

Annex 1 – Responses to specific questions from Ofgem Consultation on RIIO-ED2 Sector Specific Methodology Consultation

Overview Document Questions

Interlinkages and CMA Appeals in RIIO-2

→ OVQ1. Do you have any views on our proposal to include a statement of policy in Final Determinations that in appropriate circumstances, we will carry out a post appeals review and potentially revisit wider aspects of RIIO-2 in the event of a successful appeal to the CMA that had material knock on consequences for the price control settlement?

As per WPD's Response to Ofgem's RIIO-2 Sector Specific response in March 2019, and our recent response to Q40 of the Gas and Transmission RIIO-2 Draft Determination consultation, the consequences of an appeal made to the Competition and Markets Authority should remain self-contained to the scope of the appeal.¹

If there are any consequential issues associated with the area being considered in an appeal then these should be incorporated within appeals proceedings. There should not be any post appeal adjustments for areas of the price control not considered during the appeal.

The appeal itself should consider maintaining a coherent regulatory settlement and therefore it is inappropriate for Ofgem to carry out additional adjustments to the price control arrangements not covered by the appeal.

The impact of any successful appeal should not be extended to any other licensee, unless that licensee has been specifically identified as potentially being impacted by an appeal. This will allow the potentially affected licensee to be involved in the appeals process, providing any supporting evidence necessary. It is wholly unacceptable for a licensee to be affected by an appeal, where it has not been directly involved with the appeals process.

→ OVQ2. Do you have any views on the proposed pre-action correspondence, including on the proposed timing for sending such to Ofgem?

Ofgem states in the GD&T2 Draft Determination that they expect any prospective appellant to send pre-action correspondence at a sufficiently early stage after the publication of Final Determinations and ahead of the deadline for making an application for permission to appeal.

It is not clear what Ofgem means by a 'sufficiently early stage'. The detail and complexity of any Final Determination, and the time taken to review and understand the decision, will impact on how swiftly any prospective appellant could issue pre-action correspondence.

¹ WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution, 14th March 2019; WPD (Sept 2020) 04092020 WPD Appendix Question Responses to RIIO2 GD&T Draft Determinations, Core Question 40, p17.

Net Zero and Innovation

→ OVQ3. Do you agree with our proposed approach to a Net Zero re-opener?

RIIO-2 proposals must inherently support the net zero transition. WPD acknowledges the need for a Net Zero re-opener mechanism, but this should only be used to capture significant policy, technology or customer driven changes which could not have been reasonably predicted when setting baseline revenues.

Whilst there is some uncertainty over the absolute trajectory of the transition to net zero by 2050 (at the latest), there is without doubt a need to commence work now on low regret investments, particularly within electricity distribution, to ensure it is feasible to achieve a UK net zero position.

→ OVQ4. In what circumstances, would a centralised approach to setting forecasted outputs be appropriate? What form should this take?

Where the regulator has confidence in a single outlook set at a national level, which has been robustly informed by local and regional stakeholders, this forecast would be appropriate to use. The outputs need to be considered for significance, particularly with respect to underlying demand and generation growth. The outputs must have some methodology for each of the technologies to generate a DNO-specific forecast and an expected electrical behaviour assigned to each technology to allow the DNOs to have a common view of capacity required. Networks designing to different electrical assumptions will have different investment requirements even if given an identical volume allocation.

→ OVQ 5. What would be the factors we should take into account that would give us high certainty in a centralised approach to setting outputs?

High certainty in a centralised approach would require high confidence in the chosen scenario being in alignment with the expectations of local and regional stakeholders. There must be a low expectation that the correlation of co-location for the outputs will deviate from the national average, both in volume and also in timings. The robustness of the national scenarios must be highly certain, otherwise errors in investment required will be replicated through the whole electricity system. Where sufficient data exists to determine the regional allocation of outputs without this being informed by network company engagement, then this approach would be more certain.

→ OVQ 6. Alternatively, in what circumstances would it be more appropriate to take a decentralised approach to determining forecasts?

Where a robust process for engaging with local and regional stakeholders can be demonstrated and evidence can be sufficiently substantiated behind decentralised forecast scenarios, then these models would be valid. A decentralised approach will naturally contain more detail about the technology volumes, regional allocation and deployment timescales, allowing much more granular forecasts to be provided and

hence, more opportunities to review and benchmark the accuracy of the forecasts to prove efficiency.

→ OVQ 7. What would be the factors that we should take into account that would give us high certainty in forecasted outputs derived through a decentralised approach?

High certainty would be aligned to the robustness of evidence gathered from national, regional and local stakeholders. This must include specific work on understanding technologies, volumes, timescales and confidence in delivery.

→ OVQ 8. Do you consider that the LAEP Best Practice guidance produced by the Centre for Sustainable Energy and the Energy Systems Catapult provides adequate checks and balances to ensure that local or regional energy plans are robust, unbiased and have broad support?

Yes, the framework provides a decent standing for benchmarking the quality of LAEPs and the confidence in their delivery.

→ OVQ 9. Which of the uncertainty mechanisms and incentives in Appendix 3 will be most effective in enabling efficient strategic investment?

Where confidence can be gained in a forecasted view, then baseline allowances will be most effective in enabling efficient strategic investment. Where uncertainty exists, the regret of investment not being used efficiently or assets being stranded should be compared against the regret of investment not being sufficient to deliver decarbonisation targets. Where this demonstrates there is not a case for this strategic investment to be included in baseline allowances, then uncertainty mechanisms could be used.

Where a local authority energy plan has volumes/timescales which significantly outstrip the forecasts of the view being used, then the ability to trigger and deliver this investment needs to be fully considered and funded under one of the relevant ED2 mechanisms.

Where the combination of LAEPs summate to volumes/timescales outside the forecasted view being used, then this may be handled through a volume driver. Technology volume drivers work well when it is a specific technology, with a consistent, predictable behaviour driving investment. Technology volume drivers can be measureable across a short timeframe. Once there is a mix of technologies or the behaviour becomes unpredictable, a capacity volume driver might be more appropriate.

WPD sees ED2 being dominated by EVs and so more suited to a simple EV related volume driver. If EV charging behaviour becomes difficult to forecast due to market interaction, then the technology volume driver may become unsuitable, triggering other mechanisms, such as reopeners.

Incentives around asset/network utilisation can have unintended consequences. As utilisation grows away from a peak utilisation rate of 50%, the rating of the asset will need to be decreased to maintain the assumed aging rate. An incentive on keeping asset utilisation high may also undermine effective use of strategic investment, with

DNOs being penalised for under-performing against utilisation strategies needing a greater level of assurance from new connections that they will use capacities allocated. Metrics around network utilisation will also need to take into account contracted capacity as well as utilised capacity. Whilst the DNO is capable of applying their own assumptions to the diversity between contracted capacity and utilised capacity, they also need to demonstrate they are operating resilient, secure and safe networks. An incentive on making leaner assumptions for the average behaviour of the network may not allow for extreme edge cases, e.g. adjacent outages, 1-in-20 year events, unseasonal cold snaps, or behaviour clustering.

→ OVQ 10. Do you agree with our proposals to increase levels of BAU innovation?

Yes. Under the RIIO framework WPD has consistently innovated as BAU during ED1. We expect this growing trend to continue during ED2 as new solutions becomes more widely available and payback periods shorten.

→ OVQ 11. Do you agree with our proposed methodology in relation to the RIIO-2 Strategic Innovation Fund?

Yes. We support the combination with ESO and electricity schemes and welcome the coordination with other public funding bodies. As a consequence of SIF projects being larger than £5m we expect to use NIA to deliver medium size projects previously funded through NIC. We also support the creation of a sector-wide energy innovation strategy and are looking forward to contributing to this.

→ OVQ 12. Do you agree we should adopt a consistent NIA framework for DNOs, and other network companies and the ESO?

Yes.

→ OVQ 13. What are your thoughts on our proposals to strengthen the RIIO-ED2 NIA framework?

WPD already exceed this minimum NIA/NIC governance requirements. Hence we have no issue with strengthening NIA framework to ensure all companies apply best practice project management principles.

→ OVQ 14. Do you have any additional suggestions for quality assurance measures that we could introduce to ensure the robustness of RIIO-2 NIA projects?

We do not think it is necessary to be overly prescriptive on quality assurance for innovation projects. DNO Innovation teams deliver a wide range of projects using a variety of funding sources (EU, BEIS, Innovate UK, Energy System Catapult). Mandating best practice project management principles, coupled with internal and external audit oversight is sufficient.

We welcome the introduction of technical quality assurance measures. WPD already includes a peer-review element throughout the delivery of our specialist projects and we

think such measures are essential to ensure projects are delivered to a high standard. We believe such quality assurance measures should be in place throughout the project. A number of DNOs have asked us to carry out technical peer review at the end of their projects but we feel this is too late in the process to provide much benefit.

The technical experts required to perform such quality assurance activities vary per project, therefore it is important that DNOs are able to select the most suitable organisation to complete this activity on a per project basis without being restricted to specific organisations.

→ OVQ 15. Do you agree with our proposed approach for setting individual levels of NIA funding?

Yes, although the absolute level of funding for each DNO may need increasing to account for those projects no longer high enough value for NIC (typically £3-£5m range).

Modernising Energy Data

→ OVQ 16. Do you agree with our approach to regulating digitalisation and better use of data through the introduction of cross-sector licence obligations?

Yes, we agree with the implementation of the two proposed licence conditions, Digitalisation Strategy and Action Plan implementation and update and use of data to meet the Data Best Practice guidance. The creation of these licence conditions will support the work towards a standardised approach to digitalisation and the creation, management and sharing of data. Publically sharing our approach to digitalisation and the specific actions we're taking and the progress and benefit made will support our commitment to regularly engage with customers and stakeholders to ensure that our activity is relevant and appropriate. The Data Best Practice licence condition supports our presumed open data approach and implementation of a data triage approach. As digitalisation is a developing environment it is important that the implementation of licence conditions do not move organisations away from the current collaborative approach of delivering solutions and approaches in this area.

DSO transition

→ OVQ 17. Do you agree with the proposals we have set out to support optionality for wider institutional change should we later decide to separate DSO functions from DNOs? How else could the methodology support optionality?

Optionality must remain in place whilst the Ofgem GB System Operation review is still underway. Decisions to separate functions must be made for the benefit of customers and must allow interoperability. This will develop as more DSO functions are realised and must be flexible with the experiences they bring. As DSO functions mature, alignment and convergence can be achieved, potentially with the help of third parties and decisions can be taken on ownership of functions.

→ **OVQ 18. Do you agree with our proposal to use the Business Plan Incentive to encourage companies to reveal standards of performance higher than our baseline expectations in their DSO strategies? Do you agree we should require, where appropriate, all DNOs adopt these revealed standards?**

All DNOs should be expected to learn from and consider best practice standards of performance outlined in other Business Plans. The measure of appropriateness to drive adoption must be the benefits to the customers of the specific DNO. Some other DNO best practice standards may include elements unique to the operation, geography or customer base of the proposing DNO.

Having DSO performance scored within the BPI may allow for a DSO performance floor to be established, but, similar to innovation, unless there is funding for DSO development or sufficient ability for out-performing DSOs to be rewarded within year, there will be little voluntary investment in DSO processes all the while there is optionality for the extraction or separation of these functions.

→ **OVQ 19. Do you agree with our proposal to invite companies to provide metrics and performance benchmarks in their DSO strategies?**

Yes.

→ **OVQ 20. Do you agree with our proposal to introduce a DSO ODI in which we would, via an ex post incentive, penalise or reward companies based on their delivery against baseline expectations and performance benchmarks? If so, what criteria and other considerations should we take into account in determining whether we should apply a reward or penalty?**

An ODI will require all baseline expectations and benchmarks to be clear, measureable and consistently applied across DNOs for the ODI to operate effectively. A reward or penalty should be applied strictly against the ODI expectations and benchmarks which should be jointly proposed by all DNOs via the Energy Networks Association.

→ **OVQ 21. Do you agree with our proposal to undertake that ex post incentive performance assessment in the middle and at the end of the price control? Do you think the assessment should be more or less regular?**

Since the smarter, more flexible energy systems plan was published, DNOs have made significant progress in developing competence in DSO functions. If all DSO development funding is proposed to come from this incentive, more regular assessment and settlement should be undertaken to ensure good visibility of DNO reward/penalty exposure.

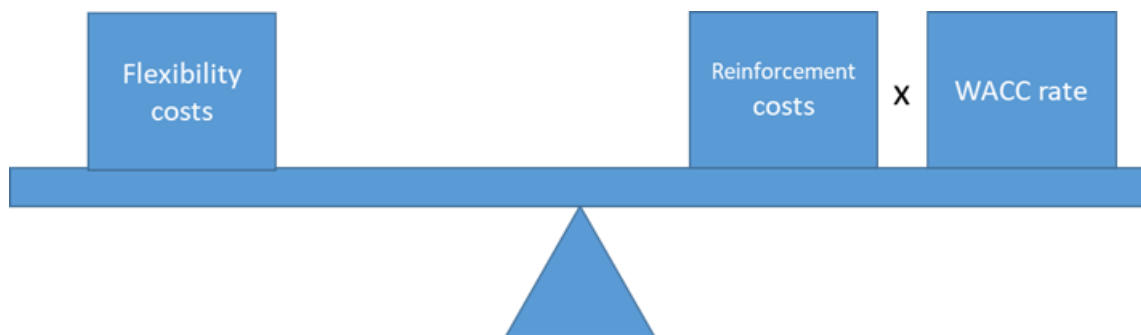
→ **OVQ 22. Do you have views on how we might set appropriate values for rewards and penalties associated with the DSO ODI?**

Following WPD's commitment to 'Flexibility First' principles in 2018, we have been seeking market-based approaches for deferring or avoiding reinforcement, ahead of committing to traditional investment pathways. Flexibility markets are still nascent and there is insufficient liquidity in these markets for them to be considered reliable and competitive in all areas. This potentially places a higher risk on DNOs accelerating the use of flexibility, and this should additional risk that DNOs are taking on to established should therefore be recognised and rewarded in RIIO-ED2.

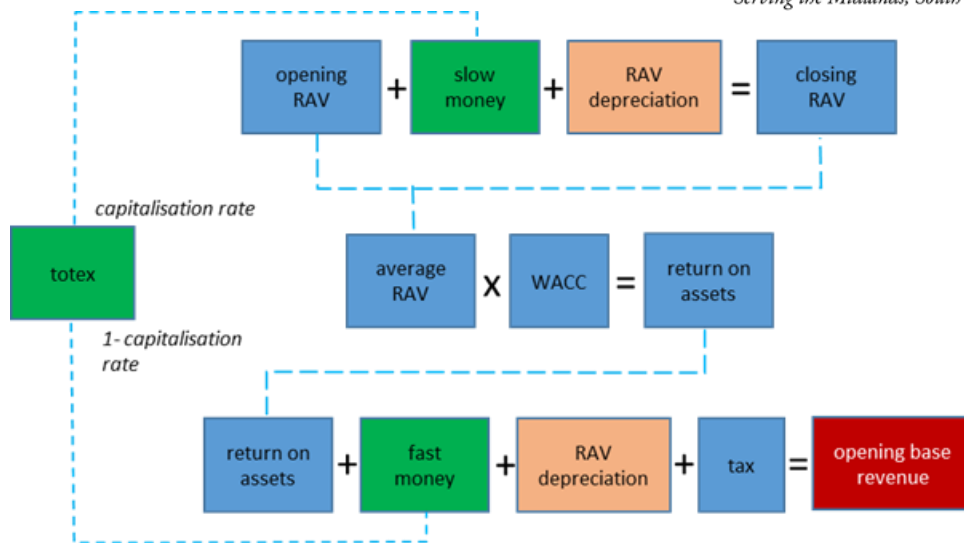
Where flexibility is used to defer or avoid reinforcement, the TIM can act as an incentive, if the whole traditional reinforcement cost is provided as allowed expenditure in the price control. We have seen this approach work well within ED1. In ED2, there is an expectation that some degree of traditional reinforcement expenditure will be reduced through the use of flexibility, however where this change is assumed expenditure is embedded into the price control settlement – i.e. funding for flexibility costs only is agreed, then there is a disparity between the reward for successful delivery of flexibility (low totex) and reinforcement (high totex).

To ensure there is a level playing field maintained within the existing RIIO incentives when considering traditional reinforcement and flexibility options, consideration should be given to a "RAV-equivalent" to capture the value of avoided/deferred totex provided through flexibility. The difference between traditional reinforcement costs and flexibility costs can then be used as a "RAV-equivalent" when calculating base revenues to equally incentivise DNOs to maximise the use of flexibility compared to increasing the RAV through conventional reinforcement. This revenue would be directly proportional to the benefits delivered through DSO operations.

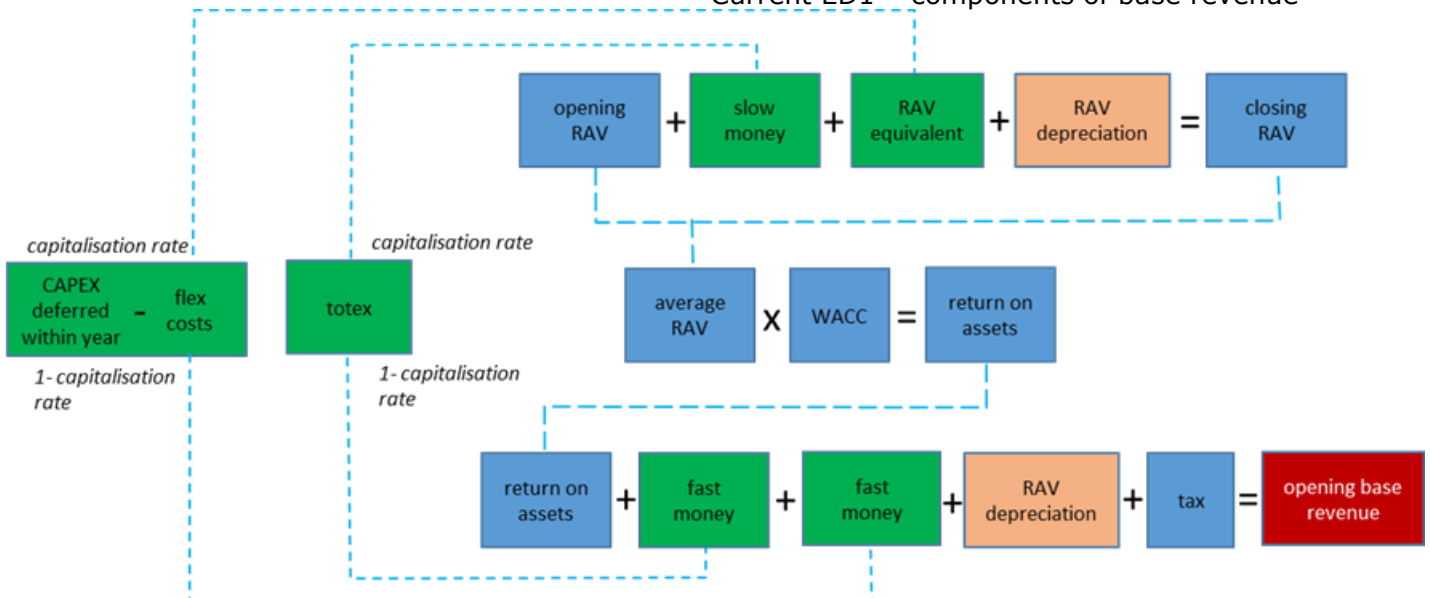
With marginal other benefits/costs, the decision between investing in conventional assets and a flexibility solution will be equal when the OPEX flexibility costs equal the CAPEX reinforcement costs multiplied by the WACC rate.



In terms of TOTEX, this means the flexibility investment pathway will have an expenditure between 25-50 times lower than the conventional asset reinforcement pathway.



Current ED1 – components of base revenue



Proposed ED2 – components of base revenue

→ **OVQ 23. Do you agree with the DSO roles, principles and associated baseline expectations in Appendix 5? Does it provide sufficient clarity about the role of DNOs in RIIO-ED2? Do you think amendments or additional baseline expectations are required?**

The roles and principles set out a clear view of the expectation of DNOs through ED2. Whilst no further baseline expectations for DNOs are needed in this section, more information is required on how delivery will be assessed and allowance of the efficient cost to deliver them is required.

Many of the baseline expectations require more data to be gathered from third parties to facilitate efficient whole system outcomes, particularly from the ESO. There is an expected obligation for the DSO to share information on DSO service dispatch to the ESO and an expectation to use ESO data, however there is no equivalent RII02 requirement on the ESO to provide this information to the DSO. The lack of visibility on ESO contracts, potential actions and instructed actions will prohibit the DSO from fulfilling many of these requirements and it seems the RII02 framework to date sees the ESO-DSO data exchange as important, but one way.

A Whole system approach

→ OVQ 24. Are there any electricity distribution specific barriers to whole system solutions, and if so, are there any sector specific price control mechanisms to address these?

The outcome of the significant code review will have a material impact on any future electricity distribution specific barriers.

→ OVQ 25. Are there any electricity distribution specific issues you think should be accounted for in the Business Plan Incentive?

The outcome of Ofgem's determination on CLASS will have a material impact on the amount of new innovative services provided by DSOs.

→ OVQ 26. Do you agree that whole system solutions are relevant to the innovation stimulus?

Yes.

→ OVQ 27. Do you agree with our key proposals for the CAM?

The principles of the CAM are broadly agreeable. The actions of not only network companies can impact other network companies in the same or other energy sectors, but also network company actions can be impacted by system operator actions, and vice-versa. Whilst tangible benefits for system operation cost reduction through investment on network assets (Transmission or Distribution) can be picked up through NOA processes, system operation cost reduction benefits arising from distribution system operator actions are not readily assessed or valued. The CAM could present another opportunity for this cross-licensee revenue adjustment to be delivered.

→ OVQ 28. Do you consider that two application windows, or annual application windows, are more appropriate, and should these be in January or May?

For distribution licence purposes, having two windows is sufficient. Opportunities for annual funding transfers can, to an extent, be completed through DRS.

→ **OVQ 29. Do you consider that the current electricity distribution licences should be amended to include the CAM, or wait until in 2023 at the start of their next price control?**

Current ED licences should be amended, so that improved whole system co-ordination can be brought forward by two years.

Access SCR

→ **OVQ 30. Do you agree with the impacts of our potential Access SCR proposals that are identified in this Chapter? Are there additional impacts that are not identified?**

In addition to those identified in Table 13, some options would result in additional costs (e.g. new network monitoring or billing systems) which would need to be factored into allowances. If changes result in users being able to defer charges (e.g. connection costs) this would alter the level of risk we are exposed to which would need to be considered in the financial arrangements.

→ **OVQ 31. Do you agree with the proposed Access SCR baselines for the RIIO-ED2 business plan submissions (ie that Draft RIIO-ED2 Business Plan submissions should use Access SCR Minded to Consultation as a baseline, and that Final Business Plan submissions should use Access SCR Final Decision as a baseline?)**

Yes, although the November/December timescale for the minded to consultation will already be too late for the initial consultation we will be undertaking with stakeholders. It is important that these dates do not slip further or a complex reopener is likely to be needed.

→ **OVQ 32. How do DNOs propose to demonstrate the impact of our Access SCR reforms on RIIO-ED2 Business Plans?**

We will have to try and estimate the impact on connection volumes, behavioural change, additional data acquisition, billing systems and processes. If there are substantial changes from the current arrangements then this will be a stretching task in the time available between the SCR Final Decision and submission of the final business plan.

→ **OVQ 33. What further guidance might be required from us to allow DNOs to identify the parts of their draft Business Plan submissions that could be impacted by our Final Decision of the Access SCR?**

The more detailed and precise the final decision is the more likely that we will be able to identify the impact. This is especially important for the data that will need to be collected and the billing systems and process required to implement.

COVID-19

→ OVQ 34. Do you think we need specific mechanisms in RIIO-ED2 to manage the potential longer-term impacts of COVID-19? If yes, what might these mechanisms be?

To date, with regards to COVID-19, Ofgem and the network companies have worked closely to review priorities and review the need for any adjustments to the regulatory framework, such as those changes proposed by Ofgem earlier this year. Given the uncertainty over future impacts of COVID-19, including the impact of local lock downs, it is expected a similar flexible approach would be adopted going forward. We do not consider it necessary to have a specific mechanism for COVID-19, over and above the tools already available in RIIO-ED1.

As per WPD's response to the GD&T2 DD consultation², from a cost assessment perspective, WPD provides the following comments.

From a Cost Assessment perspective, WPD recommends Ofgem give consideration to a true-up mechanism for ongoing productivity. Whilst there is a RIIO-2 mechanism for RPEs, WPD considers a mirroring true-up mechanism is required for ongoing productivity.

It is plausible that the RPE wedge between CPIH and input prices (or indices that proxy for input prices) may increase due to the potential longer-term impacts of COVID-19. The annual true-up mechanism proposed for RIIO-2 will mean that any differences in the outturn wedge between input prices (or indices that proxy for input prices) will be true-up such that neither customers nor network companies will be out of pocket as a result of COVID-related or other sources of input price pressures.

It is also plausible that outturn ongoing productivity may be less than forecast ex-ante due to the potential longer-term impacts of COVID-19. For example, a decrease in the productivity of works completed in the road for repairs and maintenance (R&M) activity may be expected as it will take longer to complete dig and lay works whilst ensuring compliance with social distancing. In this respect, it is expected that COVID is to have a longer term impact via changing the way we work. However, in contrast to RPEs, there is no comparable mechanism in RIIO-2 to true up differences in productivity compared to forecast. Whilst network companies will be insulated against changes in RPEs due to COVID they will not be for changes in productivity.

It is important that Ofgem consider this, given RPEs and ongoing productivity assumptions are considered different sides of the same coin and given just how impactful the COVID-19 could be on the long term landscape for RIIO-2.

Ofgem may also need to consider the re-running of any ex-ante determined cost assessment models on an annual basis through the price control to understand if the causal relationships between cost drivers and expenditure are still valid as a result of COVID, as this may alter what is considered to be an efficient level of expenditure.

² WPD (Sept 2020) 04092020 WPD Appendix Question Responses to RIIO2 GD&T Draft Determinations, Core Question 42, p18.

Annex 1 - Delivering value for money services for consumers

Approach to setting outputs and incentives

→ OUTQ1. Do you agree with our proposal for setting upper and lower limits on the value of bespoke ODIs?

It seems too early in the process to be setting upper and lower limits on the value of bespoke ODIs. Ofgem's consultation states they want DNOs to focus on delivering positive outcomes in respect to three consumer facing output categories, meeting the needs of consumers and network users, maintaining a safe and resilient network and delivering an environmentally sustainable network. Ofgem proposes the use of Licence Obligations, Output Delivery Incentives and Price Control Deliverables to achieve these outcomes.

With the ongoing RIIO-ED2 working groups continuing to discuss the range of output needs for ED2, it seems premature to assume what could be captured in bespoke ODIs and subsequently set values for the upper and lower limits at this stage.

Ofgem states that the rationale for setting limits for bespoke ODIs is because they are 'likely to be newer or more novel output areas with no significant track record', but WPD will look to ensure that any bespoke outputs proposed for RIIO-ED2 clearly reflect the needs and requirements of our customers and are based on an appropriate level of evidence and data to support their relevant inclusion in any business plan.

Once the package of proposed Licence Obligations, ODIs and PCDs for ED2 are more clearly defined, then an assessment can be made around the level and need for limits on bespoke ODIs.

→ OUTQ2. Do you agree with our proposal for a minimum value for bespoke PCDs?

Please refer to our response to OUTQ1.

The need for, and value of, any minimum or maximum limits on any of the RIIO-ED2 mechanisms should be reviewed once the overall package of incentives and proposals is clearer. This needs to be considered in light of Ofgem's request for DNOs to collaborate on proposals that may have wider applicability. It is not clear at this stage whether any limit would apply to solely bespoke PCDs, or whether the limit would include the cross-company proposals as well.

Meet the needs of consumers and network users: Customer satisfaction

→ OUTQ3. Do you agree with the proposed scope and associated customer category weightings for the satisfaction survey?

The Customer Satisfaction Survey in ED1 has driven significant overall improvements in performance across the sector and we welcome the continuation of this incentive in

ED2. As stated in the consultation, the energy transition and Net Zero targets will lead to the development of new services, tailored to meet new customer requirements. It is therefore appropriate to ensure that the survey is able to capture the performance for customers in these emerging areas. It is also important that the survey maintain its robustness and accuracy with statistically significant volumes. Therefore, the work commissioned with Explain, to assess the practicalities of broadening the survey category scope will be important in determining both the final scope and in target setting.

The separate reporting of satisfaction for both PSR and LCT customers could be a useful tool in indicating improvement areas for further investigation, but we would be uncertain over the volumes being significant enough to infer satisfaction across these groups. We would like to note that it is not practical for DNOs to identify LCT customers within our interruptions data as this data is not available within our PowerOn incident management system.

→ OUTQ4. Do you agree with our proposed approach to target setting and calculating rewards and penalties in RIIO-ED2?

We support the principle that continued improvements should be rewarded and that these should only be achieved by companies demonstrating frontier, stretching performance. The proposed rewards for upper-quartile performance and dead band is therefore aligned to this principle.

We are however concerned by the proposals to embed performance gains made in ED1 and to then apply a penalty threshold of scores below this average. We believe that this will lead to penalties for very good performance and fails to recognise the excellent level of service currently delivered.

