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# Document A: Decision not to activate the Losses Incentive Mechanism in the Fifth Distribution Price Control

## Final decision

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### Overview:

This document sets out Ofgem's decision not to activate the losses incentive mechanism in the Fifth Distribution Price Control (DPCR5). It is part of a suite of documents being published to implement that decision, following a consultation published on 6 July 2012.

The issues addressed have been under consideration with representatives from across the industry for some time. This document deals only with the rationale for the decision not to activate the losses incentive in DPCR5 (and its implementation).

The Ofgem website contains more information on the work undertaken on distribution losses to date and some key associated documents.<sup>1</sup>

<sup>1</sup> [www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Pages/index.aspx](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Pages/index.aspx)

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## Executive Summary

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This document contains the Authority's decision not to activate the distribution losses incentive mechanism in DPCR5. In response to our consultation of 6 July, the majority of respondents supported our proposal not to activate the mechanism. A minority of respondents opposed our proposal.

We have considered all responses and maintain that we cannot support an incentive mechanism that results in potentially unwarranted rewards and penalties of significant value. We consider that to activate the mechanism would expose consumers to unjustified costs.

In particular, we are still concerned that the volatility of the settlement data used to set targets and measure losses undermines the incentive mechanism. Regardless of the extent of data volatility into DPCR5, the targets for DNOs would still be based on a DPCR4 dataset that is known to contain abnormalities. While the DPCR5 mechanism was designed to help address data volatility, the levels of volatility have changed to such an extent since its agreement that the mechanism cannot be effective.

In place of the losses incentive mechanism, we are introducing a reporting requirement.

The July consultation also sought views on the approach to setting tariffs for 2013-14. On this point, we suggest that DNOs set their indicative and final tariffs for the 2013-14 regulatory year in a way that will minimise volatility in future years.

This is the overarching document (Document A), published alongside a suite of other documents associated with this decision, covering:

- Document B: Consultation on the methodology for closing out the DPCR4 losses incentive mechanism
- Document C: Statutory consultation modifying Charge Restriction Condition 7 to remove losses
- Document D: Decision to establish a Distribution Losses Reporting Requirement
- Document E: Statutory consultation on Standard Licence Condition 44B
- Document F: Consultation amending Regulatory Instructions and Guidance
- Document G: Consultation on restatement of 2009-10 data and closing out the DPCR4 losses incentive mechanism.

While this decision does not seek a response, Chapter 4 outlines the timetable for responding to the associated consultations.

# 1. Introduction

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## Chapter Summary

This chapter sets out the context for our decision not to activate the distribution losses incentive mechanism in DPCR5. It explains what the document covers and shows how it is related to a number of other documents that are required to implement the decision.

1.1. A financial incentive aimed at incentivising DNOs to reduce losses of electricity on their distribution networks has been a key component of Ofgem's regulatory policy since the third distribution price control. The incentive has evolved at each price control review, although the objective has remained to reduce the negative impact of losses on consumers (costs) and on the environment (carbon emissions). The incentive was developed with the expectation that losses are equal to the difference between the units entering and units exiting the distribution network. This measurement uses settlement data.<sup>2</sup>

1.2. During the later part of DPCR4 a number of problems with settlement data came to light, including the volatility of settlement data when used for measuring losses. The data concerns contributed to the DPCR5 losses incentive mechanism containing a two-year reporting lag.

1.3. The data volatility was further aggravated by a period of unusually high, but legitimate, levels of data cleansing activity by suppliers that affected some DNOs' losses positions. These problems led to concerns that the incentive on DNOs to reduce losses had been affected to the extent that the mechanism was no longer effective. They have also made it difficult to establish with any degree of certainty whether DNOs are taking any effective actions to reduce losses. Furthermore, the problems have undermined reliability of the historical data on which the DPCR5 targets were due to be set.

1.4. In light of these concerns Ofgem published a consultation on 6 July 2012 seeking views on whether to activate the distribution losses incentive mechanism in DPCR5.<sup>3</sup>

1.5. A number of the issues raised in that document required urgent action and have been addressed in two other documents. The first considered Questions 9 and 12 of the 6 July consultation on the issue of distribution use of system charges.<sup>4</sup> The

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<sup>2</sup> Settlement measures the electricity that flows during any given half-hour, based on a combination of actual and estimated meter readings, recorded for the purpose of settling energy in the market.

