

Sector Specific Methodology Consultation response

Annex 3: Keeping Bills Low

September 2020



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1 Approach to Aggregated Econometric Analysis

Q1 Do you agree with our proposal to include totex benchmarking in our toolbox for cost assessment in RIIO-ED2?

We support the use of totex benchmarking as part of the cost assessment toolkit for RIIO-ED2, but Ofgem needs to be careful not to put undue weight on it as it tends to incentivise lowest cost and disregard quality of outcomes for customers.

We were concerned to observe the overreliance on a single totex model as observed in the Draft Determination (DDs) for RIIO-GD2. The use of a single top-down totex regression model to establish the majority of the cost baseline (c.84%) for the industry is out of step with regulatory best practice in PR19 and that utilised in RIIO-ED1.

It is generally accepted that there is no single perfect econometric model. Ofwat concluded as part of the PR19 framework that *“All models are subject to error and a degree of bias. In many instances, it is not possible to identify a single “preferred” econometric model that clearly prevails over all others. To mitigate risks of error and bias we [Ofwat] do not rely on a single model. Rather, we [Ofwat] use a diverse set of models, with different drivers and different levels of aggregation, in triangulation.”*¹

This mirrors the RIIO-ED1 approach where totex models were collectively limited to a 50 percent weighting in the overall slow-track assessment. We are not necessarily suggesting a 50 percent weighting to a totex model at this stage, but that work is done to establish a robust modelling approach.

We suggest a more holistic approach for RIIO-ED2 that uses both top-down and bottom up regression models, including the consideration of middle models, as well as non-regression or disaggregated modelling where appropriate.

Totex models can be complemented through the targeted use of disaggregated modelling techniques, such as including unit cost modelling where there are distinct costs and activities where cost trade-offs don't exist, and where justified differences between companies occur which can't be explained or appropriately accounted for through cost drivers in econometric totex regression models. In essence, multiple models, and modelling methods, which are aggregated or triangulated should be considered to account for the inevitable and unavoidable imperfect assessment process and individual model imperfections.

Q2 What cost drivers do you consider appropriate for our proposed totex benchmarking? Why?

In terms of the application of totex benchmarking, we consider that Modern Equivalent Asset Value (MEAV) continues to be the most appropriate approach as used in RIIO-ED1. Most of our current costs are a function of the current asset base and need to be assessed in that context. Despite extensive discussion in the Ofgem RIIO-ED2 Cost Assessment Working Group (CAWG), no viable alternative has currently been demonstrated.

We do suggest that the benchmarking of future costs needs to consider future drivers, particularly in specific areas. This will have particular relevance in the area of future demand management and DSO

¹ Supplementary technical appendix: Econometric approach, pg.5, Ofwat, January 2019

functions, where there may be limited impact on MEAV through non-asset solutions but still with associated efficient costs incurred.

Due to the inability of totex approaches to appropriately consider the quality of outcomes, we believe it needs to be supplemented with other forms of econometric analysis including disaggregated modelling as set out in our answer to Q1.

Q3 What are your views on the use of both historical and forecast data in our modelling?

We consider that the ED sector is relatively well placed in this regard, and more so than at RIIO-ED1, due to the stability of the RIGs over an extended period of time. However, Ofgem needs to ensure data comparability, particularly if reaching back into DPCR5 where confidence in the comparability of data reduces.

There are elements of the cost base where history is a guide to future requirements and historical data as the basis for this trend analysis can be a useful component of the assessment toolkit. We would highlight however that there are other significant areas where history is a very poor indicator of future costs especially in a changing operating environment, e.g. Net Zero, decarbonisation and flexibility, or where other legislative changes or regional differences may be driving a divergence in costs from those observed historically. In these areas, spend patterns in 2010 have little to no relevance to the challenges of 2028.

Our particular concern is on the potential application of any 'lesser of' approaches in areas where history is a poor guide. Ofgem should exercise extreme caution in this area.

Q4 At what level should we set the efficiency benchmark?

We consider that the benchmark should be set at the Upper Quartile (UQ), in line with previous practice.

We note that the RIIO-GD2 Draft Determination has used the 85th percentile but we do not support this. This is a reaction to the overall levels of underspend observed in that sector over RIIO-GD1, however, the use of a more stringent benchmark suggests a level of modelling accuracy that is unlikely to be supported by a single top-down totex regression model that covers the majority of the cost baseline as used in RIIO-GD2.

Therefore, Ofgem should think carefully about using such analysis to support the use of a more stringent benchmark, especially given the context in ED. Delivery of efficiencies in the period of RIIO-1 will be due to a mixture of reasons and not necessarily, and certainly not in RIIO-ED1, be because the benchmark used wasn't stringent enough. Interlinkages with other regulatory mechanisms such as the lowering of the totex incentive mechanism (TIM) will also change the dynamics and incentives for companies in RIIO-2.

Of further note is that in the CMA's redetermination of PR14 with regard to the Bristol Water review where it used an average benchmark as it considered that the use of an UQ benchmark may overstate inefficiency. This is particularly important where modelling is solely reliant on single methods and models and where the techniques used can't distinguish between modelling 'noise' and genuine inefficiency.

As the RIIO-ED2 price control is not commencing until 2023, Ofgem should take the opportunity to fully digest the insights from the CMA made for PR19 redeterminations and consider their application in the cost assessment process for RIIO-ED2. The use of more stringent than UQ efficiency benchmarks are being reviewed as part of these appeals. It is therefore important that the framework and future policy positions taken as part of RIIO-ED2 are made mindful of the CMA insights, but independently of other sectors and considering the evidence and unique circumstances for RIIO-ED2 at the individual licensee level. The decarbonisation challenges as well as the transformative changes required are not inherently part of the water sector as they are in energy.

Q5 Do you agree with the proposed criteria for developing cost pools for a middle-up approach?

We agree that the approach set out in the consultation appears a sensible basis for a middle-up approach and that the CEPA criteria appear appropriate.

Q6 What cost drivers would be appropriate in a middle-up approach?

This primarily depends on the categorisation within any middle-up approach as the cost drivers need to be appropriate for each category. We suggest that the equivalent practice in RIIO-ED1 is used as the precedent unless there is clear evidence to change.

Q7 What are your views on the CEPA developed totex and opex plus approach? What opex activities are there trade-offs that support the rationale for testing 'totex and opex plus' modelling?

We support a toolkit approach to cost assessment as there is no one 'correct' way of making such an assessment. If the totex and opex plus approach meets the criteria outlined and provides intuitive results that make economic sense and has strong explanatory reasoning, then we are happy to support such a method as part of the toolkit.

Q8 Do you believe it is appropriate to use bottom-up, activity-level, disaggregated modelling in RIIO-ED2?

We agree the use of bottom-up models is complementary to the totex approach, particularly in areas where a separate output applies (e.g. NARM), or where the DNO is proposing novel, stakeholder-supported investment.

Q9 If we use a combination of aggregated and disaggregated modelling approaches, how should we determine the weight we apply to each, in combining our analysis?

We suggest that Ofgem considers the combination of totex and disaggregated (disagg) modelling in two ways:

1. Assessing the same areas of the cost base and triangulating the results (as per RIIO-ED1); and

2. A hybrid approach where the cost base is split into areas covered by totex and disaggregated models and the results are added. This would allow flexibility for areas of output difference between DNOs to be fairly assessed using a disaggregated approach with reference to supporting Cost Benefit Analysis (CBA) and Engineering Justification Papers (EJP).

It is possible to have a distinction between costs and the methods of how they are assessed i.e. the use of cost pools. In this situation (i.e. 2.), there is no need to consider the method of aggregation between cost items or pools as it would be simply an addition. This approach can be observed in PR19 where base costs and enhancement costs were assessed, broadly speaking, on a totex basis and a disagg basis respectively and then combined to give a totex allowance for the period.

Where multiple models or methods assessing the same cost pool are used in approach 2. these would require combining, or triangulating. As discussed, our preference is that Ofgem does not rely on a single cost model for any item as, such in this scenario, aggregation of multiple models within cost pools will be required. Our preference is that this is done on a straight average weighting depending on the number of models included (i.e. three models would each be given equal weighting of c.33 percent). Any deviation away from equal weighting by Ofgem should be clearly signposted, justified and evidenced as to why this decision has been taken.

Q10 If we did not use disaggregated modelling approaches, what approach should we consider for disaggregating totex allowances for the setting of PCDs?

We propose the use of disaggregated modelling for setting PCDs to ensure clear linkages between the deliverable and the allowed costs to deliver them without relying on inferencing or extrapolating the results of an overarching totex assessment approach.

2 Model specification

Q11 What model estimation options should be considered for our cost assessment and why?

We suggest that further effort should be focused on reviewing the Random Effects (RE) approach as this looks at time variance. The Ordinary Least Squares (OLS) approach allocates all noise to inefficiency which may not be the case and therefore the exploration of more sophisticated model estimations options is worthwhile where the data available supports it, and it has discernible benefit to the assessment process.

