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Dear Jonathan

RIIO-ED2 Sector Methodology consultation

Electricity North West welcomes this important consultation as part of the framework development for RIIO-ED2 along with Ofgem's acknowledgement of the key role for DNOs in delivering decarbonisation, now enshrined in law and Government policy. We welcome the tone and openness of the consultation that is seeking to move the sector towards enabling the delivery of Net Zero. We support the development of a timely and appropriate framework for RIIO-ED2 that meets the challenges and changes that are occurring in our sector and that continues to deliver the essential needs of our consumers and stakeholders.

Electricity North West provide detailed responses to all aspects of the consultation in detailed appendices, but in this covering letter I want to focus on a small number of key points. I will return to the important and persistent issue of financing at the end of this letter. First of all my top five suggestions for you to consider are:

1. Innovation and incentives have been central to the successes achieved for customers in RIIO-ED1. We are pleased to see that the cornerstones of RIIO are a prominent part of the consultation. Ofgem in RIIO-1, and RIIO-ED1 specifically, set a framework that is balanced and achieved excellent outcomes for customers and stakeholders. This has been exemplified by what Electricity North West (ENWL) has achieved in many areas during RIIO-ED1 so far, such as reducing power cut occurrences by almost a quarter, shortening them when they do occur by nearly a fifth whilst making real improvements in customer service to levels on a par or better than household names like Amazon and John Lewis. **I suggest that these regulatory tools can deliver the transformational changes required in RIIO-ED2, if the incentive and innovation properties of the RIIO framework are now turned up the drive for Net Zero and the strengths of these elements are maintained.**
2. Getting to Net Zero requires an agile regulatory framework that can respond to changing priorities with pace. We support the use of reopen uncertainty mechanisms in a targeted and transparent way, but recognise they can reduce the responsiveness of the sector to changing customer and



stakeholder needs. They work best for large, one-off projects, such as those found in Electricity Transmission but are less suited to the myriad of smaller network interventions that Electricity Distributors must continue to make across their complex networks. Here, automatic mechanisms such as volume drivers and providing sufficient upfront allowances that can be mechanistically modified will best serve customers in this rapidly changing environment. **I suggest that this approach with an enabling baseline and well-designed volume drivers will serve Ofgem well in its discussions with government to demonstrate how Ofgem is enabling Net Zero.** Providing sufficient upfront allowances, as well as automatic mechanisms such as volume drivers, will best serve customers. Predictability in the level of investment is important as it underpins the supply chain investment in its capacity to deliver. Should Ofgem become the gate keeper to regionally driven decarbonisation enablement, my team and I are ready to work with you to develop new agile decision making processes that can operate in uncertainty and take decisions based on imperfect information.

