

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

RESPONSE FROM NORTHERN POWERGRID

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SUMMARY

- The current price controls do not incentivise distributors to reduce electricity losses because incentives depend upon there being a link between the actions of the licensee and the rewards and penalties that it may enjoy or suffer as a consequence of those actions. The changes in reported losses that have resulted from changes in suppliers' behaviour overwhelm anything that we can do on our network to reduce distribution losses.
- None of the options that Ofgem is considering is capable of restoring an effective losses incentive because the issue of data volatility has not been resolved. Changes that would increase the likelihood of payments flowing in one direction or another are not the same as changes that would restore an incentive, since this would still not give the certainty required on which to base sound investment decisions.
- Ofgem was told at the last price-control review that volatility in the data meant that the reported performance would not reflect our actions and the caps and collars were introduced in response to these concerns.
- The caps and collars were an integral part of the settlement proposed by Ofgem at the price-control review. They were almost certain to give rise to an asymmetric exposure to upside opportunity and downside risk. This asymmetry is not an accidental or unintended feature of the design.
- Any alteration to the targets or the caps and collars would be a fundamental departure from the price-control review settlement.
- We attached importance to the various limitations on our risk that were inherent in Ofgem's proposals and we are entitled to expect Ofgem to honour the settlement if it insists upon maintaining a settlements-based incentive for losses. Ofgem justified the low weighted average cost of capital ('WACC') assumed at the price-control review by specific reference to the caps and collars that would limit the distributor's downside risk.

- It was always clear that there would be circumstances where there would be no marginal reward or penalty because a distributor would have a reported performance that lay outside the upper and lower bounds of the incentive.
- The interaction adjustment is best understood as a component of the losses incentive for the current price-control period. This distinction may be relevant if Ofgem decides to honour the DPCR4-period settlement but to switch off the settlements-based losses incentive in the current price-control period.
- The only true conflict between the interaction adjustment and the annual incentive is that the interaction adjustment is not capped or collared. This conflict has no effect on the incentive properties of the price control because the interaction adjustment has no *marginal* effect on future income under the losses incentive. In incentive regulation it is only the marginal effect that matters.
- Restatement of 2009-10 data for the purposes of the DPCR4-period incentive is not inconsistent with strict adherence to the DPCR5 settlement. The ability to restate was built into the DPCR4 licence condition and was therefore always part of the DPCR4 settlement.
- By contrast, four out of five of the options being considered by Ofgem would materially vary the DPCR5 settlement in ways that have nothing to do with curing the inconsistency that exists between the interaction adjustment and the DPCR5-period losses incentive.
- The entirety of DPCR5 settlement is set out in the DPCR5 *Final proposals* and in the licence.
- The licence provides protection against the resetting of targets during the DPCR5 period. The licensee's consent is required before targets can be changed and changes to the targets must be consistent with the purpose declared in the licence, rather than with any other purpose or policy intent. Moreover, the licence precludes changes to targets that have retrospective effect.
- Ofgem should assess the various options recognising that bygones are bygones and that nothing can be done now to change behaviour in a period that has passed.

- The factors to which Ofgem intends to have regard when deciding what to do now are, in our view, incomplete and we think some are inappropriate. In particular, the likelihood of windfall gains and losses under the DPCR5 losses incentive scheme was understood by Ofgem when the *Final proposals* were published; to evaluate the options with reference to the desirability of avoiding windfall gains and losses is to rerun the price-control review where such gains were recognised to be inevitable (albeit limited by the caps and collars).
- Ofgem should consider the consequences that follow from the fact that suppliers have behaved differently from one another in the past and the near certainty that they will behave differently from one another in future. An even-handed approach to the design of the solution may not be sufficient to prevent an uneven outcome for distributors and customers.
- In deciding between the options, if Ofgem is determined to persist with a settlements-based losses incentive, we suggest that it should rank the options with reference to the degree of consistency with the DPCR5 settlement.
- We submit that Ofgem should also have regard to the fact that there is already a mechanism in the licence for changing the DPCR5-period targets and we believe that this mechanism should now be used if Ofgem wishes to propose any changes to these targets.
- The specific *content* of the *Final proposals* represents the settlement that has been agreed between a licensee and Ofgem and this content should take precedence over Ofgem's intention or any other wider purpose that it may have had at the time it formulated its proposals at the price-control review.
- In any case, the features of the incentive that Ofgem is now contemplating changing were deliberately designed to have the characteristics that they have, so it is not the case that the changes that Ofgem is contemplating are all consistent with the *Final proposals*.
- The departures from the DPCR5 settlement that Ofgem appears to us to be contemplating include in particular:

- changing the way the DPCR5 targets are set from an average of five DPCR4-period years to 2009-10;
 - widening the gap between the upper and lower bounds of the DPCR5-period incentive;
 - using a dataset other than the one prescribed in the *Final proposals* to determine components of the calculation by which the PPL term is computed;
 - using a dataset other than the one prescribed in the *Final proposals* to determine the ALP term;
 - removing or adjusting the protection that exists for licensees whose 2009-10 losses position is worse than the lower threshold set out in the licence;
 - introducing symmetry of exposure under the DPCR5 incentive in place of the asymmetric exposure set out in the *Final proposals*;
 - disregarding the provision in special condition CRC7 that establishes the targets for a period of five years;
 - introducing an implied purpose to the DPCR5 losses incentive that enlarges upon the purpose set out in special condition CRC7;
 - disregarding the protections for licensees with respect to changes to the ALP term that are embedded in special condition CRC7;
 - disregarding the prohibition on retrospective changes to the targets that is set out in special condition CRC7; and
 - introducing enhanced risks for licensees, having set the DPCR5-period WACC by reference to a presumption that the caps and collars would operate to protect licensees from such risks.
- We believe that Ofgem's Impact Assessment is flawed because the 'conflict' that has been identified has no bearing on incentives and because it confuses a regime under which payments may be expected to flow with an effective incentive to reduce losses.

- We do not think that Ofgem can clarify or change the details of the current incentive without equipping itself with the necessary vires to make such a change.
- We believe that Ofgem's summary of the 2009-10 dataset (i.e. restated or unrestated) that should be used for each purpose is accurate.
- For the annual incentive value and the five times E component restated data should be used and indexed values should be used.
- In our view unrestated data should be used for the interaction adjustment but it should be a matter of concern that so much turns on whether Ofgem will guess correctly about the way that supplier behaviour will impact reported losses in the rest of the DPCR5 period. However, all the evidence suggests that reported losses are not falling back to pre-2009-10 levels.
- In our view unrestated data should be used to set the DPCR5-period targets because the dataset that is specified in the licence should be used and not varied with retrospective effect and because the unrestated dataset is the one that is most consistent with the way that losses are being measured in the DPCR5 period.
- We would accept a proposal from Ofgem to switch off the settlements-based losses incentive for the DPCR5 period and we note that this would leave in place the other incentive to reduce losses that Ofgem announced in the *Final proposals* (since there were two components to Ofgem's proposals for the DPCR5-period losses incentive).
- However, if Ofgem insists on a settlements-based incentive remaining in place, the incentive set out in the *Final proposals* must be honoured in its entirety. Honouring the DPCR5 settlement means that:
 - the DPCR5-period target should be set on the DPCR4-period five-year average;
 - the 2009-10 dataset used to set the DPCR5 targets should be the unadjusted 2009-10 dataset;
 - the interaction adjustment can be capped to remove the conflict with the annual incentive;

- the interaction adjustment should be calibrated using an unadjusted 2009-10 dataset;
 - the upper and lower bounds of the active incentive should be set as per the *Final proposals*; and
 - if Ofgem wishes to vary the DPCR5 targets it should make a proposal using the process that is set out in special condition CRC7.
- Ofgem should recognise that all of the options will allow an inappropriate losses incentive to persist in the DPCR5 period and that none of the options will restore an effective incentive to reduce losses. Large sums of money may flow with no benefit attaching to those flows. The option of switching off the DPCR5 settlements-based losses incentive is the one option that is not considered in Ofgem's consultation and yet, in our view, that option is the one that is most consistent with the principal objective given to the Gas and Electricity Markets Authority by the Electricity Act 1989.

INTRODUCTION

1. On 28 March 2012 Ofgem published a consultation entitled *Consultation on conflicts in the Distribution Losses Incentive Mechanism and data to be used in calculating its components* ('the Consultation').
2. In this note we set out the response of Northern Powergrid Holdings Company ('Northern Powergrid'), Northern Powergrid (Northeast) Ltd ('Northeast') and Northern Powergrid (Yorkshire) plc ('Yorkshire').
3. This response follows the chapters in the Consultation. We have chosen to respond to the Consultation in its entirety rather than confining ourselves to the specific questions identified by Ofgem. We have also provided a summary of the representations we made to Ofgem on this subject at the last price control review ('DPCR5'). This summary appears at Annex 1. At Annex 2 we provide an analysis of the evolution of Ofgem's position on this subject at DPCR5. For completeness we have set out our answers to the questions that Ofgem has identified in Annex 3 to this response.
4. The main headings that follow are taken from the Consultation.

OVERVIEW

In reality, the current price controls do not incentivise DNOs to reduce electricity losses.

5. The first Overview¹ to the Consultation states that:

'under their price controls Distribution Network Operators (DNOs) are incentivised through the Losses Incentive Mechanism to reduce electricity losses on their network.'

6. This is a statement of policy intent. For the reasons that are set out below, it is clear that, as currently designed and having regard to the volatility of the data that is dominated by factors beyond the control of the distributor, the current price controls do *not* incentivise DNOs to reduce electricity losses. We develop this point further in our answers to Chapter 1 below.

¹ There are two parts to the Consultation headed 'Overview'. We are concerned here with the first of these.

7. The overview to the Consultation also states that Ofgem is consulting on its approach to setting the Losses Rolling Retention Mechanism ('LRRM') and the Allowed Loss Percentage (the ALP term) *for those DNOs that restate their 2009-10 losses data due to abnormal levels of settlement data corrections*. We are not sure if Ofgem means to confine some of the options that are set out in the Consultation to those DNOs that have restated their 2009-10 losses. Perhaps Ofgem would make it clear whether companies that do not opt to restate their 2009-10 losses will operate under a different regime in the DPCR5 period.

CHAPTER 1 – INTRODUCTION

The interaction adjustment is best understood as a component of the DPCR5 losses incentive.

8. Paragraph 1.1 of the Consultation states:

‘The Distribution Losses Incentive Mechanism that applies to the fourth distribution price control (DPCR4) includes an “interaction adjustment”....’

9. It may appear to be a small point, but we think it is conceptually important to recognise that the interaction adjustment is not part of the losses incentive ‘that applies to the fourth distribution price control (DPCR4)’. The interaction adjustment is part of the DPCR5 settlement. If no losses incentive were to be applied in the DPCR5 period, there would be no interaction adjustment. Such a mechanism is not necessary to deliver the correct rewards and penalties under the DPCR4-period incentive; it is necessary to ensure that, as a result of the incentive that applies in the DPCR5 period, no DNO shall receive additional rewards or penalties merely by standing still (relative to where it ended the DPCR4 period). This distinction may be important when Ofgem considers the options set out in Chapter 3 of the Consultation. Although the value of the interaction adjustment ultimately manifests itself in the PPL term (i.e. the term that also ensures that the DPCR4 incentive results in the correct rewards and penalties under that incentive), the interaction adjustment differs from the DPCR4 rolling incentive in that the interaction adjustment looks ahead to the DPCR5 period incentive. This distinction would matter if Ofgem concluded that it must honour the DPCR4 settlement, but that it must, for some reason, depart from the DPCR5 settlement.

The caps and collars and the absolute value of protection that they offered were an integral part of the DPCR5 settlement...

10. Although we think that, in this case, there is a good argument to make some changes to the DPCR5 deal (to address what we think is a manifest and unintended defect in the design of what was implemented), we are concerned that Ofgem seems to think there is merit in going beyond that so as to, effectively, change the balance of risk and return that was intended by Ofgem when it made the proposals and that was understood by the DNOs when they accepted them. Under any circumstances, proposing changes to the terms of a price-control settlement during its currency is an extremely serious step to take. In the pages that follow we shall set out, in some detail, the fundamentals of the deal that was proposed and accepted.
11. At paragraphs 1.11 – 1.13 the Consultation summarises the cap-and-collar arrangements that were introduced at DPCR5 ‘to reduce any outstanding risk to both DNOs and customers.’ The Consultation might usefully have included some more context about the introduction of the caps and collars. This marked a departure from the DPCR4 arrangements and served to reassure DNOs that had expressed concern to Ofgem about the volatility of settlements data during the DPCR4 period. The presence of caps and collars was an integral part of the risk/reward profile of the final settlement at DPCR5 and was explicitly described as such. Moreover, it is significant that the caps and collars were deliberately applied so as to be symmetrical around the *targets* set for the DPCR5 period. They were not set to be symmetrical around each DNO’s assumed starting point at DPCR5 (i.e. the 2009-10 or the 2010-11 performance on losses).²

...and were obviously certain to give rise to an asymmetric exposure to upside opportunity and downside risk.