Q12 Do you agree with our proposal to continue using Cobb-Douglas functional form? Why?

We agree with this proposal. The Cobb-Douglas functional form is a long-established and proven approach. We have not seen any evidence to suggest that it is not fit-for-purpose.

Q13 Do you have any views on our proposed model selection criteria?

We broadly agree with the model selection criteria as set out but offer some comments on each in turn below.

Economic/technical rationale: We agree that the model specifications and results should have a clear economic/technical rationale. This should also extend to being intuitive and make engineering sense. We agree with the aim to safeguard against 'data mining' and therefore this criterion and its interaction with the criterion on robustness, namely statistical test, is critically important to guard against this poor practice. Similarly cost drivers may make sense from an economic/technical rationale but could suffer from issues of multicollinearity which can be avoided through appropriate statistical testing.

Transparency: We agree that this should include the data used, the results and ease of interpretation for stakeholders. It should also include where data adjustments and or reallocations are made as well as the justification on how/why these changes are having to be made.

Additionally, transparency should not preclude complexity. Models can be transparent and at the same time complex. One should not prevent the other and, as evidenced by PR19, multiple model forms and methods can be combined in a way that is transparent to all stakeholders, if they are well understood and able to be articulated by the regulator, as well as presented in an easily accessible and transparent way. This could be an extremely important criterion for Ofgem to test itself against. This should consider the objectives, and how it has achieved these through the suite of models and tools used as part of its cost assessment process. In the interests of transparency all models should be published early in the process, along with all the information needed to fully understand, interpret and recreate them.

Robustness: We agree with this selection criterion. Models do need to have statistical testing undertaken on them as well as sensitivity analysis on the underlying assumptions. Big changes and large ranges with regards to efficiency scores should give rise to concerns. However, Ofgem should not be blinded by statistical testing. A varied cost assessment toolkit considering a variety of models, methods and techniques that make economic and engineering sense are more important than overfitting models to suffice statistical testing criteria. The over reliance on statistical tests was the failing of Ofwat at PR14 and Ofgem should seek to avoid this regulatory pitfall.

3 Regional and company specific factors

Q14 Do you agree with the proposed criteria for assessing regional and company specific cost factors that we have outlined?

We agree that the broad criteria set out appear appropriate. We encourage that further detail around what evidence is required to suffice the criteria should be set out in the Business Plan Guidance documentation.

Q15 What are your views on our approaches to account for regional and company specific cost factors in our modelling?

Our overall preference is for post-modelling adjustments as this aids transparency in terms of the quantum of the adjustment made and retains the integrity of the associated model. The document does describe the pros and cons to each of the three possible means to adjust for regional and company specific factors, hence the selection of approach needs to be weighed against its individual merits and drawbacks.

4 Real price effects and ongoing efficiency

Q16 Do you agree with our proposed approach to index RPEs, rather than setting an ex-ante allowance based on forecasts?

We understand that the proposal from Ofgem is “the same approach for gas distribution and transmission in our [Ofgem’s] RIIO-2 draft determinations”². Therefore this would consist of “Index RPEs, including a forecast of RPEs in upfront allowances, then true-up annually based on actual outturn information”³. In effect this will include ex-ante allowances for companies that are then trued-up annually.

We support the principle of identifying an index/indices to manage the risk of RPEs, but we would note that extreme care is required in the selection of appropriate indices that closely match the basket of goods purchased by the typical DNO.

We agree with the observation made in the DD consultation⁴ that the *proposed cost structures, assessment of materiality, and choice of indices* are crucial to ensuring a fair assessment and allowance for RPEs. As with the process run for GD/T2 any proposal needs to be done on a sector specific basis. This sector specific approach is evidenced by the use of notional company cost structures for GDNs and company specific cost structures for transmission companies.

Ofgem should also consider very carefully the impact of COVID-19 and the effect this will have on the indexation(s) used in the ongoing annual true-up of RPE and allowances. Consideration should be given to whether the index(es) used will reflect accurately the cost pressures faced by the sector if it is couched in the experience of the wider economy. Ofgem indicates its view that the impact of COVID-19 on the energy sector is different to the wider or more general economy, and this should be considered very carefully with respect to RPE allowances and ongoing true-up mechanisms.

We also note that RPE allowances and ongoing efficiency assumptions form part of the referrals of the final determinations in PR19 to the CMA and as such it is important that robust and well evidenced conclusions and allowances are made in respect of these two items. Because of the RIIO-ED2 price control not commencing until 2023, Ofgem has the opportunity to fully digest the findings of the CMA and how these should be considered in relation to RIIO-ED2. It is therefore important that the framework and future policy positions taken as part of RIIO-ED2 are made mindful of the CMA views and findings, but independently of other sectors and considering the evidence and unique circumstances for RIIO-ED2 specifically as well as for each licensee.

² RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, paragraph 6.12, Ofgem

³ RIIO-2 Draft Determinations - Core Document, paragraph 5.15, Ofgem

⁴ RIIO-2 Draft Determinations - Core Document, question 10, Ofgem.

Q17 Do you agree with our proposal to have a high materiality threshold for RPEs? What are your views on the materiality level for RPE submissions, and the criteria we use to select input price indices?

There needs to be a read across to the definition of materiality in the design of the uncertainty mechanisms for RIIO-ED2. We therefore suggest that the definition of the materiality threshold in this regard needs to be consistent with similar treatment within the price control framework (adjusted for its annual equivalence) to avoid having multiple interpretations.

Q18 Do you agree with the suggested common input and expenditure categories for structuring RPEs in ED2?

We agree that the proposed input and expenditure categories remain appropriate.

Care will need to be taken to ensure the short-term impacts of the COVID-19 pandemic are appropriately adjusted for (see our answer to Q16 for more detail).

Q19 Do you agree with our proposed approach, and its scope, to set an ongoing efficiency assumption for RIIO-ED2?

Based on the justification for the proposed positions in DDs for GD and Transmission (e.g. ongoing efficiency and catch-up efficiency) we have concerns that Ofgem is confusing, and mis-applying, the various levers in the RIIO toolkit as well as what they are designed to cover.

We do not support the incorporation of 0.2 percent additional efficiency due to previous innovation funding in RIIO-1 as set out in the DDs, nor its application to RIIO-ED2. Innovation investment has been primarily focused on meeting future challenges and the resulting efficiencies are visible in company submissions to Ofgem in terms of the discounts (avoided costs) that are applied to future forecasts compared to the counterfactual of traditional solutions. Innovation funding has not generally been focussed on reducing the costs of ongoing operations and meeting existing requirements. This is because companies are incentivised to self-fund innovation to lower costs and benefit through other levers in the RIIO framework such as the TIM, and customers see the benefit included in our business plan.

Careful consideration of the calibration of ongoing efficiency and what this is aimed at achieving, as well as the consideration of catch-up efficiency, and what that covers, needs to be given. It is important that being innovative doesn't become a zero-sum game to companies who need to balance a range of priorities or Ofgem's novel approach become a disincentive to innovate. The regulatory framework needs to have real rewards for innovation, not unmerited additional discounts to future costs for past success in addressing future long-term challenges facing consumers, stakeholders and companies.

We also have concerns that the most recent data observations are not being included in the assessment for GD/T2. The impact of COVID-19 will be underplayed and underassessed on this basis. A global event with the impact that COVID-19 has had is unprecedented. In operating our ED business, at the time of this response in September 2020, we are still assessing the medium and longer-term implications of COVID-19. Any ongoing productivity assumption needs to be cognisant of this unknown impact and be calibrated in a way that is well informed in its assumption with quantification of all the facts.

It is incorrect to say that our sector is not directly impacted by changes in the wider economy. This extends to where Ofgem is considering setting forward looking ongoing efficiency assumptions solely on the basis of those observed in RIIO-ED1 or earlier⁵. We do not support the use of this experimental method on its own. Traditional methods drawing on wider productivity assessment should be the basis for calibration of ongoing efficiency assumptions.

We also note that Real Price Effects (RPEs) allowances and ongoing efficiency assumptions form part of the referrals of the final determinations in PR19 to the CMA and as such it is important that robust and well evidenced conclusions and allowances are made with respect to these two items.

Q20 Do you agree with our proposal to use a growth accounting approach as our primary source of evidence to set an ongoing efficiency assumption? What parameters would best support this approach?

Use of such a model must be set against a context of declining UK productivity rates since the 2008 financial crisis. The recent COVID-19 impact will also have a significant impact on general UK productivity rates. As such, use of this model must be done with a great deal of caution, noting a critical need for an accurate specification to deliver realistic expected productivity gains based on the circumstances that will prevail. We believe Ofgem should adopt a wider assessment approach that also takes account of Bank of England (BoE) and Office for Budget Responsibility (OBR) forecasts.

We support the comprehensive analysis and conclusions First Economics draw in their paper for the ENA⁶ in the recent GD/T Draft Determination submission.

