

Decision on a Mid-Period Review for RIIO-ED1

Final decision

Publication date: 30 April 2018

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Overview:

To help manage uncertainty in the RIIO price controls, we made provision for a Mid-Period Review (MPR) of outputs.

We consulted on the potential scope of an MPR in December 2017, as well as the issues that we could consider. Having taken account of respondents' views, we have not identified any issues within the scope of an MPR as defined in the RIIO-ED1 Strategy Decision. Further, given Western Power Distribution's (WPD) voluntary return of unspent allowances relating to rail electrification projects, and having carefully considered the potential costs and benefits for GB consumers, we do not consider it is appropriate to widen the scope of the MPR to address other issues. Consequently, we have decided not to launch an MPR for RIIO-ED1.

We expect Distribution Network Operators (DNOs) to continue to manage their networks in the best interests of GB consumers, delivering the services needed at a fair price. This will mean responding to a rapidly changing energy industry, and delivering more with their existing allowances. We welcome the DNOs' commitments to using their existing allowances to drive the move to a smarter, more flexible energy system, which they currently estimate will benefit consumers by over £600m. We will continue to monitor DNO performance closely and we will use the mechanisms available to us within RIIO-ED1, including the close out process, to assess company performance and act where we consider strong financial performance has not been in the best interest of consumers.

Context

RIIO is Ofgem's framework for setting price controls for the monopoly network companies. The RIIO-ED1 price control sets the outputs that the companies who run the distribution (lower voltage) network need to deliver for consumers, and the associated revenues they are allowed to collect for the eight-year period from 1 April 2015 until 31 March 2023.

The RIIO framework allows for a Mid-Period Review of outputs halfway through the price control.

Associated documents

[Handbook for implementing the RIIO model](#)
[Strategy Decision for RIIO-ED1 – Overview](#)
[Strategy Decision for RIIO-ED1 – Uncertainty](#)
[Potential RIIO-ED1 Mid-Period Review: timetables and next steps](#)
[Consultation on a potential RIIO-ED1 Mid-Period Review](#)

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Executive Summary

Background

RIIO-ED1 sets the outputs that the electricity Distribution Network Operators (DNOs) must deliver, and the revenues they are allowed to collect, between 1 April 2015 and 31 March 2023.

The eight-year price control settlement includes a number of uncertainty mechanisms to account for the fact that some outputs and funding cannot be set with certainty at the start of the period. One of these uncertainty mechanisms is the Mid-Period Review (MPR) of outputs. This mechanism is in place to allow for material changes to outputs where there have been clear changes in government policy or consumers' and network users' needs. It also allows for new outputs to be introduced and existing outputs to be adjusted, to meet the needs of consumers and other network users.

Consultation

In December 2017, we published a consultation on whether to launch an MPR for RIIO-ED1. In this consultation, we sought views on three options:

- Option 1 - Maintaining the scope of the ED-MPR as defined in the RIIO-ED1 Strategy Decision
- Option 2 - A potential small extension of scope justified by clear changes in government policy to cover discrete projects with clearly defined deliverables
- Option 3 - A wider extension of scope enabling us to consider other issues relating to financial and incentive performance and design.

We received 18 responses to our consultation. In addition, we have spoken to a range of parties regarding their views on an MPR.

Our decision

Having considered respondents' views, we have decided that it would be appropriate to proceed with Option 1, maintaining the original MPR scope. We noted in our consultation that we had not identified any issues that fitted within this scope. Consultation responses confirmed that the issues we had identified either had an uncertain impact on outputs within RIIO-ED1, or resulted in changes that could be managed through other mechanisms within the price control. As a result, we do not intend to launch an MPR for the RIIO-ED1 price control.

Protecting the interests of GB consumers

Our approach to these decisions requires a careful balance. As an economic regulator, we need to protect the interests of current and future consumers, ensuring that companies are able to make the investment required to deliver the services that consumers want at the most efficient possible cost.

In order to be successful, this requires stability and confidence in the regulatory framework. This stability ensures that customers can continue to benefit from high levels of investment, innovation and reliability at the lowest possible cost.

We have rejected an approach that would have provided for a wider extension of the scope of the MPR (Option 3). This is because we are concerned that this could undermine regulatory confidence and weaken incentives on DNOs to perform efficiently. This could result in increased costs, offsetting any short-term benefits, which would ultimately be borne by consumers. We reached this conclusion after undertaking an impact assessment, which we have published alongside this decision.

In terms of a potential small extension of scope, we note that Western Power Distribution recently announced¹ it would voluntarily return £77m of unspent allowances associated with the UK Government's plans for an expansion of rail electrification schemes across England and Wales that have since been cancelled. We welcome this decision as being in the interest of GB consumers.

In reaching our decision, we also note that DNOs have committed to using their existing allowances to drive the move to a smarter, more flexible energy system. These commitments, which DNOs currently value at over £600m, will help ensure that they continue to play a central role in the energy system, being more proactive and flexible in managing electricity demand, implementing new technologies, providing new services to consumers, connecting electric vehicles, and making their networks more resilient. We would expect these commitments to reduce returns as we move through RIIO-ED1.

Addressing financial outperformance

We recognise the concerns raised regarding the potential for all network companies, including DNOs, to outperform their price controls.

There are a number of targeted mechanisms built into RIIO-ED1 that enable us to address underspend or material outperformance. More generally, we will continue to monitor DNO performance, and will use the mechanisms available to us under RIIO-ED1, including a number of targeted reopeners and the ED1 close out process, to deliver the best value for GB consumers.

¹ www.westernpower.co.uk/Financial-Information-Announcement-April.aspx

1. Introduction

Chapter Summary

This chapter provides background on the MPR, outlines the comments received on our presentation of company performance and sets out the purpose and structure of this document.

