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Consultation on conflicts in the Distribution Losses Incentive Mechanism and data to be used in calculating its components

Dear Stephen

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

We provide responses to each of the questions raised in the consultation in appendix 1, however we would like highlight three key issues:

1. **Data to be used in the "Five times E" component of the Losses Rolling Retention Mechanism**
   As we show below, DPCR5 Final Proposals are clear on the data to be used in the close out of the DPCR4 losses scheme (the "Five x E" component). Specifically, the 2009-10 data to be used is settlement data for 2009-10 (based on settlement date). We are assuming that Ofgem policy in this regard has not changed from Final Proposals.
2. **DNO restatement applications**
   Since Final Proposals requires 2009-10 settlement date data to be used in the close out of the DPCR4 scheme, any DNO restatement application must be on the same basis i.e. using settlement date data for all years of DPCR4.
3. **Expectations of DNOs allowed revenues**
   DNOs have received £379m through the DPCR4 losses scheme to date. However, there is little evidence, if any, to show that any significant carbon reductions have been achieved by the losses incentive. It is currently indicated that only £187m will be returned to consumers through the close out, leaving DNOs with nearly £200m. Any view on returning revenues to their 'proper' level must be based on the value of the scheme and value to consumers and not the value of the close out term.

Further details on these issues are provided below.

<u>Data to be used in the "Five times E" component of the Losses Rolling Retention Mechanism</u>

The policy intention contained in DPCR5 Final Proposals, and accepted by DNOs, is explicitly clear in relation to the data to be used in the "Five times E" component of the LRRM.

Final Proposals state[1]:

"***Adjustments arising from settlement corrections and provision accounts***
4.19. As stated in Initial Proposals we will require the DNOs to report corrections to the DPCR4 losses that take place after the end of the DPCR4 period, so that all the settlement data associated with DPCR4 has been accounted for and the DPCR4 annual reported losses have been revised accordingly. This includes subsequent corrections to DPCR4 settlement data and the 'closing out' of DPCR4 provision accounts. As we stated, this will ensure that all DNOs receive the losses incentive based on their absolute losses performance over DPCR4 and ultimately, that rewards/penalties under the DPCR4 scheme are not influenced by the different reporting bases that companies used.

4.20. However, the final year losses reported by the DNOs will probably include corrections in settlement data for prior years. In order to ensure that the LRRM works correctly, the final year losses figure adjusted in paragraph 4.17 above will exclude any corrections to prior years.

4.21. Therefore we will determine $ACL_{2009/10}$, the reported losses in the last year of DPCR4, as the losses experienced in the final year, excluding any corrections to prior years, but with subsequent settlement corrections to the final year added in (including provision account adjustments to provide the actual final year losses). We will also determine $LUD_{2009/10}$ as the units distributed in the last year of DPCR4 excluding any corrections to prior years, but with subsequent settlement corrections to the final year added in."

The footnote associated with paragraph 4.14 of Final Proposals is also explicitly clear in this regard when it makes clear that ACL2009/10 (used in the 5 x E calculation) is the reported losses in 2009-10 subject to the adjustments described in paragraphs 4.19 and 4.20. Therefore it is reconciled settlement data that should be used in the calculation of 2009-10 losses for the purposes of the close out of the DPCR4 scheme. For the avoidance of doubt, this will include corrections to half-hourly metered data (i.e. units associated with prior years must be excluded from 2009-10 data) as well as reconciliations to non-half-hourly data.

Paragraph 4.19 refers back to Initial Proposals. The context of 4.19 is made explicit in paragraphs 7.8 to 7.11 of the Incentives & Obligations document of Initial Proposals[2]. This is extracted below:

"***Finalising DPCR4 data***

7.8 We will not have visibility of the actual DPCR4 losses until mid DPCR5. This is for two reasons:

- *The final year (2009-10) losses will not be reported until July 2010, and*
- *The settlement data from which losses are calculated can continue to be revised for a further 28 months.*

7.9 We therefore propose to leave the DPCR4 losses incentive open for the first three years of DPCR5 until the settlement corrections are complete. We will require the DNOs to report these corrections so that all the settlement data associated with DPCR4 has been accounted for and the DPCR4 annual

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[1] Chapter 4, Electricity Distribution Price Control Review Final Proposals - Financial methodologies.
[2] Chapter 7, DPCR5 Initial Proposals - Incentives and Obligations

reported losses have been corrected accordingly. This proposal will ensure that all DNOs receive the losses incentive based on their absolute losses performance over DPCR4 and ultimately, that rewards/penalties under the DPCR4 scheme are not influenced by the different reporting basis that companies used.