5 Disaggregated Cost assessment

Q21 Do you agree with our proposed approach on forecasting options for RIIO- ED2

We do not agree with the proposed approach⁷ that considers a common set with best view. There is no benefit to our customers following this approach due to the fact that this is clearly a centralised forecasting approach. All the disadvantages which are described in our response to questions 4 to 7 on the Overview document apply and should be reviewed in conjunction with our response to this question. Any top down allocation of LCT volumes⁸, simplistic trending of annual peak demand growth, and simplistic top down flexibility assumptions⁹ cannot capture the regional peak demand growth expected from a decentralised forecasting approach that has bottom up and half-hourly through year modelling in its core and is able to:

- Model regional EV charging based not only on EVs registered in a location, but importantly on the different types of charging expected per region (e.g. off-street domestic as opposed to destination charging based on work and shop commuters, as well as rapid charging based on regional data);

⁵ RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, paragraph 6.42, Ofgem

⁶ Frontier Productivity Growth (August 2020), First Economics

⁷ RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, option 3, figure 5, Ofgem

⁸ Electric Vehicles and Heat Pumps

⁹ DSR, smart meters, smart EV charging

- Model smart EV charging taking into account the demand profiles of network regions to shift demand at different times on different locations and assess effects at higher voltage levels via half-hourly bottom-up aggregation;
- Model peak demand growth taking into account how all demand components are added including not only regional uptake trends (e.g., higher heat pump uptakes on areas without access to gas networks), but also half-hourly behaviour of each demand component¹⁰;
- Include regional connections activity taking into account confidence factors for regional historical performance analysis and project specific information (e.g. expected year of energisation, requests from customers to DNO, profile characteristics based on type of load etc); and
- Model generation/battery storage uptake trends taking into account regional network planning information that can influence customer decisions (e.g. available capacity for generation per BSP), as well as regional realities such as availability of land / customer building types for the uptake of renewables.

Failure to take into account these effects using a decentralised approach with bottom up and half-hourly through year modelling is expected to reduce our confidence in capturing regional demand and generation growth trends and capturing the associated uncertainties.

The inadequacy and inherent disadvantages of using centralised forecasting approaches for distribution network planning are the main reason that we have previously scored option 3 not only behind option 2 (Open Networks approach with DFES standardisation), but also behind option 1 where a decentralised forecast without any standardisation and common scenario assumptions across DNOs is assumed.

Ofgem should require a single approach for both cost assessment and our Business Plan submission. In a recent RIIO-ED2 Overarching Working Group (OAWG) (4 September 2020) it was suggested that there could be different approaches required by Ofgem for different Ofgem purposes.

Q22 What are your views on our proposal for establishing network impacts and assessing LRE requirements for RIIO-ED2?

We agree with the proposals for establishing network impacts in RIIO-ED2. Our Business Plan submission will include proposals to use smart meter data further supported by the installation of monitoring equipment¹¹(in some circumstances only for a limited period) to:

- Understand the current utilisation of the network and target interventions only when and where needed to avoid stranded assets and/or exceed network capacity; and,
- Use, in a coordinated manner, smart meter data with monitoring data that needs to be captured by installed equipment (e.g., harmonic distortion levels, voltages at head of

¹⁰ e.g. regional DSR and smart meter effects shifting demand at different times based on primary substation loading per half hour to affect BSPs and GSPs at times defined by the loading profiles at lower voltages and not the GSP or BSP profiles

¹¹ Where the volume of these are justified based on DFES forecasts

feeders) to improve our ability to target interventions for the benefit of the whole network and the whole range of issues.

This builds on our approach in RIIO-ED1 with the introduction of the connect and manage programme for LCTs. We will provide additional information in our Business Plan submission.

Q23 Do you agree with our proposal to compare flexibility solutions and network based solutions evenly in our cost assessment?

We fully support the proposal to compare flexibility solutions and network based solutions evenly in the cost assessment for RIIO-ED2 as we see that flexibility can potentially provide significant benefits to our customers, but the approach should not presume, or be biased, in favour of flexibility (or other innovative approaches). The assessment basis needs to be carried out in consumers' interests first and foremost.

We would welcome further clarity on the cost assessment process in this regard, including how assumptions on the availability of flexibility will be considered so that companies aren't unfairly penalised for legitimate regional differences in this regard.

We have been instrumental in driving forward a common evaluation methodology for assessing the solution options through the work of the ENA Open Networks project so that the decision-making process, and the results from the evaluation, are open and transparent. The tool is due to be completed this year and implemented by 1 April 2021 and builds on our pioneering work in developing the Real Options Cost Benefit Analysis (ROCBA)¹². Delivering commonality of evaluation and placing the methodology and evaluation tool under open governance will provide the foundation for its ongoing development. This tool can be used for determining the ceiling price for flexibility and has the potential to be used in any comparison between flexible solutions and network based solutions.

Q24 How should we treat the fixed costs of procuring flexibility when considering flexibility solutions as an alternative to reinforcement?

We suggest that the costs of procuring flexibility should be an identified cost in addition to the costs of the flexibility solution itself. This would be akin to the treatment of the network planning and design costs associated with the delivery of network solutions which are identified separately and treated as a component of Closely Associated Indirect costs (CAIs). This would mean that in the evaluation methodology the options are compared on an equivalent and fair basis.

Q25 What are your views on the use of LIs as outputs in RIIO-ED2?

As discussed within Ofgem working groups, we agree that Load Indices (LIs) are a very partial view of both utilisation and drivers for reinforcement and could usefully be supplemented in time with additional measures that look at factors such as generation constraints. We have not, to date, seen detailed proposals in these areas that are ready to implement, but are happy to contribute to the ongoing debate and will work with Ofgem to define appropriate utilisation and risk metrics. One

¹² <https://www.enwl.co.uk/zero-carbon/innovation/smaller-projects/network-innovation-allowance/enwl001--demand-scenarios/real-options-model/>

suggestion would be a simple traffic light system for loading, DG hosting capacity and fault level per substation. Currently LIs apply to higher voltage levels only.

More broadly within the overall area of reinforcement, we highlight that whilst network risk associated with demand is covered by the current LI methodology for first circuit outages the current methodology does not cover risk for second circuit outages (N-2) which applies to larger demand groups (>100MW) only.

That said, we agree with the proposed retention of LIs as an overall indicator of utilisation and also support a review of the bandings and current weightings to enable the approach to produce more meaningful utilisation data. This should be done through the SRRWG.

Q26 What are your views on the treatment of incremental costs in RIIO-ED2?

In terms of the options presented in the consultation, we suggest that 'Option 2'¹³ is the most appropriate and that it is applied in defined areas where the impact of incremental costs has the potential to distort cost assessment. This is equivalent to the current treatment of losses expenditure within the RIIO-ED1 RIGs where incremental costs are reported alongside the main cost driver and included in a memo table to give a consolidated view of total losses expenditure.

Ofgem would need to ensure that the basis of any disaggregated cost assessment is clear on which is being used to ensure consistency.

Q27 Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing Non-op capex costs in RIIO-ED2?

We broadly agree with this proposal.

Ofgem will need to consider how to appropriately accommodate the impacts of the transition to low carbon on Property, Vehicles and Transport costs within this framework and also potentially allow DNOs to separate out any significant IT system investment to be subject to separate justification and scrutiny.

Q28 Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing NLRE in RIIO-ED2?

We broadly agree with this proposal and support the suggestion to simplify the workbooks associated with the NASD/NARM deliverables. We suggest that Ofgem gives thought to the process by which any adjustments to future volumes arising from the application of the Asset Replacement modelling and/or scrutiny of CBAs/EJPs are reflected into the NARM targets otherwise there will be a mismatch between the risk targets and the volumes allowed to achieve them. A re-statement process would seem to be required to support this and aid transparency.

¹³ Option 2 – Report total costs against the primary investment driver, with a supporting memo table(s) setting out incremental costs

Q29 Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing NOCs in RIIO-ED2?

We agree that the RIIO-ED1 approach remains broadly appropriate but highlight that these costs are likely to grow with maintenance requirements for new smart devices and monitoring equipment.

There will potentially be, subject to additional Ofgem requirements on inspection, data gathering as part of the NARM framework which will need to be considered as well as the costs associated with delivering this requirement.

We also repeat the point made in RIIO-ED1 that inspection and maintenance costs are often the most effective means of ensuring longevity of assets and that intelligent decisions are made in terms of investment prioritisation to maximise the effectiveness of interventions. We would be concerned if the approach adopted by Ofgem presumed a race to the bottom in these cost categories as they are often facilitators of cost reductions in other parts of the cost base.

Q30 Do you agree with our proposal to maintain the RIIO-ED1 approach for assessing CAIs in RIIO-ED2?

We agree that maintaining the RIIO-ED1 approach is broadly appropriate.

The CAI category is an amalgam of functions driven by the size of the existing asset base (control centre, call centre etc.) and those strongly linked to the quantum of work being delivered (network design, project management etc.). It is also affected by company decisions on outsourcing of functions, particularly with regard to construction services.

As such, any specific CAI modelling results should not be treated in isolation but considered in the context of the activities with which they are closely associated to give a rounded view of efficiency.

