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Our ref | Your ref | Date
1 October 2020

Dear Akshay,

Consultation on RIIO-2 Sector Specific Methodology Consultation for Electricity Distribution

I am writing on behalf of Western Power Distribution (South Wales) plc, Western Power Distribution (South West) plc, Western Power Distribution (East Midlands) plc and Western Power Distribution (West Midlands) plc. This letter and associated annexes set out Western Power Distribution's (WPD) response to Ofgem's consultation of 30 July 2020 on the RIIO-2 Sector Specific Methodology for Electricity Distribution (ED).

On behalf of WPD, I wish to thank you for Ofgem's initial work for the RIIO-2 ED Sector Specific Methodology Consultation (SSMC). Whilst all price control reviews are challenging, RIIO-2 comes at an exceptionally important time as the UK seeks to accelerate towards net zero carbon dioxide emissions (Net Zero) and in the face of the challenges caused by the Covid-19 pandemic.

WPD has already responded to the RIIO-2 ET, GT and GD2 Draft Determination consultations, and emphasised our strong belief in the benefits of a genuine incentive based regulatory regime for achieving the best outcomes for consumers in terms of low prices and high quality service levels. This, in our view, underlines the importance of an ex-ante regulatory regime, whereby cost and service targets are clearly defined in advance, and companies are incentivised to exceed these targets by the additional returns they can achieve. The regulatory regime should also ensure that the benefits of cost savings, service quality improvements and innovation are passed on to consumers through lower prices and higher service levels in future price control periods, as well as being partly shared with consumers in the current price control under the existing cost sharing mechanisms.

However, Ofgem is proposing large-scale revisions in RIIO-2 that risk undermining this effective incentive structure and the customer benefits achieved in RIIO-1. The RIIO-1 price control includes a strong incentive package that facilitates positive performance from network companies and directly benefits consumers in the current and future price control periods. In short, we want to ensure that the proposed RIIO-2 ED methodology does not ignore the benefits RIIO-1 has provided.

WPD's view is that for ED RIIO-1 broadly achieved the right balance in terms of incentivising companies to find significant efficiencies and exceed output delivery targets.

Moreover, as a result, the base line efficiencies and output targets can be revised upwards in RIIO-2. However, the basic structure of the RIIO-1 regime – particularly the setting of total expenditure (totex) allowances largely for the whole period, the incentive sharing rates of totex, ranges of Output Delivered Incentives and the absence of any Returns Adjustment Mechanism – should stay broadly the same. The approach advocated by WPD would also provide a stable regulatory backdrop for continuing engagement between Ofgem, network operators and other stakeholders on the needs for RIIO-3 and beyond.

Contrary to these objectives, Ofgem's proposals for RIIO-T2/GD2 also includes a penalty heavy "incentive" package, with the "reward" for high performing companies primarily being limited to the avoidance of a penalty. This will further transfers costs and risks asymmetrically to them, thus undermining their financeability, as found by the KPMG work referenced below.[1]

Ofgem rightly emphasises the importance of regulation being stable and predictable, since regulatory risk (in particular, where it is asymmetric in nature) will increase the cost of capital. However, Ofgem's proposals cut across this objective. Given that energy networks are capital intensive, any increase in the cost of capital can be expected to lead to higher prices to the detriment of consumers.

It should be noted that WPD agrees with much of the wide-ranging analysis carried out by consultants on behalf of the Electricity Networks Association (ENA) relating to the Transmission (T) and Gas Distribution (GD) sectors. This analysis identifies a number of serious issues with Ofgem's approach that will be important to address in RIIO-ED2, including:

(i) Oxera's estimate of the cost of equity being in the range of 6.05-7.1%, with Oxera's analysis also taking account of more recent market data and appropriate company comparators for beta risk. This range is materially higher than Ofgem's figures;
(ii) NERA's detailed analysis of borrowing costs, including the carrying costs for maintaining sufficient liquidity within the businesses, new issue premium costs and the debt costs of hedging the Consumer Price Index including owner occupiers' housing costs (CPIH) inflation risk. Again, Ofgem has understated the cost of debt financing;
(iii) Frontier Economics' critique of Ofgem's proposed further adjustments to the cost of capital to determine an allowed return below the actual weighted average cost of capital (WACC) (which is referred to the expected return (ER) - actual return (AR) adjustment); and
(iv) First Economics' critique of the on-going efficiency assumptions adopted by Ofgem, including its identification of a number of inconsistencies in CEPA's analysis. Ofgem's approach thus exaggerates the scope for network operators to achieve further cost savings over time, which will further reduce network operators' future returns.