7.10 Our proposal in this regard is not influenced by any decision we may make on the DPCR4 losses rolling retention mechanism.

Losses rolling retention mechanism

7.11 Our current view is that the absolute losses performance (i.e. losses that have been adjusted to reflect the final settlement data as described above) will be exposed to the rolling retention mechanism as considered in the DPCR4 Final Proposals."

The policy intention of the above is clear to us:

- The close out of the DPCR4 losses incentive is not to be influenced by the different reporting methodologies that companies used.
- All DNOs are required to correct their 2009-10 annual reported losses so that final 2009-10 losses is based on settlement date data (i.e. not on the basis of their own reporting methodology, or on the basis of settlement data received during 2009/10).
- It is this corrected 2009-10 data that will be used in the 5 X E calculation.

Paragraph 3.6 of the current consultation states that the "Five times E" component of the Losses Rolling Retention Mechanism (LRRM) will be drawn directly from 2009-10 revenue reporting. Paragraph 3.10 of the consultation then states that Ofgem does not consider such an approach to be a change of policy.

On first reading, this might be interpreted as inferring that if no restatement of 2009-10 data is sought by a DNO, or approved by Ofgem, then the 2009-10 data included in the original DNO revenue returns will be used in the "Five time E" element of the LRRM. However, this simple interpretation is inconsistent with Final Proposals and so would constitute a change of policy.

Therefore in order for the Ofgem's statements in 3.6 and 3.10 of the current consultation to be valid, the 2009-10 revenue reporting data referred to must be the corrected 2009-10 annual reported losses as envisaged by Final Proposals.

We believe that the correction to the annual reported losses for 2009-10 should be done via a formal restatement of the revenue return since this would then be auditable. Clearly it would not be logical to audit the losses data for the five initial revenue returns and then to simply ask DNOs to provide un-audited adjustments for the critical aspect of determining the overall value of the losses scheme.

We are currently assuming that Ofgem's policy, agreed at Final Proposals and as described above, has not changed. Clearly any change in this policy could have a dramatic impact on consumers and could not be implemented without a proper consultation and impact assessment.

DNO Restatement Applications:

The above means that, as a matter of course, DNOs will be required to resubmit corrected 2009-10 data (based on settlement date data) in order to give effect to the intention of Final Proposals. It follows that any further application for 'restatement' of 2009-10 data by DNOs must be on the same basis. If DNOs still believe that 2009-10 settlement date data has been affected by abnormal settlement volatility then their restatement application and test for abnormal volatility during DPCR4 must also be on the basis of settlement date data (i.e. not on the basis of DNOs own methodologies) to ensure a valid test. For clarity, this would require the test for abnormal volatility to use settlement date data for all DPCR4 years.

Final Proposals were clear that the basis on which the DPCR4 losses incentive would be closed out would be on settlement date data for 2009/10 for all DNOs. This is a sensible and appropriate approach. The targets for DPCR4 were based on a long term average value for losses, which will have been deemed to have represented a sensible target at the time they were set. The last sentence of paragraph 4.19 of Final Proposals is absolutely clear – Ofgem's intention, accepted by the DNOs, was that DNOs would "*receive the losses incentive based on their absolute losses performance over DPCR4 and ultimately, that rewards/penalties under the DPCR4 scheme are not influenced by the different reporting bases that companies use"*.

Given the time frame over which data was used to calculate the targets for DPCR4, we believe all possible methods of measuring losses for 2009/10 will be inconsistent with the exact basis on which targets were set, whether they use settlement date data, data received during the year or include some form of restatement.

We believe all restatement applications and statistical test for abnormal volatility received by Ofgem from DNOs should be on the basis of settlement date data and not on the basis of DNOs own reporting methodologies. If any are not on the basis of settlement date data, then Ofgem should require the DNO to resubmit the application on the correct basis.

We would also note that the use of 2009-10 settlement data for the close out of the DPCR4 scheme will allow for a more transparent process as various industry parties will have access to such data.

Expectations of DNOs allowed revenues

Ofgem have recently published data that shows that the amount of losses incentive received by DNOs over the DPCR4 period to date amounts to an incentive payment of £379m[3], £101m of which relates to the windfall gain associated with DPCR3 units recognised during DPCR4 which were excluded from the DPCR4 targets (and will also be excluded from the DPCR5 targets). The £379m does not include the estimated windfall payment of £100m received in 2004/05 by DNOs (again these low loss levels were excluded from the DPCR4 targets). There is little evidence, if any, to show that any significant carbon reductions have been achieved by the losses incentive. DNOs are currently only forecasting a close out 'payback' to consumers of £187m. Against the background of the amount DNOs have already received during DPCR4 and the limited carbon savings achieved by the scheme, we would suggest that the payback could be much higher and certainly the payback currently forecast by DNOs can not be viewed as a windfall loss.

