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Consultation on whether to activate the Distribution Losses Incentive Mechanism in the Fifth Distribution Price Control.

Dear Andy,

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

We continue to support an output based losses incentive to deliver the long term benefits of reduced losses to consumers and so we believe that the current losses incentive should continue as agreed at final proposals. We have yet to see any compelling evidence that settlements data is not sufficiently reliable and believe that the DPCR5 losses reporting method, combined with the introduction of caps and collars and a two year lag for incentive payments, has largely solved the issue of data volatility and predictability.

We note the DNO arguments about the issue of volatility in settlements data bringing unwarranted losses or gains (the "high stakes lottery"). Firstly, the *marginal* impact of any DNO activity to reduce losses, and so the incentive property, is unaffected by any perceived volatility in settlements data. Secondly, if this is the case, we would expect the £380m DNOs are currently winning on the lottery to be returned to customers. Whilst this has not been demonstrated, if the data is viewed to be unreliable for the purposes of setting targets for DPCR5 then it should not be used, in either an unadjusted or 'normalised' way, to justify any rewards for the DPCR4 period. If the DPCR5 losses scheme is to be switched off then the same logic would suggest that DPCR4 scheme should also be switched off.

We are concerned that suspending the DPCR5 incentive represents a re-opening of the DPCR5 settlement, reducing the level of risk that was included in the settlement package as a whole. This re-opening would be unfair to consumers unless it was accompanied by a compensatory adjustment to the overall package. This could be an adjustment to the rate of return but we suggest that introducing a cap on the Quality of Supply incentive could represent an appropriate compensatory adjustment that is easier to adopt.

We believe that requiring DNOs to report on actual measures undertaken to reduce losses is not likely to have significant impact. We do, however, believe that such information for the DPCR4 period would be useful for two reasons:

- It would allow Ofgem to establish a credible and justifiable level of losses for the overall incentive value of the DPCR4 losses scheme.
- It would provide a baseline to measure the success or failure of the proposed policy of suspending the financial incentive for DPCR5 and replacing it with a reporting requirement.

Finally, we disagree with your assertion that the incentive has not yet been activated. There has been an active incentive on DNOs to affect their losses performance since 1 April 2010 – DNOs have known about the details of the scheme since Final Proposals and have had an incentive to affect their marginal losses performance regardless of the absence of formal targets.

We provide answers to your consultation questions below. We trust these comments are helpful. If you have any questions please do not hesitate to get in touch.

Kind regards
[by e-mail]

Andy Manning
Head of Network Regulation, Forecasting and Settlements
British Gas

CHAPTER: Two
Question 1: Do you have views on whether the existing losses mechanism is effectively incentivising DNOs to reduce losses? Please explain your answer.

We have not seen any compelling evidence to suggest that fully reconciled data on the basis of the DPCR5 reporting methodology is producing unacceptable levels of volatility in the measurement of annual losses. Unless such evidence is provided then our view is that the existing mechanism for DPCR5 is providing an effective incentive.

DNOs have known how losses would be measured and targets set for DPCR5 since they accepted Final Proposals and have known that the incentive will apply from 1 April 2010 with a two year lag in receiving payment (similar to the quality of supply incentive). They have therefore had the incentive to impact their marginal losses performance since that date. If some DNOs have chosen to do nothing to affect their losses performance then they should not be protected from any consequences.

Question 2: Do you have views on whether or not the DPCR5 losses mechanism should be activated? Please explain your answer.

We do not agree with the premise that the DPCR5 losses mechanism is not yet active. The scheme has been active since 1 April 2010 and DNOs have had an incentive to affect their marginal losses performance regardless of the absence of formal targets. If it were the case that the lack of formal targets meant a lack of incentive on DNOs then Ofgem and the DNOs would have agreed a licence condition that set the DPCR5 incentive term to zero until such time as targets were finalised. The fact that they did not do this clearly shows that both Ofgem and DNOs were fully aware that the scheme was active from 1 April 2010 and that action taken from that date could affect their marginal reward under the scheme.

