



# Our response to Ofgem's RIIO-ED2 Draft Determination Consultation Questions

August 2022

## Contents

|  |           |
|--|-----------|
| <b>Our response to Ofgem's RIIO-ED2 Draft Determination Consultation Questions .....</b>   | <b>0</b>  |
| <b>1 Overview Document Questions</b>   | <b>6</b>  |
| <b>Section 6. Adjusting allowances for uncertainty .....</b>   | <b>6</b>  |
| <i>Q1. Do you agree with our proposal to introduce a new funding mechanism for PoLR activities?</i>  | 6         |
| <i>Q2. What are your views on our two proposed options, and do you agree with our preferred option of a DRS?</i>   | 6         |
| <i>Q3. Do you agree with our proposal to introduce a re-opener to deal with recommendations from the Storm Arwen review, our proposed trigger and re-opener window?</i>                  | 7         |
| <i>Q4. Do you agree with our proposal to maintain the RIIO-ED1 High Value Project mechanism and focus it on non-load related HVPs in RIIO-ED2?</i>                                       | 7         |
| <i>Q5. Do you agree with our proposal to remove the RIIO-ED1 smart meter volume driver?</i>  | 8         |
| <i>Q6. Do you agree with our proposed approach for a common materiality threshold being applied to RIIO-ED2?</i>   | 8         |
| <b>Section 9 Approach to the Totex and Business Plan Incentive Mechanisms .....</b>  | <b>9</b>  |
| <i>Q7. Do you agree with our view that all the DNOs have passed Stage 1 of the BPI?</i>  | 9         |
| <i>Q8. Do you agree with our overall approach regarding treatment of CVP proposals?</i>  | 9         |
| <b>Section 10 Increasing competition .....</b>   | <b>10</b> |
| <i>Q9. Do you agree with our proposed position on early and late competition?</i>  | 10        |
| <b>Section 11 RIIO-ED2 in the round, post appeals review and pre-action correspondence .....</b>   | <b>10</b> |
| <i>Q10. Do you have any views on the proposed scope of the FDQ process and pre-action correspondence, including on the proposed timing for sending such to Ofgem?</i>                    | 10        |
| <b>Section 12. Access and Forward-looking Charges Significant Code Review.....</b>   | <b>12</b> |
| <i>Q11. Do you agree with our proposal to not introduce a specific uncertainty mechanism to manage the impact of the Access SCR (and address it through the LRE mechanisms instead)?</i> | 12        |
| <b>2 Core Methodology Questions</b>  | <b>13</b> |
| <b>Section 2. Embedding the consumer voice in RIIO-ED2 .....</b>   | <b>13</b> |
| <i>Core-Q1 Do you agree with our proposals for the enduring role of the CEG?</i>   | 13        |
| <i>Core-Q2 Do you see value in the CEGs working together to deliver more coordinated and comparative reporting on some of the DNOs' Business Plan commitments?</i>                       | 13        |
| <b>Section 3. Networks for Net Zero .....</b>  | <b>14</b> |
| <i>Core-Q3 Do you agree with our proposal to adjust allowances to £2.68bn to account for the concerns highlighted by our assessment?</i>   | 14        |
| <i>Core-Q4. Do you agree with our proposed secondary reinforcement volume driver and LV services volume driver and the associated controls?</i>  | 14        |
| <i>Core-Q5 Do you agree with our proposed LRE re-opener?</i>   | 15        |
| <i>Core-Q6. Do you agree with our proposed approach to the Net Zero re-opener?</i>   | 16        |
| <i>Core-Q7. Do you agree with our proposed approach to the value of the SIF?</i>   | 16        |
| <i>Core-Q8 Do you agree with our proposed approach to weighting SSMD criteria and benchmarking RIIO-ED2 NIA requests against RIIO-ED1?</i>   | 17        |
| <i>Core-Q9. Do you agree with our proposed approach to setting NIA allowances?</i>   | 17        |
| <i>Core-Q10. Do you agree with our proposal to allow DNOs to carry over any unspent NIA funds from the final year of RIIO-ED1 into the first year of RIIO-ED2?</i>                       | 18        |
| <i>Core-Q11 Do you agree with our proposed approach for the Annual Environmental Report ODI-R?</i>   | 18        |
| <i>Core-Q12 What are your views on the proposed mid-period review on DNO environmental performance and their progress to targets?</i>  | 19        |
| <i>Core-Q13. Do you agree with our consultation position for the DNOs' EAP proposals in RIIO-ED2 as set out in this document?</i>  | 19        |
| <i>Core-Q14. Do you agree with our proposal to withdraw the Environmental Scorecard ODI-F for RIIO-ED2?</i>  | 21        |
| <i>Core-Q15. Do you agree with our proposed approach to design of the Environmental Re-opener?</i>   | 21        |
| <i>Core-Q16. Do you agree with our proposal for addressing PCB contamination in PMTs through a volume driver in RIIO-ED2?</i>  | 22        |
| <b>Section 4. Supporting a smarter, more flexible, digitally enabled energy system .....</b>   | <b>24</b> |
| <i>Core-Q17 Do you agree with our proposal for implementing a Digitalisation Licence Obligation?</i>   | 24        |
| <i>Core-Q18. Do you agree with our proposal to have staggered publications of Digitalisation Strategies between RIIO-ED2 and RIIO-2 licensees?</i>                                       | 24        |
| <i>Core-Q19. Do you agree with our proposed Digitalisation re-opener?</i>  | 25        |
| <i>Core-Q20. Do you agree with the proposed enhanced reporting framework associated with IT/OT Data and Digitalisation spend and DSAP investment proposals?</i>                          | 25        |
| <i>Core-Q21. Do you agree with our proposal to adopt TBM as part of the RIGS/RRP?</i>  | 25        |
| <i>Core-Q22. Do you agree with our intention to modernise the regulatory reporting process?</i>  | 26        |
| <i>Core-Q23 Do you agree with the proposed timeline for implementation of this modernisation?</i>  | 27        |
| <i>Core-Q24. Do you agree with our proposed design of the DSO incentive?</i>   | 27        |

|   |           |
|---|-----------|
| <i>Core-Q25. What are your views on the outturn performance metrics and RRE we are proposing to include in the DSO incentive? If you do not support their inclusion, please outline which alternative outturn performance metric(s) or RRE you think should be included in the framework instead.</i>   | 30        |
| <i>Core-Q26. Do you agree with our proposal for the DSO re-opener?</i>  | 32        |
| <i>Core-Q27. Do you agree with our proposal to introduce a new whole system strategic planning Licence Obligation?</i> .....  | 32        |
| <i>Core-Q28. What are your views on the digital tools that could be used to support this? .....</i>   | 32        |
| <b>Section 5. Meet the needs of consumers and network users.....</b>  | <b>33</b> |
| <i>Core-Q29. Do you agree with our proposed target and thresholds for the deadband, maximum reward and penalty? .....</i>   | 33        |
| <i>Core-Q30. Do you agree with our proposed approach to working with DNOs to implement Storm Arwen actions related to customer satisfaction? .....</i>  | 34        |
| <i>Core-Q31 Do you agree with our proposed target and maximum penalty score?</i>  | 34        |
| <i>Core-Q32. Do you agree with our proposal to remove the activities proposed from DNOs' baseline allowances? .....</i>   | 34        |
| <i>Core-Q33. Do you agree with our proposals for the Consumer Vulnerability ODI-F?.....</i>   | 34        |
| <i>Core-Q34. Do you agree with the performance metrics we are proposing to include in the incentive and the approach to setting targets and associated deadbands, performance caps and penalty collars? If not, please explain why and give details of your preferred alternative.</i>  | 34        |
| <i>Core-Q35. Do you agree with our proposal for the Annual Vulnerability Report ODI-R?.....</i>   | 35        |
| <i>Core-Q36. Do you agree with the proposed content of the annual report? If not, please explain why and give details of your preferred alternative</i>   | 35        |
| <i>Core-Q37 Do you agree with setting the maximum reward and penalty limit at +/-50% of the target?</i>   | 35        |
| <i>Core-Q38. Do you agree with setting a deadband of +/-20% of the target?.....</i>   | 35        |
| <i>Core-Q39. Do you agree with our proposed design of the Major Connections incentive? .....</i>  | 36        |
| <i>Core-Q40. Do you agree with our proposed approach to target setting and applying the penalty?.....</i>   | 37        |
| <i>Core-Q41 Do you agree with our proposal to require reputational reporting of timeliness metrics for all RMS?</i>   | 37        |
| <i>Core-Q42. Do you agree with our proposal to launch a wider review of the Connections GSoP (that is, beyond updating the payment amounts for inflation and incorporating standards for DG customers)? .....</i>   | 38        |
| <i>Core-Q43. Do you have any views on what else could be done to help speed up connections to the distribution network and or develop a standard for the overall (i.e., end to end) time to connect?</i>  | 38        |
| <b>Section 6. Maintain a safe, resilient, and reliable network .....</b>  | <b>38</b> |
| <i>Core-Q44. Do you have evidence that customers would be willing to face an increase in their bills to also receive an increase in their reliability, including that they understand the actual cost and how this translates into average power cuts?.</i>   | 38        |
| <i>Core-Q45. Do you have evidence of the cost of reliability improvements and the impact that lowering the revenue cap will have on them being achieved?.....</i>   | 40        |
| <i>Core-Q46. What are your views on moving to an asymmetric cap and collar?.....</i>  | 40        |
| <i>Core-Q47 Are there alternatives to reducing the revenue cap that you think would better balance increases in reliability and the cost to consumers than reducing the revenue cap?</i>  | 41        |
| <i>Core-Q48. Do you agree with how we have characterised the operation of the current CML methodology and our reasons for changing to setting targets in line with our CI methodology? .....</i>  | 41        |
| <i>Core-Q49. Do you agree with our rationale for retaining our RIIO-ED1 position on QoS funding? Can you provide any evidence that an alternative approach would not result in double rewarding alongside the IIS?</i>  | 43        |
| <i>Core-Q50. Do you have any examples of situations where fault-related interruptions could be genuinely "exceptional" and how these could be separately identified from those that occur during planned works? .....</i>   | 43        |
| <i>Core-Q51. Do you agree with our assessment of the OEE thresholds and the financial impact on each DNO? .....</i>   | 44        |
| <i>Core-Q52 Do you agree with our proposal not to have an end-of-period adjustment mechanism? If not, what criteria should we use to determine whether a DNO has used its allowance for WSC, without it creating uncertainty? .....</i>   | 44        |
| <i>Core-Q53. Are there any other areas or metrics that we should include in our governance framework?.....</i>  | 44        |
| <i>Core-Q54. Do you agree with our proposed approach on NARM?</i>   | 45        |
| <i>Core-Q55. Do you agree with our proposal to pass through SW 1-in-20 costs as a variant Totex allowance rather than a fixed allowance in RIIO-ED2?.</i>   | 46        |
| <i>Core-Q56. Do you agree with our proposal to not set a cap for the amount that DNOs can adjust their allowance by, in the event they experience a SW 1-in-20 storm? .....</i>   | 46        |
| <i>Core-Q57 Do you agree with our proposed approach to the physical site security re-opener?</i>  | 47        |
| <i>Core-Q58. Do you agree with our proposed approach to the ESR re-opener?</i>  | 47        |
| <i>Core-Q59. Do you agree with our approach to fund DNO telecoms resilience activities through baseline allowances?.....</i>  | 47        |
| <i>Core-Q60. Do you agree with our proposal to assess the cyber resilience IT and OT plans against our BPG and RIIO-2 re-opener guidance?.....</i>  | 47        |
| <i>Core-Q61 Do you agree with our proposed re-opener windows for cyber resilience OT and IT?</i>  | 47        |
| <i>Core-Q62. Do you agree with our proposal to apply a UIOLI allowance to cyber resilience OT to manage the uncertainty around costs?.....</i>  | 48        |
| <b>Section 7. Delivering at lowest cost to energy consumers .....</b>   | <b>48</b> |
| <i>Core-Q63. Do you agree with our proposed approach to pre-modelling normalisations and adjustments? .....</i>   | 48        |
| <i>Core-Q64. Do you agree with our approach to Totex benchmarking?.....</i>   | 49        |
| <i>Core-Q65. Do you agree with our proposed assessment approach for primary reinforcement? .....</i>  | 52        |
| <i>Core-Q66. Do you agree with the application of a volume adjustment based on the industry average ratio of forecast capacity added relative to the forecast demand growth above firm capacity? If not, what do you consider to be a better approach to assessing the efficiency of a DNO's proposed workload for primary network reinforcement? .....</i> | 52        |
| <i>Core-Q67. Do you agree with our proposed assessment approach for secondary reinforcement?.....</i>   | 52        |

|   |           |
|---|-----------|
| <i>Core-Q68. Do you agree with the level of disaggregation and period of data used to calculate the unit costs listed in the table above for transformer reinforcement, circuit reinforcement and proactive service reinforcement?.....</i> | 53        |
| <i>Core-Q69. Do you agree with our proposed assessment approach for fault level reinforcement?.....</i>   | 54        |
| <i>Core-Q70. Do you agree with our proposed adjustments to account for outlier volumes data for ENWL and SSES?.....</i>   | 54        |
| <i>Core-Q71. Do you agree with our proposed assessment approach for connections?.....</i>   | 54        |
| <i>Core-Q72. Do you agree with our proposed assessment approach for NTTC expenditure?.....</i>  | 54        |
| <i>Core-Q73. Do you agree with our proposed assessment approach on asset replacement?.....</i>  | 54        |
| <i>Core-Q74. Do you agree with our assessment approach to refurbishment?.....</i>   | 56        |
| <i>Core-Q75. Do you agree with our proposed assessment approach for asset replacement driven civil works?.....</i>  | 56        |
| <i>Core-Q76. Do you agree with our proposed assessment approach for Condition Based Civil Works?.....</i>   | 56        |
| <i>Core-Q77. Do you agree with our proposed assessment approach for diversions?.....</i>  | 57        |
| <i>Core-Q78. Do you agree with our proposed approach for Rail Diversions?.....</i>  | 57        |
| <i>Core-Q79. Do you agree with our proposed approach to assessing Non-Operational, Operational and Business Support IT&amp;T costs?.....</i>  | 57        |
| <i>Core-Q80. Do you agree with our proposed assessment approach for Legal and Safety?.....</i>  | 59        |
| <i>Core-Q81. Do you agree with our approach to assessing Overhead Line Clearance costs?.....</i>  | 60        |
| <i>Core-Q82. Do you agree with our proposed approach to assessing ESR costs?.....</i>   | 60        |
| <i>Core-Q83. Do you agree with our proposed approach to assessing QoS and NoSR costs?.....</i>  | 60        |
| <i>Core-Q84. Do you agree with our proposed assessment approach for Physical Security?.....</i>   | 60        |
| <i>Core-Q85. Do you agree with our proposed assessment approach for Flood Mitigation?.....</i>  | 60        |
| <i>Core-Q86. Do you agree with the proposed approach to assessing Rising and Lateral Mains costs?.....</i>  | 60        |
| <i>Core-Q87. Do you agree with our approach to assessing WSCs?.....</i>   | 61        |
| <i>Core-Q88. Do you agree with our proposed assessment approach for Losses?.....</i>  | 61        |
| <i>Core-Q89. Do you agree with our proposed assessment approach for environmental reporting?.....</i>   | 61        |
| <i>Core-Q90. Do you agree with our proposed assessment approach for PCBs?.....</i>  | 62        |
| <i>Core-Q91. Do you agree with our proposed assessment approach for Property?.....</i>  | 62        |
| <i>Core-Q92. Do you agree with our proposed assessment approach for STEPM?.....</i>   | 63        |
| <i>Core-Q93. Do you agree with our proposed assessment approach for Vehicles and Transport?.....</i>  | 63        |
| <i>Core-Q94. Do you agree with our proposed assessment approach for HVPs?.....</i>  | 63        |
| <i>Core-Q95. Do you see any merit in setting a HVP threshold for RIIO-ED2, and if so should it be based on the RIIO-ED1 threshold?.....</i>   | 63        |
| <i>Core-Q96. Do you agree with our proposed assessment approach for faults and ONIs?.....</i>   | 64        |
| <i>Core-Q97. Do you agree with our proposed assessment approach for Tree Cutting?.....</i>  | 65        |
| <i>Core-Q98. Do you agree with our proposed assessment approach for Severe Weather 1-in-20 Events?.....</i>   | 65        |
| <i>Core-Q99. Do you agree with our proposed approach to assessing Inspections and Repair &amp; Maintenance costs?.....</i>  | 66        |
| <i>Core-Q100. Do you agree with our proposed assessment approach for NOCs other?.....</i>   | 66        |
| <i>Core-Q101. Do you agree with our proposed assessment approach for Smart Metering Rollout?.....</i>   | 67        |
| <i>Core-Q102. Do you agree with our approach to assessing CAI costs?.....</i>   | 67        |
| <i>Core-Q103. Do you agree with the proposed assessment approach for Business Support costs?.....</i>   | 68        |
| <i>Core-Q104. Do you agree with our approach to assessing streetworks costs?.....</i>   | 68        |
| <i>Core-Q105. Do you agree with our proposal to carry out a demand driven post-modelling adjustment?.....</i>   | 69        |
| <i>Core-Q106. Do you agree with our proposal to not carry out any Quality of Service based adjustments?.....</i>  | 69        |
| <i>Core-Q107. Do you agree with our approach to combining our Totex and disaggregated benchmarking models?.....</i>   | 69        |
| <i>Core-Q108. Do you agree with our approach to setting and applying the efficiency challenge using a glide path between the 75th and 85th percentile over a 3-year period?.....</i>  | 70        |
| <i>Core-Q109. Do you agree with our proposed RPEs allowances? Please specifically consider our proposed notional cost structure, assessment of materiality, and choice of indices in your answer.....</i>                                   | 71        |
| <i>Core-Q110. Do you agree with our proposed approach to setting the ongoing efficiency challenge and the level of challenge applied?.....</i>  | 73        |
| <i>Core-Q111. Do you agree with our proposed disaggregation methodology?.....</i>   | 79        |
| <b>3. SPEN Annex Questions.....</b>   | <b>81</b> |
| <b>Section 2. Setting outputs.....</b>  | <b>81</b> |
| <i>SPEN-Q1. What are your views on the values for the company specific parameters we have proposed for the common outputs that we have set out above?.....</i>  | 81        |
| <i>SPEN-Q2. What are your views on our proposals for SPEN's bespoke ODIs?.....</i>  | 81        |
| <i>SPEN-Q3. What are your views on our proposals for SPEN's bespoke PCDs?.....</i>  | 82        |
| <i>SPEN-Q4. What are your views on our proposals for SPEN's CVPs?.....</i>  | 83        |
| <b>Section 3. Setting baseline allowances .....</b>   | <b>85</b> |
| <i>SPEN-Q5. What are your views on our proposals for the outcome of Stages 3 and 4 of the BPI for SPEN?.....</i>  | 85        |
| <b>Section 4. Adjusting baseline allowances for uncertainty.....</b>  | <b>85</b> |
| <i>SPEN-Q6. What are your views on our proposals for SPEN's bespoke UMs?.....</i>   | 85        |
| <b>5. Innovation.....</b>   | <b>86</b> |
| <i>SPEN-Q7. What are your views on the level of proposed NIA funding for SPEN?.....</i>   | 86        |
| <b>4. Finance Annex Questions.....</b>  | <b>88</b> |
| <i>FQ1. Do you agree with our approach to estimating efficient debt costs and setting allowances for debt costs?.....</i>   | 88        |
| <i>FQ2. Do you have any views on the model to implement equity indexation that is published alongside this document, (the 'WACC Allowance Model RIIO-ED2 30th April 2022 update Alternative Wedge')?</i>                                    | 91        |

|   |     |
|---|-----|
| FQ3. In light of the upcoming change to the definition of RPI in 2030, should the RPI-CPIH inflation wedge be based on: a) a single year (as shown in the WACC allowance model when: cell D2 is "year 5 forecast" and cell B5 is "01/04/2022"); or b) should it be based on 20 years of inflation forecasts (as shown in the WACC allowance model when: cell D2 is "20 year geometric" and cell B5 is "01/04/2031")?    | 92  |
| FQ4. Is there evidence that suggests we should change our approach to TMR for RIIO-ED2?.....  | 93  |
| FQ5. Can stakeholders confirm their view on the trade-off between: the objectivity of using outturn averages (even though the results may be materially higher or lower in future price controls than current TMR expectations); versus the benefits of putting more weight on current expectations (noting the evidence from cross-checks and the associated risk of subjectivity)?                                    | 94  |
| FQ6. Do stakeholders agree with our proposal to apply the same TMR for RIIO-ED2 (a mid-point of 6.5% CPIH) as we did for RIIO-GD&T2?.....   | 95  |
| FQ7. Do you believe that DNOs have a higher or lower level of systematic risk than the GD&T companies during their respective RIIO-2 periods?   | 96  |
| FQ8. What are your views on the relative risk comparison shown in Table 10?   | 98  |
| FQ9. Do you have any evidence that suggests the beta for GD&T companies has materially changed since RIIO-GD&T2 Final Determination in December 2020?.....  | 98  |
| FQ10. Do you agree with our interpretation of the cross-check evidence?   | 99  |
| FQ11. Do you agree with our updated MAR and OFTO cross-check techniques, in terms of drawing better inferences for RIIO-ED2?.....   | 102 |
| FQ12. Do you agree with the cross-checks we have used and are there other cross-checks we should consider?.....   | 102 |
| FQ13. Do you consider we should put greater weight on cross-checks or reconsider our CAPM parameters in light of the adjusted cross-check results?  | 104 |
| FQ14. Do you agree that we should not adjust for expected outperformance when setting baseline allowed returns on equity?.....  | 104 |
| FQ15. Do you believe there is new evidence which would support an adjustment downwards (e.g., expected outperformance) or upwards (e.g., aiming up) that we have not yet considered? .....  | 104 |
| FQ16. Do you think we should adjust our approach to allowed returns (noting our approach to expected inflation for WACC and outturn inflation for RAV as described above) so that outturn inflation does not permit the notional company to generate real equity returns that are materially higher or lower than our cost of equity allowance? What would be the consequences to consumers and DNOs of doing so? ..... | 107 |
| FQ17. If you believe we should make such an adjustment, what is the best method for making it?  | 108 |
| FQ18. If you don't believe we should make such an adjustment, how should we ensure that the fairness of the price control is maintained to prevent ex post returns from deviating from ex ante expectations for both consumers and investors? .....   | 108 |
| FQ19. Do you agree with our approach to assessing financeability?.....  | 108 |
| FQ20. Do you have any evidence that would enable us to improve our calibration of stress test scenarios?.....   | 109 |
| FQ21. Do you agree with the requirement to provide the Financial Resilience Report within 60 days?  | 110 |
| FQ22. Do you agree with our proposals to make allocation and allowance rates variable values in the RIIO-ED2 PCFM?.....   | 110 |
| FQ23. Do you agree with the proposed additional protections? In particular: .....   | 110 |
| FQ24. Do you have any views on a materiality threshold for the tax reconciliation? .....  | 111 |
| FQ25. Do you think that the "deadband" used in RIIO-ED1 is an appropriate threshold to use? If not, what would be a more appropriate alternative?.....  | 111 |
| FQ26. Do you have any views on our proposals relating to the Tax Trigger and Tax Clawback mechanisms? In particular, do you have any views on a proposed "glide path" for the notional gearing levels used in the tax clawback calculation? .....   | 111 |
| FQ27. Do you agree with our proposals for the RAM thresholds and adjustment rates?  | 111 |
| FQ28. What are your views on the technical implementation of the switch to CPIH as set out in the attached PCFM?  | 112 |
| FQ29. Do you agree with our proposal to set depreciation policy on RAV additions in the RIIO-ED2 period to 45-years straight line, based on the average economic life of the assets?.....   | 113 |
| FQ30. Do you agree with our proposal that we should set different capitalisation rates for ex ante allowances and re-openers and volume drivers?  | 114 |
| FQ31. Do you have any evidence that would enable us to improve our estimates of regulatory capitalisation rates? .....  | 115 |
| FQ32. Do you have any views on the use of forecast RAV opening balances for the start of RIIO-ED2, which will be trued-up following RIIO-ED1 closeout? .....  | 115 |
| FQ33. Do you agree that additional corporate governance reporting described (including on executive director remuneration and dividend policies), will help to improve the legitimacy and transparency of a company's performance under the price control? If not, please outline your views in relation to the rationale provided for these additional requirements, including consumer protection. .                  | 116 |
| FQ34. What are your views on the proposed consolidation of the revenue RRP and PCFM, or applying a fully dynamic concept of allowed revenue?  | 116 |
| FQ35. What are your views on allowing licensees to self-publish the PCFM with their charging statements, rather than relying on an Ofgem publication or direction to determine allowed revenue?.....  | 117 |
| FQ36. What are your views on having a best endeavours obligation for charge setting: "The licensee must, when setting Network Charges, use its best endeavours to ensure that Recovered Revenue equals Allowed Revenue"?  | 117 |
| FQ37. What are your views on applying a single time value of money to all prior year adjustments, based on nominal WACC? .....  | 118 |
| FQ38. What are your views on our proposed approach to using forecasts within RIIO-ED2?.....   | 119 |
| FQ39. What are your views on the proposed charging penalty mechanism? .....   | 119 |
| FQ40. What are your views on the proposed revenue forecasting penalty mechanism?.....   | 119 |
| FQ41. What are your views on removing lags from incentives?   | 120 |
| FQ42. What is your view on using RoRE as a general baseline for describing ODI caps, rather than base revenue?.....   | 120 |
| FQ43. What is your view on fixing the potential £m 20/21 value of incentives using one number for all years, based on a forecast of RIIO-ED2 at Final Determination (an approach similar to RIIO-ED1)?.....   | 120 |
| FQ44. What is your view on the method of calibrating incentive caps in RoRE terms, or the overall proposed incentive caps?  | 121 |

FQ45. What are your views on our proposal to remove the Bad Debt terms from the pass-through licence condition? ..... 121  
FQ46. Should Ofgem allow proposals to re-allocate or re-profile revenue throughout the RIIO-ED2 period and what profiles could be considered in the customers' interest? ..... 121

## 1. Overview Document Questions

### Section 6. Adjusting allowances for uncertainty

**Q1. Do you agree with our proposal to introduce a new funding mechanism for PoLR activities?**

**SPEN agree with this proposal.**

With the licence obligation in place confirming the Provider of Last Resort (PoLR) role, a mechanism is required to remunerate any costs incurred as a result of DNOs taking on this role. However, there is currently a gap in the licence in this area and therefore we agree with Ofgem's proposal to introduce a new funding mechanism for PoLR activities.

We have received strong stakeholder support for DNOs being able to undertake this role, especially from Transport Scotland and the Scottish Government, who we worked closely with on our extremely successful Project PACE<sup>1</sup>

**Q2. What are your views on our two proposed options, and do you agree with our preferred option of a DRS?**

**SPEN believe Ofgem must decide what regulatory mechanism is appropriate on a case-by-case basis.**

We have analysed the options set out by Ofgem in their Draft Determination document and believe that the appropriate regulatory mechanism be decided on a case-by-case basis. It is unclear how often DNOs will be required to discharge the PoLR obligation, but the expectation is this will be infrequent. Furthermore, at this early stage of the required EV charging infrastructure rollout it is difficult to predict what charging requirements the market will find commercially viable to deliver and, therefore, difficult to predict the scope and costs of works falling to the DNO PoLR obligation. Finally, given the differences in delivery models for EV charging across the different governments, it is likely that each failed tender case will be different, especially if they fall into different jurisdictions. In some instances, DRS may be most appropriate, and in others a pass-through mechanism may be better suited.

By way of example, as part of project PACE, we installed charge points on behalf of two Local Authorities<sup>2</sup>, which was completed before the PoLR licence condition was written into the licence. In this case, the Local Authority was the 'host' and had the contract with the electricity supplier and leased the infrastructure from SPEN. In this instance, we believe that DRS would be appropriate. We would bill the party requesting the infrastructure (the Local Authority in the example above) and would bill them through DRS for costs uplifted by an appropriate WACC over an appropriate period of time. This would work similarly to the principals that exist for sole use connections.

The infrastructure would then be put out for competitive tender every 5 years, as per the licence condition, subject to cost recovery (i.e., the written down value of the asset).

---

<sup>1</sup> <https://www.spenergynetworks.co.uk/pages/pace.aspx>

**Q3. Do you agree with our proposal to introduce a re-opener to deal with recommendations from the Storm Arwen review, our proposed trigger and re-opener window?**

**SPEN agree with the proposal to introduce a re-opener to deal with recommendations from the Storm Arwen review, however, we do not fully agree with the proposed trigger or materiality threshold.**

SPEN agree with Ofgem's proposal to introduce an early RIIO-ED2 Uncertainty Mechanism (UM) re-opener to fund unforeseen levels of network investment or operational/customer service activities following storm Arwen. This approach will give DNOs the opportunity to implement recommendations from the Energy Emergencies Executive Committee (E3C's) and Ofgem's review into storm Arwen Findings from these reviews, including potential amendments to industry design specifications, or vegetation clearance distances, could significantly impact DNO programmes of work and expenditure We agree there remains significant uncertainty around the scale of this impact at the time of setting baseline allowances.

**SPEN agree with the UM Type.** Ofgem propose to use a common re-opener for all DNOs. We believe this is appropriate given that all DNOs are expected to implement review findings, though we anticipate the specific activities required by each DNO may vary significantly

**SPEN partly agree with the UM Trigger.** Ofgem propose that the re opener should be triggered by changes to DNOs' scope of work caused by implementing a recommendation from Ofgem or the E3C's Storm Arwen reviews. Although SPEN agree that these should act as triggers, this may constrain delivery of other initiatives aimed at improving resilience to storm conditions that are not captured within the Ofgem or the E3C review Following storm Arwen, SPEN commissioned an independent review into SPD and SPM performance, it is possible that findings from this review will change original RIIO ED2 planned scopes of work The scope of the reopener should therefore be widened to include costs of activity which has changed as a result of a DNO's own reviews. We agree that Ofgem's assessment of the re-opener application should consider whether a sufficient needs case is demonstrated.

**SPEN agree with the Re-Opener Window.** Ofgem propose there should be one opportunity to trigger the re opener between the 22nd-26th January 2024. The timescales for the re-opener are agreeable to SPEN as it affords sufficient time to review the impact of Ofgem and the E3C recommendations, as well as any justified company specific initiatives However, SPEN would also support the inclusion of a second re opener window in 2025 to ensure all storm resilience opportunities can be fully reviewed.

**SPEN challenge the Materiality Threshold.** Ofgem propose a 1% materiality threshold, in line with a common approach to re openers. As this re-opener is to achieve compliance with regulatory guidance and recommendations, had it not been for the timing of storm Arwen closely coinciding with final plan submission, we believe all expenditure would have been included within baseline allowances As such we believe there would be merit in removing the materiality threshold for this re opener. We believe this would be consistent with Ofgem's approach for compliance related reopeners e.g , Electricity System Restoration and Cyber, where there is no materiality threshold.

However, if Ofgem are to apply a threshold we agree with maintaining materiality threshold consistency between the Storm Arwen re-opener, and other common re-openers. As set out in our response to Q6 we believe there is merit in revising this level to 0.5% base revenue

**Q4. Do you agree with our proposal to maintain the RIIO-ED1 High Value Project mechanism and focus it on non load related HVPs in RIIO ED2?**

**SPEN agree with the proposed UM type, trigger, and re-opener window, but disagree with the proposed materiality threshold.**

The HVP mechanism provides a valuable protection to customers and DNOs to ensure significant schemes which emerge in period can be managed without undue delay or impact on other DNO activities. In our SSMC response we proposed that the HVP reopeners should be retained, with updated guidance on its' purpose and process for triggering within the RIIO-ED2 context

We agree the HVP should be directed at non-load schemes, subject to implementation of suitable LRE UMs which manage uncertainty associated with Load Related activity. However, SPEN note that through the delivery of a HVP, DNOs may incur costs in a range of non-load related categories including Business Support Costs, and Closely Associated Indirects, as well as costs allocated as Non-Load Related Expenditure so we would request that Ofgem clarify the interpretation of non-load. We believe it is important that these costs are not excluded from the scope of the re opener.

We also agree that the HVP should apply to individual schemes of work. We consider a scheme of work may encompass a range of activities carried out at different times, locations, and costs but the scheme is underpinned by a common driver. We believe that Ofgem's proposed materiality threshold of £25m for individual non-load related schemes is very high, and as a consequence is likely to exclude the majority of unforeseen activities that emerge. Although we accept this mechanism is for high value activities, we believe this threshold may be too exclusionary. We accept Ofgem's application of a common materiality but as set out in our response to Q6 we believe there is merit in reviewing the common materiality threshold level to 0.5% base revenue

**Q5. Do you agree with our proposal to remove the RIIO-ED1 smart meter volume driver?**

**SPEN accept this proposal.**

We agree that the level of uncertainty in relation to the smart meter rollout will be lower in RIIO-ED2 compared to RIIO-ED1. On that basis, we accept that it is appropriate to remove the volume driver for smart meter interventions and retain an ex-ante allowance in this area.

**Q6. Do you agree with our proposed approach for a common materiality threshold being applied to RIIO-ED2?**

**SPEN do not agree with the proposed approach for the common materiality threshold.**

Whilst we see merit in applying a materiality threshold to avoid very low value submissions and mitigate the risk that reopener administration costs across Ofgem and the DNO exceeds the reopener value, we have the following comments on the detail of Ofgem's current proposal:

**Level of materiality threshold:** We do not agree with the 1% base revenue materiality threshold that Ofgem has proposed and believe this is arbitrary and far in excess of the costs of administering these proposals. Ofgem's policy for RIIO ED2 is to use more reopeners and agree less upfront allowance, meaning DNOs will be exposed to more costs that fall under these materiality thresholds and this does not represent an equitable balance of risk. In the Gas Distribution and Transmission sectors, we note that a materiality threshold of 1% was proposed at Draft Determination, and this was reduced to 0.5% at Final Determination following stakeholder responses; there is no evidence to suggest the Electricity Distribution sector should have a materiality threshold set at double the rate of other sectors

**Applicability of reopener threshold:** During Working Group discussions when asked how Ofgem decided which reopeners should have materiality thresholds and which should not, the guidance given was that compliance related activities would not have a materiality threshold. With this guidance in mind, we believe that the materiality threshold is not appropriate and should be removed from several of the proposed reopeners, including environment digitalisation, and Storm Arwen (as outlined in our responses to Core Q15, Core Q19 and Overview Q3).

In relation to Storm Arwen in particular, if the storm had happened in November 2020 instead of 2021 (and so allowing the outcome of the reviews to be known earlier) then 100% of the costs in relation to the report recommendations and resulting actions required would have been reflected within our Final RIIO-ED2 Business Plan for Ofgem to award as baseline allowance. The application of a materiality threshold in this instance would therefore appear arbitrary.

**Base revenue scope:** We understand that Ofgem's proposal is that the materiality threshold percentage is calculated against annual average base revenue and the Finance Annex defines base revenue as 'the following subset of calculate revenue: Fast pot expenditure, non-controllable Opex, RAV depreciation and Return'. We believe that including all these elements creates significant variances in exposure between DNOs and to ensure consistency we propose that the materiality threshold percentage should only apply to aspects of calculated revenue that correlate with the size of the business. Fast pot, RAV depreciation and return are somewhat correlated to the size of investment and size of the business; however non-controllable Opex is not and should be removed from scope. For example, if Scottish business rates are higher than the English and Welsh equivalents, then Scottish DNOs are at a disadvantage.

## Section 9 Approach to the Totex and Business Plan Incentive Mechanisms

**Q7. Do you agree with our view that all the DNOs have passed Stage 1 of the BPI?**

**SPEN accept this view.**

**Q8. Do you agree with our overall approach regarding treatment of CVP proposals?**

**SPEN do not agree with the RIIO-ED2 approach.**

It is our view that the Stage 2 CVP process should not be a feature of any future price control process. We consider the process was a failure in the RIIO-T2 and GD2 price controls with over 100 proposals being put forward and only 4 accepted at Final Determination, and despite attempts to introduce clearer guidance for RIIO-ED2 it has resulted in only 3 of 24 CVP proposals achieving incentive reward in the BPI.

Significant effort and resource has been invested by DNOs in developing CVP proposals and compiling evidence that Ofgem required. Despite these efforts, it appears that a significant degree of subjectivity remains in the process which has resulted in Ofgem rejecting the vast majority of the proposals. As such, this process is not in the best interests of consumers.

The stark difference in the number of CVPs proposed during the RIIO T2 and GD2 process and the RIIO-ED2 process shows that Ofgem's approach is impacting innovation. Network companies will exclude such projects from their business plans in the future if they know they are likely to be rejected by Ofgem.

Notwithstanding our concerns outlined above, we agree that, for the small number of CVPs that have received a CVP reward, it is sensible for companies to report delivery progress as part of an annual reporting requirement. Furthermore, we agree that the metrics should be CVP specific, and based on measurable actions or outputs rather than consumer benefit which could be unclear. We also support that CVP reward clawback should only relate to the proportion of the CVP that has not been delivered.

As outlined in our response to SPEN-Q4, we disagree with Ofgem's decision to reject the CVP reward proposed within our EV optioneering CVP and believe this decision should be reassessed by Ofgem prior to Final Determination.

## Section 10 - Increasing competition

### Q9. Do you agree with our proposed position on early and late competition?

**SPEN agree with this position.**

SPEN do not have any projects within the price control period which meet the competition criteria set out by Ofgem in their Business Plan Guidance. Nonetheless, we agree with Ofgem's proposed position not to apply any early or late competition models to baseline projects within RIIO-ED2. If at any point during the price control Ofgem want to apply competition models to projects, we would expect to see robust analysis which proves that use of the proposed competition model is in the best interest for consumers. Some Impact Assessment work has been completed in respect of competition in the provision of Transmission projects (which is flawed and outdated). No proper analysis of the risks of the introduction of competition has been carried out in respect of Distribution. It would not be possible just to rely on a transmission related assessment in this regard, because for example interactions with and implications for members of the public, are substantially different to that at a Transmission level.

## Section 11 - RIIO-ED2 in the round, post appeals review and pre-action correspondence

### Q10. Do you have any views on the proposed scope of the FDQ process and pre action correspondence, including on the proposed timing for sending such to Ofgem?

**SPEN agree with Ofgem's proposal to operate a FDQ process.**

#### Pre-action correspondence

SPEN agree with Ofgem's proposal to operate a FDQ process. We think this will help to facilitate the discussion and resolution of errors and could help avoid unnecessary CMA appeal grounds to correct those errors. The process may also assist in documenting and narrowing matters which may be subject to CMA appeal should resolution at that stage prove not to be possible.

In the context of pre action correspondence, SPEN agree that some degree of such correspondence may be beneficial for all parties, consistent with the CMA's Open Letter of 30 October 2019 (issued ahead of the RIIO-2 appeals for GD&T2) to which Ofgem refers.

However, we do not agree with Ofgem's characterisation of the intended scope of such pre-action correspondence. In particular, we note that the CMA states in its Open Letter that:

"Ideally, we would prefer such prenotification to include the potential scope of any appeal, rather than be limited to notification of the potential existence of an appeal."

Ofgem's proposal appears to go further than what the CMA has suggested, in particular that pre-action correspondence should:

" include the scope of any such appeal including, in sufficient detail, the alleged errors, and why that particular component of the price control is wrong having regard to any interlinked aspects of the decision and by reference to the price control in the round "

Ofgem states that this is consistent with the CMA's expectations as set out in the CMA Open Letter at paragraph 15. However, the CMA's position in this respect relates to submissions to the CMA in the

context of an appeal, not specifically to pre-action correspondence with Ofgem. Consequently, Ofgem's position goes beyond the CMA's stated expectations in the CMA Open Letter

Ofgem's requirements as set out in the Draft Determination are also at odds with the conventional reason for encouraging pre-action correspondence in litigation, which is to encourage parties to resolve their differences at any early stage without going to court. It is difficult to envisage, post Final Determination and following the completion of an FDQ process, how pre action correspondence would enable or encourage Ofgem or a potential appellant to resolve any outstanding differences relating to the price control without going to the CMA.

SPEN has and will continue to engage extensively and constructively with Ofgem throughout the price control process and Ofgem will be aware of SPEN's position on key issues. It follows that the scope of Ofgem's proposals for pre-action correspondence is not only contrary to established norms in litigation, but also introduces unnecessary activity into the process

As Ofgem knows, SP Transmission plc (SPT) was an appellant in the RIIO-T2 energy appeals to the CMA. Before the formal appeal process, SPT engaged in pre-action correspondence with Ofgem. Should SPEN consider that a potential CMA appeal is necessary in the context of RIIO-ED2, SPEN remains willing to engage in pre action correspondence. However, for the reasons set out above, SPEN believes that any pre action correspondence should be limited to a high level overview of the potential scope of any appeal, allowing the parties to allocate appropriate resources ahead of any application for permission being made to the CMA.

Whilst we have no particular comments as to Ofgem's proposed timings for the pre-action correspondence process, we would also note that the two-month window following a final price control determination envisaged by Ofgem in the Draft Determination would not provide sufficient time to prepare pre-action correspondence in the level of detail proposed by Ofgem.

### **Interlinkages and post appeals review**

In respect of interlinkages, we do not comment in detail on Ofgem's proposed identified interlinkages at this stage. However, in the context of interlinkages and post appeal reviews, we would note that it is important that any such post appeal price control review should not undermine or contradict any decision made by the CMA, for instance through the alteration of the overall price control package such that it 'neutralises' the effect of any CMA decision.

As Ofgem is aware, the basis for appealing Ofgem licence modification decisions (including price controls) to the CMA is section 11C of the Electricity Act 1989 (EA89). Section 11C provides that an appeal lies to the CMA against a decision to proceed with the modification of a condition of a licence under Section 11A of the EA89.

Sections 11C to 11H of the EA89, along with the Energy Licence Modification Appeals: Competition and Markets Authority Rules published by the CMA in October 2017 (the Rules), set out the process for appealing an Ofgem licence modification decision to the CMA.

Under section 11F of the EA89, where an appeal is in relation to a price control decision, the CMA must do one or more of the following:

- quash the decision (to the extent that the appeal is allowed);
- remit the matter back to the Authority for reconsideration and determination in accordance with any directions given by the CMA; and/or

- substitute the CMA's decision for that of the Authority (to the extent that the appeal is allowed) and give any directions to the Authority or any other party to the appeal.