Q31 What are your views on the different approaches presented for the treatment of BSCs in RIIO-ED2?

We support a consistent approach to that used in RIIO-ED1 in pooling of suitable BSC sub-categories, and inclusion within an econometric model using MEAV as the cost driver seems appropriate.

We strongly believe that any analysis should account for fixed costs. We also suggest that the nature of IT expenditure within, and between, companies warrants separate assessment to the other BSC sub-categories.

6 Cost benefit Analysis

Q32 Do you agree with our proposed application of CBA in the appraisal of investment options for RIIO-ED2?

We agree that CBAs will be an important component of the needs case of the submission in those areas where benefits can be clearly monetised against an agreed framework. We also agree that their requirement should be proportionate to the expenditure areas that they support.

There is significant detail in the consultation document that we suggest is formed into a specific set of guidance on the application of CBA models which can then be read alongside the separate BPDT Guidance document. This will need to accompany an updated CBA template which we have led discussions on with Ofgem. We understand other DNOs are happy to continue assisting the completion of this work.

As Ofgem is aware, we have been proposing a number of enhancements to the current CBA approach and are disappointed that the opportunity hasn't been taken to consult on these. We will continue to work on the three broad areas of:

1. Expanding the representative basket of benefits;
2. Variation on fixed factors (such as VoLL and Carbon); and
3. Use of probabilistic assessment techniques.

Our stakeholder engagement as part of this consultation response has also indicated that expanding the representative basket of benefits is important. One stated "it is imperative that the return on investment in any project is able to demonstrate customer, stakeholder and wider community benefits effectively and transparently." Additionally, this is of increasing importance when considering innovative solutions such as Smart Street and energy efficiency measures more widely. One stakeholder stated that they "endorse the wide scale deployment of programmes such as Smart Street which, in addition to preparing the network for the future, will save customers money, without relying on behavioural changes or the need for households and businesses to accommodate new technologies."

We will continue to support this and work with DNOs and other stakeholders to develop the CBA process and model for RIIO-ED2. We consider the CBA, associated guidance and developments to the approach a key priority for timely progression through the Ofgem working group programme for RIIO-ED2. An enhanced CBA approach will improve the quality of decisions made and therefore drive additional consumer benefits.

7 Engineering Justification papers

Q33 Do agree with our proposals to retain the requirement for DNOs to produce Engineering Justification Papers?

We believe that EJPs can form a useful component of the overall evidence base for the submission, however, care is required to ensure these are complementary to other forms of evidence and not a duplication.

We would also welcome clarity on how the results of EJP review are intended to feed into the cost assessment process in terms of modelling adjustments. The consultation discusses the decision-

making process and supporting data and we are interested to understand how this fits with the cost assessment framework as the same costs can be arrived at via very different approaches.

Q34 Do you agree with our proposal retain the assessment framework for EJPs developed as part of the RIIO2 process?

We broadly agree with this proposal set out in this consultation but there is a need for it to be modified to work optimally in a RIIO-ED2 context.

Some of the elements of the DNO submissions will have timing and locational elements of uncertainty within them, and we are concerned that an approach borne in the assessment of high-value, long-duration Transmission projects cannot be transported easily across to RIIO-ED2. Many of the aspects noted in this section imply a level of advance detail planning (e.g. market-based tenders) which are simply inappropriate for a DNO context.

Q35 Do agree with our proposal to adopt the principals outlined above to guide the production of EJPS and focus the engineering submission?

As noted in other responses, we are supportive of EJPs where they are a valuable and distinct addition to the evidence base of the submission and consequently support the first three principles listed in the consultation document.

We are however unclear on the role of the fourth principle in assessing the decision-making process itself. As raised with Ofgem in working groups, it is unclear how Ofgem proposes to triage views of the decision-making process and the resulting decision making outcome in its cost assessment, and therefore it is unclear how significant an input detail in the process it should be.

8 Data assurance and compliance

Q36 What specific activities and methods should be adopted to ensure the Data, Data Assurance and Compliance processes of the RIIO-ED2 price control are run as effectively as possible?

We welcome the proposed steps to modernise data assurance, compliance and exchange between Ofgem and network companies including a single consolidated licence condition to specify assurance across the framework.

We note progress to date in this area through RIIO-ED1, providing a useful and effective baseline to build on in RIIO-ED2 and producing tried and tested processes, such as the DAG framework. Network companies have been collaborating effectively through the Open Networks and RIIO-ED2 working groups, which are now well established and proven vehicles for achieving standardisation.

We support the development of Ofgem's proposed improvements but recommend that these are defined as early as possible to facilitate consistency across network companies, in a timely manner. The focus of effort should be on data quality and consistency initially rather than on technology to exchange data – spreadsheets work satisfactorily for annual data returns. Whilst we support improvements to data exchange, specific solutions such as Application Programming Interface

solutions (APIs), that are typically used for daily data exchange, should be carefully considered to identify their benefit case in more detail to ensure they are appropriate for what are usually annual reporting requirements.

As data is a key enabler of the road to Net Zero and transition to Distribution System Operation (DSO), we agree that data accuracy must attract more attention and importance in the regulatory framework in RIIO-ED2. We expect the scale and frequency of data exchanges between network companies and Ofgem to increase over RIIO-ED2, and therefore suggest Ofgem implements the recommendations from the EDTF; assess and triage relevant, meaningful and valuable data points for stakeholders and prioritise these to streamline and accelerate their assessment processes. Such activities will facilitate closer working, more efficient and faster data exchange between companies and Ofgem, thereby enabling Ofgem's more active role in decision making in RIIO-ED2. Network companies have demonstrated agility in meeting tight timescales; for example, provision of Digitalisation strategies within three months of Ofgem's request. A similarly agile assessment and feedback loop will become critical in RIIO-ED2.

Increased transparency should be provided on how reported data will be used, to support the greater understanding of reporting criteria and consistency across network companies. Regulatory reporting is a costly exercise that needs to be considered in the context of the value delivered for consumers. Ofgem should challenge itself to identify the reporting requirements that will be used to improve outcomes for customers.

This should also apply to the Business Plan assessment process in a timely manner in order for DNOs to reflect this in their Business Plan submissions. The models Ofgem will use to assess Business Plans should be shared in advance, giving network companies appropriate time to conduct their own assessments, such as on financeability, using these models. Further clarity should also be provided on the overall assessment process, including timescales for RIIO-2 Challenge group review and supplementary questions, and specific details of the assessment, such as anticipated modelling techniques.

We note the importance of visibility and transparency on requirements as well as guidance from Ofgem to support data assurance activities. Provision of clear requirements in a timely manner are critical in enabling network companies to implement robust assurance plans, reducing risk of incomplete, unclear or mis-reporting as well as inaccuracies and ensuring delivery of assured data on time. RIIO-ED1 has demonstrated the importance of high quality commentaries to accompany reported data, and this should continue as a requirement into RIIO-ED2.

Assurance must be appropriate and proportionate to the level of risk and importance attributed to the data provided. We therefore recommend Ofgem provides clear guidance on expectations on assurance for reported data in a timely manner or, alternatively, make clear that the level of assurance is for companies to decide. Should Ofgem want to specify assurance activities, especially external assurance if required on several areas of the Business Plan, then this should be communicated as early as possible to allow reasonable time to plan appropriately ahead of the submission deadlines. Careful consideration should be given to how the level of prescription in DAG compared with the intimated level of flexibility within the consultation can be applied together under the same assurance framework.

We agree with Ofgem's principle of placing greater focus and importance on data assurance. We welcome Ofgem applying the same principles and using internal peer review and assurance via the Government Actuary's Department, which was undertaken on the Gas, Transmission and ESO Draft

Determination models¹⁴ and previously within ED, as demonstrated in the Specified Street Works Costs reopener assessment¹⁵. We recommend the same approach is provided for significant publications relating to the RIIO-ED2 framework.

9 Uncertainty mechanisms

Q37 Do you agree with our proposed uncertainty mechanisms and their design?

We support a limited number of targeted uncertainty mechanisms that are well defined and are clear as to what risk or uncertainty they are to address in the RIIO-ED2 period. We do not support macro or broad measures such as the mid-period review reopener deployed in RIIO-ED1 as the broadness of the mechanism leads to a lack of clarity for companies and Ofgem about how and why these should be applied and assessed.