Performance in ED1 has been far above the top performers across all UK plc, as revealed by results from the Institute of Customer Service. This could be set to continue on an upwards trend for the remainder of the ED1 period, raising the bar further should Ofgem set targets at Draft or Final Proposals. It is then difficult to reconcile that scores of greater than 9/10 might be deemed 'poor' and worthy of a penalty, with the intent to replicate the competitive pressures that exist in a competitive market. It would be highly unlikely that a company operating in a competitive market would see customer churn at this level of satisfaction.

It is also very important when determining targets, to consider both the proposed widening scope of the survey and the uncertainty brought about by potential changes in customer requirements in the transition to a smart low carbon future. It is difficult to set a benchmark for new delivery such as new LCT services within the existing connections category and we do not think this should be baked in with current service performance. Ofgem's desire to ensure the survey "is driving meaningful performance improvements in RIIO-ED2" can mean the delivery of performance in new services, and not solely improvement in existing service.

Taking the above into account, we would therefore propose that there should also be a dead band between the revealed average performance and a threshold set below this which reflects a 'good' standard of performance. This would provide a 'warning zone' for DNOs should performance indicate that for example, new services were causing satisfaction to dip, but not automatically penalise performance deemed 'very good'. This also aligns with our preference for a static target approach should targets be set too

high at the outset. If targets are set too high there is a danger that DNOs might be discouraged from investing in performance improvements.

In terms of setting the targets, it is unclear whether Ofgem intend take scores at the end of ED1 or across the period as the benchmark. We believe that it would be appropriate to take a longer-term view on performance than has been taken for example in GD&T Draft Determinations. Taking six months of performance does not provide a wide enough view to allow for short-term fluctuations or the impact of COVID-19 on customer satisfaction leading to targets being set too high.

→ OUTQ5. Do you agree with our proposed approach to setting complaints metric targets in RIIO-ED2?

We support Option 1 and agree that setting a more challenging target base on average ED1 performance will maintain the performance gains made by DNOs so far in ED1.

→ OUTQ6. Do you agree with our proposal to remove the Stakeholder Engagement and Consumer Vulnerability Incentive in RIIO-ED2?

The current SECV incentive model demonstrates that this is a highly successful way to incentivise improved performance in stakeholder engagement. Ofgem's own feedback at this annual incentive scheme (and within this consultation) continues to highlight that there has been a significant step-change in the approach of companies in this area as a result of the financial incentive structure. The incentive has driven higher standards but also driven innovation and the identification of new stakeholder groups and new priorities demonstrated by the emergence of community energy and the tailored engagement which has resulted.

There is however continued disparity between company performance, demonstrated by the range of scores achieved and is particularly evident in the different performance levels of companies in relation to addressing consumer vulnerability. It is therefore vital that the removal of SECV does not worsen the gap in performance for customers living in different areas there should remain a focus on outputs and performance improvements driven by innovation and competition between companies.

Whilst we recognise that business-as-usual engagement is now of a much higher standard, the disparity between companies performance, combined with the significant changes being brought about by the energy system transition will require that continual improvements are made by companies to keep pace with emerging stakeholder requirements. If the engagement within the SECV is not to be replaced it should be a key element the proposed incentives on vulnerability, connections and DSO with consideration given to this in any associated reward mechanism.

It is difficult to fully evaluate the decision to remove SECV without further details and clarity on the proposed vulnerability and connections incentives. The replacement incentives should continue to reward high ambition and innovation for those areas which do not have revealed value for customers, encouraging the groundwork to be laid for the energy transition and ensuring none are not left behind.

Meet the needs of consumers and network users: Connections

→ OUTQ7. Do you agree with our proposal to expand the connections element of the customer satisfaction survey?

We believe that further consideration should be given to this proposal as we are not convinced at this stage that it is appropriate that all of the markets segments highlighted should be included in the customer satisfaction survey. Market segment LVHV includes work undertaken at high voltage, including the provision of cables and distribution substations necessary to afford supplies to major developments. It is inaccurate to state that connections that fall in to this category, for example housing developments, retail parks and industrial units, do not attract competition in this category. This is evidenced by the fact that the majority of connections to housing developments are now made by independent distribution network operators.

→ OUTQ8. Do you consider that we have identified the relevant considerations to determine which customers should be captured in its scope?

We note that some of the market segments identified in the consultation (LVAL and DGLV) are less likely to be targeted by independent connection providers, particularly where the connections already exist and require an upgrade. Specifically with regard to LVAL, these may potentially carry higher volumes such they could align with LVSSA and LVSSB. It is more uncertain that that LVDG will experience the same volumes.

→ OUTQ9. Do you agree with our proposal to retain the TTC incentive as a financial ODI in RIIO-ED2?

Yes. The TTC incentive has proven to be useful tool to drive DNOs to shorten the end to end process of connecting smaller premises to the network and evidence shows that average timescales have generally reduced. However, reducing the targets for both TTQ and TTC, from already challenging targets, could become unduly onerous, particularly if a change in the connections boundary created an increase in connection requests. The cost of additional resource to manage this would need to be balanced against the customer's current expectations, i.e. do they already feel they are receiving a good service and are they willing to pay more to receive an improved one?

→ OUTQ10. Do you agree with our proposal to include a reopener which allows us to revisit targets, and potentially introduce penalties, in the period?

Yes. It would appear sensible to allow a mid-period review when there is a high level of uncertainty about the effects of any connection boundary change. We agree that deterioration in company performance is not acceptable but reducing the target for TTQ and TTC could prove unduly onerous on DNO's trying to cope with an increase in connection requests. A balance needs to be found such that DNOs, in endeavouring to find efficiencies in the end to end process purely to meet targets, do not sacrifice good customer service in the process. We welcome the proposed deferment of the introduction of any penalties.

→ OUTQ11. Do you agree with the methodology we propose to use to set the new TTC targets?

We understand the desire to set new targets for RIIO-ED2 that will continue to incentivise DNOs to create efficiencies to reduce timescales for TTC and TTQ. However, WPD is already excelling in this sector and there is an element of diminishing returns so it is becoming increasingly difficult to improve against a pre-existing high level of performance. We question whether setting the maximum reward score at 30% below the average level makes this virtually unobtainable in some cases where the DNOs are already performing well, particularly in the area of TTQ.

→ OUTQ12. Do you have views on our proposed Connection Principles and associated standards (in Appendix 4) for RIIO-ED2? Do you disagree with any of the standards we have proposed? If so, why?

We agree that it is important to retain an output in RIIO-ED2 that drives improvement in service standards for major connections customers. Requiring DNOs to put together a connections strategy based on high-level principles and baseline standards of performance will encourage focus on key areas and help consistency and comparisons. Whilst ICE has unequivocally improved DNO performance through extensive customer engagement, the somewhat ad-hoc approach to pulling together actions doesn't always provide the same clarity of progress or benchmark improvement that a clear strategy may deliver. We agree with the three proposed connection principles as they address the key areas of customer focus when requesting a connection. The principles will ensure that DNOs are covering all bases when developing their strategy. We welcome the proposal for DNOs to work together to identify metrics and targets to assess performance. This will aid consistency of reporting and clarity of approach. It is also critical that customer engagement remains high on the agenda and that detail that sits behind the strategy is based on stakeholder feedback and agreement.

→ OUTQ13. Do you have views on our proposal to use the Business Plan Incentive to encourage companies to reveal higher baseline standards of performance and to apply this, where appropriate, to all DNOs?

Further clarity will be required to evaluate the baseline standards set out within this consultation for both DNOs to set out their strategies to meet/exceed them and for Ofgem to determine where higher baseline standards might be revealed.

However where higher standards are revealed in a company's strategy, should Ofgem determine that they should then be applied to all companies this must result in the appropriate funding allowance and sufficient time to assess and assimilate the new requirement.

When considering whether to apply a higher standard to other companies, consideration should be given to whether this is appropriate for the customers of these other companies. What is required and valued by stakeholders in one region may not represent all UK regions.

Clarity will also be required on how the enhanced baselines will be applied to the DNOs which did not propose the original higher standard. If an enhanced baseline is set, potentially as late as Final Determinations, Ofgem will need to provide a decision on whether companies are expected to deliver this standard from the start of ED2, and face

penalties for not doing so, or if there will be a 'glide-path' to enable them time to reach the desired level of performance.

→ OUTQ14. Do you agree with our proposal to use an ex post assessment to penalise/reward companies who fail to deliver their strategies in line with our guidance/exceed performance targets?

Financial incentives such as SECV have been successful in driving innovation and have encouraged ambitious initiatives through rewarding high performance and achievements of outcomes to customers.

There is a risk that the Ofgem's proposals for ex-post assessment where companies may face penalties for failing to deliver their strategies could result in less ambitious, lower-risk plans. There could be focus on more incremental improvements rather than aiming for significant step-changes, if the risk of falling short of an ambitious target outweighs the potential rewards. There should therefore be benchmarking of performance in the ex-post assessment to ensure a company is not penalised for being more ambitious than other companies. For example, it would seem unwarranted for a company to set an ambitious target for delivering customer value which they miss by a small margin and are penalised, yet another company is rewarded for surpassing a less ambitious target which has delivered a lower overall value to customers. Similarly the scale of delivery should be considered when assessing penalties and rewards such that delivering large-scale initiatives should not be discouraged nor should companies be encouraged to deliver smaller scale initiatives. Benchmarking would drive competitive ambition.

→ OUTQ15. Do you consider that an assessment of performance in the middle and at the end of the price control is a proportionate approach?

For both the connections and vulnerability ODI the inclusion of an in-period assessment would provide both transparency of performance or the direction of performance, and allows corrective action to be undertaken to drive improvements and better outcomes for customers. It would also relieve some of the burden on ex-post assessment by completing part of the process ahead of time.

There does however need to be clarity on how reward and penalties would be administered and whether this would be at the middle of the price control as well as at the end. Should there be an in-period assessment, there would need to be clarity provided on the treatment of metrics and targets which are set in companies' plans across the full period. If a company has proposed full-term improvement targets, there will need to be clarity on how the in-period assessment would treat that performance and whether targets will be assessed on a per-year basis or at the point of assessment, and whether this will be based on annual performance or at the assessment point. For example, if there is a baseline set for customer satisfaction at 90% and a company sets a higher target in their Strategy of 95%, if their performance was yr.1 91%, yr.2 93%, yr.3 95%, at the mid-period assessment, would the company be penalised for the first two years and rewarded in year three, or rewarded overall since the performance was achieved at the assessment stage?

Another example would be a scenario where two companies both proposed similar targets for the number of fuel poor customers supported, but differed in the way the targets were set:

- Company A targets 50,000 fuel customer supported by end of period

- Company B targets 10,000 per year (therefore 50,000 by end of period too)
- Both companies deliver as per the following profile: Y1 - 8k, Y2, 8k, Y3 9K, Y4 12k, Y5 13k.

In this scenario clarity is needed on whether Company B would be penalised in years 1-3 and rewarded for years 4-5, whilst Company A is rewarded for the full period?

- Another possibility is Company A meets 11k per year (achieving 55k total)
- Company B also delivers 55k overall, but delivers as 8k, 8k, 8k, 10k, 21k,

In this scenario would Company A be rewarded for each year and would Company B receive penalties for 3 years, break even 4th year and then only be rewarded in year 5?

These scenarios demonstrate the need for further detail to ensure DNOs are able to clearly set out their objectives in the Business Plan strategies and for Ofgem to be clear on the assessment process for these incentives. WPD are concerned that without more detailed structure the assessment of these incentives could rely heavily on qualitative judgements of each DNOs performance, making consistency difficult and reducing the opportunities for rewards to be applied.

→ OUTQ16. Do you agree with our proposal to retain the Connections GSOPs for all connection customers in RIIO-ED2?

We agree the Connections GSOPs should be retained. They have proven to incentivise DNO's to meet prescribed timescales for delivery of services, are firmly embedded in process and widely understood by connections customers.

→ OUTQ17. Do you agree with our proposed approach to uplifting the Connections GSOP payment values in line with inflation, indexing payment levels to inflation, and rounding to the nearest £5?

Yes, we agree with Ofgem's proposed approach to uplifting Connections GSOP payments. We suggest that DNOs should coordinate this via the annual Notice of Rights which is undertaken collectively by the DNOs.

→ OUTQ18. Do you agree with our proposal to remove the Incentive on Connections Engagement for RIIO-ED2?

Yes. Whilst the introduction of ICE has proven a useful tool in encouraging stakeholder engagement and driving DNO performance against connections activities we believe that it time to take stock and consider whether there is now a more effective method of achieving this goal. In the six years that DNOs have been preparing ICE plans there has been a disparity of approach; some DNOs committing to fewer, but arguably more onerous actions, and others creating larger but potentially less stretching plans. In addition, some actions do not necessarily lend themselves to precise KPI's but rely on stakeholder feedback for a sense of having met a specific target. In this respect there has been an element of inconsistency of approach across DNOs and so a different methodology that mitigates this is to be welcomed. We understand the proposed move to a more quantitative assessment of performance rather than qualitative and note that the current annual ICE consultation process is somewhat flawed in its approach as decisions are made based upon relatively few responses, some of which are made where a customer has a specific issue with a DNO's approach. In this respect we will be

interested to note how DNOs will be assessed against their connections strategy, particularly against an ex post evaluation, underpinned by a financial output delivery incentive. It is important that the methodology for assessment is clearly articulated prior to implementation. We believe a 'mid-term' and end of price control assessment is entirely preferential to the current annual assessment. This will encourage DNOs to formulate wider, more long term service improvements as part of their strategy rather than shorter 'quick win' commitments (notwithstanding there is still a place for those to) in order to hit targets set out in an annual ICE plan. Also noting that DNOs will still have an obligation to report progress against strategy on an annual basis.

Meet the needs of consumers and network users: Consumer Vulnerability

→ OUTQ19. Do you agree with our proposed approach to ensuring consumers in vulnerable situations receive an appropriate range and level of support in RII0-ED2? If not, what alternative approach should we consider?

We welcome the specific focus on consumer vulnerability, and the proposals to ensure all customers receive a minimum standard of service regardless of where they live. It is an area which our stakeholders value highly and continue to ask us to do more. We agree with maintaining an incentive to encourage continued improvement and ambitious targets in the support of the vulnerable.

However, we believe that further clarity is needed in particular on the minimum standards and the approach to assessment. For the incentive to deliver the intended baseline performance expected of all companies there needs to be further detail in what constitutes minimum performance, including the scale and quality of delivery under both the principles and the baseline minimum standards. The current disparity in performance in the SECV and in the scale of outcomes for consumers, demonstrates the need for clear benchmark setting to provide details on what companies are expected to deliver. This will aid both the assessment of whether this criteria has been met and the DNOs ability to clearly set out how their strategies go further than the minimum.

Without this clear understanding of what constitutes baseline performance, it will be difficult to establish metrics and target performance, in order for Ofgem to carry out a robust assessment process, which has a significant quantitative element. There is a risk that in the absence of this understanding, the assessment process for this incentive could become more qualitative than quantitative. In the Ofgem working groups held to discuss these issues with DNOs to date, Ofgem has consistently stated that it wishes for the new vulnerability incentive to be based on consistent, quantitative evaluation metrics wherever possible, moving away from qualitative judgements. However in response to the potential real-world scenarios WPD has outlined in our response to question 15 above, Ofgem indicated that it is likely to make a qualitative, discretionary decision in these eventualities, on a case-by-case, year-by-year basis. This appears to be a major contradiction, and the latter sounds more akin to the existing SECV assessment. However, it would be significantly less robust than SECV, without an independent expert panel and transparent assessment against an agreed scorecard and criteria, for example. WPD is supportive of the retention of a qualitative assessment, such as SECV believing it is the only way to meaningfully assess and compare performance in an area where the positive impacts for customers remain qualitative. However we strongly feel this qualitative assessment needs clarity and structure to ensure its application and the final decisions reached by Ofgem are consistent so that all DNO's are treated fairly.

→ OUTQ20. Do you have views on our proposed Vulnerability Principles and associated standards (in Appendix 5) for RIIO-ED2? Do you disagree with any of the standards we have proposed? If so, why?

As we have explained in OUTQ19 there needs to be further detail added to the standards set out in Appendix 5.

The minimum requirements set out the high-level activities or tasks covering what have become 'business-as-usual' for many DNOs including WPD. In order for these minimum requirements to be clear and ensure they are interpreted consistently, there needs to be clearer definition on the scope, scale and in particular the quality of the requirements. There should be clearer guidance on 'how much' and 'how far' these tasks should be scoped, in order to meet the minimum level of ambition in the requirements. This will provide stakeholders, Ofgem and the DNOs a better quality of baseline to assess the scope of ambition in BPs above these levels.

We support the principles proposed but we do not think that the minimum standards fully address these principles in particular in the lack of clear focus on the requirement to help those in, or at risk of, fuel poverty. Whilst the guidance does outline that the vulnerability strategy should include support for those in fuel poverty, the minimum standards do not provide any detailed requirements regarding the support for those in fuel poverty and other social issues in terms of the scale and quality of outputs required. Also, there is a lack of minimum requirements for the role in supporting those at risk of being left behind by the energy system transition.

In terms of the further detail which should be included to set the minimum scale of this requirements, for example the requirements to have extensive network of partnerships does not provide enough clarity, does it include for instance that the partnership network should provide coverage across the DNO's Distribution Service Area? Current SECV performance indicates that the volume of partnerships DNOs have in place vary significantly, resulting in a huge disparity in the outcomes achieved for customers (e.g. fuel poverty savings ranging from £100k by the worst performing DNO to nearly £11m by the top performing DNO). It is therefore unclear on this broad scale what the minimum standard expectation should be and without this detail it will be difficult for Ofgem to benchmark companies' strategies.

The use of 'Accessibility AA' in the minimum standards is too specific and should be changed to "an appropriate independent accreditation for accessibility". As part of the existing SECV minimum requirements WPD's accreditations via the British Standards Institute (BS18477) and Customer Service Excellence Standard have consistently met the required threshold and have been explicitly praised by the SECV awarding panel – in particular becoming the first DNO to achieve BS18477 with other encouraged to follow suit. It is therefore unclear on what evidence basis that the Accountability AA standard has been selected as the principle standard assessment going forward.

In terms of setting the standards for the quality of actions required to deliver or exceed the baseline requirements there will need to be a degree of benchmarking and discretionary assessment based on the scale of companies' initiatives. For instance in terms of the requirement for PSR data checks every 24 months, assessment should account for the size of the PSR register to ensure companies has not sort to reduce their PSR to maintain this standard.

→ **OUTQ21. Do you agree with our proposal to use an ex post assessment to penalise/reward companies who fail to deliver their strategies in line with our guidance/exceed performance targets?**

Please see our response to OUTQ14.

→ **OUTQ22. Do you consider that an assessment of performance in the middle and at the end of the price control is a proportionate approach?**

Please see our response to OUTQ14.

Maintain a reliable network

→ **OUTQ23. Do you agree with our proposed approach to retain the RIIO-ED1 methodology for setting unplanned interruptions targets?**

Yes.

The target methodology has been evolved over time, representing where companies have opportunities to improve and where network topography means that it is difficult or costly to make improvements.

The application of the improvement factor requires companies to continue to seek further improvements over time, however the scale of further improvements progressively diminishes as performance improves, making it increasingly difficult for companies to outperform the targets and gain rewards.

It has to be recognised that the IIS scheme has been structured in a way where the rewards gained from the incentive mechanism compensate companies for the costs of establishing improvements (i.e. there were no allowances provided for quality of supply investment for slow track companies in ED1).

The improvements gained in ED1 are driven by capital expenditure on new technology, remote control and automation, and operational expenditure on provision of temporary supplies and sufficient resources deployed to provide a fast supply restoration. Whilst the capital costs are one-off costs, the operational costs will continue to be incurred in delivering the levels of service achieved. This means that whilst Ofgem is trying to avoid customers paying twice, there are some aspects of costs that will require customers to continue to fund.

This means that there should be sufficient funding of those costs, either through allowances or opportunities to outperform the targets.

The targets should therefore be at a level where outperformance is achievable to compensate for additional capital investment and cover the costs of operational activities.

"Lower of" proposals

Paragraph 7.18 proposes that the targets will be set at the lower of current performance or the targets produced by the target setting methodology.

WPD disagrees with this proposed approach.

The benchmarking methodology has been designed to provide challenging and improving targets taking into account a wide range of industry performance. If a company is currently outperforming the proposed targets, that company will be having an influence on the overall benchmarks for the whole industry and therefore should not be penalised for this.

However, should Ofgem continue with the "Lower of" approach there are some further issues that need to be considered.

The proposals are unclear on what represents current performance. This should not be based upon a single year (because of the risk that the year is either abnormally low or abnormally high). Current performance should be derived using the same period(s) as those used for the derivation of targets. For example if the target is derived using four years of data then the underlying current performance should also be based upon four years of data.

Considering the points made above on continuing to fund operational activities, rather than selecting the lowest of actual performance or benchmark targets, there could be a 50:50 blend (if actual is better than target) that provides some compensation to those licensees that are clearly performing better than target and setting the baselines for others.

→ OUTQ24. Do you have views on the alternative approaches to setting unplanned interruptions targets set out? Are there any other approaches that we have not considered?

WPD feels that the current approach is tried and tested and has driven marked performance improvements across the sector and believes this method is still fit for purpose and can still produce future benefits to customers.

As Ofgem recognises the current approach is complex, but this complexity has been evolved to derive targets that are a balance between driving performance beyond benchmarks, whilst recognising network differences.

The alternative approaches considered are unproven and would need to be established and tested.

→ OUTQ25. What are your views on revisiting unplanned interruptions targets within the price control period?

Dynamic targets should not be adopted.

Having static targets during a price control allows DNOs to plan improvements in advance with a known benefit for the period of the price control.

Revisiting targets during the price control period (whether these are based upon a company's own or other DNOs' performance) will create uncertainty of the benefit of future interventions and may lead to fewer interventions being undertaken.

Ofgem cites (in paragraph 7.24) that the process of setting the targets is complex and resource intensive to run. Having static targets avoids the need to run this complex and resource intensive process annually.

→ OUTQ26. Do you agree with our proposed position not to introduce further convergence of DNOs' targets over time?

Yes.

The current methodology does produce a convergence over the long term. The use of benchmarks incorporating all DNO data means that the targets encourage improvements towards those benchmarks.

Network topography means that there will be variance in the benchmark performance that is possible for different types of network and therefore, absolute convergence may not be possible.

→ OUTQ27. What are your views on retaining an incentive for planned interruptions performance, and the associated targets?

The mechanism for planned interruptions aims to strike a balance between embedding improvements into future targets and allowing for variance in work volumes requiring planned interruptions.

The self-correcting nature of the planned interruption mechanism, means that licensees are broadly neutral for carrying out planned work.

The use of a three year historic performance allows changes (increases/decreases) in activity to be factored into future targets. So if a licensee is carrying out more/less work, with a greater/lesser impact on planned interruptions, this is factored into future targets.

Also any operational improvements that are implemented by the licensee to improve performance get 'baked in' to the future targets. This means that licensee will be penalised by missing targets if these activities are not continued.

→ OUTQ28. What are your views on the potential amendments that could be made to the mechanism, including (but not limited to) the options presented in Tables 23 and 24?

Table 23 Options

Stakeholders continue to place unplanned interruptions as a higher priority than planned interruptions.

Customers are informed about planned interruptions and can make alternative arrangements. The impact is therefore less for planned interruptions and the existing weighting of 50% should be retained (i.e. option 1 should be retained).

Whilst COVID 19 has increased the amount of home working potentially increasing the sensitivity of customers to power outages, the impact of shutdowns on customers can be mitigated by the provision of temporary supplies which can be arranged as part of

the planned notification processes. This means that planned interruptions continue to lead to less inconvenience than unplanned interruptions.

The incentive weighting should be the same for all companies and option 4 in table 23 should not be adopted.

Table 24 Options

Ofgem has captured the range of pros and cons for the various options.

Option 1 (retaining the existing approach) is self-correcting and therefore only provides a limited incentive to identify and implement improvements.

Whilst option 3 is more complex, benchmarking performance would potentially drive greater improvements in planned processes. However, any mechanism for setting the targets would need to be reflective of the agreed work programmes for the price control.

→ OUTQ29. What are your views on how VoLL should be updated for RIIO-ED2?

The reliance on electricity over other fuel sources will increase as we move to a greener energy future and using the most up to date information is important.

It should be revised using a combination of the ENWL analysis and updated ratio for domestic:SME customers, along with an uplift to account for inflation.

This would indicate a figure around £23,500/MWh.

→ OUTQ30. What are your views on the different methodologies for updating VoLL?

There should be a single value of VoLL used across all licensees.

The disaggregation of VoLL across licensees to represent the different types of customers is reliant upon socio-economic data and the variables need to be carefully chosen to justify the regional differences. Further work is required to ensure that such disaggregation does not lead to disproportionate differences across licensees. Should a disaggregated approach be found to be appropriate, then this should be fixed for the period of a price control. It should not vary or be updated during the price control.

Any further disaggregation into regions within a DNO boundary or circuits will lead to complexity of data management and should be avoided.

→ OUTQ31. Do you have a view on retaining alignment with VoLL figures used in other RIIO price controls and/or parts of the energy sector?

The increasing importance of electricity distribution in providing a reliable supply for increasing amounts of electrical equipment, powering electric vehicles and heating homes means that contemporary valuations should be adopted. The studies in 2008 and 2013 were carried out ahead of the recent growth in distributed generation and low carbon technology and therefore may not be relevant to current customers.

Full disaggregation of the methodology used to determine VoLL in ED1, along with an uplift to account for inflation would be the most correct value.

→ OUTQ32. Do you agree with our proposed approach to retain the RIIO-ED1 revenue cap for the IIS at 250 RoRE basis points?

The current level of 250 RORE BPS revenue exposure is acceptable.

Note that Ofgem has also specified other caps:

- Severe weather guaranteed standards cap of 207 RORE bps in ED1 (resultant values found in CRC 2D table A7)
- Overall combined IIS and severe weather guaranteed standards cap of 413 RORE bps in ED1 (resultant values found in CRC 2D table A6).

These caps also need to be specified for ED2.

→ OUTQ33. Do you agree with our proposal not to introduce an incentive on short interruptions in RIIO-ED2? If not, how should such an incentive be structured and developed?

Yes.

It is correct not to introduce a short interruption incentive. Many of the initiatives that DNOs have adopted in reducing the impact of long interruptions lead to short interruptions and stakeholder inform us that these momentary interruptions are tolerable.

Whilst there may be a small opportunity to reduce short interruptions by installing devices that prevent faults on spurs from affecting upstream customers, the main requirement for the elimination of short interruptions is a reduction in fault rates.

Reducing fault rates by a material amount would require:

- Increased amounts of asset replacement investment significantly above current levels to prevent assets failing due to deterioration and defects;
- Replacement of assets with more resilient designs to limit the impact of adverse weather;
- Increased undergrounding or use of covered conductor to reduce the effect of windborne objects, weather and animals/birds.
- Implementation of fines to further deter third parties causing faults (such as other utilities damaging cables).
- Enhanced security measure to prevent vandalism and metal theft.

All these solutions are relatively high cost and therefore the benefits to consumers do not warrant the high costs to make a marked impact on short interruptions.

Going forward, advancements in battery technology could lead to certain types of important equipment or even the whole house having a battery or storage system which would make the user oblivious to and unaffected by short interruptions. The evolution of such devices would negate the need for investment in the networks to reduce short interruptions.

→ OUTQ34. What are your views on a minimum standard for short interruptions for RIIO-ED2?

Any requirement for a target for short interruption or multiple interruption arrangement would require high cost investment to reduce the short interruptions (see response to OUTQ33).

The minimum guaranteed standard would predominantly lead to increased payments to customers without necessarily encouraging companies to carry out high cost preventative investment.

→ OUTQ35. What information should we be capturing in RIIO-ED1 and RIIO-ED2 to better understand short interruptions and how DNOs are performing?

We support the drive to better understand data about short interruptions, which may be able to lead to targeted cost effective activities that provided benefits for consumers.

It will be important to ensure any additional/revised data collection can be compiled without too much additional regulatory burden. We support the use of the ongoing ED1 working groups to investigate and define revised data capture requirements.

→ OUTQ36. Do you agree with our proposal to retain the RIIO-ED1 SWEE mechanism?

Yes. The SWEE mechanism has worked well to reduce the performance volatility associated with severe weather, allowing the incentive mechanism to be stable and demonstrate underlying improvements in network performance.

→ OUTQ37. Do you agree with our proposal to remove the OEE mechanism? If not, what evidence is there to support its retention, and what changes should be made to the existing approach to improve it?

No.

The OEE mechanism was established to protect companies from large events that are truly beyond their control – this principle should be retained. If Ofgem has concerns about the volume of OEE claims then it may be prudent to more clearly define what would constitute an event beyond the control of the DNO.

If the OEE mechanism is to be removed (or adjusted to have a narrower scope) then the performance exclusions previously allowed should be factored back into reference performance so that the future targets are based on data that is consistent with the future assessment approach.

→ OUTQ38. What are your views on the threshold that should apply to either exceptional event mechanism?

The approach used in ED1 for setting thresholds for exceptional event thresholds should be used. We agree that the data should be based upon a reasonable length of time and

10 years of most recent data will provide a reasonable reference for establishing the thresholds.

→ OUTQ39. What performance do you think should be excluded under each mechanism?

The exclusions should be as per ED1 arrangements.

→ OUTQ40. Do you agree with our proposal to retain the existing GSoPs? If not, what changes do you think are necessary and what are the reasons for them?

