

**By E-mail**

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Your ref

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Date

1<sup>st</sup> May 2019

Contact / Extension

Malcolm Bebbington  
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Dear Mark,

**Consultation on the closeout methodologies for RIIO-ED1**

We welcome the opportunity to respond to Ofgem's RIIO-ED1 closeout methodologies Consultation published on the 20<sup>th</sup> March 2019. It is helpful that this work is being done now, well ahead of the close-out of the period. The proposed methodologies and drafting reflects the significant effort invested by all parties in the working group to-date.

The development of the closeout methodologies has been a transparent collaboration between the network companies and Ofgem and builds on extensive work undertaken in this area to close out the DPCR5 price control. These methodologies establish a common understanding and define the basis for assessment of outputs and DNO performance relating to six uncertain cost areas at the end of RIIO-ED1.

This letter and our responses in Annex A, set out the key points we would like Ofgem to consider.

**Load Related Expenditure**

The load related mechanism does not and was never intended to deal with changes in government policy, and for example, will not facilitate the investment ahead of need required to enable Scottish Government targets for electrification of transport. As a result of government policy and market changes, EV uptake in Scotland will be much earlier than originally anticipated. Our CEO has written to Ofgem in relation to this and it has been discussed in bilateral meetings on a number of occasions.

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### **Network Asset Secondary Deliverables**

The methodology for the reopener for Network Asset Secondary Deliverables assesses delivery to be on target where the performance is within a pre-defined deadband. The extent of this deadband has not been finalised in the methodology being consulted upon. Our view is that the Authority must make a final determination of this deadband and include it within the finalised methodology.

We consider a symmetrical deadband of +5/-5 percent of the system wide monetised risk target (included in the examples in Appendix C) to be appropriate for the ED sector. This equates to approximately 1 percent of allowed revenue, in line with other reopener mechanisms. The close out process is supported by a detailed Performance Report including enabling qualitative checks at asset category level.

### **Areas of cost uncertainty not included within the consultation**

There are no established mechanisms for the close out of uncertain cost activities associated with Specified Street Works Costs (UCSSW in CRC 3F) or Rail Electrification Costs (UCRE in CRC 3F). We look forward to continuing to work with you on this.

As you will be aware, new obligations associated with equipment containing Polychlorinated Biphenyls (PCBs) will mandate interventions on our equipment which was unforeseen ahead of ED1. This is an example of a regulatory change that would have been captured by a mid-period review. It is our (and other DNOs) intention to bring forward proposals for Ofgem to consider to enable the funding of this programme in ED1 and ED2.

### **General Financial Adjustment Methodology**

For consistency and continuity through price controls, the general methodology for revenue and RAV adjustments should be worded as similarly as possible to the already established DPCR5 close-out calculations, for example DPCR5 Load Related Expenditure. The proposed general adjustments outlined in Annex E will not correctly true up revenue as suggested as it fails to account for the return component and is therefore not value neutral.

We are also concerned by the potential timing impacts of revenue adjustments. Despite the methodology spreading the impact over the 5 years of ED2, the actual impact on revenue could be over as few as 2 years, as explained further in Annex A.

As there is currently no ED2 financial model or close out workbook, the financial adjustment methodologies and impacts may change as policy develops. Therefore we would expect the flexibility to amend the calculation steps accordingly.

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## **Conclusion**

We believe that the proposed methodologies demonstrate the significant effort invested by all parties in the working group to-date. We look forward to continuing to work with Ofgem on the points above to ensure that ED1 can be closed out efficiently.

If you have any queries on this response or any further questions, please do not hesitate to contact me.

Yours sincerely,



Malcolm Bebbington

**Distribution Network Manager**

SP Energy Networks

## **Attachments:**

Annex A: Detailed responses to questions included within the Ofgem consultation document

## **Annex A**

### **Load Related Expenditure**

**Question 1: What are your views on our proposed approach to assessing the impact of demand changes, and the cost of reinforcement or alternative solutions?**

We agree that the proposed approach is consistent with ED1 policy and provides a clear understanding of how this will be applied. However, this mechanism was never intended to deal with changes in government policy, and for example, will not facilitate the investment ahead of need required to enable Scottish Government targets for electrification of transport. As a result of government policy and market changes, EV uptake in Scotland will be much earlier than originally anticipated. Our CEO has written to Ofgem in relation to this and it has been discussed in bilateral meetings on a number of occasions.