<sup>3</sup>

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=6&refer=Networks/ElecDist/Policy/losses-incentive-mechanism>

<sup>4</sup>

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=7&refer=Networks/ElecDist/Policy/losses-incentive-mechanism>

second considered Questions 8 and 11 of the 6 July consultation regarding whether to move two dates in the electricity distribution licence ('the licence') that require the Authority to give two directions by 30 November 2012 (one on the final incentive value for each DNO for DPCR4 (known as the "PPL term") and the other setting targets for the losses incentive in DPCR5).<sup>5</sup>

1.6. This is the document for the decision not to activate the losses incentive mechanism in DPCR5. It considers all of the remaining questions from the 6 July consultation (Questions 1-7 and 10). It also reconsiders Question 12 because a decision was not previously reached on this issue. It provides the rationale for the decision and explains how the decision will be implemented. We would like to clarify that this decision does not address the DPCR5 technical losses revenue allowance.

1.7. The full suite of documents required to implement a decision not to activate the DPCR5 losses incentive is explained in more detail in Chapter 4.

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<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=747&refer=Networks/ElecDist/Policy/losses-incentive-mechanism>

## 2. Responses to the consultation

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### Chapter Summary

This chapter summarises responses received to Questions 1-5 of the 6 July 2012 consultation on the issue of whether to activate the distribution losses incentive mechanism for DPCR5. It is not intended to be an exhaustive analysis of the responses, which are further addressed in chapter 3.

2.1. Responses to the consultation are available on the Ofgem website.<sup>6</sup> Of the twelve responses received, ten (including five from DNOs, three from suppliers, and those from Elexon and Consumer Focus) expressed the opinion that the existing losses incentive is not operating as intended and that it does not provide the certainty to encourage DNOs to invest in loss reduction activities. A key reason given was that the volatility of settlement data (when used to measure losses) is completely out of the DNOs' control.

2.2. Nine of the respondents agreed with our proposal to turn off the DPCR5 losses incentive mechanism before it is activated, endorsing our preferred approach (Option 3 in the consultation). Respondents noted key changes since the time that the DPCR5 Final Proposals were accepted by DNOs. In particular they highlighted the better understanding that industry (and Ofgem) now have of the way in which supplier data management practices can affect the losses mechanism. These respondents also pointed out that the significant rewards or penalties to DNOs under this mechanism bear no relevance to any actions taken by them.

2.3. Two respondents disagreed with our preference for Option 3. One supplier stated that data volatility issues were known when the DPCR5 mechanism was agreed. It also stated that it is disingenuous to suggest that problems with the DPCR4 mechanism will automatically flow into DPCR5, since the design of the DPCR5 mechanism includes tools to mitigate volatility (specifically a two-year reporting lag and a cap and collar on the amount of reward or penalty a DNO can receive each year).

2.4. One DNO was against our proposals. It argued that it has been undertaking actions during DPCR5 that have effected improvements in its losses position, which it also expects to continue. It suggested that while settlement data was not developed for measuring losses, the data available in its case demonstrates a trend which is sufficient to incentivise it to take action to reduce losses. It stated that there is no new quantifiable evidence on settlement data volatility which warrants action. A key concern raised was that a precedent would be set by intervening part way through the current price control. It believed this would substantially impact on regulatory certainty.

2.5. A number of respondents (including Consumer Focus) also voiced disappointment that the result of our proposals would be the removal of the existing

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<sup>6</sup> [www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Pages/index.aspx](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Pages/index.aspx)

financial incentive to reduce losses. The primary concern raised was the impact of losses on costs to consumers, in addition to the potential environmental impact. Notwithstanding such concerns, there was general agreement that not activating the mechanism was the best option since there was no certainty that the available data could be relied upon, particularly for calculating such a high value incentive.

2.6. Of the ten respondents answering directly, only two believed that retrospective changes should be made to the DPCR4 losses incentive mechanism. In particular they stated that if there is insufficient confidence to fully activate the DPCR5 losses incentive, there is also no justification for rewards or penalties (in some cases significant) to be made under the previous incentive.

2.7. None of the respondents thought we should have considered alternative approaches to the problem.

## 3. Decision and rationale

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### Chapter Summary

This chapter sets out our decision and considers the key arguments made for and against not activating the DPCR5 losses incentive. It also highlights consequential decisions on a new Distribution Losses Reporting Requirement (addressed in Q6 and Q7 of the July consultation) and the treatment of DPCR5 annual incentive payments in Distribution Use of Systems charges (Q12 of the July consultation).

### Decision

3.1. An incentive aimed at reducing losses on GB's distribution networks has been a fundamental part of the price control settlement since the beginning of DPCR3. The impact of losses on consumers and the environment, and the importance of incentivising activity and investment to reduce losses, have not changed.