Yes, we agree with Ofgem's proposal to retain the existing GSOPs as they remain fit for purpose.

With regard to the requirement to provide a minimum of two days notice for planned work (as required under the ESQCR), this was originally two days, then changed to five days, then changed back to two days. Whilst we endeavour to provide more than the minimum notice, we agree that this standard should align with the ESQCR. Where we become aware that we have failed to notify customers we make a voluntary payment without waiting for customers to claim. However a fully automatic standard is not possible.

With regard to multiple interruptions until DCC enabled smart meters are widely installed, we do not have the ability to detect failures at LV which means automatic payment is not possible.

→ OUTQ41. Do you agree with our proposal to uplift payment values in line with inflation, indexing payment levels to inflation, and rounding to the nearest £5 for clarity for stakeholders?

Yes we agree with Ofgem's proposed approach to uplifting GSOP payments. We suggest that DNOs should coordinate this via the annual Notice of Rights which is undertaken collectively by the DNOs.

→ OUTQ42. Do you agree with our proposal to retain some form of mechanism for WSC in RIIO-ED2?

Yes. It is right to try to improve service for customers experiencing higher volumes of faults however the current mechanism is cumbersome and does not lead to much investment activity. We observe that:

- The current scheme requires detailed administrative effort but doesn't currently attract much capital investment (i.e. across all the 14 DNOs, only £6.4m was spent on WSC in the first half (four years) of ED1).
- The current cost logging up method and reference period post intervention keeps the price control period open long after all other close out mechanisms have concluded.
- Changes to the WSC should be considered; with a preference for an ex-ante allowance being included in Totex.
- The matrices of number of worst served customers in annex B - M3 WSC provides useful data on the current populations of WSC and should be retained.

- The need for performance improvement assessments should be removed.
- The current limit of 15 interruptions with a minimum of 3 in any year should be removed (or lowered). A licensee may have very few WSC but this does not mean some of the customers just under the threshold wouldn't benefit from some investment.

→ OUTQ43. What are your views on the options presented for WSC? Are there other options that we should consider?

WPD's preferred option is Option 3. Funding WSC schemes through ex ante allowances.

We note that the scale of investment in this area is relatively small and therefore the associated performance reporting should be removed. This would significantly reduce the regulatory burden associated with the mechanism and remove the need for a close out mechanism.

Maintain a safe and resilient network

→ OUTQ44. Do you have any views on our proposed NARM framework?

The Network Output Measures relating to Network Asset Indices in RIIO-ED1, have developed out of the asset health, criticality and risk measures that have been introduced over successive price controls and are well established within the ED sector. The processes built around the Network Output Measures (for reporting, examining of asset replacement and refurbishment requirements, setting outputs and evaluating delivery etc.) are mature in the ED sector and through alignment with the cost and volumes RIGs are well integrated into regulatory processes. Therefore, it is entirely appropriate that the RIIO-ED2 NARM framework should look to build upon the already established processes rather than look to replace already proven processes.

The outlined priorities for development of NARMs have identified the key areas where improvements could be introduced that would most benefit the regulatory process.

Adoption of long term risk

The adoption of a long-term risk measure for the NARM framework creates a more meaningful metric than the 'in-year' risk measure used in RIIO-ED1. The reduction in risk achieved by interventions, when measured in this way, is more reflective of the true value of the benefit delivered. This facilitates better comparison of the relative benefits of refurbishment interventions against asset replacement interventions, because it considers the longevity of any risk improvement.

Quantification of the benefits delivered by interventions by the proposed monetised long-term risk measure also enable justifications for interventions to be quickly and directly identified through the metric. This 'automatic' justification enhances the role that NARMs can play within the overall toolkit for Business Plan assessment and should negate requirements for the submission of additional supporting information where clear justification for asset replacement or refurbishment activity is provided by the submitted NARMs.

The outlined approach to incorporating long-term risk into the NARM framework, by assigning matrix weighting factors representing the 'cumulative discounted future probability of failure, enables introduction of the long-term measure into the already established reporting framework. As outlined in paragraph 8.28, this facilitates retention of proven elements of the existing ED1 reporting framework, such as the matrices that provide an appropriate communication of the asset health, criticality and risk associated with the typically high volume asset populations within the ED sector, whilst enabling long-term risk to be introduced. This is an appropriate approach to the development of the NARM framework and will lead to more comparability across price controls.

Commonality of reporting

We support prioritisation of a requirement for NARMS to relate to a common set of asset categories for all DNOs in RIIO-ED2. This is a necessary requirement for comparability of performance between companies. It is appropriate that this common set should be determined from the asset categories currently included within the existing RIIO-ED1 CNAIM methodology, rather than expansion to further asset categories not covered by CNAIM.

The retirement of Health Indices Asset Categories, in favour of reporting at the more granular level of Asset Register Category, is welcomed. This will provide greater transparency in the setting of the NARMS targets, demonstrating a clear linkage to the Business Plan Data Table volumes and any adjustment to allowed volumes introduced within allowance setting.

Revision of CNAIM methodology/Development of guidance document

In response to discussions at the RIIO-ED2 Safety, Resilience, and Reliability Working Group, DNOs have commenced works to revise the CNAIM methodology to meet RIIO-ED2 requirements and develop appropriate Engineering Guidance to support data input to CNAIM. This work is being undertaken by the ENA NOMs ED Working Group and this group has provided regular updates to Ofgem on the changes being proposed and progress with development.

This work shall result in a new version of CNAIM that will be applicable to RIIO-ED2. It is, however, inappropriate that any revised version of CNAIM would be utilised for reporting of NOMs in the remainder of RIIO-ED1 as this would risk destabilisation of NOMs performance close to the end of the price control period.

Consequently, it is necessary that two versions of CNAIM will need to operate concurrently. The existing RIIO-ED1 CNAIM (v1.1) shall need to be retained for RIIO-ED1 regulatory purposes and the revised methodology (v2.0) introduced for use within the RIIO-ED2 price control process. Currently, the governance of CNAIM does not take account of concurrent operation of different methodologies for different price control periods. It is suggested that the Sector Specific Methodology Decision might be used to outline suitable governance processes to address this.

We note that in paragraph 8.76 that Ofgem intend to hold companies neutral to future changes to CNAIM. We also note that in paragraph 8.16 Ofgem recognise that changes to the methodology lead to a need for rebasing. We therefore urge Ofgem to consider the 'locking' of the methodology for the whole of the price control. This will enable the

forecasts, business plan assessments, reporting and close-out processes to be based upon a fixed set of rules. Any rebasing adds complexity and introduced a need for analysis that demonstrates that any rebasing has had a neutral effect. Multiple layers of rebasing add significant complexity into analysis of delivery and this potentially destabilises the assessment/incentive process. Such 'locking' would not inhibit the continued development of CNAIM, which could be evolved for application at RIIO-3.

Expansion of application of CNAIM

Future expansion of the asset categories covered by NARMs, beyond those covered by CNAIM, requires careful consideration.

Non-NARMs assets typically are asset categories where insufficient data is available to implement the type of probability of failure and consequence of failure evaluation described in the existing CNAIM methodology. To extend the NARMs framework to these categories, it may be necessary for alternative risk modelling approaches to be developed that are complementary to the NARM metric, or alternatively the framework itself may need adaptation. It is likely that significant development of NARMs will be required to achieve this. It is therefore appropriate that some consideration should be beginning to be given towards how NARMs can be developed to encompass greater asset categories within the RIIO-ED3 price control. Development of a roadmap for this process would be a positive first step.

It should also be recognised that in transmission, where there are fewer assets, there is a concept of NARM and non-NARM assets, recognising that NARM cannot be applied to all asset categories.

Three high level options for treatment of Non-NARMs assets within RIIO-ED2 are outlined in the consultation. As noted within the consultation document, all three high level options have significant drawbacks.

The fault rate measure (option 3) can only be viewed as a 'backstop' measure being a lagging output measure that is influenced by other areas of expenditure other than asset replacement and refurbishment. This means that it most likely would be fairly ineffective unless significant variances in the Non-NARMs asset replacement and refurbishment activities occur.

Both the multi-asset volume driver (option 1) and the notional risk weighting (option 2) options are input led. The multi-asset volume driver has potential to create a hard boundary between NARMs and Non-NARMs expenditure areas that may limit the capability to direct asset replacement expenditure appropriately to areas of need that emerge during the price control period. The option for use of notional risk weightings attempts to address this by creating a proxy risk trading mechanism but needs to be considered carefully as it has potential to undermine the NARMs framework if inappropriate risk weightings are assigned, as this may lead to incorrect direction of activities across asset categories. This is a significant risk with the notional risk weighting.

Given the drawbacks associated with each these three options, there are likely to be considerable challenges in developing these into viable approaches for RIIO-ED2. As there is an intention to expand NARMs in RIIO-ED3 by extending risk modelling to further Non-NARMs categories, efforts would be better directed in developing approaches for improved treatment of Non-NARMs assets in RIIO-ED3.

While none of the proposals provide an ideal solution, should Ofgem require a mechanism for non-NARM assets for ED2, it is suggested that, of the options, the multi-asset volume driver (option 1) could provide an interim approach requiring less development compared to the other options.

NARM incentive mechanism

Overall, the principles behind the incentivisation of delivery of NARMs outputs described in the consultation document, itself, appear reasonable. However, we have significant concerns about the amount of ex-post assessment that the proposals require.

The proposals for assessment of delivery are detailed in 8.72 and 8.73. We note that under-delivery will lead to a clawback of associated allowances and where this is not justified a further penalty will be applied. We also note that any over-delivery will be subject to the Totex Incentive Mechanism, with a potential for cost neutrality where sufficient justification for the over-delivery is provided. Paragraph 8.73 suggests that cost neutrality is based upon providing evidence of material consumer benefit; discussions and slides presented in cross-sector working groups suggest that there is a high hurdle of evidence required and cost neutrality will only be made in exceptional circumstances. This results in an asymmetric incentive, where the downside adjustments are greater than the upside opportunities.

Ofgem has encouraged DNOs and other stakeholders in paragraph 8.77 to review the proposed NARM Funding Adjustment and Penalty Mechanism in the Draft Determinations for the Transmission and Gas Distribution (GD/T) sectors.

Having reviewed the proposals we are concerned that they add significant complexity to an existing data intensive and complicated process. The new requirements for the submission of efficiency justification add a further burden for identification, tracking and valuation of such benefits; along with the need to document them and have them assessed by Ofgem.

Specifically, in the GD/T proposals there is a concept of a Delivery Adjustment Factor (DAF) which is applied to cost variances to claw back 95% (currently proposed) of underspend, based upon the assumption that this underspend has been achieved through activities that do not represent true efficiency. In order for licensees to avoid this clawback, there is a requirement to submit justification and evidence of how efficiency saving have been achieved. This introduces a regulatory burden for the tracking, evidence collation and presentation of efficiency justification; it also introduces regulatory risk for licensees because there is a risk that Ofgem may not accept the evidence at the end of the price control.

In our response to the GD/T draft determination we suggest an alternative simpler approach, which is based on a lower DAF of 75%, which is automatically applied to underspend. This has an implicit assumption that 25% of cost savings are based upon true efficiencies. This removes the need for detailed justification of savings and simplifies the ex-post assessment required at the end of the price control.

A very high DAF (as currently proposed), along with limited opportunity for cost neutrality for over-delivery could have a perverse impact of discouraging companies to reassess network requirements during the price control. It may lead to companies focussing solely on the delivery of the agreed plan, irrespective of updated condition data or changing needs on the network. This would be driven by the fear that any substation that leads to

over-delivery will not be fully funded and any substitution with lower cost alternatives will lead to clawback of the majority of the savings.

We accept that it is necessary to hold companies to account for delivery of the agreed work programmes, but such processes need to be practical with minimal requirement for detailed ex-post assessment.

NARM for investment justification

As already stated, the move to a long-term risk measure enables 'automatic' justification for interventions. Ofgem demonstrates this in paragraph 8.78 with green areas of the risk matrix showing that the risk benefit delivered is greater than the cost of delivery.

This means that where licensees propose volumes of activity that are supported by the NARM matrix, the burden of additional evidence such as CBAs and EJPs should be lower. It can also be used to identify those areas where NARM provides a weaker case and there is a need for submission of additional justification.

The justification through NARMs should negate requirements for the submission of additional supporting information where clear justification for asset replacement or refurbishment activity is provided by the submitted NARMs. Provision of additional justification should be proportionate to the absence of sufficient 'automatic' justification provided by NARMs.

→ OUTQ45. Do you agree with our proposal not to introduce outputs or incentives related to workforce resilience?

Yes.

Companies have different resourcing strategies and specific resourcing challenges. There is a risk that through establishing an incentive mechanism, Ofgem could dictate company resourcing priorities, rather than allowing the companies the flexibility to address their own specific circumstances.

Appropriate resources are an input to the quality of service, work delivery and outputs delivered by licensees and therefore Ofgem should continue to focus on assessment of the outputs and service delivered for consumers rather than incentivising how companies determine their resource requirements.

→ OUTQ46. Do you agree with our proposal that DNOs should submit a Cyber Resilience IT Plan and a Cyber Resilience OT plan?

Yes, industry sector understanding of OT/ICS Cyber Security is still developing and the threat/risk landscape is also still to be fully determined. Although there is likely to be a number of synergies with IT Cyber Security, OT/ICS Cyber Security will ultimately require different endpoint solutions and management processes to that of IT Cyber Security. This will result in the RIIO-ED2 OT Cyber Resilience plan having a higher degree of uncertainty than that of the IT Cyber Security plan, where solutions, tools and costs are already known and established, suggesting that two separate plans is, indeed the right option.

→ OUTQ47. Are there further requirements of expectations that we should be considering for the DNOs?

The Cyber Security threat is constantly evolving and we can only plan for what we currently already know today, therefore any plans for investment and activity during the RII0-ED2 period will have a significant degree of uncertainty. There is a high degree of certainty that significant investment in new OT Technologies and additional resource to capture and analyse OT data will be required. Therefore, it would be beneficial if the NIS directive defined more specific OT standards and cyber security expectations in order to provide a consistent approach to OT across the industry.

→ OUTQ48. Do you agree with our proposal for the establishment of a 'climate resilience' taskforce or working group, to help DNOs develop strategies for managing the risks of climate change?

Yes. There are existing working groups established through the ENA that could be utilised or expanded to cover the remit of a 'climate resilience' taskforce.

WPD is an active contributor to both the Climate Change Adaptation Reporting group (CCARG) and the overarching Resilience and Emergency Coordination group (RECG).

The purpose of the CCARG is to provide a forum for ENA Members to review existing reports and develop a formal response to DEFRA concerning climate change adaptation within the Energy industry. The group has representatives from Gas Distribution, Transmission and the Electricity Distribution companies to ensure that dependencies are identified and factored into the mitigation strategies.

The group, along with WPD, are already undertaking proactive studies using the UK Climate Projection 2018 (UKCP18) data to understand if the industries current climate change mitigation strategies are sufficient for any new or changed projections. The industry share best practice for climate change adaptation within this group and look at the most effective strategies for our networks.

The first climate change adaptation report (June 2011) identified areas for climate change adaptation mitigation that have been implemented within WPD networks. The mitigation strategies include installing taller wood poles as standard to limit the impact of increased conductor sag as hotter temperatures cause conductor to expand. WPD has also added lightning protection to all pole mounted assets in anticipation for the increase in intensity of lighting.

The RECG is an overarching group within the ENA that ensure all aspects relating to resilience, including climate change adaptation is included within the subgroups. The RECG look at the outputs from each meeting of the subgroups and look to share best practice for resilience themes.

ENA Engineering Report 7, is updated every year and details the areas of resilience and emergency planning undertaken through the ENA. The RECG compiles this report and shares best practice which feed into the engineering documents produced by the ENA.

→ OUTQ49. How should DNO strategies inform best practice that is used across the industry? How can these be used to help DNOs develop longer term investment proposals to manage the risks of climate change?

The CCARG could be continued past the submission of the 3rd round DEFRA report and be utilised to create appropriate industry guidance regarding best practice with regard to climate change mitigation across the industry.

The shared knowledge and experience from this group would enable DNOs to develop longer term investment proposals. The group has a proven track record of utilising knowledge and experience from the electricity sector and other sectors including the wider energy sector, utilities and telecommunications sectors, to identify mitigation strategies that are innovative and cost effective.

→ OUTQ50. Do you agree with our proposal to retain the RIIO-ED1 approach to flood resilience?

WPD agrees that the RIIO-ED1 approach to flood resilience should be retained for RIIO-ED2.

→ OUTQ51. What are your views on how we/industry reports on progress against flood resilience plans?

We do not see the value in developing an overall resilience metric. There are a range of different issues that can affect the resilience of networks from tree damage to loss of telecommunications. Any hybrid metric encompassing a wide range of drivers would be complex to weight across the drivers and potentially lack clarity on what aspects are causing the highest resilience risk. Our preference is for simple measures (e.g. number of substations at risk) for each different type of driver, which can then more clearly be linked to the activities being proposed in business plans and other regulatory reports.

Progress against flood resilience plans is currently measured by reporting the number of sites with permanent flood defences installed which can then be compared to the forecast within the DNO Business Plan. These summary volumes are supported by detailed regulatory reporting of substation information, including connected customers, for both sites where work has been completed and where work is programmed. As this reporting provides an indication of progress against flood resilience plans and provides Ofgem with detailed information supporting the delivered programme, it would be appropriate to continue measuring delivery in these formats.

→ OUTQ52. Do you agree with our proposal to retain the RIIO-ED1 approach to ensuring networks are resilient to trees?

Yes. Tree clearance is primarily carried out for two reasons:

- To ensure that overhead lines are clear from trees which could lead to safety issues in accordance with ENATS 43-8)
- To progressively make the networks more resilient to severe weather (in accordance with ETR132)

It should be recognised that once the initial costs of making networks resilient have been undertaken there is an ongoing cost of maintaining this resilience. Changes made to RIGs V6 incorporate additional reporting that aims to capture these resilience maintenance costs. Since these are new reporting requirements companies may not have had the facility to capture these costs and associate volumes historically and

therefore assessment of these costs for ED2 will predominantly need to be based upon forecast rather than history.

DNOs are increasingly making use of new technology such as LiDAR for managing tree clearance and therefore the arrangements for assessment of tree programmes will need to consider these changes.

→ OUTQ53. Do you agree with our proposal to develop a wider resilience measure over the course of RIIO-ED2? If so, what should it cover?

We do not see the value in developing an overall resilience metric. There are a range of different issues that can affect the resilience of networks from tree damage to loss of telecommunications. Any hybrid metric encompassing a wide range of drivers would be complex to weight across the drivers and potentially lack clarity on what aspects are causing the highest resilience risk. Our preference is for simple measures (e.g. number of substations at risk) for each different type of driver, which can then more clearly be linked to the activities being proposed in business plans and other regulatory reports.

→ OUTQ54. Do you agree with our proposed approach of retaining the existing arrangements for Black Start, physical security, and telecommunications resilience?

Retaining the existing arrangements for Black Start, physical security and telecommunications resilience is appropriate.

Requirements in these areas are driven by parties external to the DNOs and have the potential to evolve quickly. Funding for these activities should be provided through baseline allowances, based upon the requirements known at the time of Business Plan assessment, but a re-opener window needs to be available to ensure that DNOs will be able to respond to changing requirements that may occur during the price control period.

Black Start resilience includes a requirement for resilient telecommunications to key sites. Any activities to provide increased Black Start resilience in telecommunications systems may naturally overlap with requirements for telecommunications resilience required for other purposes (such as cyber security considerations, or increased reliance on reliability of data exchange). It may be necessary for this overlap to be considered in defining reopener mechanisms.

→ OUTQ55. Do you agree with our proposal to include a reopener for physical site security, with a window during the price control and a window at the end of the price control?

It is appropriate for a reopener for physical site security to be included within the price control to adjust revenues relating to those changes in requirements mandated by government.

Given that RIIO-ED2 will be a five year price control period, a reopener window during the price control may not be necessary provided that a suitable reopener is available at the end of the price control.

→ OUTQ56. Do you agree with our proposal to continue monitoring the development of telecommunications resilience and reviewing the arrangements as necessary?

Given the uncertainty over future requirements for telecommunications resilience, Ofgem is correct to continue monitoring the development of such requirements and keep the associated price control arrangements under review.

Ofgem suggests that an update on the position will be provided as part of draft determinations, however an update as part of the Sector Specific Methodology Decision would be welcome. In addition it would be helpful to understand whether an uncertainty mechanism would be applicable given that requirements are being evolved with both Ofcom and Government departments.

Delivering an environmentally sustainable network

→ OUTQ57. Do you think our proposed environmental framework will drive DNOs to deliver an environmentally sustainable network?

Yes, and the drive for DNOs to work to deliver net zero and achieve Science Based Targets is commendable. It is however important that DNOs shouldn't lose sight of the more tangible environmental impacts which our Stakeholders have expressed interest in/concern, for example pollution prevention, biodiversity loss and protected species.

→ OUTQ58. Do you consider that the proposed areas in scope of the Environmental Action Plan, and associated baseline standards, are appropriate? We particularly welcome views on any areas that should be omitted/included and if new areas should be included, what the baseline standard should be?

Generally the scope is appropriate however it is important that DNOs manage expectations to deliver on the more challenging aspects of the EAP requirements for example measuring embedded carbon and the development of natural capital assessments. Focus on the day to day management of protected species and pollution prevention should not be lost.

Would it be beneficial also to include measurement of SO_x, along with NO_x?

→ OUTQ59. Do you agree that the annual reporting through the Environmental Impact Report will increase transparency of the DNOs' activities and the resulting impacts on the environment?

If the Environmental Impact Report is an annual report which details progress towards the Environmental Action Plan then yes the Environmental Impact Report will increase transparency of DNO environmental impacts and associated environmental improvement performance.

→ **OUTQ60. Do you agree with our proposal to introduce a re-opener to accommodate environmental legislative change within the RIIO-ED2 period?**

Yes, during the course of ED1 there has been the introduction of significant environmental legislation, this may also be the case throughout ED2. A re-opener to take account of such changes seems sensible. Or alternatively a new implementation plan to address any change in legislation would not be required during ED2 period.

→ **OUTQ61. Do you agree with our proposed removal of the Losses Discretionary Reward?**

We agree with the Ofgem assessment that the Losses Discretionary Reward has moved the industry forward during ED1, including the setup of the ENA's Technical Losses Task Group where DNOs share ideas and best practice. The group's research work has shown that a measured incentive is unlikely to succeed due to the relatively small volume of losses compared to total volumes of energy flowing across networks. A reputational approach is more appropriate. Retaining a Losses Strategy and using this to report on associated performance measures is a good way to manage this area.

→ **OUTQ62. Do you agree with our proposal to retain the visual impact allowance for RIIO-ED2?**

Yes.

→ **OUTQ63. Do you agree with our proposed approach to setting a funding pot for the visual impact allowance for RIIO-ED2?**

Yes.

Annex 2: Keeping bills low for consumers

Approach to Aggregated Econometric Analysis

→ **COQ1. Do you agree with our proposal to include totex benchmarking in our toolbox for cost assessment in RIIO-ED2?**

WPD understand the inclusion of totex benchmarking in the toolbox for cost assessment in RIIO-ED2, but do not consider it should be a significant component of the cost benchmarking for the following reasons. (This reflects our response to GDQ26 of the GD/T2 DD Consultation³):

- a. Top-down models provide a very limited line of sight between the sources of efficiency and inefficiency, be that to Ofgem, network companies, stakeholders and customers. As an information tool it is therefore limited and may restrict

³ WPD (Sept 2020) 04092020 WPD Appendix Question Responses to RIIO2 GD&T Draft Determinations, p. 39-41, GDQ26

future planning, monitoring and understanding by all parties which may detriment the actual delivery of future efficiency gains. Whilst a top-down model can inform a view of overall efficiency, it neither tells Ofgem or network companies where the sources of inefficiency and efficiency are, or how the former might help drive long term improvement for subsequent controls / allowance setting (i.e. it provides no information on where or how big the efficiency gap is in respective areas). Sole reliance on a top-down model may breed long term inefficiency, as Ofgem will be limited in future price controls to assess efficiency movements at a total activity level.

- b. In a similar vein to the above, given the ED sector is, and will continue to be, in a period of significant change as it transitions to DSO, a totex approach is not appropriate to understand what DNOs are proposing and differences between them. A number of recent Government policy decisions have been, and will continue to be significant cost drivers for DNOs. As these policies evolve so do the cost on the networks. For example, the Government's Renewable Heat Incentive at the start of RIIO-ED1 resulted in significant investment in PV panels in the South West network. This policy change, along with ongoing and future developments around DSO and electrification of heat and vehicles demonstrate how Government policy changes can impact on a DNO's costs, to greater or lesser extent depending on policy rollout, which are difficult to capture in high level cost drivers associated with a totex assessment.
- c. Top down models do not make use of all the available information. In its recent GD&T Draft Determinations (p. 86, para. 325) Ofgem cite the "*extensive data collation undertaken via BPDTs submissions*", but this not made use of in a primarily totex approach. In the ED2 CAWG and ED2 BPDT sub-group of the CAWG, WPD have communicated the need for data collation in the ED2 BPDTs to be proportionate and reflect the required level of information Ofgem need to make the price control assessment. Furthermore top-down models do not readily support line of sight between modelled allowances and what DNOs are actually expected to deliver and at what cost.
- d. Ofgem need to be mindful that an ex-ante cost assessment approach will create inconsistent application of cost assessment throughout the price control. Uncertainty mechanisms (UMs), by considering discrete packages of work activities and costs naturally lend themselves to disaggregate cost assessment. Ofgem are also proposing that a significant proportion of costs in RIIO-2 will be assessed via UMs, which will, by design, have to be assessed on a different, inconsistent, basis to the ex-ante approach if this is primarily totex. Furthermore, where some costs are to be assessed both at ex-ante and via a UM, Ofgem will not be able to cross-check the assessment of efficient costs due to different methods.
Top down models can tend to associate inefficiency with underspend, which can be at the cost of service quality, performance and non-delivery. The absence of disaggregated models to balance the incentive framework and ensure delivery at an activity level may make the balance of trade-offs of underspend more appealing to network companies.

We believe that Ofgem should use bottom-up, activity level, disaggregated modelling as the key part of its toolbox – please see response to question COQ8.

→ COQ2. What cost drivers do you consider appropriate for our proposed totex benchmarking? Why?

CSVs

WPD does not consider usage of CSV variables appropriate for benchmarking for the following reasons, which we also discussed in our RIIO-2 Tools for Cost Assessment consultation response⁴:

“WPD considers that the cost driver of the totex regression model does not necessarily need to be determined by the cost drivers of the bottom-up models or that a single Composite Scale Variable (CSV) is the only appropriate driver of totex for aggregate modelling. WPD raises concerns regarding the transparency of CSVs and therefore recommends that Ofgem further considers if they are fit for purpose.

Whilst WPD broadly agrees with the general approach of building upon, rather than disregarding, the cost assessment framework developed for RIIO-1, we believe further work would be beneficial in the form of developing a robust, reproducible and transparent method for cost driver and model selection. In RIIO-1, Ofgem discarded the generally accepted and widely practiced general-to-specific approach to model selection in favour of an invented, so-called “*disaggregated to aggregated approach*”⁵ comprised of totex models informed by disaggregate drivers, in what was a less than transparent short-cut.

Ofgem may choose to consider the development of models independently of one another. This stems from the view that there is no guarantee that statistically significant drivers of disaggregate cost categories are statistically significant drivers of totex (or more aggregate cost categories) and vice versa. Disaggregate modelling seeks to identify cost drivers that are effective in explaining the variation in costs across companies for a particular disaggregate cost category. As any given disaggregate cost category represents only a part of totex, those disaggregate cost drivers may not be as effective in explaining variation in costs across companies at an aggregate level. Therefore if Ofgem intends to pursue both aggregate and disaggregate level modelling for use in the price control assessment (as has been done for RIIO-1 and also for PR19), Ofgem may wish to consider separate approaches to determining the cost drivers which influence the respective models. WPD consider there is no reason why totex regression models must necessarily be pre-determined or pre-defined by the cost drivers of the bottom-up models.

Furthermore, Ofgem may choose to further consider the use of a composite scale variable (bottom-up, top-down⁶ or other) as the driver of totex regression or indeed any models. This is because a CSV, by bundling up cost drivers into a single variable does not allow for easy interpretation of the implied relationship between the component cost drivers and costs. For example, in a standard Cobb Douglas function, the coefficients are interpreted as the driver elasticity of costs; that is to say a one per cent increase in the cost driver can be expected to increase costs by a percentage equal to the modelling coefficient on that given driver. This insight is incredibly powerful. However, when the cost driver is in fact made up of a number of cost drivers with weights attached, the clarity of the relationship between individual cost drivers and costs is lost and little meaningful insight can then be interpreted from the CSV coefficient. In accordance with Ofgem’s proposed model selection criteria of “*Transparency...of the results and ease of*

⁴ Q5, p. 5-6

⁵ Ofgem (2019) RIIO-2 tools for cost assessment Consultation, p.68

⁶ Called ‘MACRO-CSV’ in Ofgem’s RIIO-ED1 regression models

*interpretation for stakeholders*⁷, WPD recommends that Ofgem further considers the appropriateness of using a CSV throughout the cost assessment process and that separately identifiable cost drivers of totex may present an alternative approach as per the above.

