decision\\_document\\_final.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/05/mpr_decision_document_final.pdf)

<sup>15</sup> [https://www.ofgem.gov.uk/system/files/docs/2017/11/ed\\_mpr\\_consultation.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/11/ed_mpr_consultation.pdf)

price control review.” Narrative, such as the above, issued by Ofgem set a legitimate expectation that the MPR would not be used to construct two four year price controls, and this was an important factor in UK Power Networks’ acceptance of the RIIO-ED1 final determination in December 2014.

### **Extension to scope of the MPR**

Ofgem’s consultation seeks views on an extension to the scope of the MPR beyond that previously defined, e.g. to include new measures such as incentive design and/or other financial parameters which underpin the Cost of Capital. The stakeholders raising these issues do not suggest this scrutiny is required due to any external factors, implying their concerns are with the parameters as set during the determination of the price control. As clearly stated in Ofgem’s Strategy Decision document, many opportunities to challenge these decisions were provided in the price control review process and this was the correct time to voice these concerns.

*“The mid-period review is intended to cover external factors affecting the operation of the RIIO-ED1 price control. It is not intended to be an opportunity for either Ofgem or the DNOs to conduct a mini price review. As such we are keeping the scope of the mid-period review tight. The submission of business plans is the key opportunity for DNOs to propose the outputs they believe are required for RIIO-ED1. Stakeholders should provide their views on the DNOs plans and our proposals for each DNO at the appropriate stages of the review. The mid-period review should not be seen as an opportunity to re-open decisions taken at the price control.”<sup>16</sup>*

This process provided ample opportunities for stakeholders to raise concerns and challenge approaches to setting targets at the appropriate stages of the review in order that these views be taken into consideration.

### **IIS target setting**

The targets for the IIS incentive were set using a robust methodology that used the latest available performance data at the time to set individual targets for each company which built in improvements beyond the performance at that time. As stated in Ofgem’s response to British Gas Trading’s appeal to the CMA, if the forecasted reliability performance going into to the RIIO-ED1 period (i.e. forecast 2014/15 performance) were maintained throughout the RIIO-ED1 period, the DNOs collectively would have been subject to a £19m penalty<sup>16</sup>. This demonstrates that in general, rewards will only be earned in the RIIO-ED1 period where continuous improvements are made.

### **BMCS target setting**

As explained in Ofgem’s public consultation on setting the targets for the Customer Satisfaction Survey (CSS), the target was set to reflect upper quartile performance of the national view of customer service as measured by the UK Customer Service Index (UKCSI)<sup>17</sup>. The target therefore represents a stretching comparison to competitive markets and, as shown in the chart below taken from Ofgem’s consultation, the majority of DNOs were performing below the target at the time it was set. Therefore, a reward was only available where companies improved their customer service, including any improvements before the RIIO-ED1 period started. These improvements must also be maintained in an environment of evolving customer expectations, network companies must continue to address these evolving expectations to continue earning rewards.

<sup>16</sup> [https://assets.publishing.service.gov.uk/media/5609588440f0b6036a00001f/BGT\\_final\\_determination.pdf](https://assets.publishing.service.gov.uk/media/5609588440f0b6036a00001f/BGT_final_determination.pdf)

<sup>17</sup> [https://www.ofgem.gov.uk/sites/default/files/docs/2013/09/riioed1\\_custservice\\_connection\\_incentives\\_open\\_letter\\_040913.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2013/09/riioed1_custservice_connection_incentives_open_letter_040913.pdf)

## Cost of Capital

When Ofgem and other regulators are setting the Cost of Capital, they typically use long-run historic data, particularly in the case of Cost of Equity, as this best reflects the funding of long-life assets. We have seen no evidence to suggest that this approach is incorrect.

A number of parties have challenged the Cost of Equity suggesting that it is too high. However, this analysis fails to take into account issues such as the need to adjust the observed market equity betas to align them with the notional regulatory gearing that underpins the price control.

## Response to CA challenge on losses mechanism

One respondent to Ofgem's call for evidence suggested that the current scope of the MPR is inconsistent with previous approaches to uncertainty. They use the decision not to activate the DPCR5 losses incentive as an example of when Ofgem have departed from a price control Strategy Decision due to external uncertainty. However, as stated by Ofgem at the time, this decision was based on the fact that there was no certainty that the measurement of losses using settlement data reflected any action by DNOs regarding losses<sup>18</sup>. This is a very different situation to the issues being raised for consideration under the MPR for which the parameters were set at the time of the price control review and subsequent performance is directly measured in a robust and auditable way. There is no parallel between the decision not to activate the DPCR5 losses incentive and the proposal to extend the scope of the MPR.

