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By Email only

09 May 2012

Dear Dora,

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

Thank you for the opportunity to respond to the above consultation.

We have considered the options put forward in the consultation against the identified strengths and weaknesses, and the further key issue of the extent to which any option moves away from the original intention of the DPCR5 settlement. We consider that Option 4 requires the minimum change necessary in order to remove the unintended consequence of windfall gains or loss in the DPCR5 incentive mechanism. We support the principle that DPCR4 should be settled on a self-contained basis as far as possible, minimising ongoing interaction with DPCR5 and reducing uncertainty going forward.

We consider that Option 1, 2, 3 and 5 are attempting to solve an issue which is inevitable given the design of the DPCR5 incentive, and goes beyond the unintended consequence arising out of the mechanism. Data volatility can drive performance to an asymmetric risk position, or even to the cap/collar, on whatever basis the target is set. If sufficient justification can be found for attempting to mitigate this issue however, it would be appropriate to take the take the full step away from DPCR4 by setting the DPCR5 target on 2010/11 data (Option 3). Option 5 would be a completely inappropriate response and would be to the detriment of DNOs, suppliers and customers.

We do not believe that the data for DPCR5 target setting should be adjusted, as otherwise it would be necessary to continue to apply similar adjustments throughout DPCR5. Furthermore we believe it should be a fundamental principle that that the ACL2 term is calculated on a consistent basis with the DPCR5 target rather than with data used during DPCR4. We therefore consider that unadjusted data should also be used in the ACL2 term in the LRRM.

Our detailed responses to the questions raised in the consultation are attached. If you would like to discuss our consultation responses in more detail please do not hesitate to contact me.

Yours sincerely,

Tony McEntee

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Specific Questions

CHAPTER 2

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

We have summarised the perceived strengths identified by Ofgem in Table 1 below.

Table 1

Ref	**Strengths**	**Applicable Options identified by Ofgem**
1	There is no opportunity for DNO revenue loss or gain as a result of the conflict.	1, 2, 3, 4 and 5 (dependent on the size of the collar)
2	This option would spread the financial impact of the interaction adjustment over several years, rather than two years, thus reducing volatility in DUoS charges.	1 (5 years); 2 (5 years); 3 (4 years)
3	All DNOs would have an equal incentive to improve losses performance during DPCR5.	1, 2, 3
4	Setting the target during DPCR5 allows a longer lag beyond the abnormal data cleansing activity known to have affected 2009-10 data.	3
5	There are no interdependencies with the calculation of the DPCR4 LRRM and DPCR5 ALP.	5

We have the following comments on these points:

1. All options must meet this criterion as it is the main issue that the proposals are seeking to address.
2. Although this is a sensible objective, it is not restricted to options 1, 2 and 3. In the context of the significant potential changes to the mechanism proposed there is no reason why the PPL, however calculated, could not be spread over a longer term, or potentially absorbed into the RIIO ED1 settlement.
3. This does not necessarily follow; the incentive for each DNO will be driven by their relative performance against target from year to year. Experience suggests that it is possible for a DNO to be outside the cap/collar in a given year, on whatever basis the target is set.
4. We acknowledge this as a specific strength of Option 3, particularly in relation to the structurally similar Options 1 and 2. Furthermore, this option would mean that the issue of adjusting 2009/10 data, and indeed all consideration of DPCR4 data could be closed off.
5. We do not see this as a particular advantage of this option, particularly when weighed against the clear disadvantages (see below).

Our commentary on Ofgem's identified weaknesses of the options follows Table 2.

Table 2

Ref	Weaknesses	Applicable Options identified by Ofgem
1	This solution would need to be implemented before we can issue a direction on the value of the PPL term.	1, 2, 3, 4
2	This could alter the DNOs' forecasted 2013-14 and 2014-15 PPL amount, thus altering the DNOs' forecasted allowed revenue.	1, 2, 3
3	There could be a discrepancy between DNOs' reported performance against the DPCR5 ALP and the financial incentive amount that the DNO received.	1
4	The DPCR5 target only takes into account losses in one year.	2 (2009/10); 3 (2010/11)
5	The losses mechanism is effectively switched off for 2010-11, removing any rewards/penalties due to changes in performance from 2009-10.	3
6	Asymmetrical revenue exposure for DPCR5 remains, thus potentially removing the incentive for some DNOs to reduce losses during DPCR5.	4, 5
7	This option could limit the incentive amount that the DNOs can earn under the DPCR4 losses incentive mechanism.	4
8	All options to change cap and/or collar values will inevitably result in a widening of the gap between them, increasing exposure for DNOs and potential volatility for suppliers. This increased risk of volatility in DNO allowed revenue position would result in increased risk of volatility in customers' DUoS charges.	5
9	This option reduces certainty on the DNOs allowed revenue position and DUoS charges during DPCR5.	5