Background

Mid-Period Review – Background and consultation

1.1. In December 2017, we issued a consultation on the Electricity Distribution Mid-Period Review (MPR)². It sought views on those issues that we identified could potentially fall within the scope of MPR, defined in the RIIO-ED1 Strategy Decision³ as:

"The scope of the mid-period review of output requirements will be restricted to cover:

- *Material changes to existing outputs that can be justified by clear changes in government policy (e.g. if government policy on climate change changes, a higher or lower level of delivery or performance may be needed)*
- *Introducing new outputs that may be needed to meet the needs of consumers and other network users."*

1.2. This definition of scope was designed to cover external factors that affect the operation of the price control. The Strategy Decision was clear that the MPR process is not an opportunity to conduct a mini-price review.

1.3. We considered whether eight issues could fall within the scope as defined (Option 1). In the consultation, we said we were not certain about the outputs that would be required and/or material changes to the current outputs for seven⁴ of those issues.

1.4. For the eighth issue (rail electrification), we recognised that this was neither one of the six primary outputs, nor a secondary deliverable identified at the beginning of RIIO-ED1 (and, therefore, was not within the scope of MPR). However, as rail electrification is an area where clear changes in government policy are likely to have a material impact, we sought views on a small

² [Consultation on a potential RIIO-ED1 Mid-Period Review](#)

³ [Strategy Decision for the RIIO-ED1 price control - Uncertainty Mechanisms, paragraph 5.2](#)

⁴ Electric Vehicles, Implementation of the EU Clean Energy Package, National Flood Resilience Review, Resilience of Networks and Information Systems, Black Start, Whole-System Outcomes and the transition to Distribution System Operator, and Smart Meters.

extension of scope, to enable us to consider material changes to discrete projects with clearly defined deliverables, driven by clear changes in government policy (Option 2).

- 1.5. In addition to rail electrification, our stakeholder engagement and further assessment of the price control highlighted other issues that fell outside the current scope of MPR. We therefore sought views on a potential significant extension of scope to capture financial and incentive performance and design (Option 3).
- 1.6. We received 18 responses to the consultation from a range of stakeholders. We carefully considered the points raised in those responses (investigating further where appropriate). One of the responses was marked as confidential. All non-confidential responses have been published alongside this document.

Company performance

- 1.7. In the December consultation, we gave an overview of DNO performance in the first two years of RIIO-ED1, comprising information on DNOs' financial, expenditure and output performance. We subsequently published our RIIO-ED1 Annual Report⁵, which provides further performance information.

Respondents' views

- 1.8. Three respondents welcomed the performance information, noting that this supports the value delivered by the RIIO framework as it incentivises DNOs to deliver for consumers. Another welcomed further analysis on performance in relation to connections, and on the steps being taken to improve performance in this area.
- 1.9. Two respondents pointed to a number of existing uncertainty mechanisms within the price control, including the close-out process, which would address outperformance. They also highlighted the role of the sharing factor⁶ in ensuring customers benefit from efficiency through lower bills.
- 1.10. One respondent noted that their preference was for the provision of full and detailed assessment of performance, including drivers, to inform stakeholder views. In relation to assessing performance, another respondent highlighted

⁵ <https://www.ofgem.gov.uk/publications-and-updates/riio-electricity-distribution-annual-report-2016-17>

⁶ The Sharing Factor determines the level of any underspend shared with consumers. Conversely, consumers and investors share any additional costs if the network company spends more money than envisaged.

the limitations of the Return on Regulatory Equity (RoRE) calculation due to its theoretical construct.

- 1.11. Another respondent argued that the current regulatory framework places cost control and reducing consumers' bills above other metrics including health and safety, skills and workforce development and investment in infrastructure. They also noted that this suggested DNOs were not preparing networks for the transition to smarter networks and for the radically different role that distribution networks will perform in the future.
- 1.12. A number of respondents highlighted limitations with the data provided. One noted that the data presented did not take into account factors that could put downward pressure on returns, including uncertainty mechanisms such as the load-related reopener. Another noted that it would be useful if the RoRE data distinguished between underspend due to efficiency, and underspend due to lower than expected demand.

Our view

- 1.13. We can only draw limited conclusions on DNO performance based on two years' data. Some respondents rightly highlighted strong financial performance by many DNOs while others pointed to evidence of good delivery of outputs.
- 1.14. We do not agree that the current regulatory framework places cost control and reducing consumers' bills above other areas. It is possible to point to high levels of performance on health and safety, a strong focus on workforce development and significant commitments to infrastructure development. However, we welcome views on potential improvements in these areas and encourage all interested stakeholders to respond to the RIIO-2 Framework consultation so their views can be taken into account in developing the next price control.
- 1.15. We agree with the point raised by two respondents regarding the role of uncertainty mechanisms. In RIIO-ED1, we built in a number of mechanisms to allow us to address under or outperformance, particularly as part of the close-out programme. These reopeners provide an opportunity to address material underspend, including in relation to load-related allowances and on high-value projects. To illustrate, for the last ED price control, DPCR5, the DNOs returned over £200m to GB consumers⁷.
- 1.16. We note the request for a full and detailed assessment of performance. We have published a detailed impact assessment (IA) alongside this document, which contains information that informed our decision on the ED-MPR;

⁷ <https://www.ofgem.gov.uk/publications-and-updates/dpcr5-closeout-decision-adjustments-allowances>

however, we do not consider the MPR is the place to publish a full and detailed assessment of performance. This is why we publish a detailed assessment of performance each year⁸. We want to make performance more transparent, and welcome the steps taken by the DNOs to strengthen this. We welcome further engagement with all parties on any other issues that they consider important, and would help us better understand network company performance.

- 1.17. We will continue to monitor and analyse DNOs' performance and consider actions, as appropriate and within the regulatory framework, to address issues of performance that have, or could have, a detrimental impact on consumers' interests.