3.2. What has changed since the DPCR5 losses incentive was agreed is an appreciation of the extent to which supplier data management practices are able to affect DNOs' losses performance. Some of the problems associated with settlement data volatility were known when the DPCR5 losses incentive was developed. However, significant movements in settlement data over the latter part of the DPCR4 period have had a substantial impact on losses positions and have led us to conclude that the underlying data is not currently fit for the purpose of measuring losses or setting targets for DPCR5. Suppliers and DNOs have highlighted that DNOs have no influence or control over the way in which settlement data affects losses performance.

3.3. Neither Ofgem nor the DNOs can have certainty that measurement of losses using settlement data reflects any loss reduction actions taken. Appendix 1 to Document G<sup>7</sup> suggests that none of the licensees can demonstrate a steady trend in losses, on a reconciled basis, across the DPCR4 period. This raises serious concerns that consumers are being asked to pay for significant rewards (such as those in Document G) with no certainty that those rewards are delivering reductions in losses. This historical data was intended to be used to set targets for DPCR5; the same uncertainty applies regarding whether targets based on this data could possibly be set at an efficient level.

3.4. There is therefore no effective incentive on DNOs to take actions to reduce losses on their distribution networks. This position is supported by discussions held with stakeholders from across the industry in open workshops and bilateral meetings. These have confirmed that few DNOs have the confidence to invest in loss reduction actions.

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<sup>7</sup> Document G is a consultation on the close out value for the DPCR4 losses incentive mechanism [http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/8G\\_Con\\_200910data\\_losses\\_DPCR4\\_161112.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/8G_Con_200910data_losses_DPCR4_161112.pdf)

3.5. We cannot continue to support an incentive mechanism that results in unpredictable rewards and penalties of the scale<sup>8</sup> seen and we have therefore decided not to proceed with activating the DPCR5 losses incentive mechanism. The historical problems are particularly pertinent because the DPCR5 targets were due to be set based on DPCR4 data. We consider these unpredictable rewards and penalties to be detrimental to consumers.

3.6. Such a decision is made possible because targets for the DPCR5 losses incentive have not yet been set. The same is not true of the DPCR4 period where targets and an active incentive have been in place since 2005.

3.7. While some of the problems with the mechanism were known during DPCR4, the most significant concerns have only crystallised in recent years. Even though we are yet to calculate the final rewards and penalties applying to the DPCR4 period, the energy to which they relate ceased to flow in March 2010. For these reasons, and because of the significant detrimental impact on regulatory certainty, we are not prepared to go as far as unwinding the DPCR4 losses incentive mechanism.

3.8. It is therefore our decision to proceed with implementation of Option 3 from the 6 July 2012 consultation, ie not to activate the DPCR5 losses incentive. The DPCR4 losses incentive mechanism will be closed out according to the methodology set out in DPCR5 Final Proposals.<sup>9</sup> The current process of removing the effects of abnormal data cleansing activity for 2009-10 will be completed.

## Consideration of responses

3.9. The majority of respondents to the 6 July consultation supported our proposal not to activate the DPCR5 losses incentive. There are however a number of opposing arguments which warrant consideration. A number of the points raised pertain to the Balancing and Settlement Code (BSC)<sup>10</sup> data processes, which are explained further in some of the previous documentation referred to above.

### New evidence for change

3.10. Two of the respondents to the July consultation commented that there was no new evidence to justify re-opening the DPCR5 price control settlement.

3.11. We agree that some of the problems with settlement data, when used for measuring losses, were known when the DPCR5 losses incentive was agreed in

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<sup>8</sup> Document G includes the draft close out values for each DNO for DPCR4, highlighting a difference of around £100m between two DNO groups.

<sup>9</sup> It should be noted that the process of closing out DPCR4 involves calculating a value of the PPL for each licensee. The calculation for PPL set out in DPCR5 Final Proposals includes an "interaction adjustment", which applies to the DPCR5 losses mechanism. The decision not to activate the DPCR5 losses incentive means this interaction adjustment will be removed from the DPCR4 close out calculation. This is covered in Document G.

<sup>10</sup> The BSC sets out the rules for the operation and governance of settlement data.

December 2009. We further agree that Gross Volume Correction (GVC) is a settlement tool that has been used by suppliers for a number of years.<sup>11</sup>

3.12. However we do not agree that the extent to which suppliers' actions could affect measured losses was fully understood at the time. This lack of understanding is partly because suppliers have been unable to provide clear evidence of the data cleansing actions they have undertaken. We have analysed the impact of levels of abnormal data cleansing by suppliers across licensees with the same dominant supplier. From this analysis we can draw no clear conclusions about the relationship between DNO/supplier activity and its impacts on losses performance.

