

Joanna Gaches  
Senior Manager  
RIIO Networks  
Ofgem  
10 South Colonnade  
Canary Wharf  
London E14 4PU

27 October 2022

Dear Joanna,

### **RIIO-ED2 Informal Licence Drafting Consultation**

I am writing on behalf of National Grid Electricity Distribution (South Wales) plc, National Grid Electricity Distribution (South West) plc, National Grid Electricity Distribution (East Midlands) plc and National Grid Electricity Distribution (West Midlands) plc, in response to Ofgem's recent informal consultation on the draft RIIO-ED2 licence.

National Grid Electricity Distribution (NGED) welcomes the opportunity to comment on this consultation. Our ability to review and fully consider the proposals has been hampered by the fact the consultation on the proposed RIIO-ED2 licence is incomplete, partly due to some of the licence conditions being missing from the consultation (see Appendix 1), and also due to the fact that some of the RIIO-ED2 policies were still being considered when this consultation was published.

It is important that DNOs are able to view all parts of the licence and its Associated Documents together to be able to understand how the price control components will work in unison and have a clear and complete set of expectations and obligations. It is not possible for us to assess this when significant aspects have not yet been incorporated.

The current complexity is unnecessary, risks delays to efficient investments necessary to achieve Net Zero, and is currently unsupported by sufficient clarity and supporting documentation. We continue to provide options for simplifying the process and licence, including NGED's recommendation of a single, consolidated 'Policy Delivery UM', open to both Ofgem and the DNOs to trigger, which should be considered if Ofgem wishes to simplify the RIIO-ED2 proposals.

A significant amount of work remains to be done in a short period of time to correct issues in the published documents and introduce further conditions that interact appropriately with them. It is important that we are provided with adequate opportunity to review these proposed conditions prior to the statutory consultation.

The remainder of this letter provides an overview of the key issues regarding licence conditions and the licence drafting process. Our detailed comments are included in the Appendices, and the accompanying issues logs address our concerns on specific conditions.

## **Licence gaps**

NGED welcomes the opportunity to comment on the current draft of the ED2 licence. However, given a number of ED2 policies are still in development, a full assessment of the draft ED2 licence cannot be completed.

A number of recent licence conditions proposed by Ofgem are not in the latest draft, e.g., “Smart Optimisation Strategy (SOS)” Licence Obligation, yet some recent changes, including part M of Special LC 3.2 (Wayleaves and Diversions), are new licence conditions which have not been identified in separate logs. Given these inconsistencies, the completeness of the licence is difficult to assess. There are also policy areas still under development which are not currently in the licence at all, e.g., opex escalator, SCR.

The critical Price Control Financial Model (PCFM) has not been shared as part of the consultation meaning that cross-referencing from licence to PCFM is not possible. There are several important chapters of the Price Control Financial Handbook (PCFH) that are also either missing or incomplete. These are needed to be able to understand and comment on the detailed implementation of the price control.

A number of Associated Documents are not yet ready for consultation, and some licence conditions have yet to be shared. We recognise that, in some cases, this is due to policy not being sufficiently complete to support their inclusion. However, in some cases this is due to insufficient progress being made by Ofgem.

It is important that DNOs are able to view all parts of the licence and its Associated Documents together to be able to understand how the price control components will work together and have a clear and complete set of expectations and obligations. In particular, we note that there has been no progress to date in developing the Regulatory Instructions and Guidance (the RIGs) that will be needed to ensure that all necessary data is captured from start of the RIIO-ED2 period.

In particular, we note that work is ongoing to develop a mechanism to deal with increasing indirect costs where a re-opener is triggered. This is a key component of the uncertainty mechanisms that needs to be seen in order to ensure that the aim of agile and fast acting uncertainty mechanisms can be met.

## **Re-openers**

We have concerns around the clarity of the re-opener conditions in the proposed licence.

### **Re-opener drafting is not consistent with the legal requirements of the Electricity Act 1989 (EA89)**

The CMA confirmed that, for any “self-modification” licence condition to be lawful, it must specify the time, manner and circumstances in or under which a modification can be made. If such criteria are correctly set out in the condition itself, the licensee in question should be able to understand the potential impact on it of a future modification at the outset of the price control simply by reference to the condition.

We have significant concerns that two aspects of the drafting of re-opener conditions fail to meet these requirements and lead to it not being possible for licensees to understand the potential impact of a future modification on them:

- Without change or elaboration, we do not believe that the wording of the “evidence test” sufficiently specifies the circumstances under which a modification can be made.
- Several of the re-openers include provision for the Authority to “instigate the re-opener”. However, the conditions are silent on the process that the Authority would follow when instigating the re-opener and do not sufficiently specify the circumstances under which a modification can be made.

## Re-opener drafting that fails to achieve the effect expected by policy

We have further significant concerns with the inappropriate way in which some of the re-openers operate. In particular:

- We have a number of concerns related to the application of materiality thresholds in uncertainty mechanisms:
  - Firstly, inconsistency in the wording used means that it is not always clear whether the materiality threshold is to be assessed relative to the amount of allowance that has previously been provided. This makes the scope of the re-opener unclear and may lead to some DNOs who may legitimately expect an allowance adjustment not being entitled to one.
  - Secondly, the definition of Materiality Threshold merits a more prominent location in the Licence, such as in an appendix to special condition 3.2.
  - And thirdly, Ofgem’s approach to deciding which re-openers have materiality thresholds and which do not is inconsistent with Ofgem’s verbal clarification that those re-openers that relate to regulatory change/compliance-related activities would not have a materiality threshold as licensees should not have to face financial exposure from mandatory requirements.
- In addition to our separate feedback regarding concerns with the various load-related and cyber uncertainty mechanisms, we believe that two further uncertainty mechanisms still require some policy work to ensure that the key definitions are updated to set the correct scope: Wayleaves and Diversions Re-opener and PCB Interventions volume driver. We have provided detailed drafting suggestions in Appendix 2 of this letter.

## Load condition issues

The proposed licence includes a “toolkit” of uncertainty mechanisms that Ofgem plans to introduce to manage the uncertainty associated with load-related expenditure. These mechanisms need to be designed to operate correctly together to enable DNOs to be responsive to changing network demand.

Ofgem set out one of its objectives of these mechanisms as “ensuring the networks are not a blocker to net zero by having sufficient funding to invest in network capacity and that low carbon technologies do not face installation or operational delays”. As currently drafted, the conditions fail to achieve this effect. In contrast, the conditions introduce uncertainty about whether load related activities will be appropriately funded. The suite of conditions introduces unclear processes and a risk of unfunded obligations and double-counted adjustments.

Considerable work is required to achieve acceptably drafted conditions in this area. We have proposed the main changes that are required to achieve this.

The importance of getting these conditions right is further increased by Ofgem's proposal to only adjust baseline allowances for the outcome of the Access SCR for the first two years of RIIO-ED2. It is now very likely that all DNOs will trigger both the Load Related Expenditure Re-opener and the net to gross adjustment for Load Related Expenditure, and it is also possible that they will require the volume driver cap to be increased mid-period to reflect wider behavioural change resulting from the outcome of the Access SCR.

Furthermore, it is essential that ex-ante allowances are established in a manner that is consistent with the expected operation of the various uncertainty mechanisms. Any inconsistency between the way in which baseline allowances are set and the way in which the mechanisms are expected to operate may result in further double counts or gaps in the allowances that are ultimately modified into the licence. DNOs must be provided with detailed information under-pinning the assumptions made by Ofgem in setting allowances in order for the re-opener to operate appropriately.

### **Treating Domestic Customers Fairly licence condition**

We fully support the intent of SLC10AA, which is to ensure domestic customers are treated fairly. We also agree with the policy intent explained by Ofgem during policy meetings, including the examples of specific scenarios that would not result in enforcement action.

However, we remain concerned that the current drafting of the licence condition and the Fair Treatment Guidance does not fully align obligations with the policy intent and, therefore, leaves licensees exposed to unwarranted risks, including potential enforcement action. Specifically, the absolute obligations in the licence condition are drafted in such a way that could result in activities that DNOs routinely undertake breaching "the letter" of those obligations. As such, under any view the condition as drafted cannot be construed as a 'principles-based' licence condition, contrary to Ofgem's stated policy intent.

The DNOs have collectively provided Ofgem with important, detailed drafting suggestions for both the licence condition (sent to Ofgem on 15 September 2022) and the associated Fair Treatment Guidance (sent to Ofgem on 16 September 2022).

At the Licence Drafting Working Group (LDWG) on 22 September 2022, Ofgem indicated agreement with a range of our proposed drafting suggestions, and presented a further draft of the condition which implemented these. Consequently, we had expected that further version of SLC10AA to be included in the Informal Consultation for stakeholder consideration. That was not the case, and the issues log does not explain why these changes have not been made. Some DNOs have requested copies of the version of the licence condition that Ofgem presented at that LDWG but, as yet, have had no response to this request.

We are disappointed that those changes have not been consulted on and, given that position, would question whether the licence condition and the accompanying Fair Treatment Guidance were ready for public consultation.

To avoid duplication, we do not repeat our suggested drafting changes in our response to this consultation. We would emphasise, however, that we believe those drafting changes to be appropriate and that it is essential that Ofgem considers the DNOs' detailed proposals made in the two submissions and at the LDWG.