Purpose and structure of this document

- 1.18. The purpose of this document is to set out our decision not to launch an MPR in RIIO-ED1.

- 1.19. The remainder of this document is structured as follows:

- Chapter 2 provides an overview of the responses to the consultation on Option 1 (maintaining the scope of the MPR for RIIO-ED1)
- Chapter 3 provides an overview of responses to the consultation on Options 2 and 3 (extensions of the scope of the MPR)
- Chapter 4 sets out our decision not to undertake an MPR for RIIO-ED1, the key reasons behind this decision and our next steps.

- 1.20. Alongside this document, we have published a detailed IA setting out our assessment of the options.

⁸ <https://www.ofgem.gov.uk/publications-and-updates/riio-electricity-distribution-annual-report-2016-17>

2. Assessment of Option 1 – retaining the scope of the MPR

Chapter Summary

This chapter sets out our overall assessment of Option 1, which retains the existing scope of MPR, in the context of the consultation responses received.

Scope of the ED-MPR

2.1. As set out above, the December consultation highlighted that the scope of MPR was designed to cover external factors affecting the operation of the price control. Under Option 1, we sought views on the defined scope of MPR, and on our initial assessment that none of the issues identified within the original scope justified an MPR.

Respondents' views

2.2. Eight respondents supported maintaining the scope of the MPR as defined in the RIIO-ED1 Strategy Decision, and agreed that none of the issues identified were within the scope of MPR as originally defined. Two of those respondents highlighted that the scope was intentionally designed to balance the certainty of outputs consumers could expect to benefit from against the network's ability to invest with confidence.

2.3. One respondent argued that only external factors that have affected the required outputs should be considered within the scope of MPR. Another disagreed, arguing that there was no meaningful distinction between the introduction of new outputs and changes to existing outputs.

Our view

2.4. We support retaining the scope of the MPR as defined. We believe that the potential costs of extending the scope to re-open the price control at this stage could offset any short-term benefits to consumers, primarily through reduced regulatory confidence and a weakening of incentives. A stable regulatory framework will allow us to maximise savings for consumers at the next round of controls under RIIO-2. Deviating from the clearly signalled scope of the MPR could undermine this stability, weaken confidence and increase costs for consumers.

Individual issues identified by Ofgem

- 2.5. In the consultation, we sought views on a number of external factors potentially affecting the operation of the RIIO-ED1 price control. We identified eight areas. For seven of those areas we set out respondents' comments and our views below. The eighth area, rail electrification, is addressed in Chapter 3.
- 2.6. A majority of respondents expressed the view that these issues should be managed within DNOs' existing price control allowances. Indeed, the DNOs themselves largely supported this view, and have made commitments to use existing allowances to deliver these and a number of other areas that will support GB's move to a smarter, more flexible energy system. In total, the DNOs have identified actions that they estimate to have potential benefits of over £600m that they will deliver within their existing allowances. This is discussed in further detail in Chapter 4.

Issue 1: Electric vehicles

- 2.7. A number of stakeholders raised the potential accelerated uptake of electric vehicles (EVs) as an issue for consideration under ED-MPR.

Respondents' views

- 2.8. One respondent recognised the challenge presented by EV uptake, which will be seen within RIIO-ED1. They considered there is sufficient clarity on expected EV uptake and the associated demand for this to be reviewed. Another respondent agreed, giving support for an output in this area if DNOs require additional funding. A third supported establishing a reopener mechanism to enable DNOs to respond to any new government requirements that emerge.
- 2.9. Seven respondents noted that, while electric vehicles (EVs) have the potential to change outputs and therefore increase costs, the impact remains uncertain and it is therefore not appropriate to introduce new outputs at this stage. Most respondents argued that EVs should be considered as part of the RIIO-2 framework. One respondent considered that the issue should be kept under review for as long as the MPR progresses.

Our view

- 2.10. We recognise that there are always uncertainties about what will happen during the price control period, including the number of EVs that will connect. The existing RIIO framework includes a number of uncertainty mechanisms to deal with this, including the load-related expenditure re-opener that provides funding for investment required to accommodate new and changing patterns of customers' electricity use above or below what was included up front. As a result, we do not consider this issue warrants an MPR.

2.11. The pace of change makes the introduction of any new outputs more likely to coincide with the next set of price controls. As such, we consider this is an issue for consideration during the development of the RIIO-2 framework.

Issue 2: Implementation of the European Clean Energy Package

2.12. The European Clean Energy Package, announced in November 2016, is a significant piece of EU legislation that will affect the energy sector and how energy companies conduct their businesses. The current timeline for implementation is from late 2019, with entry into force of some aspects likely to be in 2020.

Respondents' views

2.13. Six respondents considered that, while implementation of the European Clean Energy Package has the potential to change outputs, the impact remains uncertain at this stage. They therefore believe it is not appropriate to introduce new outputs at this stage.

2.14. However, one respondent noted that if Ofgem did progress with an MPR on any issue, then it would make sense to retain the European Clean Energy Package in the process, in order to fully explore what adjustment to outputs might be required.

2.15. One respondent considered that, while the costs were uncertain, a new reopener should be introduced to address any potential additional costs.

Our view

2.16. We agree with the view expressed by the majority of respondents that the current timeline for implementation of the Clean Energy Package makes introducing new outputs at this stage impractical. As a result, we do not consider that this issue merits inclusion in the MPR process.

Issues 3-5: National Flood Resilience Review, Resilience of Networks and Information Systems, Black Start

2.17. We identified three issues related to network resilience in the consultation:

- National Flood Resilience Review – a government review of flood resilience infrastructure, published in September 2016
- Resilience of Networks and Information Systems – changes brought forward as part of the EU Network and Information Systems Directive, scheduled to come into force in May 2018

- Black Start – a programme to enhance the ability of networks to re-start in the event of a complete power failure.

