

6 December 2017

Mick Watson
The Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Dear Mick

Re. Introduction of RIIO Accounts – further consultation on license modification

Deloitte welcomes the opportunity to respond to the further consultation on the introduction of RIIO accounts. This letter sets our response based on our discussions with Ofgem and the network operators since the initial consultations on the introduction of RIIO accounts and our review of the work performed to date on the preparation of RIIO accounts by our audit clients in the sector. This letter reflects Deloitte's general view of the introduction of RIIO accounts and we have not sought to answer the specific questions included in the further consultation dated 8 November 2017.

Our understanding of the driving objective behind the introduction of RIIO accounts is to achieve transparent reporting of regulatory performance in a consistent manner which supports comparability across companies reporting under the RIIO regime. Deloitte continues to be supportive of the proposal to introduce RIIO accounts on the basis that they meet the original objective and do provide investors and other stakeholders

The introduction of the new regime will be costly for the companies involved, both in terms of internal resource and the direct external assurance costs. We estimate that the external incremental cost of completing the audit of the RIIO accounts would be in excess of £3 million, excluding the internal time and resource of the network operators in preparing the RIIO accounts and supporting information. On the assumption that these costs are passed on to customers, consideration does need to be given as to whether this is a value added activity in the context of managing the cost of the provision of energy to consumers.

We are committed to working constructively with Ofgem and our audit clients in the sector, however the preparation and audit of the RIIO accounts is a complex area which presents some practical considerations that need to be addressed before we would feel confident that the output would meet the intended objectives.

Below we have summarised the key complexities that were presented by us in the RIIO Accounts Workshop meeting on 17 November 2017. We note that this is not an exhaustive list but represents the common themes identified to date through this process and through working with our audit clients across the sector.

1. Interpretation of Ofgem Regulatory Financial Reporting Standards (ORFRS)

Deloitte recognises that the latest ORFRS are intentionally principles based, however in the absence of further guidance and worked examples and illustrations, there is scope for network operators to interpret them differently. When complex financial reporting standards are issued they are subject to extensive consultation periods and are typically issued along with interpretive guidance and illustrative examples.

It is clear that given the complexity of the RIIO accounts, network operators require further guidance on how to interpret and apply the ORFRS in certain areas. Specifically we have identified enduring value, taxation

and financing as being the areas which we understand, from our review of our clients' RIIO accounts preparation, involve the most judgement.

In the absence of interpretative guidance and illustrations there is a risk that the ORFRS are interpreted differently which will impair the comparability of the RIIO accounts across the sector which may undermine the objective of introducing this license modification.

2. Opening Regulatory Financial Statement Balances

Deloitte has identified a number of balances which would require Ofgem to confirm their opening position. All of these balances are derived from, or included within, models developed by Ofgem and made publicly available by Ofgem including the Price Controls Financial Model (PCFM), Price Control Proposals, Return on Regulatory Equity model (RoRE) and the Revenue Reporting Model.

Through our review of preparation of RIIO accounts by our audit clients to date, we have identified the following list of balances, transactions and rates that require confirmation or representation by Ofgem across gas and electricity transmission and distribution. We note that this list is not exhaustive and further items may be identified as we continue through our review of the RIIO accounts preparation process with our clients.

Items in the PCFM:

- Legacy price control recoveries from PCFM
- Pension true up from previous price controls
- NGET Capex Incentive and safety net
- Legacy adjustments to allowed revenue (adjustment only)
- Revenue adjustment from previous controls (base)
- Tax pool allocations and pool rates
- Base allowances
- Opening RAV values and cumulative values to opening 16/17 balance sheet (also in final proposals)
- Non-Core (TIRG) values and profile for transfer to RAV (also in final proposals)

Fixed percentages as outlined in the final proposals:

- Regulatory Fraction percent
- Totex incentive rate (sharing factor)
- Asset lives and depreciation profiles
- Capitalisation rates

Items in the Revenue Report Model:

- Opening K value and cumulative values to opening 16/17 balance sheet
- Opening RPI true up and cumulative values to opening 16/17 balance sheet
- Opening termination agreements and cumulative values to opening 16/17 balance sheet

Deloitte will require confirmation from Ofgem of what items they are prepared to confirm or represent on, the mechanism for this process and the date that this will be effective from. There is a significant cost implication based on this agreement, and in particular based on the effective date given the additional time and effort involved in auditing a balance rolled forward from the start of the price control period versus the balance from the opening position for the financial year under audit.

The absence of these representations, or confirmations, presents a risk that exceptions would be included in the audit reports equal to those areas that cannot be relied upon. These exceptions in the audit report may challenge the RIIO accounts achieving their objective with investors and stakeholders.

3. Form of the intended Audit Report

Deloitte recognises that the intention of the RIIO accounts is to include a “fairly presents” audit opinion and does not disagree that in principal this intention should be achievable. However, based on the key complexities identified in points 1 and 2 above, our view is that for the year ending 31 March 2018 an opinion based on “preparation in accordance with the ORFRS and the network operator’s methodology statement” is more appropriate and achievable, with appropriate reference to the items confirmed by Ofgem in point 2 above.

In the absence of sufficient guidance on the interpretation of the ORFRS this alternative audit opinion will enable the network operators to state in detail how they have applied the ORFRS which can be opined upon. This would continue to require the representations, or confirmations, stated in 2 above.

The completed RIIO accounts for the year ending 31 March 2018 would allow a review of the regulatory reporting across the network operators and a reassessment of the required additional guidance to develop a common methodology which would support the intended “fairly presents” audit opinion envisaged in the consultation.

Given the complexities and concerns outlined in this consultation response regarding the challenges and given the timeframes of the proposed license modification we would question whether there is merit in deferring this process by a year to allow for a more considered response to the challenges identified.

We hope that you have found this response helpful and would welcome the opportunity to have a meeting to discuss these key complexities in more detail.

Yours sincerely



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