Bringing energy to your door

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Dear Steve

Consultation on a potential RIIO-ED1 Mid-Period Review

We welcome the opportunity to respond to your recent consultation on the Mid-Period Review (MPR) and to share our views on this important mechanism.

When putting in place an 8 year price control careful thought was given to uncertainty and how risks should be shared between customers and companies. Electricity North West are supportive of the RIIO framework including the clearly defined scope for mid–period review as described within the RIIO-ED1 Strategy Decision[1]. A clear MPR scope was set, recognising that it is in customer's long term interest that Ofgem ensures a stable, predictable and clear regime. It is important that Ofgem's regulatory decision making follows the policy and strategy decisions when it set the price control and the principles of an effective regulatory regime are upheld otherwise there will be long term cost implications for customers across all RIIO regulated sectors.

Of the issues raised in Chapter 2 there is no doubt that a number of these will require additional investment by Electricity North West, (some of which will be material and certainly will be when taken in combination), over and above allowances granted through the price control that we consider are related to government policy changes and may result in new or changes to existing outputs.

In particular, potential new outputs might be required in the following areas: -

- Transition to Distribution System Operator where Ofgem/BEIS have developed guiding principles and actions;
- Smart Meters, due to delays in rollout and potential activity stretching beyond March 2021 when current mechanisms end;
- Additional flood defence programmes of work as required by changes driven by National Flood Resilience Review.

Whilst a case could be made for inclusion of these issues in a MPR following the clear scope set consistent with Ofgem's RIIO-ED1 strategy position, we consider that it is in the best interests of our customers that we maintain regulatory stability. In this case we intend to manage these risks and protect our customers from the upwards cost pressures from these in-scope areas through innovation and novel risk management approaches.

[1] https://www.ofgem.gov.uk/sites/default/files/docs/2013/03/riioed1decoverview.pdf

Absorbing these upward cost pressures for potential new outputs linked to changes in government policy is enabled by the success of the new RIIO framework to date. RIIO-ED1 has been effective in facilitating substantial investment by ENWL that is improving services to our end consumers.

DNO's are only just over two years into the eight year price control and performance is good with outputs and incentivised outcomes being consistently delivered. We believe this is a reflection of RIIO working well with benefits of company performance flowing back to North West and GB distribution customers. Out of the three options Ofgem presents for MPR approach, we believe option 1 (maintain defined MPR scope) is in customers interest however we consider initiating a review is not necessary.

The heart of the RIIO approach was to provide a transparent and predictable framework, with appropriate rewards for delivery. We are concerned that this consultation considers a range of approaches including some which Ofgem acknowledge are a significant broadening of the MPR scope set at the start of the price control.

In terms of either a small extension of scope on discrete projects or a potential wider extension of scope the principle remains the same. Core to an effective and credible price control is regulatory certainty. To move away from a committed approach set out within the Strategy Document creates risk and impact on investors and the market which will impact the ability to attract investment and for companies to invest with confidence based on the prevailing regulatory framework.

Equally, to extend the scope of MPR brings risks to customers, not only due to impact on investors, in turn affecting financeability, but also exposes customers to the risks of cost pressures and other unexpected events which DNOs have traditionally managed for the duration of a price control. If Ofgem decide that the MPR scope should be widened, then it must be over a range of issues, be symmetrical and consider both aspects of funding movement, ie provide additional allowances or incentives in some areas as equally as it broadens scope that could reduce allowances or incentives in others. This brings greater risk to customers as each and every issue may have uncertain impacts on customer bills.

For recent price controls, both with the GD1 and T1 MPR, regulatory stability was upheld where Ofgem stated "We are therefore conscious of the need to balance the reduction of costs to consumers in the short term with the introduction of regulatory risk and uncertainty, which could ultimately lead to higher costs for consumers[2]".

Additionally during the 2015 Price Control Appeal instigated by British Gas, the CMA concluded there should be no change to the two incentive schemes challenged. Any MPR scope change specifically on these incentive mechanisms appears to run contrary to Ofgem's defended position and the recent CMA ruling.