## GD&T decision on existing outputs

Ofgem's consultation expresses the view of one respondent referring to the scope of the MPR for the RIIO-1 Transmission and Gas Distribution licensees - stating that Ofgem's view is that there is no meaningful distinction between the introduction of new outputs and changes to existing outputs. However, the RIIO-ED1 strategy decision document makes a clear statement that *"the mid-period review will not be used to adjust the output measures or output incentives that were set at the price control review"*<sup>1</sup>. We fundamentally disagree that the interpretation applied to Transmission and Gas Distribution translates to the MPR evaluation. RIIO-ED1 was written two years after the development of the RIIO-1 GD&T framework and therefore built in learning and reflected latest thinking. It is illogical to seek to apply interpretation and rules from other sectors which have since been superseded. Where customer needs are covered by an output or incentive, the expectations of customers were captured when designing those incentives at the time of the price control review and it is not appropriate to review these with only two years of revealed performance in an eight-year price control.

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<sup>18</sup> [https://www.ofgem.gov.uk/sites/default/files/docs/2012/11/1a\\_decision\\_losses\\_dpcr5\\_161112.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2012/11/1a_decision_losses_dpcr5_161112.pdf)

## Appendix B – Answers to consultation questions

### Background

#### Question 1: Do you have any comments on the scope of the ED-MPR?

As detailed in our covering letter and in Appendix A, we fully support the scope of the MPR as defined in the Strategy Decision published by Ofgem. This definition of the scope was fully consulted on at the time of setting RIIO-ED1 and preserves the intention of an eight-year price control.

#### Question 2: Do you have any comments on the preliminary information on company performance provided in this document?

We agree that the RIIO-ED1 framework incentivises network companies to deliver great performance for customers. The framework also includes a suite of uncertainty mechanisms which mean that financial outperformance related to factors outside of a DNO's control (such as demand increases not materialising) will be returned to customers in full through the closeout process.

### External factors potentially affecting RIIO-ED1

#### Question 1: Do you agree with the initial view we set out in this section against each individual issue?

#### **Issues 1 to 5 – Electric Vehicles, Implementation of the European Clean Energy Package, National Flood Resilience Review, Resilience of Networks and Information Systems and Black Start**

We recognise that these issues are likely to lead to changes in the way that we deliver the outputs we agreed to in RIIO-ED1. However, we agree with your view that this impact is still uncertain at this stage for these issues and it would therefore not be appropriate to adjust existing or introduce new outputs until there is more clarity. Where appropriate this can be considered in the development of the RIIO-2 framework. We remain committed to delivering our agreed outputs within the current allowances.

#### **Issue 6 – Whole-system outcomes and the transition to Distribution System Operator**

The Totex Incentive Mechanism (TIM) within the RIIO-ED1 framework already exists as an incentive for companies to find and implement the lowest cost solutions. We agree that more work is required to develop incentives that drive the most efficient whole-system solutions but given the current uncertainty and level of work required to achieve this, it is best dealt with in the development of the RIIO-2 framework.

#### **Issue 7 – Smart Meters**

We agree that this issue is being dealt with under the governance of the DCUSA modification process so does not to be considered under the MPR.

#### **Issue 8 – Rail Electrification**

This is addressed in response to Question 3 below.

Question 2: Have you identified any other issues not covered in this section that should be considered within the scope of the ED-MPR process?

Through our engagement to date and as previously detailed in our response to your call for evidence<sup>19</sup>, we do not believe there are any issues that satisfy the criteria for an MPR.

Question 3: What are your views on a discrete extension of the ED-MPR scope as described in paragraph 2.30 (rail electrification)?

As stated in the covering letter and Appendix A, we believe that changing the scope of the MPR undermines the regulatory certainty of the RIIO-ED1 and future price controls. Uncertain areas of expenditure should be subject to clearly defined uncertainty mechanisms which allow adjustments to be made to reflect changes in the operating environment for network companies.

### **Additional issues considered**

Question 1: What are your views on a potential significant extension of scope to capture financial and incentive performance and design?

We do not believe that the RIIO-ED1 framework allows for the extension of the scope of the MPR. The uncertainty created by a departure from the decision previously made would not be in the long-term interest of consumers, as explained in more detail above.

Question 2: Do you have any views on the other issues raised in this section?

We agree with both the approach to the Load Index and the re-setting of the Average Time to Quote and Connect incentive targets.

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<sup>19</sup> [https://www.ofgem.gov.uk/system/files/docs/2017/11/ukpn\\_mid\\_period\\_review\\_response.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/11/ukpn_mid_period_review_response.pdf)