[1] WPD Annex 2 RIIO-ED2 SSMC Response KPMG Report, "Analysis of RIIO-ED2 Sector-Specific Methodology Consultation", 1 October 2020

WPD also wants to draw Ofgem's attention to a report on the overall incentive structure of the RIIO-ED2 SSMC commissioned from KPMG – please see Annex 2 to this letter.[2] KPMG raises concerns over how incentives under the proposals will be skewed towards favouring traditional methods for meeting objectives, and a "wait-and-see" approach towards tackling the challenges of Net Zero. KPMG also flags that, with respect to financeability, WPD's downside exposure is significant relative to WPD's forecast headroom. This concern is also reflected in a recent Moody's UK Energy Networks webinar that suggested Ofgem's proposals will weaken credit ratios (session entitled "RIIO-2 proposals will weaken credit quality", 9th September 2020).[3] Ofgem will also need to look very carefully at the cost of debt calibration and cost of equity taking account of the specifics of ED and the expected sector developments and financeability of the sector, and not simply carry over findings from T and GD. WPD looks forward to engaging with Ofgem on this.

Although not explicitly mentioned in the SSMC, WPD also specifically asks Ofgem to reconsider the appropriateness of the ER-AR adjustment. Ofgem will be aware that it is the only regulator taking this approach, which is entirely unprecedented. In addition, a recent paper by John Earwaker and Nick Fincham finds thin support for this adjustment amongst previous senior UK economic regulators, and they sensibly conclude that it is "inappropriate for regulators to decide before a price review even begins that they will inevitably fail to set expenditure allowances and output targets in such a way as to set up a 'fair bet' (or equivalent)."[4] WPD strongly concurs with their views. Moreover, a number of features of Ofgem's proposals are contrary to this principle of a fair bet, with this being considered in detail in the report commissioned from KPMG.[5]

In addition to the concerns outlined above, there are also serious issues with Ofgem's assessment of operators' business plans and their planned expenditures over the course of RIIO-2 which we wish to avoid for RIIO-ED2. In this regard, we note again KPMG's concern that the use of Confidence-Dependent-Incentives will skew companies' plans towards adopting established and traditional methods.[6] More generally, Ofgem's reliance on high level "top-down" models based on total costs to appraise companies' business plans and efficiency is particularly concerning. This is despite Ofgem recognising the significant change that the sector will undergo in its transition to both Net Zero and the development of the central role of the Distribution System Operator (DSO), and more generally due to technological developments and other advances. These changes will create investment and operational challenges. WPD believes that the energy networks sector is ready and willing to step up to these challenges – and WPD certainly is – but the regulatory regime must support these objectives.

In this context, Ofgem's proposed step changes in RIIO-T2/GD2 to investment incentives, such as the sharp cut in the cost of capital, and the restructuring of outputs and weakening of outperformance rewards, will seriously compromise companies' abilities and incentives

[2] WPD Annex 2 RIIO-ED2 SSMC Response KPMG Report, "Analysis of RIIO-ED2 Sector-Specific Methodology Consultation", 1 October 2020.
[3] Moody's, 9 September 2020, *Moodys-Falling-equity-returns-to-weaken-energy-networks-credit-ratios*, 21 September 2020, http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1244156
[4]First Economics, August 2020, *Information Asymmetry and the Calibration of Price Controls*, John Earwaker & Nick Fincham, 2 September 2020, http://www.first-economics.com/earwakerfincham.pdf
[5] WPD Annex 2 RIIO-ED2 SSMC Response KPMG Report, "Analysis of RIIO-ED2 Sector-Specific Methodology Consultation", 1 October 2020.
[6] WPD Annex 2 RIIO-ED2 SSMC Response KPMG Report, "Analysis of RIIO-ED2 Sector-Specific Methodology Consultation", 1 October 2020, pp2, 8-14.

to respond to changing demands with appropriate investment and operational flexibility. We expect Ofgem to consider any proposals independently for RIIO-ED2.