For the reasons detailed above we are not in support of any broadening of the MPR scope, minor or otherwise. As we have explained, Electricity North West intend to manage risks from the in-scope areas described, maintaining the interests of our customers. We do not therefore consider that initiating a MPR is required in our case.

Thank you once again for the opportunity to share our views on this important issue. We await with interest your review and further correspondence.

Yours sincerely

Peter Emery
Chief Executive Officer

[2] https://www.ofgem.gov.uk/sites/default/files/docs/2015/11/151112_mpr_consultation_document_final.pdf

Chapter 1

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

As has been explained within the main body of our letter, MPR has a set and specific scope which we are supportive of. We believe Ofgem should continue to hold to this scope which focuses on material changes to existing outputs justified by clear government policy changes or introducing new outputs needed to meet customer requirements.

We believe Ofgem should make neither a small nor a significant extension of scope at MPR but should consider issues only in the set MPR scope.

Regulatory predictability and stability is essential and is in consumer's long term interests, as this fosters the climate needed for ongoing investment in network businesses. Maintaining the scope as set at the ED1 strategy stage is also consistent with the stance taken for GD1 and T1 MPR, so departing from this, particularly in the absence of a robust and compelling CBA and broader impact assessment undermines regulatory confidence.

Any wider review will be likely to add long term cost to customers, create additional investment risk for companies and will jeopardise investment in network infrastructure and the operation of regulatory incentives that have improved service to customers at a key time when it is needed to renew ageing network assets and enable the transition to a low carbon energy sector.

Ofgem's RIIO-ED1 Strategy Decision Overview[1], as part of ensuring stability and predictability for consumers and companies, made it clear that the incentives and arrangements set at the start of the price control would not be within scope of a MPR, specifically stating, "it is not an opportunity for either us or the DNO's to conduct a mini price review or re-open decisions taken in the RIIO-ED1 review".

Furthermore the Strategy Decision supplementary annex Uncertainty Mechanisms[2], goes on to explain that other than the tightly defined scope "mid-period review will not be used to adjust the output measures or output incentives that were set at the price control review".

Ofgem has not provided any clear reasons or any justification as to why Ofgem might consider reversing that carefully considered position. The impact assessment included in the consultation does not set out any compelling benefits to support a MPR scope increase, but does recognise some of the key cost areas. The impact assessment states that Option 3 which has a very wide scope has benefits that are hard to quantify whilst recognising that this option will impact on financing costs going forward and into the next price control. We also believe that the costs caused by deviating from the set scope will be reflected in all future RIIO price controls for all networks Ofgem regulates, whereas any benefits, such that there might be any in the very short term could only be from the Electricity Distribution price control as all other MPR's have already passed.

We note stakeholder interests in the level of return in the sector, however with only two years performance data of an eight year price control, it feels disproportionate to stretch MPR scope with no evidential base. The recent Ofgem RIIO-ED1 Annual Report[3] highlights that network companies are performing well for consumers. The RIIO framework links performance to returns therefore any view on level of returns should be accompanied by consideration of investments being made and ever increasing reliability along with reductions to customer bills.

There is a need to avoid the risk of seeking short-term wins to the detriment of the stability of the longer-term picture and to maintain regulatory stability whilst ensuring an efficient cost of capital is also sufficient to ensure future investment opportunities.

[1] https://www.ofgem.gov.uk/sites/default/files/docs/2013/03/riioed1decoverview.pdf
[2] https://www.ofgem.gov.uk/sites/default/files/docs/2013/02/riioed1decuncertaintymechanisms_0.pdf
[3] https://www.ofgem.gov.uk/system/files/docs/2017/12/riio-ed1_annual_report_2016-17.pdf

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

The information in the report provided an early insight into the performance of DNO's ahead of the recent publication of the RIIO-ED1 Annual Report. The Annual Report shows strong performance with improvements for customers being delivered. DNO's have been investing in their networks to deliver improved network performance for customers and this has been seen with both number of customer interruptions and duration of interruptions reduced by 11% on average since the start of RIIO-ED1.

Customer service has also seen improvements, whilst across the industry there are reductions in business carbon footprint, harmful SF6 emissions and oil leakage.