A determination made by the CMA on an appeal will be contained in an order made by the CMA. That order is binding on Ofgem. Where the CMA gives directions to Ofgem on an appeal, Ofgem "must comply with it" (Section 11F(5) of the EA89)

In light of the overarching statutory framework, any determination made by the CMA on appeal against a price control decision must be regarded as determinative of the matters appealed, unless any party seeks to challenge them further by way of judicial review. Ofgem cannot unilaterally overturn elements of a final determination by the CMA or to undo elements of the CMA's determination with which it disagrees. While Ofgem may have some discretion on the implementation of a particular order made by the CMA (in terms of Section 11H(3) of the EA89, Ofgem is under a duty to "take such steps as it considers requisite for it to comply with" the CMA's order), that will ultimately depend on the nature of the order made by the CMA. Moreover, when implementing any such order Ofgem is under a general public law duty to act lawfully and not to frustrate the purpose of the CMA's determination. The extent of any post appeals review that Ofgem could lawfully conduct is therefore constrained by the terms of the final order made by the CMA

## Section 12. Access and Forward-looking Charges Significant Code Review

**Q11. Do you agree with our proposal to not introduce a specific uncertainty mechanism to manage the impact of the Access SCR (and address it through the LRE mechanisms instead)?**

**SPEN broadly agree with the proposals to manage the impact of the Access SCR through the LRE mechanisms.**

The outcomes and impacts from the Access SCR carry significant uncertainty but are likely to profoundly affect the behaviour and considerations of new and existing customers connected to our network

We agree with Ofgem's approach not to separate the Access SCR related costs from load related expenditure (LRE). It would not be practical to identify and separate those connections progressed as a result of SCR from those which would have progressed anyway. The proposed package of LRE uncertainty mechanisms must therefore be sufficiently agile to also cater for the increased uncertainty arising from Access SCR

At the lower voltages, the newly introduced automatic volume drivers within CV2 should sufficiently cater for uncertainty on the LV and HV networks

The LRE Reopener is expected to handle the increased activity in all other areas of load. The shallower connection charges, and improved access rights will drive a strong need for wider, more strategic, system level capacity to be made available and funded via the price control. This will impact the primary and fault level network reinforcement costs (CV1 and CV3). Schemes at this level typically have a long lead time, and the accessibility and timing of the LRE Reopener will be important to avoid delays in the connections process.

However, within LRE an area that would warrant further consideration is whether the change in levels of DUoS funded connections costs (C2) could potentially be dealt with via an annual true-up. These are reinforcement costs that move from customer funded to DUoS funded as a result of SCR changes, or curtailment fees incurred outside of DNO activity e.g. where underlying customer demand and generation behaviour changes.

Outside of LRE, we expect that Closely Associated Indirect costs may need to flex based on connections behaviours, for example to facilitate increased upfront design works and pre-engineering assessments. These costs are presently outside of the LRE Reopener and we request that Ofgem review this uncertainty following the Access SCR re submission. We are committed to continuing to work closely with Ofgem to refine and develop these mechanisms further.

## 2. Core Methodology Questions

### Section 2. Embedding the consumer voice in RIIO-ED2

**Core-Q1. Do you agree with our proposals for the enduring role of the CEG?**

**SPEN broadly agree with the proposals for an enduring role for an independent engagement group.**

We agree that the CEG played an important role in the quality of our final business plan and have committed to moving forward with a similar independent group, who will continue to provide scrutiny and challenge of our performance and business plans, ensuring our customers and stakeholders have sufficient input to our business decisions. SPEN are currently developing the terms of reference for our new independent group which will be responsible for reviewing both our Distribution and Transmission licences, enabling the group to take a whole system view. Based on our experience, this approach will deliver multiple benefits including best value for money for consumers, avoiding the risk of duplication across multiple stakeholder groups.

We agree with Ofgem's proposal for the role of the enduring group, including performance monitoring against commitments and offering both challenge and guidance in the development of price control business plans. We believe it is, however, important to adopt a collaborative approach between DNOs and independent groups to ensure expert group members are free to contribute with constructive advice and guidance if they wish.

For this reason, we strongly suggest Ofgem consider the language it uses in future guidance. The tone of solely scrutiny and challenge have deterred members from taking a co-creative approach with the DNOs and limiting the scope of their participation in the process. During the RIIO-ED2 process, our CEG often felt unable to provide more constructive advice, as they believed their role was solely to challenge our business plan proposals. This represents a missed opportunity for expert stakeholders to influence and guide our decision making as a business.

We would suggest the guidance wording to be aligned to 'co-create' which encourages open dialogue and best practice sharing – not just scrutiny

We believe this wider view will add further value to our decision making and maximise the best outcomes for customers and stakeholders.

**Core-Q2. Do you see value in the CEGs working together to deliver more coordinated and comparative reporting on some of the DNOs' Business Plan commitments?**

**SPEN see value in the chairs of the independent groups working together to share best practice, resulting in equal benefit for all the networks and their customers and stakeholders.**

However, we have a concern about comparative reporting of Business Plan commitments of the varying DNOs. In our view, the diverse nature of commitments across each of the DNOs would make it impossible for the CEGs to draw meaningful comparisons between DNOs.

Subject to that, as the groups are independent, it is our view that it should be left to independent chairs to decide on the most appropriate reporting format for their group, which could incorporate common elements if they feel this would be suitable.

### Section 3. Networks for Net Zero

**Core-Q3. Do you agree with our proposal to adjust allowances to £2.68bn to account for the concerns highlighted by our assessment?**

**SPEN recognise Ofgem's approach to setting a common baseline for UMs and support in practice, but technically disagree with the ST scenario in our DFES.**

We can understand Ofgem's preference to normalise DNO forecasts to more conservative baselines, with DNOs flexing up from this low base. This aims to protect customers from a risk that DNOs don't invest the allowances given.

This preference places much greater importance on uncertainty mechanisms than we had anticipated. This makes it essential that they enable both reactive and proactive interventions, as well as being accessible and providing confidence to invest without the risk of exposure of clawback for justified work. We are committed to continue to work closely with Ofgem to refine and develop these mechanisms further.

It is important for the UMs to enable proactive interventions above Ofgem's selected baseline as the System Transformation scenario does not achieve the interim carbon targets<sup>3</sup> and is reliant on hydrogen at a time when the technical case at a domestic level has not yet been adopted by BEIS. It also has the lowest growth of LCTs and DG of all Net-Zero compliant scenarios, and the outcomes from the Access SCR decision will accelerate the need for network capacity.

**Core-Q4. Do you agree with our proposed secondary reinforcement volume driver and LV services volume driver and the associated controls?**

**SPEN agree with the proposals.**

We believe the proposed volume drivers for secondary reinforcement and LV services are a significant step forward in the RIIO framework and we are committed to continuing to work closely with Ofgem to refine and develop these mechanisms in the lead up to RIIO-ED2.

The RIIO-ED2 framework will be required to respond to the scale of the Net Zero challenge by enabling DNOs to vary investment to ensure LCT adoption and decarbonised generation connections are not constrained, and to ensure customers continue to receive a safe, secure, and reliable electricity supply. The lower LRE baseline provided in the draft determination places a much greater importance on these uncertainty mechanisms. The Secondary Reinforcement Volume Driver and LV Services Volume Driver will need to cater not just for interventions undertaken reactively, but also for coordinated proactive delivery without the risk of clawback, providing the work is justified.

We support these uncertainty mechanisms operating based on delivered activity. During the RIIO-ED2 period, it will be vital that these mechanisms are as cost reflective as possible, to enable DNOs to

---

<sup>3</sup> "Two scenarios – Leading the Way and Consumer Transformation – see Britain reduce its emissions by 2035 by the 78% (from 1990 levels) committed to in the recent sixth Carbon Budget."

<https://www.nationalgrideso.com/news/introducing-our-2021-future-energy-scenarios>

confidently and proactively adjust their plans based on customer LCT uptake without the risk of over/under delivery. We welcome, and strongly support, the proposed provision for an in period review of the unit costs. It is our view that the unit costs for the LV Services Driver in particular will be impacted by recent upwards pressure on contract rates, and the more prevalent use of 3 phase services to future proof installations to ensure they are 'Net Zero ready'. We will continue to work with Ofgem to ensure unit costs in the Volume Drivers are, and continue to be, as accurate as possible.

The scale of activity at this level means that administration of the volume driver must not be overly burdensome, and should recognise interactivity with challenges around LCT notifications, the rollout of substation monitoring, and changes in underlying demand. There may be cases where secondary network reinforcement activity needs to be justified by a more qualitative approach. For example, fault level, power quality, voltage uprating schemes etc. In these cases, the level of justification required should be commensurate with the level of adjustment in allowance.

The introduction of a volume driver cap provides protection for customers. We welcome these protections but note that this cap needs to be carefully set and regularly reviewed to avoid the risk of restricting LCT growth. We note that the use of the CCC Balanced pathway is not the top of the scenario range, particularly for the heat decarbonisation pathways. We would welcome additional transparency in the translation between the CCC Balanced pathway and the upper cost cap for the Secondary Reinforcement Volume Driver.

#### **Core-Q5. Do you agree with our proposed LRE re-opener?**

**SPEN support the modifications to the LRE re-opener; however, the need for agility and accessibility at primary project level warrants further consideration.**

Within Core-Q3 we highlight that setting a conservative baseline, whilst protecting customers, places much greater importance on uncertainty mechanisms making it essential that they enable both reactive and proactive interventions. The shallower connections boundary within the Access SCR decision also significantly increases the level of uncertainty that will be required to be managed by this re-opener.

The load related reopener in the RIIO-ED1 framework includes a 20% deadband. This deadband disincentivises companies to invest over their baseline load related allowances. We view the removal of this deadband as a positive step toward enabling the more agile allowances. However, the proposed materiality threshold at 1% of base revenue is set too high, this equates to 30-40% of the component of our LRE not already covered by volume drivers. This limits access to the UM, and we believe this materiality threshold should be removed or significantly reduced to enable companies to have agility when responding to evolving Net Zero requirements.

The proposal provides for a single DNO triggered reopener window in year 3 of the price control. The timing and triggering of the reopener will be pivotal in facilitating the progression of Primary projects without risk of significant delays.

Primary projects have much longer lead times than at lower voltages and cannot wait for a reactive approach. Delays at this level risk significantly increasing network risks and have the potential to constrain uptakes to the lower forecasts – particularly for generation. A key consideration for the LRE re-opener is to ensure the DNOs have confidence to invest proactively.

Throughout RIIO-ED2, the impacts of Access SCR have the potential to significantly increase the requirements for major primary level projects. The shallower connection charges, and improved access rights will drive a strong need for wider, more strategic, system level capacity to be made available and funded via the price control. Depending on customer behaviour, we anticipate that increases in primary level projects may need to start early in RIIO ED2.

Within Core-Q65 we highlight significant differences between the outcomes of the disaggregated benchmarking, and the EJP assessments. This risks a lack of clarity over which Primary schemes are included / excluded within ex ante funding. Delays in progression of primary intervention schemes until year 3 – even though they have already been identified as required, included in our Baseline proposals, and reviewed as justified – will significantly increase the likelihood that these projects will not be completed within RIIO-ED2. This will bring with it increased network risks through delays to necessary intervention. To avoid this, we would welcome Ofgem applying more weighting to the Ofgem engineering team's EJP review. We also propose DNOs will need the ability to trigger the reopener throughout the period and on a project by-project basis.

We would welcome Ofgem further considering the administration of this reopener.

**Core-Q6. Do you agree with our proposed approach to the Net Zero re-opener?**

**SPEN agree with the proposal to have the Net Zero reopener in place, however, DNOs should also be able to trigger this reopener and we do not agree with the materiality threshold set.**

We agree with the proposal to have a reopener which is sufficiently broad in scope to capture additional allowances that DNOs would require to meet Net Zero targets if there is an accepted government policy shift or technological advance.

However, we believe that this reopener should be able to be triggered by the DNOs and not just by Ofgem. In many situations, DNOs will have better (or earlier sight of) information than Ofgem in relation to issues that are relevant to triggering the re-opener (for example, changes driven by local communities and devolved regions). It is therefore essential that Ofgem implements a clearly defined and transparent engagement process to allow DNOs and other stakeholders to put forward evidence supporting any relevant change of circumstances that may justify triggering the NZ re opener (for example, submissions to the Net Zero Advisory Group (NZAG) or Ofgem via calls for evidence).

We do not agree with the level of materiality threshold that has been proposed by Ofgem. As outlined in our response to the Overview document's Q6, we believe that 1% base revenue is arbitrary and far in excess of the costs of administering these proposals, and that a lower re-opener threshold of 0.5% of base revenue should be used.

Ofgem's overall policy for RIIO-ED2 is to use more reopeners and agree to less upfront allowance, this policy means DNOs will be exposed to more costs that fall under these materiality thresholds and does not represent an equitable balance of risk.

In the Gas Distribution and Transmission sectors, we note that a materiality threshold of 1% was proposed at Draft Determination, and this was reduced to 0.5% at Final Determination following stakeholder responses; there is no evidence to suggest that the Electricity Distribution sector should have a materiality threshold set at double the rate of these other sectors. Such an approach leads to a position where DNOs will not be properly funded for their activities.

**Core-Q7. Do you agree with our proposed approach to the value of the SIF?**

**SPEN accept the proposed approach.**

While we note that the SIF has not been increased to accommodate RIIO ED2, we also note that Ofgem intend to keep its size under review during the price control period

We believe there is a likelihood that the total value of the SIF will need to increase throughout RIIO 2 as Transmission and Distribution companies progress, complete and integrate innovation projects

We agree with the proposed factors to consider whether there is a need for additional SIF funding, and therefore agree with the proposed approach. Although we note Ofgem have not clarified the points in time at which the value of the SIF will be reviewed, and we would advocate this should be no later than the end of the third regulatory year, aligned with the proposed NIA review.

**Core-Q8. Do you agree with our proposed approach to weighting SSMD criteria and benchmarking RIIO-ED2 NIA requests against RIIO-ED1?**

**SPEN agree with the proposed approach to weighting SSMD criteria, however we do not agree with the proposed benchmarking approach for RIIO-ED2 NIA requests against RIIO-ED1.**

Referring to RIIO ED2 Business Plan Guidance, paragraph 4.38, Ofgem asked that companies set out and justify the level of NIA funding requested and, referring to the NIA focus areas, how much NIA funding they believe is necessary for each of these areas of focus. The expectation therefore was that the level of NIA funding requested by each DNO would be considered.

The proposed approach to weighting SSMD criteria is sensible, and we agree that Ofgem should evaluate the overall strength of a DNO's submission by grading innovation strategies against these criteria. We note Ofgem have elected to apply an equal weighting of 20% of total award to each of the criteria. We agree with this approach in the absence of a critical analysis to set alternative weightings.

Referring to the RIIO ED2 Draft Determination Core Methodology document, paragraph 3.124 states that Ofgem assessed whether any DNOs had provided evidence that justifies awarding more NIA than was available in RIIO ED1. If a DNO provided a strong, well-evidenced case, they would increase its allowance accordingly. However, by setting the maximum award in RIIO ED2 as 0.5% of base revenue for DNOs who have met all five criteria as set out in the RIIO ED2 SSMD, it is not clear how this approach would facilitate an increase in allowance when all DNOs received a minimum of 0.5% in RIIO ED1. We therefore believe that Ofgem have not provided a fair opportunity for DNOs to obtain a greater NIA allowance than was available in RIIO-ED1.

Within our Innovation strategy, we set out indicative project-specific allowances in line with Ofgem's NIA guidance and our stakeholder engagement exercises, although this reflects an increase on RIIO-ED1 levels it was not determined by calculating a % of Totex. We believe this approach gives strong confidence in the levels of NIA expenditure required, consistent with 4.38 of the Business Plan Guidance. However, by benchmarking to the lower of RIIO ED1 allowances or requested RIIO-ED2 allowances, the current approach constrains RIIO-ED2 innovation activity based on RIIO-ED1 innovation strategies. This position is difficult to align with the increased focus on innovation to support Net Zero ambitions.

**Core-Q9. Do you agree with our proposed approach to setting NIA allowances?**

**SPEN partly agree with the proposed approach. Please also see our response to Core-Q8.**

We believe that although the NIA and SIF are both viable routes to progress innovation in RIIO ED2, they are not interchangeable and NIA has an important role to play to enable smaller-scale innovation trials, and projects at low technological readiness, ahead of BAU or Totex funded innovation integration.

We note Ofgem's comments in paragraph 5.8 of the RIIO-ED2 Draft Determination SPEN Annex stating that they consider that any additional innovation required to accelerate decarbonisation can be undertaken using SIF funds, alongside DNO BAU funds. We do not agree with this.

During RIIO-ED1, NIA has been a highly successful mechanism for the funding of innovation projects. As part of our RIIO ED2 Business Plan, Appendix V of SPEN Business Plan Annex 2 presents a table of

104 innovation projects that have either been rolled out as business as usual, will be ready for deployment within RIIO-ED2 or have generated learnings that have directly impacted our RIIO-ED2 programmes of work. Of these 104 projects, 91 projects have been funded using NIA.

Table 1 of SPEN Business Plan Annex 2 1 presents innovations that have been embedded within our RIIO ED2 plan, referenced to our associated Engineering Justification Papers. These innovations have driven a £87.2m savings in Totex expenditure for RIIO-ED2, more than £60m of this is attributed to NIA funded projects Tables 2 to 5 present other NIA funded projects that are generating benefits for digitalisation, DSO, network performance and sustainability.

Over RIIO-ED2 there remains a significant requirement for innovation funding for projects which are not incentivised by Totex but will, importantly, help to facilitate the energy system transition and ensure that vulnerable customers are not left behind. Innovation stimulus allows us to pursue lower Technology Readiness Level (TRL) concepts, and to stimulate the innovation supply chain, rather than focussing solely on large SIF funded projects, or high TRL BAU funded projects. In this way, NIA funding fills an important innovation funding gap and plays a vitally important role in facilitating innovation that would otherwise not progress.

**SIF is not a replacement for NIA.** The SIF competitive process is resource intensive and has greater regulatory requirements e.g. project specific directions and Ofgem approval, as such there is a limit to the number and value of innovation projects that can be delivered by this route. We consider the SIF process is designed to deliver a small number of high value projects – acting as a replacement for the Network Innovation Competition (NIC). In contrast, the NIA delivers a broad range of smaller projects, emphasised by the high proportion of NIA projects delivering benefits in our RIIO-ED2 plan.

**BAU funding is not a replacement for NIA.** All networks have set out clear intentions to fund innovation through BAU, however this is generally where there is high certainty around the outcome, and benefits can be delivered quickly within the current price control period. NIA and SIF provide an important funding route for projects where there is greater uncertainty or risk, where there are longer timescales (including lower TRL projects), or where the project benefits are likely to outweigh costs only when benefits to the wider industry are considered. We believe the decision to limit the NIA award to the first three years of RIIO-ED2, dependant on the review scheduled for 2025, will create uncertainty in the project pipeline and for stakeholders who rely upon the funding mechanism. We request that Ofgem should instead award NIA for the full RIIO ED2 period. It is clearly in the interests of consumers, for Ofgem to continue to support funding innovation.

**Core-Q10. Do you agree with our proposal to allow DNOs to carry over any unspent NIA funds from the final year of RIIO-ED1 into the first year of RIIO-ED2?**

**SPEN agree with this proposal.**

We agree with this proposal as it will avoid uncertainty with live projects that may not finish prior to the end of RIIO-ED1. It will also ensure these projects are delivered without reducing the opportunities for RIIO ED2 NIA projects.

**Core-Q11. Do you agree with our proposed approach for the Annual Environmental Report ODI-R? SPEN agree with this approach.**

It is consistent with what was presented in the Decarbonisation and Environment Working Group and in line with the requirements for TOs. Consistency of reporting across the industry will provide clear and robust information for our stakeholders.

**Core-Q12. What are your views on the proposed mid-period review on DNO environmental performance and their progress to targets?**

**SPEN agree with this proposal.**

SPEN believe that a mid-period review would be appropriate and would strengthen the ODI-R. The mid-period review should be conducted in such a way as to minimise duplication of effort on the part of the DNOs and Ofgem. SPEN suggest that the Annual Environment Report for the relevant (3rd) year, which will document progress to targets and commitments, should provide the basis for such a review.

**Core-Q13. Do you agree with our consultation position for the DNOs' EAP proposals in RIIO-ED2 as set out in this document?**

**SPEN agree with the consultation position for all EAP proposals with the exception of Biodiversity and Natural Capital and Carbon Offsetting.**

**Biodiversity and Natural Capital**

SPEN proposed £8m of biodiversity enhancement funding across two initiatives. Ofgem has agreed to funding of only £0.5m for biodiversity enhancement initiatives across 25 hectares of our non operational land and existing linear infrastructure. No funding has been awarded for 500 biodiversity units across our networks on project and programmes as Ofgem raised concerns in the Draft Determination and during consequent bilateral discussions on our proposal.

We have provided further detail on our proposal within Annex 2: SPEN – Biodiversity and Natural Capital and we believe this should alleviate concerns Ofgem has raised. Our planned approach aligns with the direction of government policy and is supported by our stakeholders. A lack of funding in this area will impact our ability to minimise impact and provide net gains for biodiversity. It should be noted that we have adapted our approach to propose to deliver 337 Biodiversity Units at a cost of £5.5m over the course of RIIO-ED2. Annex 2: SPEN – Biodiversity and Natural Capital explains why we have made this change.

Without prejudice to our request for funding, if Ofgem retains the DD position of only allowing £0.5m for our non-operational land and existing linear infrastructure proposal then we do not believe this should be a PCD. We believe the value of funding does not merit the administrative burden associated with a PCD and is well below the £15m bespoke PCD threshold set by Ofgem in the SSMD. From discussions with Ofgem, we believe that they agree, and we expect Biodiversity and Natural Capital to be removed as a PCD in the Final Determination.

**Carbon Offsetting and removal**

SPEN understand Ofgem's concerns that there is a risk that the out-turn volumes will differ from the volumes proposed. Our Scope 1 & 2 carbon emissions have been measured and monitored over a number of years – and we have made significant carbon reductions through RIIO-ED1. We have identified a number of cost effective, high impact Scope 1 & 2 carbon reduction initiatives which will be delivered in the RIIO-ED2 Price Control, and these initiatives have been accepted by Ofgem in Draft Determination. We have provided the additional information requested in Annex 1 ED2 NLR(A) SPEN 005-ENV-EJP-ADD – Carbon Offsetting. We have provided the additional information requested in Annex 1: SPEN – EJP Review (ED2 NLR(A)-SPEN 005-ENV-EJP-ADD – Carbon Offsetting)

Further, additional information was requested for several areas within the EAP and is provided below:

### Reducing emissions from building energy use

With regard to Ofgem's queries on renewable generation at DNO sites, as part of our RIIO-ED2 Business Plan we are proposing to primarily focus on achieving a reduction in energy use at substation sites across our distribution network. Second to this, SPEN are proposing to trial renewable generation at substation sites. Additionally, SPEN propose to install renewable generation, where feasible at our operational depots.

SPEN note that the current Prohibition on Generation Guidance (POGG) does not allow for renewable generation to exceed onsite demand on a site-specific basis (see paragraph 2.13.3 of the POGG). SPEN believe that the POGG requirements should be reviewed to enable renewable energy to be generated at operational sites and used to offset operational site usages across the network, i.e., at sites with no renewable generation capacity. For the avoidance of doubt, SPEN agree with the principle that total renewable energy generated should not exceed total energy use across all operational sites. Limiting to specific sites, as is currently the case, restricts the ability of DNOs to maximise renewable generation opportunities and hinders the transition to a Net Zero network. Our proposal would require a small change to the existing requirements in the POGG, however would potentially unlock significant carbon savings benefits and efficiencies by allowing generation at one SPEN site to offset energy consumption requirements at other sites. Provided our proposition is acceptable, we would be pleased to work with Ofgem to review and consider whether any further measures are required to mitigate any (perceived or actual) risks of conflict of interest.

SPEN are proposing, should this be trialled, to install the necessary metering and report on usage through the Distribution Annual Environmental Report.

### Fluid-filled cables

During RIIO ED2, we will replace 19.42km of the highest priority cable in our SP Manweb area. This represents the best intervention after several unsuccessful interventions to stem leaks, lengthy circuit outages needed to ascertain source of leaks and the proximity of the cable circuit to water courses. This intervention will reduce the volume of oil leakage by 3,490 litres (10%) during the RIIO-ED2 period. Full justification for the primary and secondary investment drivers, associated costs, risks to delivery, and optioneering of SPEN's proposed cable replacement and refurbishment programmes can be found in Annex 4A 23 of our RIIO ED2 business plan (ED2-NLR(A)-SPM-001 UG-EJP Bootle Kirkby 132kV Cable Modernisation).

A more detailed breakdown on the environmental benefits of the cable replacement programme are outlined below:

- Reduced risk of release of oil into the environment, which in turn reduces the potential and actual direct environmental impacts to groundwater, land, and surface water, which can include harm to wildlife, loss of habitat and reduced visual amenity
- Reduces the indirect environmental impacts associated with replacing oil lost across the lifecycle of the oil, which can include:
  - Extraction and refining of crude oil: Impacts can include consumption of raw crude oil; disturbance of land; changing of existing landscapes; emissions and raw material consumption associated with the manufacture and operation of extraction and refining equipment and infrastructure; Direct environmental impacts to ground water, land and surface water arising from incidents during the extraction and refining of the crude oil.
  - Transporting, handling, and storing oil for sale and use: Impacts can include emissions and raw material consumption associated with the manufacture and operation of transport, handling, and storage of the oil; Direct environmental

- impacts to ground water, land and surface water arising from incidents during transporting, handling, and storing oil
- Managing incidents and disposing of contaminated items following a fluid filled cable leak, including: Use of spill kits and / or vactanker oil to clear up oil (use of raw materials and energy to manufacture spill kits and vactanker; emissions associated with transport to site / waste management facility); Removal and disposal / treatment of contaminated land; replacement of contaminated land (land take from elsewhere); Cleaning of concrete pipe channels and disposal / treatment of cleaning waste

**PCBs – Please see response to Core-Q16****Core-Q14. Do you agree with our proposal to withdraw the Environmental Scorecard ODI-F for RIIO-ED2?**

SPEN agree with this proposal.

**Core-Q15. Do you agree with our proposed approach to design of the Environmental Re-opener?**  
**SPEN agree with the need for the reopener but have concern that the scope may be restrictive and disagree on the trigger and materiality threshold.**

SPEN agree that there is a requirement for the Environmental Reopener to ensure that DNOs can manage uncertainty on policy requirements. We believe that there could be circumstances now or in the future where such requirements may emerge not just in legislation but, for example, through technical guidance issued by the environment agencies, and therefore propose that the reopener caters for ‘changes to statutory or regulatory requirements’ The licence drafting should reflect this.

In addition, requiring that changes relate to Environmental Action Plans (EAPs) is too narrow for the scope of the re-opener as new requirements may be unrelated to current EAP commitments. Also, as the content of each EAP is DNO specific, the current proposal would mean that the eligibility to use this reopener would vary across DNOs, even when they are required to comply with the same legislation

We do not agree that the Environmental Reopener should be Authority triggered; it is unclear how the Authority will know that DNOs face a significant increase in costs. The process would be easier to understand if, instead of being Authority triggered, the Authority determines a window in which the DNOs can submit a proposal that falls under the scope of the reopener. Such an approach would not remove the ability for Ofgem to accept or reject proposals.

During Working Group discussions, when asked how Ofgem decided which reopeners had materiality thresholds and which should not, the guidance given was that compliance related activities would not have a materiality threshold. With this guidance in mind, we believe that the materiality threshold should be removed from the environment reopener as it is for other compliance related reopeners e.g., Electricity System restoration. Please see our response to [Overview question 6](#) for more detail.

**Core-Q16. Do you agree with our proposal for addressing PCB contamination in PMTs through a volume driver in RIIO-ED2?**

**SPEN partly agree with this proposal.**

SPEN support the use of a volume driver for managing PCBs related costs in RIIO-ED2. SPEN have led the development of an industry-wide PCB analysis model via ENA working groups and have worked extensively to have this model statistically validated and accepted by national environment agencies. As such, we believe we are well placed to comment on the level of uncertainty in this area, and the appropriateness of the proposed volume driver.

SPEN partly agree with the scope and methodology of the volume driver. As set out within our PCB EJP, replacement of PMTs contaminated with PCBs will in some cases require the replacement of the associated HV pole, or protection upgrades. As these assets are replaced consequentially to the PMT, a volume driver should also include provision for associated asset upgrades.

SPEN agree with the use of licensee-specific unit costs for PMTs, and the inclusion of a tiered rate to accommodate upsizing, where appropriate and justified. This is critical to avoid customers paying twice for early asset upgrades on the journey to Net Zero, and to ensure DNOs are sufficiently funded to deliver the required works within their areas.

SPEN understand the proposed use of a sunset clause but are concerned that this is counter to the level of uncertainty. The ENA statistical model of PCBs contamination is informed by the ongoing replacement and disposal testing of PMTs. As this activity will take place throughout RIIO-ED2, the view of which assets need to be replaced will continue to be refined. It is also worth noting, that as with many overhead line schemes, delays can be caused which are outside of DNO control e.g., landowner willingness to allow access to land, grant necessary wayleaves/easements, or to agree re location of assets.

**In relation to Clause 3.181 of the RIIO-ED2 Draft Determination Core Methodology Document, Ofgem request additional information which is outlined below:**

3.181: So far, the DNOs have submitted a variety of proposals to meet their compliance obligation and address this uncertainty. We request that the DNOs provide further data and evidence for the costs and volume of work as part of their consultation responses. If this data and evidence can support the design of a robust volume driver, we propose to confirm the design in our Final Determinations, including the form and granularity of the mechanism to reflect the unit rate(s) and possible upsizing requirements. If the DNOs do not provide sufficient data and evidence, we propose to set an evaluative PCD to ensure appropriate delivery.

SPEN's proposed costs and volumes are based on a bottom-up approach, details of these (both addition and disposal), including forecast PMT ratings are provided in "Workings 5 Extra Info – SPD" and "Workings 5 Extra Info – SPM" tabs of "ED2 NLR(A) SPEN-003-ENV-CBA Management of Persistent Organic Pollutants (POPs) Polychlorinated Biphenyls (PCBs) Issue 2 0"

As covered in "ED2 NLR(A)-SPEN-003-ENV-EJP Management of Persistent Organic Pollutants (POPs) Polychlorinated Biphenyls (PCBs) Issue 2 0", the intervention volumes are based on Option 5

- For PMTs, the volume is forecast based on known and discovery rate of unknown contaminated PMTs (as advised by SPEN-led ENA statistical model).
- Strategic upsizing is considered based on SPEN's best view load/utilisation forecast at each PMT up to the year 2050, where upsizing is deemed necessary if the forecast 2050 load/utilisation is >120% of an existing rating.

- Based on the volume of PMTs needing replacement, the corresponding pole volume was calculated according to the forecast number of HI4 and HI5 poles, as well as the number of PMTs that will be upgraded to 200kVA which require double poles
- A proportion of PMT strategic upsizing required an upgrade to the existing overhead line protection. This involves the replacement of sectionaliser, and the forecast volume has been included in our submission
- Our unit costs are detailed in SPEN Business Plan Annex 5A 5: RIIO ED2 Unit Cost Manual These unit costs were based on the latest supplier/contractor framework pricing available at the time of Final Submission. Forecast volumes were multiplied by these unit costs to calculate the expenditure needed for completing the programme.

The tables below show the SPD and SPM breakdown of the cost, addition volume and disposal volume associated with PMTs, poles and sectionalisers, including PMT breakdown by rating (as provided in ED2 NLR(A) SPEN-003 ENV-CBA)

| SPD                            |                    |                 |       |       |       |       |
|--------------------------------|--------------------|-----------------|-------|-------|-------|-------|
| RIGs Asset Category            | Description        | Cost/Volume     | 23/24 | 24/25 | 25/26 | Total |
| 6.6/11kV Transformer (PM)      | <25kVA PMT         | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM)      | <25kVA PMT         | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (PM)      | <25kVA PMT         | Disposal Volume |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 25kVA PMT 1ph      | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 25kVA PMT 1ph      | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 25kVA PMT 1ph      | Disposal Volume |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 50kVA PMT 1ph      | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 50kVA PMT 1ph      | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 50kVA PMT 1ph      | Disposal Volume |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 50kVA PMT 3ph      | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 50kVA PMT 3ph      | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 50kVA PMT 3ph      | Disposal Volume |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 100kVA PMT 3ph     | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 100kVA PMT 3ph     | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 100kVA PMT 3ph     | Disposal Volume |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 200kVA PMT 3ph     | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 200kVA PMT 3ph     | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (PM)      | 200kVA PMT 3ph     | Disposal Volume |       |       |       |       |
| 6.6/11kV Transformer (GM)      | 500kVA GMT         | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (GM)      | 500kVA GMT         | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (GM)      | 500kVA GMT         | Disposal Volume |       |       |       |       |
| 6.6/11kV Poles                 | HV Pole            | Cost (£m)       |       |       |       |       |
| 6.6/11kV Poles                 | HV Pole            | Addition Volume |       |       |       |       |
| 6.6/11kV Poles                 | HV Pole            | Disposal Volume |       |       |       |       |
| 6.6/11kV Switchgear Other (PM) | Sectionaliser Only | Cost (£m)       |       |       |       |       |
| 6.6/11kV Switchgear Other (PM) | Sectionaliser Only | Addition Volume |       |       |       |       |
| 6.6/11kV Switchgear Other (PM) | Sectionaliser Only | Disposal Volume |       |       |       |       |

| SPM                       |                |                 |       |       |       |       |
|---------------------------|----------------|-----------------|-------|-------|-------|-------|
| RIGs Asset Category       | Description    | Cost/Volume     | 23/24 | 24/25 | 25/26 | Total |
| 6.6/11kV Transformer (PM) | <25kVA PMT     | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM) | <25kVA PMT     | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (PM) | <25kVA PMT     | Disposal Volume |       |       |       |       |
| 6.6/11kV Transformer (PM) | 25kVA PMT 1ph  | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM) | 25kVA PMT 1ph  | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (PM) | 25kVA PMT 1ph  | Disposal Volume |       |       |       |       |
| 6.6/11kV Transformer (PM) | 50kVA PMT 1ph  | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM) | 50kVA PMT 1ph  | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (PM) | 50kVA PMT 1ph  | Disposal Volume |       |       |       |       |
| 6.6/11kV Transformer (PM) | 50kVA PMT 3ph  | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM) | 50kVA PMT 3ph  | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (PM) | 50kVA PMT 3ph  | Disposal Volume |       |       |       |       |
| 6.6/11kV Transformer (PM) | 100kVA PMT 3ph | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM) | 100kVA PMT 3ph | Addition Volume |       |       |       |       |
| 6.6/11kV Transformer (PM) | 100kVA PMT 3ph | Disposal Volume |       |       |       |       |
| 6.6/11kV Transformer (PM) | 200kVA PMT 3ph | Cost (£m)       |       |       |       |       |
| 6.6/11kV Transformer (PM) | 200kVA PMT 3ph | Addition Volume |       |       |       |       |

|                                |                    |                 |  |  |  |  |  |  |  |  |  |
|--------------------------------|--------------------|-----------------|--|--|--|--|--|--|--|--|--|
| 6.6/11kV Transformer (PM)      | 200kVA PMT 3ph     | Disposal Volume |  |  |  |  |  |  |  |  |  |
| 6.6/11kV Transformer (GM)      | 500kVA GMT         | Cost (£m)       |  |  |  |  |  |  |  |  |  |
| 6.6/11kV Transformer (GM)      | 500kVA GMT         | Addition Volume |  |  |  |  |  |  |  |  |  |
| 6.6/11kV Transformer (GM)      | 500kVA GMT         | Disposal Volume |  |  |  |  |  |  |  |  |  |
| 6.6/11kV Poles                 | HV Pole            | Cost (£m)       |  |  |  |  |  |  |  |  |  |
| 6.6/11kV Poles                 | HV Pole            | Addition Volume |  |  |  |  |  |  |  |  |  |
| 6.6/11kV Poles                 | HV Pole            | Disposal Volume |  |  |  |  |  |  |  |  |  |
| 6.6/11kV Switchgear Other (PM) | Sectionaliser Only | Cost (£m)       |  |  |  |  |  |  |  |  |  |
| 6.6/11kV Switchgear Other (PM) | Sectionaliser Only | Addition Volume |  |  |  |  |  |  |  |  |  |
| 6.6/11kV Switchgear Other (PM) | Sectionaliser Only | Disposal Volume |  |  |  |  |  |  |  |  |  |

For completeness, the table below describes the content of the key tabs in ED2-NLR(A)-SPEN-003 ENV CBA that captured the decision making process behind SPEN's submission.

| Tab Names   | Description of Content   |
|---|--|
| Baseline Scenario Option 1, Option 2, Option 3, Option 4, Option 4s_a, Option 4s_b, Option 5  | These tabs are used to calculate the Net Present Values of the proposed investments considering their respective costs and benefits.   |
| Workings Baseline Option 1, Workings 2, Workings 3, Workings 4, Workings 4s_a, Workings 4s_b, Workings 5  | These tabs include the values of the costs and benefits of each option, including the information on volumes of investments.   |
| Cost of Carbon Catalogue  | This tab lists the cost of carbon associated with asset replacements.  |
| Workings 1 Extra Info – SPD, Workings 2 Extra Info – SPD, Workings 3 Extra Info – SPD, Workings 4 Extra Info – SPD, Workings 5 Extra Info – SPD | These tabs include the SPD costs, addition volumes and disposal volumes of proposed interventions, including a detailed view of the breakdown of capacity/rating of pole mounted transformers to be replaced.  |
| Workings 1 Extra Info – SPM, Workings 2 Extra Info – SPM, Workings 3 Extra Info – SPM, Workings 4 Extra Info – SPM, Workings 5 Extra Info – SPM | These tabs include the SPM costs, addition volumes and disposal volumes of proposed interventions, including a detailed view of the breakdown of capacity/rating of pole mounted transformers to be replaced.  |
| SPEN-Led ENA Model – Snippet  | This tab shows the summary page from the SPEN led ENA statistical model output visualisation workbook.   |
| SPD PMTs Summary, SPM PMTs Summary  | These tabs show the detailed breakdown of SPD and SPM in-service pole mounted transformer populations, the volumes associated with the risk categories in the SPEN-led ENA statistical model as well as the resultant cost and volume for each of the options. |
| GMTs Testing Needs  | This tab shows the volumes of ground mounted transformers that need in-service oil testing for PCBs.   |
| RIIO-ED2 Unit Costs   | This tab shows the unit costs used for calculating the cost of the PCBs programme. Breakdown of activities contributing to the cost of replacing pole mounted transformers of different ratings is also included.  |
| SPD Non-Green <1987 – Loss, SPM Non-Green <1987 – Loss  | These tabs show the annual losses savings in SPD and SPM for replacing like-for-like the pole mounted transformers that are in-scope for PCBs.   |
| SPD Non-Green <1987 Upsi – Loss, SPM Non-Green <1987 Upsi – Loss  | These tabs show the annual losses savings in SPD and SPM for replacing (with strategic uprating/upscaling) the pole mounted transformers that are in-scope for PCBs.   |

## Section 4. Supporting a smarter, more flexible, digitally enabled energy system

**Core-Q17. Do you agree with our proposal for implementing a Digitalisation Licence Obligation? SPEN agree with this proposal.**

We believe that the timings for publication of the Digitalisation Strategy should be considered further and would seek consideration on alignment across Transmission and Distribution, for companies who hold both licences. This is detailed further under Core-Q18. We would also seek further consideration on the need for updates every six months, as opposed to annual updates

**Core-Q18. Do you agree with our proposal to have staggered publications of Digitalisation Strategies between RIIO-ED2 and RIIO-2 licensees?**

**SPEN do not agree with this proposal.**

Whilst we agree that delaying publication of the first DNO Digitalisation Strategy by a year would present loss of information to stakeholders, we would argue that for companies holding both Transmission and Distribution licences, the alignment of the Digitalisation Strategy could occur on 1<sup>st</sup>

April 2023 and still align to the transmission licence condition and guidance to publish a refreshed Digitalisation Strategy “at least every 2 years<sup>4</sup>” In our case, our SP Transmission Digitalisation Strategy will therefore be published on 1<sup>st</sup> April 2023 as a combined RIIO-T2 and RIIO-ED2 document, meaning a combined document could continue to be published every 2 years

As Ofgem is aware, many of the processes and technology platforms are shared across our Transmission and Distribution businesses. Whilst costs have been apportioned appropriately across our plans, requiring a staggered publication of Digitalisation Strategies between RIIO-ED2 and RIIO-2 licensees would create significant duplication of internal activities. In addition, we have created a joint SP Energy Networks website<sup>5</sup> which covers Transmission and Distribution plans. This provides a clear, digital update on our Digitalisation Strategy and Action Plans. We believe staggering publications would create confusion for stakeholder groups and would not offer value for money

**Core-Q19. Do you agree with our proposed Digitalisation re-opener?**

**SPEN broadly agree with this proposal.**

Based on the potential changes in the energy sector we believe that a re opener for Digitalisation will allow us to re-assess our plans with stakeholders and customers and ensure we are able to offer the latest products and services to help to deliver the UK’s Net Zero targets.

It will be important that this re opener caters for increased requirements for LV network monitoring in the higher uptake scenarios. I.e. enabling us to flex up from the targeted deployment of 14,103 HV/LV substation monitors if significantly higher volumes of LCTs were to connect than considered in our baseline forecast. Also, the reduction in reinforcement contributions due to the Access SCR proposed changes are expected increase connections activities across all voltages. It will not always be possible, timely, or cost effective to provide customers with unconstrained connections in the short term. Flexible, smart, and innovative solutions will play an important role in facilitating the pace of connections and will provide both a short-term solution and clear evidence for future reinforcement requirements. Additional DSO Constraint Management Zones (CMZs) will be fundamental to facilitate generation uptake.

As this re opener is to achieve compliance with changes in legislation, licences, or industry codes, consistent with Ofgem’s indication that compliance related activities would not have a materiality threshold, we believe that the materiality threshold should not apply to the Digitalisation re-opener

**Core-Q20. Do you agree with the proposed enhanced reporting framework associated with IT/OT Data and Digitalisation spend and DSAP investment proposals?**

**SPEN agree with this proposal in principle, however, please see our response to Core-Q21 for details of our concerns on how the enhanced reporting framework will be introduced.**

**Core-Q21. Do you agree with our proposal to adopt TBM as part of the RIGs/RRP?**

**SPEN agree with this proposal in principle, however, please see below areas which we would wish to highlight for consideration.**

We agree in principle that the adoption of TBM as part of the RIGs/RRP will increase transparency of DSAP investments and could facilitate comparability across DNOs (and other network companies) if implemented in a consistent way, and with sufficient consultation to allow such consistency. We

<sup>4</sup> [Digitalisation Strategy Action Plan Guidance v1.pdf \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/digitalisation-strategy-action-plan-guidance-v1.pdf)

<sup>5</sup> [www.spenergynetworks.co.uk/digitalisation](http://www.spenergynetworks.co.uk/digitalisation)

would suggest that the following factors be taken into consideration as part of the process of introducing TBM as part of the RIGs/RRP:

- The scope of application of TBM needs to be tightly defined. As currently proposed, it would cover DSAP investments and therefore exclude IT, OT, Digitalisation and Data spend that does not meet the definition of Digitalisation (“the use of digital technologies to change an organisation’s operating model”). The interpretation of what should be included in the TBM reporting needs to be clearly defined and consistent across DNOs.
- The alignment between DNOs on the application of TBM and interpretation of the taxonomies will take time to implement, and it is likely that it will evolve from the initial implementation. In order to ensure DNOs are fully aligned, and to ensure sufficient RIGs and RRP consultation, the timeline for the project will require careful consideration
- Given the uncertainty in the functional model of the DSO arrangements, and the variance in proposals from DNOs, there is the potential that the functional model adopted by each DNO will result in different costs and expenditure, which will need to be considered when comparing DNO data. DNOs will also be at different maturity levels with respect to their Data and Digitalisation activities. Comparisons between DNOs will need to take account of this.
- The implementation may require significant changes to capturing, reporting, and analysing forecast and actual spend. Whilst we incorporated costs in our plans to continue to enhance our reporting systems and processes, there may be unforeseen costs and request the opportunity to seek additional funding where appropriate

We would request a project timeline with key dates and contacts for the proposal to adopt TBM as part of the RIGs/RRP and would seek clarity on expectations from DNOs such that we can sufficiently plan and adequately resource these requirements.

