

Stephen Perry  
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The Office of Gas and Electricity Markets  
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9 May 2012

Dear Stephen

**CONSULTATION ON CONFLICTS IN THE DISTRIBUTION LOSSES INCENTIVE MECHANISM AND DATA TO BE USED IN CALCULATING ITS COMPONENTS**

Please find attached our response to your consultation on conflicts in the Distribution Losses Incentive Mechanism and data to be used in calculating its components.

Our response is rather lengthy so we have included a summary of the points that may help if you need to brief colleagues on the essence of our case.

You will see that we have carried out a detailed analysis of the interactions between ourselves and Ofgem at DPCR5. From this it is clear that both sides understood the characteristics of the incentive, and in particular the protections that were built into it to deal with the unavoidable risks that arose under a settlement based incentive where the underlying data was inherently volatile and reflective of the behaviour of other parties. The caps and collars were asserted by Ofgem to be one of the reasons that justified a low cost of capital. Moreover, it was obvious that DNOs were likely to finish the DPCR4 period with a level of losses that did not leave them in the centre of the DPCR5-period caps and collars.

We demonstrate in our response that we attached value to these attributes and we do not think that Ofgem should now re-cast the deal to revise the targets or the operation of the caps and collars.

Other key points in our response are that:

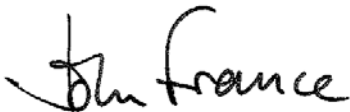
- the settlements based losses incentive in the current price controls is not an effective incentive, nor could it be made effective by any of the options under consideration;
- four out of the five options under consideration stray beyond what is necessary to deal with the conflict that has been identified;

- the specifics of the DPCR5 *Final proposals* represent the deal that was struck and this is more important than any wider purpose or underlying intent;
- for the annual incentive and the five times E component restated data should be used;  
and
- for the targets and the interaction adjustment unrestated data should be used.

We would accept a proposal from Ofgem that honoured the DPCR4 losses incentive but that switched off the DPCR5 settlements based incentive. If, however, the settlements based incentive is to be retained we believe that all of its components (other than the correction of the manifest error of the asymmetry between the uncapped interaction adjustment and the capped-and-collared DPCR5 period incentive) should be respected.

As ever we are happy to discuss any points in our response should you think that would be helpful.

Yours sincerely

A handwritten signature in black ink that reads "John France". The signature is written in a cursive, slightly stylized font.

John France  
Regulation Director