

Steve McMahon
Associate Partner
RIIO Networks, Electricity
Ofgem
Networks
Commonwealth House
3rd Floor
32 Albion Street
Glasgow
G1 1LH

02 February 2018

Dear Steve,

Consultation on a potential RIIO-ED1 Mid-Period Review

Scottish and Southern Electricity Networks (SSEN) appreciate the opportunity to comment on a potential Mid-Period Review (MPR) for the current electricity distribution price control (RIIO-ED1). We have provided a full response in the attached appendix but our position, in brief, is detailed below.

Scope of the Mid Period Review

As SSEN stated in our response to Ofgem's 'Potential Mid Period Review timetable and next steps: Call for Evidence'¹ on 30 August 2017, we agree with Ofgem's statement regarding the Mid Period Review that:

'The scope of this review will be restricted to material changes to outputs that can be justified by clear changes in government policy, and the introduction of new outputs that are needed to meet the needs of consumers and other networks users.'

The Mid Period Review was not designed to be a reopening of the price control, an opportunity to redraft the licence, or another opportunity to undertake a full suite of cost

¹ Potential RIIO-ED1 mid period review- timetable and next steps: a call for evidence: Cover Letter

assessment methodologies. As Ofgem stated in the RIIO-ED1 Final Determination² document the mid-period review is,

‘not an opportunity for either us or the DNOs to conduct a mini price review or re-open decisions taken in the RIIO-ED1 review.’

Noting that any additional output over and above those already listed would have to be limited to material issues, SSEN believe there are no specific issues which are either substantive or certain enough to warrant a MPR.

Discrete extension of the scope of the Mid Period Review

SSEN believe that there should be no opening up of a price control on an issue specific basis. The price control was set by Ofgem, and agreed by the DNOs, on an ‘in the round basis’, and should be conducted as such, and we believe it is therefore incorrect to reopen on a single issue.

Significant extension of the Mid Period Review

One of the founding principles and anticipated benefit of the RIIO framework was that setting longer term price controls would:

‘encourage the companies to make longer term plans that would allow greater innovation and efficiency savings to be made that would ultimately benefit consumers’³ and therefore, ‘we made it clear that the ED-MPR is not an opportunity to re-open the price control through a mini price review’⁴

These principles encourage network companies to seek longer term financing at lower rates which ultimately leads to a reduction of the cost to customers. It also allows for a longer term strategy for the price control, creating a stable platform for the businesses to seek efficiencies and to innovate to reduce costs.

This is the basis on which the RIIO price controls were negotiated, and ultimately challenged and upheld by an appeal to the CMA. We strongly believe that this created a Legitimate Expectation that the price control principles would be upheld for the full 8 years of RIIO 1.

Ofgem’s position on a potential widening of the scope of the RIIO-T1 and GD1 mid period review was as follows.

² Strategy decision for the RIIO-ED1 electricity distribution price control: Overview: 8.19

³ Decision on a mid period review for RIIO-T1 and GD1: 1.1

⁴ Consultation on a potential RIIO-ED1 Mid-Period Review: Exec Summary



‘We believe that widening the scope of the MPR in this way would have detrimental effects on consumers. The move to an eight-year price control under RIIO is driven by a desire to encourage the companies to adopt longer term strategies and innovate in order to deliver long term savings to consumers’⁵

We would like to see a consistent approach across all RIIO Mid Period Reviews and would be strongly opposed to a significant extension to the stated scope of the mid period review.

Should you require any clarification on any of the points raised please do not hesitate to contact me.

Yours sincerely,

Kenny McAllister
Networks Regulation

⁵ Decision on a mid period review for RIIO-T1 and GD1: 2.6

Appendix 1 – SSEN response to consultation questions

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

RIIO-ED1 Strategy Decision – part of a balanced package

We believe that in reviewing the need for a RIIO-ED1 MPR the scope should remain consistent with that set out by Ofgem in its RIIO-ED1 Strategy Decision⁶. The RIIO-ED1 settlement was agreed ‘in the round’ based on the parameters set out in the sector specific Strategy Decision. The package was intentionally designed to address areas of uncertainty, provide incentives for continuous improvements in efficiency and provide certainty to allow networks to invest in enduring improvement in outputs. The form of the RIIO price control⁷, the building blocks, demonstrates that the overall package of risk and reward is conditional on the interaction between the various components. Therefore, any change to this balanced package will, inevitably, lead to a reopening of the price control.