WPD also notes that Net Zero and technological transitions will fundamentally impact the cost structure of the sector, with the consequence that high level, top-down historical data is not necessarily a reliable indicator of future costs, and nor is a cost measure based on a single Composite Scale Variable ("CSV"). WPD is therefore concerned with Ofgem's reliance primarily on top down models of "efficient" expenditure levels. Whilst top-down econometric models can be useful, they should never form the primary basis for setting totex allowances unless they have been very carefully tested and triangulated with more detailed bottom-up analysis.

A further issue in RIIO-T2/GD2 thus far is the large-scale reduction proposed by Ofgem in operators' baseline revenues relative to their business plans, and the suggestion that future costs/investments could be funded as needed using so called ex-post Uncertainty Mechanisms. As pointed out by former Ofgem executive Maxine Frerk in her recent article in Utility Week, the over use of such mechanisms creates material risks:

> "What worries everyone though is that this emphasis on uncertainty mechanisms relies on Ofgem making quick decisions if we are to avoid delays to investment in essential infrastructure."[7]

Any uncertainty which could be caused by large ex-post elements in the RIIO-ED2 determination raises real risks for consumers, and wider Net Zero imperatives, as it makes it difficult for companies to plan with a sufficient degree of confidence, and consequently ensure they have sufficient resources with the appropriate skills available at the point they are needed to implement critical investment.

This leads finally to Ofgem's Impact Assessment of 31 July 2020 for the RIIO-2 Network Price Controls.[8] This focuses on gas distribution and electricity and gas transmission, and thus Ofgem should be carrying out a separate assessment as regards ED2. Ofgem's stated preferred approach – 'Option 3' – is described by Ofgem as continuing "*to use incentives to drive consumer benefit*" but with significant changes to increase consumer benefits.[9] For the reasons outlined above, WPD fundamentally disagrees and considers that Ofgem is dismantling the incentive based regime of RIIO-1 that has delivered substantial customer benefits.

Having reviewed the IA, we consider there are some process points that Ofgem should reflect on and consider in the development of ED2. Our review of the IA identifies that Ofgem has not looked at the granularity of its decision making, thus not undertaking comprehensive analysis of how individual policies have been informed. The IA does not sufficiently analyse the policy and decision making for GD2 and T2, with the full range of outcomes for policies not having been fully assessed. Further, Ofgem has focused on the whole option level, rather than looking at individual policy level: for example, the IA includes very little assessment of reliability, resilience or environmental sustainability. As well as this, Ofgem's IA does not provide a robust evidence base for its decisions, which

[7]Utility Week, 6 August 2020, *RIIO2: A big idea?*, Maxine Frerk, 9 September 2020, www.utilityweek.co.uk/riio2-a-big-idea.
[8]Ofgem, *RIIO-ED2 Network Price Control Draft Impact Assessment*, 14 August 2020.
[9]Ofgem*, RIIO-ED2 Impact Assessment*, p5.

flags concerns about the ways Ofgem has made some of its policy decisions. We wish to highlight these issues now to aid the development of the SSMD for RIIO-ED2.

WPD is mindful that there remains substantial work to be done to progress ED2, and stands ready to work with Ofgem to develop ED2 so as to best serve the current and long-term interests of customers, other stakeholders and UK decarbonisation efforts.

Yours sincerely,

Paul Branston
Regulatory & Government Affairs Manager

Enc:
01102020 WPD Executive Summary to RIIO-ED2 SSMC
01102020 WPD Annex 1 Question Responses to RIIO-ED2 SSMC.pdf
01102020 WPD Annex 2 RIIO-ED2 SSMC Response KPMG Report

1 Introduction

1.1 WPD welcomes the opportunity to respond to the RIIO-2 Sector Specific Methodology Consultation (SSMC) for the Electricity Distribution (ED) sector. Our response focuses on several areas where Ofgem should further reflect on its position and the robustness of its supporting evidence before making its methodology decision.

