Sustainability *first*

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To: RIIOED2@ofgem.gov.uk

Dear Akshay and team,

ED2 Draft Determinations Consultation

Sustainability First is a charity and think-tank focussed on social and environmental issues in the energy and water sectors. We have been heavily engaged in the RIIO ED2 process, initially as a member of Ofgem's RIIO-2 Challenge Group but also as a member of a company CEG and through participation in a number of the Ofgem working groups. We welcome the opportunity to provide our views on the Draft Determinations.

There is much to support in the Draft Determinations – Ofgem's clear commitment to ensure that the networks are not a "blocker" to renewables connections and the uptake of low carbon technologies (through the use of a volume driver for load related expenditure); the pressure that Ofgem has applied to the cost of capital and ongoing efficiency to minimise the cost impact on customers at this difficult time; the emphasis on the evolving role of the DSO, including better data-analytics at low-voltage and the important role of flexibility; a commitment to ongoing consumer engagement by the companies, and last but not least, clear Ofgem recognition that DNOs must adopt a 1.5 degree science-based emissions target.

Failure to adequately incentivise environmental performance

First and foremost, however, we wish once again to challenge Ofgem's outright rejection of any financial incentive to ensure that the companies deliver on their main environmental promises. Ofgem's insistence that "reputational regulation" alone will prove adequate to this task is greatly misplaced and fails to learn the lessons from the recent BEIS Parliamentary Select Committee report about taking a more proactive and less permissive approach to regulation. With financial incentives in place for a large number of other aspects of company performance (from vulnerability through connections and DSO), not having such an incentive on the environment sends an unhelpful signal about the relative importance of this area.

As it stands, Ofgem simply expects the companies to publish certain environmental data each year, leaving them to add their own gloss. The companies have an obligation to produce an annual environmental report under ED1 which has had no or minimal impact. It is unclear why Ofgem think that what they are now proposing should be any different.

Environmental NGOs simply do not have the resource or technical expertise to compare company performance or to challenge explanations. Ofgem cannot simply expect them to do its job for it. The ED2 Environmental Action Plans deal with major issues critical to the companies' environmental impact, including progress towards their own decarbonisation targets, and in particular some technically complex issues such as losses. Relying on "reputational regulation" for this key area is wholly inadequate and fails to give appropriate weight within Ofgem's principal objective to the requirement to protect the interests of consumers and future consumers*, including their interest in* *the reduction of greenhouse gas emissions*. It also sits at odds with Jonathan Brearley's public commitments to deliver on the environment and the wider political interest in this area.

If in the end Ofgem decides to rule out any financial incentive for major environmental outcomes, we would urge them **at least to give reputational regulation more teeth**. This could for example be through Ofgem producing (or commissioning) their own annual environment report with league tables / RAG ratings, reflecting both the companies' performance against their targets and the relative levels of ambition of those targets. This could then pave the way for oral hearings where network CEOs are challenged on progress against their own decarbonisation and other key environmental targets. It would also enable interested stakeholders to provide further challenge to companies who are found to be lagging.

However, our key message is that Ofgem must itself demonstrate a far more active interest in this area. If Ofgem is evidently not interested it cannot be surprised if the companies do not take it seriously.

The vital but neglected issue of losses

Within the DNO environmental agenda, the most neglected and crucial area for greater focus by both Ofgem and the companies is distribution losses. This persists as an Ofgem blind-spot despite Sustainability First having repeatedly highlighted that losses management needs a great deal more attention. In particular, we submitted a comprehensive review of the companies' losses strategies and why this area is important[1] alongside our response to Ofgem on the companies' Business Plans. Ofgem's section on losses in the Draft Determinations is sadly complacent. The lack of any financial incentive in this area represents a backward step compared to ED1 and previous price controls at a time when more, not less, focus is needed on the issue.

Our present best estimate is that, across transmission and distribution, losses currently cost every domestic customer £100 per annum (of which the majority is at distribution level)[2]. This is a very big sum. It is a similar order of magnitude to the whole of the current per household distribution cost (excluding SOLR) being set through the extensive RIIO process. Moreover, the losses cost looks set to double (in line with increased wholesale energy costs) in the October price cap.

It is frankly astonishing that Ofgem is paying so little attention to better management of losses in the ED2 process given their very substantial contribution to the customer bill.

From an efficiency standpoint this makes no sense whatsoever. Instead, Ofgem has simply accepted company arguments that losses are not a first-order issue and will anyway eventually 'sort themselves out' as the grid decarbonises. This is just not so. Losses are **a major source of carbon emissions today and a whole system efficiency issue** going forward given they are set to grow dramatically to 2030.

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[1] https://www.sustainabilityfirst.org.uk/images/Sustainability_First_-_Commentary_-_DNO_ED2_LOSSES_STRATEGIES_-_final090222.pdf

[2] This is based on Ofgem's price cap announcement in February which showed £1077 as the wholesale energy cost. Within their spreadsheet covering wholesale costs there is an uplift factor for losses of around 10% (varying by region). This gives a figure of around £100 per annum down to losses which can be expected to double in October if current forecasts for the next price cap are correct. Ofgem should make these figures more transparent to aid understanding of the strategic importance of this issue.