In our response to the ED-MPR Call for Evidence, 30th August 2017, we supported Ofgem’s reasons for originally establishing a focused scope for the RIIO-ED1 MPR and the clarity by which this was set out in the RIIO-ED1 Strategy Decision.

“The scope of this review will be restricted to material changes to outputs that can be justified by clear changes in government policy, and the introduction of new outputs that are needed to meet the needs of consumers and other network users.”⁸

The design of the MPR mechanism, and in particular its scope, was intentional. This approach balanced providing certainty of the outputs customers could expect to benefit from, and the cost of providing these against the network’s ability to invest efficiently and with confidence.

For these reasons we agree that the scope of any MPR should remain output focused and conditional on the established criteria; any new outputs must meet the changing needs of consumers or be driven by changes to government policy.

Focused scope provides necessary certainty

The Strategy Decision not only set out the drivers for a MPR, as above, it was also clear on what circumstances would not trigger a MPR. This intentional step enabled networks to develop and then deliver their business plans through RIIO-ED1 with assurance that the components of the price control would not be revised ex-post. The MPR was not designed to be a reopening of the price control, an opportunity to redraft the license or another

⁶ Strategy decision for the RIIO-ED1 electricity distribution price control: Uncertainty mechanisms

⁷ Strategy decision for the RIIO-ED1 electricity distribution price control: Overview, fig. 4.1

⁸ Strategy decision for the RIIO-ED1 electricity distribution price control: Overview, 8.16 and Uncertainty mechanisms, 5.2

opportunity to undertake a full suite of cost assessment methodologies. Ofgem confirmed that, outside the focused output changes noted above, that the MPR **will not be used**:-

- to adjust the output measures or output incentives that were set at the price control review
- to consider revenue adjustments that could be triggered throughout the process by other mechanisms.
- to reduce/increase charges to consumers where a company has delivered at lower/higher costs than expected at the price control review.

To now widen the scope of the MPR would be to unpick the RIIO settlement and leads to the very outcome which Ofgem set out to avoid, a mini price review; “it is not an opportunity for either us or the DNOs to conduct a mini price review or re-open decisions taken in the RIIO-ED1 review”⁹.

Existing mechanisms to protect customers and ensure delivery

RIIO-ED1 benefitted by being the third price control to be assessed under the RIIO framework. Many of the framework components had already been well tested and were understood. This was further reinforced through the BGT vs. GEMA appeal to the CMA in 2015 and the resulting CMA decision. The RIIO framework includes multiple measures which protect consumers from unjustified Totex expenditure, ensure network operators are accountable for output delivery and which also incentivise network operators to invest over and above their ex-ante allowances to deliver improved service.

Uncertainty over material areas of Totex allowance, from both the consumer and network operator perspective, are also addressed via a number of clear uncertainty mechanisms. These include Load Related Expenditure (CRC 3G), delivery of the Network Asset Secondary Deliverables (CRC 5D) and a range of uncertain costs elements, including High Value Projects, (CRC 3F). This combined package, incentives, uncertainty mechanisms and the MPR, achieve the balance in risk within the RIIO eight-year price control package.

⁹ Strategy decision for the RIIO-ED1 electricity distribution price control: Overview, 8.19

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

We believe the performance evidence to date supports the value of the RIIO framework through what it is delivering for customers now and in the future. Rather than presenting any justification for Ofgem to consider a change to its position on MPR scope it consolidates the reasons for maintaining the balanced package of risk and reward.