Based on Table 7 in the consultation document, we provide comments on the individual mechanisms and their proposed design below:

¹⁴ GAD Audit Letter, technical Annexes Part two <https://www.ofgem.gov.uk/publications-and-updates/riio-2-draft-determinations-transmission-gas-distribution-and-electricity-system-operator>

¹⁵https://www.ofgem.gov.uk/system/files/docs/2019/10/gad_assurance_report_-_specified_street_cost_reopener_assessment.pdf

Name	Mechanism	RIIO-1 Comparison
Cross-sector mechanisms		
Ofgem licence fee	Pass-through	No change proposed
Business rates	Pass-through	No change proposed
Inflation indexation of RAV and allowed Return	Indexation	Revised for RIIO-ED2
Cost of debt indexation	Indexation	Options for change proposed
Cost of equity indexation	Indexation	New for RIIO- ED2
Real Price Effects	Indexation	Revised for RIIO-ED2
Tax review	Re-opener	New for RIIO- ED2

ENWL Comments
We agree with the retention of the mechanism and the design used in RIIO-ED1.
We agree with the retention of the mechanism and the design used in RIIO-ED1.
Please see answer to Finance Annex question FQ15.
Please see answer to Finance Annex question FQ1.
<p>The mechanical attempt to introduce indexation into the equity allowance has pitfalls. Equity investors into UK infrastructure provide patient capital and seek long-term stable returns.</p> <p>While indexation may seem attractive to regulators, adjusting CAPM for short term fluctuations for risk-free rate in isolation is an error and provides a false sense of precision in the output, while also being disjointed from the expectations of investors, which are forward looking and long-term. Ofgem's approach introducing equity return variability increases the risk and therefore the required return level.</p> <p>Following the revision to five-year price controls, we do not believe equity indexation is either a necessary or a positive development for networks or consumers.</p>
Please see our answer to Q16 of this document.
Please see answer to Finance Annex question FQ13.

Name	Mechanism	RIIO-1 Comparison	ENWL Comments
Pensions adjustment	Pass-through	Revised for RIIO-ED2	There seems to be an inconsistency between table 7 and that stated in chapter 11 of the Keeping Bills Low annex. Clarity is needed as to whether this mechanism is to stay as it is in RIIO-ED1, or that it is to be revised and, if so, what the proposed revisions are.
Enhanced Physical Site security	Baseline allowance and/or re-opener	No change proposed	See our response to Q55 of the Value for Money annex for more details.
Cyber resilience	Baseline allowance and/or re-opener	New for RIIO- ED2	See our response to Q47 of the Value for Money annex for more details.
Net Zero	Re-opener	New for RIIO- ED2	See our response to Q3 of the Overview annex for more details.
Coordinated Adjustment Mechanism (CAM)	Re-opener	New for RIIO- ED2	See our response to Q27-29 of the Overview annex for more details.

Name	Mechanism	RIIO-1 Comparison	ENWL Comments
Specific to RIIO-ED2			
Strategic investment/Load related expenditure	Dependent on Model for strategic investment: could include volume drivers and/or reopener	New/reformed for RIIO-ED2	<p>We agree with the proposal to revise the arrangements for load related expenditure from the existing mechanism which is in place for RIIO-ED1. The regulatory framework must enable DNOs to deliver anticipatory/strategic investment without undue regulatory barriers, whilst companies must equally ensure that their decision making is supported by robust and transparent data and made with the best information available at the time.</p> <p>We provide more detailed comments on the options presented in our response to Annex 3 of the Overview document.</p>
Street works costs	Re-opener	No change	We agree with the retention of the mechanism and the design used in RIIO-ED1.
Rail Electrification	Re-opener	Reform for RIIO-ED2	We agree with the proposals.
Black start	Re-opener	New for RIIO- ED2	See our response to Q54 of the Value for Money annex for more details.

Name	Mechanism	RIIO-1 Comparison	ENWL Comments
Miscellaneous pass-through	Pass-through	No change	<p>It would be helpful for Ofgem to list what is currently intended within this category to ensure there is no misunderstanding. The statement of “no change” implies that the items listed in CRC 2B of the Electricity Distribution licence remain as pass-through. We believe it is Ofgem’s intention to continue with pass-through arrangements and we agree these should include all those items in the list provided¹⁶ as well as the following which are included in CRC2B but missing from the consultation:</p> <ul style="list-style-type: none"> • Supplier of Last Resort Costs • Eligible Bad Debt Costs <p>In addition, all transmission connection point charges should be pass-through whether they are existing or new</p>
Smart Meter interventions	Volume driver	No change	<p>We agree with the continuation of a volume driver to manage the uncertainty over timing and volume of Smart Meter Roll-Out costs in the same way as was applied during RIIO-ED1.</p> <p>There is no requirement for a tapering factor given the percentage of DNO interventions to supplier installations are better known with less volatility.</p>
Environmental legislation	Re-opener	New for RIIO- ED2	<p>We agree with the potential inclusion of an Environmental Legislation re-opener.</p> <p>This should be tightly designed as per our proposals shared in Q60 of the Value for Money response.</p>

¹⁶ 11.29, keeping bills low for consumers, Ofgem

Q38 Are there any other uncertainty mechanisms that we should consider? If so, how should these be designed?

Many of the re-openers displayed in table 7 have been developed to enable companies to respond to external factors which are beyond companies' control for example Black Start Standards, CNI sites, Cyber framework. Should there be a scenario where other external bodies, remote from Ofgem and DNOs, gain control of standards or compulsory activities which ultimately result in a material change to DNO activities and costs then a new re-opener mechanism may need to be created.

Company specific mechanisms should be allowed, and these should be assessed as part of the business plan submissions at Draft and Final Determinations stages, such as our mechanism for Moorside in RIIO-ED1 which we are reviewing for its continued requirement in RIIO-ED2. Some company specific mechanisms will potentially arise from customer and stakeholder engagement and other developments which occur between now and the business plan submission milestones.

Considering innovation, Ofgem should reflect whether a mechanism that supports the rollout of projects that are of benefit to consumers but at additional cost to network companies (when compared against BAU approaches) is required. It is a gap in Ofgem's proposals at present as without such a mechanism, any innovations that could be rolled out, where they cost more than traditional solutions but have a net consumer benefit, will have to wait to the next price control period for this to happen. We set out more detail in our response to Q10 of the Overview document.

Q39 Do you agree with our proposed removal of the above uncertainty mechanisms for RIIO-ED2?

We agree that load related expenditure (LRE) should be removed and replaced with a new mechanism for RIIO-ED2 and have proposed our own solution to LRE which has been developed in collaboration with the majority of DNOs, namely 'the Capacity Volume Driver' (see Q9 of the Overview annex for our detailed response to this). To enable decarbonisation a substantial level of ex-ante allowances should be provided as well as an uncertainty mechanism.

With regards to the other mechanisms, we agree with the complete removal of the UM relating to Link Boxes.

Subsea Cables is an example of company specific UM and so we do not comment as to its retention or removal. However, company specific UMs, where justified, should continue to be allowed.

Q40 Do you agree with our proposed common approach for re-openers being applied to RIIO-ED2?

Our position for ED is that any mechanisms for managing uncertainty, including re-openers, should be clearly defined and targeted in their use, as well as being less extensively used in ED compared to GD/T due to the differences of our sector.

The most critical process consideration for re-openers is that Ofgem will need to be able to make material decisions much more rapidly than today's processes and based, relatively speaking, on incomplete information in a faster changing world. Greater transparency from Ofgem, laying out the basis it intends to take decisions, will enable companies to react quickly to emerging needs and challenges as set out in the framework re-openers. The ability for Ofgem to act quickly is crucial to ensure that Ofgem itself doesn't inadvertently become a blocker to decarbonisation and decentralisation of the energy system.

A common approach has a benefit of being clear and easy to understand where this is to apply in most of cases. However, we have concerns with the proposed approach for each of the parameters as set out in the extract table from the SSMC below.

Re-opener parameters	Consultation position
Re-opener application windows	Bring forward re-opener application windows from May to January. Reduce re-opener application window from one month to one week (ie last week of January).
Application requirements	Provide additional detail and guidance where possible in licence conditions and guidance.
Authority triggered re-opener	Authority can trigger a re-opener at any time during price control.
Materiality threshold	For each individual re-opener application, set a materiality threshold such that we will only adjust allowances if the changes to allowances resulting from our assessment, multiplied by the TIM incentive rate applicable to that licensee, exceeds a threshold of 1% of annual average base revenues (as set out in Final Determinations). Allow for aggregation of some re-openers subject to specific criteria.

Taking each of the elements in turn:

- Re-opener application window:** Any potential increased use of UMs and re-openers will result in increased regulatory burden and this should be considered when making any changes to application windows or timescales, as well as the overall balance and use of UMs and re-openers for ED. By bringing forward the application window from May to January, it is clear the only benefit is a longer assessment time for Ofgem, however, this is not consistent with the need for agile and timely decision making as the speed of decarbonisation and the pathway to Net Zero becomes clearer. Consumers and industry need a quicker and more appropriate approach to re-opener decisions given the large number of decisions Ofgem has positioned itself to make. It is unlikely to be sustainable without an overhaul to the decision-making processes.
- Application requirements:** We support the clarification and proposal to provide additional guidance to companies and all stakeholders. We also agree with the proposal to consult on the guidance and any subsequent amendments, before it comes into effect, but this must be done before the price control starts and ideally should have been done before Business Plan submissions. We would urge that this guidance and requirements on companies is proportionate and cognisant of the impact on the regulatory burden placed on companies and Ofgem. Its aim should be to support key objectives and not slow down the process such that regulatory requirements become a barrier to the industry in delivering essential activities under decarbonisation, Net Zero, or other considerations. Guidance should be clear and set out the requirements to ensure companies are aware of the criteria to which the authority “may reject any re-opener application that does not contain all the information necessary for us to make an informed decision on the contents of the application”¹⁷ as set out in 11.45. As much as possible companies and stakeholders need to understand the basis and approach of Ofgem’s decision making so that the presented proposals from the companies align with Ofgem’s expectations and views.