1.2 As with the recent Draft Determinations for the Transmission and Gas Distribution sectors, our overall concern is that the ED2 SSMC excessively focuses on achieving short-term price reductions at the expense of medium and long-term benefits from an incentive based regime. Such an incentive regime would deliver lasting benefits to consumers – including long term efficiency, sustained increases in service levels and quality – and investment in networks capable of delivering the infrastructure needed for a Net Zero economy.

1.1 Further, Ofgem has not made the case that there are fundamental short-comings associated with RIIO-1 that warrant radical surgery as opposed to fine tuning. WPD does not agree that there is any evidence that RIIO-1 has not worked well, with the result that only minor adjustments and recalibration are appropriate. Ofgem has also not explained why the shortening of the price control period from eight to five years does not sufficiently remove the issues arising in RIIO-1 associated with forecasting demand and costs over the period of the charge control.

1.2 In this Executive Summary, we focus on three core areas:

(i) Cost of capital.

(ii) Totex allowances.

(iii) Incentives.

2 Cost of Capital

2.1 At the beginning of the consultation, Ofgem makes the important observation that:

> *"DNOs will need to make strategic investment to increase the capacity of their networks to meet this demand. How we tackle this will be one of the most important aspects to get right. Underinvesting in the network now could put Net Zero targets at risk."*[10]

[10] Paragraph 1.3.

2.2 Unfortunately, this guiding principle is not adequately reflected in the rest of the document. Ofgem fails to acknowledge the need to provide an adequate return to shareholders to incentivise them to make the required network investment. Critical drivers of Zero Carbon – such as Electric Vehicles (EV) and Heat Pumps (HP) – will rely on investment in ED networks, and can only happen with adequate investor return.

2.3 The crux of Ofgem's approach appears to be driven by the following mis-characterisation of RIIO-1:

> *"… the overall costs of the networks to consumers in RIIO-1 to date have turned out to be higher than they needed to be … the majority of network companies across all sectors are earning returns towards the higher end of our expectations when the price controls were set."*[11]

2.4 This statement does not adequately reflect why returns are higher than expected, including one-off issues associated with demand levels being lower than envisaged. More generally, if this represents Ofgem's view that no company should earn a return above the WACC (expected return), it will undermine any incentive to outperform either service performance or cost performance targets. It must also be remembered that any outperformance is partly shared with customers in the current regulatory cycle (under the totex incentive regimes) and fully returned to customers in future cycles as lower actual costs form the basis for efficiency assessments in future price control periods.

Cost of equity

2.5 Whilst making no working assumption for the cost of equity at this stage in the process, Ofgem has made clear that it will implement the same methodology that led to the low estimates for the other RIIO-2 network sectors.

2.6 WPD would be concerned if Ofgem were to apply the same (imperfect) 3-step approach in ED2, and it would not be appropriate if Ofgem were to restrict consultation to the issue of whether there are any systematic risk differences between ED and the other network sectors.

2.7 Ofgem will also already be aware of Oxera's estimate of the cost of equity in the range of 6.05-7.1% taking account of more recent market data and appropriate company comparators for beta risk,[12] in addition to its work in developing a cross-check based on the asset risk to debt risk premium.[13]

[11] Paragraph 2.7.
[12] Oxera, "The cost of equity for RIIO2", report prepared for the ENA.
[13] Oxera, "Asset risk premium relative to debt risk premium", report prepared for the ENA.

2.8 Whilst the Expected – Allowed Return adjustment is not explicitly mentioned, WPD urges Ofgem not to pursue this concept. We agree with the conclusions of the recent paper by John Earwaker and Nick Fincham:

> *"It follows that modern-day regulators, with a toolkit that is brimming with modern-day regulatory weaponry, ought to have the self-belief that they are capable of making balanced, and well-justified choices when they calibrate price controls, including by challenging regulated companies to continually improve performance and by putting in place uncertainty mechanisms to deal with situations in which it is genuinely impossible to predict the future. The corollary is that it is also inappropriate for regulators to decide before a price review even begins that they will inevitably fail to set expenditure allowances and output targets in such a way as to set up a 'fair bet' (or equivalent)."*[14]