We believe the DPCR5 mechanism should not be switched off, but should be implemented in line with Final Proposals (with the necessary correction of the error regarding the interaction adjustment and caps and collars) for the following reasons:

- Where practical, we support an output based losses incentive to deliver the long term benefits of reduced losses to consumers.
- We believe that the new method of reporting losses for DPCR5 combined with the introduction of caps and collars for the incentive payments has largely solved the issue of data volatility. We have not seen any compelling evidence to the contrary, and would suggest that Ofgem should provide quantitative evidence (on the basis of the DPCR5 reporting methodology) to support their claim in paragraph 3.9 that settlements data remains volatile.
- The introduction of a 2 year lag for the DPCR5 mechanism has improved the predictability of losses performance.
- Switching off the DPCR5 losses incentive represents a re-opening of the DPCR5 settlement, reducing the level of risk that was included in the settlement package as a whole. Unless this is accompanied by a compensatory adjustment to the settlement package, this re-opening would be unfair to consumers.

Were the DPCR5 price control package to be reopened, and the losses incentive reviewed retrospectively we would strongly urge Ofgem to review the Quality of Supply incentive at the same time. This incentive was designed with a collar to limit DNO losses but with no cap on gains and Ofgem justified this on the basis of the maturity of the data with which they were able to set targets. Collectively DNOs are forecasting to recover £108m in a single year for this incentive in 2013/14 and so we would suggest that it has clearly transpired that the maturity of the data for target setting was not sufficient to remove the cap on rewards. We believe it would be appropriate for customers to receive protection from the Quality of Supply Incentive if DNOs are to receive protection on the losses incentive.

CHAPTER: Three

Question 3: Do you agree with our position that we should not allow retrospective changes to be made to the DPCR4 mechanism? Please explain your answer.

We agree that the DPCR4 mechanism should be closed out as intended (and accepted by DNOs at Final Proposals), however we disagree that this means continuing the process of removing the effects of data cleansing in 2009-10. Indeed we believe the opposite is true – not allowing any retrospective changes to the DPCR4 mechanism requires the close out of DPCR4 in accordance with Final Proposals. On the other hand, the level of potential change to what was agreed at Final Proposals contained in Ofgem’s recent information request to DNOs for the data to close out DPCR4 clearly represents a significant retrospective change.

We would again point out that the intention of Final Proposals, and the detailed description of which data would be used for the DPCR4 close out is explicitly clear, and effectively represents fully reconciled data.

Ofgem (and DNOs) have provided no compelling evidence to the industry that the measurement of annual losses on a fully reconciled basis has shown an unacceptable level of volatility during 2009-10. Neither has it been shown that this fully reconciled data represents an unrealistic or unjustifiable performance measure for 2009-10 losses versus the targets that were set for DPCR4.

Question 4: Are there other options we should have considered?

No, rather than consider more options, options 2 and 3 should be dropped as they represent a re-opening of the price control. Ofgem consulted extensively on losses during the DPCR5 process. The issue of data volatility was looked at and the new DPCR5 reporting methodology, combined with the caps and collars dealt with the issue. We have seen no evidence from Ofgem or DNOs that the new reporting methodology suffers from an unacceptable level of volatility.

As we have already suggested, if Ofgem insist on re-opening the price control to remove the risk faced by DNOs from the losses incentive then we believe that there should be a compensatory adjustment to the risk faced by consumers. We suggest applying a cap on the quality of supply incentive. If option 2 were taken forward, the cap on the quality of supply incentive could take effect at the same time the losses incentive was suspended. If option 3 were taken forward then it would be appropriate to apply the cap from the beginning of DPCR5. The level of the cap should be symmetrical with the current collar on penalties faced by DNOs.

Question 5: Do you agree with Ofgem's preference for Option 3? Please explain your answer.

We do not agree with Ofgem's preference for option 3. Our preference is for option 1 since this is the only option that does not constitute a departure from the current DPCR5 settlement and therefore a re-opening of the price control. It is also the only option that maintains the important policy objective of limiting carbon emissions and reducing costs to consumers.

