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Our ref

Your ref

Date

25 August 2022

Dear Akshay,

Response to Ofgem's RIO-ED2 Draft Determination for Western Power Distribution (WPD)

I am writing on behalf of Western Power Distribution (South Wales) plc, Western Power Distribution (South West) plc, Western Power Distribution (East Midlands) plc and Western Power Distribution (West Midlands) plc in response to the above consultation issued on 29 June 2022.

Background

WPD is concerned about the consequences Ofgem's RIO-ED2 Draft Determination (DD) proposals will have on our 8 million distribution network customers, and the ability for WPD to play its central role delivering key elements of the government's legally binding net zero targets.

The DD proposals do not recognise the need for action to be taken now to ensure a safe, secure and reliable supply of electricity, and the need to help the country make the transition to a low carbon domestic energy system at lowest overall cost to customers, whilst supporting those most vulnerable. Despite WPD having engaged with Ofgem extensively to raise its concerns, the DD is insufficient in balancing the interests of our customers and wider stakeholders.

We welcome the opportunity, via this consultation and over the coming months, to continue to engage with Ofgem to achieve a Final Determination which will far closer reflect the requirements of our stakeholders by delivering the commitments included in our Business Plan whilst keeping the DNO element of the customer energy bill broadly flat in real terms at approximately £100 to WPD's average domestic electricity customer.

Against a backdrop of:

- customer's and businesses' increasing reliance on electricity - which was emphasised by Ofgem and BEIS following the recent storms;

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- a cost of living crisis - which must be considered from a current and future customers' perspective; and
- a climate emergency – with the need to take action to reduce the reliance on fossil fuels as quickly as possible,

it is essential that RIIO-ED2 focuses on the delivery of outputs that our customers want in a cost efficient and timely manner and with incentives for companies to continue to innovate and look at new ways of working as the energy landscape continues to evolve.

This letter details WPD's concerns and recommends actions to be taken by Ofgem to overcome these concerns.

Overview of Concerns regarding Ofgem's Draft Determinations

While WPD is supportive of Ofgem's measures to minimise current customers' energy bills, we remain concerned by the significant impact the DD proposals will have on current and future customers due to Ofgem's proposed reductions to investments in upgrading, maintaining and reinforcing the UK's energy network. By delaying much needed infrastructure investment, Ofgem risks slowing the UK's journey towards Net Zero – reducing customer access to low carbon technologies such as EV charge points, heat pumps and energy storage. Delaying or postponing a number of the proposed investments may also lead to generational inequity.

The consumer is at the heart of economic regulation and protecting the interests of consumers is Ofgem's principal duty. Yet the legislation is clear that the needs and interests of consumers are multi-faceted and comprise not only today's but also future consumers and require Ofgem to consider not only a narrow set of interests, such as bills paid for by today's consumers but rather consumer interests as a whole including energy security, sustainability, and advancement of broader policy objectives.

Ofgem's DD means we will be unable to deliver all of the commitments our customers wanted, resulting in services that fall short of our stakeholders' expectations.

The proposed 19% funding reduction contained in Ofgem's DD would likely result in the following outcomes - which are not in the interests of our current or future customers:

- A 19% reduction in expenditure on essential tree cutting and maintenance, risking increased disruption and power outages resulting from damage from falling trees and branches on electrical lines. Stakeholders tell us that their reliance on electricity, and therefore need for a reliable network, is more important than ever – particularly with major changes in the way people are working and running businesses from homes.
- Increased outages due to reductions in allowed asset replacement expenditure. We have proposed investment levels that equate to a 1 in 200 year asset replacement strategy, which we believe is the maximum risk profile that is acceptable. Reductions to replacement activity will increase the risk of asset failures impacting customer supplies.
- Longer interruptions for customers, and poorer customer service in relation to the reduction in fault spend and no allowance for quality of service.

- 21,000 fewer vulnerable customers benefiting from support and missing out on £11 million in savings during a cost-of-living crisis.
- Delays in connection, due to WPD not being able to facilitate the connection and charging for 22% of electric vehicles, a reduction of >300,000 vehicles compared to our stakeholder determined target of 1.5 million.
- Delaying investment potentially adds 2 to 5 years to local stakeholder net zero goal, despite the fact that customers will not be able to buy new petrol or diesel (ICE) vehicles from 2030.