With distribution losses at 7% and projected to rise over ED2, this represents significant **additional network and generation capacity needed on the system to meet net zero**. We recognise that a level of losses is inevitable especially at peak (due to the "physics" of heavier asset-loadings). However, actions to limit losses, especially at peak, would reduce near-term carbon emissions[3] and deliver whole system benefits in the longer term. The argument that losses do not matter because the grid is decarbonising is untenable. Across the economy, improved energy efficiency is acknowledged as being one of the keys to achieving net zero. The energy sector itself should not be an exception.

There should be no question in Ofgem's mind but that losses are absolutely a first order issue in terms of cost to consumers, carbon and whole systems impacts.

Where Ofgem also falls down is in accepting the companies' argument that losses are outside their control. The detailed company losses strategies submitted as part of their business plans – and which we summarised in our response on the plans - demonstrate that **there is indeed far more the companies can and should do**. This includes relatively low-cost innovative steps to increase understanding of losses (monitoring, analysis, metrics) to ensure better-targeted asset-policies for the long-run, as well as a wide range of operational actions to better spread loads across the network. However absent clear incentives or active compliance monitoring companies cannot be expected to prioritise work in these areas.

Allied to this we have previously highlighted **Ofgem's failure to update the cost of carbon** that the companies are expected to use in their cost benefit analyses, to be in line with net zero. In September 2021 BEIS published revised cost of carbon figures to bring them in line with the government's legally binding net zero target. **The updated figures are *three times* the earlier BEIS figure**. In October 2021 Ofgem published its CBA Guidance for ED2 in which it directed the companies to use the old BEIS figures but with a caveat that if companies wished to use an updated figure they could (provided they did so consistently). No reference was made to the updated BEIS figures that had already been published at that point. Understating the cost of carbon will lead to under investment in projects aimed chiefly at reducing carbon emissions. In our view this is further evidence of Ofgem failing to give appropriate weight to its statutory duty relating to greenhouse gas reduction, noted above.

Our asks on losses

In relation to losses we therefore make no apology for repeating our call for Ofgem to:

- **Hold the companies to account for the commitments they have made** in their Business Plans around the use of low loss equipment and early replacement of some high loss equipment (for example through use of Price Control Deliverables);
- **Encourage the companies to press ahead with the wider range of ideas and opportunities that they have mentioned in their Losses Strategies**. This would include the companies revisiting opportunities that they may have rejected previously but which would now be justified with the much higher cost of carbon figure. This also needs to include a strong element of shared learning and collaboration. A use-it-or-lose-it (UIOLI) funding pot for initiatives that were not included in the Business Plan but which are subsequently found to meet the CBA criteria would be one way forward, and is analogous to the Net Zero and

[3] Losses increase with the square of demand. For example, if demand doubles at peak, losses quadruple

Reopener Development use-it-or-lose-it allowance (NZARD UIOLI) included in GD2. A reputational incentive such as that proposed by SPEN would also help maintain focus.

- **Develop an improved framework for assessing and reporting losses**. There is a clear need for further work by Ofgem / the industry on the valuation of losses. The Ofgem CBA methodology values energy based on an average annual price whereas losses are highest at peak times when prices are highest (and emissions also). This disaggregation of losses by time of use is an important step in building understanding, along with work on how to improve measurement. A detailed 5-10 year projection of overall losses is also needed to help inform wider system planning by the ESO.

In a recent exchange with Ofgem on losses they pointed to the existing standard licence condition 'to ensure that losses are as low as reasonably practicable'[4] but this licence obligation is not referenced in the ED2 Draft Determination. This, alongside Ofgem's failure to consider the substance of the losses strategies submitted with the Business Plans, sends a strong and unfortunate signal to companies that Ofgem will not be proactive in ensuring compliance with the licence condition and is unlikely to use the condition to raise the bar on losses management (noting that "as low as reasonably practical" offers Ofgem considerable discretion in where it sets the bar). Again, where Ofgem fails to demonstrate an active interest, it can surely be no surprise if the companies also persist in a complacent stance against taking losses management more seriously.

Given the losses licence condition, together with current and future bill impacts from unmanaged losses, we have reflected on certain governance points raised recently by the BEIS Select Committee on Ofgem[5]. Our question for Ofgem is how far the Board drilled-down into the topic of losses management in their sign-off on Draft Determinations – including the question of what more Ofgem could / should do to better incentivise DNO actions on losses within the ED2 period? Fully briefed on the cost to customers of losses, it is hard to see why the Board would fail to support further work by Ofgem and the companies to develop new mechanisms and metrics geared to better management of this longstanding challenge – a substantial and growing efficiency issue with a significant impact for end-customer bills and for net zero.

SF6 – a further environmental challenge

The other area where Ofgem unreasonably rejects the need for an environmental financial incentive in ED2 is for concerted management action on **SF6 (sulphur hexafluoride**) where the companies must work out what to do about the 200,000-plus items of this kit across their networks which contain this highly potent and long-lived greenhouse gas. Much distribution-level equipment is sealed but DNOs must of course nonetheless tackle leaks (which are modest). But also, vitally, the companies must work-up detailed plans for the major logistical challenge of how, over time, they will safely get all SF6 equipment off their networks and meet their net-zero targets.