To improve the robustness and transparency of the non-conventional “*disaggregated to aggregated*”⁸ model selection approach adopted at RIIO-1, WPD recommends the use of the general-to-specific model selection process⁹ for each modelled cost area or alternatively (and more favourably) a more sophisticated method based on a statistical Monte Carlo assessment of candidate cost drivers. To expand on this recommendation, whilst the general-to-specific model selection process offers a well-established and ‘formulaic’ approach to model selection, it involves judgement to determine which variables to include and exclude from models. Using a Monte Carlo approach removes reliance on such judgements; for example by employing a statistical method to identify cost drivers which jointly, on average, are most likely to produce statistically significant coefficients and which have a high explanatory power¹⁰, when included in regression models. Furthermore, where multicollinearity between cost drivers exists (which can often lead to counterintuitive coefficient estimates) the general-to-specific approach provides no guidance to the modeller on which cost driver(s) it is appropriate to omit from the group of closely correlated variables. Considering such a Monte Carlo method could also enable presentation of a more balanced, industry-level perspective of what good models could look like (without the bias of mirroring pre-conceived regulator or company specific views of what the models should be)¹¹. This could be a highly rewarding opportunity to refine the RIIO-1 cost assessment framework.”

Furthermore and as per our GD/T2 DD response¹², CSV variables do “not lend themselves easily to the incorporation of other cost drivers not directly linked to any one particular disaggregate activity, for example regional factors. WPD set out the merits of controlling for regional factors through within model adjustments, i.e. a cost driver controlling for each regional factor, in our response to question GDQ29, insofar as it can inform as to whether the hypothesised regional factor actually has a statistically significant impact on costs. It is not clear how a regional factor cost driver could be incorporated or interpreted within a CSV. WPD do however considered that costs drivers, separate to the CSV, might be an option.”

Ofgem have previously offered the argument that a CSV does not consume many degrees of freedom compared to individually specifying each component cost driver. Given a sample size of 14 DNOs, there would be statistical scope for inclusion of multiple independent cost drivers, as an alternative to a CSV driver.

MEAV

MEAV was a cost driver heavily relied upon in both the totex and disaggregate modelling in ED1. WPD does not consider use of a MEAV cost driver to be suitable for RIIO-ED2 cost assessment given the nature of change the sector is currently and is expected to

⁷ Ofgem (2019) RIIO-2 tools for cost assessment Consultation, p.18

⁸ Ofgem (2019) RIIO-2 tools for cost assessment Consultation, p.68

⁹ This is generally accepted and widely practiced in both academic and regulatory fields.

¹⁰ i.e. that variation in the cost driver across companies / time is able to explain a high proportion of the variation in costs observed across companies / time

¹¹ Further details of what a Monte Carlo approach to cost driver selection could look like are provided in an approach used by NERA to support Bristol Water in their development of a view of cost efficiency for PR19, which was recommended to Ofwat: NERA (2017) [Comparative Benchmarking Assessment to Support Preparation of Bristol Water's AMP7 Business Plan](#); Bristol Water (2018) [Cover Letter to Consultation on econometric cost models for PR19: proposed cost models](#)

¹² WPD (Sept 2020) 04092020 WPD Appendix Question Responses to RIIO2 GD&T Draft Determinations, p. 48-49, GDQ30

continue to face. The basis of the majority of Ofgem's cost assessment methods (regression and other methods of benchmarking) seeks to understand how variations in a cost driver explain or affect variations in expenditure, with the residual interpreted as relative or catch-up efficiency. The ability of MEAV to provide an informed view on this basis is limited given the relationship between the replacement value of the assets and expenditure will be less direct than it has been in previous controls. As flexibility services and DSO functionality increase, the relationship between the monetised value of the size of the network (MEAV) and expenditure is not as direct, as DNOs find alternative non-traditional reinforcement solutions to solve capacity constraints. As such, a DNO may be increasing expenditure with little or no increase in MEAV, such that any additional expenditure (e.g. in DSO) will be considered inefficient and unnecessary spend.

Proposed alternative cost drivers

WPD's view is that Ofgem should still consider the bottom-up drivers and top-down drivers (with the exception of MEAV, see above) for ED2 cost assessment, but advises against bundling them up into a CSV variable. Other drivers may also be relevant. As per the above all candidate cost drivers should be considered using a general to specific approach to selection at minimum, with a Monte Carlo approach being WPD's preferred cost driver selection method where regression techniques are concerned. Discussion of appropriate alternative cost drivers for ED2 cost assessment is a relevant discussion for the CAWG. This will need to align with design and development of the cost driver table in the ED2 Business Plan Data Tables (BPDTs).

→ COQ3. What are your views on the use of both historical and forecast data in our modelling?

An appropriate balance between future and historic costs needs to be considered. Future forecasts may include additional efficiency assumptions and therefore should be the main reference points for analysis. However the validity and achievability of these should be considered in the context of historic costs.

As a general consideration cost assessment should place greatest weight on forecast costs and the most recent past as these present the best view of the world for the future price control. The further back Ofgem relies upon historical data the less informative it is likely to be in informing future costs and the more likely it will overlook efficiency gains realised by the company / sector in the interim. However, this is a general consideration and a full assessment can only be reached in reference to the specific data set in question.

We would certainly urge caution on the use of DPCR5 data in ED cost assessment. Some elements of reporting have changed since 2015 and so these values may be less reliable as these have been later restated. For WPD specifically, the early years of DPCR5 are not reflective of their current structure, since the Midlands was acquired in 2011 and there followed a period of significant integration of organisation and processes, which was not complete until mid DPCR5.

We also note that whilst para 3.19 of the SSMC refers to 13 years of historical data from DPCR5 and ED1, this is in practice only actually 11 years. This is because at the point when the BPDTs are submitted, data will be forecast for the last 2 years of ED1.

In terms of using econometric analysis to inform cost assessment; whilst there is great appeal in using a long data series, changes over time may well alter the explanatory power of a cost driver on costs (and the statistical validity of the relationship). Furthermore, new drivers, previously not relevant or even considered, may now be relevant and should be considered. Acknowledging that the suite of cost drivers, much like the sector, is evolving is imperative to having a cost assessment framework that is fit for purpose and one which looks to the future as much as it does rely on simply rolling forward the past. Some examples include:

- Electric vehicles and the impact they will have on costs and cost efficiency
- The ramp up in DSO activity and flexibility solutions is likely to mean the relationship between activities, spend and efficiency is defined differently in ED2 compared to ED1, such that utilising historical information may not be a helpful avenue to inform ED2 cost assessment.

The use of 2020/21 in modelling should be also be undertaken with some caution because of the impacts of COVID-19. Whilst the year is ongoing, it is difficult to assess the impact it may have on eventual modelling, but use of data and exclusion of outliers for example should be forefront when reviewing data and modelling results. As local lockdowns are likely over the remainder of 2020/21 and with government policy differences between England, Wales and Scotland, there may be differences in DNO data for which a 'one size fits all' approach is not appropriate.

→ **COQ4. At what level should we set the efficiency benchmark?**

The location of this question in the consultation would suggest that it is primarily focused on the efficiency benchmark relating to totex modelling. However WPD consider it appropriate to answer this question in respect of the total cost assessment approach on the basis that it is not known what weighting Ofgem will apply to totex cost assessment relative to other cost assessment methods.

WPD reiterates our view set out in our response to Ofgem's RIIO-2 Sector Specific Methodology Consultation, which was also confirmed in our response to the RIIO-2 Tools for Cost Assessment Consultation:

“It may not always be appropriate to choose upper quartile cost as being efficient. The approach adopted should be dependent about the comparability of the underlying data. Where there is potential for variance in work content, it may be appropriate to take a median or average value”¹³. “Whilst the upper quartile was used at RIIO-1, blanket application of the same efficiency challenge across all cost assessment areas may not be appropriate or desirable in RIIO-2”¹⁴.

At ED1, Ofgem typically applied a 75th percentile (upper quartile) benchmark to the cost areas assessed using regression and a median benchmark to most other cost areas (with a few small exceptions). WPD would not agree with any stronger change to this position. WPD do not agree with the position taken in the GD DD, where efficient costs were defined as equal to the 85th percentile of the output of the totex model – this is documented in the response submitted by WPD to question GDQ27 of this document. From a robustness perspective, utilisation of regression techniques at ED1 was limited

¹³ WPD (2019) Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation, p. 111

¹⁴ WPD (August 2019) response to the RIIO-2 Tools for Cost Assessment Consultation, Q22, p. 11

to cost assessment areas where the pool of observable data points was sufficiently large that a causal relationship could be tested and if defined, quantified using regression techniques. WPD consider that this principle informing the choice of cost assessment tool be retained for ED2; both in ED1 and ED2 there are discrete activities which do not readily lend themselves to regression methods for this reason.

There may be cost and activity areas for which Ofgem should consider not setting an efficiency benchmark (or equally and correspondingly an ongoing efficiency challenge) in ED2 where this may dis-incentivise activity or where there are new and emerging cost areas, for example:

- Net Zero activities
- DSO and flexibility
- Lane Rental street work schemes
- Clean Air Zones

All are examples of new and emerging activity and cost impacts for which application of a catch-up or efficiency challenge is not considered appropriate because practices and costs are still embedding.

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) or modelling error.

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.

→ COQ5. Do you agree with the proposed criteria for developing cost pools for a middle-up approach?

Ofgem proposes to use the same criteria for ED2 as CEPA developed for RIIO-GD2 and which were consulted in the RIIO-2 Tools for Cost Assessment Consultation. Correspondingly therefore, WPD's response to Q2 of the RIIO-2 Tools for Cost Assessment Consultation is directly transferrable and relevant to ED2; to reiterate:

"The broad principles of considering complementarity of cost drivers, cost trade-offs and cost boundary complexity seem intuitive criteria; although it would be expected that such considerations are standard practice as part of the pre-model development phases (see also WPD's response to Question 4) and in determining the appropriate suite of models along the aggregate-to-disaggregate spectrum to inform the cost assessment. The appropriateness of the "*risk of inaccurate/biased models*"¹⁵ criteria is not however clear; all models at the development stage carry the risk of being inaccurate or biased; only running them can shed light otherwise. This criteria, by suggesting that certain

¹⁵ Ofgem (2019) *RIIO-2 tools for cost assessment Consultation*, p.15

groups of costs and corresponding cost drivers can be included / excluded from the assessment simply on the basis that they may produce inaccurate and biased models, would, in extreme application, leave Ofgem having no candidate models to consider at all. Ofgem might wish to consider removing this criteria from their assessments, including those concerning 'cost pools'.

WPD would recommend the inclusion of an additional criterion that would ensure comprehensive coverage of costs at any one level of aggregation. This recommendation is based on observations of Ofwat's recent PR19 approach to cost assessment and their development of 'cost pool' based models, albeit not explicitly labelled as such. Ofwat's approach morphed from the initial consideration of mid-aggregation models consistent with mid-aggregation activities¹⁶ to a pic'n'mix approach of models of different levels of aggregation covering different groupings of cost activities. This resulted in an imbalance of cost pools representing some part of business activities to a mediocre level and others not at all; with three levels of aggregation being used across five models¹⁷ leading to an uneven coverage. This proposed additional criteria, would also ensure comprehensive capture of trade-offs and cost boundary complexities across activities and costs at any one level of aggregation.

If cost pools (or put more simply the identification of cost types and corresponding cost drivers at a consistent and appropriate level of aggregation)¹⁸ are to be pursued at all, it would be most advantageous as a joint industry and regulator based activity, which could for example, be organised through the CAWG. This reflects our view to active industry engagement as set out in our response to Question 3 and 4.

Overall, WPD does not disagree with the development of cost pools, only that they be considered as part of a balanced examination of models at all levels across the aggregate-to-disaggregate spectrum. To discount disaggregate models without investigation would be premature and ill-evidenced. Indeed, as per our response to Question 5, cost drivers that are statistically significant at a disaggregate model level may not be statistically significant at a more aggregate level and vice versa and therefore a suite of models with an even spread across different levels of aggregation has appeal.

Ofgem's consideration of cost pools marks a move away from their prior communicated intention to build upon, as oppose to disregard, the RIIO-1 framework. As WPD set out in our response to the RIIO-2 Sector Specific Methodology Consultation in March 2019 *"Starting again with a new approach [i.e. cost pools] potentially introduces new issues and errors. The cost assessment techniques adopted for RIIO-1 have evolved over time and therefore represent the collective knowledge of Ofgem, licensees and others that have contributed to working groups. It is important that the embedded knowledge and development of the existing cost assessment techniques is not lost"*¹⁹. WPD recommend that consideration of the relevant suite of RIIO-2 cost drivers and how these might have evolved from the RIIO-1 models (see also our response to Question 23) should take precedence over any potential development of cost pools.

In ED, there is a strong history of disaggregated reporting supported by established definitions. These have evolved over time to provide comparability of costs. The

¹⁶ Water resources, Network Plus, Residential Retail

¹⁷ At Initial Assessment of Plans stage

¹⁸ WPD would be grateful if Ofgem or their consultants could clarify if this interpretation is accurate by providing a definition of what is meant by the concept 'cost pool'

¹⁹ WPD (2019) *Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation*, p. 111

establishment of aggregated costs pools needs to consider whether the aggregation achieves better comparators than assessments at a more disaggregated level.

As set out in our response to question COQ1, WPD considers there are a number of disadvantages to totex modelling. As set out in our response to question COQ8, disaggregated modelling offers a number of advantages and this should be reflected by significant weighting being given to the disaggregated approach. WPD is, however, mindful that a disaggregated assessment alone may provide too narrow a view of efficient costs which does not consider the overall picture and inter-activity synergies that running a network brings. In this instance, middle models may offer a better alternative to totex models as a sense check on disaggregate models and avoid any opex / capex bias that may be apparent if a fully disaggregate approach is pursued. For RIIO-ED2, Ofgem may wish to consider middle models as another way of looking at and cross-referencing the efficient costs implied by disaggregate modelling. Providing appropriate cost buckets and cost drivers are selected, middle models could reduce cost boundary issues and expenditure bias, whilst being more grounded in engineering logic than totex alternatives that in RIIO-ED1 were driven by cost drivers that are largely static and detached from the actual operations of network companies within a price control (please see WPD's response to question COQ2). Nevertheless, using more detailed and disaggregated data would be a sensible and WPD preferred approach.

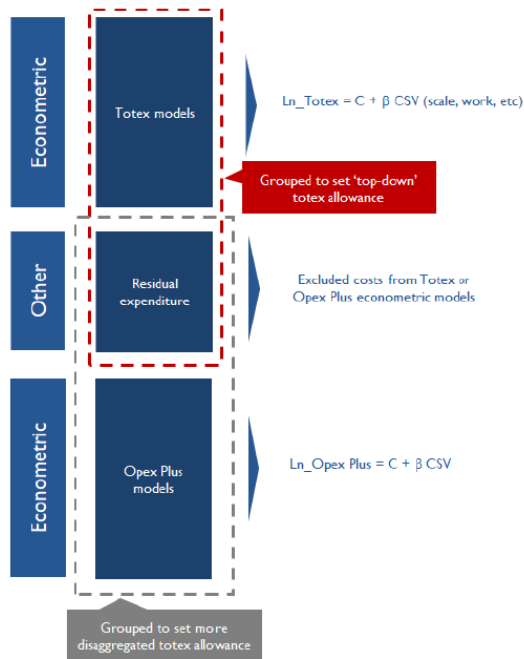
→ COQ6. What cost drivers would be appropriate in a middle-up approach?

The choice of cost drivers depends on the nature and boundary of the cost pools to be modelled. In the SSMC Ofgem has not proposed any cost pools as candidates for cost assessment in a middle-up approach or model, thus WPD is not able to provide a view of what exogenous drivers may best explain variations in costs for that particular carved-out pool between DNOs.

→ COQ7. 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?

It is not immediately clear which CEPA report Ofgem is referring to in para. 3.33 of the SSMC ED2 Annex 2, to which this question relates. The footnote reference in para 3.33 links to a news item on CEPA's website in which CEPA refers to the RIIO-2 Tools for Cost Assessment Consultation and a number of briefing papers which CEPA prepared. WPD consider that the series of options developed by CEPA as cited by Ofgem in para 3.33 may refer to those set out in Figure 5.1: Cost Aggregation modelling options, p. 51 of the report CEPA (June 2019) RIIO-GD2 cost assessment – econometric modelling & regional factors. This was not clearly signposted by Ofgem in the SSMC. Furthermore, given the report concerns the GD2 price control, it may have been beneficial to ED stakeholders, as the primary audience of the ED2 SSMC, for Ofgem to summarise diagrammatically or otherwise the consulted on "totex and opex plus approach".

Option 3: Totex & Opex Plus modelling



Broadly, WPD is open to the CEPA developed totex and opex plus approach, whilst noting the following:

- The developed example approach provides a framework option for how cost assessment methods undertaken at different levels of cost aggregation and for different expenditure types (opex, capex) could be combined together. It remains to be seen whether there are any practical examples that would fit into this framework. At this stage WPD cannot provide greater insight into the proposed approach. For example, it is not clear what costs and activities Ofgem consider in regard to the ED sector might fit into an econometric model for opex plus and then what might be assessed as residual expenditure.
- The proposed regression models in the option, seem to specify a CSV variable in each. Please see WPD's comments to question COQ2 with regard to drawbacks of using CSV cost drivers.
- It is not clear what weightings the option will put on the three component cost assessment methods. Please see WPD's comments to question COQ1 and COQ9 with regard to the relative balance of totex and non-totex assessment methods.
- The notion of an opex plus model presents some reversal of the RIIO-1 invention to move to a framework which did not incentivise one expenditure type over another (opex, capex). Ofgem need to be sure that such an approach and the costs assessed in each component does not create adverse incentives.
- The cost boundaries for assessment in the three components must fulfil the criteria for model development consulted on in question COQ5 and mitigate the concerns raised by WPD in our response above.

Separately, it is not clear why Ofgem has chosen only to consult on one of the four options set out in the CEPA report.

→ COQ8. Do you believe it is appropriate to use bottom-up, activity-level, disaggregated modelling in RIIO-ED2?

An overall toolbox approach to cost assessment is appropriate. Bottom-up, activity-level, disaggregated total expenditure cost assessment is an essential component of this toolbox, providing the most reliable and robust results out of all of the cost assessment approaches considered in the methodology consultation.

Disaggregated total expenditure cost assessment has a number of key advantages over the other approaches, including:

- Disaggregated totex benchmarking incorporates activity/cost drivers that have a causal relationship with specific activities, rather than place reliance upon the types of proxy measures that are used in top-down cost assessment. Proxy measures inherently introduce, often sizable, inaccuracies in the outcome of top-down assessments;
- Disaggregated analysis can take account of a greater number of factors that explain costs, including facilitation of separate analysis of volumes and unit cost efficiency. By contrast, a top-down approach cannot identify whether a company's relative variance in expenditure is driven by levels of activity, or efficiency of delivery. This means that, unlike the disaggregated approach, top-down approaches cannot distinguish between a company that spends less because it is efficient (i.e. lower unit cost) and a company that delivers less work;
- Quantitative and qualitative analysis of activity levels can be performed within disaggregated analysis and suitable adjustments can be accommodated. Ofgem's greater use of assessment of specific projects through analysis of Engineering Justification Papers is more aligned to qualitative assessment adjustments. The link between assessment and adjustments is difficult to facilitate within top-down assessment;
- There is no requirement for regional adjustments, such as for customer density or sparsity, because the direct relationship between volumes of activity and cost is revealed;
- Appropriate cost normalisations and adjustments can be made to specific activities to which they relate;
- Disaggregated analysis identifies the expenditure areas where companies' costs are better or worse than benchmarks. This promotes greater understanding of efficiency, helping to drive improvements within the industry, as demonstrated from RIIO-ED1 Slow Track cost assessment.

For the above reasons, disaggregated total expenditure modelling should not just be used in RIIO-ED2, but given the reliability and robustness of the results produced, should be given the largest weighting when the outcomes from all of the toolbox approaches are combined.

→ COQ9. 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?

The relative proportions of the weightings applied, when combining the results from the cost assessment modelling approaches outlined in the consultation, need to appropriately

reflect the degree of confidence that can be given to the results produced by each approach.

As explained in the response to COQ8, there are a number of significant advantages with the bottom-up, activity-level, disaggregated approach that mean that it produces significantly more reliable and robust results than the aggregated modelling approaches. In recognition of this, disaggregated modelling should be assigned a weighting that is greater than the combined weighting applied to the all of the aggregated models (i.e. top-down and middle model).

It is noted that the aggregated models (i.e. top-down and middle model) that will be used in RIIO-ED2 are not sufficiently developed to a point that the degree of confidence in the results that these approaches produce can be established at present. The response to COQ2 outlines a number of considerations that should be incorporated into the further development of the drivers for the top-down approach and, as noted in the response to COQ6, further definition is needed as to how and where the middle-up approach will be applied. WPD welcomes the opportunity to participate in the CAWG over the coming months, to work collaboratively to look at these models and try to identify any developments, for example different drivers, that may improve the confidence that can be assigned to the results from these approaches.

A particular limitation of the aggregated approaches may be the need for stable relationships to exist between costs and the selected cost drivers over a sufficient period of time for regressions to produce meaningful results. The industry has experienced significant change, particularly in the usage of the network, since RIIO-ED1 Final Determinations. Such changes include significant increases in embedded generation and the introduction of flexible capacity. This will impact upon the stability of the relationships for some of the cost drivers that were used in RIIO-ED1 cost assessment. Given that RIIO-ED2 is anticipated to be a period of further significant change, for example with the growth in low carbon technology to achieve a pathway to net zero carbon, the confidence that can be assigned to the results of any such regressions will likely be reduced due to the changing relationship between cost and proxy cost driver. The confidence in the relationship (or lack of it) will need to be reflected in the assignment of weightings to the aggregated models.

Increased weighting was applied to the aggregated models in the RIIO-ED1 slow track cost assessment, compared to fast track. In the consultation document this is explained as being a result of Ofgem's greater confidence in the slow track aggregate models. Consideration needs to be given to the fact that, for slow track, companies resubmitted their RIIO-ED1 Business Plans with the benefit of the insights into relative efficiency provided by the disaggregated modelling used in the fast track cost assessment. It is suggested that this revision of company's expenditure plans will have had a material effect upon the results of the aggregated models during slow track, with each company's plans moving closer to the efficient levels revealed during fast track. This would create a natural improvement in the confidence that could be applied to regressions. For RIIO-ED2, there is no opportunity for companies to revise their submissions based upon revealed efficiencies and therefore confidence levels in the results from the regressions in aggregated models would be expected to be lower than at RIIO-ED1 slow track. This should be reflected by a larger weighting being given to the disaggregated approach.

→ COQ10. If we did not use disaggregated modelling approaches, what approach should we consider for disaggregating totex allowances for the setting of PCDs?

In order to identify the allowances associated with individual PCDs, it is a pre-requisite that the Business Plan submissions are at a suitably granular level to enable the expenditure associated with individual PCDs to be clearly identified. This needs to be considered in the Business Plan Data Table requirements.

Where disaggregated cost assessment is utilised, any cost or volume adjustments to areas of expenditure relating to PCDs can be readily identified, facilitating the identification of disaggregated allowances for the setting of PCDs and the associated volumes of delivery.

The results from the aggregated cost assessment approaches do not identify the proportion of allowance associated with specific activities and therefore generally cannot be directly used to identify the proportion of allowances relating to PCDs. It is therefore necessary to accept an approximation.

Treatment of unit cost and volume adjustments

Cost adjustments that are made in the setting of allowances may reflect either

- efficiency in the cost of delivery; or
- adjustments made to activity volumes.

Where allowance adjustments relating to the efficiency of costs are made, these directly impact the allowed costs for delivery of the proposed PCDs. In principle it would be inappropriate for the activity volumes and associated PCD deliverable to be adjusted in response to such cost efficiency adjustments.

Where allowance adjustments relating to reduced volumes are made, in principle there should be a corresponding adjustment to the associated PCD deliverables to reflect the revised volumes. (For example, a volume adjustment that reduces the asset replacement volumes in a NARMS related asset category reduces the volume of work for which an allowance is provided, which would have a corresponding impact on the NARM deliverable risk reduction. It is not reasonable that a company should be expected to deliver PCDs where the deliverable has not been adjusted to reflect any adjustments made to allowed volumes, as this potentially commits a company to deliver the original deliverable with allowances associated with lower volumes of activity).

Disaggregated modelling enables clear identification of cost efficiency adjustments and separate identification of volume adjustments, enabling clear identification of the adjustments for associated PCD deliverables.

Treatment under aggregated modelling

Aggregated modelling does not identify whether a company's relative cost variance is driven by volumes of activity or efficiency of delivery. As a result, any allowance adjustment determined from aggregated modelling provides no transparency over how much of the adjustment relates to efficiency in the cost of delivery or volume adjustments.

For the proportion of total allowances determined through aggregated modelling, the only reasonable approximation that can be used to disaggregate the allowances for PCDs, is

to consider that any modelling adjustment applies uniformly to all costs within the assessed area of expenditure to which the adjustment applies.

Such an approach assumes that the cost adjustment is related solely to efficiency of delivery and that the efficiency would apply equally to all activities. Such an assumption would lead to scaling any PCD related expenditure shown in the Business Plan Data Tables proportionately to any cost adjustment that may be applicable to the wider area of expenditure assessed, in order to determine the allowance associated with the PCD. This approach would also need to take account of the weighting applied to the aggregated modelling approach when determining overall allowances.

This approach, however, fails to account for the fact that a proportion of any adjustment determined through aggregated modelling may actually arise from variances in volumes of activity. Without being able to identify this effect, and adjust the PCD volumes and deliverable accordingly, there is a risk that the reduced allowances will underfund the volumes of delivery required to meet the PCD. Applying adjustments solely to allowed costs, whilst keeping the volumes the same may effectively represent impossibly efficient unit costs of delivery for the PCD deliverables.

This effect can be limited by reducing the proportion of total expenditure allowances that are determined from aggregated modelling.

Model Specification

→ COQ11. What model estimation options should be considered for our cost assessment and why?

WPD reiterate our response to the RIIIO-2 Tools for Cost Assessment Consultation with regard to which model estimation options should be considered for ED2 cost assessment²⁰:

“Model estimation options should be considered on the basis of both the characteristics of the panel data set and evaluation of modelling results²¹, with appropriate evaluation of different model estimation options, all other factors remaining equal.

Whilst WPD provides no comment on the characteristics of the GD/GT panel data set, the following high level considerations are offered from a theoretical perspective.

A disadvantage of Ordinary Least Squares (OLS) is the inability of the model estimation process to distinguish between inefficiency and noise. This drawback is significant when unobserved / unmeasurable differences²² are incorrectly labelled ‘inefficiency’, which can lead to model robustness issues and also to an artificially inflated efficiency challenge being inferred and subsequently applied to company’s cost allowances. Whilst typically the former can be controlled for by using statistical methods and the latter

²⁰ Q1, p. 3

²¹ i.e. intuitive coefficients that are of the expected sign and magnitude and that are statistically significant; models that develop consistent results and which pass diagnostic tests to pre-determined levels of confidence, etc.

²² Unobservable cost driver that are specific to a company, which are present/stable in all time periods but different for each company and which are exogenous (i.e. beyond management control). RE, FE and SFA estimation methods, compared to OLS, make more formal acknowledgement of unidentifiable / unmeasurable cost drivers / genuine differences in operational practices between companies that drive differences in costs

through, for example, application of a less than frontier benchmark, the modelling approach, by being unable to identify and quantify true '(in)efficiency', is not supportive of helping companies or indeed the regulator to understand efficiency in absolute terms with confidence²³. On this basis Random Effects (RE) or Stochastic Frontier Analysis (SFA) offer benefits over OLS, despite OLS often being resorted to by economic regulators as a convenient and default estimation option.

Ofgem may choose to look again at RE and SFA model estimation options, in addition to OLS and consider the relative merits and drawbacks of each in light of the additional years of historical data which are now available. Using actuals from DPCR5 and ED1 to date will significantly extend and enrich the data series available for RIIO-2 modelling."

→ COQ12. Do you agree with our proposal to continue using Cobb-Douglas functional form? Why?

WPD reiterate our response to the RIIO-2 Tools for Cost Assessment Consultation with regard to use of the Cobb-Douglas function form²⁴:

"Function form selection should be determined on the basis of theoretical and practice-based economic and engineering understanding of the relationships between cost drivers and costs prevailing in the sector (see also WPD's response to Question 4). Expectations of returns to scale²⁵, cost elasticity of drivers²⁶, cost driver interactions and input ratios across different output levels should firstly be set and this information then used as a test to evaluate the most appropriate functional form and models to use for the sector amongst a shortlist. If expectations are broadly aligned with those set for RIIO-1, Ofgem may choose to continue to use the Cobb Douglas functional form, consistent with Ofgem's overarching approach for RIIO-2 to build on RIIO-1."

"....Setting expectations of the sector characteristics, as per the above, is a pre-requisite to informing the selection of the most appropriate functional form in all controls."

→ COQ13. Do you have any views on our proposed model selection criteria?