Ofgem's DD appears to have broadly disregarded the results of our local, area specific, stakeholder engagement, reverting to the use of historical volumes of work as default in a number of circumstances, and proposing the use of a large number of Uncertainty Mechanisms to deliver additional outputs when Ofgem deems the policy position is clearer. This goes against what our customers have said they want in each of our areas.

We welcome that the RIIO-2 framework has encouraged deeper and more extensive customer and stakeholder engagement by companies. Legitimacy of the overall Final Determination will be enhanced and Ofgem can only truly be seen to support and act in consumer interests where this is specifically taken into account.

WPD secured customer and stakeholder support for the 42 core commitments set out in our Business Plan and for the 6 Consumer Value Propositions (CVPs) which accompanied it. Consumers recognised that these commitments and CVPs cost marginally more in terms of bills today but deliver additional consumer value under lenses such as the Social Return on Investment (SROI) and as expressed by a Willingness to Pay (WTP).

The DD does not include a clear articulation as to how Ofgem has taken consumer views and consumer expressed preferences into account in arriving at its proposals; nor does the DD provide much by way of clarity as to how Ofgem has sought to balance the various, sometimes competing, duties it is charged with, in furthering its principal consumer objective. Further detail and clarity on how Ofgem has taken into account and discharged its duties should be set out by Ofgem in the Final Determination.

Similarly, there is no real explanation as to how the proposed funding reduction is in the consumer interest. Ofgem's own impact assessment has remained disproportionately focussed on the cost and bill impact of the proposals, and the impact on the level of financial performance which regulated utilities might achieve rather than how consumer value can be unlocked or what specifically consumers and stakeholders indicated they would like to see. While the lenses employed by Ofgem are important they represent only a partial lens and taken alone miss critical elements.

In the accompanying paper (Annex 5) we have set out 14 areas where the DD specifically leaves consumer value untapped and where assessed against a consumer value lens the DD unaltered does not protect the interests of consumers.

The cumulative scale of the loss of consumer value is very significant, including:

- a) £55m reduction in incentive to deliver under the IIS;

- b) Over £40m of lost Net Benefits in terms of the three CVPs proposed by WPD where Ofgem has already accepted that there are benefits but has not proposed to apply a framework of reward;
- c) Potential delays in delivery of key enablers of Net Zero such as EV and Heat Pump roll out; and
- d) Loss of value to consumers through poorer incentive properties and delays which come through implementing key activities not within a well-defined business plan but through a variety of individual not yet fully defined Uncertainty Mechanisms.

For example, where Ofgem has accepted CVPs deliver Net Benefit and should be accepted, it is important that they are actually incorporated in a manner which enables them to be delivered and which recognises that benefit. We have set out in our accompanying paper on CVPs (Annex 6) how this can be addressed and addressed in a manner which ensures the measurement and reward mechanisms are robust and consumers only pay where both programmes are delivered and benefits realised.

Next Steps

WPD is seeking specific amendment and repair of the DD in terms of the following adjustments specifically designed to enhance consumer value:

- a) Reversal of the artificial restriction of the cap on upside under the IIS from +100 bps RoRE to +250bps RoRE consistent with RIIO-ED1 to unlock the value to consumers in terms of consumers' Value of Lost Load and WTP for enhanced reliability on the network;
- b) Amendment to the target setting under IIS to take into account and to reward previous performance – and by corollary to not reward previous under performance – as part of the overall dynamic efficiency within the sector;
- c) Amendment to the Major Connections incentive to provide a symmetric upside and downside incentive and to recognise the value placed upon delivery of these connections in a timely fashion;
- d) Provision for the consumer value enhancing CVP-1, CVP-2, CVP-3 and CVP-5 propositions made by WPD to unlock the net benefits as set out applying the rewards framework set out in the RIIO2 Business Plan Guidance;
- e) Provision of full 5 year Network Innovation Allowances to encourage innovation; and
- f) Reduction in the Materiality Threshold under the Uncertainty Mechanism from 1% of baseline average annual revenue to 0.5% in line with RIIO GD2/T2 and in a manner which seeks to ensure the appropriate incentives are there to deliver under those categories of expenditure subject to the threshold.

