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Networks
Ofgem

By email:
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Date:
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Contact / Extension
Stephanie Anderson
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Dear Joanna,

RIIO-ED2 Informal Licence Drafting Consultation

This response is from SP Energy Networks (SPEN). SPEN owns and operates the electricity distribution networks in the Central Belt and South of Scotland (SP Distribution plc) which serves two million customers, and North Wales, Merseyside, Cheshire and North Shropshire (SP Manweb plc) which serves one and a half million customers. We welcome the opportunity to respond to the RIIO-ED2 Informal Licence Drafting Consultation (the Licence Consultation) which follows our active participation in Ofgem RIIO-ED2 workshops, Licence Drafting Working Groups (LDWGs) and bilateral discussions.

We recognise the improvements Ofgem have made to the licence drafting process and appreciate Ofgem taking into account some of the feedback we gave after the RIIO-T2 licence drafting process. We have seen improvements in the overall logistics of the LDWG, and the restructured Licence is a positive step, making it more intuitive and easier to follow. However, we have identified a range of drafting concerns in relation to the draft RIIO-ED2 Licence and the Associated Documents, as well as some issues with the process. These are set out further below and our detailed views can be found in our separate issues logs, responses to Ofgem's consultation questions and supporting appendices. In summary, our main areas of concern can be grouped as follows:

- The various Load Related Expenditure conditions and Associated Documents
- The Treating Domestic Customers Fairly condition and Associated Guidance
- The Re-opener conditions
- Unfinished policy development and therefore incomplete Licence drafting
- Finance related issues
- Process issues

We would urge Ofgem to urgently arrange a sufficient number of further LDWGs and policy-specific workshops, in the areas where we and other Distribution Network Owners (DNOs) have raised concerns. It is important that the issues identified are worked through effectively and are satisfactorily resolved to ensure that the final RIIO-ED2 licence achieves its intended effect.

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Load related expenditure 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 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 are at risk of failing to achieve this effect. In contrast, scope and boundary issues mean that 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 acceptable conditions in this area. We have proposed the main changes that are required to achieve this and attach c.30 pages of detailed suggestions that we have developed with the other DNOs (Appendix 1a and 1b).

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. We believe that it is now very likely that all DNOs will need to trigger both the Load Related Expenditure (LRE) Re-opener and the net to gross adjustment for Load Related Expenditure, and it is also possible that we will require the volume driver cap to be increased mid-period to reflect wider behavioural change resulting from the outcome of the Access Significant Code Review (SCR). Having only one LRE Re-opener window impacts the agility of price control and our ability to manage the increased uncertainty created by the Access SCR. In addition, there is very limited guidance on how the LRE Re-opener will manage connection projects triggering reinforcement that is subject to apportionment, but this component of uncertainty represents approximately two thirds of the increased allowances in the Access SCR ‘High scenario’ for DNOs. Ofgem therefore needs to set out much greater clarity on how these costs will flow through the re-opener.

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. 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.

In terms of the looped services volume driver, the unit costs set will be critical to ensuring that the volume driver can accurately reflect the work undertaken on the network and can provide an effective, automatic uncertainty control. We have engaged extensively on this issue with Ofgem through our Draft Determination response, Ofgem’s SQ process, and detailed bilateral discussions with Ofgem’s Engineering Hub.

We set out our detailed issues with the load related expenditure Licence conditions in Appendices 1a and 1b of this submission.

Treating Domestic Customers Fairly licence condition

We fully support the intent of SLC10AA, which is to ensure domestic customers are treated fairly - treating domestic customers fairly is a principle which SPEN wholeheartedly supports and adheres to

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without a licence condition. We have discussed this condition at length with Ofgem many times at policy and licence drafting work groups between March and September 2022 and agree with the policy intent explained by Ofgem during these meetings, including the examples of specific scenarios which Ofgem have said would not result in enforcement action.

However, we remain concerned that the current drafting of the licence condition and the draft Fair Treatment Guidance does not fully align the licence 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 (eg provision of estimated restoration times) breaching “the letter” of those obligations. As such, 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 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 changes discussed at that meeting to appear in the further version of SLC10AA to be included in the Informal Consultation for stakeholder consideration but this was not the case, and the issues log does not explain why these changes have not been made.

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 this letter but summarise these in Appendix 2. We would emphasise, however, that we believe those drafting changes to be necessary and that it is essential that Ofgem considers the DNOs’ detailed proposals made in the two submissions and at the LDWG.

Re-opener process and scope

Aspects of the re-opener drafting are not consistent with the legal requirements of the Electricity Act 1989 (EA89)

In the RIIO-T2 CMA Appeal, the CMA confirmed in their Final Determination that, for the use of “self-modification” or directions powers to be lawfully included in the licence, the relevant condition must specify the time, manner and circumstances in or under which a future modification by direction 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 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 the ED2 re-opener conditions fail to meet these requirements and make it impossible for licensees to understand the potential impact of a future modification on them:

- Without further details, we do not believe that the wording of the “evidence test” that is included as a condition to re-openers sufficiently specifies the circumstances under which a future modification by direction 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

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instigating the re-opener and do not sufficiently specify the circumstances under which a future modification by direction can be made.

Re-opener materiality thresholds and application are inconsistent and confusing

Within our response to the Draft Determination proposals, we set out our major concern with Ofgem's proposal to apply a 1% baseline revenue common materiality thresholds despite this being set at 0.5% in other sectors. We understand that Ofgem intends to address that concern via the Final Determination so have not reiterated those concerns here, but the licence drafting has also flagged some issues with other aspects around the application of materiality thresholds:

- 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.
- Ofgem's approach to deciding which re-openers have materiality thresholds and which do not is inconsistent with Ofgem's previous assertion that 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. Following this logic through, the materiality thresholds should be removed from the Environmental and Storm Arwen re-openers.