Noting the alignment between the model selection criteria set out in the ED2 SSMC with those consulted on in 2019 in the RIIO-2 Tools for Cost Assessment Consultation, WPD reiterate our response to the RIIO-2 Tools for Cost Assessment Consultation²⁷:

"WPD broadly agrees with the proposed model selection methodology. However, the proposals set out in the consultation are more akin to principles than criteria and it is therefore suggested that measurable tests or thresholds, ideally quantitative, be attached to each principle in order to facilitate transparency of application and decisions reached. Furthermore, it is suggested that a sequential, hurdle based approach be used to apply the selection criteria to candidate models as per the below order:

1. Economic / technical rationale
2. Transparency

²³ Or indeed, the extent to which adopting a UQ (or other benchmark) is actually challenging

²⁴ Q3, p. 4

²⁵ For individual companies, the industry as a whole and how the two compare

²⁶ responsiveness of cost to 1 unit / 1 per cent change in cost driver

²⁷ WPD (August 2019) response to the RIIO-2 Tools for Cost Assessment Consultation, first part of Q4, p. 4-5

3. Robustness

Examples of the types and phrasing of robustness criteria could include:

- R^2 must be greater than 80 per cent
- Explanatory variables included in regression must have a statistically significant impact on costs at the 5 per cent level

WPD recommends that failure of a candidate model to fulfil the criteria should lead to the dismissal / re-specification of the model, with the selection criteria then reapplied in an iterative fashion until all criteria are fulfilled.

With regard to transparency criteria proposed, please see WPD's commentary regarding use of the CSV variable in response to Question 5 of our response to the RIIO-2 Tools for Cost Assessment consultation, commentary which WPD considers is equally relevant to ED2.

Regional and Company Specific Factors

→ COQ14. Do you agree with the proposed criteria for assessing regional and company specific cost factors that we have outlined?

WPD broadly agree with the proposed criteria for assessing regional and company specific cost factors, however offer the following comments for potential improvement and refinement to the approach:

- WPD disagree with the wording for how the third bullet of para 5.7 of the SSMC has been constructed. In the case of a regional factor, the proposed criteria that the factor would only affect at most a small number of companies is not appropriate. For example, wages for comparable skills set may vary across the UK such that each DNO is "impacted by a significant amount, and in a materially different way to others". Each DNO is affected by the factor. WPD considers this third bullet is an appropriate criteria for the screening of company-specific factors but not regional factors for this reason.
- This relates to WPD's response to Q16 and Q17 of the RIIO-2 Tools for Cost Assessment consultation in which we set out our view that "distinction needs to be made between regional factors, which apply to all companies (albeit in different directions and magnitudes) and company-specific factors, which may be relevant to one or a few companies only." Our response in full expands upon how this distinction impacts on the optimal choice of methods for accommodating these factors in cost assessment and requests that Ofgem provide further clarity on the intended approach for regional factors and how this differs to company specific factors, a request that WPD considers equally valid for our ED2 SSMC response.²⁸

²⁸ WPD (August 2019) response to the RIIO-2 Tools for Cost Assessment Consultation.

→ COQ15. What are your views on our approaches to account for regional and company specific cost factors in our modelling?

Ofgem proposes “three approaches for taking account of regional and company specific factors within the cost assessment framework”:

- Pre-modelling adjustment
- Within-model adjustment
- Post-modelling adjustment

Building on WPD’s response to question COQ14 of this ED2 SSMC response, WPD reiterates further commentary provided in our RIIO-2 Tools for Cost Assessment consultation response to Q4:

“Where a suitable cost driver exists, regional factors lend themselves more appropriately to being assessed as a with-model adjustment; that is including a cost driver in Ofgem’s regression models whereby variations in the regional cost driver between companies provides a statistically significant explanation of differences in costs between companies. In contrast, company specific-factors do not lend themselves as well to being assessed using an in-model adjustment: the fact that by definition these factors are company-specific and may only be relevant to one or a few companies suggests that they are unlikely to offer significant explanatory power of differences between companies costs in general if included in regression analysis. This is, however, not to say that they are not significant cost drivers pertaining to the one or few companies and therefore should not be overlooked. WPD therefore suggests that a pre- or post-model adjustment for company-specific factors may be appropriate. Pre-modelling adjustments may be more favourable than post-model adjustments insofar as the company-specific effect is controlled for prior to the running of regression analysis²⁹ and is therefore accounted for in the determination of efficient costs (which affects all companies, not just those with special factors); however pre-modelling adjustments can often be data intensive. On this basis Ofgem should reconsider their dismissal of post-modelling adjustments in the consultation³⁰ on the basis that in the absence of sufficient, high quality data to perform pre-modelling adjustments in particular respect of company-specific factors a post-modelling adjustment may be the only feasible approach to accommodating such factors in the cost assessment framework.”

Whilst the above broadly exemplifies how the different approaches might be incorporated into a regression based method of cost assessment, WPD consider these too are equally valid for alternative quantitative methods of cost assessment. For example, a regional factor could be considered in ratio benchmarking via an in-model adjustment to the cost driver for the relevant companies.

Overall, it is noted that Ofgem have not set out any proposals for how they intend to assess regional and company specific factors in ED2 (labour, urbanity, sparsity). The commentary and chapter set out in the SSMC provides a summary of approaches applied in other controls, inclusive of ED1, GD2 and PR19 as well as various consultant insights on approaches. As a result, WPD have found it difficult to provide further views

²⁹ i.e. the company-specific factor is not wrongly interpreted as inefficiency (or more accurately as an omitted variable which then enters into the error term and is therefore wrongly interpreted as inefficiency)

³⁰ This refers explicitly to the RIIO-2 Tools for Cost Assessment Consultation

on the approaches the account for regional and company specific cost factors in Ofgem's modelling for ED2 at this stage.

Real Price Effects and Ongoing Efficiency

→ COQ16. Do you agree with our proposed approach to index RPEs, rather than setting an ex-ante allowance based on forecasts?

WPD agrees with the proposed approach to index RPEs, subject to the identification of sufficiently accurate (and exogenous) indices. This is as per WPD's comment in prior consultations³¹.

In the SSMC Ofgem reflects that at ED1 they decided against "*directly indexing based revenue with input prices during the price control...because of the challenge in designing an RPE index*"³². Ofgem then set out that for ED2, they "*propose to index DNOs' uncertain costs where possible*"³³. It is not clear how Ofgem intend to overcome the challenge in designing an appropriate RPE index for ED2 based upon the ED1 experience.

→ COQ17. 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?

Materiality

- The materiality threshold should be set such that individual input cost types for which an RPE is considered should represent a material proportion of total costs; and that individual cost types when considered collectively account for the majority of the overall cost base. There may be scope to introduce new input categories if these could be material (with some consideration of those used in other sectors); these should be proposed and reviewed as part of the CAWG discussions
- WPD are broadly comfortable with the proposed approach for assessment of materiality in GD/T2³⁴, subject to suitable RPE cost categories and definitions specific to ED being established. The GD/T2 approach, as per CEPA's assessment sets out that an input cost category must pass at least one of the following two tests for it to be assessed as material:
 - Test 1: The cost category represents "*a relatively large share of totex*"
 - Test 2: The cost category will "*likely face relatively large movements over time*"³⁵
- WPD raises the following observations and comments:

³¹ WPD (August 2019) response to the RIIIO-2 Tools for Cost Assessment Consultation, Q18, p. 9 and also WPD (2019) response to the RIIIO-2 Sector Specific Methodology Consultation, p.21

³² Ofgem (July 2020) RIIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, p. 42, para. 6.11

³³ Ofgem (July 2020) RIIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, p. 43, para. 6.12

³⁴ Ofgem (July 2020) RIIIO-2 Draft Determinations - Core Document, p. 45, para. 5.23

³⁵ CEPA (May 2020) RIIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p. 42

- For the GD/T2 assessment, CEPA undertake Test 1 at both a 10% and 5% materiality share of totex. For ED2 a materiality threshold cannot reasonably be discussed or consulted on until the input categories and level of disaggregation of the input categories has been decided upon by Ofgem. For example, a single labour input cost category will likely represent a material share of totex at a 5% or 10% threshold, however if a disaggregate approach is used, e.g. at with 10 sub-labour categories, then any one individual sub-labour category may not be material either at 5% or 10%, even if labour as an input in totality is material.
- Test 2 is more a test of volatility than materiality. Volatile prices can however have a material impact on costs incurred in the short term as network companies are not able to respond to changes in the relative price of inputs and in the long term it may be inefficient and not cost-beneficial (e.g. re-contracting etc.) to do so if prices subsequently fall. WPD therefore agree with inclusion of this test in the materiality assessment. The threshold for the test in the GD/T2 DD is for the expected impact of the volatility to be above 0.5% of totex over RIIO-2. As per the above comment, whether an RPE is considered material in accordance with Test 2 depends on how the input categories are defined and the level of aggregation decided upon by Ofgem.

Criteria of selection

- Ofgem do not explicitly set out their proposed criteria for selecting RPE indices for the ED2 assessment in the SSMC Keeping Bills Low Document.
- Based upon the RPE indices selection criteria (simplicity, accuracy and independence) as used by CEPA in the DD GD/T2 in the absence of ED2 specific information, WPD are comfortable with the proposed selection criteria. WPD consider the second and third criteria aligns with our proposed criteria in our response in the RIIO-2 Tools for Cost Assessment Consultation, in which we set out in our response to Q18. P.9 that indexation may be appropriate where sufficiently accurate and exogenous indices can be found.

→ COQ18. Do you agree with the suggested common input and expenditure categories for structuring RPEs in ED2?

WPD raises the below observations and comments with respect to the suggested common input categories. These comments reflect WPD's bilateral engagement³⁶ with Ofgem with regard to the design of the ED2 draft BPDT for RPEs and OE published alongside the SSMC.

- WPD observes that the RPE input categories are not currently defined terms or are not currently reported categories in the RRP.
- With particular regard to the labour input categories:
 - RRP alignment might provide greater consistency in the reporting of direct and contracted labour, compared to a general and specialist split and support future monitoring and mid-period reporting.
 - WPD noted a direct/contractor split was discussed in the RIIO-2 Tools for Cost Assessment Consultation (June 2019), which was as per the GD1 approach. The BPDTs for GD, GT and ET and associated RPE allowances

³⁶ WPD-Ofgem teleconference 10th Aug 2020

provided in the RIIO-2 Draft Determination are provided for the input categories general labour and specialist labour. CEPA in their Frontier Shift Report for the GD/T2 DD also acknowledge this change (p.41). The reason for this change by Ofgem is not clear. However, WPD also note that insight from the GD/T DD should not be precedent setting for ED2.

- WPD envisage preparation of the required RPE evidence base on the RIIO-2 BP Guidance to be more meaningful and reflective of actual operations if presented on a direct / contractor, not general / specialist split³⁷.
- DNOs choice of resourcing (in-house / out-sourcing) should not affect RPE allowances, i.e. that labour that supplies the same skill and hence cost should be subject to the same RPE adjustment whether resourced internally by a DNO or contracted out. This may then favour having no labour split, i.e. just a single labour RPE.
- There may be scope to introduce new input categories if these could be material (with some consideration of those used in other sectors); these should be proposed and reviewed as part of the CAWG discussions. For example, consideration could be given to an Energy RPE input category.
- With respect to the suggested common expenditure categories WPD note that the proposed RPEs expenditure categories need to be cross referenced with the requirements for the BPFM, as the former is an input into the latter.

→ COQ19. Do you agree with our proposed approach, and its scope, to set an ongoing efficiency assumption for RIIO-ED2?

Please see WPD's response to COQ20 with regard to part of Ofgem's proposed approach to OE which concerns the use of EU KLEMS data.

WPD disagrees with the use of historical performance data to inform the ongoing efficiency challenge:

- In application to ongoing efficiency there is no guarantee that historical performance is a good indicator of future performance. Network companies cannot know fully or with precision the types of sources or level of gains they may be able to reap in the future or in what way, if any, they relate to the sources or level of gains achieved previously. E.g. economy wider productivity gains from the computer were widespread but may not have been known about it in advance or comparable to previous sources of productivity / ongoing efficiency.
- It is self-fulfilling. Using historical performance data may create adverse incentives for network companies to not seek productivities savings greater than they have achieved historically in the knowledge that this will create a more stretching challenge in the future. WPD would agree with Ofgem's view set out in the second sentence of para 6.39 that *"if we embed network companies' historical efficiency into future targets we risk transferring potentially poor*

³⁷ WPD note that in terms of the evidence base in the narrative provided by GDNs in the public domain, those that have opted to present evidence on the wedge between DNO-own input prices and CPIH (as opposed to the wedge between input price indices and CPIH), have done so using the split of direct and contract labour for RPEs, not general and specialist.

historical performance into lower efficiency targets” and would recommend not including historical performance data in any ongoing efficiency assumption.

- Furthermore, Ofgem do not set out how they might measure this. It is difficult therefore for WPD to comment, or provide any level of agreement with limited sight of what the proposed approach might be.
- If Ofgem’s rationale for using historical performance data is to ensure inclusion of a more sector-specific evidence base in the ongoing efficiency assumption, WPD consider that this could be more effectively achieved via inclusion, appropriately weighted, of EU KLEMS data for the ‘Electricity, gas, steam and air conditioning supply’ sector.

Likewise with Ofgem’s efforts to include innovation previously funded to DNOs to bolster the ongoing efficiency challenge (see below), WPD consider that Ofgem are similarly seeking to use historical performance data in an effort to make a more stretching assumption for DNOs than would otherwise be the case if Ofgem simply looked at EU KLEMS growth accounting analysis or forward looking predictions from the BoE or OBR.

WPD does not agree with the proposal to use innovation funding previously awarded to DNOs as a source of wider evidence to support Ofgem’s ongoing efficiency assumption. As per our response to the GD/T2 DD, WPD provides the following rationale to support our position:

- With specific regard to the approach cited in the GD/T2 DD: It is not clear how Ofgem/CEPA have calculated or justified that the innovation bolt-on should be 0.2%³⁸. Despite CEPA identifying that they “*have not yet identified robust evidence for establishing a firm quantitative relationship between innovation funding and the scope for frontier efficiency improvements in the energy network sector*”³⁹, they provide an estimate of 0.2% per annum in their report.
- Investigation of this innovation bolt-on appears at best a poor attempt by Ofgem to justify a higher ongoing efficiency challenge to network companies in the face of what is, from a regulators perspective, a disappointing message for productivity when consulting EU KLEMS outturn data (especially when more recent data is consulted) and forecasts from reputable organisations alone. WPD reiterate our view set out in our RIIO-2 Tools for Cost Assessment Consultation response⁴⁰: “WPD raises concern regarding Ofgem adopting a cherry-picking approach of trying to find new and additional measures to inform a composite / triangulated view of ongoing efficiency (as has recently been attempted by Ofwat at PR19) on the basis that the EU KLEMS implied efficiency challenge is disappointing from a regulatory perspective of setting a challenging efficiency target. Present analysis by reputed organisations clearly sets out that ongoing efficiency is disappointing and this reflects the general state of the economy, prevailing political climate and the impacts that economic / political events since the 2008 recession have had on R&D investment as well as the propensity of private and equivalently public sector organisations across the economy, whom in the face of the aforementioned events have no doubt reduced their risk appetite, to embracing new technologies and innovations.”
- Mirroring the above, it appears this innovation bolt-on is taken directly from the pages of PR19 and Ofwat’s efforts to justify a productivity challenge completely

³⁸ CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, section “Impact of innovation funding on ongoing efficiency assumption”

³⁹ CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.35

⁴⁰ Q20, p. 10

out of center with current economic observations through exploring returns to the PR19 totex outcomes framework.

- As highlighted by Frontier Economics in their critique of Ofwat's PR19 approach⁴¹, in summary *"it is not at all clear why the kinds of regulatory innovation that Ofwat is talking about – totex and outcome regulation – should lead to reduction in recurring expenditures; rather, there is a respectable argument that Ofwat's incentives will typically lead to companies incurring higher ongoing expenditures in the short term as part of a drive towards whole-life cost optimisation"*. WPD consider this argument completely valid to RIIO-2 and energy networks.
- Not all innovation is focused on projects of which the end goal is to deliver efficiencies on how current activities are done. For example a significant proportion of innovations in the ED sector are more exploratory by nature and concern areas including future networks and dSO. By its very nature innovation is often associated with zero-returns, for example due to ideas that upon development are not commercially viable. Ofgem need to be clear in their distinction between different types of innovation, crucially those which can and cannot be associated with delivery of efficiency gains.
- It is not clear why separate analysis of the innovative/incentive framework of regulators requires specific attention, any more so than any other driver of ongoing productivity, such as technological developments. Innovation is just one component of the overall package concerning how network companies seek to deliver efficiencies.

Finally WPD is not clear how the Ongoing Efficiency assumption for GD/T2 DD has been calculated, in particular how the EU KLEMS data set has been analysed. For transparency and understanding Ofgem should make these workings publicly available.

→ COQ20. 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?

Ofgem propose to use a growth accounting approach as the primary source of evidence (para. 6.37). WPD recommend that greater weight be put on the forward-looking productivity forecasts for the UK economy mentioned in para 6.28, such as those provided by the BoE and OBR. WPD has this view because:

- The EU KLEMS approach to devising an OE assumption is based on historic information only and is at the time of writing limited to information up to 2017, i.e. it is not up to date (given lag in developing data set). The most recent past, arguably the best indicator of the future, does therefore not enter into the assumption if a simple extrapolation of EU KLEMS data is used as the primary source of evidence. Looking to the GD/T2 DD control, furthermore CEPA chose a time period of 1997-2016 to inform their OE assumption for the other RIIO-2 controls, i.e. that the information used to inform the assumption is even more out of date than that available in the data set.
- Ofgem appear to be placing significant weight in a single method of assessment, which may be of a greater risk than combining it with other evidence sources in

⁴¹ Frontier Economics (2019) A REVIEW OF OFWAT'S PR19 APPROACH TO ESTIMATING FRONTIER SHIFT, p.3

a triangulated approach. Given the uncertainties that COVID is and could continue to have on productivity, a triangulated approach may be preferential to take into account multiple, potentially varying views. Combining EU KLEMS with BoE / OBR information would bring the following benefits:

- Combining extrapolation of actuals with a forward look view, enables most recent past to enter into assumption but softened slightly by inclusion of historic in the event that outturn is widely different to forecast
- Increased robustness in triangulating multiple sources, not only in the bringing together of EU KLEMS, BoE and OBR information, but also the fact that BoE forecasts are developed through consulting a number of independent forecasts
- Reputational credibility of both OBR and BoE also provides good reasoning for inclusion of their forecasts as a more prevalent source.
- From the GD/T2 DD, WPD observe that CEPA use the productivity forecasts from the BoE and OBR to “support a higher top-end of the range for the ongoing efficiency challenge for opex, and a lower value for capex/replex” from their own extrapolation of the EU KLEMS information, rather than assessing the forecasts as a separate and independent source.
- As per our response to COQ19, WPD do not agree with the use of historical information or innovation bolt-on as sources of evidence in the derivation of an ongoing efficiency assumption.

WPD provides the following comments with regard to the choice of parameters (as per those set out in para. 6.31 of the SSMC: Annex 2 Keeping bills low for consumers ⁴²) that could be used, noting our position above that greater weight should be applied to BoE/OBR forecasts in the development of an ongoing efficiency assumption:

Choice of data set

- WPD agree with using the EU KLEMS data set. It is a well-established source of data for growth accounting analysis in regulatory applications. Whilst WPD are not currently familiar with the growth accounting data produced by the ONS based on the Annual Business Survey (ABS), we would be open to discussing this source and its possible application to OE analysis in the ED2 CAWG. WPD note that whilst Ofgem make reference to this alternative data source, Ofgem do not provide any further commentary on the data set and propose to use the EU KLEMS database as the primary source of data, whilst considering others. It is difficult for WPD to provide a full consultation response in this regard. Ofgem appear to have reached a proposed approach without fully considering the alternatives, or the relative strengths and weakness of the different approaches. Please can Ofgem expand on this and substantiate their proposal.

Choice of time period

- As per our response on the GD/T2 response⁴³, WPD considers that the most recent time period should be used because it reflects the latest available information. The most recent past is the best indicator of the future and therefore longer time periods which take into account more historic information should be avoided. This should especially be the case given the level of economic wide change. The ED sector in particular has not only been

⁴² Ofgem (July 2020) RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, p. 47-48, para. 6.31

⁴³ WPD (Sept 2020) 04092020 WPD Appendix Question Responses to RIIO2 GD&T Draft Determinations, p. 8, Q11

experiencing change from and as part of the wider economy, but also via a number of sector-specific changes, including the development of dSO functionality and working towards net zero targets. It is irrefutable that the economy as a whole, including energy networks, has undergone a substantial change as a result of the 2008 financial crisis; it is a commonly agreed fact in the literature of reputable institutions that productivity post the financial crisis has not returned to pre-crisis levels and may not do given an observed structural shift in the economy⁴⁴. On this basis a recent time period is essential.

Choice of comparators

- It is not clear what comparator sectors Ofgem used in the RIIO-1 determination of ongoing efficiency assumptions (para 6.34 of the SSMC: Annex 2 Keeping bills low for consumers⁴⁵). Please can Ofgem confirm. For RIIO-ED1 Ofgem accepted DNOs ongoing efficiency assumptions and whilst it is known that the ED sector did not enter into the analysis⁴⁶, it is not clear what sectors did.
- WPD agree that the selection of industries should be based on sectors that have similar business processes to DNOs⁴⁷
 - However WPD note in regard to the parenthesis that the same business processes could be delivered by different input mixes. WPD do not consider that the mix of inputs used is an appropriate basis for the selection of EU KLEMS sectors that map to the operations of a network company
 - WPD do not understand what Ofgem mean in para 6.34 that *"For RIIO-ED2, we could also consider the competitiveness of sectors to ensure that we capture productivity gains of efficient companies, as well as the stability of productivity improvements over time"*. Please can Ofgem expand on this and clarify?
 - Network companies operating in the UK are regional natural monopolies. They do not face competitive pressures but are subject to a regulatory regime which seeks to mimic competition. The choice of any sector in the EU KLEMS data set would therefore depend on the extent of competitiveness the existing regulatory framework is deemed to mimic. This could be open to judgement.
 - Related, Ofgem comment in the GD/T2 DD that the EU KLEMS dataset will under-estimate the scope for efficiency gains in regulated sectors, citing one justification that *"Lack of competitive pressure means management should be able to focus on driving higher efficiency gains"*⁴⁸. As per WPD's response to the GD/T2 DD Consultation⁴⁹, WPD disagree with this justification in theory and practice. Standard economic theory would suggest that less competition would provide weak incentives for management to drive efficiency gains as inefficiencies can be funded through customers who have no alternative provider. In theory and

⁴⁴ As indeed CEPA acknowledge: CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.16

⁴⁵ Ofgem (July 2020) RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, p. 48, para. 6.34

⁴⁶ Ofgem (May 2019) Decision - RIIO-2 Sector Specific Methodology – Core document, p.68, para 9.24

⁴⁷ Ofgem (July 2020) RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, p. 48, para. 6.34

⁴⁸ Ofgem (July 2020) RIIO-2 Draft Determinations - Core Document, p. 50, para. 5.42

⁴⁹ WPD (Sept 2020) 04092020 WPD Appendix Question Responses to RIIO2 GD&T Draft Determinations, p. 8, Q12

practice, it is the existence of regulation that creates these absent competitive pressures to be efficient.

- It is not clear why Ofgem are seeking to explore sectors aligned to networks on any basis other than those with comparable activities and business processes. To look at sectors of similar competitiveness will be subject to judgement as per the above and to look at sectors which have to date displayed stability of productivity improvements over time may say nothing of any common causation between the sectors – i.e. two sectors may to display similar productivity improvements over time but the source of the productivity gains may be very different; further there can be no guarantee that the future trend in productivity will be the same for the two sectors. It is not clear what Ofgem’s ambition is with this regard.
- On the premise that the activities that a GDN performs are similar to those that a DNO performs it could be envisaged that Ofgem will look to GD2 for choice of comparator sectors in the EU KLEMS data set that mirror the mix of operations that a network. On this basis, please refer to WPD’s response to the GD/T2 DD Consultation for choice of sector discussions with regard to EU KLEMS data⁵⁰.

Choice of productivity metrics

- With reference to para 6.35, WPD consider “*labour productivity*” and “*labour and intermediate inputs productivity*” (the third and fourth bullet points) to be examples of “*partial factor productivity*” measures insofar as they look to capture the returns to one or more inputs, but not all inputs (i.e. total factor productivity).
- WPD are in broad agreement with the approach used in the GD/T2 DD in which a TFP analysis informed the capex ongoing efficiency assumption and a labour partial productivity analysis (with capital held constant) informed the opex ongoing efficiency assumption⁵¹. Ofgem may be minded to simply use a TFP analysis to inform a combined capex and opex, i.e. totex ongoing efficiency assumption, which may be more in keeping with the totex regulatory framework. I.e. that network companies should chose the mix of inputs that brings about the greatest overall productivity from them in combination. This too may avoid what can be considered distortionary effects of using partial factor productivity measures that may include of capital substitution effects, such that the implied partial factor productivity may be higher than the corresponding total factor productivity.
- It is understood there is no agreement in the application of growth accounting measures to regulatory economics with regard to use of relative merits of using a Gross Output (GO) or Value Added (VA) approach. Based on the descriptions of the GO and VA measures of outputs used to measure productivity set out in the CEPA Frontier Shift Annex⁵² would suggest that a GO method is more appropriate to the nature of the electricity distribution sector. The VA method would appear to be more appropriate to a supply chain industry where there is limited ability for a company to change the inputs sourced in that supply chain. The electricity industry has however by regulatory design been split along the supply chain,

⁵⁰ WPD (Sept 2020) 04092020 WPD Appendix Question Responses to RII02 GD&T Draft Determinations, p. 6-7, Q11

⁵¹ CEPA (May 2020) RII0-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.5

⁵² Published as part of the GD/T2 Draft Determinations: CEPA (May 2020) RII0-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.11-12

such that WPD consider that “*intermediate inputs are a factor in production (I.e., materials, contractors, etc) and therefore business will make decisions on production if prices change for intermediate inputs*” which would be most aligned to the GO measure of productivity.

Disaggregated Cost Assessment

→ COQ21. Do you agree with our proposed approach on forecasting options for RIIO-ED2

We agree the proposed options of centralised vs decentralised and inclusion of best view either chosen by the DNO or the regulator encompass a good spectrum of options. There seems to be some confusion of terms between ‘best view’ and ‘single central’ and these seem to be used interchangeably whereas they are fundamentally different scenarios. These terms and their usage would benefit from clarification of application. The proposal of following option 3 is sensible, however, the common scenarios should be agreed between the DNOs and then DNOs should be free to either choose one of those scenarios, or put forward their own ‘best view’. The ‘best view’ potentially being an additional scenario, albeit described in base terms/units that align to how the common scenarios are derived. This is crucial for allowing regional information to embodied into the process, else leaving DNOs to only select one of the common scenarios will not sufficiently account for regionalisation and will instead be an averaging of nationally agreed scenarios.

→ COQ22. What are your views on our proposal for establishing network impacts and assessing LRE requirements for RIIO-ED2?

Monitoring of networks is an important part of understanding existing underlying demand and generation behaviour. Improving this monitoring down at a lower voltage level may improve the understanding of grouped behaviour of smaller assets, but the most valuable data will come from individual asset monitoring or in monitoring the smallest of aggregated groups. This data may be best derived from smart metering data. Monitoring of network flows will only provide the actual out-turn experienced and do not provide a good understanding of the critical edge-case behaviours a network may need to be designed to accommodate to ensure safe, secure and resilient operation. Monitored data will always need to be processed to provide that insight and hence can come from a variety of sources. Allowing DNOs to invest LRE in monitoring, where this has a positive CBA is a sensible decision, but this must be compared to other investment options, including bringing forward investment based on existing data. Accelerating the temporary deployment of retrofit monitoring may have a limited benefit if reinforcement removes the subsequent criticality for monitoring. Comparison of lifetime costs and benefits can be used to determine the best investment pathway.

→ COQ23. Do you agree with our proposal to compare flexibility solutions and network based solutions evenly in our cost assessment?

Yes. Given the uncertainty in future flexibility costs and unknown levels of market participation, the regulator must ensure sufficient funding is available to enable networks to be developed through either solution as proceedable solutions need to be

both technically and economically viable. It is also important that the regulator ensure the wider incentives used to drive DNO performance also provide an even playing field for DNOs to be identically rewarded despite different associated costs.

→ COQ24. How should we treat the fixed costs of procuring flexibility when considering flexibility solutions as an alternative to reinforcement?

The fixed costs of procuring flexibility will be directly related to the activity, either to the gross LRE without flexibility savings, or the number of interventions expected. Tendering costs for LV interventions could be similar to EHV on a per tender basis. Running flexibility as an alternative to reinforcement requires a number of direct and indirect overheads, we would expect the treatment of those costs to be similar to how these costs are treated for conventional reinforcement, but recognising that these activities are usually mutually exclusive and additional.

→ COQ25. What are your views on the use of LIs as outputs in RIIO-ED2?

Load Indices are a useful tool for demonstrating how demand changes are impacting the primary distribution networks. They should be continued into RIIO-ED2 for two main purposes: for cost assessment and to inform the operation of load related uncertainty mechanisms. However, the level of uncertainty regarding the level and rate of future demand growth and the scale of available flexibility services would make using them for a targeted output measure for reinforcement inappropriate.

WPD has previously provided suggestions regarding how LIs can be developed for RIIO-ED2 these developments included amendments to reflect the use of flexibility to manage capacity constraints, to incorporate the impact of Distributed Generation (DG), and to indicate forecast demands and the effect of planned investment.

