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Ofgem
Commonwealth House
32 Albion Street
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Dear Anthony

RIIO-ED1 Closeout: Consultation on proposed adjustments

We welcome the opportunity to respond to Ofgem's consultation on its proposed adjustments for RIIO-ED1 Closeout. This response is on behalf of Scottish Hydro Electric Power Distribution plc (SHEPD) and Southern Electric Power Distribution plc (SEPD), known collectively as SSEN Distribution.

Our response can be summarised in two key areas:

Proposed adjustments and process for RIIO-ED1 Closeout

We agree with the majority of the proposed adjustments to SSEN Distribution. However, we question Ofgem's decision in a couple of areas which we consider could set unhelpful precedents, and not in the interest of customers.

Firstly, we are concerned around Ofgem's proposal to reserve the right to reconsider any decision to accept our innovation savings for a fourth subsea cable to the Isle of Wight, in the event that we ask for funding for that cable in RIIO-ED2. While we do not currently have plans for such an investment in RIIO-ED2, Ofgem's proposal would be outside of the scope of the closeout methodology and as such sets a precedent that Ofgem can take decisions outside of the closeout methodology which is not good for regulatory certainty.

We understand the issue which Ofgem is concerned about. Given a backdrop of generally rising demand and generation growth, consideration should be given to what is an appropriate timeline for reinforcement deferral due to innovative solutions. This will become more common and requires a clearer approach developed in conjunction with DNOs and stakeholders. It needs to strike a balance between continued incentive to deploy innovations (which could still unlock considerable option value in some instances) vs protecting customers from over rewarding deployment of innovation which only defers investment for a couple of years into the next price control. We are happy to support and engage with Ofgem on any future guidance and processes, but it needs to be clearly written up, consulted upon, and placed in the closeout methodologies for future price controls.

Second, we are concerned that Ofgem is not minded to take account of Load related expenditure (LRE) projects delivered through other drivers e.g. asset replacement. This occurs when non-load drivers become the more

pressing need for investment. The impact of Ofgem not recognising these projects is that our allowances to deliver this work have effectively been removed. This leaves us worse off financially than had the work been delivered under a load driver (as highlighted in Appendix 2). While the financial value at stake is not significant, we are concerned that it sets an unwanted precedent and goes against a core principle of RIIO that companies should be indifferent to which driver they report work under. We urge Ofgem to reconsider this aspect of its minded to decision.

Learnings for RIIO-ED2 Closeout

There are inevitably some learnings having run the closeout process for the first time in eight years in Electricity Distribution. While we recognise and value the engagement with Ofgem since the start of the year on closeout, the RIIO-ED1 closeout team in Ofgem started work late against the expected process/timeline. This had an impact on how Ofgem has consulted and presented on its findings for closeout, including communication on changes to the expected process.

Looking ahead to RIIO-ED2 and RIIO-ED3, for either in period processes or closeout, we ask that Ofgem invest time early in RIIO-ED2 to set out a detailed methodology for RIIO-ED2 closeout and follow the processes and timelines which are set (either in the licence or associated methodology) to remove any uncertainty on the requirements and expectations of DNOs.

We have provided further detail of these areas in **Appendix 1**.

We ask Ofgem to consider our points prior to coming to a decision and are happy to discuss further if required.

Yours sincerely,



Patrick Erwin

Director, Commercial SSEN Distribution

APPENDIX 1

Proposed Adjustments and process for RIIO-ED1 Closeout

This section sets out SSEN Distributions view on the proposed adjustments to our licence areas.

Load Related Expenditure – Innovative savings.

We agree with Ofgem’s minded to decision to accept the innovative savings¹ created by the Isle of Wight (IoW) Active Network Management (ANM) solution in SEPD, and the Bridge of Dun/Logie Pert Constraint Managed Zone (CMZ) in SHEPD. Both solutions meet the requirements of the licence and methodology. It is vital that DNOs retain an incentive to deploy innovative solutions to reduce load related expenditure. Both the IoW ANM and Bridge of Dun/Logie Pert CMZ were innovative at the time (as supported by an independent study carried out by Frontier Economics and Ricardo). The detail SSEN submitted under the Performance Assessment Submission in December 2023, explains why the ANM and CMZ deferred the need for reinforcement and associated costs.

Ofgem note in its decision for the Isle of Wight Innovative savings that should we apply for additional funding within the RIIO-ED2 period to add reinforcement, Ofgem would take the RIIO-ED1 Closeout decision into consideration when reviewing any applications, specifically:

“We are mindful that SSEN is actively exploring a range of options on the IoW, including a fourth subsea cable. If the option of further system upgrade for export capacity from the IoW to the mainland is chosen by SSEN, triggering a request for funding through the ED2 framework, we therefore reserve the right to seek to consider the recovery of any offset applied through the ED1 closeout when considering the application.”