The main issues that our drafting suggestions sought to resolve are further explained as follows:

SLC10AA

Our main concern with the licence condition remains the absolute phrasing of the condition could result in DNOs breaching “the letter” of those obligations simply by undertaking routine activities. We remain concerned that Ofgem’s enforcement team may interpret the condition literally, leading to disproportionate and unnecessary levels of enforcement activity.

Ofgem has confirmed at policy meetings that the specific examples that concern us would not be expected to breach the requirements of the licence condition. Ofgem also expressed the view that a principles-based licence condition is not intended to stipulate definitive steps which must or must not be taken. Changes should, therefore, be made to align the wording of the licence condition with the interpretation shared by Ofgem at policy meetings and to better reflect how Ofgem has described a principles-based licence condition would operate.

Most importantly, the licence condition must be drafted to make it clearer that failure to meet “the letter” of the Standards of Conduct does not constitute a breach of the licence condition provided that the DNO has complied with the requirements to act in a manner consistent with the Customer Objective and to deliver a Fair outcome for Domestic Customers.

We believe that there are a few different drafting approaches that could achieve this:

- place a “reasonable endeavours” obligation on the DNOs and make changes/ qualification to those specific aspects of the Standards of Conduct that are of greatest concern to Ofgem (the approach proposed by DNOs on 15 September 2022); or
- change the wording of paragraph 10AA.4 so that it is clear that the Standards of Conduct are not to be interpreted prescriptively, as long as paragraphs 10AA.2 and 10AA.3 have been complied with. This could be achieved, for example, by amending paragraph 10AA.4 to read: “*The Standards of Conduct in the procedures and processes which the licensee must put in place are that the licensee and any Representative must: ...*”. This would need to be accompanied by changes/ qualification to those specific aspects of the Standards of Conduct that pose the biggest concern; or
- make detailed changes to the wording of all aspects of the Standards of Conduct so that all aspects are drafted in a way that “the letter” of each aspect could be readily met by DNOs when carrying out their routine activities.

Fair Treatment Guidance

The Fair Treatment Guidance currently adds very little to what is set out in the licence and does not provide any meaningful “guidance” to the licensee.

Sections 2 and 3 of the Fair Treatment Guidance do not provide any guidance on the interpretation of the licence condition. They simply repeat or paraphrase aspects of the licence condition itself. Furthermore, the Fair Treatment Guidance seems to introduce a new concept of “customer outcome” which is not anticipated by the licence condition itself, is not included in the licence definitions and is, therefore, unclear.

It is essential that the Fair Treatment Guidance is expanded considerably to provide guidance and actual examples.

Section 4 (How Ofgem applies the Standards of Conduct) does not fully align with the process that Ofgem has explained in policy meetings. It also introduces concepts of a “fairness test” and “compliance threshold” which are not explained. In particular, it is

essential that this section is refined to clearly set out the tests and logic that Ofgem will apply in enforcing this licence condition and the Standards of Conduct, as outlined by Ofgem at the various policy discussions for this condition.

The detailed drafting suggestions we provided previously will enable this to be achieved.

It is essential that amended versions of the licence condition and Fair Treatment Guidance are brought to the next LDWG, to allow further review prior to the Statutory Consultation.

### **Derogations**

We believe that Ofgem should also take the opportunity afforded by the detailed review of the licence to build-in learning from COVID-19 in respect of derogations. Relevant licence conditions should have clauses built into them to enable them to be switched off on request of the licensee and consequent direction from Ofgem. An alternative solution to the clauses being added into each licence condition is to include an appropriate equivalent clause in special condition 1.3 (Common Procedure) and SLC2 (Interpretation of this licence).

### **Major Connections Governance Document**

The document is incomplete and is therefore very difficult to assess. No survey scripts are included. The document still refers to a separate pre-application survey and key question. However DNOs have proposed to Ofgem that the pre-application survey is included in the application/quotation survey. Ofgem have not yet fed back on the DNOs' proposals.

No detail has been provided on minimum survey thresholds or on the appeals mechanism. The MCCSS targets are not defined and there is no methodology detailed on how the penalty will be calculated. Further issues are raised in SpC 4.5 Major Connections Incentive Issues Log.

### **Carry-over Green Recovery Scheme Project Costs**

We are concerned that the current drafting of Special Condition 3.8 Carry-over Green Recovery Scheme Project Costs (CGRSt) does not reflect the policy intent or the assurances we have received to date in relation to the funding of RIIO-ED2 Green Recovery expenditure.

The version of Special Condition 3.9 Carry-over Green Recovery Scheme Project Costs (CGRSt) and associated definitions published as part of Ofgem's RIIO-ED2 Draft Determinations provided allowances for all RIIO-ED2 Green Recovery expenditure. Since this point there has been little further engagement from Ofgem on this issue. However, a version of the licence circulated to companies in September 2022, and the published informal consultation, now apply the RIIO-ED1 Overall Expenditure Condition to RIIO-ED2 Green Recovery expenditure.

It is unclear why the policy in the Carry-over Green Recovery Scheme Project Costs licence condition does not reflect the assurances we received from Ofgem or, as we understand it, the policy intent. In order to ensure that Green Recovery Scheme Costs incurred in the ED2 period are funded, we recommend that the RIIO-ED2 definition of Green Recovery Scheme Project Costs is disconnected from of the RIIO-ED1 definition, as set out in our letter to Steve McMahon, "Treatment of Green Recovery Scheme expenditure in RIIO-ED2", dated



12 October 2022. We would welcome clarification from Ofgem in relation to treatment of this expenditure.

The attached Appendices contain sections on the following subjects, on which we raise more detailed concerns:

- Appendix 1: Licence gaps – Gaps in published consultation on the licence
- Appendix 2: Re-openers – Significant concerns around the clarity of the re-opener conditions
- Appendix 3: Unconstrained revenue adjustments by direction - Issues
- Appendix 4: Load related conditions - Issues
- Appendix 5: SpC3.3 Evaluative PCDs for cyber - Issues with drafting of special condition 3.3 and its interaction with other related licence conditions
- Appendix 6: Issues logs status – Full list of issues logs and confirmation of the logs which NGED is returning with comments.

The accompanying issues logs address our concerns on specific conditions.

## **In conclusion**

This letter provides a high level overview of a number of key licence-related issues and more detail can be found in the Appendix and accompanying issues logs. We look forward to working with Ofgem over the coming weeks to ensure the licence drafting is appropriately developed to deliver the RIIO-ED2 settlement.

Yours sincerely

A handwritten signature in black ink, appearing to be 'P. Branston', with a stylized flourish at the end.

PAUL BRANSTON  
Regulatory & Government Affairs Manager  
National Grid Electricity Distribution

Cc: Steve McMahon, Ofgem

## APPENDICES

### APPENDIX 1

#### **Gaps in published consultation on the licence**

The consultation on the proposed RIIO-ED2 licence is incomplete. It is important that DNOs are able to view all parts of the licence and its Associated Documents together to be able to understand how the price control components will work together and have a clear and complete set of expectations and obligations. It is not possible for DNOs to assess this when significant aspects have not yet been incorporated.

The consultation acknowledges that further licence conditions may be added prior to the statutory consultation in December. However, it only provides one example of a missing condition (the Smart Optimisation Strategy) making it difficult to assess whether Ofgem is aware of other gaps in the suite of documentation.

The following important licence conditions were not included in the consultation:

| <b>Missing licence condition(s)</b>                  | <b>Significance</b>  |
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| Opex escalator uncertainty mechanism<br><br>SpC 3.X  | Ofgem has signalled at cost assessment policy meetings that a condition similar to the RIIO-T2 condition may be implemented for RIIO-ED2, but no discussions have yet been held on the drafting of the condition.<br><br>Assuming that the intention is to mirror the RIIO-T2 condition, it will need to be drafted in a way to interact with all other uncertainty mechanisms. The associated algebra will need careful drafting to ensure that it interacts correctly.   |
| Smart Optimisation Strategy<br><br>SLC X             | The consultation acknowledges the absence of this licence condition from the suite of documents.<br><br>Elsewhere in this response we highlight a number of important issues with the way that the suite of conditions that relate to load-related activities interact.<br><br>This condition is likely to introduce obligations that impinge on the same set of load-related activities. It will, therefore, be necessary to carefully word this condition to ensure that it interacts appropriately with all other relevant conditions.<br><br>It is also unclear what interaction (if any) this new condition will have with the existing SLC 7A whole system licence condition and the accompanying Associated Document.<br><br>Ofgem's policy needs to be confirmed as soon as possible so that licence drafting can be concluded in time for the statutory consultation. |
| Absence of modifications to enact Access SCR changes | Three areas of the licence have previously been identified as requiring modification to enact the outcome of the   |