12. Once Ofgem had decided to set the DPCR5-period targets on the average of the reported performance in the DPCR4 period, it was virtually certain that a DNO would start the DPCR5 period from a position of asymmetric exposure to upside and downside risk. The only circumstances in which this would not be the case would be where a DNO ended the DPCR4 period with a reported performance that happened to be the

² Conceptually Ofgem has always assumed that each DNO would start the DPCR5 period from the losses position that had been reached in the final DPCR4 year.

same as the average losses performance experienced during the DPCR4 period as a whole.

That asymmetry was a feature of the design that cannot now be said to be an unintentional oversight.

13. It was therefore an inevitable feature of the design of the DPCR5-period losses incentive that a DNO whose performance was already close to the cap or the collar at the start of the DPCR5 period would be subject to a more limited incentive in one direction that it would be subject to in the other direction.
14. The Consultation is premised upon the historically correct assertion that Ofgem intended there to be an incentive on DNOs to reduce losses in the DPCR5 period. However, such an assertion invites the mistaken inference that, if a DNO is likely to find itself outside the upper or lower bounds of that incentive, this is indicative of an error in the way that this policy intent was carried forward into policy specifics. We demonstrate below why this does not follow.
15. It appears from the Consultation that Ofgem may now believe that there has been a calibration error that it should now correct to restore what is claimed to be an original policy intent that each DNO should be subject to an *active* incentive.

Any alteration to the targets or the caps and collars would be a fundamental departure from the DPCR5 settlement because it would change the risk exposure that was factored into the proposals and the decision to accept them.

16. Such an approach would be wrong because it would represent a fundamental policy change from the DPCR5 *Final proposals*. For the reasons set out above, it was always going to be the case that a DNO would be exposed to asymmetric upside and downside potential from its 2009-10 performance. That asymmetry was a deliberate component of the policy of setting targets on a five-year average with caps and collars symmetrically set around that target. The resultant asymmetry is not a calibration error or policy error, it is the deliberate and mathematically accurate enactment of the policy. If the DPCR5 targets were now reset on a different basis (e.g. 2009-10 performance) or the upper and lower bounds were altered in order to restore the prospects of a live incentive operating, this would be a very fundamental departure from the *Final*

proposals, rather than a mere recalibration of the parameters so that the underlying intent of the *Final proposals* would be better met.

At DPCR5, Ofgem was alerted to the fact that volatility in the data meant that a DNO's reported performance would not reflect the DNO's actions...

17. Moreover, Ofgem may now say that, when it designed and calibrated the mechanism that was set out in the DPCR5 *Final proposals*, it did not expect to find itself in a situation where reported performance was likely to be outside the cap or the collar. However, this *expectation* is now quite irrelevant, since the possibility of a company's being outside the cap or the collar was certainly apparent and Ofgem still chose to enact the policy as it did. Moreover, it is not consistent with the information provided to Ofgem at the time as part of the price-control process. Companies, including Northern Powergrid, were already making it very clear to Ofgem that the reported losses performance was increasingly volatile, had nothing to do with the performance of the licensees' distribution networks and was likely to lie outside the caps and collars.³

... and Ofgem introduced the caps and collars in response to these concerns.

18. The background to the Ofgem decisions about caps and collars and the basis of the targets was that the DNOs had proposed a different kind of losses incentive that would have reflected the changes made by a licensee to its network. Ofgem rejected these proposals from the DNOs and responded to the concerns about volatility by introducing caps and collars (an innovation on the uncapped DPCR4 incentive).

We attached importance to the limitations on our risk that were inherent in Ofgem's proposals.

19. Ofgem may now say that it had not expected DNOs' performance to be outside the caps and collars, but Northern Powergrid (and presumably other DNOs) attached importance to the balance of risk and reward that was designed into the mechanism as a whole. Taken in the round Ofgem's proposals were acceptable to Northern Powergrid because the risk of the mechanism was limited by the design of the incentive. In particular:

³ The history of Northern Powergrid's interactions with Ofgem about losses at DPCR5 is summarised at Annex 2.

- if reported losses were very high (because of factors beyond our control such as suppliers' dataflows), the incentive mechanism would limit our downside to 97 basis points (pre-tax) under RORE; and
 - if 2009-10 performance was worse than the DPCR4-period average, the interaction adjustment would ensure that we would not suffer a windfall loss if our performance remained at that level.
20. During the final months of the DPCR5 discussions we advised Ofgem on numerous occasions, including at formal meetings with the Authority and in our bilateral meetings with Steve Smith, the Ofgem senior partner for the price-control review, that the DPCR5 incentive that Ofgem was intent on implementing was not an effective incentive. In fact we referred to it in our exchanges as 'a high-stakes lottery' and recommended removing it from the price-control proposals altogether, to be replaced by a mechanism that tracked and rewarded actions taken (if an incentive were to be included at all). Indeed, we stressed to Ofgem that the volatility in the settlements data had nothing to do with the performance of our system and that we could easily envisage our reported performance jumping from cap to collar. We regularly referred to it in working-level exchanges as 'flip-flopping' between the cap and the collar simply because of the fluctuations in settlements data. We include this account of both our position and our vocabulary in order to reinforce how we were viewing the risk at that time. We regard this as an extremely important factor in establishing what legitimate expectation we formed in relation to the deal that we struck with Ofgem.

We are entitled to expect Ofgem to honour the DPCR5 settlement.

21. Thus, even if Ofgem could assert that *it* did not expect the caps and collars to operate (and thereby diminish or remove the incentive), that is not now the point.⁴ Northern Powergrid was quite explicit in pointing this out to Ofgem. Since Ofgem rejected our proposals for a losses incentive that would have been reflective of the actions we had taken on our network, and our alternative proposals for a lower-powered incentive that would obviate the need for caps and collars, we are now entitled to rely on Ofgem's honouring all these aspects of the package that it put forward in the *Final proposals*.

⁴ It would also be a rather remarkable claim given the evidence of settlements volatility that Ofgem already had at that point and the simple mathematics of the scheme that Ofgem itself had designed.

22. That package ensured that, in the situation in which we now find ourselves, the mechanism would be capped and collared around the DPCR4-period average. The only purpose of the caps and collars is to disapply the marginal incentive when reported performance lies above or below the cap or collar. The fact that we have been proven right in attaching value to this property of the incentive that Ofgem proposed does not justify Ofgem in redesigning or recalibrating the incentive to achieve something that is now being characterised as Ofgem’s original intent. Such an approach would be against the principles of sound regulation whereby a licensee is entitled to expect the deal to be honoured rather than revised if it turns out that certain design features will be likely to operate after all.
23. We do not feel less strongly about this because we told Ofgem on many occasions that the characteristics of the data could not support a high-powered losses incentive. Indeed, quite the contrary; we feel more strongly attached to the deal’s being taken as a whole because it was the presence of the protections that, from our point of view, offered some mitigation of what we regarded as the unwise implementation of a high-powered incentive where rewards and penalties would be randomly distributed according to suppliers’ behaviour. We suspect that, had we known then what we know now about the suppliers’ data-correction programmes, we would have been successful in persuading the Authority to accept our position. It would be a perverse outcome if Ofgem were to decide that the appropriate response to the revelation of new information that confirms that the extent of the supplier activity is even greater than originally thought is a decision to *increase* the total risk exposure that the DNOs face under the losses mechanism.

The only true conflict between the interaction adjustment and the DPCR5 incentive is that the interaction adjustment is not capped or collared.

24. At paragraph 1.2 of the Consultation Ofgem states:

‘Currently the “interaction adjustment” and the “cap and collar” work in isolation but together create a conflict which, if not addressed, is likely to undermine the incentive to reduce losses and result in unmerited financial loss or gain for DNOs. Chapter 2 of this consultation seeks views on five options put forward to address this conflict.’

25. We agree that there is a conflict between the interaction adjustment and the cap-and-collar mechanism. Indeed, it is our understanding that it was Northern Powergrid that first pointed this out to Ofgem. The conflict that we identified is limited to the fact that in calibrating the interaction adjustment no heed was paid to the caps and collars that would apply in the DPCR5 period. Where the 2009-10 performance lies outside the DPCR5 caps and collars, the interaction adjustment, through an oversight, will over-compensate. This over-compensation is symmetrical whether the 2009-10 performance is higher or lower than the caps and collars.
26. It is important to understand that this is the only ‘conflict’ between the interaction adjustment and the caps and collars.

This conflict has no effect on the DPCR5-period losses incentive...

27. It is simply incorrect to say (as Ofgem does) that ‘together’ the interaction adjustment and the cap and collar ‘create a conflict which, if not addressed, is likely to undermine the incentive to reduce losses’.
28. This is incorrect because there is nothing about the interaction adjustment (including its uncapped nature) that could possibly undermine any incentive to reduce losses. This could not occur because, whether considered in isolation or in conjunction with the caps and collars, the interaction adjustment itself has no effect on incentives in the DPCR5 period. It is a fixed financial payment to reflect expected future rewards or penalties if a DNO’s performance is unchanged over the DPCR5 period relative to 2009-10.
29. Even if we assume that a settlements-based losses mechanism could incentivise a DNO to try to reduce losses,⁵ the feature of the DPCR5 settlement that Ofgem has identified that would mean that such an incentive would be ineffective is not the interaction adjustment. Indeed, the feature that Ofgem has identified - the absence of a marginal incentive in some circumstances - has nothing to do with the interaction adjustment, but is solely the result of the caps and collars – that is what caps and collars do.
30. This is important because Ofgem seems to us to be presenting the issue in the Consultation as if the problem of the uncapped nature of the interaction adjustment

⁵ We dispute this assumption for the reasons set out in paragraphs 17 and 20 above and paragraph 48 below.

needs to be addressed because the mismatch between the uncapped interaction adjustment and the capped and collared DPCR5 incentive has the effect of removing or diminishing the incentive on the DNOs to reduce losses. It does not.

31. To proceed to alter the settlement reached at DPCR5 so as to restore an incentive that might otherwise be inactive because of the caps and collars is a very serious matter. It would be incorrect for Ofgem to present this as having anything to do with the asymmetry between the uncapped interaction adjustment and the capped and collared DPCR5-period incentive. Such a misunderstanding or misrepresentation cannot be allowed to inform the judgement that the Authority must shortly reach.
32. Since Ofgem says that the options put forward in chapter 2 of the Consultation are designed ‘to address this point’, we consider that much of the Consultation is flawed because it proceeds from this incorrect starting point.
33. Paragraph 1.15 and Figure 1.1 of the Consultation correctly describe and illustrate the unintended consequence that the interaction adjustment may recover (or pay out) an amount that exceeds the amount that the DNO could earn (or pay) during the DPCR5 period.
34. However, paragraph 1.17 and Figure 1.2 go further and present the asymmetry of the revenue exposure under the DPCR5 incentive as a ‘problem’ rather than as an inevitable consequence of deliberate policy intent.

... because the interaction adjustment has no marginal effect on future income under the losses incentive.

35. Moreover, in describing the ‘problem’ further, paragraph 1.18 fails to recognise the basic premise of incentives, namely that it is only the marginal incentive that matters. It is an accepted premise of economic theory that bygones are bygones and what has gone before can have no impact on future behaviour. It is therefore unhelpful for Ofgem to introduce a comparison between the £20m that would be clawed back under the incentive mechanism and the £5m that could be earned under the DPCR5 incentive and to conclude that the DNO ‘would be eligible for a maximum reward of only £1m per year’.

36. As far as the incentive properties of the mechanism are concerned, once the clawback under the interaction adjustment has occurred, it becomes a past event and nothing that the DNO does or refrains from doing in future will change *that* value. The *marginal* value attaching to the forward-looking incentive is the only thing that can influence future behaviour. Under that incentive, the only value at stake is the full value of the future incentive that is limited by the cap and collar. The payment under the interaction adjustment is quite irrelevant and can have no bearing on the future incentive properties of the DPCR5-period losses incentive.
37. Certainly, if it is assumed that the DNO in the example starts the DPCR5 period with the performance with which it ended the DPCR4 period, it is true that, relative to that assumed starting position, it has a potential upside in the DPCR5 period of £1m per annum but a potential downside of £9m.⁶ However, the observation made in paragraph 1.19 of the Consultation that ‘the DPCR5 *Final proposals* are silent on the need to prevent asymmetrical revenue exposure’ is easily explained. This presentation of the issue invites the reader to suppose that the asymmetric nature of the DPCR5 incentive was an unintended detailed property of the DPCR5 incentive that can now be reviewed afresh because it gives rise to ‘an outcome that limits the overarching policy intent of the mechanism – that being to incentivise DNOs to reduce losses on their network.’