- Flexibility can be used either to release additional capacity or reduce demand upon the network. WPDs proposal included separate identification of the impact through additional columns to adjust the maximum demand or firm capacity totals. Supporting information justifying the use of flexibility could also be provided, such as how much flexibility is available and the duration of such services i.e. indicators of whether flexibility will defer reinforcement or remove the need for reinforcement.
- Connected DG often masks true maximum demand resulting in a lower apparent utilisation. The existing LI template has the facility to enter values for connected DG masking latent demand and where DG contributes towards security thus increasing the firm capacity. This data is based solely upon actual generation output. We propose that offered and committed generation could also be recorded to give a view of available capacity.
- Under current connection rules, where DG has triggered reinforcement, reinforcement will generally be included on the DG connection scheme. DuoS funded reinforcement may be required if reinforcement is required at two voltage levels above the connected voltage. In these infrequent scenarios, the LIs will show an increase in capacity from the new assets, and if the DG is reported as per above, the justification for investment is visible through the increase in connected DG. A separate index for measuring DG capacity is therefore not warranted, however the treatment and reporting of DG (and connections) in

general reinforcement may need to be reviewed following the outcome of the Network Access SCR.

- The inclusion of forecast data, or a forecast end position without investment, demonstrates the rationale behind planned investment. This is particularly important at cost assessment of initial business plans, but can also be used to demonstrate changes in load patterns for use in uncertainty mechanisms and the justification for changing reinforcement solutions.
- WPD also provided a suggestion for how the LI bandings can be amended. LI3 and LI4 are currently too closely grouped together. Small changes in demand can mean that demand groups move between the two LI bands each year. This can have a distorting effect when comparing annual LI profiles and, given the risk weighting applied to each substation, can have a disproportionate effect on the overall risk profile. The following adjustments to the loading percentages were proposed to make each band wider:

Current ED1 Ranking			Proposed ED2 Ranking		
LI ranking	Loading percentage	Duration factor	LI ranking	Loading percentage	Duration factor
LI1	>=0 and <80	n/a	LI1	>=0 and <75	n/a
LI2	>=80 and <95	n/a	LI2	>=75 and <85	n/a
LI3	>=95 and <99	n/a	LI3	>=85 and <95	n/a
LI4	>=99	<9 hours	LI4	>=95	n/a
LI5	>=99	>=9 hours	LI5	>=100	n/a

The proposal removed differentiation based on duration, however it was not proposed to remove this requirement from the LI reporting template as it is useful information, particularly in relation to the use of flexibility.

There is merit in reviewing the methodologies used by the different DNO groups in completing the LI templates to ensure that there is consistency of approach. This is particularly relevant to the use of Substation Groups to assess circuit reinforcement.

Where the LIs are expanded to cover flexibility services, clarity needs to be provided for how DNOs should treat procured flexibility services. Flexibility services are generally procured based upon a forecast in the growth of demand, in order to prevent a future demand exceeding network capacity. When they are utilised, demand will be reduced for the short period of time, however the utilisation may remain high, which being managed by the flexibility services.

The use of LIs for cost assessment should be carried out by disaggregating analysis into similar voltage levels. The inherent network configuration can significantly affect the scale of capacity that is added for a particular load growth. For example a 1MVA growth in demand may lead to both a 132/33kV transformer and 33/11kV transformer requiring reinforcement. If the appropriate solution for both is to add another transformer, the capacity added for 33/11kV would be circa 10MVA, but at 132/33kV could be 60MVA. Comparing the two based upon the ratio of capacity added against demand growth would suggest that excessive capacity is being added for the 132/33kV transformer, leading to volume based benchmarking adjustments. This would exclude a valid investment.

The approach to ongoing reporting of LIs also needs to be considered. The reporting currently requires the most onerous season to be reported. This can change over time and therefore the values of capacity and demand reported change as consequence of the most onerous season changing rather than any form of intervention. This makes tracking of capacity for a substation or substation group complex, especially where the most onerous season changes regularly.

LIs should not be expanded to include Fault Level issues. The level of expenditure associated with fault level reinforcement is relatively low compared to general reinforcement and is not directly related to demand and capacity issues. Current regulatory reporting in RIGs Annex B provides details of the number of fault level issues, and how both operational measures and direct investment is being used to manage these issues. Additionally, site specific fault level information is available externally through the Long Term Development Statement.

Most LV and HV reinforcement continues to be completed on a reactive basis, and demand is currently not monitored at the same level of detail as at EHV and 132kV given the lower levels of risk associated with these networks. DNOs are revising this approach by introducing additional monitoring and, where cost-effective, investing in reinforcement for predicted localised increases in LCTs. Systems and processes for using smart meter data are also at early stages of development. Given this embryonic nature of this type of investment in the secondary networks, it would be more appropriate to develop metrics that can be used consistently by all DNOs at these voltage levels during ED2 rather than extend LIs at this stage.

→ COQ26. What are your views on the treatment of incremental costs in RIIO-ED2?

Proposals for the treatment of incremental costs (where an additional incremental cost is incurred on an activity in order to deliver a secondary outcome in addition to the outcome required by the primary driver) have the potential to drive inappropriate cost assessment outcomes. Any approach that does not retain the full cost of the activity undertaken within the reporting against the primary investment driver, leads to cost assessment based upon notional costs, which may be unrealistic and cannot be demonstrated as being reliable. This has potential to distort cost assessment outcomes. The RIIO-ED2 price control framework proposes the use of Engineering Justification Papers (EJPs) and CBAs to support evidencing of a company's strategic decision making. EJPs and CBAs already provide a suitable mechanism for a company to demonstrate that any incremental costs that are occurred are proportionate to the additional benefits that they deliver, as well as a mechanism for demonstrating the maturity of the submitted cost assumptions. These can then be taken into account as a qualitative adjustment in the cost assessment process, if appropriate. There is no requirement for further additional treatment of incremental costs.

However, if Ofgem wishes to continue to pursue the identification of incremental costs then option 2 (reporting of total costs with incremental costs and benefits identified in memo tables) is preferred.

→ COQ27. Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing Non-op capex costs in RIIO-ED2?

We would raise the following considerations when considering the approach for assessing Non-op capex costs in RIIO-ED2. Many of these points have previously been raised by WPD through the BPDT WG.

Ofgem need to give consideration to the treatment of indirect allocations with regard to the cost assessment of Non-op costs, for example whether the cost assessment models are undertaken before or after indirect allocations.

Property

At RIIO-ED1, this was assessed using a ratio analysis and applying median unit costs based on 13 years of data and using MEAV as the cost driver. For RIIO-ED2, we think some qualitative assessment should also be considered. DNO groups may have very different property strategies (e.g. owning property outright vs rental). Also, purchase of major sites and major refurbishment works will also be 'lumpy' and long term expenditure and not necessarily comparable in a 5 year price control. We would also recommend that expenditure on Business Support Property Management is assessed alongside Non-Op Capex Property. This approach was taken for Vehicles in RIIO-ED1, whereby CAI Vehicles & Transport and Non-Op Capex Vehicles were assessed together.

Ofgem may also need to consider the impact of DSO arrangements on property costs, depending on how Ofgem choose to assess DSO costs for ED2. This would support our above view for qualitative assessment to form part of the ED2 approach.

Small Tools, Equipment, Plant and Machinery (STEPM)

At RIIO-ED1 slow track final determinations, this area was assessed using a qualitative review because these costs were inconsistently reported. The definitions have since been amended and improved for ED1 RRP reporting, so potentially the use of only a qualitative approach could be reviewed and some form of quantitative assessment reintroduced.

IT&T

Non-operational IT&T was assessed alongside Operational IT&T at RIIO-ED1. We would recommend that a similar approach is also applied for ED2. 75% weighting was applied to qualitative assessment and 25% was applied to quantitative assessment, due to increasing costs in ED1. As DNOs develop DSO capability in ED2 alongside responding to cyber resilience challenges, the need for qualitative assessment remains in ED2. This should also continue to be applied to Business Support IT&T as well.

Quantitative assessment was performed combining Operational IT&T and Non-Operational IT&T. This still seems appropriate and avoids any boundary issues between these activities.

Vehicles and Transport

We agree with the approach of using a similar assessment as RIIO-ED1. We agree that Non-Op Capex and CAI costs should be assessed together.

As DNOs move to Net Zero and start to electrify more of their commercial fleet, it may be appropriate to consider some form of qualitative review as the speed of this adoption may vary across DNO groups. The introduction of clean air zones at a Local Authority level would also support a more qualitative approach, reflecting that vehicle and transport costs may vary on a more regional basis dependent on the local policy

environment. Similarly reflecting this a more forward looking approach may be more appropriate, noting that at ED1 Ofgem used both historical and forecast information to inform the assessment (13years of data, DPCR5 and ED1).

Where quantitative analysis is undertaken, it is important that the selection of an appropriate cost driver is given due consideration and that the use of the ED1 cost driver of MEAV may not continue to be the most appropriate. Please see WPD's response to question COQ2 on the selection of cost drivers in totex modelling, which are also applicable for the disaggregated benchmarking.

→ COQ28. Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing NLRE in RIIO-ED2?

The proposal to maintain the RIIO-ED1 approach to assessing NLRE in RIIO-ED2 is generally appropriate. There will, however, be a need to review the mechanisms of the cost assessment models to ensure that they remain fit for purpose.

NARM activity

The introduction of a common network asset indices methodology during RIIO-ED1, and the further development of the NARM framework to incorporate a monetised measure of long-term risk, provide enhanced opportunities for asset risk data to inform the assessment of asset replacement and refurbishment expenditure. The proposed RIIO-ED2 NARMs framework will provide an insight into the risk reduction benefits delivered through asset replacement and refurbishment activities in NARMs related asset categories. This shall enable use of the metric to provide a simple demonstration of the cost-benefit justification for NARMs related interventions. Accordingly NARMs should play a greater role in evidencing the justification of NLRE activity volumes in RIIO-ED2 than the Network Asset Indices used in RIIO-ED1 Business Plan submissions, which in turn reduces the need for extensive evidence in CBAs and EJPs.

While asset replacement activities can be readily subdivided into NARM and non-NARM asset categories, this is more complicated for asset refurbishment. For refurbishment there are three subdivisions:

- Refurbishment activities on NARM assets that provide a NARM risk benefit
- Refurbishment activities on NARM assets that do not provide a NARM risk benefit
- Refurbishment activities on non-NARM assets

The allocation of costs and volumes across the NARM asset categories is currently defined in the RIGs as activities either providing or not providing a secondary deliverable benefit. Only those activities in the first subdivision should count towards NARM outputs.

Other activities

Ofgem provide sparse commentary on their proposed approach to cost assessing NLRE in the SSMC⁵³. Ofgem only refer to NARMs and incremental costs in relation to NLRE. In order for WPD to provide further response to question COQ28 beyond NARMs (discussed above) and incremental costs (see our response to COQ26), we have assumed that Ofgem will roll-forward the RIIO-ED1 approach to assessing other areas of Non-Load. Ofgem do not discuss the assessment of other areas of NLRE in the SSMC document or

⁵³ Ofgem (July 2020) RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, p. 63-67

which NLRE categories to which treatment of incremental costs will relate. WPD's working assumption therefore that Ofgem will roll-forward the RIIO-ED1 approach for the purposes of providing a response to this question, must therefore be caveated.

WPD take this opportunity to refer Ofgem to the comments provided by WPD and other DNOs in a review of disaggregate modelling as part of the CAWG⁵⁴. The comments provided to Ofgem at the time have fed into the below response.

Diversions (Excluding Rail Electrification)

At ED1, Ofgem accepted DNOs submitted volumes. Ofgem assessed the associated costs using a unit cost benchmark based on ED1 forecast data.

WPD agree with the continuation of the ED1 approach to volume assessment, where volumes were applied as submitted by each DNO. Activity levels are influenced by customers and external factors, which may differ across DNOs.

WPD also agrees with continuation of the ED1 approach to unit cost assessment. Due to project based nature of diversionary work, WPD consider that forecast data is more reliable than historical data in ED1 and therefore roll-forward of the ED1 approach is fit for purpose for ED2.

Diversions (Rail Electrification)

At ED1, Diversions (Rail Electrification) was subject to an uncertainty mechanism. In the SSMC Ofgem have proposed to maintain this for ED2. WPD agree with this proposal whilst government uncertainty continues.

Asset Replacement

WPD broadly consider the RIIO-ED1 cost assessment approach to asset replacement to be fit for purpose with the following considerations informing a refined approach for ED2.

The ED1 volumes assessment was largely conducted on sound principles, however in some instances run-rate analysis was given precedence over a needs case assessment such that proposed volumes were not allowed on the basis that previously volumes had not been recorded in that activity. In addition, Ofgem's RIIO-ED1 analysis did not really consider the efficiency of the 'design' of the replacement. For example, no challenge was given to companies installing GIS switchgear where this was on the basis of a 'non-like-for-like' replacement strategy.

The ED1 unit cost assessment is broadly fit for ED2 planning purposes, however WPD do observe that the Ofgem ED1 analysis was sometimes skewed by low unit costs submitted by some DNOs where low volumes of assets have been forecast. It was suggested to Ofgem at the time that rather than take the median value of the average unit cost for each DNO, consideration should be to look at the median of the population of assets being installed across all DNOs (i.e. to take account of volume). Whilst the proposal was understood by Ofgem it was considered too difficult to implement. For ED2 this could be reconsidered. It also highlights the importance of data cleansing and understanding of the data and its interpretation prior to use as inputs in a benchmarking exercise. Similar to the above, at ED1 Ofgem placed limited challenge to

⁵⁴ DNOs were invited to complete a review of the ED1 disaggregate benchmarking models, inclusive of commentary on whether the models were fit for purpose for ED2. These insights were collated by SP and presented back to the CAWG (CAWG 4, 13th March 2020).

unit costs for asset types where there were very few DNOs with a population of the asset type (e.g. 20kV assets/ 66kV assets) which sometimes lead to 'pass through', again skewing overall efficiency assessment.

The overall ED1 assessment was very mix and match which raises into question the potential for replication, both from a transparency perspective and also the ability to roll-forward the ED1 approach, as per this consultation question.

Refurbishment

Ofgem need to be mindful that the reporting of refurbishment activities has developed since Ofgem's ED1 cost assessment with new and / or redefined assets and activities within the scope of refurbishment and also the split of refurb costs/volumes to those that contribute to improvements in health indices (no SDI / SDI). Therefore roll-forward, including mapping and assessment to Ofgem's expert (asset replacement) unit cost, of ED1 approach is not a simple or possible approach to ED2 cost assessment. In light of this WPD does not agree with the proposal to maintain the ED1 approach as this would seem a backwards step that overlooks the contributions of DNOs via the RIGs working group.

Part of the ED1 unit cost assessment benchmarked refurb unit costs to the Ofgem ED1 expert view unit cost for corresponding asset replacement. Given new activities and lines for refurb it will not be possible to maintain the ED1 approach for ED2 purposes. In addition to the above, the ED1 unit cost assessment led to difficulties in assessment due to the lack of a consistent 'unit' across each category. There was a significant range in cost between each of the activities shown in Annex A of the ED1 RIGs as being classifiable as refurbishment, particularly for categories where relatively small volumes were undertaken which made the comparisons relatively meaningless and invalid as a result. Where high volumes are undertaken (such as pole refurbishment or LV UG services) more appropriate.

WPD is not comfortable with Ofgem maintaining the ED1 approach to volume assessment of refurbishment for ED2. The use of age based models at ED1 was nonsensical as these models were based on the retirement age of the asset. Refurbishment activities take place before an asset reaches the end of its life and therefore volume assessment should recognise this activity earlier in the life of an asset.

Civil Works Condition Driven

WPD consider that the ED1 unit cost assessment approach was flawed. The approach used a cost of work by site which did, in some instances, lead to artificial inflation of work. This is because there was no definable unit. For example, the same works may be undertaken on one or multiple visits, which will distort assessment. Ofgem acknowledged that this area was difficult to benchmark in the ED1 cost assessment. WPD suggest that for ED2 Ofgem could consider using a 'cost per number of substations in population' for benchmarking.

With regard to civils work driven by asset replacement, Ofgem need to be mindful that change in reporting of the ED1 RRP compared to the ED1 BPDT mean that the proposal to maintain the ED1 approach needs to be revised if Ofgem is to make use of new reporting structure. The reporting changes were made to better align the civils work with the asset replacement activities to which they relate and as such should inform a more cost reflective cost assessment exercise. In light of this WPD does not agree with the proposal to maintain the ED1 approach as this would seem a backwards step that overlooks the contributions of DNOs via the RIGs working group. As an alternative ED2

cost assessment approach, Ofgem could consider cost assessing these costs against efficient asset replacement costs.

Operational IT and telecoms

Please see WPD's response to COQ27, Non-operational IT&T.

Blackstart

Currently there are no further requirement for additional resilience requirements. Ofgem need to be mindful however that this may change depending on E3C requirements. Any ED2 ex ante cost assessment will therefore need to be for works not completed in ED1.

Legal & Safety

Ofgem need to be mindful that change in reporting of the ED1 RRP compared to the ED1 BPDT mean that the proposal to maintain the ED1 approach needs to be revised if Ofgem is to make use of new reporting structure. This revision may simply be to extend the disaggregate unit cost benchmarking assessment to reflect the additional lines now reported for cable pits, fire blankets and shallow cables; however this will need to be reviewed in light of the number of observable data points, for example ED1 to date⁵⁵ only ENWL has reported costs and volumes for shallow cables.

For some categories (e.g. substation security) there is common reporting across all DNOs and therefore a unit cost benchmark, rolling forward the ED1 approach, could be established. However, work content variability across the DNOs could lead to some strange benchmarking results, as exemplified below.

Ofgem may therefore need to give consideration to the assessment of legal and safety costs on a qualitative or needs case basis, for example:

- where DNOs are submitting volumes of work substantially different to those undertaken historically or comparable to the rest of the industry. For example, UKPN ED1 to date volumes reported for fire protection are of an order of magnitude completely different to the rest of the industry. Separate cost assessment may therefore be more appropriate if Ofgem retain a unit cost benchmarking approach.
- Where DNOs have costs that are network specific, for example those entered into freeform lines for bespoke forward programmes. In such examples it may not be possible to provide comparable data that is suitable for benchmarking and a qualitative justification may be more appropriate.

Flood Mitigation

The ED1 assessment approach was based on unit cost benchmarking associated with risk reduction before and after an intervention. Interventions may not be comparable and therefore unit cost not valid. For example, substation flood defence requirements can vary and therefore the scope of works could impact the overall costs of defences per substation. Engineering Justification needs to be considered for any special bespoke arrangements.

⁵⁵ 2015/16 to 2018/19 (based on four years of data)

Moving into ED2, Ofgem might need to also consider wider climate change activities and costs? Further work required to understand what this could / should look like and this could take place via the CAWG.

Physical Security

At ED1 Ofgem accepted costs as submitted. WPD consider maintaining the ED1 approach is fit for purpose for ED2.

Rising and Lateral Mains

The ED1 approach recognised that volumes do not lend themselves to benchmarking and that many factors that drive the workload are outside DNOs' control. This may also be applicable for unit costs too.

Overhead Line Clearances

Costs identified as ESQCR for the submission of the ED1 business plans are now reported within overhead line clearance activities. DNOs no longer report against the ESQCR categories which formed the basis of the ED1 unit cost assessment. DNOs now only report on sites resolved at each voltage level. WPD consider that a unit cost benchmark, with a separate industry benchmark for each voltage level, could be appropriate for ED2.

Worst Served Customers

Please WPD's response to question OUTQ42

Visual Amenity

Any assessment at ED2 needs to take into account stakeholder views.

Losses

Please see WPD's response to question COQ26.

Environmental Reporting

Any ED2 approach adopted by Ofgem will need to reflect changes to environmental legislation (e.g. achievement of Net Zero, Persistent Organic Pollutants), which may or may not be consistent with the proposal to maintain the ED1 approach.

In the SSMC, Ofgem have proposed an Environmental Legislation Re-opener. Ofgem will need to consider the uncertainties of costs, when (ex-ante, re-opener) and how these costs will be assessed. Further consideration of the approach from that of ED1 may be required given the different nature of environmental legislation expected going forwards into ED2 compared to ED1.

→ COQ29. Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing NOCs in RIIO-ED2?

The SSMC document does not specify the RIIO-ED1 approach to assessing NOCs and how these may be applied in RIO-ED2. However WPD offers the below comments.

WPD also take this opportunity to refer Ofgem to the comments provided by WPD and other DNOs in a review of disaggregate modelling as part of the CAWG⁵⁶. The comments provided to Ofgem at the time have fed into the below response.

Faults

- At ED1, Ofgem assessed LV and HV OHL faults using regression analysis. This bundling of costs into a single regression overlooks what are different cost and cost driver relationships on LV network compared to the HV network. DNOs with a network configuration furthest from the 'average' will perform worse as a result of bundling and as such the benchmark will not be genuine. WPD agree with the use of forecast data in the models and this is substantiated in the comments below.
- At ED1 Ofgem assessed all other fault categories using unit cost benchmarking and an industry median benchmark. In contrast, the LV and HV OHL faults were assessed using an upper quartile benchmark. It is not clear why Ofgem applied a different benchmark given the similarity of activity, especially as this could lead to adverse incentives and different reporting approaches.
- For all fault categories exclusive of the LV and HV OHL faults, efficient volumes were assessment based on lower of DPCR5 and ED1 (forecast) per annum volumes. I.e. DNOs getting allowance based on historical faults without appreciation of underlying cause / future probability of fault. WPD consider that a more real-time or forward looking view of expected fault volumes is required for ED2, such that investment undertaken in ED1 to reduce faults can be explicitly acknowledged, as it should be, in the assessment approach.
- At ED1, for the assessment of LV and HV Plant and Equipment Faults, Ofgem bundled the individual fault costs/volumes into two single unit cost benchmarks (LV, HV)⁵⁷. As per the above comment, this overlooks that fault costs differ by type and that this may affect some DNOs more than others dependent on the relative mix of faults experienced. For ED2, Ofgem should consider cost assessment on a line by line as opposed to bundled as a principle improvement.
- Ofgem will need to consider whether any separate or different treatment is required for Plant & Equipment LV link boxes as a new reporting line in the ED1 RRP compared to the ED1 ex ante cost assessment approach.

Tree Cutting

At ED1 Ofgem assessed ENATS 43-8 costs using a regression model with parameters informed by 8yrs data (ED1 forecasts) and an upper quartile (UQ) benchmark. For ETR-132 activity, Ofgem used unit cost benchmarking for each voltage level (LV, HV and EHV) and a median benchmarking, again using ED1 forecast data (8yrs).

- The ED1 ENATS 43-8 regression model:

⁵⁶ DNOs were invited to complete a review of the ED1 disaggregate benchmarking models, inclusive of commentary on whether the models were fit for purpose for ED2. These insights were collated by SP and presented back to the CAWG (CAWG 4, 13th March 2020).

⁵⁷ For LV, Ofgem combined together the costs and volumes for All Other Switchgear, Plant & Equipment - Asset Repair/Replacement Required; and Plant & Equipment LV link boxes only*. For HV, Ofgem combined together the costs and volumes for Pole Mounted Switchgear Circuit Breakers - Asset Repair/Replacement Required; Pole Mounted Switchgear (All Types ex CB) Asset Repair/Replacement Required; Pole Mounted Transformers - Asset Repair/Replacement Required; and All Other Plant and Equipment (inc GM transformers) - Asset Repair/Replacement Required.

*Technically at ED1, LV only included the first category as LV link boxes as a separate reporting line was introduced in the ED1 RRP.

- bundles activity across voltage levels, and overlooks that there are different cost and cost driver relationships at each voltage, which skews the results to the hypothetical DNO with the 'average' mix of voltages. DNOs with a network configuration furthest from the 'average' will perform worse as a result of bundling and as such the benchmark will not be genuine. This bundling means all DNOs are likely to have received an allowance (over/under) that does not reflect true efficient costs had a more disaggregate approach been taken.
- formula suggests that no cutting volumes gives insignificant allowances for inspections.
- does not sufficiently accommodate differences in DNO tree cutting cycles which may be equally efficient.
- may not be fit for purpose given technological change affecting sector as DNOs move to LiDAR. See further comments below
- uses workload drivers of spans cut and spans inspected. These can be considered self-fulfilling. If Ofgem retains the ED1 approach, Ofgem may wish to consider a pre-requisite assessment of the needs case of the proposed volumes prior to benchmarking. For ED2, Ofgem could also consider alternative cost drivers that are reflective of network characteristics, such as degree of network infestation, rather than work load volumes, which may provide a more exogenous view of the costs involved.
- At ED1, Ofgem set different benchmarks for ENATS 43-8 (UQ) and ETR-132 (median). This reflects the different extent of clearance work required in each area. This means that the assessment of the two activities should be kept separate and should recognise that there is a wide range of work that could be required for ETR-132 depending on location and amount of forestation in a license area.
- At ED1, Ofgem removed data points for NPg and SP from the ETR-132 benchmark due to different reporting approaches. This highlights the importance of data quality, normalisations and consistency as a pre-requisite to effective benchmarking which should be duly noted by Ofgem in the ED2 assessment of all cost areas. It is not clear what the nature of the different reporting approaches was, however it is known that NPg and SP's data was retained in the ENATS 43-8 benchmark.
- Related, Ofgem need to be mindful of the impact that the move to using LiDAR technology might have on where and how DNOs report their tree cutting activities and costs. Ofgem need to consider the primary activity where the costs of LiDAR might be reported (e.g. inspections, tree cutting) and the impact this may have on consistent assessment across the two activities, changes that LiDAR may have on inspection and cutting cycles amongst others. Ofgem could consider collection of separate quantitative / qualitative info on LiDAR may be appropriate
- WPD agree with the use of forecast data in both the models as this most accurately reflects planned works for the forthcoming period and implicitly accounts for cycles of work done in ED1 that may overlap with the transition to ED2. The transition to LiDAR also means that ED1 data may not be relevant to ED2 planning.

Inspections and Maintenance (and Repairs)

- Please see above comment with respect to the impact that LiDAR might have on cost reporting with respect to inspections.
- As Ofgem set out in the SSMC⁵⁸, DNOs in the ED1 RRs separately report inspections costs and activities from repair and maintenance activities. For ED2, Ofgem may wish to consider separate cost assessment.
- It is not clear how Ofgem undertook the volume assessment based on MEAV, as set out in the ED1 Expenditure Assessment document⁵⁹. If Ofgem maintain the RIIO-ED1 approach to assessment, this will need to be clarified for ED2.
- Companies have different approaches to managing repairs and maintenance and therefore changes were implemented in ED1 reporting to report cost per asset rather than cost per activity. Overall scale of the network (as represented by MEAV) is a reasonable driver, with the potential to subdivide MEAV across voltages and broad asset types (e.g. segregating MEAV into overhead line, cable and switchgear)

ONIs

- Review of the ED1 assessment excel file suggests that Ofgem used a unit cost benchmarking assessment method based on the average of each DNOs 8yr (forecast) average unit cost and the industry median of this, therefore each DNO had a unique benchmark. The use of a unit cost derived from a blend of median and DNO own value allows for some variability of work scope across DNOs to be recognised in the allowed unit cost. Ofgem should consider this approach more widely for other cost assessment areas in ED2.

NOCS Other

- NOCS Other includes the activities of Substation Electricity, Dismantlement and Remote Location Generation. We consider roll-forward of the ED1 approach appropriate and proportionate, noting the relative immateriality of this activity.

Smart Metering Roll Out

- This programme will run into 2024. Ofgem need to consider how best to assess these costs in ED2, given the allowances at ED1 were related to a volume driver. Ofgem will need to be mindful of future requirements in the smart metering roll-out that may be subject to licence update in ED2.

→ COQ30. Do you agree with our proposal to maintain the RIIO-ED1 approach for assessing CAIs in RIIO-ED2?

The SSMC document does not specify the RIIO-ED1 approach to assessing CAIs and how these may be applied in RIIO-ED2. However WPD offers the following comments.

Mirroring our comment in response to COQ27, Ofgem need to give consideration to the treatment of indirect allocations with regard to the cost assessment of CAI costs, for

⁵⁸ Ofgem (July 2020) RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, p. 68-69, para. 7.82

⁵⁹ Ofgem (November 2014) RIIO-ED1: Final determinations for the slow-track electricity distribution companies Business plan expenditure assessment, p. 116, Para. 9.56

example whether the cost assessment models of undertaken before or after indirect allocations.

*Core CAI costs*_(Network design and engineering, project management, system mapping, Engineering Management & Clerical Support (excluding wayleaves), stores, network policy, control centre and call centre)

WPD have been working with Ofgem through working groups on the development of reporting of DSO related costs, which is described in the SSMC. Whilst this is in development, we would caution on the proposal to maintain ED1 approaches, particularly on Core CAI costs. Depending on the outcome of this work, the approach to cost assessment, including selection of appropriate cost drivers, will need further discussion and consideration through the CAWG and bilateral forums.

The SSMC also discusses proposals to increase levels of BAU innovation. We are supportive of this proposal (see response to OVQ10) but would highlight that the RIGs would currently direct DNOs to report many of these costs in Core CAI (Network Policy). This should be factored into any cost assessment approach and ensure that DNOs are not penalised for BAU innovation programmes.

Wayleaves

WPD is broadly supportive of the proposal to maintain the RIIO-ED1 approach in this area. One small change is recommended: we suggest that substation rents is reported and assessed separately in this area. Although a relatively small cost, it would avoid the need for a qualitative adjustment for LPN costs where this DNO received their submitted costs in RIIO-ED1 because of their lack of towers and poles data for inclusion in the assessment. If this data is recorded in the BPDTs, it can be separately considered and all DNOs treated equitably on this cost.