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| <p>SLC 14<br/>SLC 12</p>  | <p>Access SCR:</p> <ul style="list-style-type: none"> <li>• SLC 14: Ensuring consistency between the license and the new voltage rule implemented via the CCCM;</li> <li>• SLC 12: Giving effect to the policy intent to enable DNOs to strategically reinforce the network; and</li> <li>• Introduction of obligations on DNOs to offer curtailable connections to customers.</li> </ul> <p>We understand from recent working group meetings that Ofgem plans to make these modifications separately to the RIIO-ED2 modifications as housekeeping changes.</p> <p>We do not believe that Ofgem has given itself the ability to make such modifications under the Housekeeping provisions, nor do we think that it would be appropriate for it to do so.</p> <p>Furthermore, we believe that the modifications should come into force at the start of the price control, allowing alignment between charging rules, and how uncertainty mechanisms are established.</p> <p>It is unclear why Ofgem is not taking this opportunity to make these changes at this time. Ofgem should revisit this decision and act without delay in order to incorporate them into the RIIO-ED2 licence at the start of the price control period.</p> |
| <p>Ongoing Network Innovation Competition (NIC) projects with RIIO-ED2 spend</p> <p>SpC 9.X</p> | <p>The draft licence does not include any provision to permit income from the System Operator in respect of NIC projects that were approved in RIIO-ED1 and will continue into RIIO-ED2.</p> <p>An extra condition is required that mirrors the relevant subset of in CRC5A of the RIIO-ED1 licence.</p>   |
| <p>RIIO-ED2 Price Control Financial Model (PCFM)</p>  | <p>The PCFM forms part of special condition 8.1. The PCFM that will operate during RIIO-ED2 was not included with the consultation. This is a key omission. Without the PCFM, DNOs cannot fully understand how the mechanisms set out in licence conditions will flow through to allowed revenues.</p> <p>Furthermore, an early draft of the PCFM that was shared separately with DNOs some weeks before the consultation showed misalignment with the way in which many of the conditions have been drafted. For example, several of the variable values anticipated in the proposed special conditions were not included within the PCFM and, conversely, a number of variable values that are included in the PCFM are not described in the draft special conditions.</p> <p>A significant piece of work is required to ensure that the PCFM is fully aligned with the intended licence conditions and operates as expected.</p>  |

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| <p>Several important chapters are missing from the Price Control Financial Handbook (PCFH)</p> | <p>The PCFH forms part of special condition 8.1. Several chapters were not included in the consultation, including the calculations of the cost of capital and allowances for real price effects.</p> <p>Without these chapters DNOs cannot fully understand how their allowed revenues will be calculated. We urge Ofgem to share drafts of these chapters as soon as possible so they can be discussed no later than the November LDWG.</p> <p>We also note that there is no placeholder in the draft PCFH for the new guidance expected in respect of circumstances where the forecasting penalty under Part G of special condition 2.1 will not be applied. This is a very important new section of the PCFH given the changed basis to the operation of the PCFM and the calculation of Allowed Revenue for RIIO-ED2. The DNOs must be able to review and comment on the wording of this section prior to the statutory consultation.</p> |
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We recognise that policy discussions are ongoing on a number of these topics and that policies need to be clear to enable licence drafting. However, we are concerned about the extent of work that is likely to be involved in drafting these in a way that operates correctly.

There is a very significant amount of work remaining to be done in a short period of time to correct issues in the published documents and introduce further conditions that interact appropriately with them. It is important that DNOs are provided with adequate opportunity to review these proposed conditions prior to the statutory consultation. We do not believe that the one day currently set aside in November for the LDWG meeting will be sufficient to achieve this and suggest that further dates be scheduled.

In addition to the licence conditions themselves, we note that the consultation only includes a sub-set of the Associated Documents that will be required to implement the price control. Some of those that are included in the consultation are incomplete. These Associated Documents form an integral part of the price control. In particular:

| Associated Document issue  | Significance  |
|--|---|
| <p>Several important chapters are missing from the PCFM Guidance</p> | <p>The PCFM Guidance is an important document that allows DNOs to better understand how the price control will operate and the processes that they will need to have in place to implement new procedures and obligations.</p> <p>This is particularly applicable in respect of our discussions with Ofgem regarding our concerns about the proposed new obligations in and operation of special condition 2.1 in respect of using best endeavours to forecast allowed and recovered revenues, the forecasting of variable values and the recalculation of historical Allowed Revenue. It is clear that the instructions for populating variable values in the PCFM are very important aspects of the price control that DNOs will need to assess when making final decisions</p> |

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|  | about the acceptability of this new obligation. These instructions are not included in the draft document.   |
| Some published Associated Documents are incomplete       | <p>We note that, for new incentives in particular, the published Associated Documents do not contain all of the information needed by DNOs to fully understand the regulatory mechanism or area that the Associated Document is meant to be describing e.g. survey details and appeals processes.</p> <p>This information must be provided as soon as possible.</p>  |
| No progress in developing the RIGs                       | <p>We note that there has been no progress to date in developing the RIGs that will be needed to ensure that all necessary data is captured from start of the RIIO-ED2 period. It takes time to implement the process changes required to capture the data and the systems changes required to record the data. This work needs to be prioritised if DNOs are to be able to capture the data from the start of the RIIO-ED2 period.</p>  |
| Unnecessary delays to consulting on Associated Documents | <p>Ofgem proposes that a very large number of Associated Documents will be consulted on in “<i>first quarter 2023</i>”.</p> <p>It is unacceptable for so many of these to have been delayed to this late stage in the process. DNOs need to be able to review the requirements of these documents in parallel to reviewing the licence condition in order to understand the intended operation of the price control.</p> <p>We believe that a number of these should be available to be consulted on in autumn 2022 including:</p> <ul style="list-style-type: none"> <li>• Digitalisation Strategy and Action Plan Guidance</li> <li>• SIF Governance Document</li> </ul> <p>We urge Ofgem to accelerate work on all Associated Documents, including consideration of all feedback previously provided by DNOs, so that consultation can be undertaken as soon as possible.</p> |

## **APPENDIX 2**

### **Significant concerns around the clarity of the re-opener conditions**

We have concerns around the clarity of the re-opener conditions in the proposed licence. Given the number of re-openers in RIIO-ED2 and the scale of applications that may be made, we believe the resolution of these issues should be a priority for Ofgem. Our concerns can be broadly grouped as follows:

- re-opener drafting that is not consistent with the legal requirements of the EA89;
- re-opener drafting that fails to achieve the effect expected by policy; and
- inconsistency in drafting approach that further confuses the intended operation of the re-openers.

In the RIIO-T2 CMA appeal, the CMA confirmed that Ofgem can introduce a licence condition which has a mechanism for its later modification (what Ofgem referred to as “self-modification” conditions). This is permitted under section 7(5) of the Electricity Act 1989 (the EA89).

However, any “self-modification” licence condition must meet the requirements of section 7(5) of the EA89. In the RIIO-T2 appeal, the CMA confirmed, in line with the statutory requirements, that, in order for such a condition to be lawful, the condition must specify the: (a) time; (b) manner; and (c) circumstances in or under which a modification can be made.

If such criteria are correctly set out in the condition itself, the licensee in question should be able to understand the potential impact on it of a future modification at the outset of the price control simply by reference to the condition.

This note addresses five key issues that we consider must be addressed to ensure that the re-openers can be fully understood, that they work in practice, and so that they satisfy the section 7(5) EA89 requirements:

- the wording used to require “evidence of efficiency” in order to make a modification is unclear and too ambiguous (see Section 1);
- the process that will be followed when the Authority triggers a re-opener is unclear and requires clarification (see Section 2);
- inconsistency in the use and presentation of the materiality thresholds (see Section 3);
- clarification of the scope of certain re-openers (see Section 4); and
- the importance of using consistent language throughout the re-openers to remove the potential for confusion and unintentional distinctions (see Section 5).

#### **1. Proposed “evidence test” wording is unclear**

Twelve<sup>1</sup> of the re-opener mechanisms set out that the Authority may only make modifications under each of the re-openers if (variations of) “*there is evidence to demonstrate that the modification to allowances is efficient*”.

Without change or elaboration, we do not believe that this wording sufficiently specifies the circumstances under which a modification can be made. It is therefore not possible for licensees to understand the potential impact on them of a future modification. It is not sufficiently clear to understand how the requirement will be met in practice. Specifically:

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<sup>1</sup> All re-openers, except the Co-ordinated Adjustment Mechanism (CAM)

- (i) It is not clear whether it is dependent on the companies providing the requisite evidence to satisfy the test up front, or if it could be met following Ofgem's assessment of the representations. For example, it is assumed that Ofgem would carry out an assessment of efficiency, after receipt of information on costs from the licensee. In such circumstances, the outcome of Ofgem's analysis could constitute the requisite evidence. However, this is not what the condition says. The requirement is for evidence to *exist* that demonstrates that the modification to allowances is efficient. This, combined with the lack of methodology or criteria relating to any potential assessment by Ofgem of this evidence, means that it is difficult to fully understand the implications of any proposed modification.
- (ii) Given the nature of uncertainty that exists in the areas that have re-opener conditions, it is very likely that there will be situations where it is difficult to show independent evidence or conduct analysis to prove that the modification to allowances is efficient. For instance, where a proposed project or activity is innovative or where there is a lack of historical or comparative data to allow analysis to demonstrate "efficient" costs but where it is obvious an allowance should be made. In addition, in a number of areas the need for additional allowances will be driven by changes in legislation or other requirements, which may not otherwise be justifiable as "efficient".
- (iii) Ofgem does not specify a methodology or set of criteria for what is to be considered "efficient". This has the potential to allow Ofgem to make an arbitrary assessment of efficiency which may not reflect the actual efficient costs to individual licensees of the activities for which funding is being requested, or reflect wider benefits of any potential intervention (e.g., environmental or societal).

Whilst section 7(5) is intended to allow for modifications whose scale is uncertain at the outset of the price control period, there should not be uncertainty about the tests to be applied in determining whether such a modification should be made. The inherent ambiguity in the language proposed by Ofgem does not provide the requisite level of specificity. The uncertainty in the process, combined with the lack of clear methodology or criteria relating to the substance of any potential assessment by Ofgem of this evidence, means that it is difficult to fully understand the implications of any proposed modification, including the circumstances in or under which a modification can be made.