Respondents' views

- 2.18. Five respondents considered that, while all of these areas had the potential to change outputs, the impact remains uncertain, and it therefore would not be appropriate to introduce new outputs at this stage. One respondent argued these should be considered as part of the RIIO-2 framework.
- 2.19. In relation to Resilience of Networks and Information Systems, one respondent noted that there could be a consumer requirement for a new output in this area, but there is not enough evidence for that at this stage, and that consumers are currently protected by the relevant legislation. They also noted that it would make sense to retain 'cyber' in the process if Ofgem decided to hold an MPR.
- 2.20. In relation to Black Start, one respondent noted that potential changes to risk assessment could increase costs and, depending on when certainty is provided, this should be dealt with through either the MPR or a reopener established through the MPR. One respondent noted that there was not a specific Black Start output and this issue should therefore be discounted.
- 2.21. With respect to National Flood Resilience, one respondent argued that, if there is a requirement for full compliance with ETR-138 by the end of RIIO-ED1 then material additional costs will arise. Depending on when certainty is provided, this should be dealt with either through the MPR, or via a reopener established through the MPR.
- 2.22. Another respondent used a historical case of reinvested funds to protect consumers from flooding as an example of the flexibility that a stable regulatory environment provides to DNOs to respond to consumer needs. A third respondent noted that there was not a specific flooding output and this issue should therefore be discounted.

Our view

- 2.23. We consider that the three issues relating to network resilience do not merit an MPR. We agree that the specific costs and outputs these issues place on DNOs are currently uncertain. We also note the ongoing work being done on the issue of Black Start⁹, and will remain alert to any impact this may have on DNOs' outputs. As such, we will continue to monitor developments in all these areas,

⁹ A restoration standard is currently being explored by the Black Start Task Group (lead by the Department for Business, Energy and Industrial Strategy (BEIS)) and the results of this may require an update to this strategy to ensure the standard is met.

taking appropriate action where necessary. Finally, we consider that RIIO-2 is the appropriate forum to consider a number of these issues.

Issue 6: Whole system outcomes/ transition to Distribution System Operator (DSO)

2.24. There is widespread recognition that electricity networks need to become more flexible, accommodating increases in distributed generation and enabling and making use of markets for flexibility services. These developments require DNO roles to evolve in order to continue to develop and maintain efficient, coordinated and economical energy systems.

Respondents' views

2.25. Seven respondents recognised that more work is needed to develop incentives that drive whole system solutions. However, given existing uncertainty at this stage, they noted that this work would be better dealt with under RIIO-2.

2.26. Another respondent agreed, further noting that the Totex approach gives room for DNOs to make the transition to a DSO within the existing framework. Two respondents explicitly noted that they expect to incur significant additional costs in this area that were not predicted at the time of setting RIIO-ED1, but that neither is seeking an MPR for these costs. One respondent noted that it would make sense to retain DSO in the process if Ofgem did progress with an MPR, to explore what new output(s) might be required.

2.27. One respondent noted that a reopener mechanism might be justified if government expectations of DNOs' roles and responsibilities change significantly. Another respondent considered that this area has the potential to be material and require new outputs, but that it was not requesting an MPR for this issue.

Our view

2.28. We recognise that the role of DNOs is evolving, and consider that the existing RIIO framework enables them to adapt and respond to this evolution. We note that some DNOs have already invested in their DSO strategies during RIIO-ED1, and we expect this to continue. Given that more work is needed to develop outputs and incentives that drive whole system outcomes, we believe that these issues are best addressed under RIIO-2. Therefore, we do not consider whole system outcomes/transition to DSO to warrant an MPR.

2.29. In our MPR consultation, we recognised the uncertainty in exactly how roles will need to change. We agree with respondents that more work would be needed to develop specific incentives for whole system outcomes, and are considering further potential changes for RIIO-2.

2.30. We also note DNOs' explicit recognition of the need to continue to support the DSO transition and achieving whole system outcomes within their existing price control allowances. We welcome this recognition and note the commitments made by a number of DNOs to do this within RIIO-ED1 from their existing allowances. We discuss these commitments further in Chapter 4.

Issue 7: Smart Meters

2.31. In the consultation, we sought views on smart meter costs, specifically those associated with DNOs dealing with defects arising from the roll-out of smart meters. Smart meter installations are carried out by suppliers (or their contractors), and there is a service level agreement in place with DNOs, who are required to attend where an installation requires attention.

Respondents' views

2.32. Two respondents noted that smart meters do not need to be considered under the MPR as this is already being dealt with under the governance of the Distribution Connection Use of System Agreement (DCUSA) modification process. Six respondents recognised that Ofgem has the ability to monitor efficient use of funding, and this area was therefore beyond the scope of the MPR. One respondent noted that there was the potential for significant additional costs beyond the planned December 2020 roll-out date, but that they would manage this risk within their existing allowances.

2.33. One respondent supported the need for a new output relating to DNO performance in facilitating the smart meter roll-out, as DNO interventions directly impact the customer experience and consumer engagement. They further noted that even if the proposed modification to DCUSA is approved, this alone might not be sufficient to manage performance.

Our view

2.34. Our view is that the issue of smart meters does not necessitate an MPR. We note that the current arrangements under RIIO-ED1 enables DNOs to manage the challenges presented by the delays in the roll-out of smart meters on the energy network. We will continue to monitor the progress of the smart meter roll-out and the performance of DNOs, but do not consider that any new outputs or changes to existing outputs are required to facilitate this.