Each of these measures is individually designed to unlock consumer value and to enhance consumer welfare. Collectively they significantly enhance and aid Ofgem's discharge of its duty to protect the interests of consumers.

We believe these measures should be complemented by the development of the Consumer Value Metric both as a decision making tool – including where choices are being made between schemes or incentive design which seeks to enhance value, and as a measurement of performance by regulated entities in terms of the delivery of that value.

Our response to the DD includes detailed answers to Ofgem's specific questions which are included in Annex 1 to this letter.

In addition, there are a number of critical areas where we need to continue to work with Ofgem to ensure we achieve an outcome at Final Determination which is in the interest of customers. These critical areas are:

- Total Expenditure (Totex)
- Uncertainty Mechanisms
- Incentives and Output Impact
- Finance

Totex

Totex

WPD's concern: Ofgem's proposal of a 19.2% reduction to our RIIO-ED2 totex is not justifiable. The proposed totex adjustment is a combination of workload disallowances and efficiency challenges which then result in an overall adjustment applied across all cost categories, resulting in a lack of alignment between activities and costs of delivery. Also the levels of reduction in Totex associated with our Engineering Justification Papers (EJPs) and other submissions results in some key activities not being funded or only partially funded, which will have a detrimental effect on customer commitments.

Recommended remedy: Ofgem's toolkit needs to be reviewed to ensure the most statistically robust cost assessment models are used in the process along with the most relevant drivers. WPD will work further with Ofgem to develop solutions to provide a more reflective disaggregation of allowances. WPD has submitted additional information for the 104 EJPs which were classified as either unjustified or partially justified, as well as further information as part of this submission. We would like Ofgem to reassess these and ensure WPD has allowance to undertake activities in these key areas.

We have a number of concerns with Ofgem's cost assessment modelling, which result in proposed totex allowances which we do not consider are justified.

Ofgem's models are extremely complicated and it is not clear whether Ofgem's proposed adjustments are as a result of an efficiency challenge or where they are implying we do not need to undertake some of the proposed work. We welcome ongoing engagement with Ofgem to provide clarity on its cost assessment modelling.

In particular we highlight the following issues with the current cost assessment process.

MEAV and totex models

MEAV plays a dominant role in Ofgem's cost assessment approach. It is also the dominant driver in its proposed totex models.

We consider that MEAV is a flawed measure of DNO scale. MEAV is heavily skewed by underground cable asset due to their high replacement costs (cable assets represent 66% of MEAV compared to 13% overhead line assets). In practice, underground cables require less inspection and maintenance, no tree cutting and less frequent replacement than overhead lines; for some DNOs, such as UKPN's LPN, this is the majority of their network. A MEAV skewed by high replacement costs of underground cable is therefore not an appropriate cost driver for totex or in fact any activity. The use of MEAV distorts benchmarking results (in favour of companies with higher proportions of cable assets). Given its dominance in cost assessment and price determinations, we recommend that the measure of MEAV as a cost driver is reviewed by Ofgem and the sector. For RIIO-ED2 we recommend putting less weight on MEAV and instead a higher weight on more relevant and objective measures of scale such as network length and customers.

We note that Ofgem's proposed totex models are weaker than totex models in previous controls and make some practical recommendations for their improvement in our detailed response.

Disaggregated cost benchmarking

The outcome of Ofgem's latest disaggregated cost benchmarking currently shows no company as efficient. This is clear evidence of bias towards the negative within cost benchmarking. Notwithstanding this, we do believe a disaggregated approach is better equipped to deal with the significant change in the nature of services and costs of DNOs between RIIO-ED1 and RIIO-ED2, and should continue to play a significant role in the RIIO-ED2 toolkit. Our detailed response provides a number of suggested improvements to disaggregated models, and we have also provided addendums and additional information for 104 EJPs to further justify our expenditure.

