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Dear Dermot

Re: RIIO-2 Sector Specific Methodology consultation

Electricity North West (ENWL) appreciates the opportunity to respond to this important consultation on the application of the RIIO-2 Framework to those sectors whose price controls are due to commence in 2021. Our interest stems from our understanding that the same broad design principles that inform the methodology for these sectors could apply to ED2 and that the starting point for considerations of ED2 could be the decisions made for these sectors.

Our detailed response to the Cross-Sector Methodology consultation and the accompanying sector-specific materials is provided in 5 appendices to this letter. This response should also be read in light of previous correspondence in relation to RIIO-2.

We acknowledge the engagement we have had with Ofgem to date and look forward to the continuation of this. We support many of the proposals in the Cross-Sector Methodology as described in Appendix 1 to this letter. However, we remain extremely concerned that there are a number of areas in the Finance Annex, as described in Appendix 2, where Ofgem's proposals are inappropriate or suffer from a lack of detail. I believe these problems stem from a few fundamental issues that I address in summary form below.

1. The protection of the customer interest must not be too narrowly focussed on price reductions for current customers only. It appears that current concerns around energy costs may result in an over-correction of perceived errors at the expense of required investment in RIIO-2 and subsequent controls. The consideration of future customers interests appears to be largely absent from the consultation document. Furthermore, the protection of the customer interest through the continuing provision of patient, private capital to the energy networks appears to be risked by a series of overlapping measures without consideration of the overall effect.

The Acts of Parliament that privatised the energy sectors and created GEMA's duties were specifically developed to recognise that customer's long term interests are best served by the ongoing attraction of patient, low priced debt and equity. Multiple measures such as reductions to the cost of equity, sector average funding for the cost of debt, return adjustment mechanisms, high hurdle rates for change, limited incentives and cash-flow floors all increase the perception of risk and jeopardise the continuing provision of this essential customer benefit.

My concerns about this issue are heightened by the potential for the transition to the low carbon economy to require increasing investment in ED2 and beyond to coincide with an increased perception of risk for investors in the electricity distribution sector.

Whilst I appreciate the pressure GEMA is under in conducting this review; a course of action that acts to rethink the basis for financing this industry cannot be continued without widening this debate to the whole of Government. Global investment into this sector has been a huge success for thirty years (no matter if the Secretary of State was Labour, Conservative or Liberal Democrat), and policy departures that change this will need as wide an audience and as strong an evidence-based case for change as possible.

2. It would be disappointing if Ofgem's new approach was undermined by an inadequate process. Given the breadth and depth of consultation currently being undertaken, we are unclear how Ofgem expects to be able to meaningfully consider all contributions prior to reaching its decision on the Sector Specific Methodology in time for a May 2019 publication. Similarly we are concerned that the Impact Assessment developed to date does not follow Ofgem's own Impact Assessment Guidance and would not be sufficient quality to be acceptable to Ofgem as justification for investment by a licensee.

3. All relevant stakeholders must retain an unhampered right to appeal in accordance with Section 11c of the Electricity Act 1989 and Section 24b to the Gas Act 1986. The text in paragraph 2.20 setting out what Ofgem may do in the event of a successful appeal is unclear and can be read to imply that Ofgem is considering options that may, inadvertently or otherwise, be ultra-vires or dilute the statutory rights of licence-holders. Further clarity is required on the intent of this paragraph as a matter of urgency.

4. Ofgem's approach to Financeability needs to be in accordance with its statutory duty with regard to both individual licence holders being able to finance their activities and that licensees can secure both debt and equity finance. Whilst we note that this duty is stated in both para 10.60 and then para 4.1 of the Finance Annex, the proposals to put the onus on companies to ensure financeability and to introduce a Cashflow floor do not adequately discharge this statutory duty in the event that Ofgem's Finance proposals fail to give due consideration to the actual impacts for a specific licensee. Adopting a simplistic, all sector approach could easily result in efficient companies which suffer from higher financing costs by accident of timing becoming unfinanceable, thereby increasing the perceived risk by investors of the sector, to the detriment of customers.