3.13. The fundamental concern is the lack of certainty that data reflects the loss reduction actions taken. The extent of the problem cannot have been clear when the DPCR5 losses incentive was agreed since accurate settlement data (ie data reconciled to 'Run Final (RF)'<sup>12</sup>) would only have been available for the period before September 2008. The unusually high levels of data cleansing that affected the latter part of DPCR4 and continues to affect settlement data into DPCR5, will not have been apparent when DPCR5 Final Proposals were agreed.

#### **Use of reconciled settlement data**

3.14. A fundamental principle of closing out DPCR4 is the need to use fully reconciled settlement data. That is, data which has been through a number of reconciliation runs (up to RF or Dispute Final (DF)<sup>13</sup>) and is therefore a more accurate picture of the settled volumes of energy pertaining to a particular period. The reason for requiring the use of this data in closing out DPCR4 is to ensure the process is consistent across the DNOs and minimises the differences between their reporting methodologies.

3.15. A point made in responses to the July consultation is that fully reconciled settlement data, which is the basis of the DPCR5 losses incentive, does not commonly exhibit the same volatility as the reporting data used in DPCR4. The contention is that, while data volatility has affected DPCR4 losses, it cannot be expected to affect DPCR5 losses in the same way and that this is not good justification for de-activating the DPCR5 losses incentive.<sup>14</sup>

3.16. We accept that fully reconciled data shows less volatility than the data used by DNOs in DPCR4. The concern, however, is that the problems we have experienced to date have removed any certainty that any of the data can be relied upon as a fair reflection of the activity that is or is not taken by DNOs to reduce losses. This means

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<sup>11</sup> It is commonly agreed that the use of Gross Volume Correction gave rise to the abnormal data cleansing activity at the end of DPCR4.

<sup>12</sup> 'Run Final' refers to the settlement reconciliation run which takes place 14 months after the energy flowed.

<sup>13</sup> 'Dispute Final' refers to the settlement reconciliation run which takes place up to 28 months after the energy flowed

<sup>14</sup> It is important to note that the volatility seen in settlement data when used for measuring losses does not mean there is a problem with settlement data, which is accurate for the purpose for which it was designed.

that we cannot be satisfied that the costs which are ultimately borne by consumers are fair.

3.17. We also note that those DNOs that used reconciled settlement data during DPCR4 still experienced significant swings in their losses positions.

3.18. Furthermore, regardless of whether data volatility will reduce in DPCR5, the mechanism is currently designed to use the DPCR4 figures to set each DNO's losses target in the DPCR5 period. We have significant concerns therefore about the credibility of targets set on data that includes demonstrable abnormalities.

3.19. The complexity associated with resolving the type of data volatility problems dealt with in recent years, along with the consequent amount of work for both industry and Ofgem are of significant concern.

### **Measures to address volatility in the DPCR5 losses incentive mechanism**

3.20. The DPCR5 mechanism was set up with a two year reporting lag and caps and collars to limit the impact of data volatility on DNOs. However, the design of the DPCR5 mechanism does not address the problems associated with setting targets on the basis of volatile data. Regardless of levels of data volatility in DPCR5, performance would be measured against a dataset including known abnormalities.

3.21. We accept that the formulation of the DPCR5 mechanism may serve to protect DNOs and consequently consumers under normal circumstances. It did not however envisage data volatility issues on the scale recently experienced.

3.22. As for DPCR4, the DPCR5 losses mechanism was designed with a five-year losses rolling retention mechanism. Consequently the total value of the incentive over the price control period is highly-g geared to the final year of the period. Even if data were reliable for measuring losses for the first four years of the price control, any abnormality in the fifth year would drive the total value of the mechanism. As smart metering is rolled out, data cleansing activity may increase levels of data volatility, particularly towards the end of the price control period. We cannot therefore predict that data volatility will not pose serious problems again at the end of DPCR5.

3.23. We are also concerned about the extent to which DNOs are incentivised to take action to reduce losses in the light of ongoing data volatility. The majority of the data problems experienced have crystallised since the DPCR5 losses incentive was agreed. These problems (along with the lack of targets) have removed the incentive on DNOs to take significant action on losses. We are not convinced that simply smoothing volatility with caps and collars is sufficient to restore confidence in the data or, consequently, to restore the incentive on DNOs.