**Core-Q22. Do you agree with our intention to modernise the regulatory reporting process?**  
**SPEN agree with this proposal in principle, however, please see below areas which we would wish to highlight for consideration.**

Through the changes we have put forward as part of our Digitalisation and Data Strategies, we will collect, validate, process, analyse and report on more data at increased granularity across our activities, and share our data openly following Ofgem’s Data Best Practice guidance principles. We see the modernisation of the regulatory reporting process as an extension of this activity, providing increased transparency of our operation and improving confidence for our stakeholders.

However, in line with our considerations highlighted above as part of Core-Q21, we would request consideration of the following.

- The modernisation and alignment between DNOs processes and systems will take time to implement, and it is likely that it will evolve from the initial design. In order to fully align DNOs, and to ensure sufficient RIGs and RRP consultation, the timeline for the project will require careful consideration.
- DNOs will be at different maturity levels with respect to their regulatory reporting. Whilst we have been on a journey to modernise and automate our RRP reporting since the implementation of our NAMS system in January 2018, we recognise that all DNOs are on different journeys. We also note that these system solutions require extensive retraining of our workforce as part of the implementation, and this must be a consideration when developing the implementation plans
- The implementation may require significant changes to SPEN’s approach to capturing, reporting, and analysing forecast and actual spend. Whilst we incorporated costs in our

plans to continue to enhance our reporting systems and processes, there may be unforeseen expenses and would request the opportunity to seek additional funding through appropriate mechanisms.

- SPEN's regulatory reporting framework covers both of our distribution licences and our transmission licence Given the distinct differences between the Distribution and Transmission RRP packs, careful consideration would be required if these were to be aligned.
- The implementation may require significant changes to capturing, reporting, and analysing forecast and actual spend Whilst we incorporated costs in our plans to continue to enhance our reporting systems and processes, there may be unforeseen costs and request the opportunity to seek additional funding where appropriate

We would request a project timeline with key dates and contacts for the proposal to adopt TBM as part of the RIGs/RRP and would seek clarity on expectations from DNOs such that we can sufficiently plan and adequately resource these requirements.

**Core-Q23. Do you agree with the proposed timeline for implementation of this modernisation?**

**SPEN agree with this proposal in principle, however, please see below areas which we would wish to highlight for consideration.**

The implementation of a new regulatory reporting process is not only about data and technology. Changes to governance and operational processes, as well as organisational changes, may be required, and extensive re-training may be needed to ensure accuracy in the completion of the reporting. For network companies that operate multiple licences (e.g., electricity distribution and transmission), careful consideration must be given to the differences in the reporting requested by Ofgem and the timing of any changes should be coordinated. We would recommend that the modernisation of the regulatory reporting should be progressed through a working group, and that timelines, principles, scope, and implementation plans should be discussed and agreed to ensure that they can be adequately resourced and that the transition to the new solution is a success

**Core-Q24. Do you agree with our proposed design of the DSO incentive?**

**SPEN agree with parts of the DSO Incentive proposal but have significant concerns for some aspects of the proposal design. This is outlined below.**

We welcome Ofgem's decision to introduce the DSO ODI and believe it is a critical component of the overall incentive package and RIIO framework that will incentivise DNOs to deliver DSO efficiently and at pace on our journey to Net Zero

We note the additional detail Ofgem has included in the proposals at Draft Determinations that was not provided at the working groups, however, we would also like to emphasise that there is much to do in creating a fair, workable, and sustainable incentive for RIIO ED2. We also note that Ofgem has continued to present revised DSO incentive proposals to the working groups after the publication of Draft Determination

We are committed to working with Ofgem and other DNOs in the development of this incentive as we firmly believe in the need for DSO and the benefits it will bring (which we detail in our business plan)

We believe there are a number of critical areas that require refinement and further development before Final Determinations. We look forward to further discussions at working groups and the opportunity to shape the incentive further following Ofgem's DSO incentive guidance document consultation in Autumn 2022.

We have specific concerns regarding the following aspects of the DSO incentive, and we have set these out in the subsequent paragraphs:

1. Overall Components, Structure, and weighting of components
- 2 Incentive Reporting Burden
- 3 Reward and Penalty of the DSO Incentive
- 4 Target Setting Approach
- 5 Independent Performance Panel

### **Overall Components, Structure, and weighting of components**

We agree that the proposed three components making up the DSO incentive could all be used to assess a DNO's performance against finalised strategies and baseline expectations. The challenge, however, is the sheer scale of the incentive structure when combining all three components together. The complexity and administration of this incentive, from the perspective of both Ofgem and the DNOs, should not be underestimated. The result would be a burdensome activity which may prove unwieldy and counterproductive.

Should the three elements remain as currently proposed by Ofgem, we believe that the weighting should be altered to 30% SSAT, 30% Panel Assessment and 40% Metrics. This change will result in 60% qualitative and 40% quantitative assessment, which is more balanced.

### **Incentive Reporting Burden**

As highlighted, we believe there is a significant reporting burden on DNOs to ensure each DNO collects and submits all the relevant information for the three components of the DSO incentive. This also presents a large administrative burden for Ofgem in transforming and analysing DNO submissions from an objective standpoint.

Whilst DSO is the newest incentive of the three Strategic Delivery Incentives (SDIs) as part of the RIIO-ED2 framework, it is by far the most reporting intensive proposal of all incentives in the framework. This is particularly evident with the use of the independent Performance Panel and the 16 separate elements of RRE. This is on top of the new reporting requirements under licence condition 31E and therefore we believe the level of RRE and Performance Panel evidence can be rationalised and reduced through continued effort in the working groups. Rationalisation to remove duplication or unnecessary reporting is in the best interests of all involved.

Under the current proposals, we estimate that to produce the volume of evidence required under this incentive would result in additional costs per DNO group of between £254k to £382k per annum to establish a DSO incentive reporting team, similar to that in the ESO, to administer (plus panel assessment time and engagement on top of this), which we feel is excessive. If the level of reporting is to remain at the current level, we would propose that the frequency of reporting is amended with a mid and end point assessment for the Performance Panel in place of annual reporting – especially as annual changes are going to be incremental. Annual reporting would only be more appropriate if the reporting requirements are rationalised as discussed above.

### **Reward and Penalty of the DSO Incentive**

As this incentive is a new addition to the RIIO framework we believe that the DSO incentive could be more effective with asymmetrical reward and penalty like the ESO framework (with greater potential reward and a lower potential penalty), especially given the developing nature of the incentive. In an uncertain and changing environment we believe the asymmetrical incentive will be more likely to encourage the right behaviours. However, the most important aspect is to ensure certainty around what performance levels results in reward and what would trigger a penalty – without this certainty the DSO ODI will not drive the right behaviours Ofgem are seeking.

## Target Setting Approach

We understand the difficulty in setting robust, fair, and challenging targets for DNOs in this area due to the fact that there is no baseline level of performance. We agree with Ofgem's target setting approach that companies will have different starting positions and therefore agree that DNO specific targets are appropriate. We offer the following considerations for the continued development of the methodology:

- Since this is a new incentive, the target setting must be cognisant of data availability, as this will be dependent on establishing new processes and developing/installing new information technology that will be key to enabling DSO.
- A number of the metrics and targets are dependent on investment delivery that will be required to be implemented, developed and refined throughout the five-year RIIO-ED2 period (this is likely to ramp up during the period and therefore should not disadvantage DNOs in the early years).
- We believe any targets implemented should reflect these business challenges in implementation and propose a bedding-in period for this incentive to effectively test the application of the metrics and revisit targets at the end of year 1 of RIIO ED2.

## Independent Performance Panel

We have reservations around the use of the Independent Performance Panel as a way to assess performance against the DSO incentive. This stems from the historic performance of similar panels and the ability for the panel to provide an objective view, with varying DSO ambitions and regional factors to be considered across GB.

Whilst the equivalent ESO Performance Panel has worked to some extent, unlike the ESO's roles and functions, DSO is a new component of the RIIO framework. This will make it extremely challenging to determine an appropriate and meaningful performance score for DNOs – especially considering the many different starting positions of DNOs alongside evolving and diverse stakeholder views on DSO roles and remit.

There is also a risk of the panel assessing performance that is already assessed in the outturn performance metrics or the stakeholder survey. The panel's findings will be subjective, and so there is a risk that they may reach a different opinion on information provided to the findings of the outturn performance metrics assessment. In addition, applying a 40% weighting to this highly unpredictable form of assessment, that is heavily burdensome for the DNOs to collate and submit evidence, would undermine the efficacy of the incentive.

In addition, we believe the 16 individual items of RRE proposed by Ofgem is excessive and it is still unclear on the role of RRE and Metrics in the panel's assessment. If RRE is a part of metrics or the panel assessment element of the ODI, Ofgem must be explicit on its use and how it will be assessed. We believe that there is work to clarify the use of RRE, how each individual RRE will be assessed, and how it fits into the overall performance under the ODI. Should the panel remain, there needs to be clarity on what characteristics and performance levels are anticipated for each score and how the scores are derived.

**Core-Q25. What are your views on the outturn performance metrics and RRE we are proposing to include in the DSO incentive? If you do not support their inclusion, please outline which alternative outturn performance metric(s) or RRE you think should be included in the framework instead.**

**SPEN agree with parts of the outturn performance metrics and RRE, but have significant concerns in some areas**

Metrics, RRE and targets are useful measures to support the assessment of a DNOs performance against the DSO baseline expectations. We outline our views on the outturn performance metrics and RRE across the following areas:

1. Stakeholder Satisfaction Survey
2. Proposed Outturn Performance Metrics
3. Proposed RRE
4. Performance Panel & Scoring Methodology

#### **Stakeholder Satisfaction Survey**

We agree with the requirement for a stakeholder satisfaction survey to ensure we are meeting the needs of our stakeholders. However, we urge caution in its application given the nascent markets and novel interactions that could make it difficult to draw an objective view.

The development of this survey is leaning heavily on the ESO approach. The interactions of the ESO with stakeholders is well defined and a consistent understanding has developed over a long period. For DSO, the requirements, understanding and interpretation of functions between stakeholders will take time to form the same level of consistency as the ESO.

Whilst we recognise the importance of the opinions of our stakeholders, we believe the weighting for the SSAT element should be reduced from 40% to 30% of the overall DSO Incentive. This is primarily to balance the qualitative and quantitative aspects of the incentive, as described in our Core Q24 response, i.e. SSAT and Performance Panel form 60% qualitative and the metrics provide a 40% quantitative assessment.

In addition, we believe that not all questions in the survey should be weighted equally. All of the questions proposed are important however we would propose that questions 2 and 5 attract a higher proportion of the total score due to the additional importance of Data and Communication, and engagement in delivering the benefits to consumers, but also because these aspects are areas where most stakeholders will have direct experience from their interaction with the DSO.

#### **Proposed Outturn Performance Metrics**

Quantifiable metrics are a critical element to demonstrating progress in a consistent and objective manner. Currently the 20% weighting diminishes the importance of this, and we believe this should change to 40% with the Performance Panel and SSAT accounting for the remaining 60%. Overall, we are satisfied with the outline proposals for the three proposed metrics, and we will continue to engage with the working group to refine the application. We also note that there are nuances in the data sources that need explicit clarification to ensure consistency between DNO submissions.

Target setting will be critical, so we agree with Ofgem's proposal to use targets that are unique to each DNO. There are a number of details that require further refinement at working groups and through the consultation in August to ensure the definitions and reporting methodologies are robust and well defined for each of the three metrics. For instance, limiting the network monitoring metric to ground mounted substations only and removing references to publications that only some DNOs have committed to make (i.e. DNOA).

Reporting against these metrics will also require a level of development to embed robust and repeatable systems and processes to provide quality submissions on an annual basis. We believe that a ‘bedding-in’ period to develop and refine the reporting and structure of the submission would be valuable in making sure this incentive embeds effectively into the RIIO ED2 period.

### **Proposed RRE**

The current Independent Performance Panel requirements are blurring the lines between RRE and Metrics. If RRE is a part of Outturn Performance Metric evaluation, Ofgem need to be explicit on its use. In addition, we feel the proposed amount of RRE is significant and could be reduced through addressing duplication, overlaps with other reporting requirements and focusing the RRE. We therefore propose that there should be an equal number of RRE and metrics (3 RRE, 3 Metrics)

Following our initial review of the 16 items of RRE we agree with three and have concerns regarding the remaining 13. Of the 13 we have the following reasons:

- 6 due to potential duplication with LC31E
- 2 due to our view that it was unsuitable to assess performance
- 2 due to potential duplication with existing reporting
- 2 due to assessing areas that are not a specified duty of a DSO.
- 1 because scope has not been formally agreed (still agreeing datasets)

Below are some of the more specific comments and concerns in relation to the proposed RRE:

- Some items of proposed RRE are seeking to assess performance in areas not under the direct control of the DNOs or areas that are not a current obligation. For instance, RRE no 2 relates to reporting on the volume of distribution assets that are procured by the ESO – we believe that this is inappropriate considering the ESO determines the need to procure these assets and collects this data.
- Some of the proposed RRE could result in duplication with the LC31E reporting. Should Ofgem require this additional RRE to be reported on an ongoing basis this should be made explicit and included within LC31E.
- We feel that some items of RRE are inappropriate to form a robust assessment of performance, and in other cases the proposed RRE is evolving and heavily dependent on wider reporting changes such as forecasting accuracy – an example being the ongoing LTDS reform.
- Where RRE is used to assess DNOs on interactions with the ESO such as operational data sharing, there should be a reciprocal requirement on the ESO to be assessed on the same interactions.
- There are a number of proposed items of RRE that we do not feel are suitable for the performance panel to make an informed judgement on a DNO’s performance. Ofgem need to be explicit in how each item of RRE will be used to determine a performance score and the methodology for assessing RRE.

In our view there is a lot of work to be done to ensure that the proposed suite of RRE captures the right areas to provide the required view of a DNO’s performance under DSO obligations such that the panel and Ofgem may use this RRE in an appropriate, fair and consistent manner across all DNOs. We are committed to working closely with our peers and Ofgem as we have done throughout the process and look forward to refining this aspect of the incentive further in the ongoing working groups.

**Independent Performance Panel Structure, Scope & Scoring Methodology**

As stated above, we have reservations around the use of an Independent Performance Panel. However, should this panel remain, we believe the performance panel assessment should be completed using a common structure for annual reporting and that DNOs should be assessed against progress to their individual plans as opposed to directly comparing DNOs with each other. Further work is required to ensure the assessment is objective and consistent. We hope to refine the approach with Ofgem in the working groups.

However, it is important for DNOs to learn from each other in the development of the DSO and we therefore believe that the sharing and adoption of best practice should form part of the scoring criteria.

**Core-Q26. Do you agree with our proposal for the DSO re-opener?**

**SPEN broadly agree with the proposed re-opener but believe it should be expanded.**

We broadly agree with Ofgem's proposal for the DSO re-opener but believe that this should cover more than just further separation changes and should seek to support increased DSO ambition and demand from customers for DSO services.

During RIIO ED2, the requirements and level of ambition for DSO is subject to change and growth. This includes the impact from ongoing regulatory consultations that are likely to materialise, such as the regulatory position on CLASS and the Access SCR.

The current proposal for the DSO re opener focuses solely on addressing any future separation changes that Ofgem might seek to implement, which can be triggered at any point during RIIO-ED2. We believe that the purpose of the DSO re-opener should be expanded to provide a greater degree of flexibility to the DNOs. This will support a level of business agility to respond to changing customer requirements and greater levels of regulatory supported DSO ambition.

This expanded DSO re opener should at a minimum provide coverage to DNOs across the M19 DSO Memo categories. This would include and would not be limited to: CV1 & CV2 for flexibility, CV11, C4 & C13 for investments in enabling IT and OT projects and CAIs and BSC categories to support staffing and resourcing.

We are committed to continue to work closely with Ofgem to refine and develop the DSO re-opener.

**Core-Q27. Do you agree with our proposal to introduce a new whole system strategic planning Licence Obligation?**

**SPEN agree with this proposal.**

We believe the proposal is consistent with the annual report which we proposed in our Business Plan. We believe the proposal is consistent with the annual report we proposed in our Business Plan. We think that this should be complimentary to the Whole System Register that is live, to ensure that the format is agreed and sufficiently transparent and coherent for stakeholders to be informed and also stimulate further co ordination. In many ways this report should not be a historical record but also a specific signal to future planning by organisations. It should also recognise and be adaptable to the different levels of maturity of cross-vector organisations.

**Core-Q28. What are your views on the digital tools that could be used to support this?**

**SPEN's Whole System approach will be underpinned by the data and digitalisation strategies outlined in our business plan.**

Whole System thinking and planning are concepts that are familiar to SP Energy Network across both transmission and distribution. As we state in our business plan, the step change required to fully realise the potential benefits requires cross-vector collaboration and integration of those specific

needs, capabilities, know-how and all at the right pace so as to ensure that all partners in the Whole System environment can progress as one. To facilitate that, we will underpin our approach using the data and digitalisation strategies outlined in our business plan, which will provide the capacity, capability, and foundation for delivery of the following areas of focus:

- Network Planning; supported by our ENZ platform development
- Whole System Engagement; supported by deployment of our Customer Relationship Management (CRM) system, providing an interactive portal for all stakeholders and customers
- Open Data Sharing; supported by our new Opendatasoft platform
- ConnectMore; demonstrates how we can combine energy and transport data to facilitate informed decisions as part of the decarbonisation of transport
- Multi TO/DNO dedicated Whole System portal (long term to the start of RIIO-ED3), which would seek to house both data and the suite of all Whole System tools under one site; ensuring open-source data and system planning opportunities can be identified and progressed.

As a starting point of the evolution of Whole System planning, we consider that this combination will enable us to start the ongoing assessment of the value of data (both our own and other partners and stakeholders) and drive optimal decisions in complex multivariate scenarios. We have fully embedded compliance with Ofgem's Data Best Practice guidance into our Data Strategy to facilitate free-flowing bidirectional data exchange, and through this enable external stakeholders to engage with the services provided by our energy networks as they evolve. Ultimately, Whole System digital solutions should be available at industry level for RIIO ED3

## Section 5. Meet the needs of consumers and network users

**Core-Q29. Do you agree with our proposed target and thresholds for the deadband, maximum reward and penalty?**

**SPEN broadly agree with the principle of setting ambitious targets for BMCS using RIIO-ED1 data.**

We agree with the target level and thresholds for maximum penalty and reward. However, we consider that the deadband is too big and has the potential to see most DNOs fall into this area. DNOs falling into the bottom half of the deadband may then feel that the cost and effort to achieve reward outweighs the benefits attached and settle for this middle ground. A slightly tighter deadband would reduce the starting point for reward slightly and also set a slightly more aggressive target for the start of penalty to ensure that below average performance is penalised. SPEN suggest making the size of the deadband and reward the same, so have a range of 0.25 in each section. This would change the proposed incentive as follows:

|                  | <b>DD Proposed</b> | <b>SPEN proposal</b> |
|------------------|--------------------|----------------------|
| Maximum penalty  | 8.4                | 8.4                  |
| Start of penalty | 8.6                | 8.65                 |
| Target           | 8.9                | 8.9                  |
| Start of reward  | 9.2                | 9.15                 |
| Maximum reward   | 9.4                | 9.4                  |

**Core-Q30. Do you agree with our proposed approach to working with DNOs to implement Storm Arwen actions related to customer satisfaction?**

**SPEN agree with this approach.**

SPEN will support working groups to determine any changes required as a result of Storm Arwen. SPEN want to ensure that any changes made as a result of these reviews do not have an adverse impact on any of the existing incentive mechanisms which are in place and have proven effective (e.g. BMCS).

Specifically on the use of callbacks, SPEN believe that there should be consistency – that is, between how a callback not being performed in 1 hour and a call waiting in the agent queue for 1 hour are handled. This consistency will ensure that DNOs are all measured equally, especially as some DNOs do not have a callback facility in place. Consistency will also ensure that DNOs who use such capability in exceptional events, are not unduly penalised as a result.

**Core-Q31. Do you agree with our proposed target and maximum penalty score?**

**SPEN agree with both the proposed target and maximum penalty score.**

**Core-Q32. Do you agree with our proposal to remove the activities proposed from DNOs' baseline allowances?**

**SPEN disagree with this approach.**

SPEN support the removal of 1) repair / replacement of gas boilers and 2) the training of in-house employees in delivering advice through workshops from scope of baseline allowances. However we disagree with the removal of energy efficiency measures from the scope of the services delivered by DNOs as these are key services that can provide direct financial benefits to customers, especially given the current energy crisis.

We note that the main reason for this removal is due to the availability of Government funding. While this is true of traditional energy efficiency measures (such as cavity wall & loft insulation), not all energy efficiency measures (such as technology designed to reduce energy usage in the home similar to what SPEN proposed in our CVP) are eligible to funding from such schemes. We believe that technology that can directly reduce energy usage in the home, but which is not covered by such schemes, has the potential to save consumers a significant portion of their annual energy bill, for a relatively low outlay by a DNO. Excluding such expenditure from a DNO's baseline allowance would appear to remove any incentive for a DNO to incur expenditure on such technology (as it will need to reduce expenditure on some other allowed expenditure in order to remain within overall allowance).

**Core-Q33. Do you agree with our proposals for the Consumer Vulnerability ODI-F?**

**SPEN agree with the proposals for the Consumer Vulnerability ODI-F**

SPEN are pleased to see that Ofgem have taken on board the feedback provided in the Vulnerability working group over the course of the first half of this year. We believe this has led to the creation of an incentive that will drive DNOs to stretch themselves in this key focus area.

**Core-Q34. Do you agree with the performance metrics we are proposing to include in the incentive and the approach to setting targets and associated deadbands, performance caps and penalty collars? If not, please explain why and give details of your preferred alternative.**

**SPEN agree with the performance metrics proposed for use in this incentive, however we do have a number of concerns:**

- **Target level:** The CSAT measurement for the delivery of fuel poverty services and LCT support has been set at a higher maximum threshold than BMCS (target of 90/10 and a

max reward of 9.5/10). These CSAT measures are for new services provided by DNOs (and partners on behalf of DNOs) and in some areas there is very limited historical data available to benchmark against. The DD states Ofgem would not look to set targets lower than BMCS but have in fact set higher targets than BMCS. As a worst case scenario, the targets should be in line with BMCS, not set higher, therefore reward should start at 8.9/10 and have a max cap of 9.4 /10.

- **SROI methodology:** The use of a common SROI methodology is a powerful tool to drive consistency of reporting across DNOs, however further work is required to ensure that the application of this methodology is consistent and that there are appropriate governance processes in place to remove the opportunity for the tool to be used incorrectly (e.g. use of bespoke proxies). We note that from our bilateral with Ofgem on 4<sup>th</sup> August 2022 that this is also a key focus area for Ofgem ahead of FD and SPEN will support the further development of this methodology to ensure that this consistency of approach is achieved.

**Core-Q35. Do you agree with our proposal for the Annual Vulnerability Report ODI-R?**

**SPEN agree with the proposal for the Annual Vulnerability Report ODI R**

**Core-Q36. Do you agree with the proposed content of the annual report? If not, please explain why and give details of your preferred alternative.**

**SPEN agree with the proposed content of the annual report**

**Core-Q37. Do you agree with setting the maximum reward and penalty limit at +/-50% of the target?**

**SPEN agree with a maximum reward and penalty limit of a minimum of +/- 50%.**

Given this incentive has only previously been reward, we believe the targets need to be as achievable as possible given the anticipated increasing volume of connections. The customers affected by these targets are also impacted by the broader measure of customer service so we need to ensure the targets for this incentive also ensure we can provide a quality customer service too.

**Core-Q38. Do you agree with setting a deadband of +/- 20% of the target?**

**SPEN have an alternative proposal.**

Given this incentive has only ever previously been reward, we believe the deadband needs to allow DNOs to continue to operate in an efficient and timely manner given the anticipated increasing volume of connections. We also believe that DNOs should not be penalised for maintaining current performance, only penalised for deteriorating performance, again when considering an increasing number of connections forecasted.

We therefore believe there is merit in considering a 10% deadband on the target for reward, but a +20% deadband for penalty. Again given the current reward only regime and the challenging circumstances we expect to come from an increasing number and complexity of connection arrangements (stemming from the Access SCR) then we need to be mindful that speed is not the only driver to good service for our minor connections customers. Notwithstanding our preference for an asymmetrical deadband, if Ofgem decided the deadband must be symmetrical then we believe this should be +/-20%.

In terms of the targets, we recognise these are based on a 4 year historical average and are tough to achieve as performance currently varies significantly between DNOs. We would ask Ofgem to facilitate the sharing of best practice to help DNOs improve in this area. SPEN would suggest a guidance document or modification of the RIGS to show examples of different connection request scenarios

and how DNOs should report on them from a TTQ/C perspective, with scenarios including all types of hurdles DNOs can face in the process between initial application to completion. We would be happy to support Ofgem and other DNOs in developing this document.

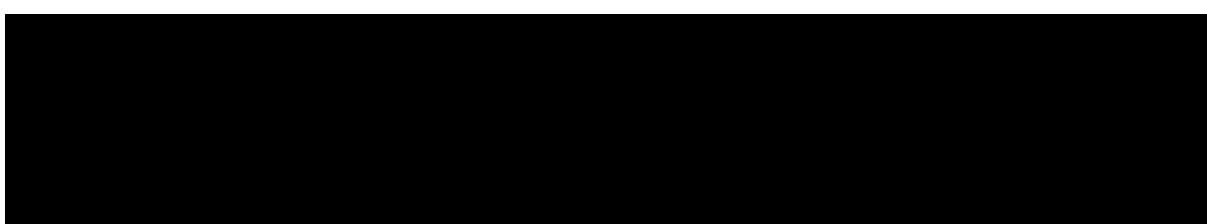
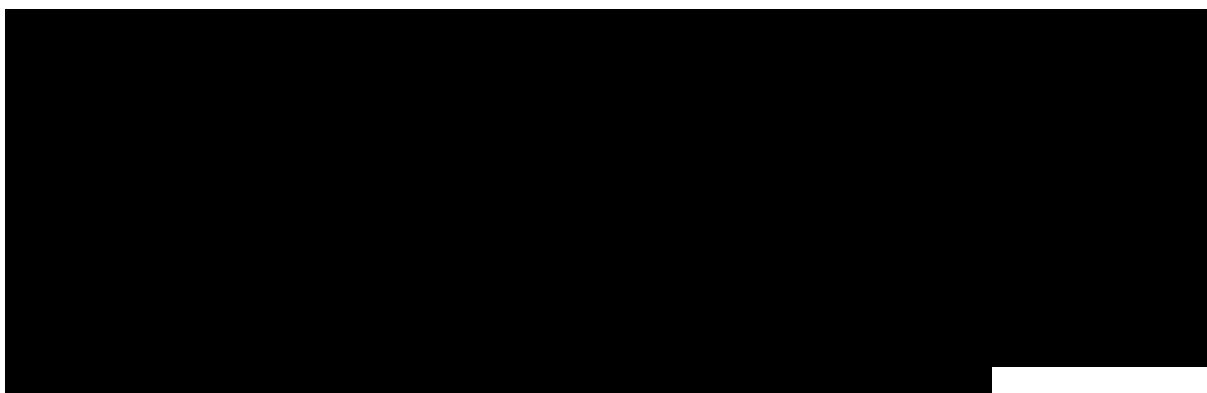
**Core-Q39. Do you agree with our proposed design of the Major Connections incentive?**

**SPEN do not agree with the design of the Major Connections Incentive and have serious concerns.**

**Targets:** Ofgem have set targets by averaging targets proposed by DNOs in the connection strategies submitted as part of the Final Business Plans. These were aspirational targets for year 5 of RIIO ED2, based on a symmetrical incentive, and are not appropriate for use in setting maximum penalty thresholds.

In the SSMD, Ofgem set out that the incentive would be symmetrical, with DNOs having the opportunity to improve performance and aim for reward. The DNOs therefore set targets on this basis i.e. proposing that the maximum performance they could realistically aim for. However Ofgem changed position in the DD and this incentive is now a penalty only regime and have set a target of 8.9 by Year 5, against which DNOs will receive the full penalty if this is not achieved. This is an overly harsh regime, especially as this is a new area for customer satisfaction measures and the breadth and diversity of customers covered under the Major Connections Incentive.

**Penalty cliff edge:** Further to this, introducing full penalty at the target point is misaligned with the approaches to the other ODIs within RIIO-ED2, namely the Consumer Vulnerability and DSO incentives. This also means that by Year 5, the Major Connections Regime is actually a tougher incentive than Broader Measure of Customer Service, which has had the benefit of the focus and reporting of the 8 year price control within RIIO-ED1 and is therefore supported by robust baseline data. Instead, we propose there should be a period of time to allow DNOs to establish baseline data, for the first two years of the price control with appropriate industry targets set at the mid point of the price control. For the first 2 years of the incentive, we would still complete a yearly reputational report and provide our most recent Customer Satisfaction data, however there should not be penalty targets and thresholds during the years of baseline gathering data.





**Weighting of these responses and survey respondents:** The weighting which Ofgem proposes to apply to the responses from each market segment, and contestable vs non-contestable service responses is currently unknown. Ofgem needs to consider this carefully as the weightings allocated could further exacerbate the points previously raised. The appeals process will be critical to ensure that segments of low volume customers cannot unduly influence the penalty outcome.

In addition, recognising that in Major Connections we may have national customers, the survey process needs to ensure that the same customers are not repeatedly surveyed by multiple DNOs each month. This could result in stakeholder fatigue, and allow a small number of parties to have control of this incentive, further distorting the process

**Core-Q40. Do you agree with our proposed approach to target setting and applying the penalty?**  
**SPEN do not agree.**

SPEN do not agree the approach to target setting and applying the penalty as stated in the above response for Q39

**Core-Q41. Do you agree with our proposal to require reputational reporting of timeliness metrics for all RMS?**

**SPEN do not agree with the proposal.**

We do not agree on the current definition for timeliness metrics and would expect the definition for quotation to be amended from 'is the time from the DNO receiving the *initial application* to issuing a quotation' to 'is the time from the DNO receiving the *competent application* to issuing a quotation'. Due to the complexity of Major Connections we need to ensure that all the relevant paperwork is completed as per the RIGs guidance for application

Equally we would expect DNOs to be consulted on the definition of 'site ready'. Our interpretation of this would include, but with consultation amongst DNOs may not be limited to:

- All land rights obtained/cleared
- Planning consents obtained for site buildings (including substations)
- Obtaining relevant streetworks notices
- Any customer excavation and other customer works on site completed to satisfactory standard
- Offsite reinforcement works complete
- Generally, the latter point with respect to reinforcement works is particularly important when considering the impact of the Access SCR is likely to have on the Major Connections Incentive.

Assuming the above points of clarity are provided, timeliness metrics as part of reputational reporting could be supplied.

**Core-Q42. Do you agree with our proposal to launch a wider review of the Connections GSoP (that is, beyond updating the payment amounts for inflation and incorporating standards for DG customers)?**

**SPEN do not agree.**

Many factors govern the speed to deliver connections for customers which are often outside control of the DNO and equally outside of the Guaranteed Standards of Performance. As opposed to a wide-reaching review of the Guaranteed Standards of Performance, SPEN would instead support regular joint working of DNOs through the ENA on specific issues influencing timeliness in order for these issues to be addressed

An example of this is the recent development of the nine-point plan for how the statutory framework for land rights could be modernised to speed up connections work to deliver Net Zero. SPEN would also support cross industry working with local authorities on the obtaining of relevant streetworks permits which vary between local authorities and therefore between DNOs.

When considering GSoPs and the relationship between the Access SCR, the complexity of design for future connections schemes affected by the Access SCR changes will require more complex analysis. We will need to consider curtailment and reinforcement requirements on an uncertain volume of projects at quotation stage to allow schemes to progress to contract. Due to the uncertain nature of the Access SCR, in terms of customer behaviour (as reflected in the requirement for this to be covered within the load uncertainty mechanism) it would be more appropriate to allow these changes to be fully embedded into DNO connection practice and allow customers to respond to these changes before a wide ranging GSoP review.

**Core-Q43. Do you have any views on what else could be done to help speed up connections to the distribution network and or develop a standard for the overall (i.e., end to end) time to connect?**

Please refer to response Q-42 which considers timeliness factors

## **Section 6. Maintain a safe, resilient, and reliable network**

**Core-Q44. Do you have evidence that customers would be willing to face an increase in their bills to also receive an increase in their reliability, including that they understand the actual cost and how this translates into average power cuts?**

**SPEN disagree that customer bills must increase to deliver an increase in reliability, and equally that there is a direct and consistent unit cost for power cut reductions.**

Customer bills are complex and derived from investment, financial adjustments and regulatory approaches across historic price control periods. In our baseline plan submission, we are delivering a reduction in our contribution to customer bills in our SPD licence for RIIO ED2, and a marginal increase in our SPM licence, despite forecasting a similar level of reliability improvement in both areas. We have also set out a pathway in our plan for our bill contribution to decrease in both SPD & SPM into RIIO ED3

Nevertheless, we accept the premise that additional spend to improve reliability will have an upward pressure on bills and on this basis below we have evidence which demonstrates that our customers are willing to pay for the level of performance improvement that our plan delivers.

As part of our RIIO-ED2 stakeholder engagement, both domestic and commercial customers have ranked speed of restoration after a power cut and not having a power cut as their first and second priorities respectively (see SPEN Business Plan Annex 3 2a: Customer Engagement Report, page 19). These customers have also responded that they want SP Energy Networks to be highly ambitious in

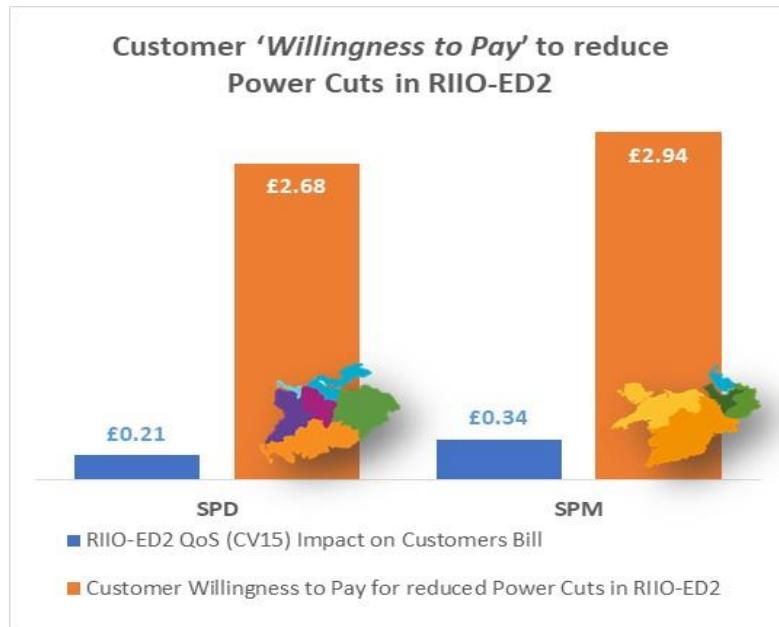
these areas. Our CI and CML reduction targets for RIIO-ED2 were welcomed by the majority of stakeholders

Stakeholders have endorsed SPEN plans to invest in additional network automation as a priority to improve performance for RIIO ED2, (see SPEN Business Plan Annex 3 2b Willingness to Pay Report pp 76-77). When presented with our Network Performance Strategy, which lays out how much improvement can be expected from each area of investment, all stakeholders agreed that it was a well-considered and comprehensive approach (SPEN Business Plan Annex 3 1d – ED2 Triangulation Record Reliability, S2.16: “All of the engaged stakeholders responded to this question, and there is a clear support of SPEN’s Network Resilience Investment strategy”)

As part of our Willingness to Pay (WTP) research we asked customers specifically about our level of spend on safety & reliability and improving power cuts. Customers exhibited a willingness to pay for these improvements and that they preferred our RIIO ED2 plans to our RIIO ED1 plans. Overall, this research suggests that:

- Customers in SPD are willing to pay an extra £0.91 for Safety & Reliability on their RIIO-ED2 bill, taking the total willingness to pay to £29.56 against the £28.65 proposed for these activities.
- Customers in SPM are willing to pay an extra £1.12, taking the total willingness to pay to £42.62 against the £41.50 proposed for these activities (SPEN Business Plan Annex 3 2b)

When we compare the amount customers were willing to pay specifically for reducing power cuts compared to the amount within our proposed investment plans, we can see that our plans were well within the expected values customers anticipated for these improvements:



Note, to derive the above chart we have converted our CV15 final Business Plan costs to impact on customer's bills using a factor of £1.69 for each of the 5 years of RIIO ED2 for every £100m of expenditure in SPD, and £2.41 for every £100m of expenditure in SPM

**Core-Q45. Do you have evidence of the cost of reliability improvements and the impact that lowering the revenue cap will have on them being achieved?**

**SPEN do not believe that lowering the revenue cap will impact on SPENs ability to make reliability improvements in RIIO-ED2. We support Ofgem's rationale that lowering the revenue cap will mitigate the risk of DNOs achieving excessive levels of reward.**

As shown in Figure 11 of Ofgem's Core Methodology Document, national reliability (CI and CML) improvements have followed a positive trend for many years, with a significant improvement since the introduction of the IIS in 2001/02. It is also noteworthy that the gradient of weighted CI/CML improvements have reduced over the course of RIIO-ED1. This demonstrates a relationship that making aggregate CI/CML improvements has become harder as performance tends to zero. The corresponding reward opportunity has also diminished as interventions, such as undergrounding conductors or deploying of automation, has already been completed in the most beneficial areas.

We do not believe there is a linear relationship (or economic threshold) between reliability improvements and expenditure, as improvements can be obtained through a wide range of activities where reliability may be the primary or secondary objective. Table 7 of Our Network Performance Strategy SPEN Business Plan Annex (4A 5), shows the range of measures we are taking in RIIO-ED2 and their potential upper CI/CML impact. The associated costs for these activities can be found within submitted BPDTs

**Core-Q46. What are your views on moving to an asymmetric cap and collar?**

**SPEN disagree with the proposal to move to an asymmetric cap and collar for IIS.**

We support Ofgem's rationale that lowering the revenue cap will mitigate the risk of DNOs achieving excessive levels of reward, while still ensuring DNOs are able to access rewards for making improvements. We are in favour of lowering the cap to 100 BPs RoRE. As explained in our response to Core-Q45 we do not believe this will negatively impact DNOs ability to make improvements in RIIO ED2. However, we believe the collar should also be lowered in line with the cap, resulting in a symmetric position, with both components set at 100 BPs RoRE.

We have several reasons for supporting a symmetric cap and collar:

- We do not consider that an asymmetric collar mitigates Ofgem's concerns that the cost to customers of a small deterioration in reliability is greater than the value of an equivalent improvement. To manage this concern Ofgem could apply asymmetric incentive rates, though we would have concerns about the fairness of this approach as there would be no change to actual customer experience either side of the target.
- We do not believe asymmetry maintains the incentive for strong performance if a DNO hits the cap. This is because it is unlikely a DNO would swing from one extreme to another as the risk of entering penalty at all is enough to incentivise DNO performance ahead of target.
- We agree that the risk of hitting the cap or collar is low, either at 100bps or 250bps, particularly with Ofgem's other changes to IIS, e.g. setting targets later and updating the CML approach. As such, we believe the fairest way to set targets is symmetrically.

As described in our later response to Core-Q49, DNOs may still find themselves in penalty even after investing in network performance, due to the unpredictable nature of faults. An asymmetric collar, in combination with potential exclusion of QoS funding, results in significantly increased exposure to risk for DNOs. We therefore believe a symmetric cap and collar of 100 BPs RoRE, represents a fairer balance of risk and is consistent with the policy decision Ofgem applied in RIIO-ED1.

**Core-Q47. Are there alternatives to reducing the revenue cap that you think would better balance increases in reliability and the cost to consumers than reducing the revenue cap?**

**SPEN Agree with Ofgem's proposed approach of modifying the revenue cap.**

We support Ofgem's decision and rationale for lowering the revenue cap. We agree with the range of alternative options that Ofgem have presented. In addition, we have previously presented arguments for an increase in the value of incentive rates, by updating the Value of Lost Load to more closely align with actual customer demand value. This is to ensure that the level of improvements customers expect can be delivered efficiently, and that reward and penalty value align with the true value customers place on their level of service. We do not agree with the interpretation that increases in the incentive rates will simply increase DNO rewards for the same level of performance.

**Core-Q48. Do you agree with how we have characterised the operation of the current CML methodology and our reasons for changing to setting targets in line with our CI methodology?**

**SPEN Agree with Ofgem's assessment of the current CML methodology, and with the reasons set out for changing this approach to align more closely with the CI methodology.**

We believe that the proposed changes to the unplanned target setting methodology produce CML targets which are fair and suitably challenging throughout RIIO-ED2. The revised approach ensures all DNOs receive improvement targets, without the addition of unnecessary extra steps to correct the underlying methodology.

This will drive DNOs to make performance improvements in line with the opportunity presented by the specific network topology, and safety limitations, up to a point that meets customer expectations. We believe the proposed methodology will incentivise all DNOs to make improvements, thus avoiding undue rewards for past performance. The proposed methodology also recognises that frontier performers have limited ability to achieve further improvements.

**We agree with Ofgem's position on the timing of setting final targets**

We support Ofgem's rationale for setting targets as late as possible, once the latest performance data for 2021/22 is available. We agree this will ensure DNOs cannot easily outperform their targets and earn rewards without delivering substantial performance improvements. Setting the targets based on the latest data will mitigate this risk, and although confirmation of the targets helps DNOs to set their plans we have been able to build our strategy on previously issued data.

**We agree with Ofgem's position to remove the ratchet proposed at SSMD.**

Given Ofgem's proposal to change the CML methodology to be consistent with the CI methodology, we agree that a ratcheted mechanism is no longer required. As targets will be based on a DNO's own performance, we do not see any additional benefit from applying a ratchet. This is strengthened by Ofgem basing the targets on the latest available data, from 2021/22, which further mitigates the risk of DNOs starting ahead of their targets.