The performance report states that under-spend, both to date and forecast, is lower than in previous price controls, and that the strong reliability and availability output performance has been driven in part by the Interruption Incentive Scheme (IIS). Both of these elements are a clear indication of the impact of the RIIO regime where setting outputs and incentives is driving delivery. It is clear that DNO focus remains on the key elements important to stakeholders, an efficient, reliable network for now and the future by incentivising innovation, network performance, delivery of outputs and overall efficiency.

Where networks efficiency results in reduced expenditure, this saving is shared with customers through existing mechanisms within the regulatory controls. Therefore at the same time as seeing improved efficiency, customers are benefitting from lower bills, another clear demonstration of the customer benefit from the regulatory regime.

In particular at ENWL we continue to deliver for our customers and this is reflected in the Ofgem analysis (Table 2.1 of Ofgem Annual Report 2016/17)[4] showing across the board green ratings for all the six RIIO primary outputs.

We have continued our leading work in Innovation, spending all our Network Innovation Allowance. We have exceeded all reliability targets and provided connection quotes and connections in the quickest time of all DNO's, whilst meeting all targets set for customer satisfaction and complaints handing. Carbon footprint, oil leakage, and losses are all showing year on year reductions, and we remain on track to meet the target of removing 80km of overhead lines in National Parks and Areas of Outstanding Natural Beauty (AONB).

Some other DNO's are predicting RORE in double digits; however it remains early days within an 8 year period, with more uncertainty ahead which could affect outturn positions. In any event, the RORE measure Ofgem uses is inaccurate, and due to its theoretical construct (such as not reflecting the actual cost of debt companies experience), for ENWL it shows overstated returns. We are concerned that because it is produced and published by Ofgem that it is therefore used by stakeholders as a true measure of company performance. In turn this leads to increased scrutiny of the sector and unwarranted pressure to review the regulatory framework as is evident in some of the subjects raised recently by stakeholders.

Within the Annual Report Ofgem note that reliability performance is slightly deteriorated in the second year compared to the first for many DNO's, largely due to weather conditions and storms. Such weather impact challenges are one element of the uncertainty that networks are managing and clearly demonstrate the need for continuing and sustained investment into network resilience as an example.

Lower than anticipated reinforcement need has been stated in the consultation as one of the main factors in totex underspend, and whilst expenditure in this area may not be following forecast profile there are many indicators of growth in economic activity which is evident within the North West region, specifically Manchester. As a result growth in electric vehicles and

[4] https://www.ofgem.gov.uk/system/files/docs/2017/12/riio-ed1_annual_report_2016-17.pdf

concentrations of generation connections are all likely to drive the need for significant reinforcement spend during the latter half of the price control period.

Chapter 2

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

Taking each in turn:

Issue 1 – Electric Vehicles – we agree there is not yet sufficient clarity to justify inclusion in MPR, however significant work will be required to better understand outputs required for inclusion within RIIO-2 framework.

Issue 2 – European Clean Energy Package – we agree there is not yet sufficient clarity to justify inclusion in MPR.

Issue 3 – National Flood Resilience Review – Electricity North West are impacted by updated government policy in this area. Flooding is an example where we have through innovation generated efficiencies in the delivery of flood protection. However the events of 2015 saw unprecedented and record flooding levels and in response we have not only reinvested efficiencies but several million pounds in addition to protect customers. This is a material demonstration of the flexibility a stable regulatory environment which allows companies to respond to customer needs.

Issue 4 – Resilience of Networks and Information Systems – Security of systems is a key area for DNOs, and we acknowledge Ofgem's initial assessment that the implementation of this new Directive is not likely to require material changes to existing outputs.

Issue 5 – Black Start - we agree the work ongoing to review Black Start arrangements will not result in a change of outputs, therefore is out of scope for MPR.

Issue 6 – Transition to Distribution System Operation
Whilst we note Ofgem's initial assessment that there is some uncertainty about precisely how roles will evolve and therefore Ofgem concludes DSO is out of scope, work undertaken through the ENA Open Networks project has provided a clearer view of what transitional requirements will be resulting in potential new outputs, whilst costs to facilitate this transition may be significant. Ofgem acknowledge that they, together with government, have developed policy on guiding principles and actions to support a smart, flexible energy system.

