



# RIIO-ED2

Response to RIIO-ED2 Informal Licence Consultation Questions

27<sup>th</sup> October 2022



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## Approach to licence drafting questions

### Q1. Do you have any views on the RIIO-ED2 licence drafting principles, set out in Appendix 1?

We have the following comments in relation to Ofgem's principles for licence drafting.

#### Best vs. Reasonable Endeavours

We note Ofgem's reference to conditions which may involve qualified obligations that rely on "endeavours". In particular, we note that Ofgem will decide whether to adopt a "best endeavours" or a "reasonable endeavours" standard on a case-by-case basis.

SPEN has engaged with Ofgem extensively, at a working group and management level during the development of the RIIO-ED2 price control, as to our (and other DNOs') position on the implications of adopting a "best endeavours" obligation as opposed to a "reasonable endeavours" obligation. Indeed, following a request from Ofgem during the LDWG on 23<sup>rd</sup> February 2022, DNOs collectively submitted a note to Ofgem on this topic on 30<sup>th</sup> March 2022. We therefore remain disappointed that Ofgem has not properly addressed our concerns, despite asking for us to set these out and we reiterate these key concerns within our response to Consultation question 10.

As regards the drafting principles, these do not set out the approach Ofgem would take when deciding to adopt a "best endeavours" standard, and we are not aware of Ofgem having published such an over-arching approach. While we are aware of Ofgem's stated reasoning for adopting a "best endeavours" standard in certain conditions (see Draft Determination Finance Annex, 10.127 – 10.131), we believe it is essential that Ofgem publishes an over-arching approach to this issue, setting out under what circumstances it would adopt one approach over the other. Such reasoning must also consider the cost implications to licensees for adopting a "best endeavours" standard as opposed to a "reasonable endeavours" standard. This will help to provide much needed clarity to licensees.

#### Additional Principle – Understanding the Licence Conditions

We think that an additional principle should be included with the list of principle in Appendix 1 of the Licence Consultation.

Namely, Ofgem should introduce a principle, stating clearly that all licence conditions should be understandable *simply by reference to the condition itself*. In essence, the reader should be able to gain a clear understanding as to the operation of a licence condition without the need to refer to other documents, such as Associated Documents. Such documents should provide *additional* specification on the meaning of obligations within the licence itself and should enhance or assist in the interpretation or 'operation' of the licence drafting

Given Ofgem's increasing use of Associated Documents in the RIIO-2 licences, together with extensive use of 'direction-making' powers within the licence, we consider that such a principle is essential. Moreover, we are concerned that certain conditions, such as those relating to the new Output Delivery Incentives, contain significant details located outside of the licence that mean that comprehension 'on the face of the licence' is difficult if not impossible without reference to the corresponding Associated Document.

Such a principle would complement the relevant Associated Document principle that Ofgem has already proposed at A2.1.

**Q2. Do you have any views on the definitions and the defined terms set out in Annex 3?**

We have included all specific views within the issues logs of the Licence Condition in which the terms are referenced. However, we would like to highlight our fundamental concern with the 'Digitalisation' definition in particular.

The proposed definition is 'using Energy System Data and digital technologies to generate benefits for consumers and stakeholders'. This is a different definition to that contained within Ofgem's Digitalisation Strategy and Action Plan (DSAP) Guidance which defines it as 'the use of digital technologies to change an organisation's operating model and provide new revenue or equivalent value-creating opportunities'.

Such a differences in definition mean that activities which may be captured under one definition, may not be captured under the other. This means that under SpC 9.5, there is a risk that the range of activities within scope of our Digitalisation Action Plan differs from those that sit within the scope of our requirement to comply with the DSAP Guidance (under the same condition).

In addition, the Digitalisation elements of our RIIO-ED2 Final Business Plan submission have been drafted with our understanding of the need to comply with DSAP and the definitions therein, a new definition for RIIO-ED2 is a fundamental change of scope.

Finally, in RIIO-T2, the Transmission Licence has no separate definition of 'Digitalisation', but it has the same obligation as RIIO-ED2 to comply with the DSAP Guidance which does contain a definition. To avoid confusion, and unintended consequences, we believe that RIIO-ED2 should mirror the RIIO-T2 approach.