In our Business Plan we provided 193 EJPs in order to provide full transparency to support the investment requirements for our network, however it appears that in some cases some licensees have not provided EJPs for key expenditure areas and thus would be subject to cost benchmarking only and not scrutiny from Ofgem's Engineering Hub. If a licensee obtains a preferable position as a result of not providing an EJP for expenditure areas which are clearly above the £2m threshold then this must be incorrect. Ofgem therefore needs to ensure that those DNOs providing information based on Ofgem's criteria in the SSMD are not disadvantaged by doing so.

In a number of instances Ofgem's DD does not provide evidence or rationale for the actions taken, for example in asset replacement Ofgem has used EJPs to determine whether activities are justified in the Business Plan, but where activities are partially justified, the evidence provided by DNOs is disregarded and flawed modelling is used, that in some cases leads to significantly lower volumes (or no volumes) compared to what had been delivered in RIIO-ED1.

South West

Based on Ofgem's totex models SWEST is an outlier in its level of inefficiency. The SWEST business plan is prepared on a consistent basis to that of WPD's other DNOs. This includes consistent unit costs (which reflect outturn prices). SWEST's unit costs are not inefficient compared to our other DNOs. It is therefore perplexing that totex models reveal SWEST to be significantly more inefficient. We are concerned that high reliance on MEAV in totex models results in an excessive challenge for SWEST which has low rates of underground cable assets and as a consequence relatively low MEAV. We will continue to explore the reasons for this result, especially as SWEST does not appear as an outlier under disaggregated cost benchmarking. We consider that Ofgem must satisfy itself that the results for SWEST are credible before setting a determination for SWEST as an outlier.

Closely Associated Indirects (CAI)

CAI is a very material area of spend (c. £5.3bn across the sector) that requires a thorough and proportionate approach. Ofgem's proposals in this area do not reflect that, but the opposite. The proposed model is very simplistic and shows the over-reliance on MEAV. This is a material and important area of expenditure that links with the development of DSOs and transition to net zero. We make clear proposals on how the assessment of CAI can be improved.

Quality of service

We are concerned that Ofgem's proposals in this area are not in the interest of customers. Ofgem proposes moving away from setting CML targets using industry benchmarks and instead setting targets for each company based on its recent performance. The effect of this is strengthening targets for industry leaders and relaxing targets for lagging companies. This approach is in contrast to incentive-based regulation and can lead to poorer outputs for customers. It also does not hold poor performing companies to account.

Ofgem also proposes not to make an allowance for quality of service consistent with the approach at RIIO-ED1. This approach was wrong then and is wrong now – companies must incur QoS costs to reach their new targets and to maintain new, higher targets. To a large degree there is no double counting between QoS expenditure and financial incentives on the IIS. Removing the QoS allowance in its entirety is not appropriate and in effect provides an additional efficiency challenge for companies. As we noted in a presentation to Ofgem's Cost Assessment Working Group (CAWG), when funding is based on benchmarking there is a funding gap for leading companies that must be closed. The QoS is particularly relevant for leading companies and must be provided.

Demand driven adjustment

The adjustment is very material for WPD and several other DNOs. The adjustment is made on the basis of a single totex model, a model which is relatively weak in the suite of models proposed and compared to historical models. We do not agree with the policy of scaling back companies' proposals, which are based on intensive engagement with stakeholders, to a conservative FES scenario, even if supplemented with automatic volume drivers. We consider that the way Ofgem has made the adjustment of HPs and EVs has not been transparent.

Efficiency

Efficiency

WPD's concern: The cumulative effect of all the efficiency challenges contained in the DD are too high and unprecedented. A number of the proposals themselves are not justifiable or supported by available evidence and, when added together, result in a proposal that would have a detrimental impact on the commitments WPD will be able to deliver.

Recommended remedy: WPD recommends that Ofgem sets Ongoing Efficiency (OE) at 0.5% and catch-up efficiency levels based on the 75th percentile. This will be challenging for the DNOs and will deliver good value for the customer.