It is inconceivable that Ofgem did not realise that there would be circumstances where there was no marginal reward or penalty.

38. We think that to suggest that Ofgem had intended there to be an active incentive on all marginal changes in losses either throughout the period or in any particular year is inconsistent with the position reflected in the *Final proposals*, when viewed in the light of the evolution of thinking in relation to the losses incentive throughout the DPCR5 process. Whilst it is true that Ofgem intended there to be an incentive on DNOs to reduce losses, it is inconceivable that the architects of the policy that informed the *Final proposals* did not appreciate that there would be circumstances where there would be no marginal reward or penalty – that is after all inherent in the introduction of caps and collars. Indeed, it is not particularly helpful to characterise the operation of the caps and collars as rendering the incentive ineffective, when what is actually happening is that the incentive is rewarding or penalising to its maximum potential. Furthermore,

⁶ Ofgem also correctly observes that the opposite is possible.

the decision to set the targets on the DPCR4-period average and to define the caps and collars symmetrically with respect to those targets inevitably brings asymmetry in the potential upside and downside relative to the assumed starting performance (i.e. 2009-10 levels of losses).

39. To say that the *Final proposals* ‘are silent on the need to prevent asymmetrical revenue exposure’ does not advance our understanding of the position. The reason for the silence is that it was inherent in the design and the considered decision to set targets, caps and collars based on the DPCR4-period average performance, even though this was always likely to differ from the 2009-10 performance. It is only to be expected that Ofgem should be ‘silent’ about the need to ‘prevent’ something that it is deliberately setting out to achieve.

Restatement of 2009-10 data for the DPCR4 incentive is not inconsistent with strict adherence to the DPCR5 settlement.

40. We expect that some suppliers may say that it would be illogical for Ofgem to allow restatement of 2009-10 losses data (as per the decision letter issued on 9 March 2012) but for Ofgem to be fastidious about observing the features of the DPCR5 incentive arrangements that are embedded in the licence.
41. Any such observations would proceed from a fundamental failure to understand that the facility to alter the method by which losses are measured was always present in the DPCR4 licence condition relating to losses. That facility was a component part of the DPCR4 settlement. Our request in November 2010 for the consent of the Authority to change the basis on which we measured losses in 2009-10 therefore used a facility that was always present in the DPCR4 settlement and was apt for dealing with inconsistencies between the data used to set the DPCR4 targets and the data used to measure performance against those targets. The giving of that consent by the Authority required no change to the licence and in no sense did it represent a reopening of the DPCR4 settlement.

Four out of five of the options being considered by Ofgem would materially vary the DPCR5 settlement.

42. By contrast, four of the five options that are set out in the Consultation would materially vary the deal that was struck at DPCR5 and is now embedded in the licence.⁷
43. Once *Final proposals* have been put forward and accepted, it is necessary for these to be formulated as licence conditions or, sometimes, as other commitments or understandings between the parties. In the licence condition that implemented the DPCR5 losses incentive, the parts of the *Final proposals* that defined how the targets will be determined are incorporated by cross-reference. The caps and collars are set out in the algebra that forms part of the losses condition itself. The express commitment that there will be a five-year rolling incentive applied to the DPCR5 period is set out in the *Final proposals* and also in the licence condition.
44. Only one of the five options set out in the Consultation would vary the deal that was struck solely to the extent necessary to deal with the conflict between different components of the losses incentive, namely the uncapped interaction adjustment and the capped DPCR5-period rewards and penalties.

The DPCR5 settlement is set out in the Final proposals and in the licence.

45. In other words the entirety of the deal at DPCR5 is set out in the licence and in those parts of the *Final proposals* that are incorporated by reference in the licence. That degree of entrenchment would ordinarily be enough for a licensee to expect to be able to rely on and it should now be enough for us merely to demonstrate that this was indeed the deal that was reached. The principles of good incentive regulation and the legal doctrine of ‘reasonable expectations’ should be a sufficient argument to convince the Authority that it cannot now alter the deal that it struck when the licence modifications were made.

⁷ Our comments in this section are made with respect to the setting of targets and the placement and the width of the caps and collars. Although a change to the uncapped nature of the interaction adjustment would also require a licence modification, we distinguish this change from the others because it is the only one that can plausibly be argued to be necessary to correct a manifest error, as distinct from being necessary to impose a new policy.

46. It occurs to us that Ofgem may observe that new information has emerged that is so significant that it justifies the imposition of a new set of targets or a different approach or the calibration of the caps and collars. We deal with this possible argument below.
47. We do not think that the information that has emerged justifies the reopening of the DPCR5 settlement in relation to target setting, and caps and collars, for all the reasons set out above: in short the DPCR5 settlement set targets on a particular basis and made explicit provision for the volatility of the data by including caps and collars that would limit the exposure of licensees and customers in precisely the circumstances in which we now find ourselves.

It is not possible to incentivise behaviour in a period that has passed.

48. Moreover, it is obvious that it is not possible to incentivise behaviour in a period that has now past. Much of the argument advanced in the Consultation is based on the claim that changes are needed to restore the incentive. By the time the Authority makes its final decision on these matters we shall be more than halfway through the DPCR5 period. Even if it were possible to restore an incentive - which we dispute because incentives depend on the person who is the subject of the incentive having confidence that his actions will indeed be rewarded or penalised and there is no reason to suppose that the data-volatility issues have been resolved - it would not be possible to change incentives in the period that has already passed. Retrospective changes can alter the rewards or penalties that will flow as a result of behaviour (or dataflows) in the past, but the past has gone and nothing can be done now to encourage anyone to behave differently in the period that has passed.
49. These arguments against retrospection and in favour of regulatory certainty are reinforced by the mechanism that is set out in the present losses condition of the licence that deals with changes to the targets during the DPCR5 period.

The licence provides protection against the resetting of targets during the price-control period.

50. Part G of special condition CRC7 is clearly designed to give licensees protection against the resetting of targets during the current price-control period.

51. After prescribing (in paragraph 7.12) that the initial targets must be ‘calculated by reference to the methodology set out in Chapter 4 of the Authority’s decision document published on 7 December 2009’, the condition makes specific provision for the resetting of those targets in certain circumstances.
52. We now draw Ofgem’s attention to this provision because it would be unreasonable to impose a licence change to bring about new targets when there is already a mechanism in the licence that is apt for these circumstances. Indeed, we are puzzled as to why this feature of the current licence receives no consideration. Important features of the process that are now enshrined in the licence are the protections for licensees that are considered further below.
53. The first component of the protection is the clear statement of intent in paragraph 7.12 of the condition that the targets (i.e. the ALP term) will be set out in a direction from the Authority:

‘that will apply (subject to paragraph 7.13) for as long as this condition continues in force.’

54. Since the price controls were set with the explicit intention that they would apply from 1 April 2010 until 31 March 2015, this is an unambiguous statement that the targets, having been set in accordance with the method set out in the *Final proposals*, will continue for the full duration of the price control and will be changed only in accordance with the provisions of paragraph 7.13 of the condition.

The licensee’s consent is required before targets can be changed...

55. Paragraph 7.13 provides as follows:

‘the Authority may, at the licensee’s request, or with the licensee’s consent (which must not be unreasonably withheld), direct the licensee to change the value of ALP, to which paragraph 7.12 refers, to a different value specified by the Authority, provided that the following conditions have been met.’

56. Since we are not requesting a change to ALP we shall concentrate on the provision insofar as it relates to a change that may be proposed by the Authority.

57. The first point to note about the provision in this paragraph is that it very deliberately gives the licensee a qualified right of veto. It is most unusual for the licence to make the power of the Authority to do something contingent on receiving the consent of the licensee. Indeed, we are not aware of any other price-control condition where the licensee's prior approval is a necessary precondition of the exercise of a power by the Authority.
58. Since it is not accidental that the licensee is given this power of veto, it would surely be a departure from the principles of good regulation for the Authority to circumvent this veto by modifying the condition itself so that the licensee's consent is not required. Having made provision for the Authority to direct that the target may be changed in circumstances where there has been a material change to the quality of the data, it would be quite wrong for the Authority to circumvent the protections that the licence confers upon the licensee in precisely those circumstances.
59. We recognise that we may not unreasonably withhold our consent to such a proposal to change ALP, but there is a very material difference between, on the one hand, making a proposal that we must consider and that we must accept if it is reasonable and, on the other hand, circumventing that protection altogether by simply changing the licence to impose new targets. By this mechanism, the licence deliberately puts the licensee in a position where its judgement - rather than the judgement of the Authority - is subject to the test of reasonableness. In this isolated instance, the licence has created a shift in the balance of power from the Authority to the licensee. That shift is designed to permit flexibility where it is needed, but it offers a special protection to the licensee that it would now be quite improper to disregard or circumvent by proposing a change to the condition itself.

... and changes to targets must be consistent with the purpose declared in the licence...

60. The second observation about paragraph 7.13 is that there are two conditions that must be met for a direction under paragraph 7.13 to be legitimate. These conditions are set out in paragraph 7.14, which provides as follows:

'The conditions referred to in paragraph 7.13 are that the Authority must:

- (a) have had due regard to the purpose of this condition; and

- (b) be satisfied, following consultation with the licensee, that there has been a material change (whether an improvement or deterioration) in the quality of the information used to derive the System Entry Volumes or Units Distributed.’

61. The test in subparagraph (a) is rather important. The ‘purpose of this condition’ is described in paragraph 7.1 of the condition as being:

‘to establish the mechanism for calculating the amount of the term IL (the distribution losses incentive term) that applies in CRC5 (Restriction of Distribution Charges: non-generation incentive revenue adjustment).’

62. Paragraph 7.2 of the condition explains that this is:

‘...in order to reflect the licensee’s performance under the Distribution Losses Incentive Scheme set out below.’

63. It is significant that the declared purpose of the losses condition in the licence is to establish the incentive mechanism *that is set out in the condition*. The purpose is not expressed in terms that encapsulate any wider Ofgem objective, such as to incentivise the licensee to reduce losses. Moreover, insofar as the purpose relates to the setting of targets, the purpose is constrained to the setting of targets in accordance with Chapter 4 of the *Final proposals*.

... rather than with any other purpose or policy intent.

64. Where the licence sets out the purpose of the incentive in such a precise and limited way it would be quite wrong for Ofgem to declare that a broader underlying purpose that Ofgem may have had in mind when it prepared the *Final proposals* should take precedence over the embodiment of those proposals in the relevant licence condition.

65. We believe that we are entitled to rely on the purpose of the losses condition that is set out on the face of the licence as being the accurate statement of its purpose. This is what we agreed to when the licence modification was made and regulatory certainty cannot coexist with the novel concept that what matters now is another, retrospectively declared, superior purpose that takes precedence over the purpose that is set out in the licence itself.

66. Moreover, paragraph 7.3 of the condition is very clear that the purpose of the condition is to implement the targets derived according to the methodologies set out in the *Final proposals* and it states categorically that these targets and incentives will apply to the licensee ‘for a period of five Regulatory Years commencing on 1 April 2010.’
67. From the analysis in the previous paragraphs it follows that it might well be reasonable for a licensee to exercise the veto that it has been given under paragraph 7.13 of the condition if the Authority’s proposal to restate the targets was at variance with the methodology set out in the *Final proposals*.
68. The criterion in subparagraph (b) must also be satisfied before a direction from the Authority could be valid. We believe that the Authority might reasonably argue that this test has been satisfied because there has been a material change in the quality of the information used to measure units distributed. However, satisfaction of the criterion in this subparagraph is a necessary, but not a sufficient, condition for the giving of a direction under paragraph 7.13.

The licence precludes changes to targets that have retrospective effect.

69. The final element of the protection that is built into Part G of the condition is set out in paragraph 7.15, which provides as follows:
- ‘A change to the value of ALP in accordance with paragraph 7.13 may be directed by the Authority at any time but may not take effect before the beginning of the next Regulatory Year following the date of the direction.’
70. This is clear evidence that the deal struck with respect to DPCR5 targets cannot be varied with retrospective effect even if the criteria for making such a change (i.e. the tests in paragraph 7.14) have been satisfied. This provision gives the licensee protection from such retrospective changes in all circumstances. We are now entitled to rely upon that protection and we would regard it as a serious misuse of the power to make licence modifications if the Authority were to seek to circumvent that protection by modifying the licence itself to impose targets with retrospective effect.
71. From the foregoing it will be clear that we believe that the Consultation does not give adequate consideration to the expressed terms of the losses settlement at DPCR5. The

terms of that settlement are explicitly set out in the licence and protections were given to licensees that were designed to reassure them that:

- the losses targets could be changed only in very limited circumstances;
- change to the targets would be subject to a licensee veto that was circumscribed only by a test of reasonableness; and
- any resultant changes to the targets would not be retrospective.