Ofgem's rationale for their preference seems to rely heavily on the volatility of settlement data. We remain to be convinced that there is a problem with data volatility on the DPCR5 reporting basis and would expect quantitative evidence to prove otherwise to support any decision to switch off the DPCR5 mechanism.

Question 6: Do you have views on our proposal to introduce a reporting requirement for DNOs to inform us of actual measures they are taking to reduce losses? Please explain your answer.

A reporting requirement on DNOs and a league table on the measures taken to reduce losses is not a proper replacement for a financial incentive on losses and we are not convinced that it will have any impact.

However we would suggest that the information that Ofgem propose to capture should instead be provided by DNOs in relation to their activities during DPCR4:

- All individual measures or programmes of measures they have undertaken to reduce losses on their networks in each year
- The cost of the individual measure (incremental cost over and above their base revenue allowances)
- The expected effect on losses (incremental effect over and above the effect expected from base revenue allowances)

To date, DNOs have received £380m from the losses incentive during DPCR4 in their annual incentive payments. DNOs have provided no evidence of any incremental activity to reduce losses in DPCR4 that would warrant this value of incentive payment.

By requesting DNOs to provide evidence of the incremental activity that they have undertaken during DPCR4 to deliver sustained loss reductions and carbon savings, Ofgem would have a reasonable way of estimating a credible and justifiable losses performance for 2009-10. Our expectation would be that DNOs should receive no more than a reasonable rate of return on any incremental activity undertaken to reduce losses.

Question 7: Do you have views on the detail of what DNOs would be required to report and the approach to publishing details? Please explain your answer.

As we state above, a reporting requirement on DNOs and a league table on the measures taken to reduce losses is a poor replacement for a financial incentive on losses and we are not convinced that it will have any impact.

CHAPTER: Four
Question 8: Do you have views on our proposal to move the date by which a direction is required on the value of PPL from 30 November 2012 to 1 April 2013? Please explain your answer.

Given Ofgem's recent decision to direct DNOs to use their May 2012 forecasts of PPL for 2013/14, we are content with the proposal to delay a decision on the value of PPL to 1 April 2013. There should be no further slippage in this timeline however.

Question 9: Do you think that DNOs should set the value of PPL to zero in their July 2012 DCUSA forecasts for 2013-14 or leave current estimates in place? Please explain your answer and respond on this point by 24 July 2012.

We have already provided our response to this question, and we welcome Ofgem's decision to instruct DNOs to leave current estimates in place.

Question 10: Do you have views about whether the PPL term, when set, should be recovered over the single remaining year of DPCR5, over two years running into RIIO-ED1 or in the first two years of RIIO-ED1? Please explain your answer.

The recent decision by Ofgem in relation to the values to use for PPL for 2013/14, as well as the guidance provided by Ofgem in relation to DUoS charge setting for 2012/13 means that some DNOs have already included assumptions about PPL within their allowed revenues and DUoS charge setting assumptions for earlier years of DPCR5. The PPL direction will need to take account of these assumptions. Provided that a final figure for the residual values of PPL will be provided by 1 April 2013, our view is that any residual PPL should be recovered in 2014/15 to minimise changes from the policy agreed at DPCR5. Any further delay to the 1 April 2013 deadline may mean it becomes appropriate to spread it over two years, 2014/15 and 2015/16 however any delay into 2015/16 should be done in a manner that keeps it separate from the RIIO-ED1 process.

Question 11: Do you have views on whether we should move the date by which a direction is required on the DPCR5 targets from 30 November 2012 to 1 April 2013? Please explain your answer.

Given Ofgem's recent decision to direct DNOs to use their May 2012 forecasts of PPL for 2013/14, we are content with the proposal to delay a decision on the DPCR5 targets to 1 April 2013. There should be no further slippage in this timeline however.

Question 12: Do you have views on whether DNOs should set to zero, their forecasts for recovery of annual incentive in 2013-14? Please explain your answer and respond on this point by 24 July 2012.

We have already provided our response to this question, and we agree with Ofgem's decision to provide no guidance in relation to this issue ahead of the conclusion to this consultation.