We have the following comments on these points:

1. This is true, but is not a sufficiently strong argument against these options (or in favour of the remaining Option 5).
2. This weakness applies to all options. The forecast revenue will continue to be subject to significant uncertainty until decisions are made on 2009/10 resubmissions, the choice of option for resolving the capping issue, and how the DPCR5 target is to be set.
3. We do not see this as a particular weakness. Arguably, the financial adjustment relates to performance in the DPCR4 period.
4. Relying on a single year's performance for target setting is not consistent with the DPCR5 final proposals. In particular, using 2009/10 as the relevant year would not be appropriate in the context of the significant data and volatility issues that have been identified.

5. Switching off the incentive for one year is not a significant issue in view of the data corrections that have taken place, and is outweighed by item (4) in the list of strengths.
6. Asymmetrical revenue exposure for DPCR5 can exist under any of the options and is a characteristic of the losses incentive as structured rather than a feature of any particular option identified here. However we acknowledge that the degree to which this might occur would be reduced by selecting Option 3.
7. This is not a weakness and is in fact the objective of all the options as set out in Strength 1. The amount earned under the DPCR4 incentive currently includes an amount related to an uncapped interaction adjustment. Application of a cap/collar to this adjustment is the most transparent way of dealing with the issue of windfall gains or losses and is a key strength of Option 4.
8. This is a significant weakness which, when considered in the light of recent experience, should make Option 5 unacceptable to DNOs, suppliers and customers.
9. Same comment as 8, above.

In summary, although we are in general agreement with the strengths identified by Ofgem, our assessment of the options, below (Question 3) is based more on consideration of the extent to which each option moves away from the original intention of the DPCR5 settlement.

The identified weaknesses do not provide compelling arguments against any particular option except in the case of Option 5, which should be rendered unacceptable by the prospect of increased uncertainty regarding the DNOs allowed revenue position and DUoS charges during DPCR5.

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

We believe that the extent to which an option moves away from the original intention of the DPCR5 settlement should be a central consideration.

We highlight below three relevant key principles of the DPCR5 settlement from the Final Proposals – Incentives and Obligations document (Table 6.1):

- Target is a fixed loss percentage based on the average of DPCR4 performance (using common reporting method)
- 5 year roller
- Annual smoothing (of cashflow); and cap and collar on total DPCR5 incentive amount

We consider that the agreed level of the cap and collar on total DPCR5 incentive amount, ie the sum of the DPCR5 annual incentive amounts and the DPCR5 closeout, to be fundamental. Option 5, changing the DPCR5 cap and collar amounts, changes the risk position fundamentally and should be ruled out on this basis.

Only Option 4 (and 5) retains the principle of a target based on average of DPCR4 performance. We consider the adoption of alternative targets to be a significant move away from the original settlement.

Similar arguments apply to the treatment of DPCR5 target and ACL2, as shown in our response to Question 10, below.

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

We consider that Option 4 requires the minimum change necessary in order to remove the unintended consequence of windfall gain or loss through the combination of the DPCR4 LRRM and the DPCR5 incentive mechanism. We support the principle that DPCR4 should be settled on a self-contained basis as far as possible, minimising ongoing interaction with DPCR5 and reducing uncertainty going forward.

We consider that Option 1, 2, 3 and 5 are attempting to solve an issue which is inevitable given the design of the DPCR5 incentive, and goes beyond the unintended consequence arising out of the mechanism. Data volatility can drive performance to an asymmetric risk position, or even to the cap/collar, on whatever basis the target is set. Options 1, 2 and 3 are structurally similar and attempt to mitigate this issue. If sufficient justification can be demonstrated for adopting one of these options it would be appropriate to take the full step away from DPCR4 by setting the DPCR5 target on 2010/11 data (Option 3). Option 5 would be a completely inappropriate response and would be to the detriment of DNOs, suppliers and customers.

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

We believe that Option 4 (applying caps within the LRRM) addresses the issue of windfall gain/loss adequately whilst requiring the minimum change from the existing arrangements.

If sufficient justification is established for moving significantly from the current arrangements to Option 1,2 or 3 (in order to make the DPCR5 incentive more effective), then it would be appropriate to go to Option 3. This option, by setting the target at the 2010/11 level, would remove the need for further consideration of 2009/10 (and indeed all DPCR4 period data) and in particular make the further adjustment of this data unnecessary.

We believe that Option 5 (increasing the caps and collars) would move away from the DPCR5 settlement to such an extent as to render it unacceptable.