These elements of the deal struck at DPCR5 receive no attention in the Consultation. That is disappointing to us and we think that Ofgem would be unwise to proceed materially to change the deal that was struck without proper regard to the reasonable expectations that it created when it formulated proposals that took effect as licence conditions and in which are embedded legal protections for licensees.

CHAPTER 2 – POTENTIAL SOLUTIONS TO THE CONFLICT BETWEEN THE INTERACTION ADJUSTMENT AND THE CAP AND COLLAR

The factors to which Ofgem intends to have regard are inappropriate and incomplete.

72. At paragraph 2.2 of the Consultation Ofgem sets out ‘some of the factors’ it will consider in assessing the options that it is contemplating. The factors listed merit some comment.

73. The first factor is stated to be:

‘whether the option upholds the purpose of the incentive mechanism (to incentivise a DNO to manage an efficient level of losses on the network.’

74. In paragraph 61 above we demonstrate that, whilst the underlying intent of Ofgem in developing its losses proposals for DPCR5 may have been to incentivise a DNO to manage an efficient level of losses on the network, the licence itself declares the ‘purpose’ of the licence condition that implements the incentive to be to give effect to the *Final proposals*. The declared purpose that is set out on the face of the licence should take precedence over an intent that features nowhere in the licence modification that was agreed between the DNOs and the Authority.

The likelihood of windfall gains and losses under certain circumstances was understood by Ofgem when the Final proposals were published...

75. The next factor that Ofgem lists is:

‘whether the option removes the potential for a DNO to incur a windfall loss or gain’.

76. We agree that windfall gains and losses are possible to differing extents under different outturn scenarios under each of the options that Ofgem is contemplating. Moreover, we further agree that regulation should be designed to avoid such windfall gains or losses in the first place. However, once a deal has been struck, where the possibility of such windfalls has been considered and addressed through the introduction of caps and collars, that deal should then be honoured. The potential for the DPCR5 losses mechanism to deliver some windfall gains or losses as a result of random data fluctuations was understood when the *Final proposals* were published. Indeed, it was the unavailability of this that led Ofgem to cap and collar the mechanism. However, our view is that neither Ofgem nor the DNOs appreciated that there was the potential for windfall gain or loss in relation to the mismatch between a capped incentive mechanism and an uncapped interaction adjustment. It is those windfalls that we think it legitimate for Ofgem to address, since we do not believe they were a feature of anyone’s understanding of the deal that was being struck at that time.

... and to evaluate the options with reference to this criterion is to rerun the price-control review.

77. To evaluate revisions to the deal struck at DPCR5 by reference to this criterion is therefore to assert that it is permissible to rerun the review process, with a retrospective element, to remove the potential for something that was inherent, and understood to be inherent, in the deal that was struck at DPCR5. We are surprised that Ofgem seems to promote such a consideration as being legitimate or consistent with sound regulatory principles.

78. The third factor listed in the Consultation is the ‘impact on the consumer.’ We agree that any function carried out by the Authority under the Electricity Act 1989 must be carried out in the manner that is best calculated to further the principal objective.

However, that objective cannot be secured or promoted without having regard to some other considerations which do not feature in the list set out in paragraph 2.2 of the Consultation. In particular we think that the principal objective is furthered if deals struck at price-control reviews are adhered to and not altered with retrospective effect during their currency.

79. The fourth factor listed by Ofgem is the implementation-timing implications of any particular option. We think it is important that Ofgem should attend to such details, but we do not believe that timing issues should eclipse the more fundamental issues, such as the need to honour the DPCR5 settlement. It would in fact be possible to divorce the recovery period from the question of the correct approach to dealing with the conflict between the uncapped interaction payment and the capped incentive scheme. Notwithstanding this, in the analysis of the strengths and weaknesses of the options that follows, we proceed from Ofgem's assumption that the timing implications of the options should be considered.

Suppliers will behave differently from one another in future...

80. The final factor listed by Ofgem is the need to treat all DNOs in an even-handed manner. This is uncontentious, but the circumstances that have arisen and, perhaps less obviously, may be expected to prevail in future, are likely to differ between DNOs in ways that Ofgem cannot now predict.

... so an even-handed design will still give rise to an uneven outcome for DNOs.

81. An even-handed design could give rise to very uneven rewards and penalties for distributors and customers depending on what happens to settlements data in future. There is no reason to suppose that suppliers that have behaved differently in the past will behave consistently in future and apparently even-handed solutions designed today will have very uneven results as the effects of varied supplier behaviour unfold over the remainder of the DPCR5 period. Ofgem gives no attention to this aspect of the problem. We regard variation in supplier behaviour as inevitable and therefore it is a serious omission for Ofgem to leave this consideration out of the Consultation.

82. Indeed, the most alarming thing about the factors listed in paragraph 2.2 of the Consultation is the factors that are notable by their absence. These are considered below.

Ofgem should have regard to consistency with the DPCR5 settlement...

83. At no point does Ofgem refer to consistency with the DPCR5 settlement, or the existing licence condition, as being a factor to which it intends to have regard. There is no acknowledgement in the Consultation that four out of five of the options under consideration would unpick the DPCR5 losses settlement in ways that are not necessary to deal with the mismatch between the uncapped interaction adjustment and the capped DPCR5 period incentive.

... and whether there is already a mechanism in the licence for addressing these issues.

84. Another factor that we believe Ofgem should consider is whether or not there already exists within the licence a mechanism for dealing with the problem that Ofgem perceives needs attention. In paragraphs 51 to 71 above we draw attention to the procedure that already exists within the licence (including the limitations and protections included in that procedure) for dealing with the resetting of targets if there are material changes to the accuracy of the data. Licensees have a legitimate expectation that, where such a provision has been included in the licence, Ofgem will follow that procedure rather than try to circumvent it by making a licence modification.
85. At paragraph 2.3 of the Consultation Ofgem observes that:

‘The options put forward for consultation are intended to address the conflict between the DPCR4 interaction adjustment and the DPCR5 cap and collar (the details of each being set out in *DPCR5 Final proposals*). As demonstrated in the high level impact assessment at Appendix 1, not correcting this conflict may result in DNOs being protected from c.£100m penalties during DPCR5 based on reported 2009-10 losses levels continuing. The impact cannot have been known by individual DNOs at the time of the DPCR5 settlement since 2009-10 data has only recently become available.’

86. The reference to protection from c.£100m of penalties as demonstrated in the high-level impact assessment appears to be based on the prospect that DNOs may receive £200m under the interaction adjustment but pay out only c.£100m in penalties in the DPCR5 period. We have no comments to make on the accuracy of the assessment and we agree that *this* asymmetry is a manifest error in the expression of the *Final proposals*. Having drawn it to Ofgem's attention, we do not intend to stand in the way of its correction. For Northern Powergrid's two licensees, the total difference between the interaction payment using unadjusted 2009-10 data, and the penalties that would occur during the DPCR5 period if losses remain at their 2009-10 level, is £10m. The company's position throughout the process, from when it first raised the issue to Ofgem's attention, is that it would not expect to retain this 'over-compensation'. However, the reason advanced by Ofgem⁸ that justifies action being taken to correct the error is, we think, flawed. We believe that the case should not depend on whether DNOs could have known about the magnitude of this discrepancy when the DPCR5 *Final proposals* were agreed. The better argument is that the mismatch was indeed a manifest error that it would be unreasonable to allow to stand now that it has been spotted.

The content of the Final proposals is the settlement that has been agreed...

87. Paragraph 2.4 of the Consultation states that:

'The options put forward for consultation represent potential ways of bringing the current situation into line with what was intended by Final proposals. Our view is that they do not represent a departure from the intended policy of the losses incentive. However, we acknowledge that implementation of the options may require clarification of, or changes to, the mechanics of how that intended policy is delivered. We further acknowledge that implementation may require a modification to DNO licence conditions.'

⁸ i.e. in paragraph 2.3 of the Consultation.

88. This passage merits comment.

... and this content takes precedence over Ofgem's intention at the time it formulated those proposals.

89. First we note that it elevates what 'was intended by Final proposals' above the actual content of the *Final proposals*. This approach to the DPCR5 settlement cannot go unchallenged. Licensees do not sign up to price-control packages that are subject to change during their currency simply because a change would be consistent with, or better achieve, the *intention* of Ofgem at the price-control review. We sign up to firm proposals. Those proposals, not the intention behind them, are the basis of the settlement. The consequences in terms of regulatory risk and the consequent effect on the cost of capital of any other viewpoint would be very serious indeed. It is not acceptable to present the options under consideration as being merely 'the mechanics of how that intended policy is delivered'. Incentive regulation is dependent upon clear deals being struck and honoured.⁹ Effective incentive regulation cannot coexist with the *Final proposals*, and indeed the licence conditions, being treated after the event as merely ancillary to the achievement of a higher purpose or a particular regulatory policy.

The features that Ofgem is contemplating changing were deliberately designed to have the characteristics that they have.

90. Secondly, we do not accept that some of the features that Ofgem is now contemplating changing were unintended. In particular, we demonstrate in this response that:

- the caps and collars were designed to ensure that the marginal incentive would cease to apply in circumstances where the data was volatile;
- windfall gains and losses were quite possible but they would be limited by the caps and collars;
- the caps and collars would give rise to asymmetric risk exposure relative to the closing performance in the DPCR4 period (i.e. the 2009-10 performance) ; and

⁹ We distinguish this from the need to correct manifest errors, which we accept should be done where it is clear that a mistake has been made.

- the caps and collars reduced the DNOs' risk exposure, thereby justifying a lower WACC.

91. These are not mere mechanics of the DPCR5 settlement that can now be varied by a change of policy by Ofgem. They represent the essence of the deal. Paragraph 2.4 of the Consultation is, in our view, very misleading.
92. We are relieved that in paragraph 2.5 Ofgem gives some place to the expression of views or concerns about 'the degree to which any option moves away from the original intention of the DPCR5 settlement'. However, once again, we note the way that the *intention* is, in our view, wrongly given precedence over the settlement itself in the framing of the question.
93. In terms of the individual options, it is first worth noting that options 1 and 2, although presentationally different, have an identical effect. They both effectively set the 2009-10 level of losses performance as the target for the DPCR5 period. One does this explicitly (option 2). The other (option 1) does it implicitly, by crediting to uncapped losses incentive performance the annualised interaction payment before the application of the cap. In both cases, the DPCR5 annual incentive payments would effectively depend on the difference between each year's measured losses and the 2009-10 level of losses.
94. In terms of their strengths and weaknesses, Northern Powergrid has the following comments.
 - Both options involve greater changes to the DPCR5 settlement than are required to address the issue of over-compensation that can arise due to the uncapped interaction payment and the capped DPCR5 incentive, since in effect they both make changes to target setting that are unnecessary to address this issue.
 - Both options materially change the risk entailed in the DPCR5 settlement compared with the risk implied by that settlement on the day it was struck, since they reposition the band of losses performance over which the incentive payment can vary, from being centred on the DPCR4-period average-losses performance to being centred on the 2009-10 level of losses performance.

- Both options would only create an ongoing and equal incentive to improve losses performance assuming no further changes to losses performance relative to 2009-10 performance. This would not be the case under two of the four scenarios Ofgem presents at paragraph 3.14.
 - Although both options effectively set the 2009-10 level of losses as the target for the DPCR5 period, around which the capped and collared incentive applies, the Consultation only mentions the use of a single year's data to set the target as a weakness of option 2. It is in fact a weakness of both options 1 and 2.
 - The interaction payment could only be spread over four years, not the five years Ofgem states, since any decision is likely to come too late for 2012-13 charges (short of causing significant near term tariff volatility). Instead, the interaction adjustment for 2012-13 would need to be carried over as an under-recovery to 2013-14, leading to a higher adjustment in that year than the following three.
95. Option 3 is a variant of options 1 and 2, with the only difference being that the 2010-11 level of losses is adopted as the target, rather than the 2009-10 level of losses. There also appears to be an unintended error in the algebra defining the option, since substation losses would be double-counted ($ALR_{2010/11}$ would already exclude substation losses under the DPCR5 common methodology, unlike $ALR_{2009/10}$, and so no adjustment would be required for substation losses through the term $SUD_{2010/11}$).
96. Since this option involves a significant change to targets in a similar way to options 1 and 2, the additional weaknesses listed above apply.
97. In terms of the strengths and weaknesses listed by Ofgem, there would be no adverse impact on the incentive to reduce electrical losses on the distribution network. Even if the current incentive effectively functioned to incentivise this, a lack of rewards and penalties for changes in performance in 2010-11 can have no impact since 2010-11 and 2011-12 have finished. The option would impact on regulatory certainty due to the resetting of targets, but this would be no more pronounced than under options 1 and 2.
98. Option 4 is the option that Northern Powergrid has advocated throughout this process to correct the conflict between the uncapped interaction payment and the capped DPCR5-

period incentive scheme. There are a number of notable advantages to the option that are not listed in the Consultation.

