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Sent by email to RIIOED2@ofgem.gov.uk.

Dear David,

RIIO-ED2 Distribution System Operation Incentive metrics consultation

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

We thank Ofgem for the efforts to resolve the issues regarding the Distribution System Operation (DSO) Out-turn Performance Metrics (OPMs). We understand and share Ofgem's concerns about establishing targets, including inconsistent approaches across the DNOs¹ and setting targets that reward the Distribution Network Operators (DNOs) for maintaining rather than exceeding current levels of performance². We therefore agree that the OPMs should not yet be switched on.

The key points of our response are:

- **The 20% value of the Distribution System Operation incentive that is assigned to the Out-turn Performance Metrics should not be reassigned.**
- **There could not have been legitimate expectations that the incentive weightings would have been changed.**
- **The target-setting issues should be resolved with urgency.**

The 20% value of the Distribution System Operation incentive that is assigned to the Out-turn Performance Metrics should not be reassigned:

We disagree with the proposal to reassign the 20% value of the DSO incentive from the OPM to the DSO Performance Panel (PP) assessment. Furthermore, we do not support any of the 20% value being reassigned to any other component of the DSO incentive, or to any other incentive within the RIIO-ED2 electricity distribution price control. Either of these actions inherently dilutes the direct financial incentive on the Distribution Network Operators (DNOs) to improve performance in the specific focus areas that are in the scope of the OPMs.

¹ For example, see paragraphs 3.7-3.12 of the consultation.

² For example, see paragraph 3.25 of the consultation.

The Out-turn Performance Metrics are intended to encourage performance improvements in specific focus areas:

We have had concerns over several years about the DNOs' performance in aspects of network operation, namely flexibility deployment, curtailment and network visibility. For example, we have been concerned that the DNOs do not always deploy flexibility when it is the most appropriate way of resolving network constraints. We have also been concerned about the degrees of curtailment that are imposed on network users at times. For example, we have received forecasts of curtailment exceeding 70% for some connections, which severely weakens the business case for investment.

We supported the OPMs being designed to measure and encourage performance improvements in specific focus areas of flexibility deployment, curtailment and network visibility. The specific focus areas that are of critical importance to us as a flexibility service provider are:

- the degree to which DNOs use flexibility to resolve network constraints (measured by the Flexibility Reinforcement Deferral (FDR) metric);
- the quality of the DNOs' forecasts of network utilisation (measured the Secondary Network Visibility metric); and
- the degree to which DNOs allow unrestricted network use (measured by the Curtailment Efficiency metric).

All these issues affect the viability of investment in flexible assets.

We supported a financial incentive being placed on the DNOs to improve DSO. We participated in the meetings that were held in 2022 to develop the incentive arrangements. We were comfortable that the OPMs that were developed in those meetings (and which were included in the October 2022 consultation³) were targeted at the specific focus areas that critically important to us. Those OPMs were confirmed at Final Determinations in December 2022. We welcomed the DNOs being directly financially exposed to their performance in the specific focus areas that relate to our 'pain points': 20% of the DSO incentive value was allocated to the OPMs.

We explain below why the none of the 20% value of the DSO incentive should be reallocated to the PP assessment. Our comments also apply to reallocating any of the 20% value to the SS. We are similarly unconvinced that doing so would represent good value for consumers and network users.

None of the 20% value of the DSO incentive should be reassigned to the Performance Panel assessment:

Reassigning the 20% value of the DSO incentive from the OPMs to the PP assessment increases the weighting of the PP assessment from 40% to 60%. It cannot be guaranteed that the DNOs can or will be held proportionately financially accountable by way of the PP for performance in the specific focus areas that the OPMs currently cover. In fact, Ofgem's proposals could increase the weighting of the PP assessment without some DNOs being required to submit performance data for the specific focus areas that the OPMs currently cover. The proposal to reassign 20% of the DSO incentive represents poor value to consumers and network users.

³ The "Distribution System Operation Incentive Governance Document" consultation. See: <https://www.ofgem.gov.uk/publications/rrio-ed2-dso-incentive-governance-document-consultation>.

The proposal to adapt the PP evaluation criteria to include more specific references to aspects of the OPMs that are not already included in the evaluation criteria does not address the loss of accountability for performance in the specific focus areas. It is unclear that the PP can successfully navigate the issues that prevent the OPMs being switched on. It is also unclear that the PP will be able to identify the 'true' levels of performance for each metric given the methodological and data issues. We question whether the PP will be able to identify robust baselines against which to measure performance or compare performance across DNOs. It is unclear whether the PP assessment of performance in the specific focus areas (even if it possible) would be sufficiently equivalent the scrutiny that the OPMs would allow.

It is not certain that the PP will be supplied with performance data for the whole sector, to allow comparisons. Ofgem is “...*minded to allow DNOs who are able to report robust data with clear methodological approaches to use this data in the DSO Performance Panel assessment*”.⁴ This does not guarantee that the PP will have access to the full suite of sectoral data. This proposal would create the risk of a perverse incentive: DNOs could avoid scrutiny by not having clear methodological approaches and/or the capabilities to report robust data.

There will likely be a loss of transparency of the DNOs' performance in the specific focus areas because performance will not be measured against targets for the OPMs. Stakeholders may not have full visibility of all data submitted to the PP, the PP's supplementary questions to the DNOs (if any), the DNOs responses to the supplementary questions and the PP's detailed assessment of performance. This means that a primary benefit of the OPMs - robust comparability of performance across the sector - will likely be lost. Competitive pressures across the sector to improve performance will also likely be lost.