There is a significant concern, therefore, that the ambiguity inherent in the "evidence of efficiency" wording may be applied in such a way as to result in a legitimate re-opener application being rejected by Ofgem. This is because by explicitly including "efficiency" as a criteria, but failing to provide sufficient clarity about what it means in this particular context, or how it will be assessed, it provides an easy route for rejection of re-openers on a basis which, when limited to judicial review grounds, would be very difficult for a licensee to challenge.

We propose two alternative solutions, either of which would mitigate these concerns:

- Replace the "evidence of efficiency" test with a provision allowing Ofgem to assess that *"the licensee has provided such detailed supporting evidence as is reasonable in the circumstances"*; or
- Replace the "evidence of efficiency" test with a (positive) power to apply an adjustment for inefficiency to licensees' applications where Ofgem has conducted an assessment and has concerns. Suggested wording of a new sub-clause within each re-opener could be *"Where the modification has been requested by the licensee under paragraph x.x.x, the Authority may undertake an assessment of the efficiency of those costs and, where inefficiency is found, the Authority may reduce the value requested by the corresponding amount"*.

These alternatives would allow Ofgem to act if either it felt that insufficient evidence had

been provided, or it had undertaken an assessment and identified areas of inefficiency. For the second option, the re-opener guidance must then expand on the efficiency review process.

## 2. Process for Authority instigated re-openers is unclear

Seven of the re-openers set out in special condition 3.2 include provision for the Authority to “instigate the re-opener”. However, the conditions are silent on the process that the Authority would follow when instigating the re-opener and do not sufficiently specify the circumstances under which a modification can be made. It is therefore not possible for licensees to understand the potential impact of a future modification on them.

It is possible that when setting policy in each of these re-opener areas, there may have been some confusion and conflation of the process of Ofgem directing a new and additional window for the re-opener (following which licensees submit their applications as they would under the pre-set windows) and the process for Ofgem instigating a re-opener at any time.

Indeed, under issue number 23 from the special condition 3.3 Part D ESR issues log, a request for guidance on the process around Ofgem instigating the re-opener was requested. This issue was closed by Ofgem because Annex 6 to the Re-opener Guidance Associated Document had been drafted to set out the process “*that the Authority will undertake when considering whether to direct a re-opener window under the Electricity System Restoration Re-opener*”. It should also be noted that such guidance only exists for the ESR re-opener and not for the other eleven re-openers where Ofgem can direct an additional window.

To clear up this confusion, we believe Ofgem needs to:

- (i) Confirm whether the processes around directing an additional window and instigating a re-opener are the same or different.
- (ii) Include a new additional sub-condition under SpC 1.3 Common Procedures in the licence, which clarifies the processes around directing an additional window and/or instigating a re-opener under SpC 3.2 (depending on the answer to (i) above).
- (iii) Include a new sub-clause within each relevant re-opener licence condition to clarify that, before making a modification as a result of instigating the re-opener, the Authority has:
  - a. requested from the licensee and been provided by the licensee with such detailed supporting evidence as is reasonable in the circumstances,
  - b. given an explanation of the rationale for the proposed direction and the basis of the calculations used in any modified allowance, and
  - c. clearly stated that the relevant circumstances under which the Authority may trigger the re-opener are the same as the circumstances under which a licensee may trigger the re-opener.

In the absence of providing this additional clarification, it is questionable whether this aspect of the relevant re-openers is consistent with the legal requirements of Section 7(5) of the EA89.

In addition, there are further concerns with the inappropriate way in which some of the re-openers operate and these are outlined below:

## 3. Materiality threshold

We have both licence drafting and policy related points to raise in relation to the materiality threshold.



- (i) The wording used to describe the application of the materiality test is phrased inconsistently in different re-openers. It is not always clear whether the materiality threshold is to be assessed relative to the amount of allowance that has previously been provided, either via baseline allowance or under an earlier re-opener application. This makes the scope of the re-opener unclear and some DNOs who may legitimately expect an allowance adjustment may not be entitled to one. For those conditions where it is Ofgem's policy that a materiality threshold should apply, we suggest that the following standard wording be used: *"The [XXX] Re-opener may be used where there has been a change in the [XXX] costs the licensee has incurred or expects to incur, relative to any previous allowances for such costs, that exceeds the Materiality Threshold"*.
- (ii) The definition of Materiality Threshold is currently not populated. We are unclear whether Ofgem's intention is to include a table in the definitions list showing the Materiality Threshold that is applicable to each DNO. Given that these are key values that are relied on by many different conditions they would merit a more prominent location in the Licence, and we suggest adding a new appendix to special condition 3.2.
- (iii) Some re-openers have materiality thresholds and others do not. Initial verbal clarification from Ofgem to allow DNOs to understand the rationale behind this was that those re-openers that relate to compliance-related activities would not have a materiality threshold as licensees should not have to face financial exposure from mandatory requirements. Following this logic through, the materiality thresholds should be removed from the Environmental and Storm Arwen re-openers.

#### **4. Clarification of scope**

In addition to our separate feedback on the various load-related and cyber uncertainty mechanisms, we believe that two uncertainty mechanisms still require some policy work to ensure the key definitions are updated to set the correct scope.

- (i) Wayleaves and Diversions re-opener: As discussed in the Wayleaves and Diversions UM workshop with Mark Hogan on 05/10/2022, it was agreed that the definitions included in the RIIO-ED2 BPDT Glossary will be used to create definitions for this Licence Condition. It is expected that these definitions of Wayleaves and Diversions Costs will also capture:
  - All Land Rights i.e., Servitudes, Easements Leases and Freeholds too (not just wayleaves) The types of land right selected affords the DNO the option of securing the most appropriate land right for the apparatus and the ability to obtain a secure land right in perpetuity and deliver the correct compensation due to the grantor, in effect resulting in an economic and efficient approach by removing any future threat to the apparatus.
  - It should be clear that this definition covers the land rights for existing electric lines and substations as well as for new ones installed as a result of a diversion.
  - The commercially negotiated compensation to grantors. This is a key cost within this process and grantors have a legal right to receive such compensation.
  - Those claims received prior to RIIO-ED2 but not paid until RIIO-ED2. If Ofgem limits the scope to NEW claims received in RIIO-ED2, this would create a perverse incentive for Land Agents to abandon a previously lodged, queued claim and resubmit it during RIIO-ED2. The timing of the claim submission is largely irrelevant because it could relate to assets that are decades old. The key date is the payment date or expected payment date.

- (ii) PCB Interventions volume driver: Although this is a volume driver and not a re-opener, we believe it is important to set out our concerns regarding the current definition of PCB Interventions. Ofgem has recently acknowledged<sup>2</sup> that both associated asset interventions and ground-mounted transformers may be required as part of PCB Interventions work in certain circumstances, but the definition of PCB Interventions does not currently allow for:
- Associated asset interventions required to support the pole-mounted transformers (such as poles and pole-mounted switchgear). There will be instances where the pole mounted transformers cannot be replaced without these associated assets also being replaced; or
  - Replacement of ground-mounted transformers where the forecast load growth exceeds the capacity that can be supplied by a PMT.

We suggest the PCB Interventions definition is amended as follows: *“in the context and scope of the PCB Interventions Volume Driver, means any work undertaken by the licensee on pole-mounted transformers and associated poles and pole-mounted switchgear in order to comply with the PCBs Regulations and such work may involve the installation of a ground-mounted transformer in circumstances where the forecast load growth exceeds the capacity that can be supplied by a pole-mounted transformer.”*

PCBs *“has meaning given to that term at Regulation 2(1) of either of the PCBs Regulations.”*

PCBs Regulations means:

*“In the case of England and Wales, the Environmental Protection (Disposal of Polychlorinated Biphenyls and other Dangerous Substances) (England and Wales) Regulations 2000, and any amendment to it.*

*In the case of Scotland, the Environmental Protection (Disposal of Polychlorinated Biphenyls and other Dangerous Substances) (Scotland) Regulations 2000, and any amendment to it.”*

## **5. Inconsistency in drafting approach further confuses the intended operation of the re-openers**

It is helpful to have the opportunity to review all conditions side-by-side as part of this consultation. In doing so, we note that a variety of similar, but not identical, phrases are used to set out the circumstances and conditions that must be met for a modification to be made.

The variation in wording compounds the issues explained above and also introduces more scope for differences in interpretation. We understand that this inconsistency is not intentional. The concern is that anyone trying to interpret them in the future will assume that, as the wording is slightly different, this was to reflect a different policy intention or approach.

In particular, there are drafting inconsistencies across the common re-opener conditions whereby only seven of the Parts in 3.2 state upfront that the re-opener *“may be used where the licensee has incurred or expects to incur”* additional costs. Although this is stated later within the drafting of the other conditions, it is not immediately obvious, and it is important that all re-opener conditions within the licence are drafted consistently to avoid any ambiguity. Consequently, a similar statement should be included in those conditions from

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<sup>2</sup> Fraser Glen during SPEN bilateral 11/10/22

which it is currently missing (Physical Security, Electricity System Restoration, Cyber OT, Cyber IT and Storm Arwen).