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

We have no suggestions in the context of the existing DPCR5 arrangements.

CHAPTER 3

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 5 times E component?

There is no reference to indexation of the ‘sum of the incentive over DPCR4’ in the relevant paragraph (4.26) of the DPCR5 Final Proposals Financial Methodologies document; however, it would seem appropriate that the ‘5 times E component’, measured in 2009/10 money, should be compared with previous earnings brought to the same base year by application of an RPI index (PIAL, as used in CRC 7).

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.

We have no particular view as to the direction in which losses positions might change; only that we anticipate increasing volatility as the smart metering programme gathers pace. This reinforces our view that un-restated data should be used for the DPCR5 target and the ACL2 figure as if restatement is used to set the DPCR5 target then this would need to continue throughout DPCR5. Although it may, in the event, be necessary to consider the issue of data corrections in DPCR5 it would be better to do this once sufficient evidence has emerged rather than to do so at the outset.

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

The issue of DPCR5 data correction should be addressed independently of the choice of option for addressing the DPCR4/DPCR5 interaction issue.

It may be noted however that Option 3, by removing the Interaction Adjustment and setting the target on 2010/11 data, removes this issue from further consideration.

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

We find it rather strange that this question should be asked independently of consideration of the DPCR5 target. The purpose of the ACL2 term in the LRRM calculation is to calculate the Interaction Adjustment, ie the amount of any windfall gain or loss that would accrue to the DNO based on its 2009/10 performance against target under the DPCR5 methodology. The important principle, therefore, is that ACL2 is calculated on a consistent basis with the DPCR5 target rather than with data used during DPCR4.

Our answer to Question 10 below indicates that we believe that the DPCR5 target, and therefore ACL2, should be based on un-restated data.

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?

The DPCR5 target should be based on un-restated data as we do not agree that correction is necessary or appropriate in respect of DPCR5 data. The key issue is that each of the DPCR4 and DPCR5 regimes is internally consistent in terms of target-setting and performance measurement. For DPCR4 this is achieved by ensuring that the data reported for 2009/10 reflects, as far as reasonably practicable, the level of reconciliation activity that was taking place when the targets were set (ie the ten year period prior to DPCR4). Equally, the baseline for DPCR5 should be set on a basis that anticipates the circumstances of the forthcoming period, as far as this can be achieved. It is legitimate for a “new normal” to be set for the new period, based on average uncorrected performance during DPCR4.

If the DPCR5 target is based on corrected data, then this implies that data should continue to be corrected throughout DPCR5. Although it may, in the event, be necessary to consider the issue of data corrections in DPCR5 it would be better to do this once sufficient evidence has emerged rather than to do so at the outset.

In summary, we believe that there appears to be good evidence for a clear distinction between data used for DPCR4 or DPCR5 purposes, so that the former can be corrected whilst the latter is not. If the DPCR5 target is based on uncorrected data then ACL2 should also be calculated on this basis.

Using the definitions from an earlier Ofgem clarification paper (Table 3), we believe the approach set out in Table 4 is appropriate.

Table 3

2009-10 reported figures (ie including all data adjustments) at RF	A
Revised 2009-10 reported figures (after correction / normalisation by the agreed methodology)	B
Initial 2009-10 figures (‘A’), including all data adjustments and re-reported using the DPCR5 common methodology	C
Revised 2009-10 figures (‘B’) (ie corrected according to agreed methodology) and re-reported using the DPCR5 common methodology	D

Table 4

Term	Reporting Methodology	Initial data to use as per Final Proposals	Data to use in the event that a methodology is applied to correct 2009-10 figures	
		LRRM AND TARGETS	**LRRM**	**TARGETS**
$LUD_{2009/10}$	DPCR4 restated	A	B	
$UD_{2009/10}$	DPCR5	C	C	C
$ACL_{2009/10}$	DPCR4 restated	A	B	
$ACL2_{2009/10}$	DPCR5	C	C	

This approach minimises the changes required to the calculations set out in the DPCR5 Final Proposals.

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 $UD_{2009\text{-}10}$?

We do not think that data should be restated under the DPCR5 methodology. If adjustments are made however, it should be possible to derive the proportion of the agreed adjustment volume (derived by the SP methodology) that arose in the 2009/10 settlement year.

We do not think there is any basis for using the second suggested approach for DPCR5 correction as the relationship between DPCR5 settlement data and DPCR4 reported data in any year is not linear.

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 believe that significant departure from the DPCR5 settlement should be minimised and that Option 4 and using un-restated data achieves this whilst resolving the conflicts that the proposals are seeking to address.