As presented at working groups, we felt the previously proposed ratchet acted as a bolt-on step to remedy instances where DNOs' calculated targets were behind their latest performance. We believe the best solution is to address the underlying methodological design to ensure DNOs' calculated targets are ahead of their actual performance, as per Ofgem's latest proposed CML methodology.

**We agree with Ofgem's position to retain the current CI target setting methodology.**

We believe that the CI targets achieve the purpose of the IIS and do not require any changes. The CI targets are based on a DNO's own performance, which represents a fair position for the entire RIIO-ED2 period. The targets drive all DNOs to make improvements, while the application of improvement factors recognises that frontier performers have limited scope to make these improvements.

We also recognise Ofgem's assessment that the incentive has driven significant improvements but believe it is the incentive rate, not the targets, that determines when there is no longer an incentive to improve performance. We also do not think alternative methodologies, such as moving to a rolling average target, will deliver any benefits compared to the current methodology, as the improvement factors drive continuous improvement.

**We agree with Ofgem's position to update the CML target setting methodology.**

We agree that adopting a CI style methodology for the CML targets results in a fairer position across all DNOs. We have highlighted in our final Business Plan (Annex 4A 5) that the CML methodology presented in the SSMD contained several key challenges, which we believe will be resolved by Ofgem's proposed adoption of a methodology consistent with the CI methodology.

We have highlighted that for some DNOs targets were unobtainable and would result in penalty even if substantial improvements were made in RIIO-ED2. We have also highlighted that the previously proposed ratchet mechanism would not fix the underlying issues with the CML methodology that resulted in some DNOs starting ahead of their targets. Both of these issues were partly caused by use of the lower quartile performance of all DNOs being used to set CML targets for all DNOs. This approach set unachievable targets for DNOs that were unable to catch up due to network limitations and caused frontier performers to be rewarded without any improvements and, in some cases, despite deteriorating performance compared to RIIO-ED1.

We do not believe that all DNOs are able to deliver the same restoration times across the network, and therefore it is unrealistic for CML targets to converge, as was the case under the SSMD proposal. We agree with Ofgem's view that DNO performance improvements have started to taper off in the latter years of RIIO-ED1, suggesting CML improvements are becoming more difficult to make. This (together with setting targets based on latest data and reducing the revenue cap) mitigates the risk of DNOs achieving excessive rewards in RIIO-ED2.

We believe that a fair target setting methodology should be based on a DNO's own performance, consistent with the CI methodology, as not all DNOs have the same opportunity to deliver performance improvements. Targets should also incentivise performance improvements for all DNOs, while recognising frontier performers have reduced opportunity to make improvements. We believe that Ofgem's proposed changes to the CML methodology are successful in all of these criteria, and we welcome the change to a CI-style approach.

In summary we would strongly caution against Ofgem reverting to the policy in the SSMD as this will reintroduce targets that are impossible for some DNOs to achieve, while creating targets that do not incentivise performance improvements for others and adding complexity to the underlying methodology through the addition of extra correcting steps.

**Improvement factors**

We agree with Ofgem's position that improvement factors are necessary to prevent DNOs from starting RIIO-ED2 ahead of their targets and to drive improvements throughout the price control period. We also agree that frontier DNOs should have a smaller improvement factor (reflecting limited opportunity to deliver improvements), whereas others should have a larger improvement factor, encouraging them to catch up. The proposed CI methodology improvement factors, 0.5% for frontier DNOs and 1.5% for remaining DNOs, are a balanced position that achieves the purpose of the IIS.

We welcome Ofgem's proposal to adjust the CML methodology to be consistent with the CI methodology. In light of this, we believe applying the CI improvement factors to the CML methodology is a well-justified approach with precedent. It achieves Ofgem's purposes behind the CML methodology adjustment, while retaining consistency between the two approaches.

**Core-Q49. Do you agree with our rationale for retaining our RIIO-ED1 position on QoS funding? Can you provide any evidence that an alternative approach would not result in double rewarding alongside the IIS?**

**SPEN do not agree with Ofgem's rationale for disallowing all QoS funding.**

As detailed in our response to Core-Q44, customers have expressed that reliability is of the highest importance.

We believe it is Ofgem's intention that funding is to bring DNOs to a baseline level of performance where penalty is avoided (as per Core Methodology paragraphs 6.9 and 6.55). Thereafter, the role of the IIS is to reward continuous improvements in performance beyond what is considered a baseline level. Therefore, a QoS allowance provides a baseline level of funding to invest in network performance to continue to deliver the reliability levels that our customers now expect, as CI and CML targets continue to tighten. This reflects that RIIO-ED2 allowances across various programmes of works are set such as to achieve the baseline level of resilience and performance. IIS will then incentivise DNOs to invest in the innovation to deliver frontier performance improvements on the network.

In light of the lower reward cap, we believe that the risks of DNOs earning excessive rewards through the IIS and of customers paying twice for the performance improvements they experience are further substantially mitigated. We would support a further qualitative review by Ofgem in this area, ahead of the FD, to help evidence and agree a revised position.

**Core-Q50. Do you have any examples of situations where fault-related interruptions could be genuinely “exceptional” and how these could be separately identified from those that occur during planned works?**

**SPEN agree with Ofgem's assessment that OEEs should be genuinely exceptional and exogenous to DNOs influence.**

Fault-related interruptions that occur while a DNO undertakes planned activities are a function of day-to-day network operations and risk. We do not believe these are beyond a DNO's control and they should be planned for as part of network operations. However, there may be exceptionality to this where a second, third or more faults occur during this period leading to far greater customer interruptions. A DNO can be expected to make their network resilient to System Security design standards (P2/7), but where the network experiences challenges beyond these thresholds the DNO is no longer funded to achieve that level of resilience. We would also consider this to apply where the faults have third-party origin.

We agree with the proposed update to remove weather-related claims under the OEE, noting discussions at SRRWG about the importance of SWEE thresholds capturing all forms of weather-related events e.g., heatwave, drought, flooding, blizzard etc. not just storms.

We also agree that the foreign objects category should be included and extended to all third-party actions within eligibility criteria. Instances where these have an impact large enough to meet the OEE threshold are rare, and DNOs cannot be reasonably expected to build their networks to be resilient to them, nor would it be efficient for customers to fund resilience to them.

**Core-Q51. Do you agree with our assessment of the OEE thresholds and the financial impact on each DNO?**

**SPEN partly agree with Ofgem's assessment.**

Although we agree that common OEE thresholds mean DNOs have similar financial exposure, as all DNOs are exposed to CI/CML below the threshold even where an exemption is given, we believe that the impact of this financial exposure is relative, and the current approach is inequitable compared to the proportionate thresholds proposed by Ofgem.

This is highlighted by an example where both DNOs experience an interruption of the same relative size but only the larger DNO is able to claim for exceptionality whereas the smaller DNO must bear the full cost. We believe Ofgem should re-consider whether it is fair for the customers of smaller DNOs that this exemption threshold applies to some DNOs, but not all.

**Core-Q52. Do you agree with our proposal not to have an end-of-period adjustment mechanism? If not, what criteria should we use to determine whether a DNO has used its allowance for WSC, without it creating uncertainty?**

**SPEN agree with this proposal.**

We agree with Ofgem's conclusions that an end-of-period adjustment mechanism is not required as:

- Ofgem's governance document (acting as an extension to the Regulatory Instructions and Guidance (RIGs)) will clearly explain and require that investments must benefit WSC
- Changes in the number or location of WSC does not mean work should not be undertaken to improve their service
- Any such adjustment mechanism would create uncertainty around allowances and inhibit DNOs from investing in improving performance for WSCs.

We believe the wider RIGs and regulatory reporting will provide the certainty around DNOs delivering expenditure on WSC activities. These should be consistent with Ofgem's proposed governance document about the regulatory rules for spending in this area

This governance document also sets out an additional reporting requirement for an annual statement on WSC numbers, schemes identified during the year, expected CI benefit, progress with schemes underway and total cost upon scheme completion. We believe that these reporting requirements will give Ofgem sufficient information to determine whether DNOs have used their WSC allowances correctly, without creating uncertainty

**Core-Q53. Are there any other areas or metrics that we should include in our governance framework?**

**SPEN partially agree with the metrics Ofgem has proposed to include in the governance framework.**

We believe Ofgem is correct in recognising that WSC numbers and locations can vary between years, and that even if a customer is not worst served in one year, they are still "badly served" and may fall back into the definition in a future year. We believe it would help to clarify threshold and spending rules if the customer qualification criteria included a confirmed 'look back' period. We suggest that if a customer qualified as a WSC in the final 2 years of RIIO-ED1 (under the RIIO-ED2 definition), they are eligible for WSC funding in RIIO-ED2. This ensures DNOs can begin to target and deliver work early in RIIO ED2

We believe that the metrics identified are mostly suitable for monitoring the WSC outcomes. However, we believe more clarity is required on what the "forecast benefit" and "actual benefit" metrics will

achieve, and why they are required if they will not be used. We agree that only schemes with a forecast ‘expected benefit’ will be undertaken, but measuring actual benefit is problematic as it becomes a comparison against a counter-factual that was avoided (e.g., measuring against faults that have not happened or customers who were not interrupted) Alternatively, it is a comparison to previous years, that may not be directly comparable and therefore gives misleading results.

We agree with Ofgem’s assessment that inclusion of a UIOLI WSC allowance will ensure DNOs don’t just deliver activity that drives greatest IIS performance but that also improves experience for WSCs. We also agree that DNOs should not be deterred from making WSC investment that also improves reliability for non WSCs, just because of the wider IIS improvements. As such we agree with a separate mechanism and governance process for WSC.

**Core-Q54. Do you agree with our proposed approach on NARM?**

**SPEN Agree with Ofgem’s proposed approach on NARM.**

SPEN have engaged and collaborated with Ofgem and the other DNOs extensively as part of the Safety, Resilience and Reliability Working Groups, and as part of the NOMs Electricity Distribution Working Group (NEDWG) throughout the duration of the RIIO ED2 framework development

**SPEN Agree with the use of NARM as an output measure to ensure companies deliver required levels of investment.** It is important to note NARM in itself is not an asset management decision making tool, but it can be used to inform companies’ investment strategies and to give regulatory confidence that companies are making appropriate and efficient investment decisions. The primary purpose of NARM is to give Ofgem a consistent and comparable view of risk for similar assets across different DNO licences and groups

**SPEN Agree with Ofgem’s position to retain Information Gathering Plans (IGPs).** SPEN agree these documents set important parameters for ensuring the accuracy and validity of information used to derive asset risk within Common Network Asset Indices Methodology (CNAIM). SPEN also believe there is value in these IGPs being subject to DNO data-share to allow for exchange of best practice

**SPEN Agree with Ofgem’s decision not to introduce an uncertainty mechanism for non-NARM related expenditure.** As advocated in previous consultations and at industry working groups, SPEN agree the wider cost assessment methodology, and the over-arching Totex Incentive Mechanism, are powerful regulatory tools for managing Non-NARM expenditure. We also agree that this as an area with sufficient levels of certainty (drawing from companies’ long-standing track records of delivering these activities) so as not to require an additional uncertainty mechanism

SPEN agree with Ofgem’s long term right approach for Non-NARM expenditure, which is the ongoing broadening of the NARM and CNAIM- style approach for RIIO ED3 and beyond

**SPEN Broadly Agree with the proposed Incentive Arrangements and NARM Deadband.** We believe a ±5% deadband around the baseline network risk output should be obtainable, allowing for inevitable variation in distribution delivery (e.g., where final condition varies from predicted, through innovation, or where work is subject to variation) However, we believe Ofgem should also ensure that there is not excessive variation of delivery within specific asset categories, and where this is the case, sufficient justification should be provided to avoid claw-back of allowances. Although SPEN agree with retaining the proposed penalty rate of 2.5% of the funding adjustment for unjustified under-delivery, Ofgem should also clarify their position on Justified Over-Delivery to ensure DNOs proceed with confidence

where justified work is identified in-period. SPEN also support maintaining general consistency with the closeout methodology for RIIO-ED1

**SPEN Agree with the adoption of companies' final Business Plan submitted views of monetised risk reduction to set Baseline Network Risk Outputs.** We understand there is a view that monetised risk targets should be modified to correspond with adjustments made by Ofgem when setting price control allowances. However, as there is no direct relationship between Ofgem's proposed adjustments (which are a blend of Totex and disaggregated modelling) and companies' asset management plans, including which specific asset types and risk bands would be affected, it is not possible to modify Baseline Network Risk Outputs in a transparent and accurate way. The only logical exception to this would be where Ofgem have found a company's 'needs case' to be unjustified, in these instances allowances and associated risk movements could be fully excluded from the settlement.

SPEN will continue to collaborate with Ofgem and the other DNOs to finalise the RIIO-ED2 NARM Licence Conditions

**Core-Q55. Do you agree with our proposal to pass through SW 1 in 20 costs as a variant Totex allowance rather than a fixed allowance in RIIO-ED2?**

**SPEN agree with this proposal.**

SPEN agree with the use of pass-through allowances for Severe Weather (SW) 1 in-20 costs, in the event that a licensee experiences a qualifying severe weather event outside of their control (note this is not limited to storms but could also be a heatwave, tidal, or even solar-flare). We agree that adopting a pass through approach will ensure DNOs are not indirectly rewarded where no such qualifying event has occurred. We agree that allowed costs should be efficient and believe the variant Totex allowance approach will enable this but highlight (as per SPEN Business Plan Annex 4A.20) that costs during these events are not comparable with business as usual activity or event usual fault repair. There is significant out-of-hours labour, a premium on materials, additional welfare and support activity that contribute to increased costs during these events.

Note: Ofgem have stated a SW 1-in 20 has a 5% chance of occurring in a given year. We do not believe this to be the case, as the threshold is derived from "42 times mean daily faults within a 24-hour period threshold", and this does not have a 5% probability of occurrence. We understand the nomenclature of this allowance is a legacy naming convention, and not a probabilistic or statistical statement of fact.

**Core-Q56. Do you agree with our proposal to not set a cap for the amount that DNOs can adjust their allowance by, in the event they experience a SW 1-in-20 storm?**

**SPEN agree with this proposal.**

SPEN agree with Ofgem's decision not to set a cap for SW 1 in-20 allowances. These events are rare; the thresholds for this allowance were not triggered for SPEN even during the level of devastation experienced during storm Arwen in November 2021. As such it is not likely to be utilised often. But it is also not practical to cap the potential adjustment a DNO may require to restore the network if a SW 1-in 20 event were to occur in RIIO-ED2. The mechanism should ensure the DNO is able to make all necessary repairs, without compromising wider Totex allowances.

We note however that there is potential for an uncapped pass-through to require levels of work beyond the deliverability of an individual DNO licensee or group, and that the DNO North East West South Area Consortium (NEWSAC, emergency sharing of resources) is likely to be triggered. In the event of a sustained NEWSAC contribution from other DNOs, they should be afforded regulatory relief for 'outputs not delivered' due to diversion of key resources

**Core-Q57. Do you agree with our proposed approach to the physical site security re-opener?**  
**SPEN agree with this proposal.**

Ofgem acknowledge there may be changes in the CNI status of a site or in Government policy within RIIO-ED2 that are not within a DNO's control and could not be foreseen beforehand. In such cases, DNOs must be able to make investments through the PSUP, which justifies the need for a re-opener

We also support the proposal that there is no materiality threshold to this reopener as this is a programme of critical national importance and DNOs should not carry the burden of costs of compliance with these standards since DNOs will be under an obligation to comply.

**Core-Q58. Do you agree with our proposed approach to the ESR re-opener?**  
**SPEN Agree with Ofgem's Scope, Trigger, Window and Threshold for the ESR re-opener.**

As stated in our SPEN Business Plan Annex 4A 17, we fully support the availability of a reopener to increase ESR allowance in the event that additional investment is needed to meet the requirements of the new Electricity System Restoration Standard (ESRS), if the ESO (or future FSO) requires DNOs to undertake additional activities to ensure that the ESRS can be met. We agree that any obligations driven by NGESO's requirement to comply with the ESRS are outside of DNO control. Developing these requirements is dependent on the publication of core modifications related to the ESRS, scheduled for September 2023, and the procurement of additional restoration services from DERs by NGESO, with contract likely to be awarded by 31st December 2023. Assuming there are no delays to these timescales, the proposed re-opener window of 24th – 28th June 2024 should be achievable for DNOs, however given the reliance on external parties we would welcome an additional re-opener window in June 2025.

However, given the uncertainty around the timing of some of the DNO obligations, we strongly agree with Ofgem having the right to trigger the ESR re-opener outside of the above DNO application window. We also support the proposal that there is no materiality threshold to this reopener as this is a programme of critical national importance and DNOs should not carry the burden of costs of compliance with these standards since DNOs will be under an obligation to comply.

**Core-Q59. Do you agree with our approach to fund DNO telecoms resilience activities through baseline allowances?**

**SPEN agree with this proposal.**

These activities are fundamental to create a secure and resilient communications network to facilitate Net Zero and support our wider network infrastructure. We believe there is high certainty on required costs for RIIO ED2. Although we agree with Ofgem's assessment of the current position with regards to radio spectrum allocation, if this (or any other exogenous factor) were to change during RIIO-ED2, SPEN consider that changes to the Operational IT and Telecoms expenditure would be captured by Ofgem's proposed High Value Projects (HVP) re-opener

**Core-Q60. Do you agree with our proposal to assess the cyber resilience IT and OT plans against our BPG and RIIO-2 re-opener guidance?**

**Core-Q61. Do you agree with our proposed re-opener windows for cyber resilience OT and IT?**



**Core-Q62. Do you agree with our proposal to apply a UIOLI allowance to cyber resilience OT to manage the uncertainty around costs?**

**SPEN agree with this proposal.**

There is considerable uncertainty around OT Cyber Security solutions and the associated costs. The process must be designed in an agile way to allow for necessary expenditure to be agreed in a timely manner and ensure that our OT infrastructure maintains resilient against cyber threats.

## Section 7. Delivering at lowest cost to energy consumers

**Core-Q63. Do you agree with our proposed approach to pre-modelling normalisations and adjustments?**

**SPEN partially agree with Ofgem's approach.**

Ofgem notes that in order to ensure costs are benchmarked on a comparable basis, it undertakes a normalisation process aimed at making any necessary adjustments to company submitted data to ensure they are consistent. Ofgem makes a number of adjustments for regional factors; company specific factors; exclusions; and other adjustments.<sup>6</sup> Whilst we agree in principle that pre modelling normalisations and adjustments are necessary and in the most part, we agree with what has been undertaken for Draft Determination, we would outline the below for consideration.

**SPEN do not agree with Ofgem's approach to adjusting for variation in Regional Wages**

To account for differences in regional wages, Ofgem proposes to apply a regional labour cost adjustment that distinguishes wage differentials based on three distinct regions: London, the Southeast, and elsewhere i.e. a three-region approach.

Ofgem acknowledges that both SPEN and SSEN note in their business plans that labour costs in Scotland are higher than the national average, and therefore proposed either a more granular 11 region approach in the case of SPEN, or by including Scotland as an additional region alongside London and the South East in the case of SSEN<sup>7</sup>

However, Ofgem proposes to retain the 3 region approach stating that:<sup>8</sup>

*"Our analysis of historical regional wage differentials based on ASHE data indicates that London remains a clear outlier compared to the rest of the country, with the effect extending to the South-East. We are not satisfied that there is sufficient and compelling new evidence to indicate that this has changed over time, specifically since RIIO-ED1 and RIIO-GD2."*

---

<sup>6</sup> Ofgem (2022) Consultation - RIIO-ED2 Draft Determinations

Core Methodology Document. Para 7.34, p. 231

<sup>7</sup> Ofgem (2022) Consultation - RIIO-ED2 Draft Determinations

Core Methodology Document. Para 7.37, p. 232

<sup>8</sup> Ofgem (2022) Consultation RIIO-ED2 Draft Determinations

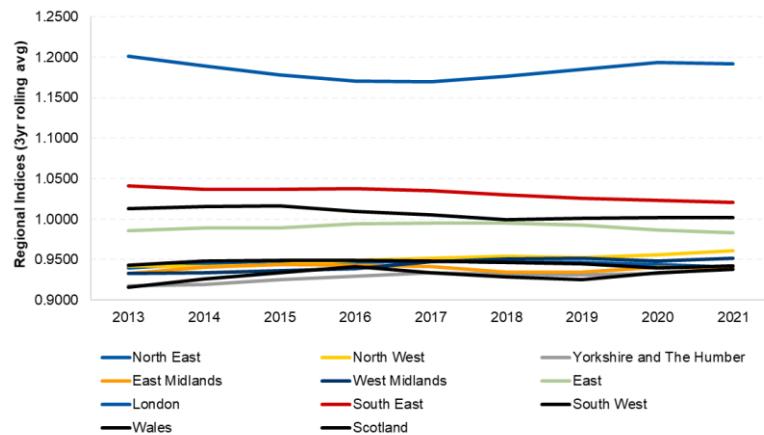
Core Methodology Document. Para 7.38, p. 232

Ofgem further notes that it considers that it would expect labour mobility throughout GB to mitigate any wage differentials.<sup>9</sup> We disagree with Ofgem's reasons for rejecting either an 11 -region approach or potentially adopting a 4 region approach, with Scotland as the additional region.

Our analysis shows that wages in Scotland have been persistently higher than in other regions (bar London and the South East) over at least the past 10 years (see Figure 1 below). Scotland is a clear and consistent outlier relative to the remaining regions. There is no reason for Ofgem to arbitrarily acknowledge higher costs in the two highest cost regions, London and the South East, but not recognise higher costs in the third highest cost region, Scotland. Ofgem accepts other claims of increased cost based on the geographies of other DNOs and so this approach is arbitrary.

Our analysis also shows that the differential has persisted throughout the RIIO ED1 period, since the 28 November 2014 RIIO-ED1 Final Determination. It is therefore not appropriate to rely on the RIIO-ED1 approach.

*Figure 1 Regional Indices 2013 - 2021*



Source: [Analysis of ONS Ashe Data](#)

In addition, we note that there is no additional modelling complexity or cost to implementing an 11 region approach: Ofgem must calculate regional wages for the 11 regions to implement its 3 region approach

We believe that Ofgem should implement an 11-region approach which will correctly adjust or normalise costs for the enduring differences in SPD's and other regional wages, and would therefore be consistent with Ofgem's stated goal of ensuring comparability of costs between the different DNOs

#### **Core-Q64. Do you agree with our approach to Totex benchmarking?**

**SPEN broadly agree with the approach taken to Totex benchmarking for Draft Determination, however we believe certain costs should be reconsidered for exclusion from the Totex models in Final Determination.**

---

<sup>9</sup> Ofgem (2022) Consultation RIIO-ED2 Draft Determinations Core Methodology Document. Para 7 39, p. 232

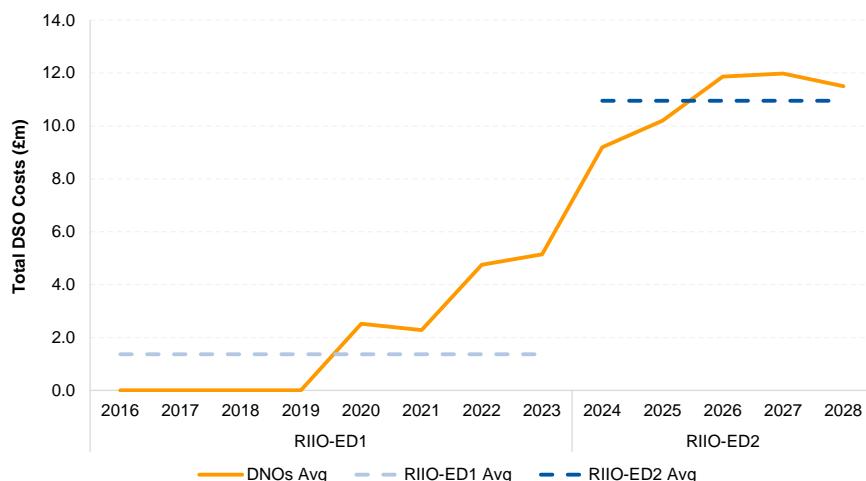
**SPEN do not agree with the decision to include DSO costs within the Totex modelling and believe that that these costs should be considered as an exclusion to the cost assessment modelling.**

Ofgem's approach to Totex modelling is to include all companies cost in the Totex modelling irrespective of whether these reflect "business-as-usual" outputs or are related to new outputs. Ofgem's rationale for including all costs is that it could be difficult to separate out BAU from expenditure related to new outputs.<sup>10</sup>

We consider DNO's enhanced DSO role clearly constitutes a new output, and the costs associated with the enhanced role can be readily identified in DNO submissions, in line with the business plan guidance and data templates. There is also a clear change in outputs between RIIO-ED1 and RIIO-ED2, and a material change in costs. Such a step change in costs is not captured by Ofgem's inclusion of activity level drivers in Totex model 2 or model 3, or time-trend specification

As shown in Figure 2 DSO Total Costs below, DSO costs are anticipated to increase five-fold during RIIO-ED2, relative to RIIO-ED1. Therefore, these costs should be excluded from the Totex modelling.

*Figure 2 DSO Total Costs*



**SPEN do not agree with the decision to include PCB costs within the Totex modelling and believe this should be considered as an exclusion to the cost assessment modelling.**

SPEN are supportive of Ofgem's proposal to accept submitted DNO volumes and agree that this is necessary due to the legal driver to remediate PCB affected assets by 31st December 2025. However, PCB expenditure is then included within the cost assessment modelling, and subject to assessment within the Totex modelling. This technique is inconsistent with Ofgem's decision to accept submitted volumes, and instead subjects volumes to an assessment that is driven by factors unrelated to the PCB programme and risks inconsistent results, with the result that in effect some PCB expenditure is disallowed.

SPEN disagree with PCB expenditure being included in the Totex modelling and believe, PCB expenditure should be treated in a similar vein as Rising & Lateral Mains, Worst Served Customers, and TCP expenditure and be excluded from the Totex models. The expenditure should be excluded, consistent with Ofgem's approach as described at paragraph 7.34 of the Core Methodology Document.

---

<sup>10</sup> Ofgem (2022) Consultation - RIIO-ED2 Draft Determinations Core Methodology Document, para 7.29, p. 229

### SPEN support Ofgem's use of MEAV within the Totex models and agree with Ofgem's Adjustments to MEAV prior to its use within all CSV cost drivers

In general, SPEN support Ofgem's approach to back calculating MEAV to address historical anomalies in asset data. We agree that the re statement has resulted in improved model results (e.g. higher adjusted R-squared, consistent with our own analysis as set out in our business plan.)<sup>11</sup>

We also agree with Ofgem's intention to include a range of assets within MEAV which were previously excluded because of concerns about the robustness of data, given that data quality issues should have been ameliorated.<sup>12</sup> Specifically, we agree with the inclusion of rising lateral mains (RLM) assets within MEAV. Although direct RLM costs are excluded from the modelling, Ofgem correctly concludes that indirect RLM costs are reflected within other cost categories such as Operational IT&T, CAI and Business Support. If RLM assets were excluded, then this would necessitate an adjustment to these submitted cost categories.<sup>13</sup>

### Ofgem Should Revise the RESET Test Code in its Stata Regression File

We find Ofgem is wrong to run the RESET tests assuming independently and identically distributed standard errors. This approach is inconsistent with Ofgem's own assumption of running regressions with clustered robust standard errors. We recommend modifying the code used in the Stata Regression File to run the RESET test with clustered robust standard errors, which is also in line with Ofgem's approach at RIIO-ED1.

### Ofgem Should Use RIIO-ED2 Dummy in Determination of Totex 2 Model

For the Totex 2 model – which consists of a top-down CSV, capacity released, a whole period time trend and a forecast time trend – the model fails Ofgem's RESET test.<sup>14</sup> However, as noted above, we find Ofgem runs the incorrect RESET test by not assuming clustered robust standard errors. After adjusting for this error, we find that Ofgem's Totex 2 passes the RESET test.

Ofgem further explains that the inclusion of RIIO-ED2 time dummy – as an alternative to the forecast time trend – results in the model passing the RESET test; however, Ofgem considered that the “*two time trend specification was more consistent with our prior expectations for why we wanted to control for time effects within our Totex models*”<sup>15</sup>

We consider that Ofgem is wrong to reject the RIIO-ED2 dummy time specification. Specifically, Ofgem is wrong to hold a prior expectation that companies' costs will reflect its “two time trend specification” relative to a range of other plausible prior expectations such as a step change in costs at RIIO ED2 (e.g. an RIIO ED2 dummy specification), and even if Ofgem's prior expectation was reasonable relative to others, it should adopt a time specification that provides the best statistical fit.

There is no requirement to have the same time trend specification across the three Totex models. The three models have very different scale drivers, and Ofgem should correspondingly allow for different time specifications to ensure the model best meets Ofgem's own diagnostic tests.

---

<sup>11</sup> SPEN RIIO-ED2 Final Business Plan, Annex 5A.3, Appendix 3

<sup>12</sup> Ofgem (2022) Consultation - RIIO-ED2 Draft Determinations – Core Methodology Document. Para 7.118, p 254

<sup>13</sup> Ofgem (2022) Consultation RIIO-ED2 Draft Determinations Core Methodology Document Para 7 120, p.254

<sup>14</sup> Ofgem (2022) Consultation - RIIO-ED2 Draft Determinations Core Methodology Document, Annex 7, p.400

<sup>15</sup> Ofgem (2022) Consultation - RIIO-ED2 Draft Determinations Core Methodology Document, para A7.4, p. 403.

We find that the use of an RIIO-ED2 Dummy performs better than Ofgem's model which uses a forecast time trend. As acknowledged by Ofgem itself, a model using an RIIO ED2 Dummy passes all of Ofgem's diagnostic tests, and we find it has a higher adjusted R-squared (of 0.87) relative to the Ofgem's model (0.85). Therefore, Ofgem should use an RIIO-ED2 Dummy in place of a forecast time trend in its Totex 2 modelling.

**Core-Q65. Do you agree with our proposed assessment approach for primary reinforcement?**  
**SPEN do not agree with the proposed assessment approach.**

SPEN considers that the proposed approach can lead to significant differences between the outcomes from EJP assessments and the disaggregated benchmarking. For example, for SPD expenditure the benchmarking proposes significant work load adjustments in both CV1 and CV3, whilst the individual scheme EJPs in these areas have been assessed as justified.

There are large variations in size, scale, and cost of primary reinforcement projects. These schemes are specific bespoke solutions to resolve individual capacity or fault level constraints. The scheme specific factors will govern both cost and volumes, including for example: the level of capacity shortfall over time; the location, capacity, and construction of existing equipment; availability of land; availability and suitability of alternative solutions such as flexibility, smart or innovative solutions etc.

However, the benchmarking parameters are unable to consider these factors, and the relatively low volume of these schemes per license does not enable a portfolio effect to average out these variations. In CV1 this applies to both cost and volume benchmarking using '£/MVA' and 'MVA capacity added' respectively. In CV3 this applies to cost benchmarking using '£/switchboard'.

We would request that Ofgem applies more weighting to the Ofgem engineering team's EJP review. Doing so will avoid anomalous conclusions on volumes and unit costs. It will make more direct use of the detailed EJPs, which are a positive addition to the RIIO ED2 process, and would enable more transparent use of the detailed reviews already undertaken by the Ofgem engineering team. These assessments involved a review of each individual needs case, options available, proposed design, supporting CBAs etc.

By relying more directly on the EJPs, this process would be better able to demonstrate that the work levels resulting from the benchmarking are consistent with the results of the EJP assessments – not only at a broad aggregated level across all DNOs but also for individual DNOs and individual schemes. We expect this will become more important when considering the in period operation of the LRE re-opener and RIIO-ED2 close out processes, which will need to have clarity on schemes included / excluded from baseline allowances.

**Core-Q66. Do you agree with the application of a volume adjustment based on the industry average ratio of forecast capacity added relative to the forecast demand growth above firm capacity? If not, what do you consider to be a better approach to assessing the efficiency of a DNO's proposed workload for primary network reinforcement?**

**SPEN do not agree with the approach.**

Please refer to our response to Core Q65 where we detail how this is unable to consider the bespoke and site-specific nature of the projects at these voltages. We would request that a greater emphasis should be placed on the Ofgem engineering team's detailed EJP review.

**Core-Q67. Do you agree with our proposed assessment approach for secondary reinforcement?**  
**SPEN broadly agree with the proposed assessment approach for secondary reinforcement.**

We broadly agree with the use of a disaggregated unit cost-based assessment for transformer, circuit, and proactive service reinforcement. The use of the same unit costs as the proposed volume drivers maintains alignment between benchmarking and allowances, both in setting initial allowances and subsequently adjusting these up/down during the period.

We also believe that the relationships between LCT volumes, demand growth and the level of required network reinforcement are highly complex and sensitive to many factors including for example the level of existing headroom and LCT clustering effects.

For example, to develop our RIIO ED2 plans, our ‘Engineering Net Zero’ model used granular forecasting including EV and HP forecasts at individual property level to systematically identify the location, magnitude, and timing of the additional capacity our customers need. We tendered for flexibility for every constraint, and we used a mathematical linear optimisation engine to determine the most economic combination sequence and timing of solutions. Our plans have identified individual schemes for all known constraints at all voltage levels including at LV. This means that our intervention plan is not just extrapolated from statistics, which is significant step from how all DNOs built Secondary Reinforcement plans at RIIO-ED1. This detailed knowledge of the constraints and solutions facilitates us pushing schemes into delivery.

When these relationships are generalised within the benchmarking process, this could risk some gains/losses. However, we view the risks associated with setting slightly higher/lower ex ante allowances in this area are sufficiently mitigated by the symmetrical volume drivers. This additional reliance on the volume drivers places further importance on the need to ensure that the unit costs used by the volume drivers are kept cost reflective and are reviewed within RIIO-ED2. Also, where volume driver administration metrics rely on a similar generalised approach, DNOs may need the ability to provide additional justification through a more qualitative approach.

**Core-Q68. Do you agree with the level of disaggregation and period of data used to calculate the unit costs listed in the table above for transformer reinforcement, circuit reinforcement and proactive service reinforcement?**

**SPEN agree with the level of disaggregation, but do not agree with the unit costs for proactive service reinforcement.**

We agree with the level of disaggregation as this maintains alignment between benchmarking and the volume drivers. However, we do not believe the expert view of unit cost for proactive LV service reinforcement is sufficiently reflective of the required activity. Unlooping of LV services is a new programme for SPEN and other DNOs, where we are facing both upwards cost pressures but also additional challenges at scale, such as routinely extending our interventions into customers’ homes and properties. While we have set challenging unit cost targets for delivery of our work programmes, we believe that there is a notable uncertainty in this area.

Therefore, we consider that the uncertainty in unit costs used within the volume driver should be managed by maintaining these under review throughout the RIIO ED2 period. As discussed in Core-Q4, it will be important that these volume drivers are maintained as cost reflective as possible to enable DNOs to confidently and proactively adjust their plans based on customer LCT uptakes without the risk of over/under adjustment.

We request Ofgem consider the supporting evidence provided through the SQ process in reviewing the proposed costs and uncertainty approach for LV service reinforcement volume driver.

**Core-Q69. Do you agree with our proposed assessment approach for fault level reinforcement?**  
**SPEN do not agree with the proposed approach.**

Please refer to our response to Core Q65 where we detail how this is unable to consider the bespoke and site-specific nature of the projects at these voltages. For example, the '£/switchboard' for resolving the constraints on an 18 panel board will be much higher than that of a 3 panel board. We consider that a greater emphasis should be placed on the Ofgem engineering team's detailed EJP review.

**Core-Q70. Do you agree with our proposed adjustments to account for outlier volumes data for ENWL and SSES?**

**SPEN agree with this adjustment; however, we feel it reflects that the overall assessment approach is not appropriate.**

The requirement to apply qualitative volume adjustments to two licences further supports our request in Core-Q65 for Ofgem to consider applying more weighting to the Ofgem engineering hub's EJP review. For example, we view that run-rate analysis forms an important tool within the benchmarking, but comparisons with previous price controls cannot assess the increased activity driven by the decentralisation and decarbonisation of generation. The detailed reviews of the need cases on an individual scheme level should therefore be able to override this broader indicator, provided that sufficient justification has been provided at an EJP level.

Similarly, a detailed review of volumes included in the relevant EJPs for the two affected licences should be used to identify whether these are justified, or whether they are outliers due to different interpretations on the reporting of volumes.

**Core-Q71. Do you agree with our proposed assessment approach for connections?**  
**SPEN partially agree with this approach.**

The benefit of Ofgem's proposal to disaggregate beyond the current classification of voltage level and demand / generation is unclear. The use of MPANs instead of projects does not reflect the amount of variability of engineering designs within each market segment which will attract different costs based on the engineering solution needed. This is the case when considering project by project or MPAN by MPAN. Also, connections expenditure includes in-year transactions against connections schemes. Therefore, there may be instances where spend is accrued against a segment in one year with an MPAN or POC not realised until a subsequent year. This will always be a factor in applying an industry average unit cost, which may lead to inaccuracies.

**Core-Q72. Do you agree with our proposed assessment approach for NTTC expenditure?**  
**SPEN agree with the proposed assessment for NTCC expenditure.**

For disaggregated assessments, a qualitative review of EJPs is appropriate because a significant portion of the costs in this area pertain to either continuing payment of exit charges associated with schemes delivered prior to RIIO ED2, or schemes assessed as part of the RIIO-T2 process.

**Core-Q73. Do you agree with our proposed assessment approach on asset replacement?**  
**SPEN agree with Ofgem's proposed volume assessment and would highlight the strength and robustness of the depth of Ofgem's qualitative review in this area, which demonstrates significant analytical and engineering appraisal has been made of DNOs' specific plans.**

As part of the RIIO-ED2 process, SPEN have welcomed the Engineering Justification Paper (EJP) process. This has given DNOs the opportunity to present well-justified needs cases, deliverability, and risk management as part of their engineering business plan. This process was reinforced by Ofgem Engineering Hub site visits which gave a further opportunity to discuss network investment needs over RIIO ED2. As such, SPEN strongly support Ofgem's qualitative approach to adjustments associated with EJPs for Asset Replacement (CV7). We have set out our views on Ofgem's graded qualitative assessment and disaggregated model impact below:

**SPEN agree with Ofgem's approach of allowing all volumes where an EJP is fully justified.**

SPEN consider Ofgem have set a high bar for DNOs to provide adequate evidence to obtain full justification. We believe this is in customers' best interests and reduces the risk of DNOs being funded for work which is not required, and subsequently not delivered. Where a paper is justified, DNOs have been able to clearly demonstrate a strong needs case, risk management and deliverability for planned works.

**SPEN Agree with Ofgem's approach of disallowing all volumes where an EJP is Unjustified.**

SPEN consider Ofgem have assigned unjustified papers sparingly, and consistently with their EJP Guidance – i.e., where a DNO has insufficiently justified the needs case, proven deliverability or clearly managed associated risks. Where a DNO has not been able to demonstrate at least partial justification to Ofgem, SPEN agree with the proposed approach of reducing allowed volumes to zero. However, we note, an alternative to this approach would be to adopt a more conservative volume from one of Ofgem's alternative volume assessment methods.

**SPEN Agree with Ofgem's approach of modifying volumes where an EJP is Partially Justified.**

As above, SPEN consider this strikes an appropriate balance between Fully and un-justified papers. We agree with Ofgem's approach of adjusting volumes by first comparing to RIIO-ED1 delivery track-record i.e., performance against RIIO-ED1 plans. We note that this assessment should be made using the best available view of DNO forecast (e.g., post RIIO-ED1 re-statement) and out-turn delivery.

We believe volume adjustments are still valid in cases where a DNO has already reduced their volumes from RIIO-ED1 run-rates. In our view, if activity has not been fully justified, then a reduction is appropriate – regardless of comparisons to past performance

We believe that the proposed adjustment should be commensurate with the assessment, e.g., if a paper is partially justified on the basis of deliverability, then DNO run rates would provide a good-basis for adjusted volumes.

**SPEN Agree with Ofgem's alternative volume assessment method of 'Age based survivor modelling'**, although not appropriate for all categories, this approach has precedence in previous price controls and can provide an indication of required levels of work in the absence of a justified needs case.

**SPEN Agree with Ofgem's alternative volume assessment method of 'Run rate analysis'**, this can provide a reliable insight into DNOs' delivery capability and asset need. However, we propose Ofgem should evaluate a DNO's own run-rate, in addition to industry median run-rate, as in many cases this will be more appropriate for proposed adjustments

**SPEN Broadly Agree with Ofgem's proposed approach to use an industry median unit cost per asset category based on RIIO-ED1 and RIIO-ED2 data, as well as expert review.**

SPEN believe that applying a common unit cost based on industry median ensures consistency across all DNOs and is appropriate for the majority of assets. By testing the industry median against Ofgem's expert view, this should ensure efficient unit costs are set fairly and accurately.

SPEN believe that Ofgem should adopt a more tailored approach to unit costs in some instances, particularly where there are variations in company strategies, activities, or types of work. Examples include SF<sub>6</sub>-free unit costs with a total incremental cost of £2.1m, HV buried transformers with a total incremental cost of £3.1m, and replacement of 33kV RMUs, an activity which is unique to SPEN's interconnected network. In these cases, we believe company submitted Unit Costs in BPDTs should be adopted. These incremental higher cost interventions should be excluded from benchmarking and allowed in full within disaggregated models if justified.

SPEN provided a fully-redacted Unit Cost Manual (SPEN Business Plan Annex 5A 5) as part of our final Business Plan. We believe this provides a highly accurate and reliable breakdown of costs and gives SPEN high confidence in our adopted unit costs.

**Further to this response, please treat submitted Supplementary Questions (SQs), including on the Unit-Cost breakdown on LV Services, as part of our wider consultation response.**

**Core-Q74. Do you agree with our assessment approach to refurbishment?**

SPEN agree with Ofgem's proposed volume assessment and would highlight the strength and robustness of the depth of Ofgem's qualitative review in this area, which demonstrates significant analytical and engineering appraisal has been made of DNOs' specific plans.

Please see our response to Core-Q73 for further detail. Further to this response, please treat submitted Supplementary Questions (SQs) in this area as part of our wider consultation response

**Core-Q75. Do you agree with our proposed assessment approach for asset replacement driven civil works?**

SPEN partially agree with the proposed assessment approach.

We agree that aligning CV7c (asset replacement driven civil works) expenditure with CV7a (asset replacement - NARM) and CV7b (asset replacement – Non-NARM) total expenditure is the most appropriate cost driver for assessing CV7c costs across DNOs. We also agree with the approach of dis associating Condition Driven Civil Works (CV10) from Asset Replacement Driven Civil Works.

SPEN believe that the CV7a and CV7b expenditure used for RIIO-ED2 used in the CV7c disaggregated model should be related to assets at Substations only (i.e. switchgear and transformers). This approach would remove asset replacement costs associated with Cables and OHL assets which do not include any civil associated with asset replacement activities. SPEN suggest that the modelled output expenditure values from the CV7a and CV7b disaggregated models (rather than DNO submitted costs) are used to ensure that there is alignment between these programmes

**Core-Q76. Do you agree with our proposed assessment approach for Condition Based Civil Works?**  
SPEN partially agree with this proposal.