The information provided within the consultation document summarises components of RIIO performance at a high level. It does not however contain any evidence which would support the 'significant extension of the MPR scope' as considered within section 3 of the MPR consultation. Furthermore, the summary within the consultation document also acknowledges that the full RIIO performance forecast after two years does not take into account factors which would place downward pressure on returns. These include the interaction of RIIO uncertainty mechanisms, such as the Load Reopener, which may reduce Totex outperformance and the ability of networks to maintain performance in incentivised areas for the remainder of the price control.

In addition, as we will describe in our response to Q1, Section 2, there are external issues that would be within scope of a MPR, but which do not yet display sufficient certainty, but which all represent additional obligations and costs for networks. Collectively these represent increased risk which networks will manage within the price control framework and demonstrate why it is necessary to ensure consistent application of the MPR scope strategy decision.

Performance to date

In both the ED-MPR consultation document, and in the Ofgem Distribution Annual Report published on 20th December 2017, Ofgem have considered DNO performance during the first two years of the eight-year price control period.

The Annual Report provides considerably more detail on the successful output performance to date which has resulted in better service for customers, improved network reliability, continued safe operation of the network and reduced impact on the environment.

This assessment, summarised again below, demonstrates that Networks are delivering against their RIIO-ED1 commitments and for the allowances provided within the settlement. It also highlights that these outcomes have been achieved because network operators have responded to the RIIO package through a range of actions. These include targeted network investment, investment in Information Technology, delivery and process reorganisation and an intensive focus on innovative solutions to reduce future customer costs.

Industry-Level performance against outputs

<u>Output Category</u>	<u>Ofgem View of Performance (16/17 Annual Report)</u>
Reliability & Availability	meeting targets
Customer satisfaction	meeting targets
Environment	meeting targets
Social Obligations	meeting targets
Safety	meeting targets
Connections	mixed performance across DNOs

In the 2016/17 Distribution Annual Report, Ofgem recognise the delivery to date and make specific points regarding a number of outputs.

- Customers are benefiting from improved network reliability:* In the reliability and availability category, Ofgem note that DNOs have been investing in their networks in order to deliver improved network performance for customers. Both the number of customer interruptions and the duration of interruptions have fallen by 11% on average since the start of RIIO-ED1. This improvement in network performance has meant that companies have been rewarded under the Interruptions Incentive Scheme (IIS). This incentive was examined within the appeal by British Gas Trading to the CMA in 2015; the CMA found no cause to alter the mechanism.
- Service is improving:* Actions taken by Networks in the first two years of RIIO-ED1 has led to improved Customer service which is evidenced by the increasing Customer Satisfaction Survey scores across all 14 DNOs. All DNOs actively engage with stakeholders, and in particular vulnerable customers, to meet their social obligations. While performance in this area is already good, all companies are looking to make continued improvements in their dealing with vulnerable customers and wider stakeholder groups over the course of RIIO-ED1.
- Reducing our impact on the environment:* Ofgem also noted that there have been environmental improvements across the industry, with reductions in business carbon footprint, harmful emissions and oil leakage. Ofgem are looking to further encourage the strong performance in this area by introducing reputational incentives, including establishing environmental league tables.

- *Safe networks:* All DNOs continue to be compliant with standards set by the Health and Safety Executive (HSE), ensuring that they are protecting their staff and the public.
- *Connections and customer engagement:* While Ofgem have stated that most DNOs are performing well against outputs so far in the price control, some improvements are required in areas such as Connections and Customer Service. As noted above the price control is designed to incentivise companies where they can improve.

All of the above performance improvement has been achieved in a sector which is also meeting its Network Risk Secondary output target, safeguarding future network resilience, and is forecast to continue to do so throughout the RIIO-ED1 period. This has been achieved with the sector forecast to efficiently underspend RIIO-ED1 allowances by c.5%, which will return over £500m to customers and set new benchmark cost levels for future price control periods.

Ofgem also note that there has been a mix of strategic performance across the sector, with some companies performing better than others on incentives, while others are focussing more on cost efficiency. Both strategies can be in the best interests of customers, allowing for relevant local stakeholder engagement, both in terms of network performance and other outputs or cost. This was one of the central tenants of the RIIO framework; to encourage companies to tailor their RIIO plans as they respond to their customers needs in order to deliver value for money, wider stakeholder benefits and also ensure that all outputs and targets are being achieved or improved on.