Vehicles and transport

WPD recommends that the ED1 approach of assessing CAI Vehicles and Transport costs alongside Non Op Capex is retained. Please see the response to COQ27

Operational training including workforce renewal

It is recommended that this area is reviewed through the CAWG and BPDT WGs. If the RIIO-ED1 approach is retained, then the collection of data needs to be considered, as some of this is not currently available in the ED1 RRs.

Streetworks

Streetworks has been an activity area which has continued to develop over the course of RIIO-ED1. It was subject to a reopener in 2019 and there is now also a requirement for a close-out mechanism at the end of RIIO-ED1. The SSMC is not clear how Ofgem propose to treat this area in RIIO-ED2 in the light of this ongoing development. Cost assessment needs to be considered taking into account various factors: policy development (see below); cost assessment RIIO-ED1 slow track; cost assessment RIIO-ED1 2019 reopener; cost assessment RIIO-ED1 close out; data collection through the ED1 RRs and proposals for the BPDT; and the uncertainty mechanism approach (which has not been specified in the SSMC – see response to question COQ37 below).

It should be noted that Street works is not definitionally speaking just a CAI cost. Costs are incurred across direct activities on jobs involving access to the roads - jobs / projects will include the costs of permits and complying with the conditions specified in

the permits, and so these are reported in the costs of many direct activities. However, some administration related costs will be reported in CAIs. The collection of data and the use of it in cost assessment needs to take this into account.

As mentioned above, street works continues to be an emerging policy area and differences can be seen across all DNO licence areas:

- Permit schemes have now been adopted in most English Highway Authorities (HAs). However these schemes are at various stages of maturity; also different HAs may operate their schemes in different ways which can impact particularly the condition costs that DNOs incur. Both these factors need to be taken into account in any cost assessment. The RIIO-ED1 final determinations accepted that permit schemes are bespoke to each HA and therefore need to be justified on a case-by-case basis. WPD agree with this approach, rather than the benchmarking approach applied in the 2019 reopener.
- Street works is a devolved policy area from a government perspective, ie HAs in Wales and Scotland do not currently operate permit schemes. Any cost assessment needs to take this into account.
- There are currently very few lane rental schemes in operation in England, but these are likely to be rapidly adopted by some HAs in the next few years. Given previous precedent (both through the RIIO-ED1 BPDTs and the 2019 reopener), DNOs will need 12 months of cost data to submit lane rental costs in the RIIO-ED2, which means lane rental scheme costs need to be in operation now. This is not currently the case and so the RIIO-ED2 approach for both cost assessment and uncertainty mechanisms needs to continue to be considered.

→ COQ31. What are your views on the different approaches presented for the treatment of BSCs in RIIO-ED2?

Ofgem set out in para. 7.95 of the SSMC: Annex 2 Keeping bills low for consumers⁶⁰ that *"In RIIO-ED2, we will be analysing the case of pooling costs with other sectors, in particular gas distribution."* Ofgem then summarise the approach taken in RIIO-GD2 and RIIO-T2. WPD are not clear what the other approaches for the treatment of BSC in RIIO-ED2 are, for which Ofgem are requiring views on in this consultation question.

Business Support costs in Gas Distribution Draft Determinations were included within the totex modelling approach and not considered or discussed at business support level. Therefore it does not appear appropriate to discuss an approach for ED2 for pooling costs with gas distribution which have not been separately assessed in that sector.

Any pooling of costs for benchmarking purposes, e.g. with GDNs, needs to be done on a like-for-like basis to ensure that the assessment is comparable.

WPD continue to support maintaining a group level analysis for Business Support costs⁶¹.

WPD believe that Property Management costs should be assessed alongside Non-Op Capex property costs (see question COQ27 above)

⁶⁰ Ofgem (July 2020) RIIO-ED2 Sector Methodology Consultation: Annex 2 Keeping bills low for consumers, p. 71, para. 7.95

⁶¹ WPD response to Tools for Cost Assessment (for GD) (questions 13-15)

WPD believe that that qualitative analysis should continue to be applied to Business IT&T costs (see question COQ27 above)

Mirroring our comment in response to COQ27 and COQ30, Ofgem need to give consideration to the treatment of indirect allocations with regard to the cost assessment of BSC costs, for example whether the cost assessment models of undertaken before or after indirect allocations.

Business Support costs and their treatment in cost assessment should be discussed within the CAWG.

Cost Benefit Analysis

→ COQ32. Do you agree with our proposed application of CBA in the appraisal of investment options for RIIO-ED2?

Yes. Our planners already look at the benefit of alternative schemes when they create proposals. The benefits might be cost driven, operational CML driven or Losses driven. Our policies require a losses assessment of schemes at 33kV and above.

Engineering Justification Papers

→ COQ33. Do agree with our proposals to retain the requirement for DNOs to produce Engineering Justification Papers?

It is appropriate that some requirement for Engineering Justification Papers (EJPs) should be retained to support RIIO-ED2 Business Plan submissions.

However any requirement for EJPs needs to be suitably focussed to ensure that EJPs are only produced where there is a material need for supporting evidence in addition to the information that will already be provided through Business Plan Data Tables, narrative etc.

The criteria for when EJPs are required needs to be clear, so the licensees provide the additional justification where Ofgem expects to receive it.

→ COQ34. Do agree with our proposal retain the assessment framework for EJPS developed as part of the RIIO2 process?

Given that it is proposed that a set of principles should be adopted to guide and focus the production of EJPs, building upon lessons learnt from the transmission and gas distribution RIIO-2 price controls, it is suggested that the assessment framework for EJPs needs to be revisited in order to ensure that the assessment framework is consistent with the guiding principles that will be developed for EJPs used in RIIO-ED2.

For example paragraph 9.5 makes reference to "boundary power flow assessments", which is terminology more relevant to electricity transmission.

→ COQ35. Do agree with our proposal to adopt the principals outlined above to guide the production of EJPS and focus the engineering submission?

The proposal to adopt a set of principles to focus the requirement for EJPs is welcomed. These principles shall need to focus the requirement for EJPs so that they are only required to be produced where they materially support the Business Plan assessment. It is important that requirements are not introduced that would require production of unnecessarily high volumes of papers that add significant regulatory burden, but little value to the regulatory process.

We agree that the use of EJPs should be focussed on areas of materiality and avoid duplication of information that is provided by other components of the RIIO-ED2 Business Plan submissions, such as that found in the Business Plan narrative or Business Plan Data Tables. It is also appropriate that EJPs should be used to articulate changes in strategy compared to previous price controls, where such changes are material.

As EJPs are a component within a wider toolbox, the guiding principles should also remove any requirement for EJPs to be submitted for areas of investment where justification is adequately provided by other components in the toolbox. For example, given that NARMs are proposed to provide a view of long term risk in present value terms, it would seem appropriate that provision of further information through EJPs would be considered unnecessary where the NARMs improvement already provides justification of the proposed activity levels.

Given the high volume of activities undertaken on the electricity distribution networks, the principles need to recognise that generally it would be only appropriate for a single EJP to cover an expenditure area such as program of works, rather than provide individual project or asset level justifications.

The introduction of a suitable materiality threshold would also assist identification of whether an area of expenditure requires an EJP.

Data Assurance and Compliance

→ COQ36. 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 consider the current licence requirements around Data, Data Assurance, and Compliance used in ED1 are thorough and put appropriate expectation and emphasis on companies ensuring data they use, publish, and report is of a reliable quality, and protected appropriately. We consider that ED2 requirements reflect those of ED1. If activities and methods become too onerous there is a danger of complications undermining the principles of data assurance and compliance.

Uncertainty Mechanisms

→ COQ37. Do you agree with our proposed uncertainty mechanisms and their design?

Please see our cover letter and executive summary for wider comments on the general use of uncertainty mechanisms in RIIO-ED2.

In addition to the defined uncertainty mechanisms, Ofgem is increasing the use of ex-post assessments, such as the review of CVP reward outcomes, NARM delivery and efficiency assessment and clawback arrangements under PCDs. This is leading to far more uncertainty across the price control, even where there is no direct external influence.

Ofgem are suggesting the following uncertainty mechanisms in RIIO-ED2 where there is a specific external driver influencing uncertainty on either the volumes of activity that will be delivered or the costs associated with work delivery. We present our views on each one individually.

Cross-sector:

Ofgem licence fee and Business rates - pass through

WPD support the continuation of these items as pass through and do not suggest any further changes to this mechanism.

Inflation indexation of RAV and allowed return – indexation

We have two concerns with the immediate switch from RPI to CPIH. Firstly, Ofgem has not provided any assurance in its proposals that this switch will indeed be NPV-neutral with respect to true-ups between RPI and CPIH forecasts and indexation.

Secondly, the cash flow benefit from a notionally higher CPIH WACC compared to an RPI WACC provides only a short to medium term easing of financing constraints that will dwindle over time with lower RAV growth – providing even less cash to service debt in the long term.

Cost of debt indexation

We do not consider the indexation of the cost of debt to be conceptually inappropriate, however, the choice and calibration of any index must be appropriate. As set out in response to FQ1, there may be a risk of circularity in the use of an index that largely comprises companies subject to econometric regulation. There is also a potential for the ratings of companies within the iBoxx utilities index to diverge from the rating of the notional company used in Ofgem's financeability assessment for RIIO-2 over time. This is particularly likely if there is a 'flight to quality' in times of economic uncertainty, with the index then no longer representing the embedded cost of debt of RIIO-2 companies. It is essential that Ofgem acknowledges this and ensures there is sufficient headroom in any financeability assessment.

Cost of equity indexation

As stated in our response to the Gas and Transmission Draft Determinations, given the importance of the cost of equity being calculated robustly and the fact that investments in the network industries are long-lived, we consider that there should be stability in the cost of equity applied. Accordingly, when setting the cost of equity it is important that a long-term perspective is adopted. WPD continues to believe that, while the cost of equity is largely outside management control and forms a material proportion of the company's total costs, it does not vary sufficiently annually such that Ofgem is unable

to set a reasonable cost of equity allowance for the whole RIIO-2 price control period. The cost of equity is not as volatile as individual parameters that form the calculation and indeed there is constancy in the TMR over time. As such, we see no reason to index the cost of equity annually. Moreover, consumers would potentially suffer from greater volatility in prices if the cost of equity is indexed.

Real Price Effects – indexation

Please see response to question COQ16.

Tax review – re-opener

As stated in our response to the Gas and Transmission Draft Determinations, we underline Ofgem's statement there will be legitimate and significant differences between notional and actual tax costs and the existence of these alone should not prompt Ofgem to trigger a review.

Pensions adjustment – pass-through

We echo Ofgem's statement that it has a long-standing commitment to consumer funding of deficits in defined benefit pension schemes, which were generally in existence before the energy network sector was privatised. Pensions should continue to be funded as set out in Ofgem's 2017 Decision on Ofgem's policy for funding Pension Scheme Established Deficits in accordance with Ofgem's Pension Principles and do not need to be subject to any new uncertainty mechanism.

Enhanced Physical Site security - Baseline allowance and/or re-opener

Please see response to questions OUTQ54 and OUTQ55.

Cyber resilience - Baseline allowance and/or re-opener

This is new for RIIO-ED2. For Cyber Resilience IT, baseline allowances will be provided subject to the Totex Incentive Mechanism; and for Cyber Resilience OT, allowances will be provided on a 'use it or lose it' basis. For both, Ofgem propose to include a mid-period re-opener mechanism to deal with uncertainty covering new cyber resilience activities, new risks or threats, as well as new statutory or regulatory requirements.

We support the inclusion of costs upfront in baseline allowances as far as possible. As stated in WPD's GD&T draft determinations response⁶², companies are already incurring costs and need to retain the skills and capabilities they have for the whole of RIIO-2 and beyond, not least for compliance with the EU Security of Networks & Information Systems ("NIS") Directive. Uncertainty over totex allowances for these crucial functions will reduce the ability of companies to provide the needed level of resilience at the most efficient resource cost in the future.

The application of a use-it or lose-it mechanisms adds additional regulatory burden for both regulator and licensee. Baseline allowances should instead be applied for OT (in the same way as for IT). DNOs will submit Cyber Resilience plans alongside their Business Plans, which will detail their plans at the outset of the price control to known cyber risks, which can be used to inform baseline allowances and be used as reference for mid-period reopeners.

⁶² 04092020 WPD Executive Summary to RIIO2 GD&T Draft Determinations, para 3.11

Net Zero - Re-opener

Please see response to OVQ3

Coordinated Adjustment Mechanism (CAM) - Re-opener

Please see responses to OVQ 27-29

Specific to RIIO-2

Strategic investment/Load related expenditure

Engagement with local authorities and other stakeholders, including use of LAEPs to inform DNO DFES reports and datasets should provide robust, justifiable and credible evidence for the majority of strategic investment to be aligned to ex-ante allowances.

The decentralised approach to settling network intervention forecasts is well developed now and DNO DFESs are high quality and sufficiently aligned to national long-term forecasts to be used as primary tools. The increased level of detail provided through the bottom-up DFES process means these more accurately reflect local historical and future requirements compared to the simple regionalisation undertaken in the ESO FES.

Network investment levels need to take into account both LCT volumes and behaviour to understand the additional capacity required at the cardinal points studied across the year. Local LCT behaviour is not covered at all within the ESO FES, leaving it unsuitable for informing a centralised view alone. If a centralised view is to be taken, it needs to provide regionalisations of national forecasts of technology volumes as well as the peak behaviour.

Where LAEP and DFES projections can support the certainty of local strategic investment, Model C should be followed.

The use of flexibility could reduce the cost of delivering load related capacity across the price control and protect customers from the risk of stranded assets, but there needs to be equal treatment of DNO incentives when comparing conventional and flexibility investment pathways – see answer to OVQ 22.

Flexibility may become uneconomic depending on changing system needs and market pricing or unfeasible due to levels of participation. DNOs need to have funding to complete the required conventional reinforcement within the price control. Equally, system needs may reduce, so a level of uncertainty mechanisms is prudent. Where there is uncertainty in delivery pathway – i.e. flexibility or conventional reinforcement may be used; then Model D, with a mechanism to flex the baseline allowance upwards, may be most appropriate.

Proposed uncertainty mechanisms cover PCDs with LAEP triggers, volume drivers and re-openers. Reopeners should be developed but recognised as unlikely to be triggered. PCDs with LAEP triggers should only be used where LAEP ambition exceeds the reasonable view of the DNO's DFES and the comparable data between those two publications can be used to set the triggers.

Volume drivers could be set against either LCT volumes or capacity. LCT volumes are difficult to accurately measure; there is significant under-reporting of LCTs being connected to the DNO networks as reported in RRP tables. Other sources of data (OLEV, DfT, DVLA, Ofgem RHI) may be used to measure, but GDPR issues need to be rectified around the transfer of data. The data sources may also not be sufficient – e.g. DVLA

registered keeper data for EVs is dominated by postcodes occupied by vehicle leasing companies.

Capacity volume drivers with or without utilisation incentives may be appropriate. The scale of the uncertainty mechanisms should be limited to where there is uncertainty in investment and not replace the ex-ante allowances.

Street works costs – re-opener

Despite being listed as a continuing uncertainty mechanism, no further detail is included in the SSMC. The timing of the adoption of lane rental schemes in English Highway Authorities (HAs) is still uncertain and there is also the possibility that Welsh and Scottish HAs move to permit and lane rental schemes. WPD would recommend that at the very least, the ED2 mechanism includes these areas and has windows both part way through ED2 and at the close of ED2.

Please also see WPD's response to the GD DD, question GDQ53. A common approach should be adopted across both ED and GD – both ED and GD are subject to the same permit and lane rental schemes of HAs.

Rail Electrification – re-opener

WPD support the proposal for an ongoing reopener for rail electrification in SSMC.

Black Start – re-opener

Since there is ongoing delay to the publication of guidance from government, we support the proposal to include an uncertainty mechanism in the interim. We also agree that costs should instead be included in a baseline allowance if timeframes allow.

Miscellaneous pass-through

See comments on Business Rates, Ofgem Licence fee and Pension Deficit Repair mechanism above.

We also agree with the proposals for Transmission connection point charges, Smart Meter IT costs, Ring Fence costs and Data Communications Company (DCC) fixed costs

Smart Meter interventions – volume driver

No further detail is provided on this mechanism, other than 'no change' from RIIO-ED1. We agree with its continuation into RIIO-ED2, but stress that some review is required because its current form ends in 2021 (we understand a licence change proposal is in development).

Environmental legislation – re-opener

As per our response to OUTQ60, during the course of ED1 there has been the introduction of significant environmental legislation, and we note this may also be the case throughout ED2. A re-opener to take account of such changes seems sensible.

→ COQ38. Are there any other uncertainty mechanisms that we should consider? If so, how should these be designed?

Telecommunications resilience

Paragraphs 8.135 – 8.139 in the SSMC Annex 1 identify the reliance of the networks on telecommunications. This reliance will grow as more digitalisation is implemented and DSO network control functions expand. In paragraph 8.143, Ofgem suggests that it will keep developments under review, however, the conclusion of the work of Ofcom is uncertain and therefore there is an unknown impact on telecommunications requirements.

We propose that baseline allowances are provided for changes to communication spectrum, but that these are supplemented with a separate reopener to take account of future Ofcom requirements.

See also our response to OUTQ56.

→ COQ39. Do you agree with our proposed removal of the above uncertainty mechanisms for RIIO-ED2?

Load related expenditure

There is a need for some form of uncertainty mechanism to adjust allowances to reflect significant variability in demand or generation driven network capacity issues. Ofgem has proposed a number of options for dealing with this uncertainty which replace the need for the ED1 load related re-opener.

High value projects

Ofgem is utilising PCDs in RIIO-2 to hold companies to account for specific projects. The PCD mechanism provides similar functionality to the high value projects mechanism.

Link Boxes

We agree that this mechanism could be removed.

Subsea cables

This reopener was specifically for SSEH in RIIO-ED1. We see no need for it continuing into ED2.

Innovation rollout mechanism

Ofgem is changing the general arrangements for innovation and we agree that this mechanism could be removed.

→ COQ40 Do you agree with our proposed common approach for re-openers being applied to RIIO-ED2?

We do not agree with the proposed bringing forward of the window to January. This is long past the end of the previous regulatory year, but also means that DNOs cannot include the most recent data for the next year. However we also recognise the resource constraints involved in a May window, both for Ofgem and the DNOs (where regulatory resources will be concentrated on preparing RRP submissions). Instead, WPD proposes October as an alternative; this allows annual reporting to be completed and the case for the re-opener made using the latest data on a timely basis (mid period reopener window in ED2 in October 2025).

We agree with one week window (instead of one month) – our experience is that most DNOs tend to submit on last few days of the specified month in any case.

We also agree with the provision of increased guidance upfront. This will help to avoid issues with lack of uniformity where multiple DNOs make submissions on the same topic in different formats which makes Ofgem assessment more difficult (as was the case in RIIO-ED1 on the street works reopener in 2019). Use of the RIGs and the RRP reporting to help collect reopener data should also be explored as far as possible.

Ofgem has proposed that the Authority can trigger a reopener. This is something that concerns us, and we would welcome more detail on this proposal. There is also a concern about this being at any time during the price control. This could be incredibly complicated, and could lead to chaos. Ofgem should have defined windows so that DNOs are clear when a window is passed that no re-opener will take place that year.

Regarding the materiality threshold WPD notes that the threshold example is as per the current arrangements. We request that the specific values are stated in the relevant licence conditions in order to avoid ambiguity about the threshold value. It should also be clear that once the threshold is breached, all the costs associated with the reopener are considered, not just those above the threshold.

Increasing Competition

→ COQ41. Do you agree that our flexibility proposals are sufficient to incentivise DNOs' native competition?

Yes.

→ COQ42. Do you believe there are similarities between DNOs running early competitions and the roles and activities that may be related to electricity DSO functions?

Yes, DSO activity identifies system needs and potential for third party solutions but the DNO activity holds the expertise in traditional asset solutions.

→ COQ43. Do you agree with our proposed approach on early competition?

Yes, an impact assessment on early competition for the electricity distribution sector is essential once the ESO has completed its early competition plan along with detailed consideration of criteria that are appropriate.

→ COQ44. Do you have any views on our draft RIIO-ED2 Late Competition Impact Assessment?

Due to a lack of any trials in this area, both the costs of running late competition and the savings resulting from it are highly speculative.

→ **COQ45. 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.**

We agree with the criteria for late competition that projects need to be for new, separable and above £100m.

→ **COQ46. Do you agree that the late competition models proposed could deliver benefits in RIIO-ED2?**

Potentially yes. The value threshold needs to be high enough to ensure that additional interface and process costs do not exceed potential savings although this will restrict the volume of projects that it will apply to.

→ **COQ47. Do you agree that our proposed criteria for identifying projects suitable for late model competition are applicable in the context of electricity distribution?**

Yes.

→ **COQ48. 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)?**

The Network Development Plan (under the implementation of the EU CEP package) will identify significant issues that are likely to arise and hence give an early indication of potentially suitable projects.

→ **COQ49. Do you agree with the proposed range of options available for repackaging projects in RIIO-ED2 in order to maximise consumer benefit?**

Yes, although given the geographic dispersion of projects that may be considered for bundling historic experience has indicated that best value can be achieved with a range of providers under native competition.

→ **COQ50. What relevant factors do you think we should consider in deciding how these repackaging proposals are specifically applied in electricity distribution?**

DNOs are already incentivised to maximise customer benefit via unit cost monitoring and the overall RIIO package. In considering repackaging proposals it is important to consider the impact on existing contracting arrangements and customer satisfaction together with the cost of organisational change that may be required to deliver.

Incentivising Business Plans and their Delivery

→ **COQ51. Do you agree with our proposed approach to implementing the CDIR method in setting the TIM efficiency incentive rate?**

In principle, Ofgem's methodology for blended sharing factors, whereby the strength of the sharing factor relates to the robustness of the underlying expenditure forecast, has theoretical appeal.

In practice, the strength of the sharing factor will be critical. As Ofgem correctly stated: "If we set the sharing factors too low, the 'price' consumers have to bear when companies underspend may be higher than required. If we set sharing factors too high, then companies may not invest effort in finding cost efficiencies or may choose to capitalise expenditure when it is not in consumers' benefit". [reference - "RIIO-2 Sector Specific Methodology", Ofgem, December 2018, paragraph 9.58] We agree with this characterisation of the issue but conclude that it should suggest to Ofgem a presumption on sharing factors over 50%. To see this, consider the consequences of respectively setting the sharing factors either too high or too low:

- Setting sharing factors high will mean that companies are highly incentivised to seek efficiencies. Companies will retain a high proportion of the benefit in the existing price control, but upon entering the new price control targets will be reset passing the whole of the benefit to consumers in a lower allowed revenue for the company. In the long-term, consumers will unambiguously benefit from more efficient companies;
- Setting sharing factors too low will be a temporary loss to consumers if the company achieves higher savings, and a temporary gain to consumers if the company fails to make expected savings. This is a symmetrical effect and if the Totex targets have been accurately set will represent neither an expected gain or loss to consumers. Further, it is only a temporary benefit or loss until the end of the price control when allowed revenue will be reset. Most importantly, the companies will not have been exposed to strong incentives to make efficiency savings and this will be an enduring loss to consumers perpetuating into the next price control period.

Ofgem should be more concerned about incentivising long term efficiency than to distributing money back to consumers at the earliest opportunity.⁶³

→ **COQ52. Do you agree with our proposed design of the BPI for RIIO-ED2?**

No.

We have significant concerns that, while the BPI is capped symmetrically at +/- 2% of totex, the overall application of the mechanism is biased towards penalties rather than rewards. This is evident from the draft determinations for gas distribution and transmission where only one licensee gained a small reward of £1.6m, but in combination the other licensees had a total penalty of £141.4m (noting that the penalties would have been even higher had the downside caps not been in place).

We discuss the four elements of the BPI below:

⁶³ WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation, 14th March 2019

Stage 1: meeting minimum requirements

We have two specific concerns about the proposals for the qualitative assessment.

The proposals suggest that if a licensee fails to meet all the requirements, then a fixed penalty of 0.5% of Totex will be applied. The Business Plan Guidance has a long and detailed list of requirements and therefore there is a risk that some of the requirements may not be fully addressed, especially where the guidance changes during the process. We agree that licensees should seek to provide all the necessary information to enable Ofgem to carry out a qualitative assessment, however, at present, any single failure would lead to the same penalty as a business plan with many omissions. This binary approach does not seem to be a fair and balanced treatment. We propose that the penalty should be variable and proportionate to the scale of the failure to meet requirements, up to a maximum of 0.5% of Totex.

Furthermore, there is a double jeopardy associated with the failure against stage 1. Ofgem proposes that where a licensee fails against stage 1, it cannot participate in either stage 2 (CVP) or stage 4 (high confidence cost) reward elements. This seems grossly disproportionate. A licensee that fails stage 1 could have excellent CVP proposals and very efficient cost proposals, but will not gain any benefit from these. We propose that the restriction placed on licensees that fail stage 1 assessment should be removed and that all licensees should be able to gain rewards under stage 2 and stage 4.

Stage 2: consumer value proposition (CVP)

We have had concerns about the assessment of CVP since the proposals were made under the GD/T Sector Specific Methodology Decision. This specifically relates to what constitutes a CVP and how the additional value can be demonstrated.

The wide range of different proposals and valuations of CVPs in the GD/T submissions illustrate that clearer guidance is required.

It is helpful that in the ED2 sector specific consultation and associated Business Plan Guidance that Ofgem has specified the baselines above which a CVP proposals can be proposed. However, because these baselines embed best practice and high expectations they lead to a high hurdle for the provision of additional CVP.

These high hurdles mean that it will be challenging to achieve any CVP related rewards. This is again evident from the draft determinations for gas distribution and transmission where only two CVPs were accepted out of 137 CVP submissions.

The introduction of caps will potentially limit the range of CVP proposals, especially where benefits for consumers can be provided below the £3m lower threshold. Further clarity is required on how the lower threshold operates. For example, does a £5m CVP benefit proposal which is reduced back to £1.6m by Ofgem accrue a £1.6m CVP reward (as it started above the £3m threshold) or zero (as the final evaluation is below the £3m threshold). In the GD/T draft determinations this situation arose for NGN, where they proposed a DVP value of £5m, but they were awarded £1.6m. Would this £1.6m still be awarded under the new caps and thresholds?

More details on baseline standards and specific proposals for ED2 CVP are provided in the responses to COQ53, COQ54 and COQ58

Stage 3: low confidence cost assessments

We appreciate that in the case of transmission there are many unique and bespoke projects where it is not possible to identify a comparative benchmark. However, in electricity distribution the work mainly consists of high volumes of low cost work carried out by a number of network operators. It is therefore more readily possible to have comparative analysis that allows the setting of independent benchmarks.

Ofgem specifies in paragraph 13.7 that it will not determine which costs are high-confidence until after the receipt of business plans. In paragraph 13.6 Ofgem suggests a list of evidence that could be used to assist Ofgem in classification of costs as high-confidence. None of this guidance provides an indication of which cost areas would already be classified as high confidence, given that detailed disaggregated data has been reported for a number of years.

It would be helpful, either through the working groups or via the Sector Specific Methodology Decision, for Ofgem to indicate the areas which are already identifiable as high-confidence costs. This would allow licensees to focus on areas where additional evidence of comparative costs is required as part of business plans.

Stage 4: high confidence cost assessments

We are concerned about the application of the high-confidence costs assessment.

We are surprised by the outcome of the GD/T draft determination, where no reward has been proposed for this element of the BPI. We would have expected that some of the licensees would have proposed forecast high-confidence costs that are lower than the 'independent' benchmarks. This suggests that the benchmarking process may be being based on benchmarks that are not achievable.

A reasonable benchmarking process would have some elements of some licensees' costs being better than a benchmark (unless frontier costs are being used for every element). We suggest that the calibration of the cost assessment process needs to be reviewed to recognise and reward those elements of business plan cost proposals that are better than a 'reasonable' benchmark.

→ COQ53. 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)?

The proposal to enhance baseline standards based upon draft business plan submissions will lead to fewer new and improved services being recognised as CVP under the final submission. This erodes the reward opportunity for companies that are proposing new and improved services.

Significant stakeholder input would have been carried out ahead of submitting draft business plans. This engagement may reveal the need for certain new and improved services and licensees may have responded by developing proposals to address stakeholder requirements. Because the new and improved activities are different to business as usual, it would be reasonable that the licensees may expect some form of CVP reward for developing these enhanced services.

The proposed 'ratcheting' of baseline requirements will require all DNOs to adopt the proposals made by the licensees originally proposing the new and improved services in

draft business plan. This will have the effect of having baseline requirements that represent service significantly above business as usual. It will also mean that the opportunity to gain a CVP reward will be removed for the licensees developing the new and improved service proposals.

In addition, given that proposed CVP related outputs will have been created with DNO's specific stakeholders' requirements and priorities, the relevance or direct applicability of these CVP outputs to other licensees cannot be guaranteed. Furthermore, licensees will have different delivery models for certain outputs, some of which may be interlinked with other service areas and mandating additional service provision requirements at a late stage may not align to a licensee's ED2 plans or stakeholder requirements. For example, hypothetically were WPD to propose more frequent cleansing of our Priority Service Register than Ofgem's minimum requirements, our model for doing so is interlinked with our industry-leading fuel poverty referral programmes which many DNOs do not have equivalents to and therefore other licensees tend to take a simpler approach to PSR data cleansing (e.g. letter drops). Therefore using revealed CVP proposals from WPD to ratchet up baseline standards for all carries complexity in its fair application and how those activities would be consistently delivered.