3.24. One additional consequence of this decision is that the unintentional conflict between the interaction adjustment and the cap and collar for DPCR5 no longer needs to be addressed.<sup>15</sup>

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<sup>15</sup> We consulted on options for addressing this issue in March 2012:  
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=691&refer=Networks/ElecDist/>

### **Potential for DNO performance in DPCR5**

3.25. A point made in some submissions, particularly in the context of whether to reopen DPCR4, is the perception that a decision to deactivate the DPCR5 losses incentive is now being considered to protect DNOs going forward while many have already benefitted from significant rewards under the DPCR4 losses incentive.

3.26. Document G (published alongside this document) demonstrates that there is an inconsistent picture in terms of rewards/penalties expected in the close out of DPCR4. Furthermore, DNOs' support for non-activation is regardless of any anticipated performance over DPCR5 (noting that this is particularly uncertain given that the DPCR5 targets have yet to be set).

### **Reassessing DNO risk and exposure under the price control settlement**

3.27. One response raised the issue that the overall DNO risk and exposure under DPCR5 should be re-examined in light of one incentive mechanism of the price control settlement not being activated. We do not consider that this is appropriate, as in the DPCR5 financeability analysis the losses incentive value was assumed to be zero to reflect DNOs' equal exposure in terms of rewards and penalties. As all DNOs were found to be financeable without taking account of revenues from this incentive mechanism its non-activation would not change this analysis.

### **Related decisions**

3.28. The July consultation sought views on a number of additional issues that are considered below.

### **A new reporting requirement on DNOs**

3.29. Questions 6 and 7 of the July consultation sought views on whether, as a result of not activating the DPCR5 losses incentive, there should be a new requirement for DNOs to report on the actions they are taking to reduce losses across their networks during the remainder of DPCR5.

3.30. Document D<sup>16</sup>, published alongside this document, considers responses to these questions and sets out our decision in favour of introducing a new requirement to be known as the Distribution Losses Reporting Requirement (DLRR). It replaces the previous distribution losses reporting regime and will be in place from 1 April 2013 until the beginning of the RIIO-ED1 price control period in April 2015.

3.31. The process of implementing the new DLRR requires modification of Standard Licence Condition 44B and amendment of the Regulatory Instructions & Guidance documents. We are consulting on these modifications in Documents E and F<sup>17</sup> respectively, which accompany this document.

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[Policy/losses-incentive-mechanism](#)

<sup>16</sup> [http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/4D\\_Decision\\_Losses\\_Reporting\\_DPCR5\\_161112.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/4D_Decision_Losses_Reporting_DPCR5_161112.pdf)

<sup>17</sup> Document E; <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive->

### **Treatment of DPCR5 annual incentive in DUoS charges**

3.32. The July consultation set out proposals on the way DNOs should be forecasting the value of DPCR5 annual incentive payments in the current and future Distribution Use of Systems (DUoS) charges, which are payable by suppliers.

3.33. The consultation stated that if the DPCR5 losses incentive was not activated, any annual losses incentive already forecasted by DNOs during DPCR5 would need to be clawed back. In order to limit this amount, and because it was not considered appropriate to be recovering estimations of annual incentive associated with a losses mechanism that we proposed to turn off, we suggested that DNOs set to zero their 2013-14 DUoS forecasts for the annual losses incentive.

3.34. Views were sought on this proposal in advance of the wider consultation document in an attempt to provide certainty ahead of the August 2012 DUoS forecasts. However, we received representations suggesting that an early decision would prejudice the outcome of the consultation, and the decision was thus deferred.

3.35. We received nine responses to the question: from all six DNOs and three suppliers. Four respondents (all being DNOs) were in favour of setting the forecasts for the annual incentive to zero and four respondents were in favour of setting forecasts in line with the estimates that had been made in the May DCP066<sup>18</sup> forecasts (one DNO and three suppliers).

3.36. As with responses to Question 9 (decision published on 25 July 2012)<sup>19</sup>, there was strong representation that setting any estimates of annual losses incentive to zero could result in significant price volatility in later years. Our analysis suggests that, for the vast majority of DNOs, the May 2012 estimates will reduce the volatility associated with recovering the PPL term value over subsequent years.<sup>20</sup> However, in some circumstances using the May estimates may increase volatility for later years.

3.37. We therefore suggest that DNOs set their indicative and final tariffs for the 2013-14 regulatory year in a way that will minimise volatility in future years. For most DNOs, but not all, this is likely to mean using the estimates of DPCR5 annual incentive they made in the May (2012) DCP066 reports.