We believe the performance evidence to date supports the value of the RIIO framework through what it is delivering for customers now and in the future. Rather than presenting any justification for Ofgem to consider a change to its position on MPR scope it consolidates the reasons for maintaining the balanced package of risk and reward.

Section 2: 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?

We recognise that there are several legitimate emerging network issues at the moment. These fall into the following categories:-

- Material but uncertain – insufficient clarity on output change for ED1 MPR
- Future material – highly likely to occur but unlikely under RIIO-ED1
- RIIO-ED1 risk - Part of the ‘in the round’ ED1 settlement therefore for DNOs to manage

We believe that the issues raised in Ofgem’s consultation fall into these three categories and therefore do not provide justification for a RIIO-ED1 MPR.

External factors – RIIO2 issues / not yet material

The RIIO-ED1 Strategy Decision is clear. It requires ‘clear changes to Government Policy’ to justify a MPR. While there are a number of impending industry changes around Flexibility / Smart Networks / DSO we believe that these do not align with the MPR timeline and are more likely to be an issue to be addressed during RIIO-2. In the current period, specific mechanisms such as Network Innovation Allowance and Network Innovation Competition already exist to encourage innovation and the move towards smarter electricity networks. Uncertainty mechanisms such as the Load Related Expenditure reopener are in place to address some of this risk.

Our position on potential issues, such as flooding and black start, is that while they will place upward pressure on networks to meet obligations at this time there is insufficient clarity or detail around the potential output. Following the MPR strategy this does not merit inclusion in a MPR.

Noting that any additional output over and above those already listed would have to be limited to material issues, we believe there are no specific issues which are either substantive or certain enough to warrant a MPR.

<u>Issue</u>	<u>Narrative</u>	<u>Ofgem Position</u>	<u>SSEN Position</u>
Electric Vehicles	Cost of potentially accelerated uptake of EVs	No MPR Not enough clarity around changes to outputs	No MPR Agree with Ofgem SSEN is actively facilitating expansion of EV within its Networks. If / when this occurs on a wide scale SSEN recognises that, while innovation will avoid unnecessary costs there will be substantive network investment required.
European Clean Energy Package	Increased costs associated with implementation of new European policy	No MPR Not enough clarity around changes to outputs	No MPR Agree with Ofgem Output remains unclear
National Flood Resilience Review	Increased costs associated with revision to current flood protection programmes	No MPR No material change in outputs	No MPR Agree with Ofgem
Resilience of Networks and Information Systems	Costs associated with the implementation of the Network and Information Systems Directive	No MPR No material change in outputs	No MPR Agree with Ofgem SSEN recognise this may require further network investment within RIIO1.
Black Start	Costs associated with the requirement for Black Start resilience in excess of original ED1 levels	No MPR No change to outputs	No MPR Agree with Ofgem Output changes are being proposed however scale and timing remain uncertain
Whole system outcomes and the transition to DSO	Costs associated in delivery of integrated whole system benefits	No MPR No material change to outputs	No MPR Agree with Ofgem SSEN is active with all DNOs in developing the DSO transition through the Open Network project
Smart Meters	Costs associated with higher than expected defect rate for the installation of smart meters.	No MPR This would be beyond the scope of MPR	No MPR Agree with Ofgem

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?

As previously stated in our response to the Mid Period Review Call for Evidence, we have not identified any other issues that should be considered within the scope of the ED-MPR process. There has been nothing since then to amend this view.

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

Ofgem are seeking views on, what it describes as, a small extension of the RIIO-ED1 MPR scope in respect of ex-ante Rail Electrification allowances. This is limited in a manner which it believes is consistent with the Strategy Decision on external factors, therefore enabling Ofgem to consider material changes to discrete projects with clearly defined deliverables, driven by clear changes in government policy.