In chapter 2 of Ofgem's consultation, a common weakness listed for a number of the options is that it would alter the DNOs forecasted allowed revenue for 2013-14 and 2014-15. It is important for Ofgem to realise that the expectations of the market are influenced by these forecasts and the

[3] Supporting spreadsheet to Electricity Distribution Annual Report for 2010-11; Electricity_Distribution_Annual_Report_(public).xlsm. Note that we have corrected the ENWL 2009-10 losses incentive to reflect the restated value of £0.67m contained in Ofgem's interim decision of 29/07/2011.

current published DNO information suggests a net reduction in revenues of £187m in relation to the close out of the DPCR4 scheme. As we explain above, we do not believe that this reduction in revenues represents a windfall loss to the DNOs, rather we believe that in the majority of cases this will simply be paying back unwarranted annual incentive gains from earlier years in DPCR4. It is the overall value of the scheme (5 x E) that is important in understanding whether windfall gains or losses may have occurred, not the value of the close out (PPL term). Any view on returning revenues to their 'proper' level must be based on the value of the scheme and value to consumers and not the value of the close out term.

I trust our response is helpful to you in forming your decision in this important area. If you have any questions on any of the issues raised in this response please do not hesitate to get in touch.

Kind regards,

[by e-mail]

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Appendix 1:

Chapter 2: Potential solutions to the conflict between the interaction adjustment and cap and collar

Question 1: Which of the strengths and weaknesses we have suggested are most important to you as we consider options to resolve the conflict?

All of the strengths and weaknesses Ofgem suggest are important however our key concern is the impact on consumers and ensuring that DNOs do not receive further windfall gains. Consumers are already funding significant increases to network investment to facilitate the transition to the low carbon economy, and at a time when household budgets are being squeezed, it is imperative that they are protected from also funding unwarranted and unjustified windfalls for the network companies through an incentive that has provided at best modest reductions to carbon emissions.

It is also important that any proposed solution to the interaction with the DPCR5 caps and collars is not seen to be some sort of compromise approach which reduces the potential windfall gains received by the DNOs. DNOs have already received a windfall of c. £200m for DPCR3 units not included in DPCR4 targets – there must be no further windfalls in the close out of DPCR4.

Depending on the outcome of DNO restatement applications and any consequential impact on ACL2, the solution to the caps and collars issue should seek to ensure that suppliers and consumers are protected from huge changes to the current forecast in the public domain.

Question 2: Are there any strengths or weaknesses we have missed?

We believe Ofgem have captured most of the key strengths and weaknesses. We believe a further criterion would be how well the options maintain the integrity of the incentive scheme. Options 1 and 2 would appear to do this better than options 3 to 5. Option 3 breaks the link between the DPCR4 close out and DCPR5 targets, whilst options 4 and 5 could result in asymmetric incentive properties.

Question 3: What is your assessment of the options we have suggested? In providing your response, please also consider the extent to which any option moves away from the original intent of the DPCR5 settlement.

Ofgem identify two potential problems with the DPCR5 cap and collar. First, it is possible for the amount that the LRRM interaction adjustment recovers exceeds the overall DPCR5 cap/collar for the DNO which will cause a windfall gain or loss.

The second problem is that even if the amount that the LRRM interaction adjustment recovers does not exceed the cap and collar amount, the restrictions of the DPCR5 cap and collar create an asymmetrical revenue exposure for the DNO that will affect the theoretical incentive properties of the DPCR5 scheme.

Option 1. Remove the interaction adjustment from the DPCR4 LRRM and introduce an annual interaction adjustment during DPCR5.

This option would seem to us to resolve the issues identified and maintains sensible targets and incentives.

Option 2. Remove the interaction adjustment from the DPCR4 LRRM and set 2009-10 performance as the target.

This option resolves the issues, but in theory could provide caps and collars which from a practical perspective are inappropriate (as the target may not represent ongoing performance) and therefore may not provide the correct incentive properties.

Option 3. Remove the interaction adjustment from the DPCR4 LRRM and set 2010-11 performance as the target.

Of all the options considered, this seems to us to represent the largest departure from Final Proposals since it breaks the link between the close out of the DPCR4 scheme and targets for DPCR5.