¹⁷ RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, 11.45, Ofgem

- **Authority triggered re-openers:** We think that this parameter should apply only to a small number of re-openers with defined windows, where consumer benefit can be demonstrated and not be applicable to any or all re-openers by default. We have concerns that this will increase uncertainty on companies, thereby raising risk and costs for consumers in the long run.

The process for triggering re-openers should be the same for both Ofgem and companies in terms of certainty and clarity as to what might be triggered when. This isn't the case as it stands in proposals where the Ofgem can trigger at any point. Certainty and clarity underpins good regulatory practice. An open-ended asymmetrical process does not provide this to companies and stakeholders alike.

- **Materiality threshold:** We support the flexibility to aggregate re-openers where there are items that don't meet materiality on their own. It is unclear on reading the SSMC and the DD documentation precisely which re-openers are and which are not eligible for aggregation. We would urge that a clear table is produced showing each re-opener and the associated parameters. It is also not clear why a higher or even a different materiality threshold should apply to aggregated items¹⁸. By the Ofgem definition a materiality threshold "provides a balance to ensure network companies and consumers are protected from significant variations in expenditure over the price control"¹⁹ There should be no difference between a single item materiality threshold and an aggregated claim where appropriately evidenced and justified against the relevant criteria. Also, applying the company specific sharing factor (TIM) has the same effect of changing the level of significance between companies. A lower TIM for RIIO-ED2 also has the result of increasing materiality from RIIO-ED1 levels, which is inconsistent with a lower risk price control. Under a lower risk, lower returns price control it would be a surprise if materiality thresholds increased. A flat percentage of allowances, reviewed in the round to ensure risks are not increasing for companies with lower returns, would be simpler and not create differences in what is or is not significant between companies.

10 Increasing competition

Q41 Do you agree that our flexibility proposals are sufficient to incentivise DNOs' native competition?

We agree that the TIM provides a sufficient incentive for DNOs to seek innovative solutions to mitigate a network need, and we see no need to bring in additional targeted formal arrangements. DNOs are already committed to explore flexibility first as per the agreement through the ENA²⁰, and the DSO principles, as proposed, apply greater clarity to companies as to Ofgem's expectations in this area.

As part of the RIIO-ED2 price control discussions ENWL proposed a capacity volume driver for load related expenditure that would facilitate the increased use of flexibility services as network operators work to deliver the capacity requirements of network users at the lowest costs. The design of the capacity volume driver is complementary to the TIM and seeks to achieve this by using capacity

¹⁸ RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, paragraph 11.58, Ofgem, gives the example of 3% compared to 1% for single item re-openers.

¹⁹ RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, paragraph 11.56, Ofgem

²⁰<https://www.energynetworks.org/assets/files/ENA%20Flexibility%20Commitment%20Our%20Six%20Steps%20for%20Delivering%20Flexibility%20Services.pdf>

requirements to drive funding, but not specifying the solution whether that be either traditional network or flexibility service, as the company will select the optimal solution for customers.

Flexibility gives advantages in situations where there is uncertainty in forecasts; flexibility could increase costs in the short term but avoid stranded assets if the lower forecasts are realised.

Q42 Do you believe there are similarities between DNOs running early competitions and the roles and activities that may be related to electricity DSO functions?

Within Ofgem's classification of early competition in the consultation there appears to be no similarities identified with the functions under DSO. We would argue that the timing associated with the early competition model is exactly the same as the procurement of flexibility services as an alternative to traditional reinforcement (i.e. when we identify a need we look into potential solutions) which includes the tendering for flexibility services.

As we share more network data, embracing data as a key enabler in RIIO-ED2, we fully expect that stakeholders will identify areas of the network that will have a potential future need and highlight this to us in conjunction with offering to provide the solution.

Q43 Do you agree with our proposed approach on early competition?

We support competition, innovation and enabling new forms of service provision by new parties. This is evidenced by the fact that we were assessed as having enabled the most competition in connections of any DNO at the start of RIIO-ED1.

We already utilise both early and late competition type models where currently appropriate, such as:

- All our load related proposals seek flexibility alternatives adopting the flexibility best practice established by the ENA (early competition)
- We tender all our framework contracts, and comply with OJEU rules as set out earlier (late competition)
- Certain construction projects are also competitively tendered to ensure best value (late competition)

We employ this approach and apply it to all our supply chain. Further, we utilise tendering and competition testing extensively on our procured expenditure with circa 80 percent covered by competitively secured framework agreements and more on top of this tested separately through one-off competitive processes. We understand that every pound we spend is funded by consumers and as such we are targeting to increase the percentage we test in RIIO-ED2 from our already strong current position in RIIO-ED1.

These examples demonstrate how we utilise and support competition where appropriate and in the best interests of customers, and will continue to do so in the future, however we do not support artificially creating competitive processes which increase costs and risks where there is no customer benefit in doing so.

To bring benefits for consumers, both in the ENWL region and nationally, we developed CLASS that provides services to the ESO. This is meeting the operational needs of the ESO multiple times a day, which in turn mitigates the risk of power cuts such as that observed on the 9th August 2019.

Additionally, we apply a contestability test for market testing of flexible services for network reinforcement. The test is “is the reinforcement requirement greater than 200kVA and greater than £200,000”. The ENWL network is well managed, with capacity available on our network in many areas of the region, so, whilst our volume of accepted flexibility tenders is lower than some DNO groups, our commitment to flexibility markets is equal to or stronger than other DNOs.

It is clear from the above that early competition is already embedded in our business as well as the ED sector overall and we suggest that any additional requirements based on those set out for GD and T would represent a disproportionate tool for ED given that the additional consumer benefit is unlikely to outweigh the additional costs incurred. We also note the work being undertaken by the ESO on the Early Competition Plan (ECP) for ET. We understand that the applicability of the ECP to ED is being considered but we question what additional benefit this would bring beyond that already being delivered by DNOs, facilitated by Ofgem’s existing framework, in RIIO-ED1. We further understand the timing of this work to be February 2021. This timing in consideration of the Business Plan submissions is too late, assuming review and conclusions need to be drawn by Ofgem after this date of publication.

We suggest Ofgem focusses on the marginal consumer benefit of any competition policy changes within ED and carefully quantifies these for ED specifically as well as assessing the costs. The scale, separability and length of development (i.e. early sight) of Transmission projects, along with all the work done over the last five years or more, suggests that it is more important to focus on Transmission for the early competition model to learn and develop the model further. There currently is not enough detail provided as part of this consultation to see how the model could work as it still seems to be at conceptual stage. We are not clear that the model for Transmission is the right starting point and much work could be needed for ED to introduce early competition that looks like the approach(es)/model(s) for Transmission. Additionally, an early model of competition already in place, and working in ED1, is where the DSO tenders load related reinforcement to potential service providers, be this flexibility providers or other innovative solutions. We are solution agnostic where proposals meet our customers’ needs for reliability, resilience, safety, customer service and cost. RIIO-ED1 and, we expect, RIIO-ED2 will provide us with strong incentives to find the most cost-effective solutions for consumers, continuing to drive this sort of early competition for distribution solutions.

Having looked at Ofgem’s information presented in the consultation, we are concerned that the threshold for early competition projects is proposed at projects in excess of £50m. Our view is that this is a disproportionate tool considering the consumer benefit for ED and noting the costs of competitions themselves contained within Ofgem’s impact assessment. We suggest the threshold for both early and late competition should be where the value is in excess of £100m. Further, having looked at the potential costs, projects might need to be much higher value than £100m to deliver net benefit to consumers. Early competition models might be applied when there is significant uncertainty associated with the project so to be confident the benefits outweigh costs a higher threshold might be especially relevant for early competitions.

The way Ofgem is consulting on the same competition models and approaches for ED as for Transmission doesn’t align with ED having a separate process. There is a risk as a result that Ofgem’s process leads to a sub optimal outcome for consumers and stakeholders. It would seem that Ofgem assumes perceived issues in transmission equally apply to distribution without specific consideration of how ED is different to the ET sector.

Q44 Do you have any views on our draft RIIO-ED2 Late Competition Impact Assessment?

The impact assessment came out part way through the consultation period though it is heavily based upon the Transmission models and their justification. Of the late competition models, we support the CADO model, as we do not see any circumstances where an SPV model would be a preferable to CADO. We cannot see a case for developing the SPV model further, as Ofgem does not set out any advantages of this model for consumers over and above the CADO model, and we can see SPV will be extremely difficult to implement.

The costs of running the competition look low to us. We also disagree that failed bid costs will never come back to customers. With each bid having a multi-million pound cost, over time, we expect bidders to need to recover their costs of bidding, or they will quickly stop engaging if they continue to be unsuccessful. Either way there is a cost of failed bids to the economy and so Ofgem should not just assume this away.