3.38. One consequence of the decision not to activate the DPCR5 losses incentive is that the annual incentive will be derived solely from the PPL term. Document C is a statutory consultation on the licence changes to achieve this. Any future recovery of

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[mechanism/Documents1/5E\\_Statcon\\_SLC44B\\_Losses\\_Reporting\\_161112.pdf](#); Document F: [http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/6F\\_Conletter\\_Modify\\_RIGS\\_Losses\\_Reporting\\_161112.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/6F_Conletter_Modify_RIGS_Losses_Reporting_161112.pdf)

<sup>18</sup> The latest DCP066 forecasts are available here:

<http://www.dcosa.co.uk/Public/Documents.aspx?t=10>

<sup>19</sup> [www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=7&refer=Networks/ElecDist/Policy/losses-incentive-mechanism](http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=7&refer=Networks/ElecDist/Policy/losses-incentive-mechanism)

<sup>20</sup> Document G (see Chapter 4) consults on the period over which the PPL terms should be recovered.



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the annual incentive will need to off-set any prior provisions for the DPCR5 losses incentive. This matter is also covered in Document G.

## 4. Implementation and next steps

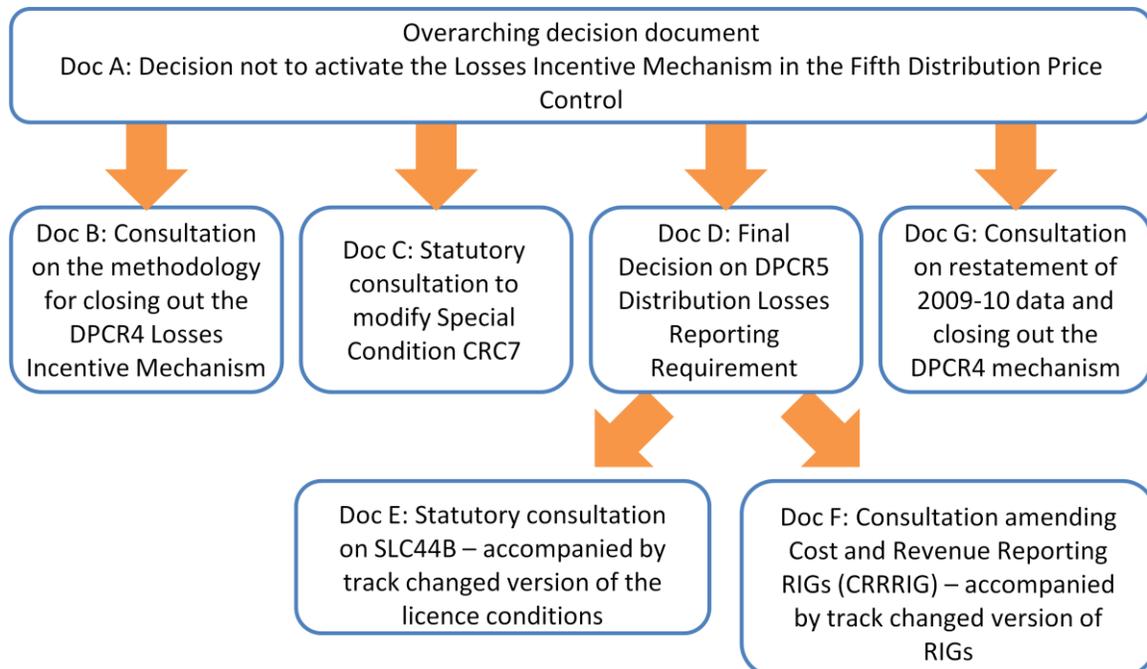
### Chapter Summary

This chapter sets out how the decision not to activate the DPCR5 losses mechanism will be implemented. It explains how the suite of documents published to implement the decision fit together, sets out the next steps in respect of each and provides an associated timeline. It also summarises the process for closing out the DPCR4 losses incentive and provides a response on Q10 of the July consultation on the period over which the PPL term will be recovered.

### Implementation of the decision

4.1. The DPCR5 losses incentive was established through a series of policy, licence and reporting documents, all of which will require modification, annulment or replacement with new documents. This process is to be achieved through a suite of documents published alongside this one. The relationship between the documents is as follows:

**Figure 1: Document map showing relationship between the documents published to implement the decision not to activate the DPCR5 losses incentive**



### Explanation of the process and next steps

4.2. As set out above, this document (Document A) represents the overarching decision document in respect of the decision not to activate the DPCR5 losses

incentive mechanism. No further action is required by the Authority or stakeholders in response to this document.

4.3. The DPCR5 losses incentive mechanism is set out in DPCR5 Final Proposals, which provides the basis for the calculation and recovery of rewards and penalties (as set out in Special Condition CRC7 of the licence), and a reporting regime (as set out in the SLC44B of the licence and the Regulatory Instructions and Guidance document).