- The option corrects *only* the conflict between the two mechanisms, and does nothing to change the nature of the DPCR5-period losses-incentive targets and the caps and collars. This has the advantage that it has maximum respect for the DPCR5 settlement while still dealing with the conflict. In particular, it does not impact on the risk profile entailed in the DPCR5 settlement on the day it was struck and the range over which payments under the losses incentive scheme could vary.
- The option would mean the interaction payment has a stable impact on charges for the two years when it is not zero, rather than an uneven profile over four years (which, as explained above, would be the impact of option 1-3).

99. Option 5 widens the caps and collars. As the Consultation notes, this would entail a change in the ongoing risk profile of the DPCR5 settlement, for both customers and network companies. However, it is not clear that this would be any more significant than the overall change in risk profile entailed by options 1-3. This is because, in the example given by Ofgem, the upper and lower levels of losses performance across which the scheme is active would be similar to those under the original DPCR5 settlement. Options 1-3, on the other hand, significantly shift the location of the band relative to the DPCR5 settlement, precisely to keep it active across a wider range than should have been the case, and so could in fact entail a greater change in the risk profile to customers and companies.

CHAPTER 3 – DATA TO BE USED FOR THE DPCR4 LRRM AND DPCR5 ALP

100. At paragraph 3.5 Ofgem sets out where restated and unrestated 2009-10 data would be used ‘if we were to adhere to the DPCR4 LRRM and DPCR5 ALP methodology (as set out in the *DPCR5 Final Proposals*.’

Ofgem's summary of the 2009-10 dataset (i.e. restated or unrestated) that should be used for each purpose is accurate.

101. We agree with Ofgem's summary of the position in 'Table 1: Status quo for use of 2009-10 performance data.' In particular, if no changes are made, restated data would be used for the DPCR4 LRRM (the five times E component) but unrestated data would be used for the interaction adjustment and for the setting of the DPCR5 targets (i.e. the ALP term).
102. Ofgem might usefully have added that it is not only the DPCR5 *Final proposals* that would require this approach: it is also the licence that incorporates these aspects of the *Final proposals*.
103. At paragraph 3.6 Ofgem says that the key question 'is whether we should move away from the position above set out in Table 1 above.'
104. It is no light matter to depart from the requirements of the licence and the *Final proposals* and we are surprised that Ofgem has given very little attention to such a departure in its consideration of the issues.
105. However, since Ofgem is clearly open to the idea that it can now revise the *Final proposals* and licence, we set out below our views on the intrinsic merits of the use of adjusted or unadjusted data for each purpose.

For the annual incentive value and the five times E component restated data should be used...

106. We agree with Ofgem that, for the purpose of the annual incentive and the DPCR4 LRRM five times E component, adjusted data must be used. Once it has been determined that adjustments to the 2009-10 dataset are required to restore consistency with the way the DPCR4 targets were set, there is no case to use unadjusted data for either the annual incentive (which represents merely payments on account) or the LRRM five times E component (which determines the true value of the DPCR4 losses incentive).

... and indexed values should be used.

107. Although Ofgem set out the logic of the five times E component in the DPCR5 *Final proposals*, it did not set out whether nominal or RPI-indexed values of incentive payments over DPCR4 should be used.
108. We believe that the RPI-indexed values should be used for the calculation of rewards and penalties already received by DNOs, as per the Excel template issued with the previous consultation on losses (reference 137/11). RPI is taken into account in calculating the total value of the losses incentive for DPCR4 (five times E), so its effect should not be ignored in calculating the total value of the annual rewards or penalties during the course of DPCR4. To do otherwise would represent an inconsistency between the two calculations. Northern Powergrid has taken this approach in all its submissions on losses to date.

Unrestated data should be used for the interaction adjustment...

109. With respect to the interaction adjustment we note the presentation of the outcomes using adjusted and unadjusted data in ‘Table 2: Scenarios for DPCR5 losses performance.’
110. Ofgem presents the problem starkly at paragraph 3.14, which states:
- ‘The appropriate operation of the interaction adjustment hinges on which of these [four] scenarios best reflects reality.’
111. This is a welcome and very frank acknowledgement of the issue. The interaction adjustment will generate windfall gains and losses, relative to its intended operation, under two of the four scenarios. However, it is not possible to choose between the use of restated and unrestated datasets now in the certain knowledge that the windfall loss or gain will thereby be avoided. Whatever choice is made about the dataset carries the risk of unintended outcomes.
112. In our view this highlights the issue that the rewards and penalties that will arise under the DPCR5 incentive will be dominated not by the behaviour of each DNO and the effect that its actions have on real electrical distribution losses, but by whether or not

Ofgem guesses right about whether the level of DPCR5 losses will continue at the unrestated 2009-10 level or whether they will continue at the restated level.

... it cannot be sensible to set up a situation in which so much turns on whether Ofgem guesses right about how supplier behaviour will affect reported losses in future.

113. We believe that it would be wholly inappropriate for Ofgem to try to anticipate how this unreliable data will behave in the DPCR5 period because so much value would turn on whether Ofgem guessed correctly. This further reinforces the point that the incentive would not encourage DNOs to invest in physical work on the distribution system to reduce electrical losses. This is the case regardless of whether the DNO happens to be within the incentive bands.
114. Moreover, the Consultation seems not to contemplate that there may be differences not only of degree, but also in the sign, for different DNOs because the outcome will differ according to how suppliers have behaved in the past and how they may behave in future.
115. It is common ground that the data problem that has given rise to this entire episode has been driven largely by the ability of suppliers to use facilities such as gross volume correction ('GVC'). Different suppliers have used different approaches to differing extents and over different timescales in different parts of Great Britain. It is far from clear exactly what changes have been made by what suppliers and in what periods, so making a judgement today about how this behaviour may change in future, as if the pattern of behaviour will be the same across the country, is not possible. To subject companies and customers to such risks without carefully considering the evidence available in each case would be inappropriate.

All the evidence suggests that reported losses are not falling back to pre-2009-10 levels.

116. However, if Ofgem is determined to try to remove the potential for windfall gains and losses – whilst not being prepared to deactivate the settlement-based elements of the DPCR5 losses incentive – then it appears to have no choice other than to try to judge (or perhaps more accurately, guess) the future level of losses and hope that it gets close to the ultimate outcome. Whilst we do not support this approach, we present the available evidence for Northern Powergrid below in paragraph 129 below. As this

demonstrates, all the evidence to date is that the reported losses are continuing at the higher levels commensurate with those reported by settlements in 2009-10.

117. On that basis the most suitable 2009-10 dataset to use for the interaction adjustment is the unrestated dataset.
118. The most appropriate outcome (because it is the most probable) is the one shown by Scenario 3 in Table 2 of Chapter 3 of the Consultation. That dataset corresponds with the most likely outcome for the data reported by settlements in the DPCR5 period, based on the DPCR5-period data we have already seen. It is also the dataset that must be used if the licence is not amended.
119. For the reasons set out above Northern Powergrid would object to any attempt to modify the licence to allow Ofgem to use adjusted data in the interaction adjustment. We estimate that the use of adjusted data could lead to a payment by Northern Powergrid of £90m under the interaction mechanism, to be followed by annual penalties of totalling £36m during the DPCR5 period, i.e. the maximum permitted by the caps and collars that presently exist. This, of course, is the situation that Ofgem describes under Scenario 1.
120. As a result, the options highlighted in the table at paragraph 3.16 of the Consultation have no bearing on the choice of whether restated or unrestated data should be used for the interaction payment, for a company in our position (i.e. where losses appear to be remaining close to the new higher level). In all cases, unrestated data must be used for the interaction payment in order to avoid a windfall penalty. This includes option 2, where unrestated data should be used to calculate the interaction payment regardless of whether restated or unrestated data is used for target setting (assuming that unrestated data continues to be used to measure losses performance during the DPCR5 period).

Unrestated data should be used to set the DPCR5 period targets...

121. At paragraph 3.19 the Consultation states that:

‘As in Table 1 above, if we did nothing DNOs would be required to use un-restated 2009-10 values for the DPCR5 ALP.’

122. We agree with this statement, which is simply another way of saying that the deal struck at DPCR5, as set out in the *Final proposals* and enshrined in the licence, requires the 2009-10 data used in the determination of the DPCR5 targets to be the unadjusted dataset.

123. Thus, when Ofgem follows this with the statement that ‘The question is whether to instead require DNOs to use restated 2009-10 values for calculating the DPCR5 ALP’, we would have expected this possibility to have been accompanied by a clear statement that the introduction of such a requirement would amount to a material variation of the DPCR5 settlement.

... because the dataset specified in the licence should be used and not varied with retrospective effect...

124. Moreover, since it is clear that this would result in a change to the target level of losses in the DPCR5 period, the Consultation should surely have mentioned that:

- Ofgem would be circumventing the mechanism (including the accompanying protections) already set out in the licence for changing the targets in the light of new information about the quality of the data; and
- Ofgem would be changing the targets *with retrospective effect* when more than half of the price-control period has elapsed.

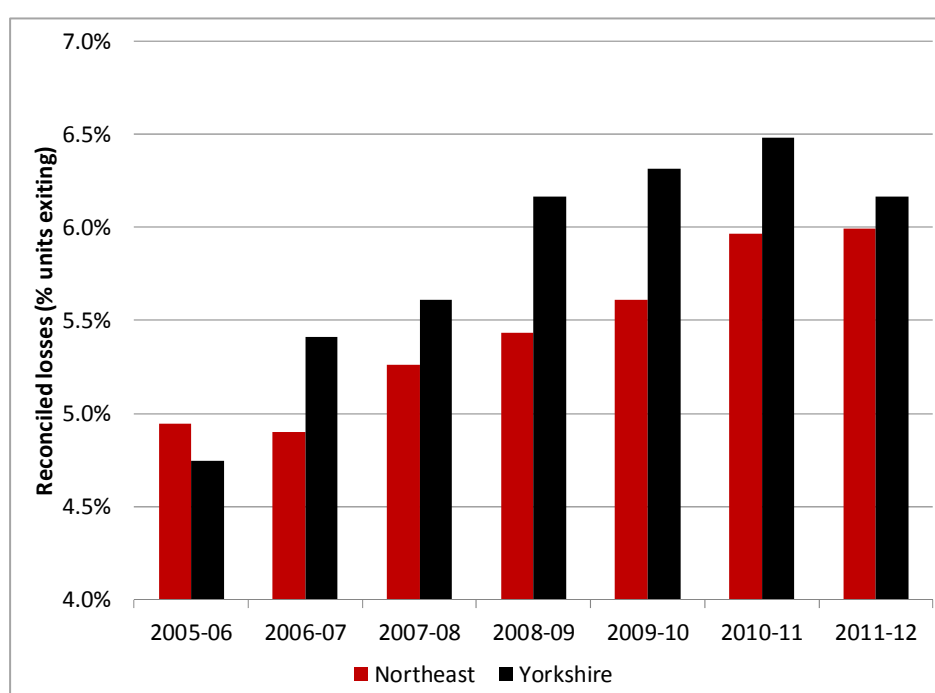
125. These two features should weigh heavily in Ofgem’s consideration of the issues and we are disappointed that these important considerations did not feature in the Consultation.

126. At paragraph 3.20 the Consultation succinctly and correctly explains why it does not follow that, if adjustment should be made to the 2009-10 data for the purpose of the DPCR4 incentive, the same adjustments should be applied for the purposes of the DPCR5-period losses targets. The purpose of the adjustment to the 2009-10 data for the purpose of the DPCR4 incentive is to restore consistency with the basis on which the DPCR4 targets were set. It is not to render the dataset more accurate *per se*. Disregarding important matters such as regulatory commitment, the policy issue that confronts Ofgem is which 2009-10 dataset – adjusted or unadjusted – is the more likely

to be consistent with the way that the outturn data will flow from the settlements system in the DPCR5 period.

... and because the unrestated dataset is most consistent with the way losses will be measured in the DPCR5 period.