Ofgem's positions on disallowing over 19% of proposed Totex, setting catch up efficiency at 85th percentile and setting the highest OE ever set by a regulator, demonstrates how Ofgem's proposals go to the most challenging position in all cases (irrespective of the evidence), resulting in allowances for a notional DNO that does not exist and may not be able to deliver on essential customer requirements.

Catch-up challenge

Ofgem proposes to set the catch-up challenge at the 75th percentile and glide to the 85th percentile over three years. Ofgem justifies its' proposals as consistent with its RIIO-GD2 ("GD2") approach, ignoring the very different contexts between RIIO-GD2 and ED2 (despite the CMA emphasising the importance of context when making a decision on the catch-up challenge). At RIIO-ED1 DNOs are not showing the same large and consistent outperformance of totex as at GD1, which was key to Ofgem's decision at GD2. At RIIO-ED2 the materiality of the decision to move to the 85th percentile is significantly higher than at GD2. Importantly, at RIIO-ED2 the proposed totex models are weaker and therefore less reliable than at GD2 and RIIO-ED1, where the 75th percentile was used. Evidence based regulation would support a less stringent catch-up challenge than the upper quartile, not a more stringent one.

Ongoing efficiency

Ofgem's proposal is not justified based on the evidence. The proposal is based on the highest point in a range of estimates provided to it by its consultants, CEPA. The proposed OE rate is significantly higher than estimates provided by other consultants and by the DNOs. It is also higher than recent CMA determinations on the appropriate OE rate at PR19 and GD2, and it is also higher than CEPA's recommended value in the very recent CAA determination for Heathrow Airport, which was 1% per year, despite prediction of low productivity growth in the coming years by the Bank of England and the OBR.

We consider that CEPA's report on OE contains un-evidenced assertions and the selective use of evidence to allow it to arrive at high estimates of OE. The proposed high OE rate is not a central value (of an evidence-based range) and allocates risk disproportionately to DNOs. The implementation of 1.2% OEs prior to the RIIO-ED2 period is also not appropriate.

The additional ENA analysis by NERA on OE, along with the ENA joint work by Frontier on OE are included in Annexes 16 and 17 to our response. We re-iterate our view, based on the evidence, that OEs of 0.5% per year in RIIO-ED2 only are appropriate.

Additional efficiency challenge through NARM target setting

In addition to the declared efficiency challenges, there is a hidden efficiency challenge in Ofgem's proposals for NARM targets. Through the EJP review and cost assessment Ofgem has reduced the volumes of activity and consequently the cost allowances. However, Ofgem has not pro-rated the NARM target to take account of volume and cost allowance reductions. This requires DNOs to deliver NARM risk output without funding. Ofgem asserts that, because DNOs have over-delivered in RIIO-ED1, then the same is possible in RIIO-ED2. In order to deliver the risk reduction targets DNOs will need to deliver more work. This implies that efficiencies can be found in order to achieve this. No evidence has been provided that shows that the targets can be achieved without the necessary funding. Without changing the targets, Ofgem is implementing a hidden efficiency challenge. This is not acceptable.

Uncertainty Mechanisms

Ofgem's DD proposes the use of 34 uncertainty mechanisms (UMs) in RIIO-ED2, up from 19 in RIIO-ED1, which was a period Ofgem stated was a time of significant uncertainty given the changing Government policy objectives and the 8 year price control. UMs should by definition only be used where expenditure is uncertain. In many cases in DD that is not the case.

The DD states the use of UMs will help ensure customer requirements are delivered at lowest cost. However, there remains a number of details to resolve, such as the design of the UMs and the additional investment associated with Ofgem's proposed access and charging reforms, so that we are able to invest at a pace to match the journey to net zero that our customers and communities wish to take.

Our RIIO-ED2 Business Plan recognises where a DNO is well placed to manage risks, moving significant expenditure areas to UMs does not recognise the need to balance risks whilst ensuring processes do not become blockers to the delivery of outputs.