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[4] SLC49 – requires the licensee to ensure that Distribution Losses from its Distribution System are as low as reasonably practicable, and to maintain and act in accordance with its Distribution Losses Strategy. https://epr.ofgem.gov.uk//Content/Documents/Electricity%20Distribution%20Consolidated%20Standard%20Licence%20Conditions%20%20-%20Current%20Version.pdf

[5] HC 236. Business, Energy and Industrial Strategy Committee. Energy pricing and the future of the energy market. 26 July 2022
https://committees.parliament.uk/publications/23255/documents/169712/default/

While Ofgem had required all companies to have SF6 strategies, from our detailed review[6], which we shared with Ofgem, the quality of these varied enormously, from carefully considered long-run approaches to a handful of bullet points. Ofgem seems to judge all the strategies equally as meeting baseline requirements. This is woefully inadequate in terms of the long-run business risk to both DNOs and to customers. Ofgem needs to make it clear that more is expected of the laggards and that cross-industry collaboration is key.

As part of our detailed review of SF6 strategies we put forward some suggestions on how DNO SF6 strategies could be financially incentivised, but these have not been pursued in the Draft Determination. **A failure by Ofgem at this point to properly incentivise the network companies to plan long-term, including active engagement with the supply chain, will only increase costs for future consumers when environmental regulations require phase-out and ultimately prohibit use of SF6 equipment**.

Vulnerability and energy efficiency

A separate matter for considerable regret in the Draft Determinations, and of real concern given the current energy price crisis, is Ofgem's decision to reject all company proposals for energy efficiency measures targeted at customers in vulnerable situations. Ofgem thinking is extremely hard to understand given the extent to which prices have escalated since the company business plans were submitted, creating a real affordability challenge for millions of households. We also note that on the same day that Ofgem published its Draft Determination, the Climate Change Committee published its annual report to parliament highlighting the inadequacy of current funding on energy efficiency.

We would like to see additional funding provided in this area to help address the very real challenges that customers are now facing. In our response on the Business Plans we proposed that Ofgem should introduce a use-it-or-lose (UIOLI) pot for action on vulnerability, as is in place for the GDNs, which could be set at a common level to avoid the postcode lottery that also seems to be a concern for Ofgem. Our understanding is that the UIOLI mechanism has been successful in gas and is simple for partners to understand. We would urge Ofgem to give this idea serious consideration.

Clearly there are genuine concerns about "scope creep" and the fact that funding additional support would further add to customer bills. However, providing some level of targeted support can be justified and is within Ofgem's gift. In other fora Ofgem has stressed the limited tools at its disposal to help customers with higher bills at this time. This is an instance where Ofgem does have the tools but has chosen not to use them.

Separately, and on the plus side, we were glad to note that one of the four themes for strategic innovation funding is energy efficiency. We would urge Ofgem to encourage a focus on projects that by the start of ED3 (when electric heat will be more prevalent) can help to clarify what the 'value-adding' role might be for a DNO within the highly complex and fragmented energy efficiency landscape. **DNOs do have an obligation to promote energy efficiency as an alternative to reinforcement** (under licence condition 31E). Ensuring that vulnerable customers can benefit from this should be key to a just transition.

[6] https://www.sustainabilityfirst.org.uk/images/Sustainability_First_-_Commentary_-_DNO_ED2_SF6_STRATEGIES_-_final09022.pdf

DSO

Last, on DSO treatment in the Draft Determinations. There still remain many fundamental and unanswered questions for net-zero delivery around DSO evolution, DSO 'boundary' issues with the ESO, and the overall DSO institutional role. Not least, DNO business plans are set to bake-in six different underlying commercial models over the next five years. Together with BEIS and the ESO, Ofgem must work to clarify at least some of these basic questions soon. **This includes a much-needed assessment from a consumer standpoint of the benefits and costs of greater DSO / DNO separation and / or integration.**

We are pleased that Ofgem has made clear that it is still in listening mode and that the Draft Determinations are very much a consultation. We hope therefore that Ofgem will now give proper consideration to the well-considered and serious concerns we highlight here. We would be happy to discuss further any points that are not clear.

Yours sincerely

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cc Judith Ward (Associate Sustainability First), Zoe McLeod (Policy Director Sustainability

Ofgem ED2 Draft Determinations – Sustainability First Response to Questions

Overview document

Q8. Do you agree with our overall approach regarding treatment of CVP proposals?

We are happy with the CVPs that Ofgem has chosen to reward and are pleased that – as we suggested in our response on the Business Plans - Ofgem has chosen to fund some other CVPs (but without a reward) where the project delivers strong benefits but is not pushing the boundaries. In this category we welcome the funding being given through CVPs to strengthen links with local authorities which we see as key to moving forward local area energy planning (which we noted as key in our response on DSO Local Governance) and also ENWL's Smart Streets rollout which, in our view, could have merited some reward given the benefits it delivers for low income households.

Core Methodology Document

Core-Q1. Do you agree with our proposals for the enduring role of the CEG?

Given the recognised value of the CEGs, Ofgem should put a formal requirement on the DNOs to keep the groups. In gas distribution various promises were made by the companies but Cadent's group was discontinued despite being held up by Ofgem and the Challenge Group as best practice. A formal requirement also helps to give the CEGs teeth and supports their independence. The regulator should, as a minimum, set a clear expectation that they continue. Much would be lost by way of company learning and insight, that could usefully be used to hold companies to account, if all members of the CEGs are replaced at the same time.