We do not support the widening of the MPR scope on an issue specific basis. This is consistent with the criteria established in the Strategy Decision, see our response to Q1, section 1. The price control was set by Ofgem, and agreed by the DNOs, on an 'in the round basis' and must be permitted to function as such. Any potential benefits for customers would be outweighed by the negative perception of reopening the price control on investor confidence.

On the narrow issue of Rail Electrification, we acknowledge that there is inconsistency between the allowance design for the fast-track company and the uncertainty mechanism for the remaining companies. Ofgem stated at fast-track that estimated costs for DNO impacts from Network Rail's rail electrification were within the fast-track business plan and would be included in ex-ante allowances. Ofgem judged that these costs were efficient, and that there was a high degree of certainty around the completion of the particular schemes involved. The fast-track settlement does include a mechanism to enable Ofgem to claw back unspent allowance where the costs were borne by a third-party. This recognised that at the time of setting allowances there was an unresolved debate as to whether Network Rail would be picking up the costs of this work or whether the costs would be borne by DNOs under the Master Wayleave Agreement. This ensured that electricity customer had limited exposure to funding costs which Network Rail customers had already funded.

Conversely, there is a ‘re-opener’ mechanism rather than an ex-ante allowance for the slow-track companies. This means that efficient costs which have been incurred as a result of Rail Electrification through the RIIO-ED1 period can be recovered at the appropriate window.

At the time of the RIIO-ED1 Final Determinations, a substantial amount of preparatory work had already taken place on a number of these Rail Electrification projects, and there was no wider political suggestion that these critical national infrastructure projects would not be completed. It is apparent that Ofgem was trying to protect both electricity and rail customers. With the benefit of hindsight, a reopener mechanism in the style of the High Value Project reopener, which protects customers in instances where schemes no longer go ahead, would have been a more appropriate mechanism. We are encouraging Ofgem to ensure such learning is built into its design of the RIIO2 framework.

In such situations, and as demonstrated by other RIIO companies, it is for the individual network company to evaluate whether it is appropriate to return allowances to customers. This, however, falls outside the MPR scope and can only ever be considered on a case by case basis.

Section 3. Additional issues considered

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

Ofgem have outlined in their most recent Distribution Annual Report, 2016/17, that Distribution companies are delivering against output targets in the early days of RIIO-ED1. An eight-year price control has afforded companies the opportunity to take time to improve investment scheme planning, work with contractors to ensure the best value for money and deliver the best possible outcomes for customers over the longer term rather than purely having to focus on immediate delivery.

This approach to identify and pursue longer term value for customers has been made possible by the stability anticipated during an eight-year price control and by the RIIO framework, a package of outputs and incentives that was accepted ‘in the round’.

As illustrated by Ofgem’s RIIO framework¹⁰ DNOs consider the components of the price control overall rather than focussing on any one specific area. Outputs improvements have been made possible due to the stability and certainty of the price control settlement and the assurance that the parameters on which investment decisions were made would not be altered retrospectively.

¹⁰ Strategy decision for the RIIO-ED1 electricity distribution price control: Overview, fig. 4.1

The basis for the IIS and Broad Measure incentives were tested by the CMA through the BGT appeal in 2015. Through this process it was recognised that the networks were not being funded during RIIO-1 through ex-ante allowances for step changes in IIS or BM performance. Therefore, networks could make improvements in outputs with the expectation of recovering costs through the resulting incentive payments. The incentive structure was therefore considered to be consistent with Ofgem’s objectives. Under this framework, networks have invested in asset and process changes which, as recognised within the 2016/17 Annual Report have led to an 11% improvement in the network reliability performance and continued and improving customer service satisfaction.

The purpose of MPR was intended to address fundamental changes in outputs in relation to the RIIO price controls as set out by Ofgem’s strategy decision for RIIO-1. We believe that any significant deviation from this policy decision would inadvertently de-stabilise investor sentiment and increase the risk associated with Network related investment.

