

# Networks breakout sessions

1.1. Discussion centred around four main issues: outputs measures, managing uncertainty, equalising incentives, and information quality incentives.

## Development of output measures

1.2. There was general support for the concept of using output measures in the manner proposed by Ofgem. Much of the discussion focussed on how such a method could be best implemented.

1.3. It was noted that for DPCR5 it would not be possible to implement the same set of output measures for all DNOs. Some participants felt that in the long term it would be desirable to implement a homogenous set of output measures across all DNOs to allow comparisons to be made, Others felt that the DNOs have the knowledge and information. There shouldn't be an issue with a certain amount of diversity. It was suggested that the choice of output measures would need to be flexible to reflect the future demands on the networks.

1.4. Some concern was raised over the robustness of any proposed output measures given the timescale available for their development. Some of the data required to develop particular output measures might not yet be available. One DNO mentioned that disaggregated data and measures existed for different parts of its network and that any measure proposed to Ofgem would need to be a consistent macro-measure capturing a range of this data.

1.5. Some attendees were in favour of experimenting at DPCR5 so that lessons could be learnt for future reviews while others were in favour of a more cautious approach with no direct link to price control revenue. Failure to achieve outcomes could trigger a review of the DNO's performance, It was recognised that any lessons learnt would not be costless and that financial exposure of the scheme should be proportionate in terms of the potential costs to customers.

1.6. There was a question raised as to whether Type 1 companies (those who develop tightly defined, measureable and verifiable output measures) should be given higher or lower powered incentives compared with Type 2 companies (those who develop more limited output information). It was clarified that the intention is for Type 1 companies to be able to earn higher returns based on verifiable performance against the measures proposed. It was also clarified that the distinction between Type 1 and Type 2 companies is largely to incentivise the development of output measures, and that there are other incentives in place to encourage efficiency of delivery. A question was raised as to whether companies would be able to progress from Type 1 to Type 2 during the price control period.

1.7. One attendee noted that if a company was risk averse it may prefer to be Type 2 as this would allow it greater protection against uncertainty through both weaker incentives and less tightly defined output measures giving it greater flexibility.

1.8. One attendee commented on whether it was really credible that Type 2 DNOs would face less scrutiny of their cost forecasts. They also commented that the symmetry present in the IQI meant that an opportunity to earn higher returns was also an opportunity to make lower returns when faced with overspends.

1.9. There was discussion around the mechanism to deal with DNOs that miss output targets. Ofgem suggested that this should act as a trigger for a more intrusive review which would consider whether targets have been "traded" to accommodate changing network requirements.

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1.10. There was general agreement that the development of output measures for DPCR5 would be work in progress. The aim should be greater clarity on what the DNOs are expected to deliver for the costs. There should be some flexibility and scope for reprioritisation through the period.

### Uncertainty

1.11. The issue of indexation to manage price uncertainty was discussed. It was raised that Ofgem has previously been opposed to introducing indexation into price controls and that a mechanism to trigger indexation at a certain level of price fluctuation might be a compromise. Concerns were expressed over suitability of indices currently available and the composition of any new index that might be proposed. In particular, there were concerns that this might incentivise companies to hedge against the fabricated index rather than against genuine price risks.

1.12. A supplier noted that it would like to be able to offer its customers more stability in prices which would be best aided by having either more predictability in charges or indexation of charges against items that they could hedge against.

1.13. It was suggested that if indexation of input prices were introduced then the pass-through of changes in input prices should only be partial. It was thought that this might incentivise DNOs to better manage their costs.

1.14. The possibility of introducing a focussed reopener for a "material" event was raised, dependent on a suitable definition of materiality being reached. It was generally agreed that any mechanism to deal with uncertainty should be symmetrical.

1.15. Comparison was made to the water industry where a change in costs (increase or decrease) greater than 10% of a year's revenue can trigger a reopener. It was pointed out that when real prices have decreased the onus is on the regulator to initiate a reopener.

1.16. There was discussion concerning the increase in complexity of the price control that drivers and indexation would bring and also the increase in regulatory burden and cost to DNOs brought about by price control reopeners. A consensus was not reached on whether it would be a good idea to set out in advance a predefined process for such reopeners.

### Equalising incentives and the IQI

1.17. The materiality of the issue was raised by one attendee who questioned whether there were practical examples of inefficient trade-offs or of misreporting being made between opex and capex. Examples were given of the activities that occur at cost boundaries and incentives to re-categorise costs (particularly between direct opex and capex). Within the discussion it was also suggested that operational measures such as demand side management which reduce network investment requirements should be treated in the same way as network investment costs so that DNOs face an efficient trade-off between the measures.

1.18. It was generally agreed that the cost boundaries should be revisited. Two options were proposed – capitalisation of a percentage of the total cost base (totex) or a more cautious reassessment of cost categorisation and capitalisation policy, capturing the main areas where there are boundary issues. There were differing opinions expressed as to the benefits/pitfalls of the totex approach. One concern raised about the totex approach was its effect on the financeability of the DNOs.

1.19. The approach that the water industry has adopted of much more detailed regulatory accounting guidelines and independent audits was also raised as an alternative.

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1.20. Two attendees commented that they thought the approaches being discussed were big decisions that would set precedents for future reviews and that a better forum for their discussion might be as part the RPI-X@20 review.

### Information quality incentives

1.21. It was commented that it is in the interests of DNOs to try and gain the highest baseline they can from the IQI and that their initial forecasts might form part of this process. One attendee stated that from their experience risk aversion was real: companies might inflate their forecasts to obtain a lower expected return but more pass-through of any over- and under-spends. It was also pointed out that a stronger incentive rate from the IQI is an opportunity to gain both higher and lower returns than are available from weaker incentive rates. In response to this it was suggested that Ofgem may wish to consider an asymmetric scheme which did not treat over- and under-spends equally.

1.22. Attendees did not put forward any ideas for further steps that could be taken to ensure that companies deliver more robust forecasts.