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Our ref

Your ref

Date

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Dear James

Consultation on the RIIO-2 Framework

I am writing on behalf of Western Power Distribution (South Wales) plc, Western Power Distribution (South West) plc, Western Power Distribution (East Midlands) plc and Western Power Distribution (West Midlands) plc. The attached documents set out Western Power Distribution's (WPD) full response to Ofgem's consultation of 7th March on the RIIO-2 Framework.

Despite only having two full years of reporting available in the current price control, it is clear that RIIO-ED1 is delivering good outcomes for consumers. Customers are receiving the highest level of service and performance from the networks and electricity interruptions are at an all-time low. Thus RIIO-2 should build on the success of RIIO-ED1 and maintain the principles of good regulation.

Applying the core principles of good regulation is essential in RIIO-2. The overall balance of risks, rewards and incentives needs to be considered holistically, as a price control "in the round", and hence it is important the overall package is assessed, rather than looking at component parts in a piece-meal way, to ensure that adverse unintended consequences do not arise.

In developing the price control in the round, WPD agrees with Ofgem that there is scope in RIIO2 to improve customer engagement; that the Innovation schemes should be retained, that there needs to be a whole system approach to the price control setting; and incentive schemes should be refined and developed.

Extending the period of the price control to eight years has contributed to the success of RIIO. Licensees have had more opportunity to apply leadership focus on how work programmes are delivered, to innovate and to more effectively manage and resource changing business needs. Consumers continue to share in the benefits from these new ways of working.

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High quality business plans are key to the success of RIIO. Retaining the Information Quality Incentive and fast-tracking processes are significant drivers to companies providing good plans, which subsequently assist Ofgem in its assessment and delivering better outcomes for consumers.

Ofgem's overall toolkit for cost assessment will continue to evolve for RIIO-2, building on the wealth of data it collects annually from Licensees. One area of focus is real price effects and WPD considers that annual indexing of RPEs could be helpful in bringing greater accuracy to cost allowances with respect to both over and under performance.

However, Ofgem's proposals to introduce relative performance schemes would create uncertainty and risk, adding to the complexity of RIIO, and undermine incentives. Relative performance targets that move within a price control do not provide certainty of outcome at the time of decision making and hence are likely to drive the wrong behaviours. Relative performance schemes also expose companies to errors made in setting targets for other companies, creating risks that are beyond their control. The additional uncertainty and risks of such schemes would concern investors and need to be compensated for through a higher cost of equity.

CEPA's estimates of the total market return (TMR) and asset Beta are materially flawed, as demonstrated in our full report. Errors made by CEPA in estimating the TMR and erroneously benchmarking the asset beta have led to a lower proposed cost of equity than the information supports.

On indexing, WPD does not support indexation of the cost of equity, it is not necessary and consumers would potentially suffer from greater volatility in prices if the cost of equity is indexed. Secondly, any change in the inflation index for price setting purposes should be neutral in net present value terms and hence a transition from RPI to CPI must be carefully managed to avoid creating unanticipated costs.

Finally, WPD's view is that the current estimates of the cost of equity raise serious financeability issues and Ofgem should revisit CEPA's analysis of the cost of equity.

WPD is keen to ensure that RIIO-2 is successful. We therefore wish to engage with Ofgem in a constructive dialogue both in the context of this consultation and more broadly to achieve this.

Further information regarding our response to Ofgem's consultation on the RIIO-2 Framework is set out in the attached paper and annexes.

Yours sincerely



Paul Branston
Regulatory & Government Affairs Manager