In addition to the drafting changes to address the specific issues that we set out above, we also include details in the following table aspects of the condition that are phrased inconsistently. Where appropriate, we also include our view of the form of words that should be used consistently throughout the condition.

| Section  | Comments/ wording  | Action required  | Changes needed to   |
|--|--|--|---|
| This part establishes ...  | Consistent across all re-openers   | No action required   |   |
| The *** re-opener may be used where...   | PSUP, ESR, Cyber x 2 and Storm Arwen do not have costs incurred or expected to be incurred here  | Change to include this clarity   | 3.2.6, 3.2.21, 3.2.44, 3.2.52, 3.2.68   |
| The licensee may only apply ...  | Inconsistency - some Parts say "during such other periods as the Authority may direct", whilst others say "during such other periods as the Authority directs"           | This should be consistent. It should also refer to the process for directing an additional window and/or instigating a re-opener discussed in section 2 above. | All parts of 3.2 should be checked and corrected where necessary                          |
| The licensee may only apply ...  | Inconsistency - some Parts say "may only apply to the Authority for modifications to this licence", whilst others say "may only apply for modifications to this licence" | Correct where the words omit "to the Authority"  | 3.2.15, 3.2.30, 3.2.45, 3.2.53, 3.2.61, 3.2.76, 3.2.84, 3.2.91, 3.2.106, 3.2.113, 3.2.120 |
| The licensee must, when making an application under the... send to the Authority a written application that: | These are naturally different depending on the re-opener itself, but the final 3 should be consistent - see below  |  |   |
|  | sets out any modifications to the value of *** in Appendix 1 being sought  | All Parts of 3.2 should be checked and corrected where necessary   |   |
|  | explains the basis for calculating any modifications requested to allowances and the profiling of those allowances   | All Parts of 3.2 should be checked and corrected where necessary   |   |
|  | provides such detailed supporting evidence as is reasonable in the circumstances   | All Parts of 3.2 should be checked and corrected where necessary   | 3.2.8(f), 3.2.77(g)   |
| An application under this Part must:   | Again, naturally different depending on the re-opener itself, but some should be consistent:   |  |   |
|  | be confined to costs incurred or   | All Parts of 3.2 should be   | each re-opener has a slight   |

|   |  |  |  |
|---|--|--|--|
|   | expected to be incurred on or after 1 April 2023   | checked and corrected where necessary                            | variation of this wording - suggest all are changed in line with 3.2.9(b) " <i>(b) be confined to costs incurred or expected to be incurred on or after 1 April 2023</i> "   |
|   | take account of allowed expenditure which can be avoided as a result of the modifications requested                                  | All Parts of 3.2 should be checked and corrected where necessary | suggest that all re-openers align to the wording used in 3.2.47(c) " <i>(c) take account of allowed expenditure which can be avoided as a result of the modifications requested</i> "                                    |
| The following modifications to this licence may be made under the *** Re-opener:                | First sub-bullet generally varies to the individual re-opener  |  |  |
|   | modifications to the value of *** set out in Appendix 1  | All Parts of 3.2 should be checked and corrected where necessary |  |
|   | modifications confined to allowances for Regulatory Years commencing on or after 1 April 2023  | All Parts of 3.2 should be checked and corrected where necessary |  |
| The Authority may only make modifications to this licence under the *** Re-opener by direction: | This opening sentence differs - in some re-openers it ends with "where", and in others, the corresponding bullets begin with "where" | One style should be chosen and then used consistently in 3.2     |  |
|   | Sub-bullet 1 usually varies with the individual re-opener  | Consistency can be gained  | some list all the links to the trigger, but others say " <i>where the circumstances in *** exist</i> " - the latter is a more effective way of addressing this point. This should be the default wording for consistency |
|   | the requirements in paragraphs x.x.x and x.x.x have been met   | Consistency can be gained  | This may vary depending on whether it is licensee only trigger or licensee and Authority - in  |

|  |  |  |   |
|--|--|--|---|
|  |  |  | which case there are extra links to the trigger paragraph |
|  | where there is evidence to demonstrate that the modification to allowances is efficient (or similar words) |  | See section 1 above                                       |



## **APPENDIX 3**

### **Unconstrained revenue adjustments by direction**

In addition to the standard wording setting out the required 28 days consultation on any proposed direction, any process where the Authority may direct adjustments to otherwise routinely calculated values it must:

- Appropriately constrain the extent of any directed adjustment, by:
  - constraining the quantum of the adjustment value,
  - constraining the maximum and minimum permitted magnitude of any value changed by the directed adjustment, or
  - by describing the calculation/ scope of the adjustment; and
- Clearly explain the factors that the Authority will take into account in deciding whether to make any adjustment and what quantum of adjustment to make.

If this detail is to be provided in an Associated Document, the licence should clearly reference this.

Without this clarity on the face of the licence, DNOs are exposed to potentially different future interpretations of the intent of any adjustment made by direction, leading to unconstrained revenue adjustments or adjustments that have quite different effect to those that were reasonably expected based on policy discussions.

There are numerous examples of such unconstrained adjustments in the proposed licence including:

- The adjustment of MC<sub>t</sub> term in the major connections ODI if the Major Connections Survey Threshold has not been met
- The adjustment to Allowed Revenue under special condition 7.8 “*by the amount that the Authority has determined to be unrecoverable*”
- The calculation of any allowance adjustment under the Net to gross adjustment for Load Related Expenditure
- The calculation of any BPI<sub>t</sub> adjustment under special condition 4.7

## **APPENDIX 4**

### **Issues with load related conditions**

The proposed licence includes a “*toolkit*” of uncertainty mechanisms that Ofgem plans to introduce to manage the uncertainty associated with load-related expenditure. These mechanisms need to be designed to operate together to enable DNOs to be responsive to changing demand.

Ofgem set out one of its objectives of these mechanisms as “*ensuring the networks are not a blocker to net zero by having sufficient funding to invest in network capacity and that low carbon technologies do not face installation or operational delays*”. As currently drafted, the conditions fail to achieve this effect.

This core “*toolkit*” of mechanisms is established via a range of documents including:

- Special condition 3.2 - Uncertain Costs Re-openers
- Special condition 3.3 - Evaluative Price Control Deliverables
- Special condition 3.9 - Load related expenditure volume drivers
- Special condition 3.11 - Net to gross adjustment for Load Related Expenditure
- Special condition 6.1 - Pass-through items
- Load Related Expenditure Re-opener Guidance
- Load Related Expenditure Volume Drivers Governance Document
- Price Control Financial Model

The issues that we have identified with the scope and operation of this “*toolkit*” of documents arise due to issues in individual documents and issues with the interaction between them.

Considerable work is required to achieve acceptably drafted load-related conditions. We have proposed the main changes that are required to achieve this and include them in the detailed issues log.

The issues that we have identified are individually material and cumulatively huge. In summary:

- The combined scope of the Load Related Expenditure Re-opener and the Load Related Expenditure volume drivers is unclear. This leads to uncertainty as to whether some load-related activities are included at all, as well as the potential for very different interpretations of the required calculations of Load Related Expenditure Re-opener allowance adjustments.
- The boundary between the Load Related Expenditure Re-opener and the Load Related Expenditure volume drivers is unclear. This leads to confusion as to whether all load-related activities are addressed within the toolkit of activities. In particular, it is unclear whether several load-related activities at 11kV and below are addressed by either mechanism.
- The scope of the Load Related Expenditure Re-opener “trigger” does not recognise that a difference may exist between the DNO’s forecast demand and the basis of Ofgem’s RIIO-ED2 ex-ante allowances in the Final Determinations. It also does not include changes to the proportion of forecast expenditure that will be funded by DUoS customers. It is essential that the condition clearly states that changes due to any difference between Ofgem’s

assumptions and the ultimate load constraints on the network may be included in any re-opener application.

- The process to be followed in the case of “red flag” volume driver “check metrics” is unclear, incomplete and based on data that have not historically been reported and may be subject to reporting inconsistencies. This leads to a risk that a “failure” of one metric leads to protracted and intrusive discussions about the efficiency of volumes as well as uncertainty of allowances for all relevant volumes. In turn, this risks DNOs delaying key investment due to concerns about whether volumes will be allowed.
- The text and calculations in Special Condition 3.9 are internally inconsistent and also inconsistent with inputs expected by the draft PCFM shared with DNOs. It is absolutely crucial that it is clear whether relevant calculations are to be calculated to replace ex-ante allowances or to make adjustments relative to ex-ante allowances, and that – in turn – these align with the intended operation of the PCFM. The current inconsistency leads to the risk that materially incorrect totex allowances may be calculated.
- The process for potentially modifying the load related expenditure volume drivers condition mid RIIO-ED2 has not been established correctly. It is essential that text is included on the face of the licence setting out the manner, and circumstances in or under which such a modification may be made.
- The boundary between pass-through and the Load Related Expenditure Re-opener is not clearly defined. It currently seems likely that allowances for transmission connection point charges will be partially double counted.
- It is premature to assume that all Strategic Investment projects should be subject to evaluative PCDs. Furthermore, the definition of Strategic Investment is too broadly defined and may result in an inappropriately large number of relatively small projects being subject to PCDs leading to disproportionate processes being introduced.
- Ofgem’s proposed continuation of the net to gross adjustment for Load Related Expenditure condition into RIIO-ED2 needs much more consideration. Ofgem has not consulted on this proposal and the proposed drafting is unclear. For example, it double counts Totex Incentive Mechanism adjustments and introduces a risk of unconstrained allowance modifications. Additionally, several important calculations that are required to calculate any adjustment are not clearly defined. This leads to a risk of unexpected or unwarranted adjustments to allowances for Load Related Expenditure.
- Furthermore, the net to gross adjustment for the Load Related Expenditure condition has not been drafted in a manner that is compatible with Ofgem’s proposed approach to setting baseline allowances for years 1 and 2 on a different basis to years 3 to 5 in respect of the outcome of the Access SCR. It is highly likely that all DNOs will trigger this mechanism as a direct consequence of the difference between Ofgem’s assumptions in setting baseline allowances and the charging basis introduced following the Access SCR.
- The proposed net to gross adjustment for Load Related Expenditure also does not include a proposed range. More consideration should be given to the width of the deadband, especially in light of Ofgem’s approach to setting allowances to reflect the Access SCR.