We agree that the Net to Gross adjustment should only be made where there is no adjustment made under the Load Related Reopener.

We agree that Load Indices should be used as part of the assessment of efficient load related expenditure, but not as a standalone close-out mechanism. We look forward to working with Ofgem and stakeholders to collectively develop enhanced metrics in this area.

Some minor amendments on Section 2:

Para 2.4 – Amend “additional costs exceed the relevant materiality threshold” to “additional costs exceed *the deadband plus* the relevant materiality threshold”.

Para 2.6 – Amend “expenditure *up* to the deadband” to “expenditure *within* the deadband”.

Some minor amendments on Annex A:

Para A.15 – Amend “steps 4 and 5 above” to “steps 3 and 4 above”.

**Question 2: Do you agree with our proposal to build on the approach taken at DPCR5 Closeout for load? Do you agree with our proposed approach?**

We agree with incrementally building on the DPCR5 approach to implement ED1 policy, subject to the points raised in our responses to question 1 and question 3.

**Question 3: Do you agree with our approach to load indices (LIs)? Is there an alternative you believe we should use?**

We agree with Ofgem's approach. LIs should be used as part of the assessment of efficient load related expenditure, but not as a standalone close-out mechanism.

Setting targets for LIs would not provide a robust way to measure DNO's performance in ED1. LIs are a useful tool when assessing demand driven reinforcement, however they cannot be used to assess reinforcement requirements driven by increasing generation or fault level. Furthermore, the use of innovation such as active network management and flexibility solutions are not adequately captured by the current LI reporting.

We look forward to working with Ofgem and stakeholders to collectively develop enhanced metrics to cover a wider variety of reinforcement drivers (including generation and fault level) and interventions ahead of RIIO-ED2. This work should also focus on ensuring that DNOs have a reasonably consistent approach to the level of acceptable risk associated with network loading, especially as networks become more complex with advanced management techniques operating in real-time.

It is our view that as part of the qualitative LRE assessment, DNOs should be required to explain why any significant under-delivery against their LI position was justified and in the best interests of customers.

**Network Asset Secondary Deliverables**

**Question 4: Do you agree with our proposal to build on the approach taken at DPCR5 Closeout for NASD?**

See response to Question 5.

**Question 5: Do you agree with the manner in which we have developed the DPCR5 approach? Is there an alternative approach you believe we should use?**

We agree with the proposed approach subject to the points outlined below.

Significant advancements have been made in the NASD area since DPCR5. During ED1, the distribution network companies have developed and implemented a common method of assessing

asset risk in monetary terms – using a combination of asset condition and the monetised consequences of failure. Targets for all companies were re-based in 2017. This approach to asset management has been embedded through-out our organisation. We firmly believe a condition based approach, ranked on consequence, provides a robust and scientific tool to help inform prioritisation and efficient asset management practice. It must be viewed within the wider obligations network companies have a duty to fulfil including ESQCR, Health and Safety, environmental and security of supply obligations. In the long term interest of customers, network companies must continue to have the ability to select the most appropriate interventions to effectively manage network risks.

### Monetised Risk Deadband

We require clarity on the level of the NASD pre-defined deadband for evaluation of over/under delivery. We also believe Ofgem should provide clarity in the process and methodology through which the level of this deadband will be determined.

We agree with the use of a deadband around the NASD monetised risk target to assess compliance. A symmetrical deadband of monetised risk is useful to protect customers and network companies from the substantial resource costs required to run Stage 5 to Stage 7 of Annex C of the RRP in instances where the over/under-delivery is of such a scale that cannot be offset by the cost of running the process.

Our experience from DPCR5 closeout also supports that there is little or no benefit to be gained by customers through running the detailed over/under-delivery assessment for small deviations from target. The +5/-5 percent deadband of the system wide monetised risk target (included in the worked examples in Appendix C of the consultation) results in a magnitude that, for ED equates, to approximately 1 percent of allowed revenue. This is in line with other reopener mechanisms and we believe it provides an appropriate deadband level. The close out process is supported by a detailed Performance Report including enabling qualitative checks at asset category level.