The impact assessment on late competition underplays the work needed on, and challenges of, managing distribution networks under RIIO-ED2 with complex regulatory arrangements especially if other network providers become key parts of delivering a reliable and safe electricity provision to consumers. For example:

- Arrangements for customer service and interruptions incentives; how would a customer differentiate between an issue caused by the monopoly or a CADO?
- Overheads for stakeholders of needing to work with a CADO/SPV; and
- Additional costs of CADOs/SPVs needing to undertake activities such as DSO.

The impact assessment does not set out how new connections will be managed under each of the potential new delivery models. With decarbonisation a key government aim, the ability to change existing assets and connect new assets needs further specific thought as to what obligations CADOs and SPVs would have.

Should any late (or early projects be identified in RIIO-ED2) then impact assessment(s) will need to be done for each specific project.

To an extent Ofgem's approach to RIIO-ED2 is really a competition proxy model on a grand scale. With paragraph 12.26 of the Keeping Bills Low annex referring to the perceived benefits of competition cited as allowing efficiencies through:

- *Establishing and locking in long-term debt and equity rates, as well as gearing, that reflect current market rates for financing a project:*
Developments in the RIIO-2 framework should look at fair debt and equity rates and the right gearing to reflect efficient market rates and Ofgem is undertaking this anyway for the whole networks sector.
- *Establishing economic and efficient capital and operational costs that reflect current market rates:*
This ought to be where Ofgem seeks to get to and we support Ofgem achieving this for RIIO-ED2.
- *Enabling efficient costs for a project through a project-specific risk allocation:*
This can be achieved through the various licence mechanisms such as uncertainty mechanisms and re-openers.

Therefore, we don't think the competition proxy model would deliver additional benefits to consumers if the RIIO-ED2 price control is set appropriately. Additionally, the way Ofgem is consulting

on the same competition models and approaches for ED as for Transmission doesn't align with ED having a separate process. There is a risk as a result that Ofgem's process leads to a sub-optimal outcome for consumers and stakeholders.

Q45 What are your initial views on the three models of late competition (CATO/CADO, SPV and CPM) in the context of electricity distribution? If there would need to be differences from the other sectors, can you please explain what these should be, and why.

Our initial view is that:

- The CADO model is relatively more suitable than other models. Since we already have IDNOs and ICPs competing effectively to provide distribution services, Ofgem should consider specifically how these models compare, contrast and what, if any, impacts their existence has on the late competition models relevant for ED. Equally Ofgem might find that changes to IDNOs and ICPs are needed;
- SPV would be very difficult to implement and doesn't have particular customer benefits to commend it over CADO; and
- CPM from its description sounds like it seeks to achieve what Ofgem is targeting for customers for RIIO-ED2 more generally, and so seems likely to be irrelevant for ED.

We and other DNOs are actively market testing flexibility which already gives a route for competition. How this can complement any potential late competition should also be considered.

Q46 Do you agree that the late competition models proposed could deliver benefits in RIIO-ED2?

We support using competitive forces and utilise them ourselves to secure innovative solutions and best prices for customers. This, and the DNOs expansion to include flexibility solutions alongside traditional asset-based solutions, when combined with Ofgem's approach to setting a stretching RIIO-ED2 framework, means that there is little or no ability for late competition models to deliver additional benefits to consumers.

We question the relative priority of work to introduce late (or early) competition models when the opportunity cost for customers of developing these models might be less progress on key areas such as decarbonisation and reliability.

Q47 Do you agree that our proposed criteria for identifying projects suitable for late model competition are applicable in the context of electricity distribution?

As set out by Ofgem the high-level criteria of; new, high value (£100m or more) and separable, are a suitable starting point to undertake a bespoke benefits/cost assessment on a specific larger project basis. The threshold of £100m may in fact be too low given that the potentially lower financial parameters for RIIO-2 compounded by more challenging base cost allowances could in turn erode or negate any potential cost savings from other parties.

Q48 What are your views on the best ways to identify a suitable project pipeline for late competition in electricity distribution (eg our proposal to require flagging of projects that meet the high-value, new, and separable criteria)?

Should Ofgem progress with late competition in RIIO-ED2 it would be sensible to request that DNOs include potential projects meeting the relevant criteria in their business plans. This will require a clear decision on the criteria in good time (by March 2021) to enable the relevant projects to be listed in time for final Business Plan submission in December 2021.

Q49 Do you agree with the proposed range of options available for repackaging projects in RIIO-ED2 in order to maximise consumer benefit?

Whilst repackaging should be thought about, its deployment needs to be carefully considered. We can foresee circumstances where existing assets might be efficiently bundled with new ones as part of a project, though repackaging should only be undertaken with bespoke consideration of the specific circumstances.

Q50 What relevant factors do you think we should consider in deciding how these repackaging proposals are specifically applied in electricity distribution?

The repackaging proposals should be focussed around net benefit to consumers. The proposals are very high-level as set out and don't really include any insights as to how they might be applied to ED. We look forward to reading and reflecting on the responses received when these are published.

11 Incentivising ambitious Business plans and their delivery

Q51 Do you agree with our proposed approach to implementing the CDIR method in setting the TIM efficiency incentive rate?

We understand the approach that Ofgem is taking with regards to the CDIR in setting TIM, although we have some concerns with the approach taken.

Firstly, we are pleased to observe the TIM sharing rates as part of the DDs. Sharing factors at 50 percent represent a relatively fair and balanced position, and reflect good regulatory precedence as acknowledged by Ofgem in the SSMC²¹. Due to the increased number of comparators in ED a sharing rate of 50 percent should be the outcome rather than those observed in transmission.

It is concerning to see the proposed rate for transmission companies and should this be the outcome for ED it would risk a significant impact on the sector's ability to deliver Net Zero and the increased investment required to deliver this crucial policy objective. This is because a strong TIM sharing rate reveals more innovations and cost reductions in that period. It becomes harder to find or replicate these in future periods and subsequent price control reviews – therefore the strength of TIM needs to be increased rather than diminished.

²¹ RIIO-ED2 Sector Methodology consultation: Annex 2: Keeping bills low for consumers, paragraph 13.9, Ofgem

In RIIO-ED2, with a 5-year price control, we do think Ofgem needs to consider the benefits that come from sharing factors in excess of 50 percent as this will ensure the strength of the incentive to enable investment in initiatives in a shorter control so there is adequate payback. Lower sharing factors in RIIO-ED2 than in RIIO-ED1 are likely to result in slower progress in driving savings than RIIO-ED1 experienced.

Our principle concerns stem from the blended nature of the sharing factor and how this interacts with highly ambitious and innovative business plans which may include a number of first mover or leading edge innovative projects that have, potentially, relatively more uncertainty than activities that have been done historically, but in our view do have robust evidence, potentially gained through the IRM. The cornerstones of RIIO, namely *innovation* and *incentives*, need to be complementary and not work in contradiction to each other and companies should not be penalised for being ambitious and innovative by facing lower potential benefit from lower sharing factors. A blended sharing factor and a lower TIM risks companies reining back innovation and ambition in business plans where there is a chance these are assessed as low confidence costs.

We note that there are proposals for how costs can be justified or evidenced to be assessed as high confidence, although we urge that more detailed guidance is provided and developed in collaboration with DNOs. Transporting these straight from GD/T without consideration to the unique circumstances of ED is sub-optimal. We welcome a request to increase the scrutiny and robust analysis of company plans but this should not treat innovation unfairly through TIM and should actively encourage innovation rather than discourage it.

Q52 Do you agree with our proposed design of the BPI for RIIO-ED2?

Whilst the design of the BPI is reasonably clear, how Ofgem implements it in practice is not. From what we have observed of the implementation in the early RIIO-2 sectors, we are concerned that unless there are changes made for the application of the approach within RIIO-ED2 that there is a real risk of the BPI becoming a skewed incentive where companies only aim to avoid significant downside penalties. In turn the BPI could reduce companies' ambition, where compliance with the guidance and avoiding the substantial downsides seen in GD/T is the goal, thereby reducing the potential for stimulating positive outcomes for consumers.

For clarity we provide comment on each stage in turn:

Stage 1 and 2: From observing the GD2/T2 process and reviewing the recent DDs, it is clear that there has been a lack of understanding and clarity between companies and Ofgem surrounding the BPI and the process of its assessment. During industry discussions and workshops there has been ongoing uncertainty over the CVP element of the business plan guidance and this has manifested itself in the outcome and assessment of the DD proposals.