Cost of debt and financeability

2.9 In respect of the cost of debt, Ofgem appears to be open to considering whether it would be more appropriate to use either: (a) an assumption based on the RIIO-ED1 (10-20 year trailing average) approach; (b) an assumption based on the cost of debt calibration proposed for RIIO-2 GD&T networks (10-14 years); or (c) another calibration. It will be important for Ofgem to undertake a preparatory analysis of these options to see which best fits the debt maturity profile of the DNOs. Whatever approach is taken, it is important that Ofgem includes a reliable estimate of all the costs of debt financing. Ofgem will already be aware of NERA's work for the ENA on energy company debt costs, including the carrying costs for maintaining sufficient liquidity within the businesses, new issue premium costs and the debt costs of hedging CPIH risk.[15]

2.10 Ofgem is proposing moving to the iBoxx Utilities 10 year+ index, (deflated by the OBR CPI forecast as a proxy for CPIH forecasts) with a 17 basis points (bps) additional borrowing cost margin added (in lieu of the fact that this index has a lower yield than the previously used index). However, since this index is not directly fixed to any investment grade, ED companies are exposed to changes in risk and investment grading of companies in other utility sectors. For example, if water sector risk falls and water companies benefit from lower debt premiums, ED companies will suffer an unfounded reduction in their own debt interest allowance.

2.11 As regards financeability, Ofgem recognises that there is a concern if the cost of equity falls faster than the cost of debt. However, as in previous consultations, Ofgem states that this requires action from the companies themselves via:

[14] "Information asymmetry and the calibration of price controls", John Earwaker & Nick Fincham August 2020.
[15] NERA, "Review of Ofgem's DD Additional costs of borrowing, and deflating nominal Iboxx", report prepared for the ENA.

- dividend policy adjustments – but this would impact appetite for future equity investment;
- equity injections to reduce gearing - but this requires an acceptable cost of equity;
- re-financing of "expensive debt or other financial commitments" – but it is not clear how this would help due to the cost of unwinding existing debt;
- network companies proposing alternative capitalisation rates and/or depreciation rates, if appropriate - but this would only help with cash profiling and would not address the underlying problem of an insufficient return on equity relative to debt;
- adjusting notional gearing[16] – but this would only be of notional assistance and under Modigliani-Miller, used by Ofgem in the Draft Determinations, would not affect the overall WACC.

2.12 A report commissioned from KPMG[17] finds WPD has significant downside exposures relative to its forecast financial headroom and suggests that Ofgem should not be confident that the forecast reduction in financial headroom is consistent with financeability. KPMG believe further analysis is needed in respect of downside scenarios, and where financeability challenges are identified, amendments may be needed: either in the form of mitigation of downside risk or additional remuneration. This concern is echoed in a recent Moody's UK Energy Networks webinar that suggested Ofgem's proposals will weaken the credit ratios.[18]

2.13 As Ofgem is aware, it has a statutory duty to ensure that reasonably efficient companies are able to finance their activities. It therefore cannot simply rely on companies to take actions to avoid financeability issues. If there is a clear risk that companies will not be able to finance their activities under the proposed approach, this not only raises questions as to Ofgem's compliance with its statutory duties, but also raises a "red flag" that the overall price control regime (including permitted returns) is not well balanced.

3 Totex allowances

3.1 In relation to setting totex allowances Ofgem says:

[16] The SSMC lists this as an action companies could take (e.g. Finance Annex, 4.8-4.9), whereas in fact it would be for Ofgem to decide.
[17] KPMG "Analysis of RIIO-ED2 Sector-Specific Methodology Consultation", September 2020.
[18] Session entitled "RIIO-2 proposals will weaken credit quality", 9th September 2020).

> *"Econometric analysis or benchmarking represents our primary cost assessment tool".*[19]

3.2 WPD is concerned that such an approach will be overly sensitive to the model specification and assumptions. Instead, Ofgem needs to give more weight in RIIO-ED2 to a "middle-up" approach, i.e. modelling at a lower level of aggregation (but not as disaggregated as bottom-up). Unlike the top-down modelling, this will require models to capture the trade-off substitution between, for example, capital expenditure (capex) and operating expenditure (opex). Nevertheless, using more detailed and disaggregated data would be a sensible approach.