- Special Condition 3.11 Part B suggests an inappropriate expectation that DNOs will deliver a specific percentage of Gross Load Related Expenditure via Specific Customer Funded Reinforcement. This suggests that DNOs should somehow manage their investment to keep the ratio of work that is part-funded by connecting customers and that funded by existing customers within a particular range. This would be a very unhelpful and potentially counter-productive obligation that could stand in the way of delivering for customers. In the context of Ofgem's proposed approach to setting allowances for the outcome of the Access SCR, it may also conflict with the requirements of the Common Connections Charging Methodology. It should be removed.
- The timings of the mechanisms do not align and may lead to "boundary issues" in the operation of the mechanisms. Furthermore, the Load Related Expenditure Re-opener cannot be triggered in time to confirm allowances for year 3 of RIIO-ED2. Given that Ofgem proposes not to adjust baseline allowances for year 3 to take account of the outcome of the Access SCR, this means that DNOs will have no certainty of allowances for year 3 at the time that they are required to commit to expenditure.

It is also important that baseline allowances are set in a manner that is consistent with the expected operation of the various uncertainty mechanisms. Any inconsistency between the way in which baseline allowances are set and the way in which the mechanisms are expected to operate may result in double counts or gaps in the allowances that are ultimately modified into the licence. These issues are further compounded by the complexities associated with Ofgem's proposed approach to setting baseline allowances following the outcome of the Access SCR. The overall effect of this suite of issues is to create significant uncertainty as to whether key, load-related activities will be appropriately funded during RIIO-ED2. DNOs must be provided with detailed information under-pinning the assumptions made by Ofgem in setting allowances in order for the re-opener to operate appropriately.

Once the issues in the core "*toolkit*" of documents have been resolved, further work will be required to ensure that the core mechanisms interact correctly with other RIIO-ED2 conditions. We have identified the following further conditions that need to correctly interact with the toolkit of load-related uncertainty mechanisms:

|   |   |
|---|---|
| SpC 3.2 Storm Arwen Re-opener             | May result in fundamental changes to planning standards which could include, for example, changes to interconnection standards (normally be categorised as LRE)         |
| SpC 3.2 West Coast of Cumbria (ENWL)      | Will result in new assets, including new GSPs, resulting in amended LRE (inc TCP) requirements<br>May remove assets that were previously scheduled to be subject to LRE |
| SpC 3.6 Net Zero                          | Definition of Net Zero Development includes " <i>new investment arising from the agreement of a Local Area Energy Plan</i> " – commonly these would result in LRE       |
| SpC 3.7 Co-ordinated Adjustment Mechanism | May transfer LRE projects (including Strategic Investments) between DNOs or between ED and T<br>May move costs from TCP to LRE or vice versa                            |

|  |  |
|--|--|
|  |  |
| SpC 3.8 Green Recovery   | Some Agreed Schemes may deliver load-related outcomes  |
| SpC 3.12 Off-gas grid mechanistic Price Control Deliverable (UKPN) | Relates to provision of capacity ahead of need to Off-Gas Grid Customers                                 |
| SpC 9.X Whole System Strategies                                    | Policy and condition not yet made available, but may affect expenditure that could be categorised as LRE |

## **APPENDIX 5**

### **Issues with drafting of special condition 3.3 and its interaction with other related licence conditions**

#### **1. Strategic Investment PCD**

##### **1.1. It is premature to assume that all Strategic Investment projects should be subject to evaluative PCDs**

We currently do not expect any DNO to be provided with a baseline allowance to deliver a load-related project that has been designated as a Strategic Investment project. Sub-paragraph 3.2.80(b), along with paragraph 1.11 of the Load Related Expenditure Re-opener Guidance, currently assume that any Strategic Investment projects that are funded via the Load Related Expenditure Re-opener will be subject to evaluative Price Control Deliverables. Special condition 3.3 makes provision for the assessment of delivery against those PCDs along with possible consequential allowance adjustments.

It is unlikely that the generic approach to assessing the delivery of evaluative PCDs would be appropriate for the assessment of Strategic Investment projects. In discussions with Ofgem it has been suggested that targeted delivery assessment mechanisms are likely to be required, possibly through the modification of the licence to introduce a mechanistic PCD. It is, therefore, inappropriate for the licence to presume that an evaluative PCD will automatically be created.

The introduction of any PCDs associated with Strategic Investment should be introduced via a modification made under section 11A (modifications of conditions of licences) of the Act (using the drafting approach used in paragraph 3.6.10 for the Net Zero Re-opener). Changes to the drafting of special condition 3.2, 3.3 and the Load Related Expenditure Re-opener Guidance will be required to achieve this.

Furthermore, the proposed definition of Strategic Investment is very broad. As drafted, it can even include LV projects that are being deployed in anticipation of longer-term need. We understand from Ofgem's load-related policy meetings that Ofgem's expectation is that there will be far fewer Strategic Investment projects than the defined term currently suggests. Consequently, this term needs to be updated to better reflect the assessment that Ofgem intends to apply when identifying Strategic Investment projects that may merit being subject to a PCD mechanism.

#### **2. Cyber OT and cyber IT PCDs**

We have identified a number of issues with the drafting of and interactions between the various licence conditions that enact the processes associated with cyber IT and cyber OT:

- Cyber Resilience OT Re-opener (SpC 3.2 Part G)
- Cyber Resilience IT Re-opener (SpC 3.2 Part H)
- Evaluative Price Control Deliverables (SpC 3.3)
- Price Control Deliverable reporting requirements (SpC 9.3)
- PCD Reporting Requirements and Methodology Document
- Price Control Financial Model

The DNOs have previously provided details of a number of issues with these conditions to Ofgem



and we were, therefore, expecting much greater change to these conditions and associated guidance relative to previous drafts shared with DNOs following various policy discussions.

We note that Ofgem's issues log refers to a number of changes having been made in response to the DNOs' note. However, some of these changes are not always apparent in the versions included in the consultation. These are noted in the following sections.

## **2.1. The proposed obligation in paragraph 3.3.10 to “take all reasonable steps to deliver the outputs specified” risks duplicating or even contradicting obligations elsewhere**

Paragraph 3.3.10 sets out that:

*“The licensee must take all reasonable steps to deliver the outputs specified in the Cyber Resilience OT PCD Table and the Cyber Resilience IT Table in accordance with and by the delivery dates specified in those tables.”*

The DNOs have previously highlighted that this is an unnecessary obligation that effectively duplicates a sub-set of obligations contained in the extensive secondary legislation and guidance. Indeed, there is also a chance that this paragraph could contradict the Network and Information Systems (NIS) Regulations 2018 (e.g. in the case of misalignment of timing between changes and re-opener decisions, or differences between specified PCDs and wider activities that DNOs must undertake to comply with the NIS Regulations 2018). This drafting also goes against Ofgem's licence drafting principle not to use “all reasonable endeavours”. Ofgem would have powers as the Competent Authority under the NIS Regulations to investigate and levy penalties beyond the removal of associated allowances, if appropriate.

Ofgem's issues log (row 28) sets out that Ofgem agrees with the DNOs' position and has made the wording changes requested by the DNOs, but this change is not apparent in the condition published in the consultation.

If the cyber PCDs are to remain part of a wider evaluative PCD condition and other mechanisms require the inclusion of Part B, we suggest that the following, alternative form of standard words proposed by Ofgem could be used:

*“The licensee is funded to deliver the outputs specified in the Cyber Resilience OT PCD Table and the Cyber Resilience IT PCD Table in accordance with and by the delivery dates specified in those tables.”*

However, if a separate cyber condition was to be developed, we do not believe that Part B would be necessary as the revised words do not perform any operative function.

## **2.2. Several aspects of the process for the assessment of PCD delivery are not appropriate for the assessment of cyber PCDs.**

The process for the assessment of evaluative PCDs that is set out in Part C of special condition 3.3 was developed as part of the RIIO-T2 and RIIO-GD2 price control reviews. It is a generic process. Some aspects of this generic process are not appropriate for the assessment of cyber PCDs. The generic drafting of key defined terms that this condition relies on (such as Consumer Outcome, Efficiency and Innovation) makes it difficult for DNOs to understand how cyber PCDs will be assessed or the likely impact on future allowance modifications. As cyber PCDs are likely to be

the only evaluative PCDs ascribed to DNOs at the start of RIIO-ED2, the fact that the generic wording of the condition is not appropriate to cyber activities is concerning.

The DNOs have previously provided Ofgem with details of our concerns. The most significant of our remaining concerns are set out below.

