

Appendix 5 – Issues with drafting of special condition 3.3 and its interaction with other related licence conditions

1. Strategic Investment PCDs

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 implemented via a modification made under section 11A (modifications of conditions of licences) of the Electricity Act 1989 (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).

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 (paper submitted in June 2022). 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 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 the need to address 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 R110-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.