127. There are two reasons to suppose that the answer must be the unadjusted dataset.
128. The first of these arises from the observation that suppliers maintain that the (unadjusted) 2009-10 data includes proper corrections, parts of which may relate to prior years in the DPCR4 period. Once these corrections have been made it is logical to expect the correction to continue to be reflected in the data even if suppliers reduce or, indeed, end their GVC-type activity.
129. The second reason is empirical. We can see that there is no evidence that 2010-11 and 2011-12 losses are falling back to the lower level that preceded the suppliers' increased use of GVC and similar facilities. This is shown in the figure below. These losses figures are illustrated on a reconciled basis, under the DPCR5 common methodology. The dataset for 2010-11 is now almost complete, with only half a month's reconciliations left to be received. The 2011-12 projection is based on the reconciliations received so far and the 2010-11 values for reconciliations data not yet received. These 'substitute' values include a full year of RF data, six months of R3 data, three months of R3 and one month of R1 data.



130. As can be seen from the chart, while there may be indications of a small reduction in losses in Yorkshire, this is not significant relative to the 2009-10 performance. Moreover, there has been a worsening trend for Northeast which appears to be continuing. If the targets were reset to the level of 2009-10 losses performance, this appears likely to cause a significant windfall penalty for Northeast within the DPCR5 period that can only be due to the ongoing impact of supplier settlements corrections.
131. Finally, it should also be noted that 2011-12 reconciliations to date have on average been more negative than during corresponding settlements runs for 2010-11. If this pattern continues, the final losses performance for both licensees will be worse than shown above.
132. We believe that Ofgem would prefer not to have to go through an exercise like the current one again to close out the DPCR5 incentive (assuming of course that there are no further significant changes in supplier corrections behaviour). We therefore assume that unadjusted data will be used in the measurement of actual losses in the DPCR5 period. It follows that the requirement for consistency between targets and outturn means that unadjusted data must be used to determine the DPCR5-period targets.
133. We note that even the use of unadjusted data may not be enough to ensure consistency between outturn and targets. This would be the case, for example, if the suppliers increased, or even merely continued at, the present rate to 'correct' data during the DPCR5 period. However, the dataset that has the best chance of being consistent with the outturn is undoubtedly the unadjusted 2009-10 dataset.
134. At paragraph 3.23 of the Consultation Ofgem notes that the use of 2009-10 data to set the targets for the DPCR5 period under option 2 could lead to an over-statement of the allowed loss percentage (ALP) if that single year happens to have unusually high losses. We also note that this would be the case under any option that uses a single year's data to set the targets, and so the comment also applies equally to option 1 (which implicitly uses 2009-10 data to set the targets) and option 3 (which uses only 2010-11 data to set the targets).

The ability to deal with different ways of measuring losses for the DPCR4 incentive close-out and DPCR5 target-setting was built into the DPCR5 Final proposals and the licence.

135. Northern Powergrid has consistently maintained that unrestated data should be used for DPCR5-period target setting (as these are more likely to be reflective of data that will flow during the DPCR5 period) and ACL2, while restated data should be used for calculating the value of the DPCR4 5xE component and ACL.

136. Units distributed in 2009-10 appear in two places in the DPCR5 *Final proposals* (and, by cross-reference, the licence). One is for the purpose of DPCR5 target setting and the setting of ACL2 (UD₂₀₀₉₋₁₀) and one is for the purpose of calculating the DPCR4 close-out, or the PPL term (LUD). In other words, the *Final proposals* appear to have anticipated a difference between the measurement of units distributed for these two purposes, and hence the proposals should allow the approach that Northern Powergrid has consistently advocated to be implemented.

- UD₂₀₀₉₋₁₀, which is used for setting targets and ACL2, should be based on unrestated units distributed (i.e. it should be measured from actual data on a reconciled basis in line with the DPCR5 common methodology).
- LUD, which is used for calculating the value of the DPCR4 five times E component and ACL, should be based on restated units distributed (i.e. it should be measured according to the SP methodology).

137. Since Northern Powergrid does not believe any restatement should be applied to UD_{2009/10}, neither of the options presented for the restatement of UD_{2009/10} should be implemented, at least for companies facing the same position. This should also have the benefit of not requiring a departure from the DPCR5 *Final proposals* or a licence modification. However, in terms of the relative merits of the two options presented, since the SP methodology must be used to restate LUD, it is not clear why any different approach would be used for the restatement of UD_{2009/10}, if it were to be restated.

Ofgem cannot clarify or change the details of the current incentive without equipping itself with the necessary vires to make such a change.

138. At paragraph 3.26 the Consultation states that:

‘...implementation of some of the proposals throughout this Chapter may require clarification or changes to the detail of what was set out in *DPCR5 Final proposals* and/or may require modification to the DNO licence conditions.’

139. Once again the Consultation somewhat understates the position. Since the licence condition states that the key terms within the algebra of the condition *will* be calculated according to ‘the methodology set out in Chapter 4 of the Authority’s decision document on 7 December 2009 under reference 148/09’, any changes to the components of the formula that differ from the way that such components would be calculated by reference to that methodology would require a modification to the licence.
140. It is important to understand that Ofgem cannot now issue ‘clarification’ that a particular component should be calculated differently, nor can it make ‘changes to the detail of what was set out’ in the *Final proposals* without equipping itself with the vires to do so. We are concerned that paragraph 3.26 of the Consultation suggests that Ofgem supposes that it has options to alter the calculations or the datasets that are required to be used by the licence without, in some cases, preceding such a change with a licence modification.
141. Nowhere in the Consultation does Ofgem set out which components of the calculation are not governed by the cross-reference in the licence to Chapter 4 of the *Final proposals*. For the avoidance of doubt, we do not believe that any of the components of the incentive that Ofgem discusses in the Consultation can be varied by a ‘clarification’ or by changing ‘a detail’ of the *Final proposals* without first providing the necessary vires by a licence modification that releases Ofgem from the constraints of the *Final proposals*.
142. It is necessary to make some further observations that relate to matters that are not considered by the Consultation.

The Consultation does not mention the other DPCR5 mechanism to incentivise DNOs to reduce losses...

143. Throughout the Consultation and in remarks made in meetings there is an underlying assumption that the settlements-based losses incentive that is set out in special

condition CRC7 is the only mechanism established at DPC5 to encourage DNOs to improve the losses performance of their networks.

144. This is not the case. At DPCR5 Ofgem also established £16m of up-front funding for low-loss investments. The purpose of this was to allow DNOs to finance such investments ‘while ensuring that customers only pay for schemes that have a robust investment case.’¹⁰

145. Unfortunately, the interaction between this allowance and the settlements-based incentive would discourage any DNO from using the facility. An integral part of the funding mechanism is that ‘companies will then be set tougher targets to make sure the investments deliver the losses reductions they claim’.

... so switching off the settlements-based incentive would not mean there was no remaining incentive.

146. It would be wrong, therefore, to suppose that, if the settlements-based incentive were to be removed from the licence, there would be no mechanism by which Ofgem could incentivise DNOs to reduce system losses over the remaining years of the DPCR5 period. Such a mechanism already exists, but its effectiveness is impeded by the settlements-based incentive. Moreover, it is not too late to build on that mechanism in place of the settlements-based incentive, which is clearly unfit for its purpose.

147. We and many others have suggested that the only sensible option is to switch off the settlements-based losses incentive for the duration of the DPCR5 period.

148. Ofgem has rejected such suggestions and justified its response with the statement that

‘Ofgem is committed to action that seeks to reduce losses across the distribution network as well as ensuring certainty for companies. Undertaking a review of the losses mechanism well into the DPCR5 price control period is likely to undermine that certainty.’¹¹

149. Whilst we endorse this clear acknowledgement of the benefits of regulatory certainty, we must observe that it is being somewhat inconsistently applied in the Consultation.

¹⁰ *Final proposals*, paragraph 2.14.

¹¹ Letter from Dora Guzeleva to Losses and Gross Volume Correction Working Group Members, 7 November 2011.

We would accept a proposal from Ofgem to switch off the settlements-based losses incentive for the DPCR5 period...

150. For the avoidance of doubt, Northern Powergrid would agree to a proposal to switch off the settlements-based DPCR5 losses incentive despite the fact this was clearly set out in the DPCR5 *Final proposals* and in the licence. We believe that there is overwhelming evidence that it is not fit for purpose and none of the changes being contemplated by Ofgem in the Consultation will render it an effective and proportionate incentive.

... but if Ofgem insists on a settlements-based incentive remaining in effect, the incentive set out in the Final proposals must be honoured.

151. However, if Ofgem insists that the settlements-based incentive must continue, we shall similarly insist that the mechanism in its entirety must continue as it was set out in the *Final proposals* and entrenched by a modification of the licence. We shall not accept adjustments to the mechanism that will not cure it of its defects, but will expose us to risks that were not present in the original deal.

152. In summary this means that

- the DPCR5-period target must be set on the DPCR4-period five-year average;
- the 2009-10 dataset used to set the DPCR5 targets must be the unadjusted 2009-10 dataset;
- the interaction adjustment can be capped to remove the conflict with the annual incentive;
- the interaction adjustment must be calibrated using an unadjusted 2009-10 dataset;
- the upper and lower bounds of the active incentive must be set as per the *Final proposals*; and
- if the Authority wishes to vary the DPCR5 targets it must make a proposal to us using the process that is set out in special condition CRC7.

APPENDIX 1 – IMPACT ASSESSMENT

Ofgem's impact assessment is flawed...

153. Paragraph 5 of the Impact Assessment (included at Appendix 1 to the Consultation) states that Ofgem's assessment has been informed by 'two key objectives of the policy options to address the conflict between the DPCR4 interaction adjustment and the DPCR5 cap and collar'. Ofgem goes on to state that these two key objectives are

'to ensure that:

- All licensees are incentivised to improve losses performance during DPCR5.
- No licensee incurs a windfall gain or loss.'

154. This presentation of the analysis requires comment.

155. On a point of detail, it is not accurate to describe the interaction adjustment as 'the DPCR4 interaction adjustment'. The interaction adjustment looks ahead to the DPCR5 period and, indeed, no adjustment would be needed if there were no losses incentive in the DPCR5 period.

... because the 'conflict' that has been identified has no bearing on incentives...

156. More substantively, we have shown in paragraphs 27 to 34 above that the *conflict* between the interaction adjustment and the DPCR5 cap and collar has absolutely no bearing on whether licensees are incentivised to improve losses in the DPCR5 period. To the extent that the caps and collars may remove any incentive to improve losses, this feature arises from the underlying purpose of any cap and collar to an incentive (i.e. it is the point at which marginal changes have no effect on the outcome). It is nothing to do with the interaction adjustment, whether that mechanism is considered in isolation or in conjunction with the caps and collars.

157. The asymmetry between the interaction adjustment and the caps and collars has no effect on incentives in the DPCR5 period, but it appears that this incorrect assumption is embedded in Ofgem's assessment of the options. This should be corrected if Ofgem

does not wish to expose itself to challenge on the grounds of having been influenced by a factor that logically cannot be present.

... and because it confuses a regime under which payments may be expected to flow with an effective incentive to reduce losses.

158. The Impact Assessment makes the invalid assumption that, if payments are likely to flow one way or another under the losses incentive, this is the same thing as an active incentive on a DNO to reduce losses. For the reasons set out above this assumption is not sound. We believe that there is now overwhelming evidence that a settlements-based output incentive for losses will confer rewards and penalties according to the behaviour of suppliers with respect to settlements data and according to the guess that Ofgem is about to make about how that behaviour will be reflected in the settlements data received during the DPCR5 period. The presence of a time-limited incentive, caps and collars and the asymmetric nature of the way losses data may be expected to fluctuate mean that no DNO could rationally suppose that its own actions will be rewarded or penalised. The recalibration of the incentive so that payments are more likely to flow is not at all equivalent to the restoration of a real incentive on a DNO. The Impact Assessment appears to make that faulty assumption.

159. Generally speaking we would support the second key objective (i.e. that licensees should not incur a windfall gain or loss). However, this should be balanced against a third key objective, namely to honour the DPCR5 settlement. We found it disconcerting that Ofgem did not include the honouring of a price-control settlement as worthy of being listed as one of the ‘key objectives’ in an exercise of this kind.

The impact assessment should consider the option of switching off the DPCR5 incentive altogether.

160. We believe that the policy options are incomplete because they do not include what might be regarded as the most obvious policy option of all – the removal of the settlements-based DPCR5 incentive. Although such an option would score a ‘negative’ if considered against the (absent) key objective of maintaining the deal struck at DPCR5, it is the only one that can be certain to deliver a result where no licensee incurs a windfall gain or loss. We regard this as a very considerable omission.