Option 4. Introduce a cap and collar on the DPCR4 LRRM interaction amount.

This does not solve the issue of the cap and collar being (theoretically) inappropriate if 2009/10 performance varies from the target.

Option 5. Change the DPCR5 cap and collar amounts.

Option 5 may lead to larger and potentially asymmetric caps and collars which has the potential to produce more volatile incentive outcomes.

Question 4: Which is your preferred option for resolving the conflict and why?

For the reasons outlined above, we have a preference for option 1.

Question 5: Are there any other options we should consider?

We are comfortable with the range of options proposed by Ofgem.

Chapter3: Data to be used for the DPCR4 LRRM and DPCR5 ALP

Question 6: Do you think that nominal or RPI-indexed values for incentives over DPCR4 should be used in the LRRM calculation? And do you have any other views on the Five times E component?

Although not explicitly stated in Final Proposals, common sense would dictate that the intention was to use RPI-indexed values for incentives over DPCR4. There is also a strong case to suggest that the close out calculation should be performed on an NPV neutral basis.

Question 7: What are your views on the reasons why losses positions might increase, remain at 2009-10 levels or reduce? What bearing should this have on the decision about whether DNOs should use a restated or un-restated ACL2 figure? Please provide evidence or analysis you consider necessary to support your position.

Ofgem provide 4 scenarios in the consultation as follows:

Scenario	Level of DPCR5 losses	Data used to calculate the interaction adjustment	Result
1	Continues at un-restated 2009-10 levels	Restated 2009-10 data	DNO incurs a windfall loss
2	Continues at restated 2009-10 levels	Restated 2009-10 data	Interaction adjustment operates as intended
3	Continues at un-restated 2009-10 levels	Un-restated 2009-10 data	Interaction adjustment operates as intended
4	Continues at restated 2009-10 levels	Un-restated 2009-10 data	DNO incurs a windfall gain

It is difficult to predict what will happen to losses as measured by settlement data over the DPCR5 period. Two DNOs (WPD and NPG), representing 6 licence areas, included losses data for the DPCR4 period as part of their recent responses to Ofgem's consultation on the effects of GVC on the losses incentive. It is clear from this data that losses performance from the early years of DPCR4 was not indicative of overall scheme performance, so we can dismiss considering data from the early years of DPCR5 as being indicative of losses performance for the overall DPCR5 period.

The overall value of the DPCR5 scheme will not be settled until the data for 2014/15 has been finalised. If restatements are allowed, it is in the interest of consumers to use restated 2009-10 data for the interaction adjustment as this will remove the possibility of DNOs receiving a windfall gain. If losses turn out (in 2014-15) to have broadly followed the un-restated level (scenario 1) and the DNOs have incurred a windfall loss then there is a natural commercial driver for them to apply for a restatement. It seems very unlikely to us that if the reverse scenario occurs (scenario 4), that DNOs will come forward with a restatement application to avoid the windfall gain. This is supported by the fact that in the years during DPCR4 when losses were unfeasibly low, no DNO came forward with a proposal to restate or adjust their methodology and neither did Ofgem, who had the power to do so embedded within the DNO licence[4]. Whilst this current process of closing out the DPCR4 losses scheme has proved to be difficult, it seems obvious to us that consumers would prefer the industry to go through it again, if necessary, at the end of DPCR5 rather than provide DNOs with the opportunity for windfall gain.

Ofgem implemented the DPCR4 losses incentive scheme in a manner which locked in the ability to allow DNOs to make windfall gains by not including in the DPCR4 targets any remaining out performance relating to DPCR3 years received after the targets were set. Windfall gains have been made because of this (estimated at £200m across all DNOs) – it would be dangerous for Ofgem to make a decision for the DPCR5 scheme which could provide another opportunity for locked in windfall gains.

Question 8: Do the options put forward for Chapter 2 have any bearing on the question of whether to use a restated or un-restated ACL2?

In our previous consultation response on this matter, we provided robust analysis and evidence to support the view that any restatement of the ACL term will distort the overall value of the losses incentive scheme unless it is accompanied by either an identical adjustment to the value of the ACL2 term or by including the restated data in the calculation of the DPCR5 targets. Both approaches will give the correct net incentive payment, as shown by the model we have previously provided to Ofgem, however which is most appropriate depends on whether you view that any corrections included in 2009-10 settlement data represent corrections to previous DPCR4 years or whether they represent corrections to much earlier years (DPCR3). If Ofgem believe that the corrections relate wholly to DPCR4 years then any restated data should also be used for ACL2 and the un-restated data used for the calculation of the DPCR5 ALP. If however Ofgem believe that the correction relates wholly to DCPR3, then the ACL2 term should not use restated data but the DPCR5 ALP term must use the restated data since to do otherwise will result in targets that are too lenient.