Other issues raised by stakeholders

2.35. In the consultation, we sought views on any other issues that should be considered in an MPR.

Respondents' views

- 2.36. One respondent argued that the consultation did not consider the impact on DNO costs from delays to the smart meter programme itself. They highlighted two aspects: (1) smart meter efficiencies were no longer achievable; and (2) costs of continuing to provide Radio Tele-Switching services (RTS). The respondent noted that, where the increase in these costs was material, they should be considered within the scope of the MPR. One respondent noted that the treatment of smart meter costs would need to be delayed if the roll-out was delayed, but separated this from the MPR process. Another respondent supported the view that a new output may be required to continue to run the RTS service beyond 2020. A third respondent agreed that the delay in the smart meter roll-out would affect costs and that this issue should be included in a wider scope, if Ofgem initiate an MPR.
- 2.37. One respondent noted that the Interruptions Incentive Scheme (IIS) should be reviewed because it has ceased to be effective. They stated that, given that some DNOs' performance is beyond the level at which rewards are capped, there is limited incentive for those DNOs to improve performance. The respondent argued that this should qualify as a change in outputs and that a similar argument could be made for the Broad Measure of Customer Satisfaction and the Time to Connect incentives.
- 2.38. One respondent, while noting that they had not identified any new issues, highlighted the recent scope of changes affecting the energy industry and noted that, if an MPR should proceed, then it is reasonable to assume that there would be further significant changes in the coming 12 months that could merit inclusion.
- 2.39. One respondent highlighted three other areas that it considered should be addressed as part of the MPR process:
- changes to the Financial Handbook to account for the years affected by data not being published by the Bank of England for use in the cost of debt indexation model
 - changes in government policy (move in line with the Consumer Prices Index) which will reduce the level of business rates combined with inaccuracies in the ex-ante allowances, meaning these bear little relevance to the actual costs expected to be incurred
 - giving clarity on whether Regulatory Asset Value deductions were made for top-up and standby revenues that some DNOs treated as excluded services during DPCR5 (in the case of fast-track licensees).

Our view

- 2.40. As set out under Issue 7, we do not consider the issue of smart meters including costs associated with the delays, warrants an MPR. We believe the RIIO framework enables DNOs to accommodate the delay and uncertainty around the roll-out of smart meters. We will continue to monitor progress in this area, as well as DNO performance in facilitating the roll-out.
- 2.41. We also believe that uncertainty surrounding the roll-out of smart meters and, therefore, the role of RTS beyond 2020 mean making changes to outputs at this stage would be premature. We also understand that work is taking place to establish a replacement for RTS if needed, and consider that DNOs should manage any associated costs.
- 2.42. We note the points raised by one respondent regarding the need to review the IIS, BMCS and Time to Connect incentives given the level of performance experienced to date. We recognise that there has been strong performance by DNOs in relation to a number of these incentives mechanisms, meaning the DNOs are benefitting financially. However, there is an associated benefit to consumers in terms of increased levels of network reliability, better levels of service and faster connection times. We disagree with the view that given that some DNOs are meeting targets means they have no incentive to improve. Performance to date shows the number and length of power cuts has reduced to the point that performance exceeds the incentive mechanism. Further, we welcome the commitments made by a number of DNOs to continue to deliver performance improvements in each of these areas. Incentive performance and design is discussed in further detail in Chapter 3.
- 2.43. We note the concerns raised regarding data not being published by the Bank of England for use in the cost of debt indexation model. Our analysis and approach to revise the 2018/19 cost of debt figure used in the 2017 Annual Iteration Process by a lower cost of debt figure based upon the complete data series is currently out for informal review with industry. Therefore, we do not consider that further changes are required as part of the MPR.
- 2.44. On the treatment of business rates, we note that these are already a pass-through item. The pass-through term in the Allowed Revenue calculation adjusts for the difference between (efficiently incurred) actual business rates expenditure and the allowance as set out in Final Determinations. Therefore, we do not consider consumers would benefit from any changes in this area.

2.45. Finally, on the treatment of RAV deductions for top-up and standby revenues, we note that the RAV adjustment was only made for slow-track licensees as, in the case of fast track licensees¹⁰, we accepted their business plan.

Other issues raised by Ofgem

2.46. We identified two miscellaneous issues in the consultation. The first was the treatment of load indices (LIs), where we noted that we do not intend to make any changes to the LIs or equivalent metrics, even if we decide to initiate an MPR. The second was resetting time to connect (TTC) targets, which we noted we intend to do after four years, but that this should be a separate piece of work from the MPR.

Respondents' views

2.47. Four respondents supported the proposed approach to both the Load Index and re-setting of the Average Time to Quote (TTQ) and Connect incentive targets.

2.48. One respondent noted the importance of the development of LIs to better understand the uptake of low carbon technologies (LCTs) and active network management solutions. Another respondent noted that LIs are not the only driver or measure of load investment, and that load capex investment may have multiple drivers, which LIs would not always capture.

2.49. One respondent considered that the LI outputs should be formalised as part of the MPR process in order to provide transparency ahead of RIIO-ED1 close-out. They noted that this was important given underspend on network reinforcement to date.

2.50. On TTC, one respondent noted that this should be consistent with the approach originally used for RIIO-ED1 and that, to account for different customer service and commercial practices, it should be DNOs' own historic performance that set targets. Two other respondents noted the desire to work with Ofgem to set effective TTC and TTQ targets for the second half of RIIO-ED1, and that an early start on this work was needed. One of those respondents further noted that Ofgem should take into consideration the points previously raised regarding circumstances outside DNOs' control.

2.51. One respondent noted that the additional issues identified were beyond the scope of an MPR and that:

¹⁰ In RIIO-ED1, the four licensees of the Western Power Distribution group were fast-tracked as a reward for the quality of their business plans submitted during the RIIO-ED1 cost assessment process.



Decision on a Mid-Period Review for RIIO-ED1

- (1) Ofgem did not plan to make changes to the LI targets for the RIIO-ED1 period
- (2) The TTQ and TTC targets should be set for the second half of the RIIO-ED1 period in a separate process from any MPR.

Our view

2.52. In light of respondents' comments, we retain the view that both of these issues should be addressed outside of the MPR process.