161. The Impact Assessment ‘for simplicity’ makes certain assumptions in the presentation of the assessment of the options in the table that follows paragraph 8. As it happens we agree with both the assumptions that have been made (i.e. that unrestated data should be used in both the interaction adjustment and the ALP term), but these simplifying assumptions mask the risks of windfall gains and losses under some of the scenarios considered in Chapter 3. Since the avoidance of windfall gains and losses is said to be a ‘key objective’, this presentational approach seems rather questionable.
162. In our view, the ‘impacts on consumers’ summarised in the bullet points at paragraph 9 amount to a partial analysis because:
- it is (in our view wrongly) assumed that recalibration so that payments are more likely will unquestionably restore the incentive on DNOs to reduce losses;
 - there is no recognition that some of the options that Ofgem is considering would be likely to lead to consumers paying large sums for nothing other than data changes by suppliers; and
 - there is no consideration of the long-run damage to consumers that would result from a regulator’s unpicking a deal halfway through its duration, with retrospective effect, and after having set the WACC on the basis of caps and collars that may well be widened or recalibrated. That would be bad regulation, which would ultimately be bad for consumers.
163. The summary of the impacts on competition is reasonable, but we believe that it too suffers from the omission of an evaluation of the option to switch off the DPCR5 settlements-based losses incentive altogether.
164. We believe the summary of the impact on the environment to be faulty for the same reason as set out in paragraph 158 above – i.e. it assumes that restoring the likelihood of a flow of payments in one direction or another amounts to an effective incentive on a DNO to reduce losses.
165. Accordingly, we consider the conclusion to the Impact Assessment to be flawed because it proceeds from the same incorrect assumptions and omissions listed above.

**ANNEX 1 - THE HISTORY OF NORTHERN POWERGRID'S SUBMISSIONS TO
OFGEM ON THE VOLATILITY OF LOSSES AND CAPS AND COLLARS AT
DPCR5**

1. Over the period from January 2008 to November 2009 Northern Powergrid made six written submissions to Ofgem and 11 presentations to the Authority or to Ofgem officials in which losses featured prominently. These representations were in addition to the representations made by DNOs collectively through the Energy Networks Association (ENA) and in meetings of the Ofgem-led Environmental Working Group.
2. The common thread that runs throughout these numerous submissions is Northern Powergrid's repeated warnings to Ofgem and to the Authority that settlements data was not a satisfactory basis for a high-powered losses incentive.
3. Until September 2009 Northern Powergrid continued to promote a losses incentive that would have been based on an engineering model of the losses impact of the changes made to the distribution network by the licensee. Ofgem resisted this solution and preferred an outputs-based mechanism that was wholly reliant upon settlements-system data.
4. Following the *Initial proposals* (in August 2009) Northern Powergrid concluded that Ofgem was determined that there would be an incentive that was driven entirely by settlements data. From September 2009 until Ofgem published its *Final proposals*, Northern Powergrid argued in favour of a lower powered incentive, without caps and collars, that could be followed by a more highly powered incentive once the reliability of the data had improved.
5. This history is summarised below.
6. Our response¹² to Ofgem's DPCR5 *Initial consultation* commented that:

‘total system losses can be neither measured nor modelled robustly. The rewards for improving system losses are masked by movements in the data from the settlement system.’
7. Our first bilateral meeting¹³ included a slide that stated:

‘Losses incentive scheme cannot continue to be based on a small difference between two large numbers – the settlement system is far from “cleaned up”.’

¹² 23 June 2008

¹³ 22 October 2008

Our response to the Ofgem DPCR5 *Policy paper*¹⁴ made a similar comment and provided several pages of analysis of the volatility of settlements data, demonstrating that these fluctuations far exceeded the marginal effect of any activity that could be undertaken by the distributor. We were particularly clear in that response that the losses incentive introduced risk into the business that would affect its earnings profile.

8. By the time of our bilateral meeting with Ofgem on Environmental Issues¹⁵ we were very clear about our misgivings. The slides for that meeting contain the following observation:

‘...the DPCR5 incentive is heading towards becoming a high-stakes lottery....’

9. At this meeting we also drew attention to the importance we attached to targets that were based on an average performance, rather than performance over a short period:

‘Ofgem seems to wish to set the DPCR5 targets to reflect performance in later years, e.g. on a two-year historical average. We can understand this position but settlements-volatility impacts drive us to the conclusion that a longer period (5-10 years) is required.’

10. This was the first meeting at which we expressed support for a cap and collar, commenting:

‘It would also be appropriate for an “outputs”-based scheme to incorporate a cap and collar to prevent excessive reward or penalty not based on performance benefits.’

11. However, we explicitly recognised that with a cap and collar:

‘DNOs would flip-flop between the cap and collar depending on settlements variations.’

12. Thus by 21 May 2009 we had alerted Ofgem to the fact that we expected to find ourselves outside the cap and the collar in each year of the scheme.

¹⁴ 10 February 2009

¹⁵ 21 May 2009

13. From this it is clear that we appreciated both the need for a cap and collar *and* that we expected to find ourselves with a reported position that placed us outside the active incentive in any given year.
14. These observations continued to feature in our presentations to Ofgem, for example:
- at the Financial issues bilateral meeting on 4 June 2009;
 - at the bilateral meeting on 5 June 2009;
 - at the Committee of the Authority on 11 June 2009;
 - in our response to Ofgem’s ‘Methodology and Initial Results Paper’ (on 10 June 2009);
 - at a meeting with Steve Smith and Rachel Fletcher held on 19 June 2009;
 - in a paper on the close-out of the DPCR4 Rolling Incentive (June 2009);
 - in our response to Ofgem’s *Initial proposals* (on 14 September 2009);
 - in our presentation to the Committee of the Authority (on 7 October 2009); and
 - in our presentation to Steve Smith (on 21 October 2009).
15. We were particularly clear about our position on the consequences of settlements volatility and caps and collars in our meeting with Steve Smith on 19 August at which we gave our feedback on the *Initial proposals*. Our presentation included the following observations:
- ‘...there is no direct, reliable or vaguely predictable link from an action to reduce losses to payments under the scheme – especially in the presence of the necessary caps and collars – there is therefore no investment case that can be made.’
16. It is clear, therefore, that by August 2009 we had concluded, and informed Ofgem, that
- the so-called incentive would not incentivise us to invest in loss-reducing measures because the benefits would be lost in the random dataflows of settlements;

- we attached importance to the caps and collars that would protect us against these random data fluctuations;
 - we expected to find our reported performance outside the upper and lower bounds of the incentive and, therefore, without a reward or penalty for further marginal improvement or benefit; and
 - we attached value to the use of a longer period of time to determine the DPCR5-period targets.
17. Any revision to the DPCR5 losses incentive that Ofgem is now contemplating that changes any of these features would not only be inconsistent with the DPCR5 *Final proposals* (and therefore inconsistent with the principles of incentive regulation that depend on regulatory certainty) but would also be inconsistent with the position that we had declared to Ofgem prior to our acceptance of the *Final proposals*.
18. Accordingly, as Ofgem approaches decisions that are the subject of the Consultation, what matters now is not whether *Ofgem* had a full appreciation that its proposed losses incentive mechanism might not reward or penalise DNOs that lay above or below the upper or lower bounds, but the fact that we relied upon our understanding of the entirety of the mechanism that was being proposed by Ofgem in circumstances where we had expressed our deepest concerns about the reliance that was being placed upon a dataset that was not fit for purpose.

ANNEX 2 - OFGEM'S POSITION ON LOSSES AT DPCR5

1. In this annex we set out the way that the record reflects the development of Ofgem's thinking as shown in the publication of policy papers and consultations at DPCR5. We have paid attention to the following:
 - the volatility of settlements data;
 - the basis on which DPCR5 targets would be set;
 - the introduction of caps and collars; and
 - the determination of the weighted average cost of capital (WACC) having regard to the introduction of caps and collars.
2. In the December 2008 *Policy paper* Ofgem recognised that:

‘2.87. Many DNOs feel that the current mechanism does not incentivise them to undertake actions to reduce the technical losses (physical losses on the system) since the results of these actions are masked by the fluctuations within the settlement system. We agree that settlement volatility has made it difficult for DNOs to measure the results of loss reduction initiatives, but note that the volatility is decreasing and that the DNOs still receive the marginal benefit of any technical loss reduction despite the fluctuations.’
3. There are three things to note about this passage.
 - the issue of volatility had been brought to Ofgem's attention;
 - Ofgem believed this volatility was reducing. This was disputed by DNOs and recent developments have shown this concern to be well founded;
 - Ofgem's view that settlement-data volatility would merely mask (but not alter) the marginal benefit that the DNO would receive from its own actions was naïve. For this statement to be true there would have to be a consistent losses incentive value applied over a long enough period of time for the volatility to even out, the volatility would have to be truly random (i.e. not skewed in one direction or another), and there would have to be no caps and collars that might act to prevent a DNO from receiving its reward or penalty in a particular

period. Some of these points appear to have been recognised by Ofgem later in the process.

4. The problem of volatility was considered further at the Environment Issues Working Group meeting held on 18 March 2009. An Ofgem presentation to this group reviewed the possibility of caps and collars as a solution to volatility.
5. At the next meeting of that group held on 20 May 2009 the slides that bear the Ofgem logo show an awareness of the drawbacks of an output-based incentive based on settlements data. Among the ‘cons’ of such a solution were the following:
 - ‘settlement volatility creates short-term gains/losses’; and
 - ‘hard to see impact of specific action’.
6. Among the ‘risks’ attaching to the output based incentive were the following:
 - ‘may not drive low-loss investment’; and
 - ‘possibility of windfall gains/losses’.
7. We think that this is rather important. It shows that Ofgem pressed ahead with its proposals for a settlements-based output incentive in the knowledge of these drawbacks and risks. It cannot now be said that the possibility of windfall gains or losses for DNOs or customers was something that Ofgem did not expect. This is relevant to the presentation of the options in the Consultation where Ofgem describes certain outcomes that could arise if the DPCR5 *Final proposals* are not now amended (i.e. with respect to the ACL2₂₀₀₉₋₁₀ term) as ‘windfall gains and losses’. There may indeed be windfalls, but the likelihood of ‘windfalls’ was fully understood by Ofgem when it arrived at its *Final proposals*.
8. Indeed, the same presentation considers what might be done to ‘mitigate for “cons”’. It was to address these problems that Ofgem proposed to place a ‘cap and collar on the incentive amount’.
9. The caps and the collars were evidently conceived by Ofgem in response to the problems of volatility and to limit the magnitude of (not to remove altogether) the likely windfalls.

10. Accordingly, it is clear that:

- the likelihood of windfalls was recognised and addressed in Ofgem's DPCR5 proposals; and
- the cap-and-collar mechanism was integral to the solution that Ofgem proposed for mitigating the drawbacks and risks associated with an output-incentive based on volatile settlements data.

11. Also, the following extract from the *Initial proposals* (in August 2009) seems clear enough:

‘Ideally, all incentive mechanisms should pay out or penalise the DNOs in response to the behaviour of the DNO and so the returns they make should be within the DNOs’ control. However, in some cases, such as the losses incentive, other factors can play a role in how the DNO fares under the mechanism and where this is the case we think it is important to put in place caps and collars to limit the risk and reward under the scheme.’¹⁶

12. At paragraph 6.12 of the *Initial proposals: Incentives and Obligations* Ofgem is also quite categorical:

‘Other proposed changes include... applying a cap and floor to the incentive outturn in order to mitigate the quality and volatility of settlement data...’

13. In the same document Ofgem is clear that the purpose of the cap and floor is ‘in order to reduce any outstanding risk to both the DNOs and consumers’ and moreover states that ‘this is consistent with our overall approach for DPCR5.’

14. At DPCR5 Ofgem introduced the new concept of the return on regulatory equity (RORE). In a presentation to the DNOs’ Regulation Managers’ Meeting on 9 October 2009 Ofgem explained that:

‘We propose a holistic approach to the settlement’

making it clear that:

¹⁶ Paragraph 4.10, *Initial proposals* 3 August 2009.

‘This involves trading off WACC and RORE’.

15. The DPRC5 losses incentive was relevant to the RORE and WACC debates because Ofgem advanced the view that the caps and collars under the DPRC5 losses incentive reduced the risks for DNOs, relative to those present at DPCR4, and therefore justified a lower WACC. This was expressed in the Ofgem presentation in the following way:

‘Losses incentive in DPCR4 could have gone both ways for DNOs. Caps and collars will reduce the risks in DPCR5’.