In practice, neither Ofgem nor the industry know for sure what proportion of any corrections to 2009-10 data represent corrections to prior DPCR4 years or earlier DPCR3 years. We believe the majority of the corrections relate to prior DPCR4 years based on our own policy of data corrections at the time, however we do not believe it is critical to know for sure what years are being corrected. What is important is to make a principled decision based on the best information available and then stick to that principle. This means that if Ofgem allow restatements and they believe that the majority of the corrections made in 2009-10 relate the years prior to DPCR4 then they need to follow that logic through to the setting of ALP for DPCR5. Similarly if Ofgem allow restatements and believe the majority of corrections in 2009-10 relate to earlier DPCR4 years then they need to follow that logic through and adjust the ACL2 term in the interaction adjustment.

In relation to the options put forward in chapter 2, we would point out that option 2 (removing the interaction adjustment) removes the option of adjusting ACL2 and therefore for this option the DPCR5 ALP must be calculated using restated data regardless of whether or not Ofgem believe any 2009-10 corrections relate to DPCR3 years.

Question 9: Should we use a restated or un-restated ACL2 for calculating the DPCR4 LRRM Interaction Adjustment?

[4] Paragraph 7, *SPECIAL CONDITION C1 – Calculation of charge restriction adjustments arising from the distribution losses incentive scheme*

As we state above, Ofgem must either use the restated ACL2 value for calculating the DPCR4 LRRM Interaction Adjustment or use restated 2009-10 data in the calculation of the DPCR5 ALP. Which option is most appropriate depends on Ofgems view on whether the majority of corrections to 2009-10 data are for errors in DPCR4 years or for errors in DPCR3 years.

Question 10: Do you think we should use restated or un-restated 2009-10 data for the purposes of calculating the DPCR5 target? Please consider your response to the previous question and to questions in Chapter 2 of this document in responding?

As stated above, we believe that if restatements are permitted then Ofgem need to decide whether the corrections included in the original 2009-10 settlement date data related to earlier DPCR4 years or not. If the corrections represent years prior to DPCR4 then the targets for DPCR5 must use restated data (and ACL2 can use un-restated data) however if the corrections represent earlier DPCR4 years then it is appropriate to use un-restated data for DPCR5 (but ACL2 must use restated data).

Question 11: Do you think either of these two options may successfully be used to restate units distributed in 2009-10 under the DPCR5 methodology? Can you offer an alternative method? Which method should be used for restating UD2009-10?

We do not think that either method is appropriate. The model that we provided in our response to the previous consultation clearly shows that in order to arrive at the correct financial outcome the adjustment required to the ACL2 term must be the GWh value adjustment applied as part of the DNO restatement uplifted for the DPCR5 allowed loss percentage (ALP) (cell H53 of the 'D' options in our model contains the required adjustment to the formula).

Question 12: Alongside your consideration of whether to use restated or un-restated 2009-10 data, we are seeking views on the degree of any departure from the DPCR5 settlement and any observations or concerns you may want to share with us.

We have already highlighted out key concerns with regards to any departure from the DPCR5 settlement, especially in relation to the data to be used in the five x E component of the close out calculation.

Given the potential impacts on consumers, we believe that all relevant information should be made available before any restatement application is approved. For example, at a minimum we would expect to have sight of the following for each DNO:

- The amount of annual incentive received during DPCR4 (we note that this information has recently been published by Ofgem).
- The overall value of the DPCR4 scheme (5 x E) with no restatement.
- The overall value of the DPCR4 scheme (5 x E) with restatement.

In relation to Ofgem's decision letter on the regulatory measures to address the effects of gross volume correction and other settlements data adjustments on the distribution losses incentive mechanism, we believe there is a potential anomaly with Ofgem's proposed cap to restatements applications.

If any restatement application is capped such that the restated gross close out of DPCR4 may not be greater than if the average performance for the first three years of DPCR4 was maintained during 2008-09 and 2009-10 then the cap could be based on data that contains abnormally positive reconciliations, or is not credible due to exceptionally low level of losses. In these circumstances, a DNO that has received very high incentive payments for the first three years of DPCR4, unwarranted by actual DNO activity, would be allowed to keep this incentive, contrary to market expectation, maintaining revenues above the proper level.