## Consultation questions

**Q3. What are your views on the proposed changes to the structure of the SpCs?**

We agree that the general structure of the new SpCs are easier to follow, and that alignment with the Transmission licence is logical. We would, however, suggest that the conditions under Chapter 9 are somewhat eclectic in nature and it would be useful for those navigating Standard and Special conditions if Ofgem could clearly explain why those conditions in Chapter 9 appear in that chapter and not elsewhere in either Licence.

## Associated Documents questions

**Q4. Do you agree with our principles for Associated Documents?**

We have the following comments in relation to Ofgem's proposed principles for Associated Documents.

**Timing of publication**

We agree with the principle that Associated Documents should be published "*in a timely fashion bearing in mind the specifics of the Associated Document and the obligations in question.*" It is vitally important that Ofgem acts consistent with this principle. We have concerns around the status of numerous Associated Documents at this stage of the ED2 process. For instance, many Associated

Documents contain very limited detail and a large number of ‘holding spaces’ (such as the Major Connections Guidance). Others contain little substance, and offer limited assistance to licensees in organising their compliance activities— such guidance is of critical importance for new, highly onerous licence obligations – in particular Standard Condition 10AA (Treating Domestic Customers Fairly).

### Other points

We agree that the licence condition relating to an Associated Document should set out clearly what the Associated Document will encompass. We think that this should be made clearer, in that the condition must do this in a reasonable level of detail. As it stands, some conditions contain very high-level descriptions of what the relevant Associated Document may encompass for instance, Standard Condition 10AA (Treating Domestic Customers Fairly).

The principles should be expanded so as to make clear what Associated Documents should not contain, and by consequence, what should be contained within the licence itself. For instance, our view is that Associated Documents should not contain key conditions, values or obligations which have material financial or operational consequences to the licensee. These elements must be included in the licence itself, and Associated Documents should instead provide *additional* specification on the meaning of obligations within the licence.

### **Q5. Do you have any views on our proposed list of Associated Documents and the timetable for consulting on and implementing them?**

We are concerned that many of the Associated Documents have significant gaps in them which makes it difficult for us to fully understand the proposed expectations and requirements on us. This increases our compliance risk, especially as Ofgem has taken the approach of including less detail in the licence and instead referencing the requirement to comply with the Associated Documents.

Although Ofgem has said it aims to share a draft of all Associated Documents before it is ‘required by the licence’, we do not feel that this commitment is strong enough as the licence only requires a 28 day period of representation and then a 56 day standstill period before it can be brought into force. The growing number of these documents and the level of detail they need to include, means that for these documents to be properly understood and tested, they should have been completed and issued for review in *advance* of the informal licence consultation to allow proper review alongside the licence.

Our detailed comments on the content of the specific documents have been included in the individual issues logs.

## Finance related questions

### **Q6. Are there any areas where the licence drafting has not correctly implemented the proposals set out in paragraph 4.1? If so please describe.**

On review of the relevant licence conditions, it would seem that the policies that are listed by Ofgem have been implemented into the current drafting of the licence, though it has been difficult to fully assess this without a working compatible PCFM. A compatible PCFM and completed associated guidance document will be essential to ensure that the policy intent has been fully reflected. Until this is the case, we cannot confirm that the policies have been fully reflected in their entirety.

We believe further policy engagement is still required in relation to some of the areas listed below before the licences are issued for statutory consultation.

In relation to Time Value of Money (TVM), as set out in our response to the Draft Determination, we see no reason to change the established framework where separate TVM mechanisms are used depending on the type of true-up, which is equitable and consistent with investor expectations as well as the current approach adopted across Gas Distribution, Transmission & Electricity Transmission. At RIIO- T2, we previously commissioned First Economics to produce a report on the subject which has been passed to Ofgem's RIIO-ED2 team and is summarised below.

In principle, under and over recoveries against the revenue cap should roll forward at a base rate plus margin interest rate as they do in RIIO-ED1. This reflects the short-term nature and scale of these types of adjustments due to the nature of the true up required. However, prior year adjustments relating to expenditure items should roll forward at the allowed cost of capital. This is because, when a company is not permitted to recover revenues in relations to these costs, be that due to a timing difference, or a reopener, investors must step in to finance the mismatch between costs and revenues. This is also true for the opposite scenario where financing requirements may not be required and scaled back due to lower investment requirements in which case any over-recoveries should rightly be returned to the consumer. Therefore, we believe the existing approach is equitable and regulated companies' capital requirements should be treated in a homogeneous way, with adjustments for an advance / delayed return in line with the underlying applicable cost of capital for the regulated business.