SPEN agree the proposed assessment approach of using '*industry median unit costs and ratio of annual average volumes to total asset register, by asset class*', is a reasonable approach for benchmarking condition driven civil works for typical scenarios where expected work is within a reasonable range of the industry median unit cost

However, this approach does not allow for instances where DNOs have exceptional schemes of civil work where required investment far exceeds industry median cost, as included with SPENs business plan.

As part of our RIIO-ED2 final Business Plan, we included a small volume of ‘Major Civil Project’ sites, these are detailed within ED2-NLR(A)-SPEN 002-RES EJP Condition Driven Civils (CV10) Issue 2. For example, Cowgate primary substation in Edinburgh is a large, listed building within a conservation area, approaching 100 years-old and in need of significant modernisation. We undertook detailed civil engineering inspections at all these locations and have detailed cost breakdowns for the levels of expenditure required to ensure the sites are safe, secure, and habitable for electrical plant. A subset of these locations was visited by Ofgem’s Engineering Hub during the RIIO-ED2 Site Visit process, with positive discussion and recognition of the atypical scale and cost of works required.

Including the costs and volumes for these locations within median benchmarking unfairly skews SPEN’s position as a result of good asset management and cost forecasting. As such, SPEN believe Ofgem should exclude the costs and volumes relating to the ‘Major Civil Project’ schemes from disaggregated modelling and add them back in (subject to Ofgem’s qualitative review) post modelling.

**Core-Q77. Do you agree with our proposed assessment approach for diversions?**

**SPEN agree with the proposed assessment approach.**

We agree with the use of Median Unit Cost data for all DNO’s over RIIO-ED2 period only and would also agree with the proposals under consideration for an uncertainty mechanism in this area.

**Core-Q78. Do you agree with our proposed approach for Rail Diversions?**

**SPEN agree with the proposed approach for the assessment of Rail Diversions, noting that SPEN have no forecast costs within this area.**

**Core-Q79. Do you agree with our proposed approach to assessing Non-Operational, Operational and Business Support IT&T costs?**

**SPEN do not agree with the proposed assessment approach.**

Ofgem proposes to use ratio benchmarking to assess IT&T costs, using MEAV as the cost driver and an industry median benchmark ratio based on both RIIO-ED1 and RIIO-ED2 data. Ofgem also undertakes a qualitative assessment, using its assessment as the input into the quantitative analysis (i.e., disallowing selected schemes and costs prior to quantitative assessment).<sup>16</sup> Under the current approach, all DNOs receive a materially lower allowance in IT&T compared to their business plan. This is because DNOs are forecasting that they require to undertake increased levels of investments in IT&T during RIIO-ED2 relative to RIIO ED1 due to the expansion of their DSO activities, which are fundamental to achieving Net Zero.

As Ofgem models IT&T costs based on the RIIO ED1 and RIIO ED2 industry median benchmark, the current approach fails to recognise the new, and increased activities during RIIO-ED2. By including the RIIO ED1 period, new DSO activity required for Net Zero delivery is significantly reduced within model outputs. Further, the use of Median “DNO Cost/MEAV” as a cost driver is unable to recognise differences in DSO starting positions, or ambition.

SPEN have planned the roll out of 14,102 LV Monitors across SPD and SPM, covering 19% of secondary substations and 75% of customers. This is a material increase on RIIO-ED1 and will result in increased

---

<sup>16</sup> Ofgem (2022) Consultation RIIO-ED2 Draft Determinations Core Methodology Document, p 298

network visibility to prioritise interventions, reduced secondary reinforcement costs, enable faster connections and inform LV flexibility. Reductions to this programme will inhibit our ability to maximise capacity utilisation of the LV network and deliver our DSO and Net Zero ambitions.

SPEN have also planned the roll-out of 22 Constraint Management Zones which will give coverage of 30% of the EHV Network, over three times the level of activity in RIIO-ED1. These will enable faster connection of generation, smooth compliance with Access SCR changes, and enable dynamic network control to defer conventional reinforcement. Reductions to this programme will constrain DSO activity, drive the need for greater reinforcement investment, and inhibit Net Zero.

In order to address the above, we propose the use of an econometric model instead of a ratio model, as the econometric form can allow for non-constant returns to scale, e.g. a fixed cost element. In conjunction with NERA, we have undertaken a regression (in log terms) of total IT&T cost over 2016-2028 regressed against MEAV, a time trend, and a forecast time trend, as per the current approach to modelling the time specification in Totex models.

Further, as per our response to Core-Q64, we believe DSO expenditure (as per the M19 memo table) should be assessed separately, and we propose that these costs are excluded from cost assessment models. This allows benchmarking of core IT&T costs against the full RIIO ED1 and RIIO ED2 period and for DSO cost assessment to recognise the varying starting positions, ambitions and strategies across DNOs.

The results of our proposed econometric model, Total IT & Telecoms (RIIO-ED1 & RIIO ED2), excluding DSO (M19), are demonstrated in Table 1 below. The co-efficient on the forecast time trend is positive and significant, capturing the expected increase in costs over time. We also find that the MEAV scale variable and the constant is statistically significant, demonstrating that there are non-constant returns to scale. The econometric form is therefore preferred to the current ratio model which imposes constant returns to scale. In addition, our proposed model passes all diagnostic tests, bar the normality test, and explains a relatively high proportion of the variation in companies' costs (i.e., high adjusted R-squared value). **We believe a combined (75 Quantitative : 25 Qualitative) approach, as per RIIO-ED1, should be introduced to ensure the qualitative EJP review has greater weight in setting allowances.**

An econometric model which uses DSO costs-only performs poorly and fails to generate statistically significant results. It is therefore critical that a qualitative review of EJPs is used to evaluate and support the assessment of DSO costs.

*Table 1*

| Parameter           | Coefficient | P-value | Diagnostic test |       |
|---------------------|-------------|---------|-----------------|-------|
| Ln (MEAV)           | 0.77***     | 0.001   | RESET           | 0.146 |
| Time trend          | 0.01        | 0.688   | White           | 0.125 |
| Forecast time trend | 0.05        | 0.120   | Normality       | 0.162 |
| Constant            | -9.53***    | 0.008   | Pooling         | 0.993 |
| Adj R-squared       | 0.51        |         |                 |       |

If Ofgem elect to maintain the current approach, and do not amend the cost assessment model to exclude DSO costs or apply an updated econometric model to BAU IT&T costs, there would be a requirement for an additional uncertainty mechanism for DSO related costs within this area, this could

be in the form of a volume driver for LV monitoring or re-opener for roll-out of DSO infrastructure. These could emulate the load related proposals for LCT uptake and CV1 reinforcement. **However, SPENs preferred approach would be for improved cost assessment in this area, as set out above.**

**Core-Q80. Do you agree with our proposed assessment approach for Legal and Safety?**

**SPEN do not agree with the proposed assessment approach.**

Activities undertaken under Legal, and Safety are driven by the DNOs legislative and regulatory responsibilities to operate and maintain a safe network, and under a duty of-care to ensure public safety from the system. The modelling approach adopted by Ofgem should recognise the DNOs identified need to invest to meet these responsibilities. If allowances are reduced in this area, there will need to be a consequential reduction in other areas of Totex as Legal & Safety delivery is generally non-negotiable.

Ofgem currently propose to use a ratio benchmarking approach with MEAV as the cost driver in its determination of legal and safety costs, and also subjects the cost allowances to an engineering review of the associated EJPs.<sup>17</sup> We consider that it would be appropriate to consider an econometric model form for legal and safety costs. An econometric model-form can capture potential non-constant returns to scale, or fixed cost component associated with legal and safety activities. By contrast, the ratio model imposes constant returns to scale

In conjunction with NERA, we have tested a simple econometric model-form, regressing legal and safety costs against MEAV, and the time-trend specification proposed within the draft determination. We identify statistically significant coefficients for the scale and constant terms, meaning that the costs demonstrate non constant returns. Although our revised regression fails the RESET and normality test, the simple regression is a demonstrable improvement on a ratio model form. This is because we allow the data to specify the form of the cost relationships, and the coefficient on the model variables are statistically significant

*Table 2 SPEN proposed Legal & Safety model*

| Parameter           | Coefficient | P-value | Diagnostic test |              |
|---------------------|-------------|---------|-----------------|--------------|
| Ln (MEAV)           | 0.74**      | 0.044   | RESET           | <b>0.007</b> |
| Time trend          | -0.06*      | 0.087   | White           | 0.278        |
| Forecast time trend | 0.14***     | 0.004   | Normality       | <b>0.035</b> |
| Constant            | -11.07*     | 0.062   | Pooling         | 0.999        |
| Adj R-squared       | 0.15        |         |                 |              |

Following this analysis, we do not believe a strong enough cost driver can be identified to act as the primary mechanism to set allowances in this area (low Adj R-squared value and RESET Failure). This is because all DNOs undertake different activities under the Legal and Safety sub-categories

---

<sup>17</sup> Ofgem (2022) Consultation RIIO-ED2 Draft Determinations Core Methodology Document, p 301

SPEN recommend that Ofgem take a qualitative assessment approach to DNO Legal and Safety activities using submitted EJPs. Where EJPs are unavailable, an econometric model using MEAV as the cost driver can provide a mechanism to set remaining allowances.

Furthermore, we would also suggest Ofgem seek a more granular data set relating to Legal and Safety proposals. This is key to effectively review and to understand common and bespoke activities submitted by DNOs within the BPDT. The current approach is too high level and risks distorting Cost Assessment benchmarking by assuming all DNOs activities are the same in size, scope and cost

**Core-Q81. Do you agree with our approach to assessing Overhead Line Clearance costs?**

**SPEN agree with the proposed assessment approach.**

We agree with Ofgem's proposal to accept justified volumes in this area and note that, as a safety-critical and legislated activity, any downward adjustments would adversely affect other parts of the price control. SPEN supports the use of Median Unit Cost data for all DNO's, over the RIIO-ED1 and RIIO ED2 period, as costs have been broadly stable

**Core-Q82. Do you agree with our proposed approach to assessing ESR costs?**

**SPEN agree with the proposed assessment approach.**

We agree with Ofgem's proposal to use an engineering qualitative assessment based on review of the supporting documents we provided and believe the resultant decision of accepting costs & volumes in full is appropriate. We also agree with Ofgem's proposed re-opener mechanism for ESR to address uncertain costs which may arise during the price control period, as per our response to Core-Q58.

**Core-Q83. Do you agree with our proposed approach to assessing QoS and NoSR costs?**

**SPEN do not agree with the proposed assessment approach.**

SPEN do not agree with Ofgem's decision to exclude all QoS funding, as this risks DNOs underdelivering on reliability programmes below a level that customers expect. Please see our response to Core-Q44 and Core Q-49. As detailed in our response to Core-Q49, we believe a baseline level of QoS funding will give DNOs the certainty to invest in network performance and mitigate the risks of under delivery and penalty. We believe a qualitative engineering review is the best approach to determine volume adjustments, as each DNO has different network configurations and various levels of existing reliability. For cost assessment, we believe that the industry median unit costs based on RIIO-ED1 and RIIO-ED2 data to be the most appropriate

**Core-Q84. Do you agree with our proposed assessment approach for Physical Security?**

**SPEN agree with the proposed assessment approach.**

**Core-Q85. Do you agree with our proposed assessment approach for Flood Mitigation?**

**SPEN agree with the proposed assessment approach.**

We agree with the adoption of industry median unit cost, and further agree that adoption of a longer time-series is preferable where the difference is small between scenarios. We agree with Ofgem's proposed assessment of volumes, using engineering qualitative assessment

**Core-Q86. Do you agree with the proposed approach to assessing Rising and Lateral Mains costs?**

**SPEN agree with the proposed assessment approach.**

From RIIO ED2 business plans, SPEN remain the industry leaders in addressing risk associated with Rising & Lateral Mains (RLMs), and there continues to be significant variation across DNO groups in

the level of activity in this area. For this reason, SPEN agree with Ofgem's proposal to exclude RLMs expenditure from Totex modelling

Due to the level of industry variation in activity, we agree with Ofgem's proposed approach of using DNO median unit cost rather than an industry median unit cost approach. As shown in the appendix of our Rising & Lateral Main EJP, the unit cost and scope of work for each type of intervention can vary significantly, SPEN therefore agree that unit costs should be calculated per sub-category (house/flat/multi-storey)

SPEN agree with Ofgem's proposed approach to assess unit costs across RIIO-ED1 and RIIO-ED2 as the scope of intervention between price controls has not varied

SPEN agree with Ofgem's proposed approach to apply volume adjustments where there is insufficient justification through engineering qualitative review

**Core-Q87. Do you agree with our approach to assessing WSCs?**

**SPEN agree with the proposed assessment approach.**

We note it is Ofgem's intention to utilise a Use It Or Lose It (UIOLI) uncertainty mechanism for Worst Served Customer allowances. We have responded to this question on the basis that Ofgem proceed with their consultation position. We agree with Ofgem's proposal to accept the WSC costs as submitted. This will give DNOs certainty to proceed with planned activities and improve the performance of customers who meet the definition of worst served. We agree with the application of a UIOLI mechanism, as per our responses to Core-Q52 and Core-Q53.

**Core-Q88. Do you agree with our proposed assessment approach for Losses?**

**SPEN agree with the proposed assessment approach.**

We agree with Ofgem's proposal to use the expert asset industry median unit cost for transformer replacement. We agree with this approach in light of the limited range of asset unit costs submitted by DNOs, making comparability challenging. We agree that this will ensure the most robust modelling approach out of the discussed options. We also agree with Ofgem's proposal to use engineering qualitative review to determine volume adjustments

**Core-Q89. Do you agree with our proposed assessment approach for environmental reporting?**

**SPEN broadly agree with the proposed assessment approach.** This is discussed below, excluding the approach to PCBs which we have discussed in our response to Core-Q90.

**SPEN agree with the continuation of the approach from RIIO-ED1,** which in turn results in RIIO-ED1 and RIIO ED2 data being used to calculate industry median unit costs for each category covered under CV22. We note that in RIIO ED2, DNO specific median unit costs have been used for some activities rather than industry median, we support this methodology for areas with inconsistent/incomparable unit costs.

**SPEN broadly agree with Ofgem's proposed application of either industry median or DNO-specific unit costs** as set out in Table 50 of Core Methodology. However, we believe that Ofgem should consider changing SF6 Mitigation scheme costs to be benchmarked using DNO specific unit costs. This is due to the variable scope of activity proposed under this category by each DNO.

SPEN also note that Ofgem have removed all carbon offsetting costs for SPEN despite its EJP classification of partially justified. We will submit additional information as requested by Ofgem in

Section A1.43 of Appendix 1 of Core Methodology. Please refer to our response to consultation question Core-Q13 on EAP proposals within RIIO-ED2 for further detail on carbon offsetting

**We support Ofgem's decision to allow submitted volumes following engineering assessment.** Where DNOs have not submitted EJPs or these have been classified as partially justified or unjustified, we support Ofgem in scrutinising the justification for these volumes comparatively across all DNOs and applying appropriate volumes adjustments or exclusions.

**Core-Q90. Do you agree with our proposed assessment approach for PCBs?**

**SPEN broadly agree with Ofgem's proposed approach towards PCBs in RIIO-ED2.**

SPEN are supportive of Ofgem's proposal to accept submitted DNO volumes and agree that this is necessary due to the legal driver to remediate PCB affected assets by 31st December 2025.

SPEN agree with Ofgem's proposal to use DNO submitted unit costs for the PCB volume driver, as per our response to Core-Q16. However, due to differences in reporting and proposed work in RIIO ED1, we believe the unit costs should only consider RIIO-ED2 data to develop an efficient unit cost for activities associated with PCBs, as opposed to the current approach which uses RIIO-ED1 and RIIO-ED2 data. SPEN believe calculating unit costs using RIIO-ED2 data only will ensure the most accurate representation for this programme of work

SPEN agree with the use of a volume driver for pole-mounted assets given the level of uncertainty on volume of affected assets. This has been discussed in detail in our response to consultation question Core-Q16. Note, we believe this volume driver should also extend to associated assets e.g., poles and protection.

We stress the need for ensuring PCB costs are ring fenced and set on a consistent and transparent basis to ensure that public/staff safety and network performance are not compromised, while meeting our environmental obligations, and believe this can only be achieved if PCB expenditure is separately assessed.

As per our response to Q64, we believe PCB expenditure should be excluded from Totex modelling assessment. This technique will subject DNOs PCB volumes to an assessment that is driven by factors unrelated to the PCB programme and risks inconsistent results in comparison with the disaggregated assessment

**Core-Q91. Do you agree with our proposed assessment approach for Property?**

**SPEN do not agree with the proposed assessment approach.**

Ofgem uses a ratio benchmarking approach in line with its RIIO ED1 methodology in its determination of Property. Ofgem assesses Non-Operational Property costs and Property Management costs together, using MEAV as the cost driver and an industry median benchmark ratio based on RIIO-ED1 and RIIO-ED2 data<sup>18</sup>

We consider that it is inappropriate not to consider an econometric model form for Property costs. An econometric model form can capture potential non-constant returns to scale or in other words any fixed cost component whereas the ratio model imposes constant returns to scale.

In conjunction with NERA, we have tested a simple econometric model, regressing combined Property costs against MEAV, and Ofgem's own time-trend specification. We identify statistically significant

---

<sup>18</sup> Ofgem (2022) Consultation RIIO-ED2 Draft Determinations Core Methodology Document, p 323

coefficients for the scale and constant terms, meaning that the costs demonstrate non constant returns to scale. Although our revised regression fails the heteroscedasticity and normality tests, the simple regression reform is a demonstrable improvement on the ratio model given the statistically significant coefficients and correct specification form (i.e. passes the RESET test)

However, as demonstrated by the low Adjusted R-Squared value, the results of this model (and ratio model) using MEAV fail to explain much variation between DNOs expenditure. For this reason, the results of the quantitative assessment should be complimented by a qualitative review of DNOs property justification within their business plans.

*Table 3 SPEN proposed Property Model*

|               | Coefficient | P-value | Diagnostic test        |       |
|---------------|-------------|---------|------------------------|-------|
| MEAV          | 0.434***    | 0.007   | RESET                  | 0.673 |
| t             | -0.022      | 0.118   | Heterosce<br>dasticity | 0.003 |
| t_forecast    | 0.035       | 0.171   | Normality              | 0.010 |
| Constant      | -5.060***   | 0.038   | Pooling                | 0.999 |
| Adj R-squared | 0.14        |         |                        |       |

**Core-Q92. Do you agree with our proposed assessment approach for STEPM?**

**SPEN broadly agree with the proposed assessment approach.**

We note that like the other ratio models, Ofgem should consider testing an alternative hypothesis which utilises econometric methods approaches for this area

**Core-Q93. Do you agree with our proposed assessment approach for Vehicles and Transport?**

**SPEN broadly agree with the proposed assessment approach.**

We note that like the other ratio models, Ofgem should consider testing an alternative hypothesis which utilises econometric methods approaches for this area.

**Core-Q94. Do you agree with our proposed assessment approach for HVPs?**

**SPEN agree with the proposed assessment approach.**

**Core-Q95. Do you see any merit in setting a HVP threshold for RIIO-ED2, and if so should it be based on the RIIO-ED1 threshold?**

**SPEN partly agree with this proposal**

We believe that Ofgem's proposed materiality threshold of £25m for individual non-load related schemes is very high, and as a consequence is likely to exclude the majority of unforeseen activities that emerge. Although we accept this mechanism is for high value activities, we believe this threshold may be too exclusionary. We accept Ofgem's application of a common materiality but as set out in our response to Q6 we believe there is merit in reviewing the common materiality threshold level to 0.5% base revenue

**Core-Q96. Do you agree with our proposed assessment approach for faults and ONIs?**  
**SPEN do not agree with the proposed assessment approach.**

Ofgem uses regression analysis to model the Faults and ONIs costs. Ofgem regresses submitted costs of faults (operational) and ONIs over 2011–2028 on the number of faults, number of ONIs, and its time trend specification.<sup>19</sup>

We believe it would be an improvement to distinguish different types of faults in the regression analysis, as costs can vary significantly between fault types and voltages. For example, EHV overhead line faults cost more to resolve than LV overhead line faults, and these are comparably cheaper than underground faults at the same voltages. Therefore, regressing faults costs against the aggregated number of faults fails to capture the varying costs incurred and forecast by DNOs.

We distinguish the number of faults into four categories based on their voltage level and location: (i) Low Voltage & Underground Cables Faults; (ii) Low Voltage & Overhead Lines and Other Faults; (iii) High Voltage & Underground Cables Faults; and (iv) High Voltage & Overhead Lines and Other Faults. We have also run regressions on Faults and ONIs individually (Table 5 and Table 6), to allow for the specific modelling of ONI costs.

In conjunction with NERA, we have tested a simple econometric model and estimate statistically significant coefficients for ONIs and each fault type, these have the correct positive sign. The only exception is the high voltage & underground cables faults variable, although this still has the correct positive sign. Overall, our model captures the impact of different fault types on DNOs' costs and is a clear improvement on the current approach.

*Table 4: Current Faults and ONIs mode (as per Draft Determination)*

| Parameter           | Coefficient | P-value | Diagnostic test |       |
|---------------------|-------------|---------|-----------------|-------|
| # faults            | 0.70***     | 0.001   | RESET           | 0.224 |
| # ONIs              | 0.32***     | 0.001   | White           | 0.414 |
| Time trend          | 0.01**      | 0.022   | Normality       | 0.015 |
| Forecast time trend | -0.03***    | 0.000   | Pooling         | 1.000 |
| Constant            | -6.37***    | 0.000   |                 |       |
| Adj R-squared       | 0.81        |         |                 |       |

*Table 5: Our ONIs econometric model (co-developed with NERA)*

| Parameter           | Coefficient | P-value | Diagnostic test |       |
|---------------------|-------------|---------|-----------------|-------|
| # ONIs              | 1.18***     | 0       | RESET           | 0.262 |
| Time trend          | 0.03***     | 0.005   | White           | 0.118 |
| Forecast time trend | 0.05***     | 0.001   | Normality       | 0.048 |
| Constant            | 10.26***    | 0       | Pooling         | 1     |
| Adj R-squared       | 0.74        |         |                 |       |

<sup>19</sup> Ofgem (2022) Consultation RIIO-ED2 Draft Determinations Core Methodology Document, p 331

*Table 6: Our Faults econometric model (co-developed with NERA)*

| Parameter           | Coefficient | P-value      | Diagnostic test |          |
|---------------------|-------------|--------------|-----------------|----------|
| LV (UG)             | 0.49***     | 0            | RESET           | 0.517    |
| LV (OH + Other)     | 0.17**      | 0.037        | White           | 0.901    |
| HV (UG)             | 0.21        | <b>0.14</b>  | Normality       | <b>0</b> |
| HV (UG + Other)     | 0.11***     | 0            | Pooling         | 1        |
| Time trend          | 0.01        | <b>0.022</b> |                 |          |
| Forecast time trend | -0.03***    | 0.006        |                 |          |
| Constant            | -4.39***    | 0            |                 |          |
| Adj R-squared       | 0.82        |              |                 |          |

*Note: HV faults here include HV faults, EHV faults and 132kV faults.*

**Core-Q97. Do you agree with our proposed assessment approach for Tree Cutting?**

**SPEN partly agree with the proposed assessment approach.**

Although we agree with Ofgem's approach of handling ENATS 43-8 and ETR 132 costs separately (as these activities vary significantly) and agree with Ofgem's decision to model efficient costs by voltage and activity category, we do not agree with the proposed benchmarking period for ENATS 43-8.

For RIIO ED2, Ofgem have proposed to use RIIO-ED1 and RIIO ED2 dataset to model efficient unit costs for ENA TS43 8 (Note: within the current CV29 disaggregated model the benchmarking period is set using DPCR5 and RIIO ED1 data) However, SPEN do not believe that either of these approaches provides a robust or accurate basis for modelling forecast RIIO-ED2 activity.

Due to the nature of vegetation change and growth, significant variation in the vegetation density on the distribution network can be expected overtime. For instance, as vegetation is felled naturally or manually, is planted or seeded in new areas, or where growth of younger vegetation becomes a risk to the network

In preparation for RIIO ED2, SPEN undertook a detailed network assessment to determine the effect of vegetation on overhead lines, this used data collected via Light Detection and Ranging (LiDAR). As a result, our RIIO-ED2 forecast is our most up-to-date and accurate view of vegetation risk. It is our view that the practice of LiDAR inspections is now common for this purpose across DNOs, and that this was not the case in DPCR5 or the early part of RIIO ED1

As such the most robust and accurate dataset for use within the ENATS 43-8 model, is the RIIO-ED2 time-series. This approach is consistent with the methodology used in RIIO ED1 where only forecast data was used.

We agree with Ofgem's proposed approach for the ETR 132 component of Unit Costs and volumes.

We accept Ofgem's decision to apply run-rate analysis modelled volumes to ENATS 43-8 and ETR 132 activity volumes, although we believe submitted volumes are the most accurate basis for setting allowances. We also agree with Ofgem's decision not to progress with regression analysis for setting tree-cutting allowances.

**Core-Q98. Do you agree with our proposed assessment approach for Severe Weather 1-in-20 Events?**

**SPEN agree with the proposed assessment approach.**

As per our response to Core-Q55, SPEN support the introduction of a SW 1-in-20 Pass Through mechanism. In our Business Plan, we included a baseline level of allowance within Totex, to ensure

DNOs had the ability to respond quickly and with confidence if a SW 1-in-20 event occurred, with a further opportunity for a Pass Through UM if required

Now that there is clarity on Ofgem's proposal for an uncapped Pass Through triggered by the onset of a qualifying event, we agree with Ofgem's proposal to set zero baseline allowances in this area for RIIO ED2.

**Core-Q99. Do you agree with our proposed approach to assessing Inspections and Repair & Maintenance costs?**

**SPEN disagree with the proposed assessment approach.**

Ofgem uses a ratio benchmarking approach to model the Inspections and Repair & Maintenance costs together. Ofgem proposes using a MEAV ratio benchmarking, with the industry median as a benchmark and based on RIIO-ED1 and RIIO-ED2 data<sup>20</sup>

We consider that it is inappropriate not to consider an econometric model form for Inspections and Repair & Maintenance costs. An econometric model form can capture potential non constant returns to scale and capture any trend in costs over time, as we include Ofgem's time-trend specification employed in its own econometric models. By contrast, the ratio model used by Ofgem imposes constant returns to scale and neglects the cost trend effect.

In conjunction with NERA, we have tested a simple econometric model, regressing combined Inspections costs and Repair & Maintenance costs against MEAV, and Ofgem's time-trend. We identify statistically significant coefficients for all terms in the regression, meaning that the costs demonstrate non constant returns to scale and a time-trend. Our simple regression reform demonstrates improvement to the Ofgem's ratio model

*Table 7 SPEN proposed Inspections, Repair & Maintenance model*

| Parameter           | Coefficient | P-value | Diagnostic test |             |
|---------------------|-------------|---------|-----------------|-------------|
| Ln (MEAV)           | 0.74***     | 0.00    | RESET           | 0.599       |
| Time trend          | -0.03***    | 0.09    | White           | <b>0.00</b> |
| Forecast time trend | 0.06***     | 0.001   | Normality       | <b>0.00</b> |
| Constant            | -9.62***    | 0.001   | Pooling         | 0.99        |
| Adj R-squared       | 0.68        |         |                 |             |

**Core-Q100. Do you agree with our proposed assessment approach for NOCs other?**

**SPEN broadly agree with the proposed assessment approach, however, would outline two specific areas which we believe require further consideration prior to Final Determination.**

---

<sup>20</sup> Ofgem (2022) Consultation RIIO-ED2 Draft Determinations Core Methodology Document, p 337

### Dismantlement

We do not agree with Ofgem's proposed approach for Dismantlement. By benchmarking these costs using Industry median costs to MEAV Ratio, there is no consideration of qualitatively justified costs from EJPs. We believe costs that are justified within EJPs should be allowed in addition to Ofgem's benchmarked costs.

### Substation electricity

Substation electricity costs are subject to supplier charges, which have changed dramatically since business plans were submitted at the end of 2021 and remain highly uncertain. We believe Ofgem should re-consider how these costs are treated and awarded, and if awarded as ex ante allowance as proposed in DD, we would ask that Ofgem consider whether these costs could be subject to a re-opener in RIIO-ED2, with a materiality threshold consistent with our proposals for 0.5% materiality in Q6. We welcome the opportunity to discuss this further with industry and Ofgem.

### Core-Q101. Do you agree with our proposed assessment approach for Smart Metering Rollout?

**SPEN agree with the proposed assessment approach.**

We accept Ofgem's proposal to use the industry median unit cost for smart meter interventions for RIIO ED2 only

### Core-Q102. Do you agree with our approach to assessing CAI costs?

**SPEN broadly agree with Ofgem's approach to assessing Closely Associated Indirects costs.**

To set allowance for CAI costs, Ofgem regresses submitted CAI costs over RIIO-ED1 and RIIO ED2 on MEAV as the explanatory variable, and also includes time trend variables. SPEN's licensees rank at the top in cost efficiency of the aggregated CAI cost based on Ofgem's model. However, Ofgem's model fails the RESET testing, suggesting the model is mis-specified.

### **SPEN do not agree with the current approach of including Operational Training expenditure within a quantitative benchmarking model.**

Ofgem's approach to Closely Associated Indirects modelling incorporates Operational Training within the assessment. This approach is out of sync with the application in RIIO-T2, and adversely impacts SPEN's ability to recruit and deliver in line with our own bespoke needs.

DNOs operate quite varied resourcing models, with distinctly different levels of insourcing and outsourcing, and will have specific needs arising from geographical location, market capacity challenges, internal workforce age and mix, as well as variations in the skills and capabilities required. All of which will differ significantly across DNOs and isn't explained for by Cost Drivers such as MEAV, or Customer Numbers. Workforce requirements will also vary depending on past resourcing decisions and RIIO ED2 requirements will be specific to each DNO and not suitable for comparative assessment.

For this reason, we believe Operational Training costs should be excluded from assessment and be assessed on a qualitative individual DNO basis. The current approach is also not aligned with that applied during the assessment of the RIIO T2 price control period, and our proposal is that we align with the approach taken to this area in RIIO T2.

SPEN have also noticed an error in the modelled cost allocation which we believe needs correcting for Final Determination. The current approach allocates the CAI model output back to the three categories based on the 2011 allocation of DNO expenditure. This is an obvious error and will result in DNOs RIIO-

ED2 model output being out of sync with RIIO-ED2 requirements. SPEN believe this should be corrected and allocated based on DNOs average RIIO-ED2 expenditure requirements

**Core-Q103. Do you agree with the proposed assessment approach for Business Support costs?**

**SPEN broadly agree with Ofgem's approach to assessing Business Support Costs.**

To set allowance for Business Support costs, Ofgem regresses submitted Core BS costs over RIIO-ED1 and RIIO ED2 on MEAV and time trend variables. The model manages to capture a good part of the Core BS costs dynamics, as suggested by the Adj. R-squared of 0.65. However, Ofgem's model fails the RESET testing, suggesting the model is mis-specified as demonstrated in the table below. However, we recognise the lack of a better alternative model in assessing business support costs.

*Table 8 Current Draft Determination BSC Model*

| Core BS             | Coefficient | P-value | Diagnostic test |       |
|---------------------|-------------|---------|-----------------|-------|
| Ln (MEAV)           | 0.75***     | 0.000   | RESET           | 0.009 |
| Time trend          | 0.01        | 0.233   | Heterosc.       | 0.157 |
| Forecast time trend | 0.00        | 0.946   | Normality       | 0.033 |
| Constant            | -9.492***   | 0.000   | Pooling         | 1     |
| Adj R-squared       | 0.65        |         |                 |       |

**Core-Q104. Do you agree with our approach to assessing streetworks costs?**

**SPEN disagree with Ofgem's approach.**

SPEN have reviewed Ofgem's approach to the disaggregating modelling for Street works expenditure and have identified an alternative approach which we believe should be considered for Final Determination.

In setting allowances for street works costs, Ofgem proposes to use DNOs recent streetworks costs to model future spend. Ofgem has determined a base year spend equal to the average annual costs between 2019 and 2021 and allowed for growth in costs over RIIO-ED2 based on a weighted average of connections, LRE and NOCs volumes, specific to each DNO

However, SPEN have not incurred any streetworks costs over the period 2019-21 and therefore the current approach does not provide any allowance for SPEN over RIIO-ED2. This is contrary to Ofgem's own statement that: "streetworks is an emerging area of spend for many DNOs and is therefore likely to look different in future years compared to the earlier years of RIIO-ED1"<sup>21</sup> We consider that Ofgem should take an alternative approach to setting cost allowances which we set out below.

---

<sup>21</sup> Ofgem (2022) Consultation - RIIO-ED2 Draft Determinations Core Methodology Document, para. 7.396, p 348

- Calculate the ratio of Ofgem's normalised submitted streetworks costs relative to the costs associated with Connections, LRE, NOCs, for the period 2019-21, consistent with Ofgem use of the growth rate in these areas to determine streetworks costs in RIIO-ED2
- Determine the industry median ratio from the step above, and multiple by SPEN's connection, LRE and NOCs costs to determine an expected level of spend for SPEN over the period 2019-21
- Estimate the Streetworks costs over RIIO-ED2 based on the expected change in the relevant volumes, as per Ofgem's approach to setting DNO allowances.

**We recommend that Ofgem review and update the disaggregated model for Streetworks for RIIO-ED2.**

**Core-Q105. Do you agree with our proposal to carry out a demand driven post-modelling adjustment?**

**SPEN agree with the proposed assessment approach.**

In line with our response to Core Q3, we can understand Ofgem's preference to normalise DNO forecasts to more conservative baselines, with DNOs flexing up from this low base. These demand driven post modelling adjustments aim to protect customers from a risk that DNOs don't invest the allowances given.

However, as discussed during our bilateral meetings, the System Transformation scenario is an outlier across all NGESO and CCC forecasts in terms of EV and heat pump uptakes in RIIO-ED2 being notably lower than all other credible Net Zero scenarios. This preference places much greater importance on uncertainty mechanisms than we had anticipated, making it essential that they enable both reactive and proactive interventions, as well as being accessible and providing confidence to invest without the risk of exposure of clawback for justified work

We are committed to continue to work with Ofgem to refine and develop these mechanisms further.

**Core-Q106. Do you agree with our proposal to not carry out any Quality of Service based adjustments?**

**SPEN agree with the proposed approach.**

The current approach proposes not to carry out any adjustments to account for perceived funding gaps associated with cost and the quality of service DNOs provide. This is because of the significant complexity involved in calculating how to apply the adjustment and the difficulty in finding exogenous cost drivers that reflect quality of service

The CMA at the PR19 redeterminations rejected the inclusion of a quality of service variable, given the difficulty in identifying a variable outside of management control and we believe this would also be difficult for RIIO ED2

**Core-Q107. Do you agree with our approach to combining our Totex and disaggregated benchmarking models?**

**SPEN accept the proposed approach.**

We recognise that the RIIO-ED1 final determination precedent has been applied in combining the Totex and disaggregated benchmarking models, and do not believe there is sufficient justification to move away from this approach in RIIO-ED2. We believe that there are various advantages and disadvantages to both Totex modelling and disaggregated modelling and believe that this area

warrants further consideration for future price control period assessment. However, we would strongly encourage that the core of the methodology, of which this is a fundamental consideration, is retained at FD, as changes at this late stage could undermine the robustness of cost assessment.

**Core-Q108. Do you agree with our approach to setting and applying the efficiency challenge using a glide path between the 75th and 85th percentile over a 3-year period?**

**SPEN do not agree with the proposed assessment approach.**

Ofgem's efficiency challenge should be based on efficiency score for Totex and disaggregated modelling in combination

Ofgem requires companies to achieve 85th percentile efficiency score on Totex models, but not for disaggregated models. Ofgem explains the reason not to define the catch-up as the 85th percentile efficiency score as follows:<sup>22</sup> “The disaggregated element of the modelled costs is not subject to a benchmarking efficiency adjustment because we consider that the substantial technical input into our activity-level assessment already captures a sufficient level of cost efficiency”

For the Totex models, the 85th percentile adjustment involves an adjustment of 0.98-0.95 to modelled costs.<sup>23</sup> For the disaggregated models, the 85th percentile efficiency score lies above 1, at 1 08 1 06

In effect, by using the Totex models in isolation, Ofgem's approach requires companies to achieve an overall cost standard that no company has met. Instead, Ofgem should set an efficiency challenge corresponding to an achieved cost level. This requires Ofgem to set a common challenge using both Totex and disaggregated modelling

Such an approach is also consistent with regulatory precedent. At RIIO-ED1, Ofgem determined an efficiency score based on the results of the Totex and disagg. models.<sup>24</sup> By contrast, Ofgem's RIIO-ED2 DD uses the 85th percentile based on company performance for one set of models (in this case, Totex). It therefore results in an unrealistic efficiency challenge that is not met by any single DNO.

**Ofgem's reasons for setting a more demanding catch-up factor than RIIO-ED1 are not valid**

Ofgem proposes to adopt an efficiency benchmark at RIIO-ED2 that includes a linear glide path from the 75th to the 85th percentile over the first three years. Ofgem consider the proposed approach for RIIO-ED2 is consistent with its approach in the gas distribution sector. Ofgem also notes that the adoption of a glide path to the 85th percentile does not have material difference relative to the RIIO-ED1 approach (which did not have such a glide-path).

We consider that Ofgem's reasons for imposing a more demanding catch up target than RIIO-ED1 are not justified. As we have explained in many of our response above, in many instances Ofgem's econometric models fail the critical RESET test, which indicates that the form of the model does not reflect the correct cost relationships. This is the case for Ofgem's disaggregated econometric forms (question responses Q96, 102, and 103)

We also do not believe that precedent from gas distribution network (GDNs) is relevant. The tightening of the glide-path at GD2 reflects Ofgem's concern about the benchmarking process at GD1 which led

---

<sup>22</sup> Ofgem (2022) Consultation RIIO-ED2 Draft Determinations Core Methodology Document, para 7.23 p.226

<sup>24</sup> Ofgem (2014) RIIO-ED1: Final determinations for the slow track electricity distribution companies Business plan expenditure assessment, para 3 28, page 30

to systematic outperformance by GDNs. By contrast, the benchmarking process at RIIO-ED1 did not lead to industry-wide outperformance.

**Core-Q109. Do you agree with our proposed RPEs allowances? Please specifically consider our proposed notional cost structure, assessment of materiality, and choice of indices in your answer.**  
**SPEN do not agree with Ofgem's proposed RPE allowances**

Ofgem have set out its decision on the selection of the benchmark RPE indices to be used in the context of the indexed RPEs allowance over the RIIO-ED2 control period, and the resulting upfront RPEs allowance forecast, based wholesale on the recommendations from its economic consultant's (CEPA) report.<sup>25</sup> We and other DNOs, as part of the ENA, have commissioned NERA to provide an independent assessment of Ofgem/CEPA's proposals and to advise on a recommended approach for RIIO ED2. Our response reflects the evidence from this report, which the ENA has submitted directly to Ofgem.

NERA's assessment has found that there are several flaws within CEPA's recommendations and Ofgem's consequential consultation position. This creates the very material risk of the RPE allowances undercompensating DNOs for expected rises in their input costs beyond that of general inflation, resulting in us and other DNOs not fully recovering our efficiently incurred costs. This is in the context of persistently high wage and price inflation rates across the economy. We highlight the following errors identified by NERA, and invite Ofgem to consider NERA's analysis in full:

- (i) No RPE allowance for plant and equipment, (P&E) and Transport costs and "other costs";
- (ii) Flaws in CEPA's approach to index selection; and
- (iii) Combination of general and specialist labour into a single labour category

#### RPEs for P&E, transport and other costs

Ofgem have not provided DNOs with an RPE allowance for P&E and Transport costs, as well as 'Other' costs, as these cost categories were deemed to be of low materiality because each constitutes less than 5% of the Totex of a notional efficient DNO – this means that these input cost categories will be indexed to CPIH. CPIH is a manifestly poor proxy for these cost categories as the index is comprised of a basket of goods that bear no relation to DNOs' input purchases. As noted by NERA, 32% of the growth rate comes from "Housing and household services" costs, 11% from "Recreation and culture", and 4% from "Alcohol and tobacco". A material element of SPEN's costs will not be indexed in a way that reasonably reflects inflation. This is in the context of very significant inflation pressures.

Ofgem is wrong to argue that cost categories with low materiality do not warrant an RPE<sup>26</sup>. The approach of applying a zero RPE to all low materiality cost categories is illogical as it implies the very existence of an RPE allowance depends on how costs are categorised – in theory, costs could be categorised in such a way that no category meets the set materiality threshold. Ofgem should consider how these low materiality cost categories might be aggregated to meet a pre determined materiality threshold. This appears to be the approach adopted for materials where they combined materials (capex) and materials (Opex) into a single category based on materials (Opex) being of low

---

<sup>25</sup> CEPA (June 2022), "RIIO-ED2: Cost Assessment - Frontier Shift methodology"

<sup>26</sup> NERA, OE report P14

materiality (i.e. 2.7% of Totex). This should be adopted for the omitted cost categories as they constitute 12% of Totex for the notional DNO. If Ofgem fails to allow for recovery of efficient costs in these categories, it will be failing to adequately finance a portion of Totex that is material by CEPA's own 10 per cent threshold

We propose that the P&E and Transport cost categories be combined and have an RPE allowance set based on the third party "BCIS PAFI plant and road vehicles (90/2)" index given that it better reflects the input price pressures for both input categories relative to CPIH, based on precedent and composition. We also recommend that the output producer price index (PPI), produced by the ONS should be used for setting an RPE allowance for 'Other' costs – this index is likely more closely to reflect the cost pressures that DNOs face compared to CPIH

#### Index selection

Looking at their index selection process, NERA find that CEPA have not sufficiently adhered to its own described sequential process for index selection, where indices are first assessed on a pass fail basis against high-level criteria and then assessed against more detailed criteria. NERA find that most of the criteria CEPA establishes are redundant, in that all indices perform equally well on them. The result is that CEPA have relied exclusively on just two sub-criteria in their index selection process: accuracy (i.e. whether the index reflects DNO costs) and credibility (i.e. whether the index has known statistical or methodological flaws)

However, CEPA's assessment of 'accuracy', which assumes such importance in the choice of index, is unduly theoretical and flawed. CEPA do not consider actual evidence on movements in DNOs' costs, as provided by the input cost data used in NERA's previous report.<sup>27</sup> The assessment of 'accuracy' therefore relies only on high level descriptive information, thereby limiting the ability of the 'accuracy' criterion to discriminate between indices.

CEPA's process for index selection has in practice ended up relying heavily on regulatory precedent. The final indices selected are identical to those used to determine the RPE allowance in RIIO ED1. There is a high degree of risk that CEPA's index selection process results in a final set of indices that do not accurately track the external pressures in DNOs' input costs over time, as DNOs adopt different functions in the future (e.g. DSO) and have made efficiency improvements in costs from adoption of different practices and technologies.