Uncertainty Mechanisms

WPD's concern: The 34 uncertainty mechanisms make the price control complex and delay the access to funding to invest efficiently to deliver net zero. In parallel, when you factor in the proposed materiality threshold this creates additional risk for the DNOs and will have the consequence that effective investment will not be undertaken.

Recommended remedy: Ofgem needs to provide clarity on the operation of the UMs, demonstrate how they will work together, ensure that they are agile and set the materiality threshold at 0.5% of base revenue.

Ofgem's DD proposals for UMs lack guidance, definition and specificity leading to increased risk whilst at the same time increasing consumer cost through cost of delay. Ofgem must consider its proposed extensive use of UMs in RIIO-ED2, focussing on how these will operate and importantly how they will operate together along with the other mechanisms Ofgem has proposed, including caps and collars and Revenue Adjustment Mechanisms (RAMs). We are yet to see a working model from Ofgem on how all of the proposals will work together, which demonstrates the complexity of the proposals.

In Annex 11 of this response we have included our assessment of the proposed UMs, as well as identifying some of the issues and challenges with the proposals as currently set out given there will be significant interdependencies between policy decisions relating to Net Zero, Digitalisation, DSO etc. In light of this, rather than having individual reopeners for each, with disparate timing, we would recommend a consolidated, single 'Policy Delivery UM', open to both Ofgem and the DNOs to trigger, which would encourage more holistic responses to public policy developments. This should be combined with additional baseline funding to ensure the DNOs are able to engage proactively with policy development and so be in the best position to respond thoughtfully but rapidly.

Alongside some of the proposed UMs for capex there also needs to be consideration for an associated 'opex scaler', where an increase in capex expenditure will also drive a need for associated opex delivery and support costs. We will continue to work with Ofgem in the design of an 'opex scaler' in the period up to Final Determination.

It is unclear how Ofgem has derived the 98% capitalisation rate for uncertainty mechanisms, which is a flat rate across all DNOs. We do not object to the principle of split capitalisation rates; if the rates are calibrated correctly then each type of expenditure should be capitalised in the same way whether it sits within Base or Variant expenditure.

Further, it is unclear how the DD decision then reconciles with Ofgem's statement that "We agree with submissions that natural rates of capitalisation are desirable. Regulatory capitalisation rates reflecting the natural rates of capitalisation help ensure, over time, that charges are fair."¹

A capitalisation rate of 98% is deferring all but 2% of costs to future customers; it is not clear how this aligns with Ofgem's statutory duty to protect the interests of existing and

¹ Para 10.26, p.107, Ofgem ED2 DD.

future consumers. PA Consulting's report, included in Annex 9 to this response, highlights the need for Ofgem to provide further detailed analysis around its choice of capitalisation rates for UMs in RIIO-ED2, and demonstrates the need for the use of a 'natural rate' of capitalisation for UMs which we consider will be significantly lower than the proposed 98%.

Finally, the rationale for the materiality threshold proposed by Ofgem in RIIO-ED2 DD is not evidenced. In T2/GD2, Ofgem confirmed in the FD core document that the default re-opener materiality threshold was 0.5% of base revenue. We consider that a similar threshold is appropriate for ED2.

Incentive and Output Impact

Incentives & Outputs Impact

WPD's concern: The incentives package in the DD is skewed towards penalty and therefore negative. Effective regulation should drive companies to strive for frontier performance not seek to merely avoid penalty. One good example of this is the major connections incentive which is penalty only.

Recommended remedy: Make the major connections a symmetrical reward and penalty incentive. Also revise the IIS incentives to be 2.5% RoRE upside and downside. These actions would address the skewed incentive package and drive company behaviour to continue to significantly improve the services for the customers

Ofgem's proposed RIIO-ED2 incentive package is clearly skewed to the downside, with the highest potential performance being stated as 195bps, versus a downside risk of 400bps. In addition incentive target calibration appears to particularly disadvantage stronger performers in RIIO-ED1 such as WPD on IIS.

Within DD there is no evidence of Ofgem's translation of customer preferences or consumer research to the proposed outcomes, levels of outputs or incentives that have been proposed.