2.53. With respect to resetting TTC targets, we reaffirm the intention to do this after four years and agree with the respondents that suggested this process should be initiated shortly. On LI targets, we will soon begin developing methodologies for closing out RIIO-ED1, and will discuss this topic as part of that process.

3. Assessment of Options 2 and 3 – extending the scope of the MPR

Chapter Summary

This chapter sets out our overall assessment of Options 2 and 3, which would involve an extension of the scope of an MPR, in the context of the responses received to our consultation.

Views on Option 2 – discrete extension of the MPR

- 3.1. We consulted on a potential small extension of scope to enable us to consider material changes to discrete projects with clearly defined deliverables, driven by clear changes in government policy (Option 2). We only identified one issue that could be addressed under that approach: changes to the UK Government's rail electrification programme, announced in July 2017.

Respondents' views

- 3.2. Five respondents did not support any change to the scope of the MPR, four of whom argued that a price control should not be opened on an issue-specific basis. These respondents further noted that any such change in scope would constitute a reopening of the price control, which would have a negative impact on investor confidence. Another considered that such issues should be dealt with by defined uncertainty mechanisms, and another noted that since rail electrification is not one of the six primary RIIO outputs or a secondary deliverable, it is therefore out of scope.
- 3.3. Two respondents, while highlighting that they do not believe rail electrification is within the scope of the MPR, noted that if Ofgem considered it appropriate to widen the scope, then it should consult on identifying other issues that would fall in that widened scope.
- 3.4. Two respondents highlighted two essential core regulatory principles: maintaining regulatory predictability, and avoiding regulatory risk. Both respondents considered that an extension of the scope MPR to include rail electrification would create a perception of asymmetric regulatory risk that would affect future price controls. Both respondents noted that WPD had agreed to take on the risk of overspend on the rail electrification projects. They also highlighted other material cost increases to WPD such as the costs of transition to a DSO that WPD were not seeking additional funding for, and that WPD had been disadvantaged on a cost of debt recovery basis by being fast-

tracked¹¹. One of the respondents considered that the implementation of Option 2 would increase the cost of equity to all energy networks to the detriment of consumers, and would reduce incentives for operators to secure fast-track status.

- 3.5. Four respondents considered that rail electrification was a direct result of changes in government policy and that there should therefore be a small extension of the MPR scope to address this.
- 3.6. One respondent explicitly disagreed with Ofgem's draft IA, specifically with the view that the extension of the scope of MPR to include rail electrification was "small". They noted that WPD has borne costs and risks associated with a number of other government decisions, also highlighting that rail electrification was not identified as an output during the fast-track process, and that no uncertainty mechanism was included to protect WPD from changes in the rail electrification programme resulting in additional expenditure. It also noted that there was a strong likelihood of further diversionary works taking place during RIIO-ED1, pointing to the Welsh Affairs Committee inquiry into the appropriate scope of rail electrification in South Wales.
- 3.7. Another respondent noted that one potential option was to extend the rail electrification reopener for slow-track DNOs to WPD, but that this should not delay the allowances being returned to consumers. Another respondent highlighted that the fast-track settlement included a mechanism to enable Ofgem to clawback unspent allowances where rail electrification costs were borne by a third party. They also noted that, as it was outside of the MPR process, it should be for the network company to evaluate whether it is appropriate to return the allowances to customers.

Our view

- 3.8. A small extension of scope would have primarily affected WPD. Its four licensees received ~£96m as part of their overall RIIO-ED1 price control settlement to cover the costs of diverting power lines to enable the electrification of rail lines. In July 2017, the UK Government announced that some projects included in the rail control period to 2019, including within the WPD network in the midlands and Wales, would not progress as previously planned.
- 3.9. Following the consultation, WPD has volunteered to return to customers the unspent capital costs that are no longer required (£77m), on the condition that it is covered for any further change in policy resulting in increased spend on diversions. This would take the form of a change to WPD's licences to give it the same uncertainty mechanism as applies to the other DNOs. This will enable

¹¹ They argue that WPD's settlement did not include the 'trombone' debt indexation (valued up to £137m) that the slow-track companies' settlements did.

it to recover any material amounts should any future work be required in response to a change in UK Government plans.

- 3.10. We welcome the decision by WPD, which is in the interests of consumers. As a result of this decision and given that no further issues were identified by any respondents under the category of 'discrete' extensions of the scope of the MPR, we do not consider there is any basis for pursuing Option 2.
- 3.11. We will implement the changes to WPD's allowances, which will take effect through the remainder of RIIO-ED1, through this year's Annual Iteration Process (AIP), and will issue a consultation on changes to WPD's licences following this decision. The effect of this will be to ensure WPD is treated in the same way as the other DNOs.

Views on Option 3 – significant extension of the ED-MPR

- 3.12. We also consulted on a wider extension of scope, to enable us to consider other issues relating to financial and incentive performance and design (Option 3). This arose following engagement with a number of stakeholders, as well as wider interest in DNO performance.

Respondents' views

- 3.13. Fourteen respondents strongly opposed extending the scope of MPR. They considered this inconsistent with Ofgem's previously stated policy, the regulatory precedent set by the RIIO-T1/GD1 MPR, and contrary to the determination made by the Competition and Markets Authority in 2015¹². All argued that the stability of the regulatory regime underpins investor confidence, and that any change in scope would create undue regulatory uncertainty, raise the cost of capital and ultimately discourage long-term investment in UK regulated entities. This, they argued, would lead to higher costs to invest in the networks and a reduced drive to deliver efficiencies, which would ultimately be detrimental to current and future consumers.
- 3.14. A number of the same respondents also noted that it would weaken trust in the regulatory regime and future Ofgem commitments. One of the respondents cited evidence from current Spanish gas and electricity network regulation, where perceived risk of unexpected regulatory changes led to negative share price reactions and an increased risk perception for both equity and credit.
- 3.15. Another cited the impact on network company share prices since the publication of the MPR consultation, and a third forecast that the potential cost to consumers of extending the scope could be in excess of £800m per annum

¹² <https://www.gov.uk/cma-cases/energy-price-control-appeal-british-gas-trading#final-determination>

over the duration of the RIIO-2 price controls (through the 2020s). This analysis assumed that a decision to extend the scope would result in a one percentage point increase in the cost of capital across all RIIO sectors, with the resulting increase in financing costs off-setting any short-term benefits to consumers.