Lastly, CEPA's approach involves creating thematic groups of indices within cost categories and selecting one index from each thematic group, without considering how these thematic groups should be weighted, inherently suggesting each thematic group has an equal impact on the overall cost category.

#### Combination of general and specialist labour into a single labour category

Finally, an additional flaw relates to Ofgem/CEPA's decision to combine the general and specialist labour categories into a single "labour" cost category. This decision runs contrary to regulatory precedent and materially increases the risk that SPEN will not recover efficiently incurred costs. A consequence is that a material element of SPEN's costs will not be indexed in a way that reasonably

---

<sup>27</sup> NERA, Price Effects for the RIIO-ED2 Price Control, Nov 2021

reflects the inflation pressures faced by SPEN against a background of very significant wage and price inflation pressures. The proposed approach is wrong

The result of the Ofgem/CEPA approach to combine both labour categories into a single “labour” costs category is that Ofgem/CEPA assume that a majority (63%) of DNOs’ Totex can be expected to face the same external price pressures. This is an implausible assumption as these are costs that are likely to grow at differing rates over time. The decision is justified by CEPA because CEPA consider that there is inconsistency in how DNOs have allocated costs between general and specialist labour. Ofgem/CEPA’s decision is not a valid response to this perceived problem. The issue here is a result of the lack of guidance from Ofgem on how to categorise costs – there are no RIGs definitions for the RPE categories. The obvious solution is for Ofgem to provide clearer guidance on how to classify costs, rather than to combine both labour categories into a single “labour” cost. We understand the lack of guidance has been raised before. We would encourage Ofgem to provide this and allow companies to resubmit their cost structures accordingly ahead of final determinations.

We conclude that Ofgem and CEPA should recognise and apply any RPE allowances to Plant and Equipment (P&E) and Transport, review the approach to selecting appropriate benchmarks, avoiding regulatory precedent as the default position, and update the notional cost structure to account for Draft Determinations.

**Core-Q110. Do you agree with our proposed approach to setting the ongoing efficiency challenge and the level of challenge applied?**

**SPEN do not agree with Ofgem’s approach to setting the ongoing efficiency challenge in RIIO ED2**  
Ofgem has made a series of errors in its analysis of the ongoing efficiency (OE) rate that it believes the electricity distribution sector can achieve over the RIIO-ED2 period. The result is that the proposed annual OE challenge figure in Ofgem’s RIIO-ED2 Draft Determination of 1.2% for Totex is overstated. The proposed OE assumption is arbitrary and cannot be justified by a reasonable interpretation of the evidence on productivity. SPEN’s 0.5% assumption is founded on recent evidence.

There are a number of errors, which underpin Ofgem’s consultation position. These are set out in detail in the NERA and Frontier reports as submitted by the ENA. We invite Ofgem to review these reports. In this section we refer to some of the errors NERA and Frontier have identified, as follows.

- (i) Ofgem has set the OE target at the highest target recommended by CEPA, 1.2%. The overwhelming weight of evidence points to a lower target. Ofgem has selected the extreme end of the range.
- (ii) CEPA do not provide any justification for its change from its previous position – that same evidence justified a target that was 20bps lower at 1%.
- (iii) CEPA’s top end estimate / target of 1.2% is based on flawed analysis.
- (iv) CEPA and Ofgem’s analysis give insufficient weight to a range of factors that indicate a much lower OE target
- (v) CEPA does not provide evidence to support the assertion that innovation funding justifies a higher target and Ofgem and CEPA rely on a set of speculative forward-looking assumptions to support the 1.2% target.
- (vi) Ofgem/ CEPA make a range of double-counting errors

Each of these errors mean that the 1.2% target is flawed and imposing such a target would be a clear error.

Ofgem has set the OE target at the highest target recommended by CEPA, 1.2%. The overwhelming weight of evidence points to a lower target Ofgem has selected the extreme end

Ofgem's decision on the OE target has been informed by the economic analysis conducted by its consultant CEPA.<sup>28</sup> However, Ofgem have set the target based on the highest of the three reference points that CEPA recommends Ofgem consider when setting its OE challenge for RIIO ED2:

- 0.5%, consistent with the OE challenge proposed by the least ambitious companies.
- 1.0%, consistent with the OE challenge proposed by the most ambitious companies.
- 1.2%, which would represent a more stretching outlook for the frontier efficiency achievements possible in RIIO-ED2
- 

CEPA's recommended OE target of 1.2% represents the highest estimate from its 48 estimates derived from its growth accounting analysis of EU KLEMS data. Even before discussions on the methodological errors made by CEPA, it is evident that the overwhelming weight of quantitative evidence from CEPA's own analysis in fact points to an OE target of less than 1.2% (and indeed, even less than 1%) – see table below. Ofgem's decision to base its OE challenge equal to the highest estimate in the entire sample of estimates, rather than a balanced metric such as the median or mean statistic, is accordingly both an error and not supported by the data. It amounts to a rejection, without good justification, of all the other 47 estimates that CEPA derived

CEPA do not provide any justification for its change from its previous position that the same evidence justified a target that was 20bps lower at 1%.

Worse, the 1.2% target used in the 'stretching outlook' reference point is not itself well justified. CEPA has not provided any material justifications for adjusting its interpretation of the same evidence it reviewed in previous price control reviews by concluding a 20bps higher OE target.

**Table Core Q110a**

*Table 1: Average historic TFP growth rates based on the 2019 EU KLEMS database (to 1 d.p.)*

| Average TFP growth (%)   | Full time series (1995-2016) |      | Various business cycle definitions |             |
|--|------------------------------|------|------------------------------------|-------------|
|  | VA                           | GO   | VA                                 | GO          |
| Unweighted average of narrow comparator set  | 0.8%                         | 0.4% | 0.3 to 0.4%                        | 0.2%        |
| Unweighted average of expanded comparator set <sup>2</sup>                         | 1.2%                         | 0.6% | 0.9 to 1.0%                        | 0.5 to 0.6% |
| Weighted average of market Economy (all industries excluding L, O, P, Q, T, and U) | 0.8%                         | 0.4% | 0.7 to 0.8%                        | 0.3 to 0.4% |

*Source: CEPA analysis of EU KLEMS*

CEPA's top end estimate of 1.2% is based on flawed analysis.

We and other DNOs, as part of the ENA, have commissioned NERA to provide an independent assessment of CEPA's analysis and Ofgem's subsequent decision on OE. The ENA has also commissioned Frontier Economics to provide a high-level review of the parallels between Ofgem's

<sup>28</sup> CEPA (June 2022), "RIIO-ED2: Cost Assessment Frontier Shift methodology"

proposed ongoing efficiency challenge for RIIO-ED2, and the decisions Ofgem made in RIIO-ED1 (the Smart Grid Benefits (SGBs) decision) and RIIO-GD2/T2 RIIO-GD2/T2 (the Innovation Uplift decision) which were subsequently overturned on appeal to the CMA.

In its quantitative analysis, NERA find that CEPA have made a series of individually unjustified decisions and conclusions, which collectively compound to exaggerate the top end of its OE range to a level that cannot be justified by any objective reading of the economic evidence. We summarise below NERA's findings of the key issues present in CEPA's methodology:

- **Reliance on VA TFP measures:** CEPA have incorrectly relied on Value Added (VA) Total Factor Productivity (TFP) measures to inform its OE recommendations. Indeed, CEPA's recommended OE challenge is based exclusively on VA estimates. VA measures the value added at the stage of the production process, as opposed to Gross Output (GO) measures which also include the full value of intermediate inputs. VA estimates by construction result in TFP measures which are higher than those measured based on GO. The exclusive use of VA TFP is erroneous because Ofgem intends to apply the OE assumption to total expenditure. The theoretically preferable measure for application to regulated utility networks is therefore GO because intermediate inputs are part of networks Totex
- **Inappropriate comparator set:** the upper bound of CEPA's OE challenge is derived based on estimates from CEPA's Expanded comparator set. This set of comparators does not provide an appropriate benchmark for the RIIO ED2 OE challenge. CEPA have added two new sectors into the set of comparators that was used in RIIO-GD2/T2. The set now includes the "Professional, Scientific, Technical, Administrative and Support Service Activities" and "Information and Communication (ICT)" sectors. The inclusion of the ICT sector is inappropriate and likely exaggerates the achievable OE over the RIIO-ED2 period. This is because the ICT sector is an outlier in terms of productivity growth, especially over the sample period which includes the internet and communications boom of the late 1990s and early 2000s. This bias from the inclusion of the ICT sector is exacerbated by CEPA using an unweighted average for the Expanded comparator set. As result, the ICT sector is assigned a weight of 1/6 in the TFP calculations.
- **Use of full 2019 EU KLEMS Sample:** CEPA calculates TFP for the full time-period of the 2019 EU KLEMS dataset (1995 to 2016), as well as for four definitions of complete business cycles. This is an extension to the time period considered by CEPA's in RIIO-GD2/T2 assessment of the same data set, where instead they selected the time-period 1997 to 2016 to rely on the last two complete business cycles. The inclusion of the two extra years increases the TFP estimates. CEPA does not explain why it has decided to refine its approach.
- **Methodological choices that bias TFP estimates upwards:** Overall, CEPA's changes in methodology; extending the time period and considering an expanded comparator set, increase the VA estimate by 0.7% to 1.20% aligning with Ofgem's RIIO GD/T2 FD position which was subsequently revised down to ~1 0% following the CMA RIIO 2 appeal

CEPA and Ofgem's analysis give insufficient weight to a range of factors which indicate a much lower OE target

CEPA's overall conclusion is that a productivity target of 1.2%, if chosen by Ofgem, would imply that Ofgem believe historical growth rates calculated from EU KLEMS "*significantly underestimate the frontier efficiency improvements that can be achieved in RIIO ED2*".<sup>29</sup> Both Ofgem and CEPA state that the ultimate target recommendation is not dependent on one specific EU KLEMS estimate, but instead is based on judgements from a range of qualitative factors.

CEPA assesses seven categories of qualitative factors to consider when interpreting the EU KLEMS results and making its recommendations to Ofgem for its determination of the OE challenge.

CEPA have disregarded or downplayed five of these seven factors that would indicate an OE assumption lower than that specified by CEPA's quantitative analysis. These disregarded factors include regulatory precedent, proposals in business plans, economy wide productivity forecasts incorporating recent events such as Brexit and Covid, the slowdown in productivity growth following the Global Financial Crisis (GFC) and evidence on historical productivity growth for DNOs prepared by NERA – see NERA's report for further detail on their review of each of these qualitative factors and why CEPA's dismissal of certain factors is not valid<sup>30</sup>

This error results in a materially overstated OE target.

CEPA does not provide evidence to support the assertion that innovation funding justifies a higher target and Ofgem and CEPA rely on a set of speculative forward looking assumptions to support the 1.2% target

Having discounted or given insufficient weight to highly relevant evidence CEPA recommend that Ofgem only consider two specific factors which it believes increase the OE assumption: (1) the RIIO-ED2 context of innovation funding and Net Zero transition and (2) the possibility for failing to count embodied technical change

For factor (1), NERA are unable to find any evidence (quantitative or otherwise) which substantiates Ofgem and CEPA's speculative assertion that DNOs over the RIIO-ED2 period have the potential to achieve productivity growth rates above and beyond historic TFP growth rates (in other sectors) as a result of delivering the transformational change required in the sector to enable Net Zero ambitions

CEPA recommends that Ofgem considers the presence of innovation funding, and higher investment allowances more generally and for specific areas like digitalisation, as positive qualitative factor to justify a higher OE figure.<sup>31</sup> No quantitative evidence is provided by Ofgem or CEPA to link the impact of additional overall allowances and digitalisation on productivity.

Past innovation funding does not justify a higher OE target. Productivity growth resulting from R&D spending is already factored in the EU KLEMS analysis from competitive sectors and the fact is that past innovation funding was not targeted principally towards achieving efficiency gains. Historical benefits from past funding are also already sufficiently included in SPEN's and as NERA explains, other

---

<sup>29</sup> CEPA (June 2022), "RIIO-ED2: Cost Assessment - Frontier Shift methodology", p. 16

<sup>30</sup> NERA (August 2022), "Response to RIIO-ED2 Draft Determination on Ongoing Efficiency", section 4

<sup>31</sup> Ofgem (29 June 2022), RIIO-ED2 Draft Determinations Core Methodology Document, p. 365.

DNOs' business plans. Those innovation efficiencies that have materialised are sufficiently factored into DNOs' baseline allowances because of Ofgem's comparative benchmarking Any efficiencies expected to materialise over RIIO-ED2 already feature in our own OE assumption for RIIO-ED2.

- Appendix V of SPEN Business Plan Annex 2.1 presents a table of 104 innovation projects that have either been rolled out as business as usual, will be ready for deployment within RIIO ED2 or have generated learnings that have directly impacted our RIIO-ED2 programmes of work. Of these 104 projects, 91 projects have been funded using NIA.
- Table 1 of SPEN Business Plan Annex 2.1 presents innovations that have been embedded within our RIIO ED2 plan, referenced to our associated Engineering Justification Papers These innovations have driven a £87.2m savings in Totex expenditure for RIIO-ED2, more than £60m of this is attributed to NIA funded projects

For (2), CEPA points to embodied technical change<sup>32</sup> as a reason for considering that the GO-based TFP analysis might underestimate the total potential for cost savings that can be achieved by network companies when quality improvements in the factor inputs are considered.<sup>33</sup> NERA highlight that the EU KLEMS data will likely include embodied technological change due to measurement error, and as a result any additional adjustment risks "double-counting".<sup>34</sup> The impact that this factor has on the achievable rate of OE is entirely unclear as neither Ofgem or CEPA have provided any quantified evidence to suggest that the effect of 'correcting' this issue would more than double CEPA's GO-based estimates to arrive at an OE figure of 1.2% CEPA and Ofgem are only speculating on the impact of this perceived issue and provide no evidence to justify such a material adjustment on the OE challenge to 1.2%

As NERA outline, the impact of both factors is uncertain and less well evidenced and documented than the other qualitative factors, which point to an OE figure lower than the 1.2% recommended by CEPA e.g. slowdown in productivity growth following the GFC.

NERA's review has shown that Ofgem and CEPA's recommendation of a 1.2% OE challenge is arbitrary and assuming that this figure is achievable for DNOs over the RIIO-ED2 period reflects a flawed and biased interpretation of the quantitative and qualitative evidence available

#### Ofgem/ CEPA make a range of double-counting errors

Ofgem make vague assertion that "analysis of the BPs suggests that the basis on which the DNOs claim to have embedded cost efficiencies from previous innovation funding is inconsistent. Based on the DNOs' submissions, we have been unable to quantify the extent to which any such efficiencies are already captured to some degree in the comparative benchmarking". Therefore, there is unjustified double counting in the approach levelled by Ofgem

Looking at the Ofgem's decision in RIIO-GD2/T2 to utilise the 0.2% "Innovation Uplift" to increase the overall OE challenge to 1.2%, CEPA advised Ofgem that:

- there was a risk of double counting between the innovation uplift and the benchmarking of business plans and Ofgem should therefore seek to satisfy itself that "no additional

<sup>32</sup> Productivity gains from employing new inputs over and above the gains obtainable from a comparable amount of pre-existing inputs.

<sup>33</sup> CEPA (June 2022), "RIIO-ED2: Cost Assessment - Frontier Shift methodology", p. 22

<sup>34</sup> NERA (August 2022), "Response to RIIO-ED2 Draft Determination on Ongoing Efficiency", section 4.3

- ongoing efficiency driven by innovation funding in RIIO-1 is already embedded in the baseline spending plans submitted by the companies ”
- there was also a risk of double counting between the innovation uplift and the core productivity challenge of 1%.

CEPA’s RIIO-ED2 paper<sup>35</sup> acknowledges that *it is possible that efficiencies specifically linked to previous innovation funding are partly captured by the comparative benchmarking* and recommend Ofgem should consider that possibility as it makes an ‘in the round’ assessment of the ongoing efficiency challenge.

#### **Adoption of novel approaches by Ofgem to determine OE**

As described above, Ofgem have adapted its approach for RIIO ED2 to interpret the EU KLEMS growth accounting analysis in a novel and different way, rather than relying on robust and well evidenced analysis, to justify a more stretching target.

In the recent energy price controls (RIIO-ED1 and RIIO-GD2/T2), Ofgem proposed novel approaches to the assessment of OE targets – the Smart Grid Benefits (SGBs) analysis in RIIO ED1 and the “Innovation Uplift” in RIIO-GD2/T2 – to materially increase the productivity target above a credible level. These proposals were subsequently found to be wrong by the CMA upon appeal.

In the Northern Powergrid Appeal<sup>36</sup> the CMA emphasised the importance of robust evidence-based decision making.

*“robust, evidence-based decision-making, taking into account the potential limits of evidence on issues where there is significant uncertainty, is itself central to protecting the interests of consumers.”<sup>37</sup>*

*“the importance of smart grid solutions as a policy goal cannot, in our view, negate the need for decisions in relation to SGBs in the price control to be justified and supported adequately by reasoning and evidence.”<sup>38</sup>*

*“4.140 We accept that, in general, GEMA was able to draw on a wide range of evidence and its regulatory judgement in reaching the decisions that informed its RIIO-ED1 Final Determinations. However, in the context of this ground of NPg’s appeal, we have considered carefully what was presented to us as that wider evidence base including the approach which GEMA adopted at Final Determinations to estimate embedded and potential SGBs. In our view, for the reasons set out above, neither the evidence nor the reasons put forward by GEMA, at the time or subsequently, support GEMA’s decision to make a specific SGB adjustment. In the absence of evidential support for the judgement, GEMA’s discretion cannot, in our view, be treated as sufficient to justify the adjustment to NPg’s Totex that it made.”*

Ofgem’s proposed innovation uplift was successfully appealed to the CMA by SPT and four other licensees. While the CMA did recognise that *“some past innovation funding is likely to result in cost reductions”*, they determined that the appellants had established that Ofgem’s choice of 0.2% was a

<sup>35</sup> CEPA (17 June 2022) RIIO-ED2: Cost Assessment Frontier Shift methodology paper, p 25

<sup>36</sup> Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc v the Gas and Electricity Markets Authority Final determination, 29 September 2015

<sup>37</sup> Paragraph 4.59

<sup>38</sup> Paragraph 4.132

result of four material errors relating to important parts of Ofgem's evidence base.<sup>39</sup> The CMA considered that, without this evidence, Ofgem could not support an innovation uplift of 0.2%,<sup>40</sup> and that remitting to Ofgem for further review would not significantly change the evidence base available to Ofgem.<sup>41</sup> Yet Ofgem now appear to be trying to do exactly that for RIIO ED2.

Frontier Economics notes that Ofgem's current proposal represents a third attempt to introduce an arbitrarily high productivity assumption, without sufficient underlying evidence or reasoning. In the past two energy appeals in this area, the CMA found Ofgem's supporting evidence and analysis to be wrong. Any judgement made by Ofgem must be grounded in sound reasoning and evidence.

Frontier Economics consider that many of the same errors that were identified by the CMA in RIIO ED1 and RIIO-GD2/T2 CMA appeals apply equally to the proposals made by Ofgem for RIIO-ED2 in this respect. SPEN agrees. The OE target specified in the Draft Determination is wrong. SPEN invites Ofgem to correct the errors contained in the Draft Determination.

#### **Core-Q111. Do you agree with our proposed disaggregation methodology?**

**SPEN do not agree with the proposed disaggregation methodology.**

SPEN have reviewed Ofgem's approach to disaggregating modelled costs / allowances to activity level and table specific values and disagree with the approach taken at draft determination. We have identified two alternative approaches and would outline option 2 as our preference for Final Determination.

#### **Ofgem draft determination approach**

Ofgem's current approach scales DNO allowances by their normalised submitted costs and applies the overall Totex reduction on a uniform basis across all cost areas. This approach differs from what Ofgem's benchmarking models prescribe as an efficient view and thus by delivering to these sets of numbers, DNO efficiency will diverge further over time causing disparity for cost assessment in future price controls. The current approach also makes it difficult to explain and align the outcome of the benchmarking assessment to key stakeholders.

#### **SPEN proposed Option 1**

SPEN believe an alternative approach to disaggregating allowances would be to do so based on scaling Ofgem's own disaggregated assessment. However, this would assume efficiency is derived 100% from the disaggregated modelling and would raise the question as to why undertake Totex modelling.

This approach does not ringfence costs associated with bespoke activities or price control deliverables and could impact output delivery if reductions from the benchmarking assessment are material. It would also skew the allocation of the Totex reductions or increases based on the absolute value of the disaggregated content. This, however, would be a preferred approach to that taken at draft determination, and would result in an improved convergence of DNOs spend over time to the efficient position at a disaggregated level.

#### **SPEN proposed Option 2**

An improved approach on Option 1 would be:

---

<sup>39</sup> CMA, Final Determination, paragraph 7.802.

<sup>40</sup> CMA, Final Determination, paragraph 7.803.

<sup>41</sup> CMA, Final Determination, paragraph 7.814.

- to ringfence Uncertainty Mechanisms, Price Control Deliverable and bespoke activities, safeguarding output delivery; and
- to incorporate a 50% weighting on the output of the Totex modelling. By doing this, allowances would be set at a level of efficiency that has been achieved by each DNO and will ensure that all DNOs are placed on a trajectory to the efficient level. This will enhance and support the assessment of future price controls, and would result in an improved convergence of DNOs spend over time to the efficient position at a disaggregated level.

**SPEN would suggest the following approach as the best option for how Ofgem can incorporate the Totex modelling within the disaggregation of allowances. This can be undertaken using a simple model built in Microsoft Excel.**

- Identify cost activities that should be ring fenced (PCDs, Uncertainty Mechanisms, Bespoke Activities) and set cost equal to output from separate assessments
- Run an econometric model for all three Totex Models against each individual cost activity (minus costs identified at step 1) using the same parameters and model form as per Totex model assessment – this would roughly work out to be c114 individual “middle up models”.
- Scale the result of each individual model to ensure that the aggregate of all middle up models equals the output of each Totex Model (minus costs identified in step 1)
- Reverse any pre modelling adjustments
- Apply Demand Driver adjustment
- Net to Gross Ratio
- Catch up efficiency applied to Disagg. and Totex Models
- Weight each activity as per 50% Disagg. and 16.67% for each Totex model

### 3. SPEN Annex Questions

#### Section 2. Setting outputs

**SPEN-Q1. What are your views on the values for the company specific parameters we have proposed for the common outputs that we have set out above?**

**SPEN broadly agree with the parameters but raise some details of concern**

**IIS: The IIS targets align with our business plan.** In setting the CI and CML targets, we believe Ofgem has reached a position that reflects SP Manweb's and SP Distribution's opportunities to make performance improvements. These bespoke targets, based on each licence area's historical performance, are fair and suitably challenging, and will incentivise performance improvements from current levels. We have a more in-depth view on the target setting methodology in our response to Core-Q48.

We believe the IIS revenue cap is appropriate for our business plan. However, our view is that the collar results in too large a financial exposure. Therefore, we believe the collar should be reduced in line with the cap, resulting in a symmetric position. We have provided more detail on this in our responses to Core-Q45 and Core-Q46.

**NARM: The NARMs targets outlined align with our business plan.** We have detailed our views on using these targets in our response to Core-Q54, in summary we support the use of submitted NARMs risk reduction as baseline network risk outputs as these reflect the work DNOs need to undertake, and we do not believe it would be possible to modify these accurately

**Vulnerability:** The targets align with our vulnerability template submission provided to Ofgem on 2<sup>nd</sup> May 2022

**Major Connections:** We agree that the maximum penalty % base revenue reflects Ofgem's minded to position as stated within the May 2022 Consultation on review of competition in the electricity distribution connections market. Our only comment is that to be consistent with the other incentives, Ofgem should re-state the maximum penalties against % RORE.

**SPEN-Q2. What are your views on our proposals for SPEN's bespoke ODIs?**

**SPEN do not agree with Ofgem's position to reject our bespoke ODI proposals**

We are disappointed that Ofgem has decided to reject our bespoke ODI proposals. We believe that our final Business Plan demonstrated that these align with the priorities of our customers and stakeholders and have the potential to generate clear positive benefits

The overall RIIO-ED2 incentive package is now skewed to risk higher downside and the tougher targets within the common incentive suite reflect a dilution of reward potential; both of these factors undermine one of the underlying features of RIIO which is meant to be 'an incentive based model'.<sup>42</sup>

---

<sup>42</sup> Page 12, Ofgem's Guide to the RIIO-ED1 electricity distribution price control (January 2017)

**SPEN-Q3. What are your views on our proposals for SPEN's bespoke PCDs?****SPEN have some concerns with Ofgem's proposals****3 Bespoke PCDs proposed by Ofgem:**

We are pleased that Ofgem have accepted our costs in relation to our bespoke proposals on EV optioneering, Biodiversity (partially) and Network Loss reductions and safety enhancement.

However, given the nature of the spend and the deliverables it would be more appropriate for these costs to be awarded as UIOLI allowances with licence drafting giving sufficient assurance around spend. We are happy to work with Ofgem to discuss this further and mirror existing drafting for UIOLI outputs. For example:

- **EV optioneering:** The meaning of EV optioneering work could be defined to align with our proposals accepted by Ofgem to ensure spend is targeted at related activities only
- **Biodiversity:** The biodiversity enhancement spend definition could be aligned with DEFRA definition to ensure spend in correct area (similar to UIOLI drafting for Visual Amenity)
- **Network Loss reductions and safety enhancement:** The spend definition could be clearly linked to the spending to lease the MAAV vehicle (similar to UIOLI drafting for Visual Amenity)



**SPEN-Q4. What are your views on our proposals for SPEN's CVPs?**

We are pleased to see Ofgem agree that there is merit in 3 of our 4 CVP proposals, and that our baseline costs for these activities are to be awarded. However, we are disappointed that Ofgem have rejected the reward associated with all 4 of our CVP proposals.

Each of our CVPs have been rigorously tested against Ofgem's baseline requirements, and we believe the minimum criteria for CVP award has been met

We would like to understand, in particular with respect to our EV optioneering CVP, the reasons why Ofgem rejected our reward proposal. Ofgem state that they are not satisfied that this proposal has provided evidence that the activity goes sufficiently beyond SPEN's baseline expectations to engage with Local Authorities on investment and infrastructure planning needs. However, Ofgem's reasons for this position are not clear to us. In contrast, we believe that our proposals go *significantly* beyond both energy network BAU activity, and the baseline activities that were presented within Ofgem's RIIO ED2 Business Plan Guidance.

**EV Optioneering is beyond BAU activity.** As already set out in our Strategic DNO Annex<sup>43</sup>, the EV Optioneering Work will replicate the methodology used as part of Project PACE, a £500m site selection study funded by SPEN's Green Economy Fund. This methodology goes significantly beyond the usual engagement that energy network companies have with Local Authorities.

For example, Phase 1 Initial Screening includes establishing land ownership, high level assessment of proximity of electricity network and land rights and environmental concerns such as protected sites

---

<sup>43</sup> <https://www.spenergynetworks.co.uk/userfiles/file/Annex%204A%20-%20Strategic%20DNO.pdf>

and conservation areas. Furthermore, Phase 3 Site Optimisation includes assessing the social or community-based activities that the hub location services. Car parks that support multiple services ensure that a greater number of users can benefit from the EV charging infrastructure.

Additionally, to reduce the perception of bias towards low constraint areas, we will instruct an independent review of selected sites to provide independent validation, using experience of community adoption of existing EV charging hubs. This ensures that the hubs are in the places that best suit not only the electricity network to reduce connection costs and speed up timeframes, but also best meet the needs of the local communities that will be served by the infrastructure. The full EV Optioneering Methodology can be found in Appendix 4 of our Strategic DNO Annex<sup>44</sup>

We will also enhance this methodology with data from our RIIO-ED1 project, EV Up, to tailor our works to areas with low levels of off-street parking and low household income

To our knowledge, no other DNOs have carried (or propose to carry) out this level of detailed analysis and engagement, working in partnership with Local Authorities, to accelerate the connection of EV charging infrastructure

- EV Optioneering goes beyond the expectations set out within the RIIO-ED2 Business Plan Guidance (BPG). As part of Ofgem's BPG under 'Enabling whole system solutions', DNOs need to demonstrate cross sector engagement, optioneering, and planning with sectors other than their own<sup>45</sup>. Although there is no set definition of optioneering in the business plan guidance, we believe that our proposals go significantly beyond what Ofgem is referring to. Our RIIO-ED1 project PACE carried out optioneering work with 2 Local Authorities; however, under this CVP we are proposing to carry out optioneering in RIIO ED2 with 37 Local Authorities, spanning the entirety of both our licence areas. We believe that carrying out this type of work, has not been carried out, nor proposed for RIIO ED2, by any other DNO. We believe that this demonstrates our ambition at scale.
- By definition, Ofgem have indicated that 'cross sector' refers to "any licence in one energy source sector e.g., electricity, working with any licensee in another sector, such as gas or water". Furthermore, 'sector' refers to the distribution, transmission, and operation of a single energy source. Our EV Optioneering proposal goes beyond these baseline requirements by working directly with Local Authorities and strategic transport bodies, who do not fall under this scope. Through this, we will ensure that we are focused on areas where there is a need for public intervention in the delivery of public EV charging infrastructure, while avoiding areas where they expect the market to deliver. Finally, working directly with Local Authorities will ensure that local knowledge is also utilised, which is essential for EV Optioneering.

<sup>44</sup> <https://www.spenergynetworks.co.uk/userfiles/file/Annex%204A.27%20-%20Strategic%20DNO.pdf>

<sup>45</sup> [ED2 Business Plan Guidance September 2021 1 \(3\) pdf](#) page 41

## Section 3. Setting baseline allowances

**SPEN-Q5. What are your views on our proposals for the outcome of Stages 3 and 4 of the BPI for SPEN?**

**SPEN partially agree with Ofgem's assessment of Stage 3 BPI, however, please see our response to Core-Q13 in relation to biodiversity costs.**

**SPEN do not agree with Ofgem's assessment or calculation of the Stage 4 BPI.**

As outlined in our Cost Assessment Annex<sup>46</sup>, we have undertaken our own assessment of confidence in our costs. Based on our assessment, we believe our costs are high confidence and efficient.

SPEN believe that the Stage 4 output should be calculated on an individual cost area basis (i.e., Load, Non Load, Indirects etc) instead of the Totex modelled output which is currently used for Draft Determination. The use of modelled output at Totex level does not provide a clear view of modelled or efficient costs for individual cost areas which may be efficient.

For the purposes of BPI Stage 4 High Confidence Cost assessment and potential reward calculations, we believe Stage 4 BPI calculations should be undertaken following the disaggregation of allowances (as per the outcome of Core-Q111) and reward calculated through comparisons to submitted cost

## Section 4. Adjusting baseline allowances for uncertainty

**SPEN-Q6. What are your views on our proposals for SPEN's bespoke UMs?**

**SPEN disagree with Ofgem's rejection of bespoke UMs.**

Our views on Ofgem's proposal for each area where we proposed a UM are set out below. We welcome the fact that Ofgem is proposing new common UMs in the areas we highlighted

**PCB volume driver:** we are pleased that Ofgem has proposed a common volume driver in this area and our comments on the detail of the proposal can be found in our response to Core Q 16.

**Strategic investment and Significant Code Review:** Ofgem's intentions is that the proposed LRE UMs address uncertainties in these areas and our response to the detail of those proposals can be found in our response to questions Overview-Q11, Core Q4 and Core Q5

**EV charge point Provider of Last Resort:** As indicated in our response to Overview Q1 and Q2, we are pleased that Ofgem is proposing to introduce a regulatory mechanism to fund these activities

**Severe Weather 1 in 20:** As outlined in our response to Core Q98 in, we support the Ofgem proposal to introduce a variable Totex allowance in this area.

**Digitalisation:** We are pleased that Ofgem has accepted a version of our proposed digitalisation UM and proposed that this is accessible to all DNOs. We provide further views in our response to Core Q-19 in the Core document

---

<sup>46</sup> SPEN Business Plan Annex 5A 3 Cost Assessment Chapter 7

**Distribution Net Zero Fund:** In addition, Ofgem has grouped our Distribution Net Zero Fund proposal as a UM and rejected our proposal saying that ‘DNOs are expected to provide guidance and support to vulnerable consumers as well as engage with local communities to help facilitate the Net Zero transition as part of the RIIO-ED2 price control’ We are disappointed with this decision and believe the £30m funding pot is justified both in terms of value and need.

More evidence on the justification for this initiative can be found in Annex 3: SPEN Net Zero Fund

## 5. Innovation

### SPEN-Q7. What are your views on the level of proposed NIA funding for SPEN?

**SPEN challenge the level of NIA reward proposed by Ofgem.**

Please also see our responses to Core-Q8, and Core Q9.

We were pleased with Ofgem’s assessment that we satisfactorily met the five NIA criteria set out in the SSMD, and with Ofgem’s positive decision to include NIA allowances at the outset of RIIO ED2. However, we were disappointed with Ofgem’s assessment that we have not justified the level of requested NIA, and the adopted approach of benchmarking RIIO ED2 allowances to RIIO-ED1 levels.

We note Ofgem have queried support from stakeholders and concerns raised by our CEG about our stakeholder engagement activity. We undertook an expansive series of stakeholder and customer engagement for RIIO-ED2, to test our ambitions and inform our final plans. Although a number of specialist organisations responded to this activity, we do not feel this undermines the process, nor do we feel that absence of a preferred funding route by stakeholders undermines our submission. As per our response to Core-Q9, NIA plays a vital innovation funding role.

Section 7.4 of our SPEN Business Plan Annex 2.1 presents our engagement activity in detail and describes how our stakeholders’ views have been used to guide the development of our innovation strategy. In addition to a dedicated workshop on innovation, this also includes details of a stakeholder survey where 60% of respondents said that DNOs should ask for an increase in NIA funding compared to RIIO 1 levels. On this basis, we undertook a detailed review of existing and previous innovation projects and compared this against the challenges now facing the industry, to develop a bottom up approach to identifying the level of investment required. This is the primary justification that underlines our increased RIIO-ED2 NIA request.

It is our view that our innovation strategy submitted as part of our RIIO-ED2 Business Plan, Annex 2.1, has set out significant justification for the NIA requested. Page 5 of the Annex includes a reference table signposting specific justification and evidence against each item set out in the Business Plan Guidance.

Appendix III of SPEN Business Plan Annex 2.1 presents a detailed table of the NIA project areas we propose in Section 7.4. As detailed in Section 7.4.3, this was established using a bottom-up approach to identify the level of investment required within each innovation focus area. For each area, an assessment of the existing market was completed, and example projects identified. This assessment was then extrapolated from the real project examples to provide a most likely funding source for other project concepts. The outcome of this analysis was more than £80m of proposed innovation investment, as detailed in Appendix III, that includes the £35m minimum NIA investment program that we have a high confidence that we can deliver within the RIIO-ED2 period.

The specific needs case for NIA investment, in addition to other funding routes, is the large number of low-mid TRL innovation projects that will be required to meet all of the objectives identified against each innovation sub-theme presented within Appendix III of SPEN Business Plan Annex 2.1.

We would request that Ofgem reconsider their position with focus on the above areas of justification for an increase in NIA for RIIO ED2 relative to RIIO-ED1.

#### **Innovation Measurement Framework (IMF)**

We note the request from Ofgem that, as part of their consultation response, DNOs should provide evidence to satisfy us that the IMF is robustly quantifying the benefits created by innovation on a consistent basis across DNOs. We are currently engaging with Ofgem on the IMF via the ENA. SPEN have already started using the IMF for Transmission and will begin using it for distribution in RIIO-ED2.

We recognise the importance of robust and consistent completion of the IMF across DNOs and are committed to working with Ofgem through the ENA Electricity Innovation Managers Gas Innovation and Governance Group (EIM GIGG) to ensure that an appropriate common approach is put in place. We will also quantify the benefits using an Ofgem approved CBA whenever practicable. We believe the CBA template used for the RIIO-ED2 business plan to be fit for this purpose.

We note that IMF reporting is only intended for RIIO-2 NIA projects. Although SPEN will be forecasting benefits from the outset, we expect that most projects will not deliver BAU benefits within the first year of deployment, in some cases not until they are embedded in RIIO-ED3 plans.

We will use our Social Return On Investment (SROI) tool in conjunction with the IMF as part of the Cost Benefit Analysis process, to evidence benefits for projects focussed on societal benefits. While all benefits can be converted to a monetary value, we suggest that the type of benefits realised by an innovation project is also considered when comparing innovation benefits realised, rather than just the cost savings. Otherwise, projects where the primary driver is societal or environmental (for example) might be seen as less worthwhile than projects with a larger impact on cost.

## 4. Finance Annex Questions

SPEN, as part of the ENA, have jointly commissioned several expert economic consultants reports which are referred to throughout our responses. In the interest of co ordination and clarity the ENA will submit these reports on behalf of all DNOs.

The documents and data published by Ofgem at the Draft Determination stage do not contain sufficient information for SPEN to fully understand Ofgem's approach to setting baseline and variant capitalisation rates and their resulting impact on allowed revenue and financeability. This means that SPEN has not been able to fully respond on such topics. In order to ensure a fair consultation, we recommend that, consistent with the BPDTs, Ofgem provides allowances by cost activity and, following provision of additional information, allows SPEN and others sufficient time to consider and respond.

**FQ1. Do you agree with our approach to estimating efficient debt costs and setting allowances for debt costs?**

**SPEN believe Ofgem should broaden its cost of debt modelling of plausible macroeconomic risks.**

We do not consider that Ofgem's assessment on the appropriate calibration for the cost of debt index has led it to selecting an index that meets its objective of broadly matching debt allowances with the expected efficient debt costs of the ED sector over the RIIO-ED2 period. Ofgem risks not providing the sector with adequate funding, given its current selected index calibration, to meet the expected debt costs over RIIO ED2 considering plausible macroeconomic risks, for example:

1. long term high interest rates to reflect successful monetary policy seeking to control inflation,
2. long term low interest and inflation, and
3. the current environment where increase in interest rates lags the growth in inflation.

We recommend that Ofgem consider broadening the inflation and interest rate scenario levels used in its analysis to better reflect the greater level of macroeconomic risks faced by the ED sector over the RIIO-ED2 period. By better capturing these risks within the assessment, a more appropriate calibration of the index will be selected which minimises the sector's risk of under-recovery of its efficient debt costs.

In its RIIO-ED2 DD, Ofgem have maintained its Sector Specific Methodology Decision (SSMD) position that the 17-year trailing average of the Utilities 10yr+ index, plus 25bps for additional borrowing costs, sufficiently reflects expected industry debt costs over the RIIO-ED2 period. Ofgem have based this decision on the results of its debt calibration exercise, which tests the suitability of calibrations of the cost of debt index with forecast industry debt costs (based on Business Plan information on DNOs' expected borrowing requirements) against different scenarios around inflation and interest rates – the results are presented in table 7 of the DD Finance Annex.

However, Ofgem's decision and justification for retaining its SSMD position does not fully take into consideration the greater level of macroeconomic risks, specifically the war in Ukraine war, Russian sanctions, and the disruption to supply of gas from Russia, and the consequential impact on inflation, that the sector faces over the regulatory period. Ofgem's preferred calibration suggests that the ED sector will marginally underperform (2bps) on its debt costs over the RIIO-ED2 period under its base case. Greater levels of underperformance were observed under the high inflation and high interest rate scenarios – indeed, all the index calibrations in Ofgem's assessment present a risk of

underperformance under the aforementioned scenarios, except for the 20-year trailing average calibration

Despite the downside risks seen in the estimated outcomes for its selected calibration, Ofgem have not provided a sufficient level of headroom on the allowance compared to expected sector debt costs. Ofgem justify this decision on the principle that they “*do not need to fully compensate networks in all potential macro-economic environments*” and that such an approach “*could lead to consumers overpaying on network debt costs to cover risks that [Ofgem] consider to be best borne by equity holders*”<sup>47</sup>

The decision is in contrast with that taken by Ofgem in its cost of debt index selection for the RIIO GD2/T2 Price Controls. In its RIIO-GD2/T2 Final Determination, Ofgem decided that the 10-14-year trailing average of the iBoxx Utilities 10yr+ index yields (plus 25bps for additional borrowing costs) was the appropriate calibration<sup>48</sup> as it would improve the networks’ expected debt cost recovery relative to other calibrations since it provided the industry with a robust enough headroom to recover its actual debt costs under a range of different scenarios – 26 29bps under its base case.<sup>49</sup> This outcome was also observed in Ofgem’s calibration assessment cross-check where derivatives and intercompany loans were taken into account when forecasting industry debt costs.<sup>50</sup>

Selecting instead an index calibration with a longer trailing average length would provide the sector with a reasonable level of headroom over expected average debt costs, which would help mitigate against reasonable inflation and interest rate risks over the RIIO-ED2 regulatory period. Such a decision would be in line with that taken by Ofgem in RIIO-GD2/T2.

The justification for providing headroom for the sector is further strengthened if greater downside risk scenarios are considered within Ofgem’s scenario analysis. Ofgem’s +/- 1% risk assumptions around both inflation risk and interest rate risk do not sufficiently capture the heightened macroeconomic risks faced by the sector over the RIIO-ED2 period.

On inflation risk, specifically RPI-CPI basis risk, Ofgem’s use of the same RPI high/low scenarios of +/- 1% relative to the OBR’s inflation forecast as in RIIO GD2/T2 is not appropriate for RIIO-ED2 due to the greater levels of inflation volatility and RPI-CPI differential risk expected over the RIIO ED2 period relative to that assumed at the time of RIIO-GD2/T2.

Inflation has spiked considerably over the course of 2022 and is well above expectations from just a few years ago, as seen in table FQ1a below. Indeed, there has been a series of successive upward forecast revisions from various forecasting bodies as the post pandemic inflation wave has materialised. The latest OBR forecasts predict both RPI and CPI to rise sharply to 9.8% and 7.4% respectively in 2022.<sup>51</sup> RPI-CPI differential risk has also increased because of the OBR’s elevated forecasts, with the RPI CPI wedge forecast to be well above 1% over the next years – the differential between RPI and CPIH is even greater.

---

<sup>47</sup> Ofgem (June 2022), RIIO ED2 DD Finance Annex, p 22

<sup>48</sup> Ofgem decided on a different debt mechanism for SHET.