4.4. The DPCR5 Final Proposals document also sets out the process for closing out the DPCR4 losses incentive mechanism. The result of the close out process is a value known as the PPL term, which is the residual incentive (which may be a reward or penalty) from the DPCR4 period. As with the DPCR5 incentive, it is recoverable under CRC7 of the licence.

4.5. In order to prevent more than one active policy document governing losses at any one time, Document B is a consultation on the methodology for closing out the DPCR4 Losses Incentive Mechanism.<sup>21</sup> It clarifies the process for the close out of the DPCR4 losses mechanism in the absence of an interaction adjustment for the DPCR5 incentive. Document B also includes, for reference, the sections in the remainder of DPCR5 Final Proposals that no longer apply as a result of this decision. Responses are requested to this consultation document by 14 December 2012. If no responses are received or if no or minor changes are proposed to the revised methodology, a decision will be issued confirming the changes and reissuing a final version of the methodology.

4.6. The recovery of incentive rewards and penalties has to date been facilitated by Special Condition CRC7 of the licence. In line with the decision contained in this document, there is no need for DNOs to recover any incentive associated with the DPCR5 losses mechanism. A mechanism is still required, however, for DNOs to recover the value of the PPL term pertaining to the DPCR4 losses incentive. These provisions are therefore retained in CRC7 with an updated reference to a new policy document (Document B) which explains the steps needed to calculate the PPL term, as opposed to the DPCR5 Final Proposals which, as explained above, would no longer apply with respect to losses.

4.7. Document C is a Statutory Consultation on amendments to CRC 7. It follows another statutory consultation published by the Authority on 24 August 2012 which resulted in a licence modification issued on 1 October 2012. Responses to this further statutory consultation are requested by 14 December 2012. Depending on the responses received, the Authority will publish a decision concerning its intention to make the proposed modifications to CRC7.

4.8. The Authority made clear in the July 2012 consultation that it is keen to understand what actions DNOs are currently taking to reduce losses in the period until the RIIO-ED1 mechanism is introduced. This was the subject of Questions 6 and 7 of the July consultation and responses have informed the decision to establish a

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<sup>21</sup> Documents B to F are all available here:  
<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Pages/index.aspx>

new DLRR. That decision is set out in a separate document, attached as Document D. No further action is required by stakeholders or the Authority in respect of this document.

4.9. The DLRR decision document (Document D) sets out the process needed to implement the new DLRR. It involves modifying Standard Licence Condition (SLC) 44B of the licence to remove the original Distribution Losses Reporting Regime and replace it with the new DLRR. Those modifications are facilitated by a statutory consultation, Document E, on which the Authority is seeking views by 14 December 2012. Depending on the responses received the Authority will publish a further decision document confirming its intention to make the proposed modifications to SLC44B. The statutory consultation is accompanied by a draft track-changed version of SLC44B.

4.10. In addition to the statutory consultation on SLC44B, amendments are required to the Regulatory Instructions & Guidance (RIGs) which set out the detail of the information which DNOs must collect and provide in respect of losses. A further consultation, Document F, is required to make these amendments. Responses are requested from stakeholders by 14 December 2012, following which a decision will be published and the RIGs reissued. The consultation is accompanied by a draft track-changed version of the section of the RIGs, as well as the proposed new reporting template.

4.11. The final document accompanying this one is Document G, a consultation on the results of applications made by DNOs seeking to have their 2009-10 losses positions restated to remove the effects of abnormal data cleansing activity.<sup>22</sup> This consults on a value of the PPL term for each of the 14 licensees in order to close out the DPCR4 losses incentive mechanism (explained further below). It also covers the financial implications of any restatement of 2009-10 data for the purpose of annual reporting. Responses are requested to this consultation by 14 January 2013. Depending on the responses received, a decision will be issued on the restatement applications and a direction given on the value of the PPL term for each licensee. A direction on the value of PPL is required by 1 April 2013.

4.12. The following table (Figure 2) sets out the proposed timeline with respect to the decision not to activate the DPCR5 losses incentive.