For example, Ofgem has not adequately recognised how the role and work of the DSO will evolve over RIIO-ED2 in line with stakeholder requirements in the proposed incentive package. Whilst the DSO incentive comprises a number of elements they are largely qualitative ex-post assessment which do not provide the necessary impetus to embrace DSO functions.

The DSO incentive is only marginally higher than the established Time to Connect incentive demonstrating the need for the overall RIIO-ED2 incentive proposals to be reviewed to ensure they are aligned proportionately to customer requirements.

Whilst Ofgem has highlighted concerns around the risk of DNOs significantly outperforming individual incentives in the past, the current design of the RIIO-ED2 incentives alongside Ofgem's proposed Return Adjustment Mechanism (RAM), means the ability for companies to significantly outperform outside of Ofgem's expectations is not possible under any credible scenario.

Finance

Finance

WPD's concern: The proposed cost of equity is insufficient. Ofgem has largely applied the RIIO-T2/GD2 proposals rather than reflecting more appropriate approaches and data.

Recommended remedy: Ofgem should update the risk free rate and total market return parameters within its cost of equity proposal. For the risk-free rate Ofgem should apply the CMA PR19 approach rather than relying exclusively on index linked gilts, an approach which is recognised to be the bottom of any plausible range. For the total market return Ofgem needs to reflect the CPIH inflation back-cast data that has been published by the ONS rather than an outdated CPI back-cast.

Ofgem's proposed allowance for the cost of equity is forecast to be 4.75% on average in real, CPIH-stripped terms (based on data as at April 2022). This is materially lower than the 4.96% forecast return that WPD proposed in our December 2021 Business Plan. In our view, Ofgem has not tabled compelling evidence to show that returns ought to be below the level that we set out in our plan.

We asked Frontier to update the cost of equity analysis they ran in November 2021 which we included in our RIIO-ED2 business plan (Appendix A04 of our Supplementary Annex SA09 Financing our plan).

Frontier's latest report retains the approach they used to estimate the parameters for the cost of equity in November 2021, while taking into account up to date data on all parameters, including the Risk-Free Rate, the Total Market Return, and beta. Frontier conclude that the updated midpoint for the cost of equity is 5.24% before their recommended aiming up. This is 28 basis points higher than the 4.96% they concluded in their November 2021 report, reflecting an increase in the risk-free rate during the last year and an increase in the total market return following the publication by the ONS of an updated CPI inflation back-cast and an even more relevant, CPIH inflation back-cast. There is an offsetting fall in the equity beta but to a level that remains above Ofgem's mid-point. A full copy of their report is included in Annex 7.

Therefore in deciding on its Cost of equity for RIIO-ED2 we recommend Ofgem takes the following steps:

- On RFR Ofgem should follow the CMA's lead and expand the basket of proxies to include, for example, AAA non-government bonds.

- On TMR, WPD considers that it is essential that the RIIO-ED2 TMR is (a) based on the latest available data; and (b) makes use of the best available series for historical CPIH inflation.

Ofgem has selectively chosen and applied a series of cross checks to compare its proposed cost of equity against. Our response provides new evidence demonstrating why the MAR cross check and others selected by Ofgem should not be relied upon, as well as setting out a series of other relevant cross checks that Ofgem should consider. We conclude that, once corrected, cross checks do not support a cost of equity in the lower half of Ofgem's range but support higher values instead.

As part of the RIIO-ED2 consultation Ofgem has proposed new work on the treatment of inflation. Aside from a change from RPI to CPIH indexation, the treatment of inflation within the price control has been consistent for many years. Ofgem reconfirmed the policy decision to index the RAV to inflation as part of the RPI-X@20 review². Investors value the current and long-standing treatment of inflation within the price control and companies have based financing strategies on that treatment. The existing treatment of inflation is deeply embedded within the mechanics of the price control and any efforts to review or amend that treatment would need to be done with extreme caution involving substantial analysis and consultation. A knee jerk reaction to the currently high levels of inflation risks spooking investors at a time when significant investment is needed in the networks for Net Zero.