3. Return Adjustment Mechanisms (RAMs) proposed at 300 basis points (bps) on return on regulatory equity (RoRE) is too restrictive and would undermine the legitimate strength of incentives when these are considered as a collective package, potentially curbing a company's ambition to drive outcomes for consumers. However, I recognise Ofgem needs to provide extra confidence to stakeholders if companies are successful in delivering what customers value across several incentives and therefore some extra mechanism is required. **I suggest that if returns exceed the 300 basis point threshold a company report demonstrating that customers are receiving the benefits intended by the incentives is published AND that companies contribute 1 in every 10 bps over this threshold to a fund that will support customers in vulnerable circumstances in their region.** Something like this will enable Ofgem to increase the full RAMs trigger point to 500 basis points with confidence that legitimacy will be secured. Our stakeholders in the North West have made it very clear through our business plan engagement that additional support for those in vulnerable circumstances and those in poverty is required. Furthermore, Ofgem must include finance and tax within RAMs as this will protect customers and consumers from inappropriate returns in RIIO-2 earned by companies for example by just being lucky in the timing of their financing.
4. It is essential that Ofgem visibly demonstrates that the RIIO-ED2 regulatory framework protects customers in vulnerable circumstances and, as we recover from the economic effects of the COVID-19 lockdown, is helping those least able to pay their electricity bills. **I suggest that our innovative Smart Street technology is a key example, lowering customers energy bills by up to £70 each per annum, and that Ofgem require that a wider roll-out of the benefits of Smart Street to be included in all DNO business plan submissions targeted at areas of high fuel poverty.** Ofgem should specify this through the business plan guidance.
5. The integrity of the RIIO-ED2 framework lies in its ability to respond to legitimate regional stakeholder requirements. **I suggest that Ofgem puts regional customer and stakeholder views as a central part of the framework and assessment of DNO business plans.** We have been engaging directly with our customers and stakeholders to ensure their views are at the heart of our plan for the period of RIIO-ED2 and beyond and this is continually scrutinised by our challenging customer engagement group (CEG) of key experts. **I am also providing a copy of this letter to Andy Burnham (Greater Manchester Mayor), Angie Ridgwell and Katherine Fairclough the respective leaders of the Lancashire and Cumbria County Councils as part of our engagement with them.** Our CEG is also actively involved in assessing the RIIO-ED2 regulatory developments and we also share all our regulatory correspondence transparently with them. Local/regional bespoke service offerings and how these interact with the proposed limitations on bespoke Output Delivery Incentives (ODIs), Price Control Deliverables (PCDs) and wider interaction with the process of cost assessment must be considered carefully. Companies should not be inadvertently penalised for committing to deliverables that are valued/prioritised by customer and stakeholder engagement or have other regions deliverables imposed on their customers.

ENWL welcomes the following key initiatives proposed by Ofgem:

1. We welcome the opportunity to transition towards DSO in RIIO-ED2 and will deliver what customers need given a supportive regulatory framework. We are well on with our transformation towards DSO, including our significant and industry-leading investments in the next generation of Network Management Systems. **Ofgem should consider the impact on the outcome for customers and not just what is perceived as the leading standard. Tailoring for each DNO is the right way to ensure the optimal benefit for all consumers and stakeholders to go at the right pace for each region.** It is important that we as a DNO can continue to deliver our core services which underpin the transition to DSO in ED2 and the framework should not lose sight of this. ED2 is not time to consider separation, ED3 should review delivery, fully informed by the learning in ED2.
2. Particularly with respect to DSO, data and use of data is key and we agree this is a key enabler in a changing energy environment. **We are making substantial progress in making more of our data open and continue to support the principles and recommendations of the Energy Data Task Force (EDTF) and associated working groups, as well as actively readying ourselves as part of our preparations for RIIO-ED2.**
3. We welcome Ofgem's continued considerations of how efficiently incurred embedded debt costs should be addressed in the RIIO-ED2 framework and the potential that a special company premium may be appropriate for specific circumstances.
4. Additional clarity and guidance proposed as part of the evolution of the Business Plan Incentive (BPI) and Consumer Value Proposition (CVP) process for RIIO-ED2 is welcome. **Care should be given to not stifle DNOs ambition by being overly prescriptive in CVP guidance, areas such as Smart Street and leading decarbonisation should be included in the list of areas that can be included.** It must be clear that if a handful of strong propositions to benefit customers are put forward, Ofgem will not dismiss or penalise the company because the CVP item doesn't immediately fit the guidance area. We understand and support Ofgem's provision of further guidance, but do not want it to restrict consumer value.