- 3.16. One respondent did not believe the RIIO framework allows for an extension of the MPR scope as proposed under Option 3. Another respondent expressed concerns that widening the MPR could become a crude cost control exercise with negative implications for areas such as infrastructure investment, workforce training, employee remuneration and research and development, ultimately to the detriment of consumers.
- 3.17. However, one respondent considered that an extension of scope to capture financial and incentive performance and design was sensible and that they would support such an approach. Similarly, another respondent noted that Ofgem should act in accordance with its principal objective, and that if consumers could benefit from changes to the financial and incentive performance design framework, then this should be addressed through MPR or any other means.
- 3.18. Another argued that the voluntary returns in GD1 and T1 created a precedent, and that this should be formalised by Ofgem through the MPR as soon as possible. They argued that this would increase fairness and improve consumer and political trust in the RIIO framework. The same respondent sought further information on Ofgem's assessment of the quantified impacts of the proposal to extend the scope of MPR. Finally, another respondent noted that the additional issues they had identified, including those impacting financial parameters, fall within the MPR scope as currently defined.

Our view

- 3.19. We recognise the concerns raised by a number of respondents regarding the performance of DNOs under RIIO-ED1. As highlighted in our December consultation there are examples of outperformance against some incentive mechanisms, as well as significant underspends by some DNOs. Consequently, we recognise that an extension of the scope of the MPR focused on addressing financial and incentive performance and design could secure benefits from consumers.
- 3.20. We note the arguments raised by respondents regarding the costs of reopening the price control and accept that such an approach would be beyond the scope of the MPR as originally defined.
- 3.21. To assess the relative costs and benefits of such an approach, we carried out a detailed IA. This is attached as an appendix to this document. Our key findings in the IA are as follows:

- resetting incentive targets and reducing underspend could deliver consumer benefits of up to £682m in present value terms between 2019/20 and 2022/23.
- the costs associated with changes to regulatory confidence from an extension of the MPR scope are potentially significant, but also highly uncertain (potential range of £300m to £3.1 billion in present value terms across all RIIO-2 network price controls).

3.22. The assumptions underpinning this analysis are in the IA. The analysis concludes that the benefits of resetting incentive targets and reducing underspend could be completely offset by an increase in the cost of equity of 0.5% (50 basis points) or in the cost of capital of 0.2% (20 basis points). Evidence from available academic literature and from other regulatory decisions, both in the UK and elsewhere, suggests that increases of such magnitude are not unlikely.

3.23. This leads us to conclude that the benefits of maintaining regulatory confidence outweigh any short-term benefits to consumers from a widening of the scope of the MPR. By using other available levers through RIIO-ED1, including the close-out programme, this ensures that the DNOs can continue to focus on the long term and delivering the investment required by consumers at the most efficient cost possible.

4. Decision and next steps

Chapter Summary

This chapter sets out our decision on MPR, followed by our expectations of DNOs over the remainder of RIIO-ED1.

Our decision

- 4.1. Deciding on the approach to MPR requires carefully considering the costs and benefits to consumers of the different options. As an economic regulator, we need to protect the long-term interests of consumers, ensuring that network companies are able to make the investment required to deliver the services that consumers want, at the most efficient cost possible.
- 4.2. In order for the regulatory framework to be successful, this requires, among other things, regulatory stability and confidence. This ensures that customers can continue to benefit from high levels of investment, innovation and reliability at a low cost.
- 4.3. WPD's decision to voluntarily return unspent capital costs associated with rail electrification projects not currently progressing removes the need for a discrete extension of scope. Based on the consultation responses and our additional analysis, we believe that a wider extension of scope could:
 - reduce regulatory confidence and potentially increase the risk premium faced by companies, which could lead to higher costs for consumers
 - weaken incentives for network companies to outperform future regulatory settlements
 - affect our ability to recover costs later through reopener mechanisms already built into the RIIO-ED1 price control.
- 4.4. We therefore believe that maintaining the scope of MPR as defined is in the best interests of consumers. Based on the consultation responses, we do not believe that any of the issues raised warrant an MPR, so have decided not to carry out an MPR for RIIO-ED1.

Responding to a changing energy sector - DNO commitments

- 4.5. Another facet of our decision to maintain the existing scope of the MPR is a recognition of the value DNOs can deliver without the requirement for new or amended outputs or any additional allowances.
- 4.6. We recognise that the energy sector is facing a period of unprecedented change. The energy system is evolving, especially with regard to the services and flexibility that network and non-network companies can provide. There are

also major changes expected on the demand side, with increasing uptake of technologies such as EVs and smart meters. We need to ensure that the critical infrastructure and the right regulatory framework are in place to facilitate this transition, and the DNOs have a key role to play in this.

- 4.7. In a number of their consultation responses, the DNOs made commitments to use existing allowances under RIIO-ED1 to deliver emerging commitments and drive forward GB's move to a smarter, more flexible energy system.
- 4.8. Following the consultation, we encouraged the DNOs to develop and confirm these commitments. The key points raised are below. Although these areas broadly align with those that we identified against Option 1 in our consultation document, responses did vary by DNO. This is not unexpected, as we recognise that the issues facing each network are different. However, where DNOs face the same challenges, we expect them to be consistent and look to best practice in managing these areas.