Conclusion

As the key issues above highlight, we consider there is clear evidence of asymmetry in Ofgem's current proposed RIIO-ED2 package through choice of point estimate on totex, calibration of the incentive package, unfunded obligations, and with a higher likelihood of companies under performing the baseline.

In addition, as highlighted there are a large number of unfunded obligations and significant unfunded and unexplained cost gaps. Finally, the many UMs allow for at best cost recovery, where the distribution is not only asymmetric but truncated. Oxera's report into the RIIO-ED2 balance or risks, included in Annex 8 to our response provides further demonstration of the asymmetry in Ofgem's DD.

The attached annexes of our response to DD answer the specific questions raised by Ofgem in its consultation and provide a number of solutions to the issues to ensure the Final Determination is in the interest of consumers, along with supporting analysis.

We trust that the constructive feedback we have presented in our response, focussing on the material issues and providing a series of practical remedies to ensure that the Final Determination does deliver what our customers, stakeholders and government want, is helpful as we continue to finalise the RIIO-ED2 price control.

We are pleased with the work we have done with our stakeholders and very cognisant of the needs of our customers, both domestic and business, recognising their increased reliance on electricity, whilst also recognising the conflicting pressures of a cost of living crisis and a climate emergency, which is why WPD proposed a balanced Business Plan

² Ofgem's RPI-X@20 review October 2010 'Handbook for implementing the RIIO model Ofgem' para 11.34

which looked to deliver our customer needs in an efficient way whilst keeping the average domestic customer's bill flat in real terms into RIIO-ED2.

We look forward to working constructively with Ofgem in the coming weeks, as we work towards a Final Determination which enables us to deliver for our customers, stakeholders and current and future consumers.

Yours sincerely



PAUL BRANSTON
Regulatory & Government Affairs Manager

Enc:

- Annex 1 – WPD responses to Draft Determination consultation questions
- Annex 2 – Responses to Draft Determinations EAP additional information requests from Ofgem Consultation on RIIO-ED2 Draft Determinations
- Annex 3 – Responses to Draft Determinations Cyber Resilience consultation questions from Ofgem Consultation on RIIO-ED2 Draft Determinations (Not for publication)
- Annex 4 - Responses to Draft Determinations Engineering Justification Paper feedback from Ofgem Consultation on RIIO-ED2 Draft Determinations (Not for publication)
- Annex 5 – WPD, Consideration of Consumers, Consumer Value and Delivery of Outputs under RIIO-ED2
- Annex 6 – WPD, Response on CVPs
- Annex 7 – Frontier Economics, Cost of Equity – Response to RIIO-ED2 Draft Determinations, a report prepared for WPD, 23 August 2022
- Annex 8 – Oxera, RIIO-ED2 balance of risks, prepared for the ENA, 22 August 2022
- Annex 9 – PA Consulting, Assessment of the Capitalisation Rate Applied to Uncertainty Mechanisms in the RIIO-ED2 Draft Determinations, prepared for the ENA, 23 August 2022
- Annex 10 – Frontier Economics, RIIO-ED2 Cost of Equity Cross-checks, prepared for the ENA, 23 August 2022
- Annex 11 – WPD, Use of Uncertainty Mechanisms as part of RIIO-ED2 Draft Determinations
- Annex 12 – Oxera, Market-to-asset ratios as a cost of equity cross-check, prepared for the ENA, 22 August 2022
- Annex 13 – Frontier Economics, Inverse Inflation Exposure, Response to ED2 Draft Determination, prepared for the ENA, 24 August 2022
- Annex 14 – Oxera, Assessing the new ONS CPIH back-cast, prepared for the ENA, 15 August 2022
- Annex 15 – Oxera, Cost of equity in RIIO-ED2 Draft Determinations, prepared for the ENA, 25 August 2022
- Annex 16 – NERA, Response to RIIO-ED2 Draft Determination on Ongoing Efficiencies, prepared for the ENA, 23 August 2022
- Annex 17 – Frontier Economics, RIIO-ED2 Productivity Target, prepared for the ENA, 23 August 2022
- Annex 18 – NERA, Response to RIIO-ED2 Draft Determination on Real Price Effects, prepared for the ENA, 23 August 2022