ENWL seeks **further advice** from Ofgem on specific process issues:

1. Given the recognition that ED is at the forefront of Net Zero **we support Ofgem having a Net Zero Advisory Group (NZAG) and the Net Zero Innovation Board.** DNOs have a strong track record of leadership on decarbonisation and collaboration with Ofgem (recent examples include COVID-19 responses), so our trusted voices should not be ignored in the establishment of these two bodies. **There is a need for greater transparency and detail about these two bodies and the defined role they will play** and further development and publication of group scope, terms of reference (ToR) and work schedule should be a priority and cognisant of the wider RIIO-2 process. As an example, the Net Zero Innovation Board as a replacement for the existing Energy Innovation Board only has its ToR published. No minutes have been published and it is unclear what this Board has undertaken since creation in late 2016.
2. We acknowledge and welcome the engagement we have had with Ofgem to date and look forward to the continuation of this and urge that this happen at pace. **The importance of progress in working groups to meet the December decision is crucial as well as the key dependency on the Access and Charging Significant Code Review which cannot be allowed to slip.** We look forward to working with Ofgem and other stakeholders over the coming period to further develop and shape the framework for RIIO-ED2.

We note that many financing details aren't being consulted on as part of this sector specific methodology consultation, but we agree that *"underinvesting in the network now could put Net Zero targets at risk"* in turn worsening outcomes for current and future customers. **We urge that Ofgem take further stock of financial issues and adopt a more balanced approach than Ofgem appears to be taking in RIIO-2 so far.** This includes not making arbitrary adjustments through aiming down (AvE) and more balanced use of values towards the mid-points in ranges when the decisions are taken at the

appropriate time. It should also consider the characteristics of RIIO-ED2 specifically and the needs to attract long term investment, with parity between both debt and equity holders.

In the low return world of RIIO-ED2 companies will not have the ability to support underfunded debt allowances with equity any longer. Therefore, our position on financeability and the inclusion of derivatives has not changed, and we will continue our dialogue on these matters with your team. If structurally companies are to receive different equity returns because of past luck in financing decisions this will have a material impact on financeability and result in a different level of Net Zero progress in unlucky regions. Financing and tax costs must be addressed by the regulatory framework in a similar manner to all other totex costs with company specific factors being included in their assessment and the implications of under or over performance included in RAMs mechanisms. We are keen to ensure that financeability is assessed on a licensee basis to ensure that whole regions are not left behind in the drive to zero carbon because investment is not available to them.

Ofgem has stated that RIIO-2 should be a lower risk, lower returns price control. However, we consider that proposals which increase the breadth of ex-post reviews, rely on a number of less clear reopeners mechanisms and also reopeners that only Ofgem can trigger will **change the nature of the regulatory relationship into one of permanent and perpetual price control discussion**. This is a fundamental change to the nature of the regulatory framework, one that was recognised in your presentation of RIIO-2 to investors. **Our investors tell us that this represents a substantial increase in the risk associated with the regulatory framework.**

We are pleased to see Ofgem recognises that *"the electricity distribution networks will be at the forefront of the changes needed to support Net Zero"*. It is crucial that the development of the framework for RIIO-ED2 recognise this and the unique circumstances that DNOs will be operating in in ED2 and into future price controls. **I strongly recommend Ofgem extends the timeframe for considering financing issues to the end of February 2021 and uses this extra time to commission an authoritative, academic, evidence-based report as part of the RIIO-ED2 development process.** This report should consider the effect on equity risk of the proposed RIIO-ED2 regulatory framework bearing in mind that these are complex businesses facing massive change. Additionally, I urge that Ofgem should include within this report a review of the different levels of equity risk for Electricity Distribution, comparing Electricity Distribution to Water, Transmission and Gas distribution to identify differences in risk and required investor reward.

Our detailed response to the RIIO-ED2 Sector Methodology consultation and the accompanying topic specific materials is provided in five appendices to this letter. This response should also be read in light of previous correspondence in relation to RIIO-2 and our response to the Draft Determinations submitted 4 September 2020.

If you have any questions on any elements of the response, please do not hesitate to contact me or Paul Bircham (paul.bircham@enwl.co.uk).

Yours sincerely



Peter Emery
Chief Executive Officer

Encs:

Annex 1: Overview

Annex 2: Delivering value for money services for consumers

Annex 3: Keeping bills low for consumer

Annex 4: Finance

Annex 5: Transaction Cost Premium for Infrequent Debt Issuers