

Ofgem, RIIO-ED2 Team

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25 August 2022

Dear Steve,

RIIO-ED2 Draft Determinations

Thank you for the opportunity to provide feedback on the RIIO-ED2 Draft Determinations. This letter represents a consolidated response on behalf of UK Power Networks' three distribution network operator licence-holding companies, Eastern Power Networks plc (EPN), South Eastern Power Networks plc (SPN) and London Power Networks plc (LPN). We have provided detailed responses with supporting evidence to Ofgem's consultation questions.

There are many elements of the Draft Determinations that we support, which we believe represent a progressive evolution of network regulation – from the incorporation of agile uncertainty mechanisms making adaptive regulation a reality, through to the stronger emphasis on the role of DSOs to ensure investment decisions are made in the best interests of customers, as well as the emphasis on data and analytics to drive further efficiencies and lower costs for customers. However, there are also material issues outstanding that we believe must be addressed by Ofgem ahead of the Final Determinations. This letter outlines these issues, and we have provided replies with greater detail and supporting evidence to each of Ofgem's consultation questions in our attached Draft Determinations Response. We have also provided detailed feedback in our sessions with your teams since we received the Draft Determinations which should also be taken into consideration.

Ofgem was very clear about the strategic context and its associated guidance for the RIIO-ED2 Business Plans

We understand Ofgem's principal concern that the Distribution Network Operators (DNOs) must not be a blocker to achieving Net Zero. We need to continue to excel in delivering the basics which form our licence to operate – safety, reliability, and customer service – whilst adapting to our changing environment and customers' expectations. At the same time, DNOs need to play an ambitious role in supporting the transition to Net Zero in their regions. However, this does not necessarily equate to customers paying upfront for costly network expansion. Being genuinely ambitious means facilitating Net Zero at the lowest cost to customers by maximising the utilisation of the existing network and exploring the scope for customer participation through flexibility. We need a different mindset; moving from one that only invests in building the network, to one that unlocks the full potential of a smarter and more efficient energy system that is significantly cheaper for customers. UK Power Networks' 'Final Business Plan' in December 2021 embodied this approach, and it is even more relevant today given the acute cost of living challenges facing customers.

Ofgem's Sector Specific Methodology Decision (SSMD) document established a clear expectation that companies would be rewarded for submitting high quality and ambitious RIIO-ED2 business plans that reflected this strategic context. It was anticipated that high performing companies would be rewarded for doing this by:

- Achieving larger increases in totex allowances relative to their peers;
- Benefiting from a higher totex sharing factor; and



- Achieving the highest Business Plan Incentive reward.

However, there is a critical disconnect between the Draft Determination outcomes and Ofgem's Business Plan guidance.

UK Power Networks embraced the position set out in the SSMD in good faith. We worked hard to submit a Business Plan that exceeded expectations. We are widely acknowledged, including by Ofgem's independent Challenge Group, to have submitted the highest quality RIIO-ED2 business plan. We should have been rewarded for doing this. However, the reality is that, in the Draft Determinations:

- Our totex allowances have been cut by £400 million (nine percent) – despite being the most efficient and lowest cost DNO;
- We did not benefit from the Business Plan Incentive;
- We have the same totex sharing factor as the other DNOs; and
- DNOs that took a "traditional" approach of asking for more totex, have been allowed substantially more totex compared to their RIIO-ED1 actual expenditure.

Ofgem's Draft Determinations reinforce the "*traditional DNO view*" that the more you spend, the more you ask for, the more you are rewarded. We do not subscribe to this view at all – both our RIIO-ED1 track record and our RIIO-ED2 Business Plan commitments are testament to this. Furthermore, the high-powered incentives that have driven record levels of reliability and customer satisfaction during RIIO-ED1 have been diluted significantly from the SSMD – through a combination of a 40% cut in upside rewards, the introduction of deadbands and by penalising high performers with even tougher targets in RIIO-ED2. We would therefore request that Ofgem reconsiders the fairness of our settlement and increases our totex allowance to reflect that efficiency is already baked into our submission, award a BPI and amend our totex sharing factor so that we benefit from having created an ambitious and highly efficient, low-cost plan.

The lack of alignment between Ofgem's guidance and the Draft Determination outcomes must be addressed by the Final Determinations. We have outlined below seven material issues that we believe are crucial to ensuring that the RIIO-ED2 framework delivers on Ofgem's strategy and guidance. More detailed evidence is provided in our response to each of Ofgem's consultation questions.