We also remain concerned that Ofgem's proposals for a Cashflow floor seek to protect the interests of debt holders to the detriment of equity holders. We do not believe this is appropriate as equity as well as debt investment is needed in any efficiently financed company as Ofgem has made clear.

5. Customer and Stakeholder contributions to the Business Planning process should be valued by Ofgem and network companies. The document indicates to us that Ofgem will set a very high bar on the acceptability of bespoke mechanisms and applications proposed by network companies. Furthermore, ongoing engagement on the development of a single, GB-wide scenario for the future decarbonisation indicates this requirement for conformity may be extended to forecasts for the rate of change across the sector. Given the importance the RIIO-2 Framework is rightly placing on enhanced engagement with customers and stakeholders, it is vital that licensees are able to gain regulatory support for bespoke approaches that respond to the needs of the customers they serve or reflect specific circumstances in their regions. Ofgem must avoid seeking a 'common denominator' as this has the potential to undermine the balance established between a licensee and its customers.

Ofgem needs to be clear that customers and stakeholders are not the same and that customers may set different priorities in different regions.

As Ofgem's duty is to protect the interests of consumers, it needs to ensure that its decision making is not unduly influenced by the views of stakeholders. Stakeholder views are important to ENWL but we have been rightly challenged by the Chair of our Customer Engagement Group that these should be validated by customer views. Appropriately valuing and balancing the contributions from customers and stakeholders will increase the legitimacy of network companies' plans in the eyes of consumers as they will be able to clearly see how our service meets their needs and understand any associated bill impact.

6. Customers and network companies should not be 'held hostage' by the decisions of other sector participants. Proposals for cross-sector averages (such as proposed for Gas Distribution Return Adjustment Mechanisms) and 'pots' (such as for the Business Plan Incentives) place customers at risk of price changes that are unrelated to the performance of the network they utilise and licensees at the risk of poor decisions by other licensees. Customers should not be exposed to volatility in prices driven by the performance of companies that they do not engage with. Prices should not increase if other companies make mistakes in their business planning. Similarly, ENWL cannot control the Business Plans submitted by other DNOs and so should not be exposed to a risk that its revenues are adjusted if others perform too well or too poorly. We can have no idea how ambitious (or not) other companies plans may be, yet the current proposals tie our potential incentives and ultimately our returns to the levels of ambition in those plans and how effectively other management teams deliver against them.

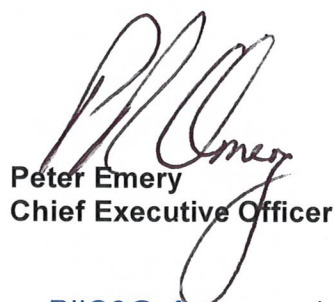
Given the six significant issues that I observe within the RIIO-2 consultation to date, principally revealed within the Financing Annex, I would welcome confirmation in the May decision document that the approach to ED2 will be a stand-alone process that is:

- Based on specific consideration of how RIIO-ED1 has performed for consumers and consumer needs and willingness to pay;
- not fettered by precedent determined for the electricity transmission or gas distribution and transmission; and,
- allows plenty of consultation time in which to develop a specific methodology.

I remain convinced that these issues can be overcome and hope that with further engagement I can help you to achieve an appropriate resolution.

If you have questions on any element of the response, please do not hesitate to contact me or Paul Bircham (paul.bircham@enwl.co.uk).

Yours sincerely



Peter Emery
Chief Executive Officer

cc RIIO2@ofgem.gov.uk
cc Professor Cave

Encs:

- Appendix 1 - Response to Cross-sector questions
- Appendix 2 - Response to Finance questions
- Appendix 3 - Response to Electricity System Operator questions
- Appendix 4 - Response to Gas Distribution annex
- Appendix 5 - Response to Electricity Transmission