The areas of scope proposed make broad sense, in particular continued oversight of company actions on vulnerability outcomes. However, we note that the Draft Determination does not include sustainability in the list of areas the CEGs looked at as the business plans were being developed (paragraph 2.9) while the original Customer Engagement Guidance for the original CEG roles did list it explicitly. Given the reliance that is being placed by Ofgem on reputational regulation for DNO own-decarbonisation and their environmental action plans, it seems particularly important that the CEGs monitor company performance in this area. The delineation in terms of what is / is not included in RRPs is not necessarily a particularly clear or helpful one for CEGs.

We welcome the proposals around independent periodic reporting.

Core – Q2. Do you see value in the CEGs working together to deliver more coordinated and comparative reporting on some of the DNOs' Business Plan commitments?

There clearly is value in the CEGs continuing to meet and exchange views to help put any reporting by the individual CEGs in a broader comparative context. This collaboration needs to be sufficiently resourced. Even so, given the resources available to the CEGs it is not clear that they would be in a position to produce joint collaborative reports that looked in detail at comparative performance across the companies. This should be Ofgem's role. Below, specifically on the EAP, we suggest that Ofgem should produce a detailed annual comparative environment report. Among other things, this would be of great help to relevant CEG members in challenging their respective companies on comparative performance and best practice.

Core-Q4. Do you agree with our proposed secondary reinforcement volume driver and LV services volume driver and the associated controls?

We support Ofgem's commitment not to be a 'blocker' of net-zero investment. We have no comment on the detailed design of the mechanism beyond noting from an end-customer standpoint that the mechanism needs to be robust and carefully calibrated – neither too generous nor too tight – given the importance of this investment to delivery of net zero. We are keen in particular that the operation of this mechanism is transparent to wider stakeholders. Ofgem's focus on keeping down the headline baseline spend by pushing ever more spend into uncertainty mechanisms reinforces the need to be fully transparent in terms of the overall impact in the ED2 period on the end-bill.

Core-Q11. Do you agree with our proposed approach for the Annual Environmental Report ODI-R?

Please see also our cover letter on this point as well as our detailed response on the Company Business Plans.

As we have consistently highlighted, environmental stakeholders like ourselves simply do not have the resource to ensure company comparisons are being made on a consistent basis, to dig behind numbers and challenge the justifications given by companies for failing to meet targets. This should be Ofgem's job and it should not be trying to outsource it to charities and NGOs. It would not do this with interruptions or any other part of the regulatory framework so why with the environment – in particular on complex technical issues like losses or SF6 (discussed further in Q13).

Where Ofgem is relying on reputational incentives it needs to have a much clearer view of how this mechanism is expected to work and have teeth. As we set out (in some detail) in our response to the SSMD consultation in September 2020[7], this involves ensuring comparative data is readily accessible to enable benchmarking within / beyond a sector; reflecting on the sources of reputational influence (and how best to strengthen them) and making a link to the regulatory framework. Stakeholders will expect Ofgem to know what is happening in the sector and see Ofgem as a trustworthy source of information looking across the DNOs.

In ED1 the companies already have an obligation to produce an annual environmental report which in our view has had no impact at all in terms of being able to meaningfully track company performance in key environmental areas over time. Ofgem needs to be clear how what it is now proposing in their new guideline for the AER – in particular on common approaches to measurement and base-lining targets, metrics and commitments - will significantly improve on current reporting arrangements and to learn from how these reports have been used by stakeholders (or not) in ED1.

If Ofgem insists on relying on reputational rather than financial incentives in this area then we have made suggestions about how that could be given teeth for example through Ofgem producing league tables or RAG ratings that could then be used as the basis for open hearings involving the CEOs to ensure this area remains high on their agenda. Ofgem's role is crucial as if it appears that Ofgem has little interest then the companies will quite understandably not see this as a priority area.

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[7] https://www.sustainabilityfirst.org.uk/images/publications/consultations/Sustainability_First_-_ED2_SSM_Submission_-_250920_-_final.pdf

We would therefore ask Ofgem seriously to consider both these options – or any other ideas it may have to give the proposed approach more teeth.

Core-Q12. What are your views on the proposed mid-period review on DNO environmental performance and their progress to targets?

See our points above (Q 11) on a basic need for Ofgem to specify common approaches to measurement and base-lining targets, metrics and other environmental commitments reported in the AERs – but also for Ofgem itself to show an interest in the reports.

We were unclear from the consultation whether Ofgem was proposing to carry out this mid-review itself which would be welcome and in line with our desire to see reputational regulation given more teeth (see Q11). However, as we read it Ofgem is simply asking the companies mid-period to produce an enhanced version of their AER, which again risks the companies glossing their story in whatever way they wish. If that is the case then we see the proposal as being of very limited value.

In particular we would suggest in relation to losses that a mid-period review should be a compliance review to test whether companies have complied with their licence obligation (SLC49) to ensure that Distribution Losses from its Distribution System are as low as reasonably practicable, and to maintain and act in accordance with its Distribution Losses Strategy. It is vital, as the BEIS Committee highlighted that Ofgem is proactive in monitoring and enforcing licence conditions. The mid-period review would seem an appropriate time for Ofgem to do this.

Core-Q14. Do you agree with our proposal to withdraw the Environmental Scorecard ODI-F for RIIO-ED2?