An unintended consequence of applying such a ratchet could be that licensees may not include CVP proposals in their draft plans, in order to avoid having them subsumed into baseline requirements.

We propose that the baseline requirements should be fixed at the time of Sector Specific Methodology Decision. These can be informed by the responses from licensees and stakeholder to the Sector Specific Methodology Consultation. After that, any new and improved services proposed in draft business plans should not lead to enhanced baseline requirements. This will allow new and improved services proposed in draft and final business plans to be considered eligible for CVP rewards.

→ COQ54. Do you agree with our proposal to cap the number and value of CVP proposals that can be included within business plans?

We recognise the administrative challenge for Ofgem to review many and varied CVP proposals, but such a challenge should not be used to limit the ambition and opportunity for service enhancements in ED2. We suggest that the lower limit should be reduced and that more CVP proposals be allowed.

Furthermore, it is unclear how the value cap and limit on number of proposals would impact DNO groups with multiple licence areas.

The overall CVP value of proposals cap is set as an absolute value of £50m, but the BPI cap is set as 2% of totex. For a small licensee the £50m value may significantly exceed the 2%, but for a DNO group the £50m value may fall short of the overall BPI cap. Further clarity is required on whether the cap relates to licensees or DNO groups. It may also be more consistent to have the CVP proposal cap being based upon a percentage of totex proposals.

Setting a lower limit of £3m potentially excludes some new activities (of lower value) that are related to service enhancements welcomed by stakeholders. It may be more reasonable to have a lower limit of £1m per CVP.

Ofgem has specified five service areas where CVP could be proposed, however, the limit of 10 CVP proposals per business plan only gives scope for an average of two CVP per service area. This appears low and it may be more appropriate to allow 15 submissions. Again there needs to be clarity whether the limit relates to licensees or to DNO groups.

As detailed in the response to COQ52, there is a need for further clarity on how the lower threshold operates. For example, does a £5m CVP benefit proposal which is reduced back to £1.6m by Ofgem accrue a £1.6m CVP reward (as it started above the £3m threshold) or zero (as the final evaluation is below the £3m threshold).

→ COQ55. 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?

Checklist

We welcome the addition of the business plan content checklist (referenced in para 8.7 of the Business Plan Guidance) and see that this is a valuable reference document to ensure that the required content of the business plan is included in Business Plan submissions. We would like to highlight that it would be unfair for Ofgem to impose a penalty under stage 1 of the BPI for requirements that are in addition to those captured on the checklist. The checklist needs to be a comprehensive list of all the requirements and be the reference for assessment of completeness.

Outputs Checklist

As we welcome the checklist for the contents of the Business Plan, we would also welcome a checklist to summarise all of the LOs, ODIs and PCDs specified as an absolute requirement for the Business Plan.

200 page limit

The requirement to limit business plans to 200 pages (excluding additional annexes) and the extensive range of requirements that need to be included in the business plan means that a considerable amount of detail will need to be included in the supporting annexes. The content within the 200 page document will naturally be succinct and therefore Ofgem should refrain from penalising companies for omitting details in the summaries provided in the main business plan (especially where additional information is referenced and included in the annexes).

CVP baseline requirements

CVP opportunity is identified in five activity areas, but only four of them have specified principles and clearly defined actions that are documented in Appendix 1-4 of the Business Plan Guidance. The guidance for Whole System more is generic (e.g. plans and processes for joint planning) and therefore it is more difficult to identify the services that would be above the baseline requirements. It would be helpful for the whole system baseline requirements to be presented in a similar way to the other four areas.

Cost forecasts

There is limited guidance on whether the presentation of cost information should mirror the cost categories in the BPDT. We anticipate that Ofgem's analysis of the business plan will be subdivided into subject areas and therefore to make cross referencing of

business plan narrative and costs submissions easier it would make sense to have costs presented in the same structure as in the BPDT.

IT/OT strategies

There is some guidance provided on the requirements for separate IT and OT cyber resilience plans. However, the cyber resilience plans can over-lap with more routine IT and OT expenditure. It would be helpful to have greater guidance on how the whole areas of non-operational capex for IT and business support IT should be presented in the context of routine activities and those specifically for cyber security.

→ COQ56. Is there other information that we should be requesting in the Business Plan Guidance in order to assess a network company's Business Plan?

No reference is made to the BPDT commentary. We understand that there will be a requirement to complete a commentary pack associated with the completion of the BPDT. It is unclear what role this will play as an addition to the Business Plan and supporting annexes, CBAs, EJPs and BPDT. It would be helpful to have clarity on how the type of information that is required in the BPDT supports the evaluation of the business plan.

→ COQ57. 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?

We provide feedback to specific paragraphs in the minimum requirements.

8.5. We expect Business Plans to be fully justified and accompanied by all relevant evidence, including, where appropriate expert and legal evidence (on a confidential basis if need be).

The expectation of 'fully justified' will be based upon a subjective assessment. Licensees may believe that a proposal is fully justified, but Ofgem may disagree. We suggest the alternative wording of "...Business Plans to be accompanied with justification and relevant evidence..."

In addition, it is unclear how this additional evidence should be provided. We suggest that it should be acceptable for the evidence to be included in supporting annexes and have external documents referenced as supporting documents. This needs to be made clear.

8.7. For a plan to be complete under the Stage 1 BPI assessment, it must:

- *contain all the material detailed in this Guidance (the relevant material is listed in the Minimum Requirements Index Sheet for ease of reference).*
- *be presented in a clear and understandable manner and in line with the timetable for submissions.*

In our response to COQ55 we highlight the importance of the Index Sheet checklist containing all the relevant requirements to ensure that it can be used as a checklist for completeness. Ofgem should not impose a penalty under stage 1 of the BPI where licensees omit to include content relating to requirements that are in addition to those captured on the checklist.

With regard to the second bullet point of 8.7, further guidance is required on what constitutes “clear and understandable”. If Ofgem has a typical audience in mind then this needs to be specified. This may be assisted with examples of what Ofgem considers to be clear and understandable, supplemented with examples of what Ofgem considers to be complex and confusing.

→ COQ58. Do you agree with the approach for assessing companies CVP proposals that is set out in the draft Business Plan Guidance?

Excluding licensees that fail stage 1

With reference to paragraph 8.11, we disagree that companies that fail stage 1 should be excluded from participating in rewards under CVP. As highlighted in the response to COQ52 this creates a negatively biased incentive mechanism which excludes rewarding licensees that put forward new and enhanced service proposals for consumers.

Reference to minimum/baseline requirements

The identification of baseline requirements is helpful; it makes it clear what activities are deemed to be excluded from consideration as a CVP.

However, as explained in the response to COQ54, the ratcheting of baseline requirements should be avoided, once the baseline requirements are specified in the Sector Specific Methodology Decision. The enhancement of baseline requirements following the submission of draft business plans should not take place because this will destroy the potential reward that should be received by companies suggesting new and enhanced services.

Assessing CVPs

In the second bullet of paragraph 8.20 Ofgem states, “we would not expect to reward activities currently undertaken by DNOs”. There may be circumstances where DNOs are currently carrying out certain activities, but the scale of ambition and delivery may be very different (e.g. WPD’s assistance for vulnerable customers has been recognised as being far more comprehensive than other DNOs under the ED1 SECV incentive). It would seem appropriate to retain some consideration of current activities, providing a CVP reward for companies that excel beyond a base level of expectation/service, rather than simply a baseline expectation of carrying out an activity (irrespective of quality of output).

Clarity is also required on what is meant by “currently undertaken by DNOs”. This needs to be clear on whether it relates to a DNO’s own current activity or whether it relates to activity carried out by any DNO. For example if this relates to a DNO’s own activity, a DNO could propose an output in the area of vulnerable customer/fuel poverty that for them represents entirely new activity, but this could be very similar to services that another DNO has been delivering for some time and they could obtain a CVP reward even if their service levels fall below the other DNO’s already established levels. If, however, this relates to the performance of any DNO, then a reward would not be provided.

→ COQ59. 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?

Yes, we have and are investing in business information models to describe and understand in more detail our data flows throughout the business. Our data dictionary and lineage activity is developing and will support further the understanding of data, its source and its dependants that would enable increased cross-referencing of data.

Annex 3: Finance

Allowed return on debt

→ FQ1. Do you agree with our proposal to use the iBoxx Utilities 10yr+ index rather than the indices used in RIIO-1?

Any financeability assessment performed by Ofgem should be based on the ratings of the companies represented by the index. The iBoxx Utilities Index current rating is around A/BBB, but if Ofgem use this index throughout RIIO-2, companies will then have the risk of the index rating improving over the RIIO-2 period.⁶⁴ This will be particularly relevant as the RIIO-2 settlement is likely to have a negative impact on ratings due to the financeability issues it raises.

Further there may be a risk of circularity in the use of an Index that largely comprises companies subject to econometric regulation. There is a potential for the ratings of companies within the iBoxx utilities index to diverge from the rating of the notional company used in Ofgem's financeability assessment for RIIO-2 over time. This is particularly likely if there is a 'flight to quality' in times of economic uncertainty, with the index then no longer representing the embedded cost of debt of RIIO-2 companies. It is essential that Ofgem acknowledges this and ensures there is sufficient headroom in any financeability assessment.⁶⁵

→ FQ2. With reference to paragraph 2.8, do you have a view on what debt allowance calibration should be used for business plan working assumption purposes, and why?

As a key component of the WACC, the Cost of Debt needs to be correctly calibrated to match a company's debt profile; in terms of tenor, rating and also in the recognition of transaction costs and cost of carry. The Trailing average period should reflect the maturity profile of the company's debt. In RIIO-ED1, WPD has seen significant underperformance to date against the cost of debt allowance and we are forecasting for this to continue for the remainder of the price control period. This is mainly due to the incorrect trailing average period being set by Ofgem. This underperformance would have been less material if WPD had been awarded the trombone profile as used by the

⁶⁴ NERA's slides for ENA meeting: *Ofgem's Draft Determination: Key issues for Cost of Debt Allowance*, 14 July 2020; WPD's Response to Ofgem's RIIO-2 Draft Determinations for Gas Distribution and Transmission, 4 September 2020.

⁶⁵ WPD's Response to Ofgem's RIIO-2 Draft Determinations for Gas Distribution and Transmission, 4 September 2020.

slow track companies. Therefore the cost of debt must be correctly calibrated to the company's debt profile.⁶⁶

→ FQ3. Do you have any evidence to suggest ED networks should or should not have a debt allowance that has a different calibration to GD&T networks?

See response to FQ2 above. Rather than being a one-size-fits-all approach, Ofgem has a duty to have regard to the need to secure that licence holders are able to finance their licenced activities. Looking back at Ofgem's guide to the RIIO-ED1 electricity distribution price control, this can be summarised as meaning "that efficient network companies should be able to secure financing in a timely way and at a reasonable cost to support the delivery of their regulatory obligations." Therefore, as stated above, the Cost of Debt should be calibrated to match a company's debt profile, which may vary across sectors. [reference - Electricity Act (1989), Part 1, Section 3A, Paragraph 2(b) "the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed..." Ofgem (2017) 'Guide to the RIIO-ED1 electricity distribution price control' 18 January, p. 59.]

→ FQ4. Do you have any views on our analysis of additional costs of borrowing that may not be captured by an index of bond yields?

In historical regulatory decisions debt issuance costs have received only a cursory analysis. However, as the WACC declines these costs will become an increasingly important component requiring a full bottom-up analysis of:

- New debt issuance premiums;
- Professional fees for corporate finance and legal professionals;
- Audit fees;
- IPA (Issuing and Payment Agent) fees;
- Rating agency fees;
- Arrangement fees;
- Roadshow costs; and
- Bookrunner and underwriter fees.

In addition, the true cost of other components of the overall debt platforms costs need to be explicitly quantified. For example, the true costs of maintaining essential revolving credit facilities has never been explicitly included in the regulatory financing cost base, but [if Ofgem intends to proceed with its proposal], it must now be considered in a more rigorous analysis of the liquidity margins that are needed in practice by companies. Currently the cost of debt methodology takes no explicit account of these cost of debt factors.

These factors should all be taken into account in calibrating a regulatory debt index. They are not offset by any so-called utility "halo" benefit claimed by CEPA's earlier reports. Work by NERA has clearly shown that any estimates of a such a factor result from CEPA's use of the coupon as its measure of the cost of debt, CEPA's failure to correctly control for bonds' rating at issue, and in the case of indexed linked debt most of the outperformance is from before 2010 when the index linked market was distorted by the New Pension Regulation.⁶⁷

⁶⁶ WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution, 14 March 2019

⁶⁷ WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution; 14th March 2019.

→ FQ5. Do you agree with our proposal to use the longest term OBR forecast for CPI to deflate nominal index yields to a real CPIH allowance and to switch to using OBR CPIH forecasts if these become available?

If the OBR forecast of CPI inflation is to be used as a proxy for CPIH then this should be trued up for the actual CPIH when known. This would then be in line with how nominal revenues are calculated and could be done as part of the AIP.

In practice we believe use of CPI would be preferable over CPIH. The two indices are closely aligned, but forecasts for CPI are available from at least three accepted sources (HMT, OBR and the Bank of England) aiding transparency without any need for taking account of the CPI-CPIH wedge.⁶⁸

Allowed return on equity

→ FQ6. In light of the equity methodology we set out in Draft Determinations for GD&T, do you have a view on how implementation could best be applied to the ED sector?

We remain of the view that Ofgem should fully consider its statutory duty to ensure the financing of licensees.⁶⁹ Ofgem appears to regard a financeability test as a trigger for action by shareholders, rather than a critical cross check of whether the expected cost of equity is sufficient.

In the short term, financeability risks are masked by Ofgem's decision to move from RPI to CPIH indexation of the regulatory asset value (RAV), since this will increase current revenues and reduce future revenues. However, this move is a one-off cash flow benefit that will dwindle over time with lower RAV growth. The underlying issue is that in the long-term a [4%] CPIH real cost of equity may challenge companies' current investment grade credit ratings.

Ofgem's proposed step 3 in the calculation of the cost of equity methodology, namely Distinguishing between expected and allowed returns, has resulted in a proposed Allowed v Expected adjustment to the Allowed Cost of Equity in the recent Gas and Transmission Draft Determinations for RIIO-2. A recent First Economics report (<http://www.first-economics.com/earwakerfincham.pdf>), which presented the results of interviews with 30+ former regulators on the question of "should regulators make an upfront deduction from the allowed return/allowed revenues in anticipation of company out-performance against expenditure allowances and output targets", clearly sets out that in a well calibrated price control, with the extensive range of tools available to the regulator to enable a judgement 'in the round' to be taken, such mechanisms are not required: "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

⁶⁸ This is as per paragraphs 5.2.6 - 5.2.8 of *WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation*, 14th March 2019

⁶⁹ WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution; 14th March 2019

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)."⁷⁰

→ FQ7. Do you have suggestions on how we could estimate systematic risk for ED2 or any evidence to support a difference between ED and the other RIIO sectors, GD&T?

Ofgem is proposing large-scale revisions. We find this surprising given the success of RIIO-1 [as outlined above]. In WPD's view, the current RIIO-GD2/T2 proposals ignore the benefits RIIO-1 has provided. The RIIO-1 price control includes a strong incentive package that facilitates positive performance from network companies and directly benefits consumers. However, Ofgem's proposals for RIIO-2 include a penalty heavy "incentive" package, with the reward for high performing companies primarily being limited to the avoidance of a penalty.

Such large-scale revisions also raise real risks for consumers. 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. Given that energy networks are capital intensive, any such increases in the cost of capital can be expected to lead to higher prices to the detriment of consumers.

The failure of Ofgem's RIIO-2 proposals to provide a logical and predictable continuation of RIIO-1 is especially of concern given the changing technological and market environment in which companies are operating. This changing environment creates investment challenges. In this context, Ofgem's proposed step changes in RIIO-2 to investment incentives, such as the sharp cut in the cost of capital, the restructuring of outputs and weakening of outperformance rewards, seriously challenge companies' abilities to respond to these changing demands with appropriate investment.⁷¹

Financeability

→ FQ8. Do you agree with our proposal to align the RIIO-ED2 financeability approach with the approach we have taken for GD&T?

We remain of the view that Ofgem should fully consider its statutory duty to ensure the financing of licensees. Ofgem appears to regard a financeability test as a trigger for action by shareholders, rather than a critical cross check of whether the expected cost of equity is sufficient.

In the short term, financeability risks are masked by Ofgem's decision to move from RPI to CPIH indexation of the regulatory asset value (RAV), since this will increase current revenues and reduce future revenues. However, this move is a one-off cash flow benefit that will dwindle over time with lower RAV growth. The underlying issue is that in the

⁷⁰ Shorter reference to Earwaker/Fincham report included in WPD Response to RIIO-2 Draft Determinations for Gas Distribution and Transmission, 4 September 2020, <http://www.first-economics.com/earwakerfincham.pdf>; p.27.

⁷¹ WPD Response to RIIO-2 Draft Determinations for Gas Distribution and Transmission, 4 September 2020; WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution; 14th March 2019.

long-term a [4%] CPIH real cost of equity may challenge companies' current investment grade credit ratings.⁷²

→ **FQ9. Are there any reasons why this approach should differ for RIIO-ED2?**

Please refer to our response to FQ8.

→ **FQ10. Do you have a view, supported by evidence, regarding the appropriateness of different measures to address any financeability constraints?**

Whilst we agree that capitalisation rates should, where possible, reflect accounting distinctions, flexibility around capitalisation rates may be one option to improve financeability.⁷³

→ **FQ11. Do you have any views on the proposed scenarios to be run for stress testing?**

Ofgem scenarios referenced are those from Table 19 of the G & T RIIO-2 SSMD.⁷⁴ Focus on financeability should not simply be focussed on the short term. We remain of the view that Ofgem should fully consider its statutory duty to ensure the financing of licensees. Ofgem appears to regard a financeability test as a trigger for action by shareholders, rather than a critical cross check of whether the expected cost of equity is sufficient.

In the short term, financeability risks are masked by Ofgem's decision to move from RPI to CPIH indexation of the regulatory asset value (RAV), since this will increase current revenues and reduce future revenues. However, this move is a one-off cash flow benefit that will dwindle over time with lower RAV growth. The underlying issue is that in the long-term a 4% CPIH real cost of equity may challenge companies' current investment grade credit ratings.⁷⁵

Financial resilience

→ **FQ12. Do you agree with our proposal to place additional requirements on licensees in RIIO-ED2 to provide Ofgem with a) published ratings reports, and b) a financial resilience report if their issuer credit rating falls below specified levels?**

We do not see the benefit of doing so; no company would intentionally seek a reduction in credit rating and this seems to add a further reporting burden without providing any relief. It is unclear how this would work as companies may not have permission to share all rating reports. Ofgem needs to discuss with the relevant credit agencies in order to

⁷² WPD Response to RIIO-2 Draft Determinations for Gas Distribution and Transmission, 4 September 2020; WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution; 14th March 2019.

⁷³ WPD Response to RIIO-2 Draft Determinations for Gas Distribution and Transmission, 4 September 2020.

⁷⁴ Ofgem, RIIO-2 SSMD Finance, 24 May 2019, Table 19.

⁷⁵ WPD Response to RIIO-2 Draft Determinations for Gas Distribution and Transmission, 4 September 2020.

be in a position where they are able to monitor and access reports as required. Further, Credit rating reports may be at the group level rather than the licensee level.

Corporation tax

→ FQ13. Do you agree with our proposal to align the RIIO-ED2 tax approach with RIIO GD&T including; to pursue Option A; the approach to additional protections; the approach to capital allowances; and not to pursue the Fair Tax Mark certification as a requirement for RIIO-2?

We agree with Ofgem's proposal to maintain the tax allowance and not to pursue the Fair Tax Mark accreditation. We do not consider that a board assurance letter is required given that any submissions to Ofgem will already have been through the Data Assurance process. Also the statutory accounts of the companies are externally audited and tax forms a key element of this process. If Ofgem requires any assurance over tax information provided, we propose a return to the submission to Ofgem of a copy of the Senior Accounting Officer certifications provided to HMRC, as previously provided alongside the RRP submissions, plus submission of NWOs' published tax strategy documents.

→ FQ14. Are there any reasons why this approach should differ for RIIO-ED2?

No comment.

Indexation of the RAV and allowed return

→ FQ15. Do you agree with our proposal to implement CPIH inflation?

We have two concerns with this immediate switch. Firstly, Ofgem has not provided any assurance in its proposals that this switch will indeed be NPV-neutral with respect to true-ups between RPI and CPIH forecasts and indexation.

Secondly, the cash flow benefit from a notionally higher CPIH WACC compared to an RPI WACC provides only a short to medium term easing of financing constraints that will dwindle over time with lower RAV growth – providing even less cash to service debt in the long term. The underlying issue is that in the long-term a 4% CPIH real cost of equity could challenge companies' current credit ratings.⁷⁶

→ FQ16. Are there any reasons why this approach should differ for RIIO-ED2?

No comment.

⁷⁶ WPD Response to RIIO-2 Draft Determinations for Gas Distribution and Transmission, 4 September 2020.

Regulatory depreciation

→ **FQ17. Do you have any specific views or evidence relating to useful economic lives of ED network assets that may impact the assessment of appropriate depreciation rates?**

Based on the diligence that was performed on this issue in preparation for RIIO-ED1, we consider that the 45 years established in RIIO-ED1 as a proxy for economic life is maintained in RIIO-ED2 unless changes are needed for financeability reasons. However, WPD considers that changes should not need to be adapted purely for financeability reasons - one should address why these financeability issues arise.⁷⁷

→ **FQ18. During RIIO-ED1, the assumed asset life is being increased. Do you consider another change is required in RIIO-ED2 to reflect the expected economic asset life? If so, do you have supporting evidence and proposals, at this stage?**

Please see our response to FQ17.

Capitalisation rate

→ **FQ19. Do stakeholders support licensee specific rates for the ED sector?**

Yes. Capitalisation rates should be viewed as part of the company specific business plans and be judged in terms of overall value for money to customers and overall financeability of the companies.⁷⁸

→ **FQ20. For one or more aggregations of totex, should we update rates ex-post to reflect reported outturn proportions for capex and opex?**

WPD considers that all Totex capitalisation rates should be set ex-ante. Any ex-post adjustment would add considerable complexity and uncertainty to the RIIO-2 settlement; companies would not be able to have a view of performance during the price control and any ex-post true up would result in confusing restatements of values – RAV, RoRE etc. at the end of RIIO-2 - this does not seem acceptable for stakeholders or from a rating perspective. Further, any discussions around RIIO-3 would not have a full picture of performance until any ex-post adjustment was finalised.⁷⁹

Directly remunerated services

⁷⁷ WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution, 14th March 2019.

⁷⁸ WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution, 14th March 2019.

⁷⁹ WPD Response to RIIO-2 Draft Determinations for Gas Distribution and Transmission, 4 September 2020.

→ FQ21. Are there any reasons why the RIIO-ED2 approach to directly remunerated services should differ from RIIO-ED1?

We consider the current approach for RIIO-ED1 should be rolled forward to RIIO-ED2.

Disposal of assets

→ FQ22. Do you support our proposal to continue the RIIO-ED1 approach to disposal of assets for RIIO-ED2?

We are in favour of retaining the RIIO-ED1 approach, where cash proceeds from both disposal of assets and scrap income are netted off against Totex in the year in which they're received. This means there is both incentive on the licensee to maximise this and thus benefit to the consumer, as through the TIM arrangements both licensee and consumer will benefit through a share of the underspend.

With regards to amounts recovered from third parties, including insurance companies, in respect of damage to the network, we do not consider this as similar to disposal of assets and these are not reported in the same way in ED1. Rather this is recovering costs that would otherwise not have been incurred by the business in rectifying the damage. However if there is any scrap arising out of the repair, this is dealt with in the same way as other scrap.

The consultation proposes that DNOs include as part of their business plans clear forecasts of, and sufficient detail on, any asset disposals during RIIO-ED2. It is recommended that this is developed and included within BPDs, rather than reliant on written detail in plan documents.

Dividend policy

→ FQ23. Do you agree that additional reporting on executive pay/remuneration and dividend policies will help to improve the legitimacy and transparency of a company's performance under the price control?

WPD does not support additional narrative around executive remuneration. A requirement to disclose personal data/information for publication is not one that Ofgem can impose and also conflicts with requirements in respect of good corporate governance and the disclosure of directors' remuneration set by Parliament, the FCA and any exchange a company's securities are listed.

Information is already provided in the Statutory Financial Statements, for those companies which are required to disclose such information, where it is subject to external audit and presented in a common way across the UK. Any information provided to Ofgem would not be subject to the same reporting standards. Note that some licensees are not currently required to report such information in their Statutory Financial Statements. Further, as a principle, Ofgem should not what appears to be micro-managing certain cost sub-categories as it is for the DNO to determine how to

meet its obligations as efficiently as possible within the envelope of its allowed costs. Similarly, information on forecast dividends is commercially sensitive and is not currently a requirement set by either the Statutory Financial Statements or the Regulatory Accounts, as previously required by Ofgem.⁸⁰

Return adjustment mechanism

→ FQ24. Do you agree with our proposal to introduce a symmetrical RAMs mechanism?

As WPD has previously stated, we consider that any RAMs approach will reduce incentives for the sector to outperform. (1) Further, we would like to understand whether and how Ofgem has included the long term impact of the dampening of incentives to outperform, both as a result of the AvE adjustment and the introduction of RAMs, in its Impact Assessment. However, if Ofgem insists on introducing a RAM, we agree this should be symmetrical and company specific, and welcome the simplification from earlier iterations.⁸¹

→ FQ25. Do you agree with our proposal to introduce a single RAM threshold level of 300 basis points either side of the baseline allowed return on equity?

No comment.

→ FQ26. Do you have any other comments on our proposals for RAMs in RIIO-ED2?

No further comment.

Other Comments

BPDTs

Draft BPDTs, including tables, guidance, glossary and commentary, were issued by Ofgem alongside the SSMC on 30th July 2020. Whilst these are not officially part of the consultation and thus this response, we are providing the following general high level comments on these tables. Detailed comments have already been provided to Ofgem informally via an issues log on 11th September 2020 and WPD will continue to contribute to development of BPDTs through the working group.

One of the purposes of the BPDT is to provide data to assist in the cost assessment process. The SSMC indicates that disaggregated benchmarking will be continued in

⁸⁰ The requirement to produce Regulatory Accounts is still included in the licence; as the RFPR is now prepared and published, Network operators have received a consent from Ofgem to not prepare Regulatory Accounts for the remaining years of RIIO-ED1 but there are conditions to the consent which means it can be revoked.

⁸¹ WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution, 14th March 2019; WPD Response to RIIO-2 Draft Determinations for Gas Distribution and Transmission, 4 September 2020.

some form and so it is important that relevant activities are reviewed as part of CAWG discussions to assess potential approaches and to inform any additional data that may be required for RIIO-ED2 cost assessment (and also whether any data requirements could be deleted). The aim should be to ensure such data is included in the BPDT to avoid the need for supplementary data requests later in the process.

Similarly there will be work undertaken in various working groups to identify the data required to justify forecasts for specific activities, and therefore the BPDT tables will need amendment following this work. For example, following the SRRWG on Thursday 10th September, our expectation is that the SRRWG will lead development of BPDT tables for Asset Replacement and Refurbishment in conjunction with developing proposals for a BPDT NARM workbook and will feedback proposals to the BPDT WG.

It is not clear in this consultation how DSO may impact cost assessment and if there are any proposals for how to address this. WPD are participating in the exercise initiated in the BPDT WG to identify where costs associated with DSO are captured within current reporting. Whilst this review should improve definitions and guidance and identify if there are costs that do not fit within the reporting structure, it is not clear how this exercise will be used to identify DSO forecasts within the BPDT separately from DNO costs. DSO costs may have different drivers to DNO costs, and the different approaches to DSO across DNOs will be reflected in cost forecasts. It would therefore be sensible to separately identify DSO associated costs within the BPDT wherever possible, and whilst the current RRP Annex B memo table M19 included in the BPDT proposal does separate costs by activity, this needs review to ensure it is at the appropriate level of detail.

Further thought is needed on how data on activities relating to uncertainty mechanisms will interact with other tables across the pack. There is currently a proposed separate table and it needs to be considered what sits in this table, what is in the activity tables and what flows through to summary cost tables and the totex/BPFM/finance tables. There are different kinds of uncertainty mechanism, for example there are ones where costs are £nil at this stage because of lack of clarity of legislation or policy; there are also areas where baseline costs may be awarded but additional costs may arise through the price control period. The BPDT will need to be developed alongside the uncertainty mechanisms to ensure requirements for what should be included in the BPDT are clear.

We note the discussion on forecasting options in the SSMC and provide our views in the response to COQ21. Depending on the approach taken, there may be the requirement to develop the BPDTs to accommodate for differing scenarios. The ED1 BPDT submission was made up of 2 pack submissions: Best View and Reference Case.

The scope of the proposed BPDT Commentary is wide and includes areas/material which would also be expected to be included in the main narratives of submitted business plans. For example, explanations of scenarios used, interaction with government policy and descriptions of benchmarking undertaken.

It would be useful for Ofgem to further consider their preferences and thoughts for uses of the BPDT commentary versus the business plan narratives, and also how this sits alongside CBA and EJP submissions. Please see also our response to COQ56.