In our own experience and in conversations with Investors and Analysts, we see there is a clear nervousness about any deviation from policy, particularly in relation to elements that were originally out of MPR scope. As such, any extension of MPR to cover RIIO-1 financial parameters introduces regulatory risk unnecessarily for future price controls. The adverse impact on investment would need to be fully considered as part of the set-up of the RIIO-2 framework if the MPR scope were to be extended to financial parameters.

We would strongly disagree with any extension of MPR beyond the original policy intention and believe that Ofgem should focus on future price controls, namely RIIO-2, to consider any concerns held with the current framework. Any increased risk and the perception of an unstable regulatory framework may inadvertently increase the cost of capital which is contrary to the objective of a longer price control with a defined set of regulatory mechanisms, including the MPR. We believe that any negative impact on investor confidence arising from re-opening the ED1 settlement would extend beyond distribution into other sectors’ price controls. Ofgem also acknowledges this negative effect within its impact assessment which accompanies the consultation.

In its consultation Ofgem affirms that ‘as with the approach for RIIO-T1 and RIIO-GD1, we made it clear that the ED-MPR is not an opportunity to re-open the price control through a mini price review’¹¹. One of the founding principles of the RIIO framework is that stability and certainty are key components of price controls which ‘encourage the companies to make

¹¹ Consultation on a potential RIIO-ED1 Mid-Period Review: Exec Summary

longer term plans that would allow greater innovation and efficiency savings to be made that would ultimately benefit consumers¹².

These principles encourage the networks companies to seek longer term financing at lower rates which ultimately leads to a reduction of the cost to customers. It also allows for a longer term strategy for the price control, creating a stable platform for the businesses to seek efficiencies and to innovate to reduce the cost of energy provision.

This is the basis on which the network business plans were developed, assessed, challenged and, ultimately, accepted. We strongly believe that this created a Legitimate Expectation that the price control principles would be upheld for the full 8 years of RIIO 1.

The two outcomes from the RIIO-T1 MPR (noting that there was no MPR for RIIO GD1) fell within the scope that had been set out and involved only the recovery of money no longer required due to the anticipated increase in generation connections not materialising and extra allowance due to changing requirements as a result of policy change.

Indeed, when respondents to the T1 and GD1 mid period review consultation suggested a widening of the scope Ofgem's position was 'we believe that widening the scope of the MPR in this way would have detrimental effects on consumers. The move to an eight-year price control under RIIO is driven by a desire to encourage the companies to adopt longer term strategies and innovate in order to deliver long term savings to consumers'¹³.

We would like to see a consistent approach across all RIIO Mid Period Reviews and would strongly resist a significant extension to the stated scope of the mid period review.

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

Load Index (LI)

Ofgem has indicated that it is not minded to make any changes to LIs or equivalent metrics. We consider that LI is no longer the only driver or measure for investment in respect of Load Related Expenditure. We believe that Load Capex investment may have multiple drivers, which LI will not always capture. This has been previously discussed with Ofgem and we look forward to working with Ofgem and wider stakeholders to ensure the best value investments for customers in this area.

¹² Decision on a mid period review for RIIO-T1 and GD1: 1.1

¹³ Decision on a mid period review for RIIO-T1 and GD1: 2.6

Connections Targets - Setting TTC / TTQ Targets for second half of RIIO ED1

These targets had been set for the first four years of RIIO-ED1 and were anticipated to be extended at the mid-point of the price control for the remainder of the ED1 period. This however was not considered to be part of the MPR scope, but sat independently.

We look forward to working with Ofgem to set effective targets for the second half of RIIO-ED1. Our objective is always to provide exceptional customer service, and one of the main parts to this is having sufficient time to fully understand customers' requirements during the quoting stage, which in turn would assist with getting customers connected efficiently post acceptance.

We are encouraged that Ofgem are engaging with key stakeholders in this area, and are hopeful that Ofgem will take into consideration the points raised previously regarding circumstances outside DNO control. These include customers not being ready to connect within the incentive period and delays to outstanding legal consents prior to connection, which have impacted negatively on Time to Connect performance in the sector.