<sup>49</sup> Ofgem (February 2021), RIIO 2 FD Finance Annex, Table 5, p.17

<sup>50</sup> Ofgem (February 2021), RIIO-2 FD Finance Annex, Table 6, p.17

<sup>51</sup> OBR March 2022 forecasts: <https://obr.uk/download/historical-official-forecasts-database/>

The anticipation in March from the OBR was for inflation to peak in 2022 and subside over 2023 and 2024. However, the latest views from the Bank of England forecast CPI inflation will rise to 13% in 2024, and for these elevated inflation levels to persist for longer than previously anticipated.<sup>52</sup>

**Table FQ1a – Inflation expectations RIIO-GD2/T2 vs RIIO ED2 DD**

|                                  | 2021            | 2022  | 2023  | 2024  | 2025  | 2026  |
|----------------------------------|-----------------|-------|-------|-------|-------|-------|
| <b>OBR Mar '20 (RIIO-GD2/T2)</b> |                 |       |       |       |       |       |
| CPI                              | 1.80%           | 2.06% | 2.05% | 2.02% | 2.02% | 2.02% |
| RPI                              | 2.74%           | 3.05% | 2.95% | 2.85% | 2.85% | 2.85% |
| <b>OBR Mar '22 (RIIO-ED2 DD)</b> |                 |       |       |       |       |       |
| CPI                              | 2.58% (outturn) | 7.44% | 4.04% | 1.54% | 1.88% | 2.00% |
| RPI                              | 4.05% (outturn) | 9.83% | 5.51% | 2.34% | 2.52% | 2.71% |

Source: OBR's CPI and RPI worksheets. Available here: <https://obr.uk/download/historical-official-forecasts-database/>

A similar story is present with Ofgem's interest rate risk assumptions of +/- 1% relative to forecast rates for iBoxx and LIBOR, with a greater level of interest rate risk expected over the RIIO-ED2 period compared to that assumed for RIIO GD2/T2. The yields on the iBoxx Utilities index have increased significantly over the first quarter of 2022; driven by the macroeconomic prospects of a weaker economy with high inflationary risks. Indeed, there is a higher degree of uncertainty over the future macroeconomic environment, with factors such as central banks pursuing policies of monetary tightening to counter rapidly rising rates of inflation (i.e. raising base rates and balance sheet reduction) and an increasing risk of entering a period of prolonged and deep economic contraction contributing to greater levels volatility in corporate bond rates over the coming years.

Ofgem should make its determination based on the best assessment available at the time, and for RIIO-ED2 that needs to take account of changes to the macro environment that have become evident since the GD2/T2 determinations. Ofgem should expand its high and low risk scenarios in its scenario analysis to better reflect the greater level of macroeconomic risks faced by the ED sector over RIIO-ED2. Not factoring in these wider scenario ranges within the analysis would heighten the risk that the current selected cost of debt index will not provide adequate funding for the sector's expected debt costs over RIIO ED2 should these plausible risks materialise.

Providing the ED sector with sufficient headroom to avoid under-recovery of efficient debt costs is consistent with Ofgem's decision at RIIO-GD2/T2. The case for doing so in RIIO-ED2 is even stronger now than at previous reviews due to the heightened macroeconomic risks faced by the sector over the regulatory period. A trailing average longer than the 17-year length selected by Ofgem in the DD would help to achieve the objective of minimising the sector's risk of under-recovery of its efficient debt costs.

Additionally, a longer trailing average is in line with the conceptually correct trailing average length. When determining the trailing average, it should be set at a length that matches the average tenor at issuance of network companies' debt. By doing so, an energy network that issues a bond in line with the average tenor will receive an allowance equal to the efficient cost of the bond in each year of the lifetime of the bond, thus ensuring a reasonable likelihood of servicing its debt costs. The weighted

<sup>52</sup> Bank of England (August 2022), Monetary Policy Report August 2022

average tenor of issuance for DNOs' bonds is around 20 years based on industry data – the length is in line with Ofgem's conceptual approach assessment<sup>53</sup>

The calibration of the cost of debt index must ensure that additional borrowing costs are efficiently funded. Our position on the recommended allowance for these additional debt costs remains in line with that submitted as part of our RIIO ED2 business plan.<sup>54</sup> In particular, as stated in NERA's report<sup>55</sup>, we disagree with Ofgem's approach to estimating the 'Halo' effect. Its analysis incorrectly: (i) includes callable bonds, which could lead to imprecise duration matching and hence inaccurate halo estimate; (ii) excludes SSE plc issuances from its sample despite the fact that the purpose of these bonds is to finance the corporate activities of SSE's three energy networks; and (iii) uses the pricing date rather than the issue date to compare yields – the final terms of bonds represent the yield at the issue date and should therefore be used instead. Ofgem should update its RIIO-ED2 DD halo analysis in line with the methodology set out by NERA.

Based on NERA's assessment on each constituent element of the additional cost of borrowing allowance as part of its study for the ENA,<sup>56</sup> we believe that Ofgem should provide an additional cost of borrowing allowance of 43bps (instead of its 25bps assumption).

On the appropriate deflation approach for the allowed cost of debt, please see our responses to FQ16 18.

**FQ2. Do you have any views on the model to implement equity indexation that is published alongside this document, (the 'WACC Allowance Model - RIIO-ED2 30th April 2022 update Alternative Wedge')?**

**SPEN view remains that the true RFR sits above the ILG yield and that it is wrong not to address this.**

We do not have any comments to make on the functionality of the model for estimating the RFR based on Ofgem's approach for the purposes of cost of equity indexation. However, we would like to comment on the approach used for estimating the RFR for RIIO ED2, specifically on the RFR proxy instruments used in the estimation of the parameter, which would necessitate amendments to the model.

In line with our RIIO-ED2 Business Plan, our position remains that it is wrong for Ofgem to place exclusive reliance on the yields of 20-year index-linked gilts (ILGs) for the determination of the real RFR.<sup>57</sup> This is because this RFR benchmark instrument contains downward distortions which depress their yield below the "true" RFR. We also do not agree that 20-year SONIA swap rates are an appropriate proxy for the long-term RFR. 20-year SONIA swap rates should be disregarded as a cross-check on the RFR, noting Oxera's analysis on this instrument in its cost of equity report<sup>58</sup>

---

<sup>53</sup> Ofgem (June 2022), "RIIO-ED2 Draft Determinations Finance Annex", footnote 25

<sup>54</sup> SPEN (December 2021), "RIIO-ED2 Business Plan Annex 5D.1: Finance", p.24 25

<sup>55</sup> NERA (June 2021), "Additional costs of borrowing and Small Company Premium at RIIO-ED2", section 1

<sup>56</sup> NERA (June 2021), "Additional costs of borrowing and Small Company Premium at RIIO-ED2"

<sup>57</sup> SPEN (December 2021), "RIIO-ED2 Business Plan Annex 5D.1 Finance", p. 9-10

<sup>58</sup> Oxera (August 2022), "Cost of equity in RIIO-ED2 Draft Determinations", section 2 2

It is acknowledged in the financial literature and empirical research that sovereign bond yields contain a “convenience premium” which arises due to these instruments having certain ‘money-like’, safety and liquidity benefits compared with other securities.<sup>59,60</sup>

The existence of the convenience premium has also been recognised in recent regulatory precedent, with the CMA adopting a RFR between the ILGs and AAA corporate bonds, accounting for the convenience premium in the PR19 redeterminations<sup>61</sup> The CMA in their Final Determination for the RIIO GD2/T2 appeals agreed that there is evidence to support the notion of a “convenience yield” in government-issued securities, and that ILGs are an imperfect proxy for the RFR<sup>62</sup> Consistent with CMA analysis, the CAA confirmed in their recent Final Proposals for H7 that they “remain of the view that ILGs may exhibit a “convenience yield” or other specific factors that mean that the yields on ILGs may underestimate the “true” risk free rate.”<sup>63</sup> The provision of a convenience premium has also been recognised by European regulators, with ARERA (the Italian regulatory authority) and BNetzA (the German regulatory authority) including a convenience premium when setting their RFR estimate.<sup>64</sup>

Our approach remains that the true RFR sits above the ILG yield and that it is wrong not to address this. If Ofgem continue to place sole reliance on evidence from ILG yields, then Ofgem must, at a minimum, make an explicit upwards adjustment to account for the convenience premium embedded in this RFR benchmark measure. This approach would also be consistent with that adopted by the CAA in its Final Proposals for H7<sup>65</sup>

Our view remains that the inclusion of AAA rated bond yields in the estimation would provide a more accurate estimate of the ‘true’ RFR. Setting the parameter based on a blend of AAA-bonds and ILGs yields, in line with the CMA’s approach in PR19, would create an unbiased and practical approach for estimating the RFR that recognises that both measures contain distortions. The unadjusted approach can implicitly adjust for the imperfections in the yields of these benchmarks and can therefore better meet the RFR requirements of the CAPM compared to either instrument purely on its own.

**FQ3. In light of the upcoming change to the definition of RPI in 2030, should the RPI-CPIH inflation wedge be based on: a) a single year (as shown in the WACC allowance model when: cell D2 is “year 5 forecast” and cell B5 is “01/04/2022”); or b) should it be based on 20 years of inflation forecasts (as shown in the WACC allowance model when: cell D2 is “20 year geometric” and cell B5 is “01/04/2031”)?**

**In order to make a decision on which methodology is more appropriate Ofgem would need to provide further clarity on the assumptions it proposes to take.**

If based on the yields of the 20-year RPI-linked gilt a revised version of option (a) should be the chosen approach for deriving the RPI CPIH wedge used for converting the RFR into CPIH terms. If using this

<sup>59</sup> See NERA (June 2021), “Cost of Capital at RIIO-ED2”, footnote 38

<sup>60</sup> Oxera (August 2022), “Cost of equity in RIIO-ED2 Draft Determinations”, section 2.1.1-2.1.2

<sup>61</sup> CMA (March 2021), ‘Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations – Final report’, para. 9.264

<sup>62</sup> CMA (October 2021), “RIIO 2 Final Determination – Volume 2A”, para 5.68

<sup>63</sup> CAA (June 2022), “Economic regulation of Heathrow Airport Limited: H7 Final Proposals - Section 3: Financial issues and implementation”, para 9.245

<sup>64</sup> Oxera (August 2022), “Cost of equity in RIIO-ED2 Draft Determinations”, section 2.1.3

<sup>65</sup> CAA (June 2022), “Economic regulation of Heathrow Airport Limited: H7 Final Proposals - Section 3: Financial issues and implementation”, para 9.250

benchmark as the proxy for the RFR, then the RPI-CPIH wedge used in its conversion into CPIH terms should be consistent with the inflation assumption priced into the yields of this instrument.

In November 2020, the UK Statistics Authority (UKSA) decided to reform the RPI index, where by 2030 it will no longer be calculated but will instead simply be aligned with the CPIH index. Despite this decision, information from breakeven inflation forward curves (derived from forward curves for ILGs and nominal gilts) do not indicate that the market is factoring in the change to RPI for year 2030 in the pricing of ILGs. The market's apparent doubt about the future convergence of RPI to CPIH can be explained by the degree of uncertainty remaining around the reform and the timing of its implementation. The UKSA's decision has been taken to Judicial Review by pension funds for determination by the High Court, with potential outcomes being revisions to the reform and/or compensation provided to ILG holders.<sup>66</sup>

Given that the future reform to the RPI index is not currently being reflected in the yields of UK ILGs, the RPI-CPIH wedge used in the RFR estimation should be set based on the longest available forecast available for RPI and CPI as it is more consistent with the long-term inflation expectations assumed in the yields of this RFR proxy measure compared that derived using the Option (b) method.

We propose Oxera's recommended revision to option (a)<sup>67</sup>, where instead of using the OBR's 5 year ahead forecast of 70bps, Ofgem should adopt the OBR's long term wedge forecast of 100bps as stated in its March 2022 publication<sup>68</sup>. This revision would ensure that approach is aligned with Ofgem's intention of using the 'longest horizon available' for its long term inflation expectations.<sup>69</sup>

If Ofgem, however, choose instead to adopt option (b) – in essence accounting for the RPI reform – then the RPI-CPIH wedge should be adjusted to around 59bps, based on Oxera's analysis on zero-coupon RPI and CPI swaps and the historical CPI-CPIH wedge<sup>70</sup>.

#### FQ4. Is there evidence that suggests we should change our approach to TMR for RIIO-ED2?

**Ofgem must abandon its use of the outdated 'old' historical series for CPI in favour of using the new CPIH series as published by the ONS as the basis for converting historical UK realised returns estimates into real-CPIH terms. Failing to adopt this change would be an error by Ofgem.**

Ofgem have retained the approach it used in the RIIO-GD2/T2 Final Determination for evaluating the total market return (TMR) when setting the estimate for this parameter for RIIO ED2. Ofgem's approach is to base the TMR primarily on evidence from real long-run averages of realised UK equity market returns, combined with additional consideration on evidence from forward-looking approaches.

Although we do not object to this overall broad approach for setting the TMR, we have issues with the specific methodology used in Ofgem's analysis for setting the TMR. Specifically, Ofgem's choice of historical inflation series used by Ofgem to deflate nominal long-run realised market returns into real CPIH-terms is in error.

Ofgem's RIIO ED2 DD decision continues to adopt the 'backcast' CPI inflation series published in the Bank of England's (BoE's) 'Millennium dataset' when converting of the historical nominal TMR into

---

<sup>66</sup> Oxera (August 2022), "Cost of equity in RIIO-ED2 Draft Determinations", section 2.3.2

<sup>67</sup> Oxera (August 2022), "Cost of equity in RIIO-ED2 Draft Determinations", section 2.3.1

<sup>68</sup> OBR (March 2022), "Economic and fiscal outlook", p. 40

<sup>69</sup> Ofgem (July 2020), "Consultation - RIIO-2 Draft Determinations Finance Annex", para 1.8

<sup>70</sup> Oxera (August 2022), "Cost of equity in RIIO-ED2 Draft Determinations", section 2.3.2

real CPIH-terms. The use of this inflation series by Ofgem is not justifiable: the series is considered to be outdated, a point that is confirmed by the Office of National Statistics (ONS) March 2022 publication of both a revised historical CPI series, as well as a new series on historical CPIH series for the period 1950-88.<sup>71</sup> The ENA have commissioned Oxera to assess the impact of using the new CPIH inflation series published by the ONS on the average inflation between 1900–2021, and the consequent estimate of the CPIH-real equity returns series over the same period derived using this new historical inflation series<sup>72</sup>

The full detail of Oxera's assessment can be found in their report, as submitted by the ENA. To summarise, Oxera find that the methodology of the new modelled CPI and CPIH series is superior to that used in the previous CPI series – it provides historical estimates of CPIH instead of CPI, which aligns with the measure of inflation applied in RIIO ED2. Oxera find that the new modelled CPIH series is, on average, 0.82% lower than the previously published CPI backcast series over the period 1950–88. When incorporating this new series into the 1900–2021 time series, which involves combining the series with the Consumption Expenditure Deflator (CED) data to cover the pre 1950 period, the average inflation over this period is 0.24% lower than that estimated from the old CPI series, which translates into an increase in the CPIH real equity returns of 0.24%

If Ofgem continue to rely on its preferred approach to estimating the real TMR, then Ofgem must abandon its use of the outdated 'old' historical series for CPI in favour of using the new CPIH series as published by the ONS as the basis for converting historical UK realised returns estimates into real CPIH terms. Failing to adopt this change would be an error by Ofgem.

**FQ5. Can stakeholders confirm their view on the trade-off between: the objectivity of using outturn averages (even though the results may be materially higher or lower in future price controls than current TMR expectations); versus the benefits of putting more weight on current expectations (noting the evidence from cross-checks and the associated risk of subjectivity)? Our view is aligned with Ofgem's position in its RIIO ED2 DD (and RIIO-GD2/T2 FD).**

Greatest weight should be placed on long-run historical realised returns when estimating the expected real TMR as it provides an unbiased and objective estimate of investors' future expectations of equity market returns due to the parameter's stability over time.<sup>73</sup> However, Ofgem indicate in their RIIO-ED2 DD that other evidence, such as the cross-checks that Ofgem employ, may suggest that current expectations are materially lower than outturn averages

We do not dispute in principle the use of forward-looking approaches of TMR expectations as they can provide useful cross-checks to the TMR estimates derived based on long-run historical realised returns. However, we consider that these evidence sources should be treated with caution. Estimates from forward-looking dividend growth models (DGM) may be unreliable due to the uncertainty involved in their calibration given their sensitivity to input assumptions. The long-term dividend growth assumption, and investment managers' forecasts of market returns are not robust as the

---

<sup>71</sup> See Office for National Statistics (2022), 'Consumer price inflation, historical data, UK 1950 to 1988', <https://www.ons.gov.uk/economy/inflationandpriceindices/datasets/consumerpriceinflationhistoricaldatauk1950to1988>

<sup>72</sup> Oxera (August 2022), "Assessing the new ONS CPIH back-cast - Note prepared for the Energy Networks Association"

<sup>73</sup> Ofgem (June 2022), "RIIO-ED2 Draft Determinations – Finance Annex", para 3.23.3.24

results tend to depend on the identity and outlook of the respondents and how they interpret the questions being asked<sup>74</sup> The CMA has observed<sup>75</sup> their volatility over time.

However, limited weight should be attached to these forward looking TMR approaches given the degree of subjectivity involved in their estimation. In recognising the benefit of predictability and stability in a regulatory framework, it is therefore appropriate to attribute more weight to evidence from historical realised returns than that of individual forward looking projections.

**FQ6. Do stakeholders agree with our proposal to apply the same TMR for RIIO ED2 (a mid-point of 6.5% CPIH) as we did for RIIO-GD&T2?**

**SPEN do not agree with the proposed approach to calculating the TMR**

As stated in our response to FQ4, the use of the outdated ‘old’ historical CPI series in the conversion of long-run realised UK returns from nominal to real-CPIH terms is a mechanical error, not least given the publication of the new historical CPIH series by the ONS. The use of the new series, in combination with the CED series, produces an average annual inflation rate over the 1900-2021 period that is 0.24% lower than that estimated from the previous historical CPI series.

If it continues with its preferred methodological approach for estimating the real TMR, Ofgem must, at a minimum, adopt the new historical CPIH series when deflating the nominal historical UK realised returns estimates into real-CPIH terms. The result is that Ofgem’s range and point estimate for the real-CPIH TMR should be corrected upwards by c. 25bps i.e. a range of 6.50% - 7.00% with a mid-point of 6.75%.

In line with our previous positions in this area, we propose that the real CPIH TMR estimates be primarily informed by ex-post historical UK realised returns estimates using the established unbiased expected returns estimators developed by Blume and JKM – which produce substantially higher TMR estimates – for holding periods from 1 to 5 years, as well as the arithmetic average.

The use of these averaging techniques is superior to Ofgem’s approach of applying a subjective upwards variance adjustment of 1%-2% to the geometric mean of historical UK realised returns estimates to account for the variance in annual returns. Ofgem’s reason for not using an uplift that would make the estimate equivalent to the arithmetic average is based on an assumption of returns predictability, or serial correlation. The CMA found that the uplift Ofgem applied to its geometric return to be consistent with the limited evidence on serial correlation in UK returns.<sup>76</sup> However, neither the authors of the UKRN study nor Ofgem have presented evidence of serial correlation in the series. Oxera note that there is evidence which suggests that no such correlation exists. Oxera highlight<sup>77</sup> that, in Professor Stephen Schaefer’s submission to the CMA in the NATS (2020) price control redetermination, he noted that the observed relationship between the arithmetic and

---

<sup>74</sup> NERA (June 2021), “Cost of Capital for SPEN at RIIO- ED2”, Appendix B.3

<sup>75</sup> CMA (July 2020), “NATS (En Route) plc / CAA Regulatory Appeal – Final Report”, paras. 13.237-13.238.

<sup>76</sup> CMA Final Determination, paras. 5.251-5.258

<sup>77</sup> Oxera (August 2022), “Cost of equity in RIIO-ED2 Draft Determinations”, section 3.2

geometric averages suggests that the serial correlation is itself insignificant, or that the impact of serial correlation on the relationship between arithmetic and geometric average returns is insignificant.<sup>78</sup>

In the absence of reliable and robust empirical evidence on serial correlation, Ofgem's approach for estimating the historical TMR cannot be justified and the historical TMR should instead be based on the established unbiased estimators referenced above.

We also support deflating nominal historical UK realised returns using both the historical CED/RPI and CED/CPIH inflation series. Both historical inflation datasets contain shortcomings and a balanced approach which places weight on both recognises these shortcomings. It is an error to place undue weight on one particular deflationary approach by excluding other reasonable approaches – the RPI series contains relevant and available evidence, being based on actual outturn data for the majority of the historical period and is important to be taken into account in the estimation given the inherent uncertainty and unreliability of the backcast CPIH series

The case for inclusion of the RPI series is further strengthened as the Consumption Expenditure Deflator (CED) index (used for the period 1915-49), as noted by Oxera in their report<sup>79</sup>, is likely to be constructed based on price series that were constructed in a similar way to the measure of general inflation at that time, which was RPI. The CED index may therefore include some degree of upward formula effect bias. Oxera previously discussed this hypothesis with the ONS, which expressed its agreement with this interpretation<sup>80</sup>

The above methodological approach would help to arrive at a more appropriate and balanced estimate of the real TMR

**FQ7. Do you believe that DNOs have a higher or lower level of systematic risk than the GD&T companies during their respective RIIO-2 periods?**

**Ofgem understates beta for electricity distribution. Ofgem should amend its beta assessment methodology to include European network comparators for the RIIO-ED2 Final Determinations.**

DNOs face a higher level of systematic risk compared to gas distribution and gas and electricity transmission networks under the RIIO-GD2/T2 price controls. It follows that the beta for electricity distribution should be higher than that applicable for GD&T. It is also important to note that the beta figure set by Ofgem for GD&T in RIIO 2 materially understates the systematic risk exposure faced by the GD&T networks and so understates the applicable beta. In determining the beta for GD&T at T2 Ofgem did not undertake a robust beta assessment, with methodological decisions taken that do not strike an appropriate balance of the evidence. This assessment has led to an understatement of the beta for the RIIO GD2/T2 controls and therefore provide an understated starting point for assessing beta for RIIO-ED2.

In these circumstances the beta proposed in the Draft Determination is too low and therefore wrong

---

<sup>78</sup> Schaefer, S. (February 2020), "Using Average Historical Rates of Return to set Discount Rates", Appendix, contained within Oxera (February 2020), "Deriving unbiased discount rates from historical returns"

<sup>79</sup> Oxera (July 2022), "Assessing the new ONS CPIH back-cast Note prepared for the Energy Networks Association", section 2C

<sup>80</sup> Oxera (November 2019), 'The cost of equity for RIIO-2: Q4 2019 update', p. 16.

We recognise that Ofgem's assessment of the beta was covered in the RIIO-2 GD&T appeals, with the CMA not able to conclude that Ofgem erred in its approach to estimating beta for GD&T. However, Ofgem must still carefully consider how to assess beta for electricity distribution, and must, as part of this exercise, consider new evidence.

Because the CMA was not willing to disturb what it considered as reasonable regulatory judgements made by Ofgem, we do not consider that the underlying question of what comparators Ofgem should use was resolved during the RIIO-2 GD2/T2 appeal process. Indeed, Ofgem would be in error if it were to treat the CMA appeal as having determined or resolved these issues, rather than making its own full assessment of the issues based on the evidence and submissions before it for the present determination.

We present further evidence produced by Oxera in 2022 that supports our view that Ofgem's proposal in the Draft Determination places disproportionate weight on water company betas and not enough (or any) weight on estimates from those of more comparable European energy networks. It follows that Ofgem would be in error if it took the same approach for electricity distribution.

Oxera have presented empirical analysis which show that there is a significant difference in systematic risk between the UK listed water companies and National Grid (NG).<sup>81</sup> Oxera find that NG's 2, 5 and 10-year asset betas have been consistently higher than the average asset beta of the water comparators – indeed the water asset beta is below the lower bound of the 90% confidence interval for the NG beta in some regressions. Oxera also observe that the mean and median in the distribution of the asset betas for the UK water companies were 0.02 and 0.03 below those seen in the distribution of NG betas.

Oxera's analysis shows that Ofgem's decision to place weight on water betas in its beta assessment results in an allowed beta estimate that is anchored to the low-end of the distribution of NG's beta. These findings justify further why water companies are not reflective of the risk associated with energy networks regulated under the RIIO-2 regime and their inclusion without adjustment in the beta assessment for RIIO-ED2 therefore leads to a material understatement of the RIIO ED2 beta.

Although we remain of the view that NG betas are the most relevant evidence for informing the UK energy network beta for RIIO-2 since NG is the most direct available comparator, we agree that relying on just one energy comparator in the assessment can have potential shortcomings, particularly if the energy sector under review is different to that under which the comparator operates. This can be resolved by including evidence from relevant European energy network comparators in the assessment.

Following the outcome of the RIIO-2 appeals, Oxera have undertaken an assessment of the risk exposure of the UK energy network companies relative to regulated European energy networks and UK water companies.<sup>82</sup> Oxera have compared the differences in risks associated with the regulatory regimes that the different UK regulated (energy and water) companies and selected European energy networks operate under, noting that the regulatory regime is a key driver of systematic risk exposure.

---

<sup>81</sup> Oxera (August 2022), "Cost of equity in RIIO-ED2 Draft Determinations", section 4.1

<sup>82</sup> Oxera (March 2022), "Assessing the risks of GB energy networks"

Oxera find that the regulatory frameworks under which the selected European energy networks operate under are sufficiently comparable to that of RIIO-2 and therefore exposes them to broadly similar risks as GB energy networks. On the regime differences between UK water and GB energy networks, although Oxera note that there are similarities in how both regimes operate, the redetermination appeals process in the UK water sector relative to the appellate regime in energy exposes water companies to lower levels of risk exposure. This is because the water appellate regime allows for a full re determination by the CMA. By contrast the Gas Act 1986 and Electricity Act 1989 appeal regime limits the CMA's role to finding whether GEMA was wrong on any of the specific grounds prescribed under the respective legislation and as raised by the appellants.

Oxera's results are then cross-checked using the cost of traded debt (data on the traded yield spreads) of the companies in Oxera's sample as a measure of relative risk. The outcomes are consistent with the results from Oxera's regulatory regime assessment

The newly developed empirical evidence and regulatory regime review by Oxera provides further justification as to why it is an error for Ofgem to give weight to UK water comparators while giving no weight to more comparable European energy network comparators. Ofgem's approach leads to an underestimate of the beta for RIIO-2 and, considering this, Ofgem should amend its beta assessment methodology to include European network comparators for the RIIO-ED2 Final Determinations.

**FQ8. What are your views on the relative risk comparison shown in Table 10?**

We agree with Ofgem's assessment.

Ofgem in its table have set out a qualitative risk comparison between the ED sector and the other regulated sectors under the RIIO-2 framework during their respective RIIO-2 periods.

We support that Ofgem have reflected that DNOs face greater risk compared to other regulated networks from the scale of their investment programmes relative to their existing RAV over RIIO ED2. We highlighted in our RIIO-ED2 Business Plan that this was a systematic risk exposure faced by our distribution licensees, with both SPD and SPM having higher capex to RAV ratios than GDNs, implying greater relative capex size and higher investment risk. The capex to RAV ratio is used as a sensible metric of construction/investment risk and was considered by Ofgem in RIIO 1 where they noted that companies with a higher capex to RAV ratio were more exposed to cash flow risks and thus higher risk than those with smaller capex programmes<sup>83</sup>

**FQ9. Do you have any evidence that suggests the beta for GD&T companies has materially changed since RIIO-GD&T2 Final Determination in December 2020?**

As per our response to FQ7, Oxera observe higher beta for GD&T companies, insofar as the figure set by Ofgem for GD&T in RIIO-2 materially understates the systematic risk exposure faced by the GD&T networks and so understates the applicable beta.

---

<sup>83</sup> Ofgem (December 2012), "RIIO-GD1: Final Proposals Finance and uncertainty supporting document", para 3 17

**FQ10. Do you agree with our interpretation of the cross-check evidence?**

**SPEN do not agree with Ofgem's interpretation of cross-check evidence.**

We continue to disagree with Ofgem's interpretation of its cross-check evidence as used in Step 2 of its assessment on the allowed equity return. We consider the validity of Ofgem's selected cross-checks as evidence sources in estimating forward-looking equity market returns – and their derived estimates – to be poor, containing errors in their application, and are ultimately of limited or no relevance when setting the allowed equity return for regulated electricity distribution networks.

Our response to this consultation question does not cover our views in relation to the use of each of Ofgem's various cross-checks as this has been detailed extensively in our past submissions, including in the CMA RIIO-GD2/T2 appeals<sup>84</sup> and our final RIIO ED2 business plan<sup>85</sup>. We instead focus our response on Ofgem's use of the MARs cross-check as we have identified additional new evidence that we submit for Ofgem's consideration.

During the RIIO-GD2/T2 appeals, and in our RIIO-ED2 business plan, we argued that the premium on observed MARs is driven by both quantitative and qualitative factors that are not related to the allowed return. We argued that there was no cogent evidence that MARs differ from 1 after adjusting for these various factors that affect company valuations, and that the magnitude and uncertainty around these required adjustments make the MAR evidence an unreliable method for deriving or cross-checking the cost of equity.

The CMA in its Final Determination of the RIIO-GD2/T2 appeals did not agree with our, and other appellants', arguments that 'little to no inference could be taken from MAR premiums'<sup>86</sup> and found that Ofgem was not wrong to have relied on MAR evidence as a cross-check to its cost of equity estimate.<sup>87</sup>

Whilst we acknowledge the CMA's decision, we have commissioned Oxera and Frontier Economics to assess the following two additional areas about MAR evidence that were not considered in the RIIO-2 appeals: (i) 'stickiness' in investors' expectations around the terminal value and (ii) the valuation of the regulated utilities relative to the market. The findings from these reports provides new evidence that support our previous arguments that MARs are an unreliable and inconclusive source of evidence on equity returns and should be afforded little weight in the determination of the allowed equity return.

*Oxera – terminal value impact on MARs*

On the first topic, the ENA have commissioned Oxera to assess the implication that investors' expectations around the long-term assumption on the terminal value has on MARs.<sup>88</sup> In particular, Oxera explore the hypothesis that there is 'stickiness' in investors' expectations in that they have persistent expectations around payment of a premium to the RAV for successfully acquiring network

---

<sup>84</sup> SP Transmission (March 2021), "Notice of Appeal (RIIO-T2 Energy Licence Modification)", section F3

<sup>85</sup> SPEN (December 2021), "RIIO ED2 Business Plan Annex 5D 1: Finance", p 19-20

<sup>86</sup> CMA (October 2021), 'Cadent Gas Limited, National Grid Electricity Transmission plc, National Grid Gas plc, Northern Gas Networks Limited, Scottish Hydro Electric Transmission plc, Southern Gas Networks plc and Scotland Gas Networks plc, SP Transmission plc, Wales & West Utilities Limited vs the Gas and Electricity Markets Authority. Final determination. Volume 2A: Joined Grounds: Cost of equity', para 5.686.

<sup>87</sup> *Ibid*, para 5 707

<sup>88</sup> Oxera (August 2022), "Market-to-asset ratios as a cost of equity cross-check"

assets based on previous transaction prices. This expectation can support them using a long-term assumption of a future terminal value (i.e. an exit MAR) in excess of the RAV in their valuations and subsequent purchase of regulated network assets.

Oxera test this hypothesis by measuring the sensitivity of both traded and transactional MARs to both the challenge of regulatory determinations, as reflected in deviations of the allowed return on equity from the required return on equity (proxied using movements in the headroom of both the regulatory RFR allowance the allowed cost of equity against the yields on index-linked gilts (ILGs)) and companies' recent performance levels, as measured by the RoRE<sup>89</sup>

In their analysis, Oxera find that MARs are insensitive (i.e. uncorrelated) to both of these factors, with MARs fluctuating within an above 1x range over an extended time period, despite deviations in network performance levels and the level of challenge assumed on the allowed equity return – as an example, higher MARs were exhibited post-2019 despite regulatory allowances being more challenging during this time.

Oxera's findings show that there is no clear link between high MARs and current expectations of operational outperformance levels or the level of regulatory allowances. It is instead the 'stickiness' in investors' expectations about terminal values in excess of the RAV that can explain – at least a significant proportion of – the premium paid by investors for network assets.

The findings also help address the CMA's point of not observing a 'buyers' strike' following challenging regulatory determinations<sup>90</sup>: investors pay a premium for these assets despite recent challenging regulatory determinations, as their long-term valuation assumptions are underpinned by past (high) acquisition prices and the confidence in the regulatory regime that has been built in – it is these assumptions, rather than short-term performance levels and regulatory allowances, that better reflect the premium paid.

The MARs evidence is therefore deemed to be inconclusive by Oxera and is not a sufficiently robust piece of evidence to be used on whether the level of the cost of equity allowance is set too high or too low. Indeed, as Oxera point out in their report<sup>91</sup>, there is no theoretical basis for Ofgem to use MARs in the setting of regulatory allowances, as the link between company valuations and the level of revenues that a company would earn would not happen in a competitive market – in a competitive market setting, high company valuations would not affect the equilibrium price of the product in the short term, leading to a reduction in revenues. This should equally apply in the regulated utility setting, where high market valuations – based on latest MARs evidence – should not be used to justify a further reduction in regulated revenues.

A continuation by Ofgem to rely heavily on observed MARs premium in its cost of equity assessment presents a real risk of erroneously lowering the equity allowance despite already having been set at a challenging level. With the weak link found by Oxera between MARs premia and the level of regulatory

---

<sup>89</sup> Oxera (August 2022), "Market-to-asset ratios as a cost of equity cross-check", sections 2B and 2C

<sup>90</sup> CMA (October 2021), 'Cadent Gas Limited, National Grid Electricity Transmission plc, National Grid Gas plc, Northern Gas Networks Limited, Scottish Hydro Electric Transmission plc, Southern Gas Networks plc and Scotland Gas Networks plc, SP Transmission plc, Wales & West Utilities Limited vs the Gas and Electricity Markets Authority Final determination. Volume 2A: Joined Grounds: Cost of equity', para 5.684

<sup>91</sup> Oxera (August 2022), "Market-to-asset ratios as a cost of equity cross-check", section 3A

challenge, a premium could still be observed prior to the subsequent price control despite the previous challenging determination

It is important to note that investor “stickiness” and confidence in the regulatory regime can stop applying, if investors lose confidence in the regulatory regime, and the future likelihood of obtaining reasonable returns on their investment. If Ofgem continues to make determinations which underestimate the reasonable returns required by investors, this will result in a breaking of trust and confidence that investors have in the regime. Such a scenario would result in MARs declining significantly due to revision to long-term assumptions. This would lead to an increase in long-term investors’ required cost of capital, presenting real challenges to the sector of securing sufficient levels of capital required to facilitate investment. It would then take a long time and several reviews for Ofgem to restore the trust and confidence that investors previously had in the regime.

#### *Frontier Economics – valuation of the regulated utilities relative to the broader market*

On the second topic, Frontier Economics in their cross-checks report<sup>92</sup> critique the key assumptions underpinning Ofgem’s MAR analysis, which is that if the regulatory price control is calibrated appropriately (i.e. allowances exactly equals costs, and allowed return equals the required return) then the observed MARs (in transactions) should be close to or equal to 1. The rationale then is that a MAR above 1 suggests that investors expect companies to outperform their regulatory settlement because of operational outperformance on costs and incentives and/or the deviation of the required return on equity from the return on equity allowance.

However, as Frontier Economics note, this assumption is not plausible as it is dependent on a perfect market assumption holding – which it does not. Ofgem cannot draw conclusions regarding the “generosity” of a regulatory settlement from market-based valuation metrics because, in reality, market valuations of companies are influenced by various unpredictable factors and not based on fundamental valuation models – a company may have a high valuation but be underperforming currently as investors can expect to sell the asset for a premium at a later date (as explained in Oxera’s work where investors embed a high terminal value assumption in their valuations)

Frontier show that carrying out a relative valuation exercise can help to identify if a stock is out or under-performing. Frontier do this by comparing the valuation of the regulated utilities with the market and with relevant benchmark peers or indices. Frontier’s analysis consists of observing two generally accepted valuation ratios, the Cyclically Adjusted P/E ratio and the EV/EBITDA ratio, to assess if regulated utilities outperform the rest of the market – these metrics are used as it is not possible to compute a MAR for non-regulated companies without a RAV.

Frontier’s analysis focuses on:

- whether networks’ valuation ratios move in line with the market; and
- whether the magnitude of networks’ valuation ratios is in line with or lower than the rest of the market (e.g. median/average)

Frontier’s analysis of both metrics, after adjusting for short-term noise, shows that the valuations of listed regulated utilities in the UK generally move in line with the market (as referenced by the FTSE100

---

<sup>92</sup> Frontier (August 2022), “RIIO-ED2 Cost of Equity Cross-checks”, section 2

share index), but slightly at the lower end, lying in between the lower quartile range and the median – see figure 1 in Frontier’s report. This is in line with where utility stocks would be expected to sit within the market as they are generally considered to be “income stocks” and as such trade at lower valuation multiples than the market as a whole, with the top end being comprised of “growth stocks” such as technology firms.

The results show that regulated utilities are not overvalued compared to the market as a whole. The key point here is that the higher MARs are explained by higher valuations for equities in general, and not the “generosity” of regulatory settlements. This runs contrary to the conclusions Ofgem has drawn from its MAR analysis, and therefore does not suggest that regulators have been too generous in their settlements with their regulated entities, either on cost allowances or the allowed return. If Ofgem wishes to rely on a cross-check based on market valuations, then it is more appropriate to focus on relative valuation as performed by Frontier Economics.

Both the new evidence from Oxera and Frontier Economics show that Ofgem’s interpretation of, and over-reliance on, MAR evidence is in error as that evidence is inconclusive and not robust. It should therefore not be included as a cross check to inform on whether the Step 1 cost of equity level is too high or too low.

**FQ11. Do you agree with our updated MAR and OFTO cross-check techniques, in terms of drawing better inferences for RIIO-ED2?**

**SPEN do believe MAR or OFTOs provide meaningful cross-checks.**

We do not consider that either of these cross checks provide robust or meaningful inferences about the appropriate allowed equity return for RIIO ED2.

Specifically, OFTOs are inappropriate benchmarks as they are not relevant comparators to energy networks given that OFTO projects face significantly lower risk exposure. For example, OFTO bidders usually acquire assets that have been constructed, tested and operated for some time i.e. they face no construction risk (a systematic risk, as explained in response to FQ8, and therefore one that affects beta)

In any event, bid prices cannot be equated to expected returns, given that bidders will bid on the basis of expectations for cost, tax and financial outperformance and other factors. OFTO IRRs are therefore an unreliable estimator for cost of equity as they include elements of the bidder’s valuation that are unrelated to the cost of equity.

**FQ12. Do you agree with the cross-checks we have used and are there other cross-checks we should consider?**

**SPEN do not believe the cross checks MAR or OFTOs provide a reliable basis on which to inform the cost of equity for RIIO-ED2.**

As stated in our response to FQ10, we do not agree with the cross-checks utilised by Ofgem as they do not provide a reliable basis on which to inform the cost of equity for RIIO ED2 and should not be used in the determination of the allowed equity return. We instead recommend that Ofgem place weight on evidence from the established dividend growth models (DGMs) and from the asset risk premium (ARP) and debt risk premium (DRP) differential cross-check proposed by Oxera. We consider both these evidence sources to be appropriate and valid cross checks on the allowed cost of equity. We also draw attention to the new evidence produced by Frontier on their long-term profitability

cross-check as well as KPMG's use of Multifactor Models (MFMs) as an alternative and robust cross-check on the allowed returns for RIIO ED2

#### DGMs

The DGM is a well-established, forward-looking market-implied methodology used for valuation assessment or to estimate the implied cost of equity given market valuation. The DGM derives a discount rate which sets the present value of all projected future dividend payments equal to the current share price of a quoted business. In our RIIO-ED2 Business Plan and the RIIO GD/T2 CMA appeal, we explained why a robust cross check would use DGMs as a method for cross-checking the TMR estimates derived from long-run historical realised returns.

Frontier Economics have applied a two stage DGM – which assumes that dividends grow at different rates over two periods – across the five listed utilities in the UK to derive a range of plausible implied real cost of equity estimates. Further detail on the methodology and assumptions used in Frontier's DGM can be found in Frontier's report.<sup>93</sup>

Frontier's results reveal that the implied cost of equity, across all scenarios and for all companies, is higher than the 4.75% allowed equity return proposed by Ofgem in its RIIO ED2 DD. The evidence here suggests that Ofgem's view that its cross-check evidence supports the lower half of its Step 1 CAPM range is wrong, and that instead a higher equity return allowance than that set by Ofgem is justified.

In addition, Frontier's DGM analysis also shows that the implied cost of equity for the listed energy companies is higher than that of water companies – this is further evidence that GB energy networks face higher levels of systematic risk exposure compared to the GB water networks

Although having better predictive power compared to other approaches (e.g. MARs)<sup>94</sup>, we consider that evidence from DGMs should still be treated with caution given the relative sensitivity of the results to the input assumptions, especially assumptions relating to long term future dividend growth expectations

#### ARP-DRP

In March 2019, Oxera submitted evidence to Ofgem on how the regulator's proposed allowance on the CoE compared with the pricing of risk for these companies in the debt markets, explaining that the differential can be used as a cross check on the appropriate level of the allowed CoE. A second paper followed in 2020, before new evidence was provided to the CMA in the RIIO GD/T2 appeals.

Oxera have now updated their analysis to account for RIIO-ED2 Draft Determinations, concluding that an upward revision to the allowed CoE is required. They observe a considerable decline in the ARP-DRP differential from RIIO-ED1 to RIIO-ED2, with an ARP-DRP of 1.73% and 0.93% respectively. Most of this reduction (52bp) is driven by the reduction from RIIO-ED1 to RIIO ED2 in the allowances for the ERP and for the asset beta, which can be seen when these parameters are expressed using a calculation methodology that is consistent over time.

#### Long-term profitability

---

<sup>93</sup> Frontier (August 2022), "RIIO-ED2 Cost of Equity Cross-checks", section 3.3 and Annex A

<sup>94</sup> Frontier (August 2022), "RIIO-ED2 Cost of Equity Cross-checks", section 3.2

Frontier set out in their report that the long-term profitability of comparator companies can provide a valuable cross check for the CAPM-implied estimates on the cost of equity

Frontier identify the disconnection between the so-called “lower-for-longer” interest rate environment and the belief that all assets should therefore require lower returns versus the actual profitability that businesses have been able to make within this environment, casting doubt on regulators’ position that they should set the allowed returns (profitability) of the regulated utilities firmly in line with capital market conditions.

It is important for Ofgem to remember that its task is to set an appropriate profitability for the regulated companies, instead of calibrating the price control to deliver certain levels of investor valuation (which is the primary concern of short-term valuation based cross-checks such as MAR)

**FQ13. Do you consider we should put greater weight on cross-checks or reconsider our CAPM parameters in light of the adjusted cross-check results?**

Multi-factor models

We and other DNOs, as part of the ENA, have commissioned a review of Multi factor models by KPMG to ascertain if it is a robust and reliable cross check to setting the Cost of Equity for regulated networks. This report will be submitted to Ofgem in due course.

**FQ14. Do you agree that we should not adjust for expected outperformance when setting baseline allowed returns on equity?**

**SPEN agree Ofgem should not adjust for the concept of expected outperformance**

We support Ofgem’s proposal in the Draft Determination to not make a downwards adjustment for a notion of ‘expected outperformance’ in the determination of the allowed equity return for RIIO ED2. We recommend that this decision be extended to all subsequent price reviews undertaken by Ofgem.