We also disagree with the need to provide a PCFM to Ofgem 14 days prior to the formal deadline for tariff setting as it will in effect pull forward the price setting timeline by 2 weeks. This could result in the DNOs not being able to reflect any changes that may arise prior to the publication of tariffs at the end of December, for example in relation to any SoLR claim that is received as per the timeline set out in the licence.

We look forward to working with Ofgem on these issues following publication of the Final Determinations.

**Q7. Are there other terms or definitions that would be valuable to standardise with other sectors?**

We are in agreement with the principal that where possible terms and definitions should be aligned across the electricity and gas distribution and transmission licences. This makes it easier for stakeholders to interpret and compare performance and values across sectors. Therefore, the changes particularly to SpC 2.1 are welcome. However there are elements where ED currently diverges from the rest of the sectors where we believe alignment is essential such as the approach to Time value of Money adjustments and the terms used for revenues true up such as super K term (See answer to Q10 below).

## Licence Chapter 1 Questions

**Q8. What are your views on the proposed changes to the SpCs outlined in this chapter?**

We have no particular comments on this, however, have addressed points relating to specific definitions in our responses to the questions / issues logs for each condition.



**Q9. Do you think any other common procedure should be added to Spc 1.3 (Common procedure)?**

We have no particular views on whether any additional common procedure should be added to this condition.

## Licence Chapter 2 Questions

**Q10. What are your views on the proposed changes to the SpCs outlined in this chapter?**

We have reviewed the proposed changes in relation to the Revenue Restriction conditions and have summarised our main issues below.

Best Versus Reasonable Endeavours

As stated in our note to Ofgem in March 2022, we do not believe that the obligation on DNOs regarding setting network charges should be changed from reasonable to best endeavours. We believe that this change would oblige DNOs to undertake actions that would be disproportionate and that may cut across other legitimate policy objectives. An unqualified best endeavours standard will cause additional costs (compared to reasonable endeavours), which will ultimately fall on electricity consumers.

For example, as part of the process of setting network charges DNOs will be required to forecast key economic factors that affect the calculation of Allowed Revenue. The best endeavours obligation may oblige all DNOs to incur additional costs in developing, refining and updating forecast methodologies. These costs may have little or no real benefit to energy consumers, because the marginal gain from DNO accuracy of forecasting these values is likely to be small in the context of the uncertainty that applies to them and other inputs to energy bills.

Monthly Inflation calculation

Ofgem have proposed a monthly/hybrid inflation methodology which we understand is the approach adopted in RIIO-T2 due to the specific SHETL requirement for a detailed monthly figure. However, we believe this requirement is not required for RIIO-ED2 and, in any case, the approach is inaccurate in the short term and introduces unnecessary volatility.

We believe that a yearly inflation approach should be adopted given all our revenues are calculated on a yearly basis, with additional RPI-CPIH inflation differential, as this would be more accurate and much simpler. The benefit of this approach is that it would remove the current year forecast issue where the mixing of actuals and forecast derives an incorrect annual value and would easily align with the values published by OBR/HM Treasury. Furthermore, the separate differential would be an observable value which aids transparency allowing stakeholders to understand the impact of this differential and makes clear that this gives the full year-end benefit of RPI in RIIO-ED1.

ADJ & K term (Super K Term)

SPEN believe separate true-up terms should continue in relation to both Allowed Revenue (i.e. MoD) and Recovered Revenue (i.e. K term) which would align the RIIO-2 arrangements across the sectors. To achieve this, no additional inputs are required as all the requisite elements are captured. We see no benefit of combining these into a single term which will result in a loss of transparency for stakeholders in relation to performance true ups.

### Time Value of Money

We see no reason to change the established RIIO-ED1 framework where separate TVM mechanisms are used depending on the type of true-up, which is equitable and consistent with investor expectations as well as the current approach adopted across Gas Distribution, Transmission & Electricity Transmission.

### Forecasting Penalty

We believe DNOs should not be exposed to risk or penalties for movements in elements of revenues that are out with their reasonable control. The current drafting of the forecasting penalty would expose DNOs to movements in passthrough elements which are also known as “non-controllable Opex”, this also includes SoLR payments where it is not appropriate that DNOs should face any penalty relating to these payments. We therefore recommend this element is removed from the definition of base revenue in relation to the forecasting penalty to avoid penalising companies for an element of cost/revenue which they cannot control.