**2.2.1. The condition does not make it clear that Ofgem will assess PCD delivery based on evidence that was reasonably available at the time that the decisions were made**

Cyber security is a relatively fast-moving activity area. DNOs will need to make decisions about the most appropriate course of action based on the information that is available to them at the time. It is possible, once further information becomes available or technologies evolve, that alternative solutions may – with the benefit of hindsight – seem more beneficial. For example, DNOs may need to implement new solutions that make relatively recent (i.e. within RIIO-ED2) investments redundant.

It is important to maintain the principle that Ofgem should assess the efficiency/ effectiveness of the investment made based on the information that was reasonably available to the DNO at the time of making the relevant investment decision. For new PCDs this will presumably be assessed at the time of the re-opener but the principle should also be incorporated in the principles for assessment of Fully Delivered With An Alternative Specification and both Partially Delivered options.

This important principle was enshrined in the DPCR5 and RIIO-ED1 close out processes and should be continued for RIIO-ED2.

The DNOs have previously suggested drafting that would achieve this. We cannot see reference in the issues log that sets out Ofgem’s rationale for not including this extra drafting.

**2.2.2. The assessment process is likely to result in inappropriately intrusive ex-post efficiency assessment of any partially delivered outputs**

Cyber security is subject to multiple external requirements. These requirements change relatively frequently. The threats that cyber activities seek to address can also evolve rapidly, as does external best practice as to how best to address the threats. As a consequence, DNOs may be required to amend their cyber work programmes during RIIO-ED2. These programme changes may sometimes lead to DNOs deciding to only partially deliver previously agreed outputs and to focus on new outputs instead.

Ofgem has acknowledged the potential need to change cyber work programmes by introducing specific re-openers.

While a decision to cease the delivery of planned cyber outputs in such circumstances would be sensible as it would be inappropriate to incur unnecessary expenditure, DNOs are at risk of being penalised because such decisions would not meet the definition of Efficiency proposed in the licence. This is because many changes will arise due to “*factors beyond the reasonable control of the licensee*” and also result in “*lower Consumer Outcome than would have been achieved if the licensee had delivered the output as specified*” both of which are explicitly excluded from the definition of Efficiency.

In addition, it is possible that some outputs may be partially delivered as a result of innovative alternatives being deployed. However, it may often be the case that the reasons for ceasing an output may not meet the definition of Innovation as the application of technology, systems or processes may well have been proven (in other relevant contexts) as at the time of submission of the Business Plan.

This leaves DNOs with a risk that any cyber outputs that are ceased for good reason during the price control period would be subject to ex-post efficiency review. The DNOs have previously highlighted to Ofgem the difficulties of such an approach for cyber activities. We do not believe that historical benchmarking or bespoke engineering and cost assessments (as described in 3.3.13(e)) are likely to be appropriate or effective for assessing the efficiency of the expenditure associated with specialised, and generally mandated, cyber activities. The process is likely to result in Ofgem (and customers) incurring costs associated with conducting reviews that will not provide meaningful information about the efficiency or otherwise of expenditure.

The prospect of such a process might well incentivise a DNO to continue with the delivery of an output, even if it is no longer the best thing to do.

We urge Ofgem to reconsider the assessment and allowance adjustment process and the associated wording of the licence and to introduce a practical, workable approach to adjustment of allowances for cyber projects that are cancelled before the associated output is fully delivered.

### **2.2.3. Further examples should be included in the PCD Reporting Requirements and Methodology to aid understanding and interpretation**

We recommend that the following scenarios be included in further “*hypothetical examples*” in the Associated Document to aid understanding:

#### **The treatment of a Partially Delivered output where costs are “front end loaded”**

The DNOs have previously raised concerns with the fact that the formula for determining allowances for Partially Delivered PCDs incorrectly assumes that the output and Consumer Outcome delivery are likely to be proportional to expenditure incurred.

It will often be the case that cyber projects target specific cyber resilience outcomes rather than other wider components that appear in the definition of Consumer Outcome. If a cyber output is cancelled and can be demonstrated to be attributable to Innovation (for example because an alternative, innovative solution is to be deployed but where that new solution does not meet the specified output for the PCD set out in the Cyber Resilience IT (or OT) PCD Table), a more likely occurrence will be that the DNO has delivered lower output/ Consumer Outcome than originally planned, but that the costs associated with delivering that outcome would be higher than the strict pro-rate approach set out in 3.3.13(d).

Ofgem’s issues log (row 25) sets out that, in such a scenario, Ofgem would be able to fund the efficiently incurred costs via the processes in 3.3.13(a) (although we think Ofgem means 3.3.13(e)). We do not understand how Ofgem would be able to use this branch of 3.3.13 instead of 3.1.13(d). We also do not understand what approach the DNO should take to reporting the delivery status of a PCD in this situation. Paragraph 1.12 of PCD Reporting Requirements and Methodology Document does not permit the DNOs an option to indicate that assessment under

3.3.13(e) is appropriate. It would be helpful if Ofgem could include a “*hypothetical example*” in the Associated Document explaining this process.

#### The treatment of any PCDs that are delayed into RIIO-ED3

Cyber programmes have multiple external drivers, which can result in re-prioritisation of tasks in order to accommodate addressing new cyber risks or requirements. It is, therefore, possible that the delivery of a cyber OT or cyber IT PCD could be delayed into the RIIO-ED3 period.

It would be helpful if Ofgem could confirm that the re-profiling of any allowances associated with Delayed PCD delivery set out in 3.3.13(c) would extend to any PCD that is delayed into the RIIO-ED3 period. A “*hypothetical example*” to confirm this treatment would be helpful.

#### **2.3. It is unclear whether cyber OT is still subject to a potential additional Use It or Lose It (UIOLI) adjustment**

Special condition 3.3 does not include any UIOLI adjustment for cyber OT. We agree that the presence of the re-opener, PCD delivery mechanism and the PCD reporting provisions means that a UIOLI adjustment is not needed. However, we note from Ofgem’s issues log that a UIOLI mechanism is expected.

Any UIOLI adjustment needs to interact correctly with any allowance adjustment made under Assessment of the Evaluative Price Control Deliverables (currently Part C of SpC 3.3) to avoid any risk of double counting of adjustments.

Ofgem’s issues log (row 29) sets out that the following text has been included in special condition 3.3 Part D:

*Cyber resilience OT PCD assessment" will take place as part of close out of the price control. This is because of the two-stage assessment that is required. We will first consider whether any adjustment is required as a result of following the methodology for Evaluative PCDs in this document. We will then consider whether any Use It Or Lose It Adjustment is required. The Use It Or Lose It Adjustment will be determined by assessing the licensee's total efficient spend for qualifying cyber resilience OT activities against the total use-it-or-lose-it allowance for cyber resilience OT. We will make one adjustment, if required, to reflect both assessments*

However, this paragraph has not been included in the licence.

The proposed paragraph is not sufficiently precise to avoid the risk of any double count. For example, it is not clear how “*the licensee’s total efficient spend*” or “*total use-it-or-lose-it allowance*” will be determined. It also does not explain how adjustments would be made to the separate Cyber Resilience OT Baseline Allowances and Cyber Resilience OT Re-opener Allowances.

The DNOs have previously submitted text and associated algebra that could enact this adjustment if it is required.

#### **2.4. The interaction between the special conditions that regulate cyber allowance adjustments is difficult to understand and should be brought together into one combined licence condition**

The interaction between the three special conditions that regulate cyber allowance adjustments is difficult to understand.

We note Ofgem's question 12 in the consultation asking "*Should we maintain a combined Evaluative Price Control Deliverable condition in SpC 3.3 (Evaluative Price Control Deliverables) or split out the relevant Re-openers and Price Control Deliverables? What are your reasons and how do you think we should split out the conditions?*"

We also note Ofgem's statement at para 7.33 of the consultation stating that "*The methodology for assessing PCDs would then move to SpC 9.3*".

Fundamentally, we think that it is important to address the issues with the operation of the licence conditions in respect of cyber OT and cyber IT as outlined earlier in this response. Once those issues have been resolved, we would also support the creation of a single condition that covers all aspects of the regulation of cyber OT and cyber IT allowance adjustments. However, this objective is secondary to ensuring that the various components operate correctly.

We disagree with Ofgem's proposal that the methodology for assessing PCDs would then move to special condition 9.3 as this would not address the issue that Ofgem's standard approach to evaluative PCD assessment is not appropriate for the assessment of cyber PCDs.

Our reasons for supporting the creation of a single condition are:

- It is currently difficult to understand the interactions between the various conditions. It is important that all aspects that may influence the basis of totex allowance adjustments related to cyber interact with each other properly and can be clearly understood. The creation of a separate condition combining all the relevant elements would better facilitate this.
- The specialist nature of cyber outputs, combined with the fact that much of the detail associated with these projects is confidential in nature, means that some of the standard approach to the assessment of evaluative PCDs is not appropriate to the assessment of cyber projects. Bringing all aspects into one condition would also allow aspects of the assessment of PCD delivery evaluation to be better tailored to cyber projects.