Whole System Outcomes/DSO Transition

- 4.9. We welcome the clarity the DNOs have provided about their intended actions to deliver against their outputs and responsibilities in the context of the evolving energy system. These actions are not exhaustive, and we encourage the DNOs to continue to focus on maximising the benefits they can deliver for consumers.
- 4.10. As signalled in our Smart Systems and Flexibility Plan¹³, DNOs already have incentives and obligations in RIIO-ED1 to develop timely reforms to the way they plan and operate their networks. The industry is working collectively under the Open Networks¹⁴ project to develop responses to meet the needs of the changing system, and we welcome their continued focus through this programme.
- 4.11. We expect the DNOs, alongside other licensees, to continue to engage to support progress in delivering whole system outcomes and improved access to the networks. We expect to see the outputs of their thinking being built into their business-as-usual practices where they can deliver early benefits for customers, and continued, constructive engagement with industry programmes (such as our work on Network Access Reform¹⁵).

¹³ <https://www.ofgem.gov.uk/publications-and-updates/upgrading-our-energy-system-smart-systems-and-flexibility-plan>

¹⁴ <http://www.energynetworks.org/electricity/futures/open-networks-project/>

¹⁵ <https://www.ofgem.gov.uk/publications-and-updates/reform-electricity-network-access-and-forward-looking-charges-working-paper>

EVs

- 4.12. The uptake of EVs is expected to increase over the remainder of RIIO-ED1. Broadly, the DNOs acknowledge that they need to ensure the networks can handle the anticipated volumes of connections, and will make sure the systems and processes are in place to manage the increased load.
- 4.13. We welcome the DNOs' commitments to manage these risks, but we do not consider this to be beyond their current requirements. DNOs are legally required to offer a connection to customers that want to connect to their networks. This, combined with a package of incentives that encourage DNOs to consider the needs of customers connecting LCTs and Distributed Generation, pushes DNOs to deal with increasing load from LCTs without overloading the network or increasing network capacity unnecessarily. We expect DNOs to consider newer, more flexible solutions where appropriate.
- 4.14. We recognise that there are uncertainties within the price control. This is why we included a number of uncertainty mechanisms (including the Load-Related Reopener), to accommodate new and changing patterns of customers' electricity use (both increases and decreases in demand on the network).

Smart meters

- 4.15. Due to the delay in the roll-out of smart meters, the DNOs are likely to face different challenges from those expected at the beginning of the price control. DNOs acknowledge that it is their responsibility to manage these challenges as they appear.

Resilience

- 4.16. DNOs are likely to need to carry out additional work to ensure the networks are resilient to different threats (including cyber and flooding) over the remainder of RIIO-ED1. Some of this work has already started, but several DNOs have committed to ensuring that the changes coming from government and/or EU reviews will be delivered within their existing settlements.
- 4.17. We welcome these commitments, again noting that we do not consider these to be beyond their current requirements. Maintaining a secure and reliable network is core to a DNO's role, and we expect them to adapt as the nature of threats changes.

Potential consumer benefits

- 4.18. Taken together, these commitments represent significant potential benefits for GB consumers. The DNOs currently estimate that these activities will provide consumers with value of over £600m through the remainder of RIIO-ED1. Further, they will ensure that the DNOs play a central role in the energy system transition. The approximate breakdown of this value is outlined here.

Table 1: Overview of areas of investment

| Area of investment | Estimated value (£m) |
|---|-----------------------------|
| Whole System Outcomes/DSO Transition | 227 |
| Resilience – including flood prevention, cyber security and Black Start | 168 |
| EV roll-out | 85 |
| Smart meters | 9 |
| Additional investment in network assets including the additional protection and replacement of assets | 111 |
| Other – including visual amenity and protecting vulnerable customers | 20 |
| Total | 620 |

4.19. We welcome the clarity the DNOs have provided about their intended actions to deliver for GB consumers, but note that these are not exhaustive. The nature of the challenges that DNOs will face over the remaining years of RIIO-ED1 remains uncertain. One of the main benefits of the Totex approach is that it gives companies the flexibility and control to manage the issues that affect their networks in the way that best suits consumers. Overall, where new challenges arise during RIIO-ED1, we expect DNOs to manage these challenges within their existing settlements. We expect this to be reflected in spending levels through the remainder of RIIO-ED1.

4.20. Given levels of uncertainty with the specific nature of the sector transition, we do not consider it appropriate to place specific obligations on DNOs to deliver these commitments. We will, however, closely monitor performance in these areas, and we expect the DNOs to demonstrate the delivery of equivalent value as a minimum.

Next steps

4.21. We will work with WPD to give effect to the voluntary return of the £77m of rail electrification funding through this year's AIP. We will shortly issue a consultation on changes to WPD's licences to ensure it has the equivalent treatment as other DNOs should any future work be required in response to a change in the UK Government rail electrification programme.

4.22. We will continue to closely monitor DNO performance, including in relation to their commitments to use existing allowances to deliver more for GB consumers.

4.23. We have a number of mechanisms available through the remainder of RIIO-ED1, including the close-out process, and will continue to take action where it is in the best interests of GB consumers.

Appendices

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Appendix 1 – List of consultation respondents

1.1. There were 18 responses to the consultation. One response was marked confidential, either in whole or in part. The following table provides a list of the respondents.

Respondents to the RIIO-ED MPR consultation

- 1 1 x CONFIDENTIAL
- 2 Cadent
- 3 Centrica
- 4 Citizens Advice
- 5 Drax
- 6 Energy Networks Association
- 7 Electricity North West
- 8 E.ON
- 9 M&G Investments
- 10 National Grid
- 11 Northern Gas Networks
- 12 Northern Powergrid
- 13 PPL
- 14 Prospect
- 15 SP Energy Networks
- 16 Scottish and Southern Energy Networks
- 17 UK Power Networks
- 18 Western Power Distribution