Furthermore, it is important that Ofgem builds a mechanism to allow licensees to record instances where any forecasting error is outside their reasonable control, and such errors should be removed from the penalty calculation. Ofgem should clearly set out the process for this to happen so DNOs are assured they will not be unfairly penalised under this mechanism.

### Right to amend tariffs - SoLR and Materiality Thresholds

The current drafting of the SoLR condition removes the materiality threshold and removes the explicit right for DNOs to seek a derogation to subsequently amend tariffs following a SoLR claim, which protects DNOs from significant cashflow risk. Ofgem has noted in licence drafting working groups that DNOs have the right to request a derogation to amend tariffs in general covering the whole price control, rather than specific to SoLR, which Ofgem may or may not grant. However, Ofgem has not provided any guidance or guarantee to that effect. We therefore believe that Ofgem needs to clearly set out details on the process by which a derogation would be granted, such as the level of evidence required to allow DNOs to confidently request a derogation where it could be reasonably assumed to be granted, this should include any level of materiality which Ofgem will take into account in assessing the derogation request, (which should be no more than the level of common materiality set for re-opener submissions).

We further believe that derogations to amend tariffs in relation to SLC38B SoLR costs should be treated in isolation, and assessed as such, and not grouped together with derogation requests from other areas of the licence (there was some discussion around this suggestion at working groups).

In summary, the right for DNOs to amend tariffs after receipt of SoLR claims needs to be prescribed in the licence. Setting out this process clearly will reduce DNOs risk exposure, and without this clarity DNOs are unfairly left with potentially exorbitant cashflow risks at a time of increasing risk likelihood during the current energy crisis.

### Tax Allowance Adjustment

We believe that more work is required on the end-to-end "Tax Reconciliation" process i.e. "Linkages between Special Condition 2.2, Special Condition 9.8, PCFH Chapter 6, the Tax Reconciliation template, PCFM Guidance and the RFPR guidance to ensure that the various documents reflect the intended policy. The main issues identified to date have been shared with Ofgem via the ENA note shared on 25th April 2022. Although some of the identified issues have been negated, we believe that until DNOs



can review all elements of the relevant documents we cannot provide our final views on the suitability of the current drafting.

Further details are set out in the attached issues log for the chapter 2 conditions.

## Licence Chapter 3 Questions

### **Q11. What are your views on the proposed changes to the SpCs outlined in this chapter?**

As Ofgem has chosen to reduce ex ante allowances and increase the scale and scope of uncertainty mechanisms in RIIO-ED2, it is essential that these mechanisms work smoothly and in an agile way or they risk becoming a blocker to Net Zero delivery and network activities.

We have extensive comments on the drafting in chapter 3 and have grouped these into separate Appendices: 'Appendix 1a Load', 'Appendix 3 Re-openers' and 'Appendix 5 SpC 3.3 and related issues'.

### **Q12. 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?**

Currently, for SPEN, we will only have Evaluative PCDs relating to cyber. The interaction between the special conditions that regulate cyber allowance adjustments is difficult to understand, so we believe that these should be brought together into one combined licence condition. However, fundamentally, we think that it is important to firstly address the issues with the operation of the licence conditions in respect of cyber OT and cyber IT as outlined in our Appendix 5.

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

- 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 continuing 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
  - 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

However, we disagree with Ofgem’s proposal that the methodology for assessing PCDs would then move to SpC 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 (as we have outlined in Appendix 5).

## Licence Chapter 4 Questions

### Q13. What are your views on the proposed changes to the SpCs outlined in this chapter?

Our detailed views on this chapter have been included in the separate issues logs, but we would like to highlight the following:

- **Numerical values:** Most of the numerical tables within the chapter are blank because the figures cannot be finalised until the Final Determination (FD). As the timescales for reviewing these figures will be linked to the statutory consultation review period, it is important that DNOs are clear on both the calculations and input parameters used by Ofgem to derive the figures. During a meeting with DNOs, we asked Ofgem to provide a document explaining the calculations and parameters; Ofgem agreed to this request and we would urge Ofgem to publish this alongside FD
- **SpC 4.5 Major Connections:** Despite discussing this point many times in the Working Group, we remain concerned that including third parties within a survey which is used in a mechanistic penalty setting regime will give them undue influence over penalty levels and distort competition in the market. This risk exists regardless of whether they are completing the survey in relation to a service provided in a segment with or without competition. This is because these third parties operate across multiple segments and geographies, so will have the ability to score in a certain way in order to meet their overall business objective. Although the Guidance document has a header to suggest there will be an appeals process, there is not yet any detail on this and this is not included within the penalty setting process in the licence. We firmly believe that, if third parties remain within the scope of this incentive then the licence should indicate that they have to evidence any score which would trigger a penalty, and if they do not then Ofgem will exclude them from the process.
- **SpC 4.6 Vulnerability:** There should be separate PSR reach targets for the mid-point and end of RIIO-ED2. The current drafting only sets one target and this has been based on end of plan targets submitted as part of DNO Final Business Plans. This has been raised in Working Groups but has not been rectified in the licence drafting.
- **SpC 4.8 DSO:** The development of the DSO ODI is the furthest behind of all of the new ODIs, both in terms of policy finalisation and licence drafting. Despite requests by DNOs to simplify this ODI, there are more layers of assessment than other incentives like BMCS where the reward/penalty associated is double the size. Ofgem’s determination to mirror the ESO incentive as far as possible will result in significant resource burden for all DNOs and also for

Ofgem. We have doubts as to whether details like the metric targets, benefits calculations, survey mechanics and Panel selection will all be ready in time for 1<sup>st</sup> April 2023. We therefore believe that Ofgem should make provision in the licence to switch off this condition for 2023 if that happens.

## Licence Chapter 5 Questions

### **Q14. What are your views on the proposed changes to the SpCs outlined in this chapter?**

On review of the changes to the Chapter 5 conditions we have not identified any major issues with the current drafting. Further review may be required following publication of the Final Determinations to ensure that final policy is reflected within the relevant conditions.

## Licence Chapter 6 Questions

### **Q15. What are your views on the proposed changes to the SpCs outlined in this chapter?**

On review of the changes to the Chapter 6 conditions we have not identified any major issues with the current drafting. Further review may be required following the publication of the Final Determinations to ensure that final policy is reflected within the relevant conditions. This will be key to ensure that all intended elements of passthrough expenditure are captured within this condition.

## Licence Chapter 7 Questions

### **Q16. What are your views on the proposed changes to the SpCs outlined in this chapter?**

Following review of the changes to the drafting of the Chapter 7 special conditions, we note that they do not accommodate a balanced or appropriate implementation for recovering allowed revenues from the end of the RIIO-ED1 price control. The changes present a risk of potential unnecessary volatility in the DNOs' tariff setting over the first half of the RIIO-ED2 period.

The current drafting in the Legacy MOD term condition (special condition 7.2) does not accommodate the implementation for the future closeout adjustment mechanism of the RIIO-ED1 price control. This contrasts with the modification proposals for the Legacy MOD term within the RIIO-GD2/T2 licences as set out within the *"Statutory Consultation to modify the RIIO 2 Price Control Financial Instruments and Licence conditions to implement the closeout of RIIO 1"*.

Furthermore, several of the legacy adjustment special conditions apply an inadequate inflationary adjustment for the revenue true-ups for specific lagged RIIO-ED1 mechanisms (i.e. LMOD, LTRU, LIP and LPT terms). The correct inflationary adjustment applied in these conditions should be implemented in accordance with that stated in the RIIO-ED1 licence.

## Licence Chapter 8 Questions

**Q17. What are your views on the proposed changes to the SpCs outlined in this chapter?**

In relation to special condition 8.1, we are in agreement with Ofgem on the proposals to move to “self-publication of Allowed Revenue” as opposed to the current direction approach in R10-ED1.

However, as set out in our response to Question 6, we disagree with the need to provide a PCFM to Ofgem 14 days prior to the formal deadline for tariff setting as it will in effect pull forward the price setting timeline by 2 weeks.

Furthermore, we believe that more work is required on the whole “Price Control Financial Instruments” linkages i.e. (Special Conditions, Price Control Financial Handbook, Regulatory Financial Reporting Guidance, Price Control Financial Model & Associated Guidance) to ensure that the various documents reflect all intended policy. We continue to work with Ofgem via the dedicated workstreams but believe that until DNOs can review all elements of the relevant documents we cannot provide our final views on suitability of the current drafting.

## Licence Chapter 9 Questions

**Q18. What are your views on the proposed changes to the SpCs outlined in this chapter?**

We have made a small number of comments on these conditions within the individual issues logs.