We propose that the following conditions/ Parts of conditions be combined into one condition:

- Uncertain costs re-opener (SpC 3.2)
  - Introduction
  - Part A – relevant terms, with wording evolved to recognise that these values will not be placed in the public domain
  - Part G – Cyber Resilience OT Re-opener
  - Part H – Cyber Resilience IT Re-opener
- Evaluative Price Control Deliverables (SpC 3.3)
  - Part A – Relevant paragraphs
  - Part C – tailored for the assessment of cyber outputs, including tailoring of defined terms to better reflect cyber activities
  - Part D – Relevant paragraphs
- Use It or Lose it adjustment basis for cyber OT (if required)
- Price Control Deliverable reporting requirements (SpC 9.3) – Part B and appendix 1

- Text to create a separate guidance document covering cyber OT and cyber IT activities – bringing together the re-opener guidance that is currently set out in Re-opener Guidance and Application Requirements Document with PCD reporting and assessment requirements that are currently set out in PCD Reporting Requirements and Methodology Document.

## **2.5. Process for variant baselines for cyber in the PCFM is unclear.**

The treatment of allowances associated with cyber OT and cyber IT in the PCFM seems to create variant baseline allowances. This is quite different to the more familiar approach of creating fixed baseline allowances and/or separate variable values, and is not consistent with how the draft PCFM operates.

It would be helpful if Ofgem could explain how it envisages these allowances operating in the PCFM, and also provide guidance to DNOs on how it expects DNOs to adjust these values when setting network charges. This will help us to check whether the allowance adjustments envisaged in these conditions are being specified in a manner that is consistent with the intended operation of the PCFM.



## **APPENDIX 6**

| <b>Issue Logs</b>   | <b>RETURN STATUS</b>               |
|---|------------------------------------|
| SLC 3A Housekeeping.xlsx  | Returned with comments.            |
| SLC10AA Treating Domestic Customers Fairly.xlsx                               | Returned with comments.            |
| SLC11 Reporting on performance issues log.xlsx                                | No return. No additional comments. |
| SLC15A DG standards direction issues log.xlsx                                 | No return. No additional comments. |
| SLC25 Long Term Development Statement.xlsx                                    | Returned with comments.            |
| SLC26 Disposal of relevant assets.xlsx  | No return. No additional comments. |
| SLC48 The Innovation Strategy issues log.xlsx                                 | No return. No additional comments. |
| SLC48A Electricity Network Innovation Strategy issues log.xlsx                | Returned with comments.            |
| SLC5 Payments to the Authority .xlsx  | No return. No additional comments. |
| SLC50 Business Plan Commitment Reporting & Guidance issues log.xlsx           | No return. No additional comments. |
| SLC8 Safety and Security of Supplies Enquiry Service.xlsx                     | No return. No additional comments. |
| SpC 1.1-1.3 Interpretation, definitions and common procedure.xlsx             | Returned with comments.            |
| SpC 2.1 Bad Debt, SpC 6.1 pass-through, SLC 38B and SLC 38C issues log.xlsx   | Returned with comments.            |
| SpC 2.1 Restriction of allowed revenue.xlsx                                   | Returned with comments.            |
| SpC 2.2 Tax Allowance adjustment.xlsx   | Returned with comments.            |
| SpC 2.3 Return Adjustment.xlsx  | Returned with comments.            |
| SpC 3.1 and SpC 9.2 NARM .xlsx  | Returned with comments.            |
| SpC 3.10 Severe Weather 1-20 Events.xlsx                                      | No return. No additional comments. |
| SpC 3.11 Net to gross adjustment for load related expenditure.xlsx            | Returned with comments.            |
| SpC 3.12 Smart Street PCD issues log.xlsx                                     | No return. No additional comments. |
| SpC 3.2 Cyber Resilience OT and IT Issue Log.xlsx                             | Returned with comments.            |
| SpC 3.2 Part B Physical Security Reopener.xlsx                                | No return. No additional comments. |
| SpC 3.2 Part C Rail Electrification Re-opener.xlsx                            | No return. No additional comments. |
| SpC 3.2 Part D Electricity System Restoration re-opener.xlsx                  | Returned with comments.            |
| SpC 3.2 Part E Environmental re-opener.xlsx                                   | Returned with comments.            |
| SpC 3.2 Part F Specified Street Works Costs Re-opener.xlsx                    | Returned with comments.            |
| SpC 3.2 Part I Digitalisation re-opener_issues_log.xlsx                       | No return. No additional comments. |
| SpC 3.2 Part J Storm Arwen Re-opener.xlsx                                     | No return. No additional comments. |
| SpC 3.2 Part K LRE Re-opener and 3.3 Strategic Investment PCD issues log.xlsx | Returned with comments.            |
| SPC 3.2 Part L HVP - issue log.xlsx   | No return. No additional comments. |

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| SpC 3.2 Part N West Coast of Cumbria re-opener.xlsx                  | No return. No additional comments. |
| SpC 3.2 Part O Hebrides & Orkney re-opener (SSEN).xlsx               | No return. No additional comments. |
| SpC 3.2 Part P Shetland Enduring Solution issues log.xlsx            | No return. No additional comments. |
| SpC 3.2 Uncertain costs re-opener.xlsx                               | Returned with comments.            |
| SpC 3.3-9.3 PCDs IssuesLog.xlsx                                      | Returned with comments.            |
| SpC 3.4 EV Optioneering UIOLI (SPEN) - issue log.xlsx                | No return. No additional comments. |
| SpC 3.4 Visual Amenity.xlsx  | Returned with comments.            |
| SpC 3.4 Worst Served Customers UIOLI.xlsx                            | No return. No additional comments. |
| SpC 3.5 PCB volume driver.xlsx                                       | Returned with comments.            |
| SpC 3.6 NetZero Re-opener IssuesLog.xlsx                             | Returned with comments.            |
| SpC 3.7 Coordinated Adjustment Mechanism issues log.xlsx             | No return. No additional comments. |
| SpC 3.8 Carry over Green Recovery Scheme.xlsx                        | Returned with comments.            |
| SpC 3.9 LRE Volume Drivers.xlsx                                      | No return. No additional comments. |
| SpC 4.10 Collaborative streetworks ODI (UKPN) - issue log.xlsx       | No return. No additional comments. |
| SpC 4.2 Time To Connect issues log .xlsx                             | Returned with comments.            |
| SpC 4.3 Broad Measure of Customer Service (BMCS).xlsx                | Returned with comments.            |
| SpC 4.4 IIS ODI.xlsx   | Returned with comments.            |
| SpC 4.5 Major Connections Incentive Issues Log.xlsx                  | Returned with comments.            |
| SpC 4.6 Vulnerability Incentive issues log.xlsx                      | Returned with comments.            |
| SpC 4.7 CVP issues log .xlsx   | Returned with comments.            |
| SpC 4.8 DSO incentive issues log.xlsx                                | Returned with comments.            |
| SpC 4.9 Dig, Fix and Go Issues Log.xlsx                              | Returned with comments.            |
| SpC 5.2 RIIO2 Network Innovation Allowance issues log.xlsx           | Returned with comments.            |
| SpC 5.3 CNIA issues log - master.xlsx                                | No return. No additional comments. |
| SpC 5.4 revenue adjustments for performance failures issues log.xlsx | No return. No additional comments. |
| SpC 7.1-7.7 Legacy Adjustments.xlsx                                  | Returned with comments.            |
| SpC 7.8 Low Carbon Network Fund close-out.xlsx                       | Returned with comments.            |
| SpC 7.9 RIIO1 Network Innovation Competition issues log.xlsx         | Returned with comments.            |
| SpC 8.1 Governance of PCFIs.xlsx                                     | Returned with comments.            |
| SpC 9.1 Annual Environmental Reporting.xlsx                          | Returned with comments.            |
| SpC 9.10 margin on connection activities issues log.xlsx             | No return. No additional comments. |
| SpC 9.13 Assistance for high-cost distribution areas.xlsx            | No return. No additional comments. |

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| SpC 9.4 Reopener guidance issues log.xlsx                                     | Returned with comments.                                    |
| SpC 9.5 Digitalisation IssuesLog.xlsx   | Returned with comments.                                    |
| SpC 9.6 Disapplication.xlsx   | No return. No additional comments.                         |
| SpC 9.7 Directly Remunerated Services.xlsx                                    | Returned with comments.                                    |
| SpC 9.8 Tax Reconciliation assurance statement.xlsx                           | Returned with comments.                                    |
| SpC 9.9 Strategic Innovation Fund issues log.xlsx                             | No return. No additional comments.                         |
|   |  |
| Load conditions issues  | Comments returned in dedicated Load conditions issues log. |
|   |  |
| Comments collated in 'Other conditions Issue log':                            |  |
| SpC 3.2 Part M Wayleaves & Diversions   | Comments returned in dedicated tab.                        |
| SpC 3.2 General   | Comments returned in dedicated tab.                        |
| SpC 3.13 Off-gas grid Mechanistic Price Control Deliverable (OGGt)- UKPN only | Comments returned in dedicated tab.                        |
| SpC 4.1 Total output delivery incentive performance                           | Comments returned in dedicated tab.                        |
| SpC 9.2 NARM methodology  | Comments returned in dedicated tab.                        |
| Term consistency  | Comments returned in dedicated tab.                        |
| SLC 1 Definitions for the standard conditions                                 | Comments returned in dedicated tab.                        |
| SLC 2 Interpretation of this licence  | Comments returned in dedicated tab.                        |
| SLC General   | Comments returned in dedicated tab.                        |
| Guidance documents  | Comments returned in dedicated tab.                        |
| PCFH  | Comments returned in dedicated tab.                        |
| PCFH Guidance   | Comments returned in dedicated tab.                        |