Please see also our cover letter on this point as well as our detailed response on the Company Business Plans.

As we have consistently said, the lack of a financial incentive in the environment area sends a strong message to the DNOs and stakeholders more widely that this area is less important than others (DSO, vulnerability, connections etc). We think this is wrong.

We understand why, given the very narrow set of metrics that the companies put forward for a scorecard, Ofgem did not want to provide a financial incentive and indeed we flagged this concern ourselves in our response to the Call for Input on the Business Plans. However, we put forward considered reasons for Ofgem to strengthen the scorecard not give up on it. We argued that the incentive should focus on the areas with the highest costs (such oil filled cables) and those with the highest carbon impacts.

There are two major environmental areas associated with successful outcomes on both emissions reduction and efficiency – which otherwise risk being invisible - where we continue to see a clear case for an EAP financial incentive of some form: management of distribution losses; and SF6 strategies.

In particular we have consistently highlighted losses as an area where the absence of any form of financial incentive is a retrograde step compared to ED1[8] and out of line with the rest of Europe (where DNOs are responsible for the costs of losses). With transmission and distribution losses

[8] ED1 Losses Discretionary Reward

currently accounting for around **£100 per household** in the annual bill under the price cap (and potentially double that from October)[9] we simply cannot understand how Ofgem considers that "reputational regulation" is adequate. Moreover, Ofgem seems to have done absolutely no work itself to look at what more could be done to reduce the cost of losses to customers in ED2, simply accepting whatever the companies put forward in their losses strategies, which vary significantly in their quality (in some cases arguably falling short of minimum requirements as we set out in our response on the plans). Equally Ofgem seemingly has no plans to ensure that these strategies are delivered.

From an environmental perspective we also find it astonishing that Ofgem buys the companies' arguments that with the grid de-carbonising by 2035 losses do not matter. You could not apply this argument to any other form of energy efficiency. This is a whole systems efficiency issue. If losses rise through ED2 as the companies suggest this will mean that more low carbon generation and more network capacity will be needed to meet net zero. Distribution losses are presently 7% of all power transferred, with the ENA's 2018 consultancy report predicting distribution losses could rise threefold. And through the ED2 period losses will continue to add to cumulative carbon emissions – in particular as losses are known to be higher at peak when more gas-fired generation is on the system (and can be expected to remain so through ED2).

We set these arguments out fully in our response to the CfI on the Business Plans and in particular in the comprehensive annex on losses[10] where we reviewed the detailed DNO ED2 Losses Strategies. We see no evidence that Ofgem has actually considered our detailed review as it continues to accept that losses are outside the companies' control - despite our highlighting the range of initiatives that the companies refer to in their losses strategies which could help mitigate some of the impacts and build a better understanding of the underlying drivers. For example Ofgem argues that losses will rise through ED2 because of increases in distributed generation. However this is a complex issue that needs to be better understood with generation located closer to demand reducing losses – while DG that increases load in particular areas could increase losses.

Our main point is that the companies, against many competing priorities, will have no incentive to pursue the actions outlined in the strategies if it is clear that Ofgem has little active interest in DNO outturns on losses or progress on innovation and measurement. We had therefore put forward a possible model for a financial incentive in this area - based on SPEN's proposed reputational ODI. As a clear illustration of Ofgem's complacent approach, notwithstanding the costs to customers and the net zero implications, Ofgem has rejected even this modest attempt by a DNO to be held to greater account for its actions on losses.

It is imperative that in its Final Determination Ofgem sets out clearly how it will hold companies to account for their funded commitments on losses, how Ofgem will ensure that companies continue to innovate and bring forward new solutions and how Ofgem and the DNOs will work to build a better understanding of the drivers of losses in terms of time of use and how losses vary across the network, including how measurement of losses could be improved with the better data that is increasingly becoming available. The current Losses Discretionary Reward takes account of these

[9] See our cover letter for basis of this calculation. In our response on the Business Plans we quoted a lower figure which we now realise was wrong.

[10] https://www.sustainabilityfirst.org.uk/images/Sustainability_First_-_Commentary_-_DNO_ED2_LOSSES_STRATEGIES_-_final090222.pdf

different elements and while not perfect we struggle to see how no financial incentive at all and a reliance simply on reputational regulation is a “more appropriate” approach.

We also raised similar concerns on Ofgem’s reticence to financially incentivise DNO SF6 strategies, including leakage - whether via the proposed score-card or otherwise. In particular, we were looking for Ofgem to incentivise DNO preparedness for eventual changeout of 200,000-plus items of small kit across their networks that contain this highly potent and long-lived greenhouse gas. In the final ED2 methodology, we welcomed Ofgem’s decision to require companies for the first time to produce an SF6 strategy. However, as part of our response on the Business Plans we reviewed the strategies in detail. Some are comprehensive, reflecting a long-term approach. Some barely more than a handful of bullet points[11] which arguably do not meet minimum requirements. Yet in the Draft Determination Ofgem has waved through each of the six SF6 strategies as meeting their baseline expectation of simply ‘having a strategy’. We cannot understand this.

SF6 assets represent a significant logistical challenge and long-run business risk to DNOs. In many cases there is still no proven supply-chain solution. New SF6 assets with a 40-plus year asset-life will continue to be installed throughout the ED2 period., not helped by the fact that Ofgem appears to be challenging the use of alternative solutions that are more costly.