As indicated within the main body of our letter, we are not proposing to initiate MPR on this subject, although it has the potential to be material and require new outputs, we plan to protect our customers from the costs incurred in the interests of maintaining stability.

Issue 7 – Smart Meters – we note a stakeholder has suggested a link of funding to performance of service levels and agree with Ofgem's conclusion that efficient use of funding is part of ongoing price control monitoring and should not be subject to specific review within MPR.

We would add however that one issue on Smart Meters not yet raised is the potential of significant costs being incurred by networks beyond the planned December 2020 rollout end date. Based on a number of uncertainties, it is possible that a large number of Smart Meters may still be being installed after the December 2020 formal end date. It was originally anticipated that no further costs would be incurred by networks to facilitate the rollout after 2020, and therefore the existing Smart Meter intervention mechanism ends in March 2021 leaving DNOs with the potential of unfunded ongoing costs. This is another area where risk lies with the DNO and Electricity North West will be managing this risk.

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?

After further consideration we have not identified any issues that have not already been covered within Chapter 2 or within our 30th August 2017 response to a Call for Evidence, however the political landscape we are operating in since the start of the price control period has been fast moving, with such significant shifts such as Brexit, a snap election and a hung parliament. Energy policy is equally fast moving, with the Helm review recently published, electric vehicles increasing in prominence and major infrastructure decisions all taking place since the start of the period. As such it is reasonable to assume there may be further significant changes within the coming 12 months which may merit consideration for inclusion within the ED-MPR process, should it proceed.

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

Ofgem should not make a small extension to the scope of the MPR to revise funding for rail electrification (issue 8).

We can see that the change of solution from rail electrification to the use of alternative technology such as the bi-mode trains are driven by a change in government policy, however we agree with the original Ofgem view that it remains out of scope as it was not one of the six primary RIIO outputs and is not a secondary deliverable.

If an extension of MPR scope to accommodate this were made, this would be seen by investors as significant because extending the scope in even a limited instance undermines regulatory stability and future investment certainty. Investors will perceive future risk that any areas may be effectively reopened, symmetry should apply and DNO's should be able to raise any areas they consider relevant. Ofgem risks that this could result in cost increase for all consumers if seeking to reopen areas beyond the scope of MPR review. To extend the scope of the MPR is a principle issue that undermines regulatory predictability, clarity and stability which would ultimately cost consumers more across all RIIO regulated companies than might be saved by this one issue.

We also note that through the Totex Incentive Mechanism (TIM) customers within the affected region would share the benefit of not undertaking the electrification work.

The principle remains that it is not good regulatory practice to revisit a previous decision seeking short-term wins to the detriment of the stability of the longer-term position.

Issue 8 does however highlight an area that is unique to the WPD fast track process.

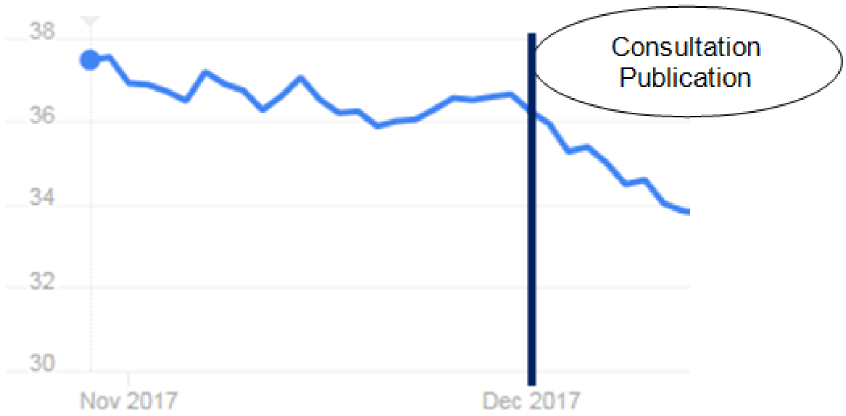
Chapter 3

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

We strongly believe Ofgem should not undertake a significant extension of scope to capture financial and incentive performance and design as this would undermine the regulatory regime that has enabled billions of pounds of investment in networks and delivered substantial improvements in the service to consumers. Performing this wide ranging review would not only cause reduced investment and raise required returns for DNO's, but would also substantially adversely impact all other Ofgem regulated sectors (GTx, GDx and ETx).