This is consistent with the outcome of the CMA’s final determination in the RIIO GD&T2 appeals, where they found that Ofgem was wrong to implement an ‘Outperformance Wedge’ adjustment and its associated ex-post true-up mechanism

Our position on this matter has not changed from that presented to the CMA and outlined in our Business Plan<sup>95</sup> To summarise, our view is that such an adjustment was unnecessary, poorly targeted, and was applied in an arbitrary and discriminatory way. It would also undermine performance improvements and investment incentives, including by increasing regulatory risk. Its application fails to recognise the existing regulatory mechanisms and tools available to Ofgem that are sufficient and appropriate to target and address any perceived information asymmetry. It would damage investor confidence in the sector and weaken incentives on network companies to identify efficiencies; ultimately leading to poor consumer outcomes.

**FQ15. Do you believe there is new evidence which would support an adjustment downwards (e.g., expected outperformance) or upwards (e.g., aiming up) that we have not yet considered?**

**Ofgem should aim up within its cost of equity range when selecting its point estimate for the allowed equity return for RIIO-ED2 in order to restore balance to the price control and ensure a ‘fair bet’ for DNOs.**

---

<sup>95</sup> SPEN (December 2021), “RIIO-ED2 Business Plan –Annex 5D.1: Finance”, p.21 24

In its RIIO-ED2 Draft Determination, Ofgem states that it has not received strong new evidence to suggest that it should aim away from its point estimate of 4.75% – the mid-point of their CAPM range derived in Step 1 of its assessment.

In the selection of the point estimate of the allowed return, it is important to consider whether the design of the price control package as a whole results in asymmetric risk that skews expected outcomes to the upside or downside. Regulators should always aim to calibrate price control packages so as to represent a ‘fair bet’ to regulated companies i.e. the likelihoods of out and underperformance against the price control are broadly balanced, so that investors can reasonably expect a fair opportunity to earn their allowed return on equity.

If an overall balance of risk and reward within the regulatory package is found to be negatively skewed, and cannot be addressed at source, then an appropriate regulatory response has been to compensate investors to allow a regulated entity to earn the investors’ required return in the base case. This has been implemented practically by adopting an approach of ‘aiming up’, which involves an upwards adjustment in the selection of point estimate of the allowed return on equity (generally above the mid-point of the cost of equity range) – this approach was adopted by the CMA in its recent PR19 redetermination to compensate for the negative skew in the overall price control package.<sup>96</sup>

We and other members of the ENA have commissioned Oxera to assess the risks DNOs are exposed to from various elements of the RIIO ED2 DD regulatory package and to examine whether those risks are associated with any bias or skew.<sup>97</sup> The ENA has submitted the report direct to Ofgem.

The misalignment across the balance of risk and reward in the package can materialise from explicit sources of negative skew in regulatory mechanisms (e.g. penalty-only ODIs), but also from other sources. For example, given Ofgem’s proposal to set individual parameters towards one end of the reasonable range, the overall balance could be skewed to the downside not only because of individual parameters not being set based on a balanced interpretation of the evidence, but from a cumulative impact of multiple individual parameters being set at the low end of their reasonable evidence range, resulting in a package skewed to the downside.

Oxera assess whether DNOs’ associated risks are symmetric (i.e. whether DNOs have an equal ability to out- and underperform under a specific mechanism or allowance) and whether there is evidence of increased risks in RIIO-ED2 relative to that in RIIO ED1, even if those risks are symmetric.

Oxera find that there are a number of sources inherent in the RIIO ED2 price control package, as implied by the RIIO ED2 DD, that contribute to a negative skew in the balance of risks for DNOs. Further detail of Oxera’s assessment of sources of risk asymmetry for each individual element of the RIIO ED2 DD package can be found in their report.<sup>98</sup>

To the extent that these downside biases in the current package cannot be addressed at source, then aiming up on the allowed return on equity above the mid-point of the range would be required in

---

<sup>96</sup> CMA (March 2021), “Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report” paras. 9.1402-9.1406

<sup>97</sup> Oxera (August 2022), “RIIO-ED2 balance of risks - Prepared for the Energy Networks Association”

<sup>98</sup> Oxera (August 2022), “RIIO-ED2 balance of risks - Prepared for the Energy Networks Association”, section 2

order to address the residual negative skew in the distribution of returns and to restore balance in the risks and returns of the overall RIIO ED2 package to better reflect a ‘fair bet’ for DNOs

In the RIIO GD2/T2 appeals process, Ofgem accepted the principle of taking such an approach if material downside risks are found within a price control settlement<sup>99</sup>

There is also recent CMA precedent for adopting this practice of aiming up for remedying downward bias within a price control package as set out in the CMA’s PR19 redetermination. The CMA in its final decision decided to aim up on the allowed equity return to compensate for the negative skew (or structural asymmetry) in the overall determination, notably on the ODI package<sup>100</sup>

In addition to the asymmetry of the price control package as a reason to aim up, aiming up is also an appropriate and established regulatory response in the face of parameter uncertainty in the measurement of the true cost of equity given that the medium/long-term consequences for consumers and society of inadvertently setting CoE too low (and deterring needed investment) are considerably worse than the short term consequences of setting it too high. The CMA in their PR19 redeterminations recognised that “*there is substantial uncertainty around the level of the WACC*” and, where the cost of capital is set too low, there is a risk that “*the wider social benefits of investment are lost, either because companies do not identify investments or put resources into planning for them, or because the finance to deliver those investments is unavailable.*”<sup>101</sup>

As outlined in our previous submissions<sup>102</sup>, selecting a point estimate above the mid-point of the estimated returns range is a necessary and appropriate response to uncertainty in the determination of the allowed return and to avoid the real longer-term risks to delivering sub-optimal levels of socially desirable investment from setting the allowed return too low. This is a critical consideration given the very significant levels of investment that are required in electricity distribution networks, to contribute to the achievement of Net Zero.

Given Oxera’s findings that there is negative skew of the balance of risks in the RIIO ED2 package, as set out in the RIIO ED2 DD, and that these sources of downward bias cannot be addressed at source by the Final Determinations, and the very material and essential investment required to make progress to achieving Net Zero Ofgem should aim up within its cost of equity range when selecting its point estimate for the allowed equity return for RIIO-ED2 in order to restore balance to the price control and ensure a ‘fair bet’ for DNOs.

---

<sup>99</sup> CMA (October 2021), “Cadent Gas Limited, National Grid Electricity Transmission plc, National Grid Gas plc, Northern Gas Networks Limited, Scottish Hydro Electric Transmission plc, Southern Gas Networks plc and Scotland Gas Networks plc, SP Transmission plc, Wales & West Utilities Limited vs the Gas and Electricity Markets Authority Final determination. Volume 2B: Joined Grounds B, C and D”, para. 5.837.

<sup>100</sup> CMA (March 2021), “Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report”, para 9 1344.

<sup>101</sup> CMA (March 2021), “Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report”, para 9 1269

<sup>102</sup> CMA (March 2021), “Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report”, para 9 1269

**FQ16. Do you think we should adjust our approach to allowed returns (noting our approach to expected inflation for WACC and outturn inflation for RAV as described above) so that outturn inflation does not permit the notional company to generate real equity returns that are materially higher or lower than our cost of equity allowance? What would be the consequences to consumers and DNOs of doing so?**

We strongly oppose any change to the current approach of applying full outturn inflation indexation to the RAV. Such a change in approach would be detrimental to present and future consumer interests.

The current approach has been a fundamental cornerstone of network regulation since privatisation. It is one of the key reasons why investors invest in energy networks. As Ofgem is aware, long-term stable inflation protected returns are critical to a range of investors such as pension funds.

An alteration to this approach in the absence of any cogent evidence that the current framework causes harm to consumers; without an impact assessment; and at such late notice, would go against regulatory best practice. It would risk destabilising the credibility of the regulatory framework - damaging investor confidence in the predictability and stability of the GB regime at a time when greater than ever investment is required in the UK to meet GB's Net Zero objectives. This is not in the interests of present and future consumers.

Ofgem sets a real cost of debt allowance by deflating a nominal benchmark<sup>103</sup> using a long-term forecast of inflation<sup>104</sup>. There is no reason to expect outturn inflation to be systematically above or below that forecast over time. It is a misconception that Ofgem's *leverage effect* is the consequence of a flaw in the regulatory policy setting of the notional company. In fact, the extent of inflation exposure is DNO specific and based on their chosen financial risk management strategy – a strategy which each DNO is free to choose, subject to adhering to standard licence conditions.

For example, a company that is funded entirely by index-linked debt will not face inflation exposure. Similarly, the same position can be achieved through the holding of derivatives and other financial instruments which convert fixed coupon debt to index-linked. Equally, networks could choose to accept this inflation exposure as part of their wider financial portfolio, where any advantage or disadvantage from the net exposure will accrue in the RAV and transfer through as reductions or increases to revenues over the long-term (45 years). Investors who took on this exposure will have lost out overall during RIIO-ED1 to-date, despite the recent spike in 2021/22. At no point did SPEN seek to address this downside, appreciating temporal differences are an intrinsic characteristic of real return price controls – a financial risk which companies are free to manage accordingly.

Investors have accepted managing the potential inflation exposure, based on their expectation and understanding of Ofgem's current approach. They will therefore question the timeliness of this intervention as highly opportunistic and leading to increased asymmetrical risk, which could ultimately impact the cost of capital, and increase customer bills.

Furthermore, any intervention which adjusts the current approach could be detrimental to customers' interests. Debt portfolios and financial risk strategies are built up over time based on confirmed policies and stable long-term expectations. A change of this magnitude to the price control framework

---

<sup>103</sup> 17-year trailing average of the Iboxx GBP Utilities 10yr+ index

<sup>104</sup> OBR year 5 forecast

will impose an entirely different risk on investors than they have ever faced before. Companies will have to react and rebalance their portfolios, incurring additional costs despite potentially being neutral under the current approach.

Any change to this framework could materially damage investor confidence, and increase the long term cost of capital. This is not in the interests of present and future consumers.

Any change also needs to be approached with caution for wider reasons. It would materially damage investor confidence in the regulatory model applicable to electricity and gas transmission, as well as gas distribution. The damage could be wider still, in particular given that the government proposes to apply a regulated asset base model to other critical investments designed to achieve Net Zero and energy security such as new nuclear stations and CCUS transportation and storage.

**FQ17. If you believe we should make such an adjustment, what is the best method for making it?**  
**See FQ 16, SPEN do not believe Ofgem should make an adjustment.**

**FQ18. If you don't believe we should make such an adjustment, how should we ensure that the fairness of the price control is maintained to prevent ex post returns from deviating from ex ante expectations for both consumers and investors?**

**As outlined in FQ16, there is no reason to expect outturn inflation to be systematically above or below that forecast over time.**

**FQ19. Do you agree with our approach to assessing financeability?**

**SPEN is of the view more importance needs to be placed on individual ratios consistent with the approach of external parties such as investors and credit ratings agencies.**

Ofgem has conducted an “in the round” assessment of financeability for the RIIO-ED2 period with the focus very much on the debt finance of a notional company and very little regard to actual company parameters or the financeability of equity. This is at odds with the analysis that companies were instructed to provide along with their business plans.

We welcome Ofgem’s view that companies should target financing ratios so that their credit rating is at least two notches above investment grade as this indicates that, in principle, Ofgem is seeking to maintain the credit quality of the sector. This benefits consumers through lower bills via interest costs, while maintaining the regulatory precedent of providing the industry with the required headroom, ultimately resulting in greater financial resilience for critical national infrastructure.

However, while an “in the round” assessment has merit, the impact on individual ratios and the importance placed on them by external parties such as investors and credit ratings agencies should not be ignored. For example, the adjusted interest cover ratio (AICR) which is a key indicator of a company’s ability to pay upkeep on its debts.

It is critical that Ofgem does not lose sight of the financeability of the actual companies during the RIIO ED2 period and the impacts that the parameters Ofgem have set will have on the ability of those companies to achieve required levels of critical national infrastructure investment and meet GB’s Net Zero objectives.

Ofgem needs to reflect the potential scale of expenditure that may be required via reopeners, through its stress testing of financeability. The output from financeability stress testing needs to demonstrate the company can maintain a comfortable investment grade rating, after funding all reopeners, to continuously comply with its licence and facilitate the raising of additional funds as required. Given the “scale” of investment that may need to be funded via reopeners, the RIIO-ED2 process needs to

include these forecasts in the annual live forecasting proposals. Inclusion of reopeners in the new “live” forecasting AIP process will be essential to reduce the burden on companies as true ups will be actioned faster.

We encourage Ofgem to include a step in its process to test if the “notional company” is realistic and whether their assumptions exhibit a level of prudence that should be expected from an objective economic regulator. A comparison of the notional company’s financial ratios to those of actual companies should be given significant weight in assessing the achievement of quantitative measures of investment grade.

Ofgem has indicated that they have reduced the financial risks that companies face in the RIIO-ED2 period with the move to further Indexation (e.g. for both Cost of Debt & cost of equity) and reduction in the Totex Incentive Mechanism (TIM). However, this does not offset the additional risks that the potential investment requirements of reopeners during the RIIO 2 period will add.

#### Equity financeability

From the draft determination Ofgem have focused most of their analysis on debt financeability. However, Ofgem seem to have provided little in the way of evidence that the RIIO-ED2 price control is financeable on an equity basis. The justification provided is that the dividend assumption is calibrated in line with market expectations with dividend yield and future RAV growth (Capital gain). This is augmented with the proposal to index the risk-free rate. The package as a whole also does little to incentivise for innovation or risk-taking. Instead, it creates a greater level of uncertainty due to the move away from ex ante allowances: this adjusted approach does not reflect the level of risk currently mirrored by the proposed RORE values.

Furthermore, due to the lack of detail provided by Ofgem at draft determinations, we are unable to assess the appropriateness of the inputs to the financeability assessment. As per our response to FQ30 and FQ31, we have significant concerns about Ofgem’s assumed regulatory capitalisation rates for baseline, re openers and volume driver expenditure.

#### **FQ20. Do you have any evidence that would enable us to improve our calibration of stress test scenarios?**

**SPEN are of the view stress testing needs to ensure DNOs can finance their licence obligations following activation of all investment reopeners and cover all plausible downside scenarios from current macroeconomic risks.**

Stress testing should incorporate the recent macroeconomic challenges we face on the notional and actual company’s financeability. We do not believe Ofgem’s scenarios reflect the extent of the current or future economic climate, where we are experiencing high input costs, increasing interest rates and the threat of a prolonged recession.

The Bank of England has just recently raised its base rate by 0.5%<sup>105</sup>, the largest single upward jump in 27 years, as it aims to address increasing inflation. Rising interest rates will increase the cost of both existing variable rate and newly raised debt. This will exacerbate the *cash flow gap* network companies face, which arises due to nominal interest debt raised being paid down by a real return with the inflation proportion added to RAV and paid over the long term. Similarly, only a fraction of the

---

<sup>105</sup> <https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp>

increased debt costs will be accounted for in the allowed cost of debt mechanism given it takes the average of an extended period

Ofgem needs to reflect in its stress testing of financeability the potential scale of expenditure that may be required to fund matters covered by reopeners. The output from financeability stress testing needs to demonstrate the company can maintain a comfortable investment grade rating, after funding all reopeners, to continuously comply with its licence and facilitate the raising of additional funds as required.

**FQ21. Do you agree with the requirement to provide the Financial Resilience Report within 60 days?**

**SPEN agree with the requirement to provide the Financial Resilience Report within 60 days**

Yes - the proposed additional requirements will enhance Ofgem's monitoring of the financial resilience of network companies. This is a prudent step towards further protecting GB customers.

**FQ22. Do you agree with our proposals to make allocation and allowance rates variable values in the RIIO-ED2 PCFM?**

**SPEN agree with proposals to make allocation and allowance rates variable values in the RIIO-ED2 PCFM**

We agree with Ofgem's proposal to make allocation and allowance rates variable values in the RIIO-ED2 PCFM, which should better capture companies' tax position.

**FQ23. Do you agree with the proposed additional protections? In particular:**

**SPEN agree with the principle of a tax review mechanism, but raise concerns over the timeliness of reconciliations**

Tax review mechanism

In principle, we are supportive of a tax review mechanism which would review the appropriateness of a tax allowance for significant events such as a change in ownership, however, due to the complexity around timing, it would be more appropriate to review any unexplained differences between notional and actual tax at the end of the price control period post submission of the period end CT600 form. We agree with Ofgem's proposal to carry out a preliminary review prior to triggering a formal tax review.

Tax reconciliation

SPEN's CT600 submissions are based on a 31<sup>st</sup> December fiscal year-end which contrasts with Ofgem's regulatory year ending 31<sup>st</sup> March. Consequently, two annual CT600 submissions are required to fully reconcile with any given regulatory year. This adds further complexity to an already challenging reconciliation process. The tax reconciliation statement proposed in GD&T is overly complicated and includes information we consider to be unnecessary and unrelated to the price control. Reconciling to a granular level of detail dilutes the perceived benefit from reporting at such a level.

### Board Assurance Statement

In principle, we are supportive of a board assurance statement to provide additional comfort over the appropriateness of the values in the tax reconciliation. However, as recognised by Ofgem, tax is a complex area, and any additional assurance must take this into consideration

#### **FQ24. Do you have any views on a materiality threshold for the tax reconciliation?**

We agree with greater transparency of any variances between tax allowances and taxes actually paid to HMRC. However, this should not solely be based on the review of one price control period but should cover the total tax allowances obtained for the cost of network assets over their life. It is a very complex area attempting to separate regulatory allowance from other impacts on taxation paid to HMRC in a particular year. It is therefore appropriate to apply a materiality threshold for residual differences.

#### **FQ25. Do you think that the "deadband" used in RIIO-ED1 is an appropriate threshold to use? If not, what would be a more appropriate alternative?**

**SPEN do not agree that the RIIO-ED1 deadband is an appropriate threshold to use.**

The deadband in RIIO-ED1 is calculated as *the greater of 0.33% of opening base revenue allowances and the effect of a 1% change in the rate of corporation tax*.

The definition of base revenue has evolved in RIIO ED2, and consistent with our response to FQ40, we believe should be further refined. It is therefore no longer appropriate to use as a basis of defining a material amount in the tax reconciliation.

A more appropriate measure would be using *Calculated revenue (before tax)* as found in the RIIO-ED2 PCFM (Revenue, AR:AV18) These revenues directly impact the resulting tax allowance, therefore correspond to the required reconciliation.

#### **FQ26. Do you have any views on our proposals relating to the Tax Trigger and Tax Clawback mechanisms? In particular, do you have any views on a proposed “glide path” for the notional gearing levels used in the tax clawback calculation?**

**SPEN agree with proposals relating to the Tax Trigger and Tax Clawback mechanisms.**

We agree with Ofgem's proposal to retain the Tax Trigger and Tax Clawback mechanisms from RIIO ED1 and to align the tax clawback policy of that of GD&T companies which allows networks a level of headroom in the tax clawback calculation as notional gearing transitions from 65% to 60%.

#### **FQ27. Do you agree with our proposals for the RAM thresholds and adjustment rates?**

**SPEN are of the view introduction of a RAMs mechanism should be on a symmetrical basis as the intent of this mechanism is to control for unanticipated financial outcomes – from either the upside or downside over the price control period.**

As outlined within our RIIO ED2 SSMC response, we do not support the principle of a Revenue Adjustment Mechanism (RAM): the price control should instead be calibrated appropriately, and outperformance should be encouraged. Outperformance demonstrates that companies are beating their targets and improving performance, delivering better outcomes for consumers as outperformance accrues to customers during the price control via the Totex sharing mechanism and is then allocated to consumers when the price control is re-set. Therefore, any RAMs mechanism must

allow for and retain a strong incentive for reasonable and genuine outperformance opportunities from efficiencies. The mechanism should focus on Totex underspends.

In principle, we would discourage an ex post adjustment. We recognise the regulator's concerns at the potential for Totex underspends and undelivered outputs in ways that may not always have led to overall efficiencies. However, such outperformance through Totex underspends can best be addressed through other mechanisms, e.g. NARMs and use it or lose it allowances.

In principle, if a RAMs mechanism was to be introduced it should be on a symmetrical basis when the price control is symmetrical as the intent of this mechanism is to control for unanticipated financial outcomes – from either the upside or downside over the price control period. However, this should be viewed in the context of the overall RoRE range from the price control package. If the proposed price control parameters happen to be asymmetrical in terms of potential RoRE outcomes (i.e. skewed to the downside), as is the case in the current RIIO-ED2 Draft Determination, then the calibration of the RAMs mechanism should take this into account

**FQ28. What are your views on the technical implementation of the switch to CPIH as set out in the attached PCFM?**

**SPEN propose that the monthly/hybrid inflation approach should be abandoned, and the inflation should simply be the year average value uplifted from OBR/HM Treasury (converted to financial year).**

Ofgem have proposed a monthly/hybrid inflation methodology which combines part year monthly actuals with the remainder being the monthly split of an annual forecast for the current year index and the forecast being an annual forecast split monthly then recombined to a yearly index. We understand that this approach was adopted in RIIO-T2 because of a specific SHETL requirement for a detailed monthly figure. However, we believe this requirement does not apply to RIIO ED2 and, in any case, the approach is inaccurate and introduces unnecessary volatility. We believe that a yearly inflation approach should be adopted given all our revenues are calculated on a yearly basis, with additional RPI CPIH inflation differential, as this would be more accurate and much simpler.

We believe there are several issues with the inflation calculation methodology proposed for RIIO-ED2:

1. We believe the theory behind the monthly/hybrid inflation methodology of bringing in part year actuals and part year forecast is incorrect. Our experience during RIIO-T2 shows that this leads to variances with the latest forecast, which gives an incorrect full year inflation forecast. Our understanding is that the forecast by different agencies is a year-end forecast rather than a forecast for the remainder of the year i.e., a forecast which already accounts for the actuals so far in the year. Therefore, including actuals as well only leads to a double count (of variations to inflation anticipated across the year) and skews the value used in the PCFM.
2. The monthly/hybrid inflation methodology effectively takes the yearly inflation forecast and breaks down into months and then combines again into a yearly figure, which is never exact and always seems to give variations to the intended inflation percentage, particularly in the crossover years into RIIO-ED2. The methodology is difficult to unpick, particularly to anyone new to the process. Because of the methodology, the previous year's values can impact the current year due to the July-June forecast period (to give the average calendar year value).
  - a. In short, the methodology is overly complex in calculating a value which is already known from the latest forecast, the methodology only serves to allow for a hybrid

approach; however, we have noted the fundamental miscalculation this gives rise to in point 1 above

3. Finally, to accommodate RPI inflation until the end of RIIO ED1, an additional calculation is needed. The proposed monthly/hybrid inflation approach does allow for this; however, the calculation is hidden within the overly complex monthly calculation, and it is extremely difficult to quantify the direct impact of this differential

#### Alternative proposals

We propose that the monthly/hybrid inflation approach should be abandoned, and the inflation should simply be the year average value uplifted from OBR/HM Treasury (converted to financial year). There should then be a separate RPI-CPIH differential correction factor applied to 2023/24 PI

The benefit of this approach is that it would:

- Remove the current year forecast issue where the mixing of actuals and forecast derives an incorrect annual value. This would easily align with the values published by OBR/HM Treasury
- The separate inflation differential leads to an equivalent end result in the current monthly inflation approach but does not rely on an overly complex monthly inflation approach.
- The separate differential is an observable value to aid transparency and analysis, and this allows stakeholders to understand the impact of this differential and makes clear that this gives the full year-end benefit of RPI in RIIO-ED1.

We acknowledge that Ofgem's proposed forecasting methodology would create a cashflow/timing issue due to the true up process for outturn data. However, Ofgem should endeavour to make this process as accurate as possible, and move away from any unnecessary volatility, particularly when it would simplify the process in doing so.

#### **FQ29. Do you agree with our proposal to set depreciation policy on RAV additions in the RIIO-ED2 period to 45-years straight line, based on the average economic life of the assets?**

**SPEN agree with the continuation of depreciating assets based on their average economic life, currently forecast at 45 years.**

We agree with Ofgem's proposed continuation of the existing RIIO-ED1 depreciation policy of using economic asset lives as the basis for depreciating the RAV, ensuring an appropriate balance of costs and benefits across current and future generations of consumers. This will see all RIIO-ED2 RAV additions depreciate on a 45-year straight line basis.

This policy can be reviewed at future price controls as the mix of assets changes because of an evolving smarter grid, which potentially includes greater volumes of short-life technology assets for monitoring and controlling the network.

#### Financeability

We agree with Ofgem's position that the depreciation policy should not be used as a financeability level. The current regulatory treatment for electricity distribution asset lives includes a supplementary depreciation allowance associated with a 15-year smoothing adjustment to pre-vesting assets which became fully depreciated. This results in a cliff-edge drop in revenue. All DNOs other than SP Distribution (SPD) and Scottish Hydro Electric Power Distribution (SSEH) faced cliff edges of differing magnitudes in the RIIO-ED1 period. This volatility and resulting impact on financeability was a key contributor to revenue profiling. In the RIIO-ED2 price control period, SPD now faces the greatest cliff

edge of all DNOs, which will result in a significant decrease in revenue from year 2 (2024/25) to year 3 (2025/26). This emphasises that altering depreciation asset lives should be avoided to solve current financeability problems as it ultimately delays addressing why these issues arise.

**FQ30. Do you agree with our proposal that we should set different capitalisation rates for ex ante allowances and re-openers and volume drivers?**

SPEN agree that different rates should be used but disagree fixing these rates at final determinations based on our business plans. The rates need to reflect any changes made to allowances through the determination process.

We welcome Ofgem's intention to align regulatory capitalisation rates with their underlying natural rates. In the longer term, a notional capitalisation rate which differs from the actual capitalisation policy will lead to an accounting mismatch, which is detrimental to customers' interests.

The allocation or natural rate for ex ante baseline allowances should be fixed following final determinations, as these costs are certain and should not significantly deviate during the price control. As stated in our response to FQ31, it is imperative companies are granted the opportunity to review Ofgem's assumed notional capitalisation rates and evidence any required changes. Regulatory capitalisation rates should be driven by company specific business plans and justified accordingly.

At draft determinations, no bridge between the benchmarking cost assessment models and the Price Control Financial Model Totex allowances has been provided. We are therefore unable to review, fully understand and respond to Ofgem's estimate of the natural capitalisation rates of baseline or UM expenditure.

Uncertainty Mechanisms

The regulatory framework should be calibrated to avoid intergenerational inequity, which a notional rate could bring about because of over- or under-capitalisation. We see no benefit in applying a capitalisation rate which is not consistent with our justified plans. Similarly, we see no benefit in applying a sector average given networks may face differing types of uncertainty in RIIO ED2.

For UMs, we believe that further clarification will be required to ensure the natural rate is applied as with the proposed approach with baseline expenditure. We are happy to work with Ofgem on this area to ensure that there is clarity around the information that is currently being used to set these parameters given the impact they can have on price control revenues.

In the RIIO ED2 Draft Determination, Ofgem have assumed any uptake in uncertainty mechanisms will be primarily capex, proposing to set a fixed rate at 98%. This is an ill conceived assumption based on a limited forecast view of uncertainty uptake. There is currently no mechanism to uplift any consequential incremental Opex relating to uncertain activities. Furthermore, fixing the capitalisation rate will cause cash flow issues. Any future incremental Opex allowances will not be recovered through fast pot revenues, instead they will ultimately be recovered via the RAV given the proposed 98% rate. This approach contradicts Ofgem's natural rate policy, which we have followed for our business plan to promote intergenerational fairness, and which was supported throughout our stakeholder engagement.

DNOs may face different types of uncertainty throughout RIIO-ED2. A company-specific flexible weighted average uncertainty mechanism capitalisation rate would ensure companies are

compensated for their relevant expenditure, consequently ensuring customer bills remain cost reflective.

As stated in the response to FQ19, our view would be that the allocation or natural rate for baseline expenditure should be fixed as these costs are certain and should not deviate to a major extent during the price control. However, uncertainty mechanisms should be allowed to flex to provide the cash flow benefit of investment during period as previously stated.

**FQ31. Do you have any evidence that would enable us to improve our estimates of regulatory capitalisation rates?**

**It is imperative companies are granted the opportunity to review Ofgem's assumed notional capitalisation rates. Consistent with our submissions to Ofgem we should be provided the draft determinations allowance by cost activity on an annual basis.**

Ofgem's RIIO-ED Business Plan Data Tables are recorded on a cost activity basis and not split by capital expenditure (capex) and operating expenditure (Opex), unlike in RIIO T2. Throughout the development of the Price Control Financial Model (PCFM), we raised concerns over Ofgem's initial approach to assuming that PCFM Totex categories could map entirely to either capex or Opex, as the underlying individual cost activity tables can contain a mixture of both

At both draft and final plan submissions, we provided an annual breakdown of our forecast capex and Opex by cost activity and the consequential allocations to tax pools. This information was not required as part of our submission, however we felt it important to provide sufficient justification to evidence our proposals.

As Ofgem have not provided the draft determinations allowance by cost activity on an annual basis, we are unable to understand, review and respond as to the appropriateness of Ofgem's assumed regulatory rate or provide an evidence-based alternative showing our revised natural rate.

As in the response to FQ30, it is imperative companies are granted the opportunity to review Ofgem's assumed notional capitalisation rates and evidence any required changes.

**FQ32. Do you have any views on the use of forecast RAV opening balances for the start of RIIO ED2, which will be trued-up following RIIO-ED1 closeout?**

**SPEN agree with using a forecast RAV and trueing up following closeout.**

Yes, this approach is sensible as there will be an extensive close out process that will revise the closing balances at the end of RIIO-ED1

Consideration needs to be given to movements between the Business Plan submission in December 2021 and the values published in the regulatory submissions made in July 2022 as these will reflect both actuals for 2021/22 and latest forecast of 2022/23. Furthermore, the impact that these values may have on final determination values such as Base revenues which are used to set incentives must also be considered.

**FQ33. Do you agree that additional corporate governance reporting described (including on executive director remuneration and dividend policies), will help to improve the legitimacy and transparency of a company's performance under the price control? If not, please outline your views in relation to the rationale provided for these additional requirements, including consumer protection.**

**SPEN do not agree with the additional corporate governance reporting requested.**

No. We believe these proposals would impose detrimental additional disclosures on energy network operators in the UK, creating an imbalance in disclosure between companies.

The Company Accounts (Disclosure of Directors' Emoluments) Regulations 1997 is the relevant legislation that guides the disclosure of Directors remuneration.

The Statutory and Regulatory Accounts of SPEN are audited for compliance with these regulations and are publicly available. The prescribed disclosure requirements in the Companies Act were set following detailed consultation. In addition, in accordance with their licences, electricity networks already publish an annual Statement on 'linkages between Directors' Pay and Standards of Performance'<sup>106</sup>.

We conclude:

- Informed reviewers of financial statements believe the relevant information is available
- We believe the format and setting of information for this area should be determined by the Companies Act / UK company law regime
- Different formats and unaudited additional information may lead to confusion and misinterpretation; and
- There is no evidence to suggest this has been requested by stakeholders.

#### Dividend Policy

In relation to the question on dividend policy it would be far more constructive for the electricity networks and Ofgem to work collaboratively to explain why it is in the interest of consumers that network companies pay dividends. There are many factors that will influence a Company's dividend profiles like gearing, pension deficit payment structures and past payment profiles. Educating stakeholders will best address interpretation issues in this area rather than complex statements some stakeholders may not fully understand.

**FQ34. What are your views on the proposed consolidation of the revenue RRP and PCFM, or applying a fully dynamic concept of allowed revenue?**

**SPEN agree with the concept of fully dynamic allowed revenue.**

We support the proposed consolidation of the revenue RRP and PCFM, including the move to a fully dynamic concept of allowed revenue. This streamlines company reporting and provides additional clarity to stakeholders

---

<sup>106</sup>[https://www.scottishpower.com/userfiles/file/SPEN\\_Links\\_directors\\_pay\\_and\\_standards\\_of\\_performance\\_2019.pdf](https://www.scottishpower.com/userfiles/file/SPEN_Links_directors_pay_and_standards_of_performance_2019.pdf)

**FQ35. What are your views on allowing licensees to self-publish the PCFM with their charging statements, rather than relying on an Ofgem publication or direction to determine allowed revenue?**

**SPEN agree with Ofgem's proposals to self-publishing.**

This brings the theory in line with practice from RIIO 1, where the introduction of the +15 months pricing timescales meant the ED companies could not use the Ofgem published revenues for tariff setting. We experienced no issues with this consequence of the +15month pricing timescales (apart from the inevitably higher true-up terms), where ED companies used their own best forecast of revenues to set tariffs, with no direct audit from Ofgem on this at the time of tariff setting.

We are supportive of the wider Ofgem goal of placing the revenue setting process responsibility with the licensees and would urge Ofgem to leave as much in the hands of the licensees as possible, relying on the relevant licence obligations to act as checks and balances on licensee behaviour – helping to streamline the process while still providing an appropriate level of regulatory oversight. We hope this goal features in the wider policy and licence drafting

We await the outcome of discussions around the use of “best” versus “reasonable” endeavours in the licence drafting, (see our response to FQ36 below) as a move towards best endeavours may necessitate firmer drafting around what the licensees can or cannot do in certain circumstances.

**FQ36. What are your views on having a best endeavours obligation for charge setting: "The licensee must, when setting Network Charges, use its best endeavours to ensure that Recovered Revenue equals Allowed Revenue"?**

**SPEN do not agree with a best endeavours approach, favouring the continuation of the reasonable endeavours approach.**

We disagree with Ofgem’s proposal to require DNOs to deploy *best endeavours* when setting network charges. Ofgem made a conscious decision to require DNOs to use reasonable endeavours when setting network charges for RIIO-ED1 and has not adequately justified its proposal to impose a more onerous obligation.

Ofgem’s argument for making this change seems to rely on three arguments:

- That the obligation is arguably “*the most fundamental obligation*” in the price control.
- That greater responsibility is appropriate given the expectation that licensees will self publish the value of allowed revenue; and
- That making the change would bring ED into line with other sectors

These arguments are not sufficient, individually, or collectively, to justify the proposed change.

We consider each of Ofgem’s arguments below

- Ofgem’s argument that a change is required to reflect “*the most fundamental obligation in the price control*” fails to recognise (a) the increasing costs this would give rise to, to be funded by consumers without additional benefit or (b) the safeguards that are already incorporated into the price control to protect customers from any deviation between Allowed Revenue and Recovered Revenue
- Ofgem has failed to provide examples that justify increasing the obligation, and has not addressed the examples provided by DNOs that demonstrate the additional costs that would be incurred in pursuing very marginal improvements in accuracy of network charges

- Ofgem's suggestion that the proposed move to self-publishing the Allowed Revenue justifies the change in obligation misrepresents the extent to which this change will improve DNOs' ability to forecast Allowed Revenue more accurately
- The change in standard for DNOs cannot be justified by reference to the standard applied in other sectors
- Ofgem's proposed change to the level of obligation is internally inconsistent with its proposal to remove the current lag on many aspects of economic condition or performance flowing through to Allowed Revenue
- If Ofgem has views as to specific actions that DNOs should undertake, it should make those requirements clear on face of the licence rather than imposing a generic obligation
- Ofgem's proposal is also inconsistent with its assumptions in other aspects of price control package

Furthermore, Ofgem has failed to recognise that it would be inconsistent to increase this obligation at the same time as making other changes to the price control package such as removing the two-year lag which applies to many aspects of the price control flowing through to Allowed Revenues.

**FQ37. What are your views on applying a single time value of money to all prior year adjustments, based on nominal WACC?**

**SPEN see no reason to change the established framework, which is equitable and consistent with investor expectations.**

Therefore:

- Under- and over-recoveries against the revenue cap should roll forward at a benchmark interest rate as they do in RIIO-ED1 and have done in previous price controls. We see no reason to change the established practise.
- Prior year adjustments relating to expenditure items should generally roll forward at the allowed cost of capital

The base rate plus a margin is a suitable interest/discount rate when a company can reasonably be expected to accommodate the movement of cashflows across years via a short-term bank facility (or equivalent) But the cost of capital ought to be used when timing adjustments entail a more substantial investor commitment and/or take effect over a longer duration.

At RIIO-GD/T2, we previously commissioned First Economics to produce a report<sup>107</sup> on the subject. The report details out the arguments around why the Ofgem proposal is wrong.

In principle, under- and over-recoveries against the revenue cap should roll forward at a base rate plus margin interest rate as they do in RIIO-ED1 and have done in previous price controls. This reflects the short-term nature and scale of these types of adjustments due to the nature of the true up required.

However, prior year adjustments relating to expenditure items should roll forward at the allowed cost of capital. This is because, when a company is not permitted to recover revenues in relation to these costs, be that due to a timing difference, or a reopener, investors must step in to finance the mismatch between costs and revenues. This is also true for the opposite scenario where financing requirements

---

<sup>107</sup> First Economics (12 August 2020), RIIO-2: Prior Year Adjustments

may not be required and scaled back due to lower investment requirements in which case any over-recoveries should rightly be returned to the consumer

Therefore, we believe the existing approach is equitable and regulated companies' capital requirements should be treated in a homogeneous way, with adjustments for an advance / delayed return in line with the underlying applicable cost of capital for the regulated business.

**FQ38. What are your views on our proposed approach to using forecasts within RIIO-ED2?**

**SPEN agree with the use of forecasts within RIIO-ED2, supporting the approach to dynamic allowed revenue.**

We support Ofgem's proposal to use the best view of variable values throughout RIIO-ED2 in a timelier manner than in RIIO-ED1. This will ensure customer bills are more cost reflective, by reducing the magnitude of revenue true-ups, matching revenue with expenditure, and will enable networks to better manage cash flows therefore mitigating customer bill volatility.

**FQ39. What are your views on the proposed charging penalty mechanism?**

**SPEN agree with the proposed applicable rate, however uncontrollable elements should be excluded from the calculation**

We agree with the principal continuation of the RIIO ED1 mechanism which includes a 6% threshold and a 1 15% penalty rate consistent with GD&T. However, uncontrollable elements should be excluded from the penalty calculation. For example, the proposed treatment of bad debt as uncollected revenue will cause an under-recovery which is entirely outside our control

**FQ40. What are your views on the proposed revenue forecasting penalty mechanism?**

**In principle, we support the notion to aspire for accurate forecasts however propose Ofgem build a mechanism to allow licensees to record instances where any forecasting error is outside their reasonable control, and such values should be removed from the penalty calculation.**

Poor forecasting does not benefit customers or companies alike. DNOs are required to set tariffs 15-months in advance. Ofgem propose to set a penalty on base revenue in *constant prices*.

For RIIO-ED2, Ofgem have refined the definition of base revenue to include:

- fast pot expenditure
- non-controllable Opex
- RAV depreciation
- return

This refinement will be used when setting materiality thresholds. The levels of Fast pot expenditure, RAV depreciation and Return, correlate to the size of the business and level of ongoing expenditure, all of which are controllable. However non controllable Opex is not. There are justifiable differences in levels of non controllable Opex across all DNOs, due to factors including engineering, geographical and political, (e.g. different governments).

As can be observed in the published draft determination PCFM, Business Rates and Transmission Exit Charges make up the bulk of non-controllable Opex. Neither show any correlation to the size of the relevant business, RAV or proposed expenditure.

Scottish network operators are subject to a different business rates assessment body to that of English and Welsh companies, whilst Transmission Connection Point Charges materially differ across the UK

We therefore recommend non controllable Opex is removed from the definition of base revenue in RIIO ED2 to avoid penalising companies for an element of cost/revenue which they cannot control. This will avoid distortion throughout this mechanism and any other which uses base revenue as the comparative driver.

Furthermore, DNOs are required to publish tariffs 15 months in advance of the relevant charging year. We are currently witnessing economic turbulence throughout the UK over the same period, with a potential recession on the horizon, which could impact our supply chain, from materials through to manpower. It is therefore important Ofgem build a mechanism to allow licensees to record instances where any forecasting error is outside their reasonable control, and such errors should be removed from the penalty calculation.

**FQ41. What are your views on removing lags from incentives?**

**SPEN agree with removing lags from incentives**

Similar to FQ38, we support the principle of using the best view of variable values throughout RIIO-ED2, which includes incentive performance. This will mitigate the magnitude of true ups, whilst benefitting companies' management of cash flows.

**FQ42. What is your view on using RoRE as a general baseline for describing ODI caps, rather than base revenue?**

**SPEN agree with using RoRE as a general baseline for describing ODI caps**

We agree with the proposed approach to use RoRE as a general baseline for describing ODI caps, for the reasons Ofgem have outlined:

- RoRE is a measure that is more directly relevant to investors.
- RAV will generally be more stable than revenue, and
- On a go-forward basis beyond RIIO-ED2, a convention of using regulatory equity sizes potential rewards or penalties based on the notional gearing of the company. We view this as reasonable, because all else being equal a £1m reward is a less significant return to a company with lower notional gearing

**FQ43. What is your view on fixing the potential £m 20/21 value of incentives using one number for all years, based on a forecast of RIIO-ED2 at Final Determination (an approach similar to RIIO-ED1)?**

**SPEN agree do not agree with fixing the value of incentives based on a forecast at Final Determinations.**

Fixing £m<sub>20/21</sub> values based on forecasts of RIIO ED2 at Final Determinations contradicts the approach proposed in FQ42 where ODIs will correspond to a percentage of RoRE. If this is to broadly align, the RAV must include a reasonable uptake in uncertainty mechanisms. Otherwise, as Ofgem indicated, £m rewards will be diluted using a smaller base case RAV.

**FQ44. What is your view on the method of calibrating incentive caps in RoRE terms, or the overall proposed incentive caps?**

**SPEN agree with calibrating incentive caps in RoRE terms.**

We agree with the proposed approach to use RoRE as a general baseline for calibrating incentive caps.

**FQ45. What are your views on our proposal to remove the Bad Debt terms from the pass-through licence condition?**

**SPEN agree with the removal of Bad Debt from pass through.**

Ofgem propose to remove the Bad Debt terms from pass through, instead treating them as uncollected revenue. We have no objections to this proposal. However, as set out in our response to FQ39, any deduction should be excluded from the charging penalty calculation.

**FQ46. Should Ofgem allow proposals to re-allocate or re-profile revenue throughout the RIIO-ED2 period and what profiles could be considered in the customers' interest?**

**SPEN support revenue re-profiling**

In RIIO ED1, Ofgem allowed distribution network operators to profile base revenues to mitigate customer bill volatility. This volatility was primarily caused by the ending of a prior accelerated depreciation allowance agreement, coupled with new assets transitioning between amortisation periods of 20 years at the start of RIIO ED1 to 45 years in the final year, resulting in cliff edge drops in revenue of differing magnitudes across the DNOs. All but the two Scottish DNOs were impacted, both DNOs face their respective cliff edge in RIIO-ED2. SPD faces the greatest cliff edge of all DNOs, which will result in a significant decrease in depreciation revenue from year 2 (2024/25) to year 3 (2025/26) of the RIIO-ED2 price control period. This emphasises that altering depreciation asset lives should be avoided to solve current financeability problems, as it ultimately delays addressing why these issues arise.