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<sup>22</sup> Document G is available here: [http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/8G\\_Con\\_200910data\\_losses\\_DPCR4\\_161112.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/8G_Con_200910data_losses_DPCR4_161112.pdf)

**Table 1: Timeline of next steps**

<b>Document</b>	<b>Next response required from stakeholders</b>
Doc A: Overarching decision document	N/A
Doc B: Consultation on the methodology for closing out the DPCR4 losses incentive	14 Dec 2012
Doc C: Statutory consultation modifying CRC 7 to remove losses	14 Dec 2012
Doc D: Decision doc to establish Distribution Losses Reporting Requirement	N/A
Doc E: Statutory consultation on SLC44B – accompanied by track changed version of SLCs	14 Dec 2012
Doc F: Consultation amending RIGs – accompanied by track changed version of RIGs	14 Dec 2012
Doc G: Consultation on restatement of 2009-10 data and closing out the DPCR4 mechanism	14 Jan 2013

# 5. Closing out the DPCR4 losses incentive mechanism

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## Chapter Summary

This chapter sets out the process for closing out the DPCR4 losses incentive mechanism and calculating the PPL term.

5.1. The process of addressing problems with the losses incentive mechanism has been ongoing for more than two years. A significant focus has been a period of abnormal data cleansing activity that affected some DNOs' losses positions in the final year of the DPCR4 period (2009-10). DNOs were able to apply to have their 2009-10 losses positions restated provided they met certain statistical criteria.<sup>23</sup> Decisions on these restatement applications are required before we are able to finalise ('close out') the DPCR4 losses incentive.

5.2. The process of closing out the DPCR4 incentive involves calculating a value known as the "PPL term"; it is the residual incentive (which may be a reward or penalty) that applies to each licensee covering the full DPCR4 period.<sup>24</sup> While the decisions we take on DNOs' 2009-10 restatement applications have no bearing on our decision not to activate the DPCR5 losses incentive, the reverse is not true, since the DPCR4 close out calculation is directly affected by the DPCR5 decision. This is because the "interaction adjustment" (which was developed to ensure that no DNO benefitted/suffered from a starting position in DPCR5 as a result of their closing position in DPCR4) is no longer needed if the DPCR5 losses mechanism is not activated.

5.3. The methodology for the close out calculation was set out originally in DPCR5 Final Proposals but, as described above, the attached Document B consults on a revised process for this calculation with the interaction adjustment removed. The PPL terms calculated for consultation in Document G are based on this revised methodology.

5.4. Depending on the results of the Document G consultation we propose to use the draft PPL values and apply the calculation in Document B to provide final values of the PPL term for each licensee. These will be set out in a direction by 1 April 2013, in line with the requirements of Special Condition CRC7.<sup>25</sup>

5.5. Document G covers the outstanding issues to be resolved before the DPCR4 losses incentive mechanism can be closed out. We asked a question relating to one

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<sup>23</sup>

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=660&refer=Networks/ElecDist/Policy/losses-incentive-mechanism>

<sup>24</sup> PPL is an acronym with no derivation.

<sup>25</sup> Note that Document C proposes that the original paragraph 7.8 of that condition (now paragraph 7.5) is modified to refer to the methodology set out in Document B, rather than in DPCR5 Final Proposals. The modified version of CRC7 is now subject to statutory consultation before being subject to a 56 day cooling off period. Should any representations be made against the decision during the consultation period we may need to revisit the way in which the PPL term is either calculated or directed.

of these issues, the period over which the PPL term is to be recovered, in the July 2012 consultation.

### **Period over which to recover PPL term**

5.6. Question 10 of the July consultation considered the period over which the final value of the PPL term should be recovered. The original intention of DPCR5 Final Proposals was that it should be recovered over the final three years of the price control period. However, the decision over the exact period was left open by paragraph 7.20 of Chapter 7 of the Incentives and Obligations document, which recognised the need to consider the impact on revenue stability and DNO cash flows.

5.7. We received ten responses to Question 10, indicating no clear preference:

- three respondents felt that PPL should be recovered over the single remaining year of the DPCR5 period (one supplier, two DNOs)
- two respondents felt that PPL should be recovered over the remaining year of DPCR5 and one year of RIIO-ED1 (one supplier and one DNO)
- two respondents felt that PPL should be recovered over the first two years of the RIIO-ED1 period (two suppliers)
- three respondents felt that no decision should be taken until the value of the PPL term was known (three DNOs).

5.8. Considering the size of the indicative values of the PPL term being consulted on in the attached Document G we do not believe it would be appropriate to allow recovery over the single remaining year of the DPCR5 price control period. We are also mindful of strong representations from suppliers on the impact on price volatility arising from having insufficient time to react. One supplier requested 15 months advance notice of elements likely to impact on charges.

5.9. We aim for a consistent approach across all DNOs and to minimise impact on consumers. We also want to finalise the issues relating to a price control that concluded in April 2010 as soon as possible, particularly in view of the time and resources which have already been spent addressing them.

5.10. Our consultation, Document G, seeks views on our proposal that the PPL term should be recovered over 2014-15 and 2015-16.