### Timing Profile of Revenue Adjustments

We understand the general approach in timing profile adjustments in other closeout mechanisms is to be based upon allowances. Our understanding is that the approach for NASD closeout differs slightly as a component of the adjustment is to mirror the timing profile of actual expenditure rather than allowances.

Page 17 of Ofgem's Network Output Measures (NOMs) Incentive Methodology (6 December 2018):

*“In the case of a justified over-delivery or unjustified under-delivery, once the associated costs of over/under delivery of NOMs are valued, Ofgem will profile the total across the price control period using the following method:*

- 1. Where the exact timing of specific over/under delivery of NOMs can be identified, in line with the actual timing of the expenditure/avoided expenditure; and*
- 2. Where the exact timing cannot be identified, in line with the Licensee’s total NOMs-related expenditure profile.”*

We require clarity on whether the NASD closeout adjustment (section 3.9) is to be profiled based on actuals, allowed expenditure or a combination thereof.

#### Interaction with HVPs

In the light of potential interaction between HVP and NASD closeouts, we also believe that it is useful to state explicitly that the closeout of HVP is evaluated prior to NASDs.

In conclusion, we agree with the manner Ofgem developed the NASD closeout approach. We believe that the ED NASD incentive/penalty mechanism (and closeout process) provides both sufficient freedom for network companies to manage asset risk, and sufficient clarity for the authority to hold network companies to account.

#### High Value Projects

##### **Question 6: Do you agree with our proposed approach to HVPs?**

We agree with the proposed approach.

##### **Question 7: Do you agree with our treatment of the interaction between HVPs and NASD for assessing an outputs gap for non-load related HVPs?**

We agree with Ofgem’s proposed approach.

The methodology would benefit from clarity on whether the HVP closeout adjustment is to be profiled based on actuals or allowed expenditure, as detailed in our response on NASD in Question 4.

#### Link Boxes and Shetland

##### **Question 8: Do you agree with our proposal for assessing link box volume delivery?**

We agree with the proposed approach.

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Following tri-lateral work between Ofgem, SPEN and UKPN, we believe that the proposal is a suitable and simple methodology for assessing volumetric delivery of link boxes for both companies.

**Question 9: Do you agree with our proposal for assessing Shetland costs?**

We agree with the proposed approach.

**Financial Adjustment Methodology**

Annex E: General Financial Adjustment Methodology

The method outlined in Annex E will not correctly true up revenue as suggested as it fails to account for the return component and is therefore not value neutral.

We believe that Steps i to iv in Annex E are correct. The following steps adopt the DPCR5 Load Related Expenditure close out calculation methodology from the current ED1 Financial Handbook:

- v. *The values obtained under step (iv) will be multiplied by 20% to calculate ED1 Fast Money amounts for each Regulatory Year in ED1*
- vi. *The values obtained under step (iv) will be multiplied by 80% to calculate ED1 Slow Money added to RAV*
- vii. *The values in (vi) are used to calculate:*
  - (a) *an amount of depreciation (being annual values calculated at the applicable asset life value); and*
  - (b) *an amount of return, at the applicable regulatory year WACC for each year of ED1.*
- viii. *The values obtained at steps (v) and (vii) will be summed to give a total value for each Regulatory Year of ED1*
- ix. *ED1 Time Value of Money adjustments will be applied to the values calculated under step (vii) to put them on a common 2023/24 time value basis and the values will then be totalled.*
- x. *The total revenue calculated in (ix) will be spread evenly across the years of the ED2 price control.*
- xi. *The Closing RAV adjustment calculated in (vii) will impact the opening ED2 RAV.*

Timing impact on revenue

Close-out adjustments proposed for inclusion in November 2023s Annual Iteration Process (AIP) will impact the allowed revenue for 2024/25; however we will have already set Use of System Charges (in December 2022) in accordance with our DCUSA obligations under Section 19. The first full impact will be trued up in 2025/26 (potentially year 3 of ED2). Similarly the November 2024 AIP adjustments will be trued up in 2026/27, year 4 of ED2. Despite the methodology spreading the impact over the 5 years of ED2, the actual impact on revenue may be over as few as 2.



Details of the financial adjustment methodologies and impacts may change as the ED2 financial model or close out workbook are developed. Therefore we would expect the flexibility to amend the calculation steps accordingly.