1. **Address the issues in the RIIO-ED2 cost benchmarking** – There are a number of issues already highlighted to Ofgem ranging from the unequal weighting given to the benchmark models (the way in which the disaggregated model sets an unachievable benchmark based on a "perfect company") though the use of one-way ratchets (which is completely out of line with regulatory precedent) through to the use of out of date RIIO-ED1 expert views (rather than taking account of actual revealed costs in RIIO-ED1). In addition to these issues, Ofgem has assumed that ongoing efficiency can be delivered at 1.2% per annum. Regulatory precedent and the Competition Markets Authority (CMA)'s determination in the case of the recent gas distribution and transmission appeals supports an assumption of 1% per annum. There is no credible evidence on which Ofgem can rely that suggests a figure above 1%.
2. **Normalise load expenditure correctly** – Having scrutinised Ofgem's methodology, we believe Ofgem has made an error by adopting a flawed normalisation approach that uses Low Carbon Technology (LCT) forecasts which do not reflect reality. For example, Ofgem assumes that UK Power Networks' share of LCTs across Great Britain will fall from 28% today to 18% by the end of RIIO-ED2. Given that our region is forecast to adopt LCTs faster than any other region of the country, there is no credible evidence on which Ofgem can rely that our share of LCTs will decline during the next price control period.
3. **Ensure the uncertainty mechanisms are properly designed and promote flexibility** – We welcome Ofgem's work in progressing the development of agile uncertainty mechanisms. However, there are several problems with the proposed uncertainty mechanisms that leave us exposed to unacceptable risks. We are particularly concerned about the way uncertainty mechanisms have been calibrated such that they do not reflect all the costs required to deliver the outputs, the inadequate treatment of flexibility, and the incorrect capitalisation rate. A combination of these factors has the effect of penalising companies that have been both ambitious and followed Ofgem's Business Plan Guidance compared to those that requested much large ex-ante totex increases.

4. **Ensure that incentives are appropriately calibrated and valued correctly** – We have several detailed comments on Ofgem's proposed incentive framework. In general, these relate to the need to set stretching but achievable targets. Setting targets that cannot be achieved by a company like UK Power Networks, which is the best-performing company in the sector, will only serve to undermine confidence in the incentive regime. The introduction of deadbands and an asymmetric incentive package all work to dilute the power of incentives. We find this even more puzzling when water companies are berated publicly for failing to get the basics of service right¹ whilst DNOs are delivering 90%+ customer satisfaction which has been underpinned by the incentive regime in RIIO-ED1. Incidentally, we note that Ofwat's PR24 methodology consultation indicates a symmetric incentive package and removal of deadbands which mimics the RIIO-ED1 formula that has delivered for customers.
5. **The size of the DSO incentive does not reflect the value that our DSO can deliver for consumers** – DSO functions have been recognised by Ofgem and the industry as key to facilitating Net Zero at lowest cost to customers. It is for these reasons that BEIS has asked Ofgem to ensure that DSO responsibilities are "supported by clear incentives"². As verified by independent studies, our DSO has the potential to unlock between £780 million and £2.6 billion benefits (including wider system benefits) in Net Present Value, up to 2040. In stark contrast to the potential savings that DSOs can deliver and counter to BEIS' request, Ofgem is only proposing a £5.5 million per annum DSO incentive. Relying on a £5.5 million incentive to deliver more than £780 million of savings will not drive the right behaviours. When combined with what Ofgem has proposed on the load-related uncertainty mechanisms and allowed totex, it risks embedding a mindset of Regulatory Asset Value (RAV) building at the expense of consumers.
6. **Utilise the Business Plan Incentive to send a strong signal that ambition is matched with an appropriate financial outcome** – The current business plan assessment process must create a clear distinction between high performing companies with ambitious business plans and the rest. Currently, there is no penalty for companies that have not met minimum requirements, the sharing factor differential is only 0.8% between companies, and there are no benchmarking rewards for the most efficient DNO. The unambiguous signal from the Draft Determinations is that mediocrity is accepted by Ofgem.
7. **Correct the errors underpinning the proposed cost of capital to appropriately remunerate companies for the risks they are bearing.** Ofgem's proposed cost of capital fails to recognise this by setting a cost of debt allowance that does not fund the sector's debt costs and provides significantly less headroom than Ofgem provided to both gas distribution and transmission companies at RIIO-GD2/T2. Secondly, the cost of equity does not recognise the additional risks that Ofgem's proposed price control framework entails, most notably a significantly asymmetric incentive package. There are also methodological errors in Ofgem's calculation of the cost of equity which must also be corrected for which evidence has been provided jointly with the industry.

We do not underestimate the challenge ahead. The scale of effort needed to decarbonise our society is huge – it is not going to be easy. We must innovate and we must be relentless in ensuring we can facilitate Net Zero whilst minimising the impact on customer bills, even more so given the severe cost-of-living challenges facing many families.

We are committed to continuing to work constructively with Ofgem ahead of the Final Determinations to address these issues and ensure that RIIO-ED2 delivers on the objectives that have been set out by Ofgem.

Yours sincerely,



Basil Scarsella

Chief Executive Officer
UK Power Networks

¹ Utility Week Article, "Ofwat Chief says companies still failing to get the basics right." May 2022

² Letter from BEIS to Jonathan Brearley, 2020.