Under the Performance Assessment Submission requirements set out in the methodology, it notes for avoided reinforcement expenditure that:

“(b) A justification of the need for the reinforcement, which the Innovative Solutions addressed, avoided or deferred, and the licensee’s best estimate of the cost of a conventional reinforcement solution;”

We note Ofgem’s concept of reserving the right to reconsider a decision should investment be made in RIIO-ED2. However, this is not documented anywhere in the licence or RIIO-ED1 Closeout methodology and we do not think decisions should be retrospectively reviewed, in particular between price controls. Our decisions are based on information available at the time we make them, and our current projections don’t require a fourth subsea cable to the Isle of Wight until the early 2030s at the earliest. This situation is obviously dynamic and dependent on whether there are significant increases in load or generation above the current DFES.

As part of our Net Zero First approach, we are taking a longer term, more strategic view of our future network’s needs. Preliminary studies showing that we may be able to defer the need for further subsea cables to the Isle of

¹ Noting the small adjustment to Bridge of Dun/Logie Pert for constraint payments.

Wight through use of innovative solutions and flexibility services, alongside the ANM, well into RIIO-ED3. This will ensure customers continue to extract value from the innovative ANM scheme for at least 15 years. In addition to this, installing a 132kV sub-sea cable is a major undertaking that, based on previous experience, could take many years to design, consent and deliver. Hence if we foresaw a need in RIIO-ED3 timescales we will need to have initiated works in RIIO-ED2 or even earlier. The deferment and optionality value of deploying innovative solutions has been realised. This has allowed us to make decisions about future investment in the IoW from a more certain and informed perspective.

We understand the concerns raised by Ofgem in this area. We consider that this is a gap in the framework as the Closeout Methodology and Licence for RIIO-ED1 only refers to costs incurred/estimated cost of reinforcement within the RIIO-ED1 period. Reference for the RIIO-ED2 period is only made in the context of adjusting allowances following the decision of RIIO-ED1 Closeout. Ofgem's proposal to reserve the right to consider the recovery costs applied through RIIO-ED1 Closeout could set a dangerous precedent which **could drive perverse incentives** which would not be in the interests of customers. In any future guidance, Ofgem should provide further clarification on the appropriate timeline and approach for avoided and deferred costs. While this comment is made in context for the IoW, this could apply across a range of scenarios.

LRE – other drivers and the Totex Incentive Mechanism

As part of our submission and subsequent engagement during the RIIO-ED1 Closeout process, we advised Ofgem that we delivered schemes, which had Load Related Expenditure (LRE) allowance, under other drivers. That is, instead of spending money under Load we delivered via asset replacement for example, as condition became the main driver. We asked Ofgem to consider this in its view of our final LRE position. This is because through ignoring the fact that the work has been delivered, Ofgem is now clawing back the allowances we had to deliver the work. Given that the work was in our RIIO-ED1 business plan and delivered, this seems fundamentally wrong. **Appendix 2** sets out an example of how this impacts our Totex position.

In its consultation, Ofgem notes that the licence or methodology does not allow it to take account of work undertaken through other drivers in its LRE adjustment. We recognise there is no specific wording giving effect to this, but we view that the purpose of the Totex Incentive Mechanism (TIM) is to allow for us to switch between drivers when appropriate. The LRE closeout mechanism, and the wording of the closeout methodology specifically, does not consider a circumstance where a DNO has an LRE underspend and an overall Totex overspend. Since it is not considered, we are concerned that an approach to disallow these costs would remove the incentive on companies to use overall allowances under the most appropriate and efficient drivers.

This could adversely encourage spend in areas where DNOs consider the risk of cost recovery to be lowest rather than supporting an approach to incentivise most efficient spend. Given this we believe it is important that Ofgem consider how this circumstance is handled. We believe the approach of disallowing these costs risks undermining the Totex approach to price controls and introduces a penalty on us for these costs - through the recovery of LRE underspend on top of the overall Totex overspend.

Load Related Expenditure – PCFM model

Ofgem has advised in its consultation that the minded-to position for LRE does not consider the operational treatment of applying the calculation of adjustments through the PCFM. Ofgem notes the value as 'return to customers' in its consultation, however we think further clarification is needed within the consultation on what the adjustment is vs what is returned to customers. i.e. where TIM is applied as part of the General Financial Adjustment Methodology. Looking ahead to RIIO-ED2 Closeout and guidance, we would ask for improved clarity on the financial treatment and mechanisms to avoid any uncertainty.