By failing to consider the very different approaches on SF6 strategies, including associated targets, Ofgem simply ‘kicks forward’ the considerable future challenge the companies will face. In doing so it risks a repeat of the PCB situation where customers are being required to pay significant costs for the removal of equipment because of a lack of foresight and planning. In our SF6 Annex, we set out how a DNO financial incentive on SF6 could drive progress on DNO future planning on this significant net-zero related risk for the companies and their customers, including through agreed targets for SF6 leakage[12]. Leakage itself appears to be a modest DNO problem (assuming that it is being accurately measured), but we have previously highlighted that there is a financial incentive for SF6 leakage in T2 which could have provided a model. We also note the inconsistency that 132KV lines are transmission in Scotland – and hence face a financial incentive – whereas in England and Wales 132 kV is distribution and hence does not.

Core-Q24. Do you agree with our proposed design of the DSO incentive?

We welcome the fact that the incentive includes both a qualitative and quantitative element. Metrics are important but this is a difficult area to judge solely through metrics and the combined approach (which mirrors that used for the ESO) is one that we have advocated. Our one caution would be to ensure that the qualitative element is not easy money given that it accounts for the lion’s share of the incentive. There should be a clear expectation as well that as more experience is gained of the DSO role it should be possible to move to more reliance on quantified metrics over time.

Core-Q32. Do you agree with our proposal to remove the activities proposed from DNOs' baseline allowances?

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[11] https://www.sustainabilityfirst.org.uk/images/Sustainability_First_-_Commentary_-_DNO_ED2_SF6_STRATEGIES_-_final09022.pdf

[12] One possibility along the lines of the ED1 LDR (losses discretionary reward)

We are extremely concerned that at this difficult time for customers Ofgem is stripping valuable support for vulnerable customers out of the baseline allowances. While we accept there can be concerns about “scope creep”, Ofgem recognises elsewhere in its Draft Determination and in its SIF proposals that the DNOs have an important interest in energy efficiency as an alternative to reinforcement (in line with licence condition 31E). In our view, rather than disallowing spend on energy efficiency for vulnerable customers Ofgem could make it a condition that such spend can only be used as a “top up” to spend that does deliver network benefits and to ensure that vulnerable households are a priority for such action as part of a just transition.

To argue that spend on energy efficiency measures is not required because the government already provides ECO and Green Homes Grant is not a valid justification given that on the same day that Ofgem published Draft Determinations the Committee on Climate Change published its annual report to Parliament in which it described the current funding for home insulation as wholly inadequate.

We are also concerned about the withdrawal of funding to train employees in the provision of energy efficiency advice given that they will have opportunities to interact with customers and provide such advice where appropriate.

More broadly we have a major concern that the Business Plans were developed and submitted before the energy crisis and wider cost of living crisis had really hit. The scale of the challenge facing individual households is massively greater than could have been envisaged at that point. In our response to the CfI on the Business Plans we proposed that Ofgem should introduce a UIOLI pot for action on vulnerability, as is in place for the GDNs, which could be set at a common level to avoid the postcode lottery that also seems to be a concern for Ofgem. Our understanding is that the UIOLI mechanism has been successful in gas and is simple for partners to understand.

Thought would clearly need to be given to the interactions with the vulnerability ODI-F (which we anyway have concerns about as set out in Q33).

At one level it could be argued that all the forms of support that DNOs help fund to tackle fuel poverty (whether income maximisation or switching advice in normal times) are not core to the DNO role. However it has always been accepted that a proportionate level of expenditure is appropriate with a focus on working through partners. We would like to see this maintained and strengthened in ED2- especially in the face of the energy crisis and the expected growth in electric heat.

Core-Q33. Do you agree with our proposals for the Consumer Vulnerability ODI-F?

We have consistently argued that it is wrong to simply rely on quantitative metrics to judge performance in what is a complex and nuanced area. In our view the ODI-F should be structured more like that for the DSO with a balance of qualitative and quantitative measures. We are aware the companies do not like the qualitative approach using a panel based on their experience of the SECV process but Ofgem should be wary of paying heed to the companies’ views over those of other stakeholders in this area. Inevitably the companies will prefer a simple quantitative metric that they can then target to maximise their financial returns – but this does not mean that this is in customer interests.

The devil is also very much in the detail in terms of the proposed metrics and Ofgem should be wary of unintended consequences. The obvious example is the proposed metric around PSR reach - the total number of households registered on the PSR out of the total number of PSR eligible households in a company's region, represented as a percentage.