3.3 If Ofgem does rely primarily on a top-down econometric assessment of costs, Ofgem needs to give careful consideration to the frontier benchmark set. Setting a high percentile (as in the case of the RIIO-GD2 Draft Determination and one higher than applied under RIIO-1) risks Ofgem erring by inferring inefficiencies from what are in fact legitimate cost differences between companies (e.g. local input cost prices or other legitimate differences in cost structure[20]) or modelling error.[21]

3.4 In any event, Ofgem will need to consider carefully the accuracy and sufficiency of any pre-adjustments made to relative cost data before the statistical regression models are estimated, particularly relative local market factor input costs across different companies and other operating environment differences not captured by the model variables. For the purposes of projecting efficiency forward, i.e. on-going efficiency, Ofgem suggests it will use CEPA's Growth Accounting approach as in RIIO-GD2; but will continue to explore the interactions that the results of this approach may have with other parts of the overall determination. In this regard, however, it will be important to avoid any "double counting" of expected efficiency.

3.5 Volume drivers and Real Price Effect ("RPE") indices need to be properly specified so that they are transparent and clearly linked to required totex. Poor proxies for volume related costs or poor measures of RPEs would increase financial risks to the companies.

3.6 Ofgem has identified a range of Uncertainty Mechanisms (UM) that could be applied. It is unclear why Ofgem never mentions the harm of uncertainty transferred from companies to customers, with no analysis of who is in the best

[19] Annex Document 2, paragraph 3.1.

[20] For example, assuming a simple single composite output variable in a Cobb-Douglas functional form when the cost volume relationship is in fact more complex and multi-dimensional will result in companies being identified as inefficient when in fact the model is failing to allow for the correct impact of economies of scale or particular mixes of outputs provided by the company.

[21] Potentially a Stochastic Frontier Regression approach can estimate the optimal position for the frontier benchmark based on the data, but these models make other strict assumptions on the form or data and modelling errors, and inefficiencies, that will need to be explored.This may show, for example that the model residuals are dominated by symmetrical model error rather than asymmetric efficiencies.

position the bear any particular source of uncertainty. This point should be highlighted in responses to the forthcoming Impact Assessment.

3.7 Whilst reduced uncertainty in financial returns is good for companies, the consequential increased uncertainty over scale and scope of future operations will complicate planning and ultimately increase costs. Ofgem should give some analytical consideration to this trade-off (i.e. lower WACC vs. greater unit cost).

4 Incentives

Totex Incentive Mechanism

4.1 Ofgem propose the Totex Incentive Mechanism (TIM) will be implemented with Confidence Dependent Incentive Rates (CDIR) in the range of 15-50%. Setting such a low range is ill advised for a number of reasons:

- the upper 50% of the range is based on Ofwat/CMA precedent, but in those cases it is in fact used as a central case and should not be applied only to a high CDIR situation; and
- the lower 15% of the range is based on highly speculative modelling by CEPA.

4.2 As an initial point, Ofgem would be better advised to implement a range around 50% (e.g. 40-60%) to ensure companies are incentivised to find efficiencies and exceed output targets.

4.3 More fundamentally however, CDIR's skew incentives towards established and traditional methods. WPD's report from KPMG discusses how this is completely inappropriate to meet the radically new challenges of Zero Carbon and the DSO function. This is further exacerbated by the SSMC's reliance of reopeners and other UMs which clearly incentivise a "wait and see" approach to these challenges and discourage any anticipatory planning and investment.[22]

Business Plan Incentives

4.4 As with other sectors, the BPI seems weighted towards penalty. It is worth reminding Ofgem of its own statement:

> *"GB's electricity networks deliver safe and reliable energy with power cuts reduced during successive price control periods and are now at around half the European average levels."*[23]

[22] KPMG "Analysis of RIIO-ED2 Sector-Specific Methodology Consultation", September 2020.
[23] Paragraph 2.17.

4.5 The implication is that GB networks are performing well and incentives should be weighted towards reward, not avoiding penalties.

4.6 As we discuss above, the BPI scheme should be an opportunity to reward innovative and anticipatory expenditure towards the challenges of Zero Carbon and the DSO operation. Instead, it operates as a scheme for penalising companies that do not base their business plans on historical trends in established traditional patterns of expenditure.