Whilst some of the issues may have been a result of the iterative approach to Business Plan Guidance, there has also been a disconnect between Ofgem's expectations and companies' understanding that resulted in a large number of CVP proposals, yet a very small number meeting the criteria, and even fewer considered worthy of award. It is clear that CEGs and stakeholders have also had a lack of understanding of Ofgem's expectations, as CEGs supported the business plans submitted in many cases, though Ofgem issued penalties to most. It is critical that these lessons are learned and are resolved for the RIIO-ED2 process so that both DNOs, their CEGs, stakeholders and Ofgem can have a more positive experience, underpinned by clearer guidance on expectations and method of assessment. Therefore, we welcome the greater clarity and guidance provided as to the approach to

BPI and CVP for RIIO-ED2, and that this is being consulted on as part of this SSMC. We do have some concern that the guidance can easily become too prescriptive and not allow appropriate flexibility to reflect customer and stakeholder preferences and priorities, and we set this out in more detail in our response to Q54 of this document.

Stage 3 and 4: As discussed in more detail earlier in Q51, greater clarity is also required as to how high and low confidence costs will be determined. Given that no company in the GD/T DD was provided with a reward in stage 4 it would be helpful for Ofgem to provide a worked example so that companies can better understand how this stage is expected to work.

We welcome Ofgem's acknowledgement that greater clarity is required in this area, and the consultation and associated guidance goes some way towards this. However, we would urge that dialogue on this important subject continues between now and the decision point in December 2020 via the formal working groups so that all stakeholders and companies can be clear on how this will work for ED in order to ensure maximisation of quality and ambition of business plans to deliver the best outcomes for consumers. These discussions should walk through each stage of the BPI and the interaction within and we suggest this is done at OAWG.

Q53 What are your views on our suggestion to use proposals contained in draft business plans in the setting of baseline standards in a number of areas (as discussed in paragraphs 13.28 and 13.29)?

It is our position that baseline standards and any potential adjustments to these between Business Plan submissions should represent minimum standards, and that companies can go beyond these where justified through stakeholder and customer engagement. Anything imposed beyond a common minimum standard would risk disconnecting the requirements on companies from that agreed with stakeholders and consumers as part of enhanced stakeholder engagement.

Caution should be applied where companies submit deliverables and outputs that exceed baseline expectations and where these are considered for wider adoption by the industry. This could undermine customer and stakeholder engagement if incorrectly applied. It is not clear within the consultation, or the Business Plan Guidance, precisely what Ofgem's intention is in terms of the draft Business Plans to be submitted by DNOs in July 2021. Throughout the documents there are a number of references that the July submission will be to the RIIO-2 Challenge Group and the December submission to Ofgem. However, within this and other sections, there is the intimation that Ofgem will use the July submission to consider CVP and baseline standards. It is critical to gain clarity as to Ofgem's intent in this area.

As with each business planning cycle there is a natural tension between collaboration and competition between companies. The BPI is designed to drive companies to reveal best practice, cost efficiency and high ambition levels, which naturally brings an element of competition. However, the need to determine common standards, methodologies and performance metrics, combined with the requirements under the Enhanced Stakeholder Engagement Guidance to ensure plans are co-created and well tested, means that companies need to collaborate and be open with their draft plans, strategies and consultative process. These two requirements are not naturally compatible and introducing a further layer of Ofgem assessing draft plans with a view to re-setting baseline standards may result in a reluctance for companies to share their plans and risk a reduction in the collaboration and engagement that Ofgem's process is seeking to strive.

Equally, consideration needs to be given to the intent to use what may be an unfinished plan to require adjustments to other company plans and the consequences of such an approach.

The Enhanced Stakeholder Engagement Guidance which we are implementing thoroughly, ensuring our business plan is shaped by our customers, will lead to our plan having standards and services within it for the North West and regions within it. What our customers and stakeholders want, prioritise and are willing to pay for will be different to those in other DNO areas so it is important Ofgem doesn't use this process to undermine local engagement outcomes.

Finally, given that there is only a period of five months between the two business plan submission dates, and at least one to two months of that time would be used by Ofgem Challenge Group considering the July plans, this gives companies limited time to consider what impact revised baselines will have on their plans and costs, and may not allow sufficient time to re-test such baselines with their stakeholders. Companies will also need to consider whether their customers have expressed a view about total bill impact to ensure an affordable settlement in the round plan.

Whilst we agree with the concept of baseline standards in some areas to ensure that no region is disadvantaged on standard services, this should be focussed on minimum standards, not raising them to the highest standards of all offered, and there is also merit in providing companies with the ability to propose a level of service that is appropriate for their region given its unique characteristics. Therefore, a one size fits all approach may not be appropriate for all activities, DSO for example being one of these.

Q54 Do you agree with our proposal to cap the number and value of CVP proposals that can be included within business plans

Whilst we welcome the clarity on the topics suggested for CVP proposals, we do not believe that Ofgem should limit the ambition of companies by constraining proposals solely to these topics. We recognise that Ofgem wishes to ensure that there is a clear signal for the areas where it would like companies to focus, however, this makes areas outside of these topics ineligible for a reward, even if backed by robust customer and stakeholder engagement. We would suggest that Ofgem keeps sufficient flexibility to allow for companies to put forward proposals outside of the five areas on a comparable basis that are eligible for rewards, where prioritised and valued by customers and stakeholders. As we propose in our cover letter, areas such as Smart Street and leading decarbonisation should be included in the list of areas to be included.

With regards to a cap on values, quantity of CVP proposals and overall cap, we also believe that this approach in combination will fetter ambition and should be reconsidered. DNOs are working together collaboratively on a convergence project on Social Return on Investment (SROI) and how this can be standardised across DNOs, building on the work done for SECV in RIIO-ED1. We urge that Ofgem considers the output and progress of this project and how this can enhance CVP assessment for RIIO-ED2.

As referenced in the previous question (Q53) we would also like to obtain clarity on Ofgem's intention on the CVP assessment between draft and final business plan submissions.

Q55 Is there any further detail on the proposed content of the Business Plans that you think should be set out in the Business Plan Guidance?

We currently do not have any specific examples of further detail required in the Business Plan Guidance other than in the description of Price Control Deliverables where Ofgem refers to 'baseline

funding'. This term is also used three times in the SSMC documentation, but there is no clarification of what this means. It would be helpful for this term to be clarified to aid in fuller understanding.

It is clear that, as the requirements evolve over the next few months in areas such as for CBA and EJP, supplemental detailed guidance will need to be published reflecting the agreed process changes.

We expect that further detailed discussion on the Business Plan Guidance will also take place within the RIIO-ED2 working groups and that any content or clarification points will be addressed within that forum as well as via this specific consultation.

Q56 Is there other information that we should be requesting in the Business Plan Guidance in order to assess a network company's Business Plan?

We are not aware of any material gaps in the Guidance subsequently issued by Ofgem, however, we will continue to work with Ofgem through the RIIO-ED2 working groups such as the BPDT Working Group to highlight these as and when they are identified.

Q57 Do you agree with the proposed set of minimum requirements for Stage 1 of the BPI that are set out in the draft Business Plan Guidance?

Through our observations of the RIIO-2 business plan process for GD/T we note that, despite the minimum requirements in the section being similar to those drafted for ED, four out of the eight companies were deemed to have not met the minimum requirements. We are unsure where the failing lies in this, as no company should fail to meet a set of clearly laid out minimum requirements. We ask that Ofgem provides more detail on how this was assessed and where the minimum requirements were not met, with examples, so that the lessons can be learned to ensure that no such failing occurs for ED companies.

Further, it is unclear from the document whether these minimum requirements apply solely to the business plans submitted to Ofgem in December 2021, and what, if any, requirements there are for the initial plans due to be submitted to the RIIO-2 Challenge Group in July 2021. It would be helpful to clearly state in the guidance this applicability.

We have no further comments on the list of minimum requirements at this point and will continue to work with Ofgem to develop the guidance through the Ofgem working groups.

Finally, section 8.7 final paragraph states "*and must also have regard to the guidance given in Section 4 of this document on the presentation and structure of Business Plans.*" This should be corrected to point to section 7 which is the section referring to presentation and structure of plans.

Q58 Do you agree with the approach for assessing companies CVP proposals that is set out in the draft Business Plan Guidance?

As we share in our response to questions 52 and 54 we have some concerns over the level of prescription within the CVP proposals. We do not believe this is in consumers' best interests and could have the effect of fettering companies' ambition and focus on the range of customer and stakeholder needs emerging from enhanced engagement. We would suggest that Ofgem keeps sufficient flexibility

to allow companies to put forward proposals outside of the five areas on a comparable basis, where prioritised and valued by customers and stakeholders.

With regard to a monetised benefit methodology, DNOs are working together collaboratively on a convergence project on Social Return on Investment (SROI) and how this can be standardised across DNOs building on the work done in SECV in RIIO-ED1. We urge that Ofgem considers the output and progress of this project and how this can enhance CVP assessment for RIIO-ED2.

Q59 We anticipate that DNOs are investing in improving / creating data dictionaries and business information models that describe the data-driven aspects of DNOs overall business architecture. We anticipate there may be opportunities to take advantage of these investments to support the process of cross-referencing data used within RIIO-ED2 Business Plans. What are your views on this?

Data integrity is a key part of assessing the quality of DNO Business plan submissions and we will be using approaches, such as those outlined, to ensure that our submission is appropriately cross-referenced.