A recent Deutsche Bank analysis report[5] indicates regulatory pressure has impacted utility market values evidencing reducing share price within PPL Corporation (Western Power Distributions parent company) since the publication of the MPR consultation as shown in the following chart.

[5] http://pull.db-gmresearch.com/cgi-bin/pull/DocPull/2059-1354/255672654/a67cfd7a-07a2-4a33-bdbc-a13a402a9782_604.pdf



Ofgem have also been very clear throughout their engagement that the MPR is not intended to be a mini price control. Within the Strategy Decision document section 5.3 "*.... the mid-period review will not be used to adjust the output measures or output incentives that were set at the price control review".* By proposing such a wide scope to include financial and incentive performance and design this would be a mini price control in all but name.

We do not see the need for a wide ranging review as the RIIO-ED1 framework is working for consumers, but would suggest it is better served by Ofgem addressing any concerns about the wider RIIO framework to the extent it considers necessary as part of setting the RIIO-2 framework.

A wider scope review would not be consistent with GD1/GT1/ET1 MPR approach which followed the defined MPR scope for these sectors. Regulatory inconsistency equates to increased regulatory risk.

We have already stressed the importance of regulatory certainty and maintaining committed approaches in line with Strategy Decision. Ofgem recognise within the consultation Impact Assessment that Option 3 analysis is based on the assumption that significantly broadening the scope of the ED-MPR will have an impact on financing costs going forward and into the next price control. Reference has also been made within the Impact Assessment to the three key risks highlighted within T1 and GD1 MPR Decision:

- Negative impact on regulatory confidence, including future financing costs;
- Impact on investment (with investment less likely to go ahead);
- Reduced drive to deliver efficiencies that are in consumer interest.

Extending the scope of MPR brings risks to customers, not only via the points raised above, but also as the re-opening of such a wide-ranging number of issues exposes customers to upwards as well as downward costs. One such example is where ENWL actual cost of debt is materially higher than Ofgem assume in the funding model, as a result of historic market trends and the timing of securing debt funding. Such broad scope extension brings a very real risk of negative outcomes to both current and future customers as a result of such an intervention.

Further, we caution that should a significant extension of scope be decided upon there is a genuine risk of distraction to network companies in terms of work plan and resources required to manage such a process which could have unintended consequences such as risks a consequential impact on performance and short term investor sentiment.

During the 2015 Price Control Appeal instigated by British Gas CMA Final Determination Report[6] decision on appeal ground 2 incentive mechanism schemes (IIS and BMCS) the CMA concluded, "our view is that 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". Any MPR scope change specifically on the incentive

[6] https://assets.publishing.service.gov.uk/media/5609588440f0b6036a00001f/BGT_final_determination.pdf

mechanisms appears to run contrary to Ofgem's defended position and the very recent CMA ruling.

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

Load Indices

We understand Ofgem's position that the Load Indices are neither an output nor a secondary deliverable, however are an indicator of network asset loading and therefore can be monitored to provide additional information to DNO's and Ofgem to facilitate the sharing of best practice. We look forward to working with Ofgem to develop this element in readiness for RIIO-ED2.

Resetting Connections Targets

We agree that the resetting of the Time To Connect targets is a completely separate piece of work that needs to be completed irrespective of Ofgem's decision on a Mid Point Review. In addition it is likely to be separate people involved both from the DNOs and quite possibly Ofgem as well so it can be completed separately once the 2017-18 submissions have been made in July. It is important that this work is initiated soon after the submissions so that the targets can be confirmed well in advance of the start of period to which they apply. We would anticipate that the changes would possibly need two rounds of consultation, firstly on the new targets and then secondly to make the necessary licence changes and therefore an early start on this work is required to ensure all is in place for the targets being set to commence from April 2019.