- Any 'additional needs' not included in the common methodology risk being deprioritised, with effectively discriminatory and harmful impacts.
- Linked to the above, unless well-designed and transparently reported, this will likely drive companies to focus on low hanging fruit such as those newly retired rather than pursuing the harder to reach customers with more complex needs – this was the lesson learned from PSR targets in the energy supply market. How will Ofgem prevent this and learn the lesson from the past?
- As much data on levels of vulnerability is not at a household level, it would be useful to have clarity on how the baseline is calculated and how Ofgem will encourage the vulnerabilities of all household members to be collected and maintained. We hope that baselines will be calculated where appropriate using the most recent Census data.
- It is well recognised, that being on the PSR, does not mean that customers necessarily receive the services they need or receive them in a timely way. How will Ofgem monitor this? There is a need for a qualitative assessment of the approach taken to ensure that companies are playing fair with reporting not just on the numbers on the PSR but the services delivered in practice to different customer segments. Again, this is another lesson learned from the supply market and is now captured in retail market monitoring.
- The requirement for data cleansing is welcome – but we are not clear what the definition for 'cleansed' will be – records actually updated; households contacted etc. A useful KPI would be to record the numbers removed from the PSR including transient vulnerability updates – this would give an indication as to whether the company was really doing what it should (and also guard against another risk with companies being rewarded for PSR reach which is that they have a disincentive to remove customers from the PSR when they should do).
- It is not clear how often the eligible households baseline will be updated – vulnerability is not static and will increase to 2028. What are Ofgem's assumptions here and how does the regulator see that impacting how easy or hard it is for companies to reach their targets?
- In practice companies with higher levels of supply interruptions will have greater opportunities to recruit households to the PSR – a particular consideration given the high weighting given to this area. If PSR satisfaction is reputational only, this could result in companies with high numbers of supply interruptions and poor PSR satisfaction getting rewarded.
- Finally, companies could get windfall gains from planned data sharing with other utilities, in particular water companies and also from policy changes – it seems unfair for companies to be financially rewarded for activity we know will happen through arguably minimal effort on their part. What are Ofgem's assumptions around how the baseline PSR reach will be impacted by such initiatives and how will this be factored into the incentive?

While we appreciate the push for more outcomes focussed metrics, we have similar concerns on the use of the SROI NPV as a metric. SROI (social return on investment) is an extremely valuable tool when used genuinely by companies to determine where to allocate spend but if used as a driver for financial rewards it risks companies chasing the metric rather than genuinely looking to maximise benefit.

At present it also fails entirely on a transparency test which is a crucial requirement in an area that will be of interest to wider stakeholders. We have tried and failed to locate the detailed methodology behind the SROI as we wanted to be clear if the calculations were based on standard assumptions around eg the proportion of customers responding to advice – or whether it actually looked initiative by initiative at the actual results delivered. This remains unclear and obviously the quality of advice provided can vary significantly. Similarly, the value of advice /intervention can vary over time or depending who it is given to. For example, Citizens Advice in their July 2022 Cost of Living briefing reported that debt and financial advice does not alleviate fuel poverty or help customers on negative budgets.

We are aware that Ofgem is proposing that the SROI figures be audited but this is not simply about whether the companies have followed the right process (which is what an audit will test) but some of the more qualitative aspects of how the projects are delivered. We would suggest as a minimum that Ofgem carries out a mid period review of how the methodology is working to ensure that the reliance on this metric is not creating any unintended consequences.

Ofgem has been wary in the past of how companies have used SROI to justify CVPs. It should apply that same healthy scepticism here – not simply allow the companies to design their own financial incentive.

Finally, we welcome in principle a measure of satisfaction for customers who receive a delivered service from their DNO or its representative which supports fuel poverty and low carbon transition. However, the timing of any survey questions is critical if the results are to be meaningful. For example, a satisfaction survey taken shortly after a measure is installed would seem unlikely to give meaningful insight into the usefulness of that intervention, rather it will more likely reflect the general experience (i.e. were they polite, was it easy, did they leave a mess, did they seem like a nice person etc). It may lead to higher satisfaction rates than a delayed survey question that allows time for people to apply or not apply the learning or use and live with the intervention. The survey should include the opportunity for the customer to give qualitative insights on why they have given that score so that lessons can be learned and improvements made. Engaging at the right time in the right way dependent on the intervention is key.

Ofgem suggests that companies need to ensure that no consumer is burdened by an excessive number of surveys across different output areas. If companies are surveying effectively using suitably diverse samples, from a PSR base that is the size they say, we are unclear why this duplication should be occurring to such an extent that it's problematic. To have confidence in Ofgem's approach, we'd welcome understanding the professional views of a research methodology expert on this issue.

Core-Q34. Do you agree with the performance metrics we are proposing to include in the incentive and the approach to setting targets and associated deadbands, performance caps and penalty collars? If not, please explain why and give details of your preferred alternative.

We have commented above (Q33) on the metrics. Performance caps are critical, as there would seem significant scope to claim very high SROIs and also opportunities for easy wins from PSR. Given that companies will have a licence condition to treat customers fairly which will require them to meet their different needs (if it is interpreted in the same way as the energy supply licence condition); and given that disability legislation requires companies to make reasonable adjustments for its customers, it is important that customers money is not being used to financially reward companies for delivering on basic legal and regulatory requirements.

Core-Q35. Do you agree with our proposal for the Annual Vulnerability Report ODI-R?

Core-Q36. Do you agree with the proposed content of the annual report? If not, please explain why and give details of your preferred alternative

We agree that a report is valuable in this area. Understanding the company's strategic approach is really important including to ensure targets aren't being chased for targets sake and approaches are efficient with customers money being used as effectively as possible, not only for the short but longer term. We would like the report to demonstrate progress that companies have made on their vulnerability strategies in the round including against the minimum standards and licence conditions. In addition, importantly, this is also an opportunity to capture how well companies are horizon scanning for changing and future needs and responding in a timely way to changing insight and unforeseen events e.g. in the last couple of years companies have needed to respond to the covid pandemic, the cost of living crisis and more recently extreme heat events. Similarly, there has been a growing understanding of the importance of community vulnerability and resilience, supported by levelling up agendas.

