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Dear Tom

**Environmental discretionary reward under the RIIO-T1 price control**

Thank you for the opportunity to respond to the consultation. Electricity North West has always supported the use of incentive mechanisms to encourage investors and managers to improve company performance in targeted areas. Historically, the environmental incentives associated with carbon reduction and environmental performance have been insignificant compared to the other areas of DNO performance (customer service, innovation etc). For example, it was recognised prior to the introduction of the DPCR5 losses mechanism that it was not sufficiently powerful to create a business case for investment in low loss assets and therefore was introduced as an incentive on data accuracy. These incentive properties have since been dwarfed by severe information distortion by suppliers. Ofgem has obviously learned a great deal from the experience and is looking to more appropriately encourage companies to improve their environmental performance.

We have reviewed the progression and developments in the RIIO-T1 and RIIO-GD1 price control reviews with great interest. One of the most obvious omissions from both reviews is the lack of new incentives for the delivery of outputs. As these are two of the cornerstones of the RIIO framework, we expected Ofgem and companies to propose and develop more mechanisms to ensure that delivery for customers is appropriately rewarded.

All of the network companies have a key role to play in facilitating the transition of the UK economy toward the Government's decarbonisation targets. The transmission networks have a key role to play in ensuring that large scale and offshore renewable generation is connected in a timely and efficient manner, alongside its responsibilities as a company to operate in a sustainable manner. We therefore welcome Ofgem's introduction of the Environmental Discretionary Reward (EDR) for RIIO-T1.

Any incentive mechanism needs to pass five tests:

- Is the desired output clearly measurable?
- Is performance controllable by companies?
- Is the mechanism suitable for the objective?
- Is the incentive rate reflective of the externalities?
- Is the rate adequate to drive the desired behaviours?

The proposed incentive design falls some way short of meeting all these tests. In particular, the success of the incentive may be constrained by the discretionary nature of the incentive. Discretionary rewards do not allow companies to build investment cases, and whilst additional

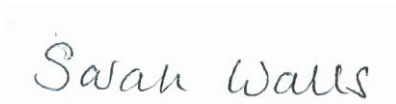
rewards may help to provide some incentives on managers to deliver the key outputs and policy objectives, these incentives can be very weak. Discretionary rewards also tend to represent a single year cash reward where as some of the changes required need ongoing funding as well as the initial investments (especially reporting or service based improvements).

For ED1, it would be appropriate to work to develop an incentive that better meets the criteria for successful incentives and hence provides a stronger incentive to improve environmental performance. Ofgem should also test the size of the incentive rewards with stakeholders. The proposed £4 million incentive revenue per annum across all licensees is unlikely to reflect the importance placed on the subject by customers and stakeholders.

We look forward to working with Ofgem to establish a suitably powered incentive mechanism for RIIO-ED1.

If you have any questions, please feel free to contact me or any of my team.

Yours sincerely,

A handwritten signature in dark ink that reads "Sarah Walls". The signature is written in a cursive, slightly informal style.

Sarah Walls  
Head of Economic Regulation

cc Dora Guzeleva