Finally, it is unclear whether the PP will be better placed or better equipped than Ofgem to resolve the issues that prevent the OPMs being switched on. If the PP can resolve the relevant issues across the sector, we would prefer Ofgem to leverage the PP's expertise to support the OPMs being implemented, instead of the PP attempting to assess performance in the specific focus areas as part of its assessment.

There could not have been legitimate expectations that the incentive weightings would have been changed:

We do not believe any stakeholder could have had a legitimate expectation that the DSO incentive weightings would be changed if the OPMs were not switched on.

Ofgem consulted on the proposed weightings of the DSO incentive (40% for the SS, 40% for the PP assessment and 20% for the OPMs) at Draft Determinations in June 2022.⁵ Ofgem confirmed the proposed weightings at Final Determinations in December 2022.⁶ Ofgem explained that the DNOs and some stakeholders proposed a greater weighting for the OPMs and others agreed with the weightings that were consulted on.⁷ We infer that there was at least broad stakeholder support for the SS and PP components comprising no more than 80% of the incentive value.

⁴ Paragraph 4.6 of the consultation.

⁵ “RIIO-ED2 Draft Determinations – Core Methodology Document”; paragraphs 4.59-4.60.

⁶ “RIIO-ED2 Final Determinations Core Methodology Document”; paragraph 4.56.

⁷ “RIIO-ED2 Final Determinations Core Methodology Document”; paragraph 4.55.

Working group meetings to develop the DSO incentive continued after Ofgem published Draft Determinations in June 2022. Several issues with the OPMs remained unresolved when Ofgem consulted on the DSO incentive arrangements in October 2022. The draft document included the proposals to set the incentive value for the OPMs to zero for 2023-24 and consult on OPMs targets “...with a view to establishing these for the Regulatory year commencing on 1 April 2024”.⁸ The version of the DSO incentive governance document that was published as part of the decision to modify the electricity distribution licences to give to the RIIO-ED2 price control was unchanged in these respects.

Both DNO and non-DNO stakeholders that provided non-confidential feedback and commented on the weightings encouraged Ofgem to *increase* the weighting of the OPM. The reasons included that the measuring performance via the OPMs is less resource-intensive than the PP assessment and, therefore, greater weighting should be applied to the OPM. None of those respondents instead proposed that the combined weightings of the SS and PP components should be increased above 80%. Furthermore, no one proposed alternative weightings that depended on when targets for the OPMs would be established.

The justification for the chosen weightings has never changed since it was first explained in Draft Determinations. The same justification was also presented in Final Determinations when Ofgem confirmed that the incentive value for the OPMs would be set to zero for the first year of RIIO-ED2 and did not reallocate the 20% of the incentive value. This situation is no different: the reason Ofgem proposes to keep the OPMs switched off is, again, because of concerns about target-setting.

The target-setting issues should be resolved with urgency:

Non-DNO stakeholders should be re-engaged in the DSO incentive working group:

As highlighted in the consultation, further working group meetings to develop the DSO incentive were held after the OPMs were confirmed at Final Determinations in December 2022. As far as we are aware, non-DNO stakeholders were not invited to participate in those meetings.

The absence of non-DNO stakeholders is relevant because the OPMs that were consulted on and confirmed at Final Determinations, and were supported by non-DNO stakeholders, have been changed. For example, the FDR metric in the consultation⁹ differs from that confirmed at Final Determinations¹⁰ or set out in the DSO incentive governance document¹¹. The version of the FDR metric in the consultation includes measures of historical flexibility deployment over multiple years whereas the confirmed version does not. This ‘smooths’ performance and results in DNOs’ performance in the relevant year having a smaller influence on the out-turn value of metric.

We accept that changes to methodologies and ways in metrics are calculated may be a necessary consequence of the effort to make target-setting for the OPM robust. However, it is necessary to ensure that the changes do not distort the out-turn values, do not introduce systematic bias and still satisfy non-DNO stakeholders’ needs. For example, it is unclear whether the revised version

⁸ “Distribution System Operation Incentive Governance Document” consultation; paragraph 5.4.

⁹ Page 14 of the consultation.

¹⁰ “RIIO-ED2 Final Determinations Core Methodology Document”; page 87.

¹¹ “Distribution System Operation Incentive Governance Document version 1”; page 23.

of the metric will allow for material changes in year-on-year performance to be identified as quickly or as easily as the original version of the metric would allow. This, in turn, may reduce the usefulness of the FDR metric to non-DNO stakeholders.

These nuances must be explored with non-DNO stakeholders to ensure any proposed changes are still fully targeted at the relevant specific focus areas of importance. We encourage Ofgem to re-engage non-DNO stakeholders and ensure that they are invited to participate in all future working group meetings.

The target-setting issues should be resolved with urgency:

We note that there is no indication of the steps that will be taken or the schedule to resolve the issues that make it inappropriate to switch on the OPMs. We encourage Ofgem to resolve the issues regarding target-setting for the OPMs as quickly as possible. This is because the DNOs will not be directly financially exposed to their performance in the specific focus areas that relate to our 'pain points' until the OPMs are switched on and, as such, there may be a weaker incentive on the DNOs to improve performance. We also encourage Ofgem to be open to switching on the OPMs during RIIO-ED2 if the target-setting issues can be resolved in a timely manner.

We hope you find these comments helpful. Please do not hesitate to contact me if you would like to discuss any aspect of this response.

Yours sincerely,

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Centrica Regulatory Affairs, UK & Ireland