Ofgem has committed to more flexible regulation and more adaptive regulation. Vulnerability is not static and Ofgem could use this annual report to encourage companies to innovate and evolve within the price control period as circumstances and priorities change.

In addition, we are aware that the GDNs also have to hold an annual showcase event. It would be worth understanding how the first of these went and whether that is a model that it would be worth pursuing in ED if partners and wider stakeholders find that a more helpful way to understand what is happening across the sector than reading 6 separate reports. The informal feedback we have had on this event was positive.

As on the environmental reporting Ofgem needs to be aware of the limited resources that charities and partner organisations have. To view the requirement for companies to produce a report as "reputational regulation" risks seeming to pass the buck to stakeholders to do Ofgem's job for it. We are therefore pleased that Ofgem is clear that this is a report to Ofgem (as well as stakeholders) and hope that Ofgem will use the reports to compare and challenge the companies.

Core-Q44. Do you have evidence that customers would be willing to face an increase in their bills to also receive an increase in their reliability, including that they understand the actual cost and how this translates into average power cuts?

We argued in our response to the ED2 Sector Specific Methodology that Ofgem needed to update research underpinning the Value of Lost Load figure on which the IIS incentive has historically been based. We highlighted the increased reliance that society now has on electricity and also the more nuanced findings that came from the ENWL research about the factors that affect how different categories of customers value interruptions.

Given the current high levels of energy prices we understand where Ofgem is coming from in questioning the extent to which customers would be willing to pay for improved reliability.

All of the companies will have done customer research as part of their business plan submissions which will have shown support for improved reliability. While there may well be questions about how far customers understood exactly what was involved, a bigger concern is simply how far such research is relevant in the context of such massively elevated energy costs.

As we have said previously, we see it as Ofgem's responsibility to carry out the customer research on the VOLL given that Ofgem sets the incentive rate in the IIS (and that the VOLL is used more widely in other aspects of energy regulation). While there may be grounds for taking an expedient approach for ED2 we would strongly encourage Ofgem to plan for a full review of VOLL ahead of RIIO3.

Core-Q88. Do you agree with our proposed assessment approach for Losses?

Ofgem's focus here is on the unit cost allowances which we have no view on.

However as flagged earlier we have a serious concern that in looking at the CBA for losses projects Ofgem is using a cost of carbon which is not consistent with the legally binding net zero target. The latest BEIS figure is *three times higher* than that which Ofgem included in its CBA template which will have led to a serious undervaluing of projects aimed at reducing losses. We also note that the wholesale energy cost is also now several times higher than it was previously which will presumably also impact on the business case for action on losses (even if one assumes that prices will ultimately fall again).

Given the significant cost of losses we find it surprising that WPD's proposed replacement of 1958 equipment cannot be justified and we hope that through further engagement with WPD Ofgem's concerns can be addressed.

Indeed, as we highlight in our covering letter, we have a real concern that Ofgem's failure to use an appropriate cost of carbon in its CBA template means that there will be a significant number of projects that the companies did not put forward but which would be justified if properly assessed using the net zero consistent cost of carbon. We have therefore proposed a UIOLI allowance (analogous to the NZARD UIOLI in GD2) for losses projects that companies find they can now justify.

Overall we remain surprised that Ofgem views £35m as an efficient level of spend in what should be a crucial area.

Core-Q89. Do you agree with our proposed assessment approach for environmental reporting?

We are concerned at the decision to reject the SF6 PCD put forward by SSEN given the importance of this area as highlighted above (Q 14). Again, our concerns about Ofgem's use of an outdated cost of carbon are relevant here. We hope that through further discussion with SSEN Ofgem can resolve any concerns it may have.

We support the decision to disallow spend on conventional offsetting (but consider that SSEN's nature-based solutions are different and require separate consideration).

Finance Annex

FQ29. Do you agree with our proposal to set depreciation policy on RAV additions in the RIIO-ED2 period to 45-years straight line, based on the average economic life of the assets?

As set out in the Grid Edge Policy report which was submitted in response to the Call for Input on the Business Plans, the question is not whether a 45 year straight line depreciation is appropriate but the significant impacts of a change from one accounting life to another. As the report makes clear, drawing on the CMA's considerations in the ED1 appeal, there are serious problems with the "payment holiday" that this shift creates which then also leads to massively higher costs for future customers (with a doubling of the RAV even with a steady level of expenditure).

While there may be good reasons for tolerating a "payment holiday" given the current energy crisis Ofgem should be going into this with its eyes wide open in terms of the implications this has for future consumers. While the real pinch point may not come until well beyond current Ofgem management have moved on, faced with fast escalating network charges (and higher absolute returns given the higher RAV) questions will inevitably be asked in years to come.

In its response to the CfI Sustainability First highlighted the importance of transparency in debating issues around inter-generational equity. We were therefore very disappointed that all the analysis continues to only look at ED1 impacts with the argument being made that future investment levels were too uncertain to attempt to project - but that electricity demand was expected to double by 2050 which made it appropriate that future customers should pay proportionately more.

While we recognise that this is a highly uncertain and complex area, we would urge Ofgem to work with BEIS to look to build a better understanding of future cost and demand scenarios to help inform these difficult questions around inter-generational equity going forward.