Scope not fully defined for all Uncertainty Mechanisms

In addition to our separate feedback regarding concerns with the various load-related and cyber uncertainty mechanisms, we believe that both the Wayleaves and Diversions, and PCB Intervention Uncertainty Mechanisms still require policy work to ensure that the key definitions are updated to set the correct scope. We have provided detailed drafting suggestions in the appendix to this letter.

Appendix 3 sets out detail on our concerns in relation to all of the areas above.

Incomplete Licence Drafting

The Licence published as part of Ofgem's Informal Licence Consultation is incomplete. It is important that DNOs are able to view all parts of the licence and the Associated Documents together to be able to understand how the price control components will work together and have a clear and complete understanding of Ofgem's expectations and our obligations. It is not possible for DNOs to assess this when significant aspects have not yet been published.

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.

We have identified gaps at various parts of the Licence, and ask that Ofgem urgently consults on the relevant Licence conditions, prior to the Statutory Consultation on the RIIO-ED2 Licence. We provide detail on the gaps in the Licence drafting in Appendix 4 of this submission, and include an indicative list below. Licence gaps include:

- Opex escalator uncertainty mechanism (SpC 3.X);
- Smart Optimisation Strategy (SLC X);
- Absence of modifications to enact Access SCR changes (SLC 14, SLC 12);

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- Ongoing Network Innovation Competition (NIC) projects with RIIO-ED2 spend (SpC 9.X);
- RIIO-ED2 Price Control Financial Model (PCFM); and
- Several chapters of RIIO-ED2 Price Control Financial Handbook (PCFH).

Finance related Licence issues

The removal of the SoLR materiality threshold and removing the drafting around the derogation to subsequently amend tariffs leaves DNOs with potentially unfinanceable obligations, given the level of SoLR costs we have seen to date. 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 have provided no guarantee around the circumstances in which derogations would be granted, or any guidance around the decision-making process. Ofgem needs to clearly set out the process by which a derogation would be granted, including; the evidence required from DNOs, criteria used to make a decision, the decision-making process itself, as well as the level of materiality considered, in order for DNOs to confidently request a derogation with the reasonable assumption it would be granted. The right for DNOs to amend tariffs after receipt of SoLR claims (an event outside of the electricity distribution industry) needs to be prescribed in the licence, via a transparent and well-defined process.

We do not believe that the obligation on DNOs for setting network charges should be changed from reasonable to best endeavours as set out in the joint note to Ofgem from the ENA in March 2022. This change would oblige DNOs to undertake actions that would be disproportionate or that may cut across other 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.

In relation to Time Value of Money (TVM), as argued 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 is summarised in our response to Consultation Question 6. This sets out that 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, as per the RIIO-ED1 approach to TVM.

Ofgem's process relating to the drafting of the RIIO-T2 Licence

We fully recognise the challenge Ofgem faces in managing this complex process. Whilst we have seen improvements in the overall logistics of the LDWG compared to RIIO-ED2, the licence drafting output has suffered as a result of slow progress in key policy development areas.

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This has meant that there was a shortage of sufficient quantities of drafting being brought to LDWG early enough in the process, which failed to make best use of LDWG resources. Indeed, despite early ambitions to have a full draft Licence at Draft Determination, only a skeleton was produced.

The lack of early progress has resulted in the latter stages of the drafting process being rushed as the hard end date of the statutory consultation becomes closer. At the last two LDWGs in August and September, 54 Licence conditions were on the agenda, which is broadly equivalent to the total number discussed across all of the other LDWGs between January and July. This has clearly been a challenge for both DNO and Ofgem resources, and whilst every effort has been made by DNOs to populate and submit comprehensive issues log post LDWG discussions, the feedback loop could have been better. Many issues have been returned by Ofgem as 'closed', without justification or explanation, or the explanation does not relate to the initial comment being closed.

In addition, in terms of the published draft licences, there are key areas of inconsistent drafting which when compared causes confusion (we have highlighted this in our Appendix 3). Further time to review the licence 'as a whole' could have avoided these issues appearing in the current licence drafting.

However, ultimately the most challenging issue resulting from slow progress on policy areas, is the gaps that remain in the suite of documentation we would have expected to receive at this stage in the price control process. We have focussed on this issue in a separate section above, but of particular note is the fact that:

- Ofgem did not publish a Price Control Financial Model (PCFM) that matched the published Licence and several important chapter of the Price Control Financial Handbook (PCFH). It has therefore not been possible for DNOs to assess if these operate in the way they should under the licence and if they match the policy intent.
- Associated Guidance content is lacking. In particular, in relation to Output Delivery Incentives, the drafting is not to the level of detail needed for DNOs to understand how these new incentives will operate or how exposed they are to penalty risk.

We trust that Ofgem will learn from these process issues when seeking improvements in the next price control process and review and address the drafting concerns we have raised. We are committed to continue working with Ofgem to ensure that by the time the statutory consultation commences in December 2022 we will have both Licence drafting and Associated Documents that operate fairly, consistently, transparently, proportionately and cohesively.

Yours sincerely,



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Documents included within this submission:

- *RIIO-ED2 Informal Consultation Questions Response*
- *Issues logs (one file per licence condition/ Associated Document)*
- *Appendix 1a - load issues summary*
- *Appendix 1b - load issues detail*
- *Appendix 2 - Treating Customers Fairly*
- *Appendix 3 - Reopener issues*
- *Appendix 4 – gaps*
- *Appendix 5 – spc3.3 and related*

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