Net-to-Gross

Ofgem notes that SHEPD has fallen outside the percentage banding for Net-to-Gross. Based on the calculation used within the consultation we recognise why Ofgem has made this statement. Our view of how the final value of Net-to-Gross is calculated differs from Ofgem, meaning we believe we are inside the banding. Ofgem has not proposed any adjustment through this mechanism given our position on LRE, therefore we are not challenging this. However, looking ahead to RIIO-ED2 Closeout, we propose that accompanying methodology should set out what should be included in the final calculation of Net-to-Gross.

As part of the consultation, we were surprised to see very little detail for other DNOs who did fall outwith their banding. Specifically, those who did not trigger LRE. Ofgem only noted that it viewed those companies to have provided adequate justification and recognised the increase in customer connections which impacted the overall percentage. Ofgem did not provide any further detail or numbers to give insight into its decision.

Load Related Expenditure – Cross over of RIIO-ED1 schemes to RIIO-ED2

Under our PAS we made the request to Ofgem that we keep underspend relating to schemes that are part delivered in RIIO-ED1 and to be completed in RIIO-ED2. We recognised that the licence and methodology does not account for this but requested it to be considered in order for us to complete the works. Ofgem has not taken this into consideration of the final value of our LRE spend.

We are not challenging the outcome of this specific point on this basis that all of the cross-over projects qualify as load related expenditure and can be used towards triggering the LRE reopener in RIIO-ED2. We raised the point that it does not seem the most efficient regulatory mechanism for Ofgem to run a process to take money back now, for us to apply under a separate mechanism to claim the funding back. However, we appreciate that Ofgem will want to see where we outturn against LRE in RIIO-ED2 to understand if funding is required via the reopener.

Although we are not disagreeing with the outcome of this as set out above, we note our concern around consistency. We have been disallowed costs associated with carrying over LRE schemes from RIIO-ED1 to RIIO-ED2, however UKPN has been allowed Green Recovery 'carry over'. Our concern is that the same principle is not being applied across the requests.

Additional Learnings for RIIO-ED2 Closeout

In addition to the learnings noted in the section above, there are a couple of additional points we want to highlight to Ofgem. All of which should be considered when moving forward through RIIO-ED2 and beyond.

Network Asset Secondary Deliverables (NASD)

For NASD, under the Closeout Methodology document, Ofgem had noted that the deadband threshold was still to be confirmed, stating:

“we consider that a decision on the level of the materiality threshold should be left open at this stage, until we have a better understanding of the data that will support performance against NASD outputs.”

We recognise that Ofgem reserved the right to set the threshold once they had the required data, however, no engagement on the threshold applied for RIIO-ED1 took place. i.e. the view of +/-5% was only confirmed under the consultation on adjustments. The threshold needs to be set up front, ideally in methodology, not as part of consultation on decision. As noted previously we are happy to engage with Ofgem to get a RIIO-ED2 Closeout methodology drafted early in the price control.

High Value Projects (HVPs)

While SSEN Distribution, specifically SEPD, did not trigger the closeout mechanism for High Value Projects as our final costs fell within the required spend, we were surprised to see the HVP mechanism included in the consultation. As part of the consultation, Ofgem notes the specific requirements of the licence that any adjustments proposed, notice should be given in December 2023. Ofgem also note the re-prioritisation of Closeout due to fast moving nature of events which happened in the latter half of RIIO-ED1. Meaning the decision to re-prioritise resource, and delay in associated assessment and RIIO-ED1 Closeout processes. We acknowledge Ofgem’s view that its assessment and proposed adjustment under HVP is to protect the interest of consumers. However, our concern is that the delay was not communicated, either through a formal or informal consultation which we might expect. Therefore, as there was no communication we would assume following December 2023, the High Value Projects mechanism for Closeout would not be triggered. It could be that other DNOs who are impacted were made aware, but Ofgem did not appear to do this based on the detail contained within the consultation. Going forward we need to ensure that timelines in the licence are followed.

APPENDIX 2 – WORKED EXAMPLE FOR TOTEX INCENTIVE MECHANISM AND OTHER DRIVERS

The first table shows our LRE position and proposed adjustment (with and without other drivers considered), the second table shows how the adjustments impact our final position under Totex.

LRE	Ofgem minded to position (inc. innovation)	Ofgem minded to position plus other driver included (inc. innovation)
Allowance (post adjustment)	115.3	117.43
LRE spend	87.8	89.93
Over/(under) spend	-27.5	-27.5
SSEN share	-15.5	-15.5
Customer share	-12.0	-12.0

OVERALL TOTEX	Ofgem minded to position (inc. innovation)	Ofgem minded to position plus other driver included (inc. innovation)
Allowance (post adjustment)	1319.5	1321.6
Totex spend	1403.9	1403.9
Overspend	84.4	82.3
SSEN share	47.7	46.5
Customer share	36.7	35.8
Post TIM Totex	1356.2	1357.4
Slow Money	840.9	841.6
Fast Money	515.4	515.8