16. The *Final proposals* also make clear that the lower DPCR5 WACC is justified in part because of the revised approach to losses. At paragraph 4.23 Ofgem explained why it took a different view from the DNOs about the risk of the Ofgem DPCR5 proposals relative to DPCR4. Ofgem highlighted five new factors that gave upside or reduced risk to DNOs. One of these five factors was that:

‘In response to the DNO concerns.... we have reduced their exposure to a number of mechanisms. We have:

- Placed a tighter collar on the maximum penalty they can pay under the losses incentive from 115 to 70 post-tax bps at Initial Proposals’.

17. Ofgem summarised its justification for the lower WACC at Table 4.1 of the *Final proposals*. This table stressed the move from an uncapped to a capped losses incentive and was followed by an unequivocal recognition of the consequences for the WACC of the changes to the incentive schemes:

‘In general we think that there is less risk in DPCR5 because we have capped all of the incentive mechanisms that were uncapped at DPCR4.... The lower potential to make additional returns in DPCR5 is due to the cap on the losses incentive which we have introduced at the DNOs request.’¹⁷

18. This makes clear something that in any case ought to be obvious, namely that Ofgem’s judgement of the assumed WACC took into account the reduction in risk that was being brought about by *inter alia* the application of caps and collars to the losses incentive. Since Ofgem was explicit that WACC and RORE were being considered holistically at

¹⁷ *Final proposals*, paragraph 4.29.

DPCR5, it cannot argue that changes can now be made that would have the effect of removing a protection, or changing the circumstances in which it may be expected to operate, when the WACC has been determined in explicit recognition of the fact that these protections were being put in place.

19. It is also clear from the *Final proposals* that the narrow band for the caps and collars was an important part of the balance of the new incentive. The caps and collars were established in recognition of:

- the increase in the incentive rate from £48 to £60 per MWh; and
- the fact that extremes of reported performance could result from factors beyond the control of the DNO.¹⁸

20. To change:

- the way that the DPCR5-period targets are derived; or
- the location of the upper and lower bounds of the active incentive

would be a fundamental change to the risks and rewards of the DPCR5 deal. We believe that such a change would not be consistent with good regulatory principles. Indeed, we find it hard to think of an action that would be more damaging to regulatory confidence than a decision to recalibrate some aspect of the DPCR5 settlement simply because the protection that was introduced is likely to operate in circumstances where Ofgem might now wish that it would not operate. To do that at any time after a deal has been struck would be bad enough. To do it halfway through the period and with retrospective effect would only make that problem worse.

¹⁸ *Final proposals* paragraph 2.14.

**ANNEX 3 - RESPONSES TO SPECIFIC QUESTIONS
RAISED IN THE CONSULTATION**

INTRODUCTION

1. In this annex we set out in summary form the answers to the specific questions that appear in the Consultation. We also include some cross-references to the paragraphs of our full response that set out further relevant detail.

Questions from 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?

2. The question relates only to those strengths and weaknesses suggested in the Consultation.
3. We accept that all the features that are described as removing the opportunity for revenue gain or loss *as a result of the conflict* between the interaction adjustment and the caps and collars constitute the most important strengths. We note that this ‘strength’ is present in all of the options presented.
4. Of the ‘weaknesses’ identified by Ofgem we think the most important one is the one that Ofgem ascribes to option 5 in relation to the widening of the gap between the cap and the collar and the inherent increase in risk.
5. However, our position is that many of the ‘weaknesses’ indicated by Ofgem are not weaknesses at all or, if they are, the weakness derives from Ofgem’s approach that was intentionally enshrined in the *Final proposals* and should not now be revisited just because it is now perceived to be a ‘weakness’. In particular, asymmetrical revenue exposure under option 4 is not a weakness of that option but a deliberate reflection of Ofgem’s design at DPCR5. It would not be fair to label the implementation of Ofgem’s deliberate policy intent as a ‘weakness’. Similarly, to state that option 5 has the weakness of asymmetrical exposure potentially removing the incentive to reduce losses during the DPCR5 period is not fair because it suggests that some other options would restore that incentive. For the reasons set out above, we think that supposition is flawed.

6. Whilst we agree that option 2 has the ‘weakness’ that it would set targets on the basis of a single year, we believe that the most important weakness of this is that the DPCR5 deal established that targets would be set on the average of the five years of the DPCR4 period.

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

7. Yes. Ofgem should consider the degree of consistency and inconsistency with the DPCR5 settlement as an indication of strength and weakness.

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.

8. Our views on each of the options suggested by Ofgem are set out in paragraphs 93 to 99 above.
9. In brief we believe that only option 4 has the merit of confining itself to curing the problem of the asymmetry between the interaction adjustment and the caps and collars. It is the only option that does not attempt to use the opportunity to correct a mathematical asymmetry to rerun policy aspects of the *DPCR5 Final proposals*.
10. We note that the question here refers to the ‘original intention’ of the *DPCR5 Final proposals*, rather than to the proposals themselves. Phrasing the question in that way risks diverting respondents from the fact that Ofgem is contemplating fundamental changes to the deal struck at DPCR5. Those aspects of the *DPCR5 Final proposals* that Ofgem is now contemplating changing (such as the basis on which the targets were set, the design of the caps and collars around the targets, thereby giving an asymmetric opportunity relative to the 2009-10 end-point and the prospect that marginal improvement (or deterioration) would receive no further reward (or penalty)) were all deliberately designed into the DPCR5 losses incentive by Ofgem. Thus, whether one applies the correct test of consistency with the deal that was actually struck, or the incorrect test of consistency with some underlying purpose, the answer is the same: only option 4 honours the DPCR5 settlement whilst addressing the manifest error of the uncapped interaction adjustment and the capped and collared DPCR5 incentive.

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

11. Option 4 is the preferred option of those listed by Ofgem because it is the only one that does not rerun other aspects of the DPCR5 settlement that do not cause (and do not arise from) the problem of asymmetry between an uncapped interaction payment and a capped incentive mechanism, which is the ostensible reason for Ofgem's consultation on this matter.

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

12. Yes. Ofgem should recognise that all of the options will allow a dysfunctional losses incentive to persist in the DPCR5 period and that none of the options will restore an effective incentive to reduce losses. Large sums of money are likely to flow for no good reason and with no incentive properties attaching to those flows, as explained in our consultation response at paragraphs 17, 20 and 48. The missing option is the one that would consider removing the DPCR5 mechanism altogether.

Questions from 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?

13. Ofgem sets out the logic of the five times E component in the DPCR5 *Final proposals*. This made it clear that performance under the DPCR4 losses incentive scheme depended only on performance under the incentive for 2009-10, rather than on performance under the annual incentive, and that annual incentive rewards and penalties should be netted off the five times E component to calculate outstanding incentive value that is due. However, the DPCR5 *Final proposals* did not make clear whether, for the purposes of the LRRM, nominal or RPI-indexed values of annual incentive rewards or penalties over DPCR4 should be used. Northern Powergrid believes that the RPI-indexed values should be used for the calculation of rewards and penalties already received by DNOs, as per the Excel template issued by Ofgem with

the previous consultation on losses (reference 137/11). RPI is taken *into account* in calculating the total value of the losses incentive for DPCR4 (five times E), so its effect should not be ignored in calculating the total value of the annual rewards or penalties during the course of DPCR4. To do otherwise would represent an inconsistency between the two calculations.

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.

14. It is impossible to state *with certainty* how losses will behave in the DPCR5 period. One thing, however, is certain and that is that the movement will be dominated by behaviour of suppliers rather than by anything that we can do. At best our behaviour could move losses by tens of GWhs in a year. By contrast, suppliers' data corrections have shown that their actions can move losses by hundreds of GWhs in a single year. In our view that renders the incentive absurd.
15. That said, there is a greater *probability* that losses will remain at the (higher) 2009-10 unadjusted level or perhaps increase further from this level rather than fall back to pre-2009-10 levels. This is because;
 - GVC-type corrections that have already been effected by suppliers will continue to be seen in the data going forward even if no further GVC-type corrections are made;
 - suppliers say that they are continuing to make corrections to data; and
 - the data we have already received from the DPCR5 period suggests that negative reconciliations are not falling back to pre-2009-10 levels.
16. This means that for the $ACL2_{2009-10}$ term Ofgem should use unadjusted data. The unadjusted 2009-10 dataset has the greatest prospect of being consistent with the data that has flowed and may be expected to continue to flow in the DPCR5 period. Since the purpose of the interaction adjustment is to compensate for rewards or penalties that would flow in the DPCR5 period if the DNO maintained its 2009-10 performance, it is

essential that the measurement of 2009-10 performance that is most consistent with the DPCR5-period dataflows should be used. The evidence, both behavioural and in the data received thus far, is that the unadjusted 2009-10 dataset is most consistent with the data that has flowed, and must be expected to continue to flow in the DPCR5 period. The evidence and analysis supporting this position are provided in paragraphs 129 to 131 above.

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?

17. The options considered in Chapter 2 must be considered having regard to what is necessary to cure the problem of inconsistency and without using that inconsistency to justify making any changes to the DPCR5 settlement that are nothing to do with that inconsistency.
18. Similarly, if the correct approach to the question of what dataset should be used for the ACL2₂₀₀₉₋₁₀ term is adopted, it will be clear that, both on merit and for reasons of consistency with the DPCR5 settlement, the unrestated 2009-10 dataset must be used for the ACL2₂₀₀₉₋₁₀ term. This is true regardless of which option is considered, and is also the case under option 2 even if restated 2009-10 data is used to set the DPCR5-period targets.

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

19. Unrestated data should be used to calculate the ACL2 term of the interaction adjustment for Northern Powergrid, as this data needs to be consistent with the way in which losses are to be measured for the purposes of the DPCR5 incentive, and since Northern Powergrid has seen losses remain at the elevated 2009-10 levels.

Question 10: Do you think that 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?

20. Unrestated 2009-10 data must be used for the purposes of calculating the DPCR5 target.

21. This is because the measurement basis for the target and the outturn must be consistent. We assume that Ofgem does not intend to allow the routine restatement of outturn data during the DPCR5 period.
22. Since the data that has flowed for Northern Powergrid, and may be expected to continue to flow, in the DPCR5 period reflects the corrections already made by suppliers, the most consistent dataset to use for the purpose of setting the targets is the 2009-10 unrestated dataset.

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?

23. Since Northern Powergrid does not believe any restatement should be applied to UD_{2009/10}; neither of the options presented for the restatement of UD_{2009/10} should be implemented, at least for companies facing the same position. However, in terms of the relative merits of the two options presented, since the SP methodology must be used to restate LUD, it is not clear why any different approach would be used for the restatement of UD_{2009/10}, if it were to be restated.

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.

24. Throughout this response we have itemised the number of points at which the Consultation is contemplating what we regard as significant, inappropriate departures from the DPCR5 settlement. The departures that Ofgem is explicitly or implicitly contemplating include in particular:
- changing the way the DPCR5 targets are set from an average of five DPCR4-period years to 2009-10;
 - widening the gap between the upper and lower bounds of the DPCR5 period incentive;
 - using a dataset other than the one prescribed in *Final proposals* to determine components of the calculation by which the PPL term is computed;

- using a dataset other than the one prescribed in the *Final proposals* to determine the ALP term;
- removing or adjusting the protection that exists for licensees whose 2009-10 losses position is worse than the lower threshold set out in the licence;
- introducing symmetry of exposure under the DPCR5 incentive in place of the asymmetric exposure set out in the *Final proposals*;
- circumventing the provision in special condition CRC7 that establishes the targets for a period of five years.
- imposing an implied purpose to the DPCR5 losses incentive that enlarges upon the purpose set out in special condition CRC7;
- circumventing the protections for licensees with respect to changes to the ALP term that are embedded in special condition CRC7;
- circumventing the prohibition on retrospective changes to the targets that is set out in special condition CRC7; and
- introducing enhanced risks for licensees, having set the WACC by reference to a presumption that the caps and collars would operate to protect licensees from such risks.

25. The question invites respondents to share any other concerns that they have with Ofgem. The principal concern that we have is that none of the options that Ofgem is considering – not even the ones that at least have the merit of honouring the DPCR5 settlement – will lead to an active and effective incentive to reduce actual losses on the electricity distribution system. The mechanism that has been created will distribute random rewards and penalties primarily by reference to the behaviour of suppliers and the guess that Ofgem is about to make about the likely impact of how suppliers' behaviour will manifest itself in the losses data for the remainder of the DPCR5 period. We are not prepared to expose our shareholder to a significant risk of undeserved penalties that could arise from many of the options that Ofgem is contemplating. Moreover, we are not in favour of exposing our customers to our obtaining similarly undeserved increases in DPCR5 revenues. Similarly, we think that the 'principal

objective' that the statute places upon the Authority should preclude Ofgem from exposing customers to equivalent risks.