WHETHER TO ACTIVATE THE DISTRIBUTION LOSSES INCENTIVE MECHANISM IN

THE FIFTH DISTRIBUTION PRICE CONTROL

RESPONSE TO OFGEM'S CONSULTATION FROM NORTHERN POWERGRID

17 August 2012

INTRODUCTION

1. On 6 July 2012 Ofgem issued a consultation paper entitled *Whether to activate the Distribution Losses Incentive Mechanism in the Fifth Distribution Price Control* ('the Consultation').

2. The Consultation observed that the incentive mechanism is not operating as intended or incentivising appropriate action by distribution network operators ('DNOs'). The Consultation set out Ofgem's preferred option (which was not to activate the DPCR5 incentive) and asked respondents for their views on a number of questions set out in the Consultation.

SUMMARY OF NORTHERN POWERGRID'S VIEWS

3. In summary, we find ourselves in agreement with Ofgem's preferred option as set out in the Consultation. In the light of the increased understanding of supplier data management exercises that has emerged since the DPCR5 *Final proposals* were issued and accepted it is now abundantly clear that settlements data is not a suitable basis for a high powered losses incentive. We appreciate that it is no light matter to decide to abandon an element of a price control settlement mid-way through the period and we believe that a very high burden should be placed on those who would argue in favour of such a proposal. However, in this case we believe that Ofgem has overwhelming new evidence that the incentive, as designed at the last price control review ('DPCR5'), is set to distribute random rewards and penalties on DNOs and, therefore, ultimately on customers. The rewards and penalties that will flow under the incentive will be determined by the behaviour of suppliers and the extent to which their data correction activities continue, decrease or increase in the DPCR5 period. The behaviour of the DNO has no discernible impact on the data on which the operation of the incentive depends.

4. Moreover, a decision not to activate the DPCR5 losses incentive has another important merit. If the DPCR5 incentive is activated, Ofgem must decide whether adjusted or unadjusted data for 2009-10 should be used in the interaction adjustment. The interaction adjustment is the part of the losses incentive formula that is designed to ensure that a DNO receives neither reward nor penalty if it continues to perform at the

level achieved in 2009-10. We have set out our views on this question in response to a previous consultation.[1] For the purposes of the present consultation it is sufficient to observe that the sensible answer to the question of whether to use adjusted or unadjusted data for 2009-10 in the interaction adjustment depends on whether Ofgem supposes that the changes in supplier behaviour that have already occurred, and any further behavioural changes that may occur in future, are likely to result in losses continuing at their 2009-10 unadjusted level or their 2009-10 adjusted level. We think that all the evidence suggests that reported losses will continue at the higher level in the DPCR5 period, but this judgement is still an informed guess and it is surely inappropriate that so much should turn on whether a regulator guesses correctly about such matters. An important benefit of a decision not to activate the DPCR5 incentive is that it is no longer necessary for Ofgem to make a guess about how suppliers' behaviour will continue to impact on reported losses in the DPCR5 period.

5. We now proceed to answer each of the questions put by Ofgem in the Consultation.

CHAPTER 2

Question 1: Do you have views on whether the existing losses mechanism is effectively incentivising DNOs to reduce losses?

6. For an incentive mechanism to operate effectively the person that is subject to the incentive must believe that the actions that he takes or fails to take will be reflected in whatever metric is used to determine the magnitude of the reward or penalty that is going to result from the application of the incentive mechanism. The DPCR5 losses incentive mechanism does not incentivise a DNO to reduce losses because:

- any decisions that a DNO may make that could lead to reduced or increased electrical losses are swamped by the impact of decisions that are made by suppliers about how to report or adjust settlements data;

[1] See our response to the Ofgem publication *Consultation on conflicts in the Distribution Losses Incentive Mechanism and Data to be used in calculating its components.*

- to the extent that the suppliers' behaviour leads to volatility in the level of reported losses that might be expected to even out over time, the presence of caps and collars and the fact that losses incentives are reviewed and potentially re-set at each price control review means that a long run assessment could not give confidence that the intended price control benefits of any investment in assets that would reduce losses would accrue to the DNO.

7. If DNOs still take losses into account in their investment appraisals, as indeed we do, we would suggest that this is because there are other factors that influence DNOs in the responsible design of their networks. It would be irrational for a DNO to invest because of the DPCR5 losses incentive mechanism.

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

8. The DPCR5 losses incentive mechanism should not be activated. The mechanism will distribute random rewards and penalties that have little or nothing to do with the performance of the DNOs. In the light of the information that Ofgem now has, the activation of the incentive would be hard to reconcile with the statutory duties of the Gas and Electricity Markets Authority ('the Authority').

9. The Electricity Act 1898 ('the Act') provides that the principal objective of the Authority in carrying out its functions under Part I of the Act is to protect the interests of consumers. The question on which the Authority is now consulting involves the possible exercise of one of the functions of the Authority (i.e. the possible modification of the licence) that is governed by the principal objective. It is hard to see how the activation of the DPCR5 losses incentive could be regarded as consistent with this objective because customers could end up paying significant sums for nothing.

10. The only good reason that weighs in favour of a decision to activate the incentive as originally planned is that changing regulatory deals after they have been struck is generally to be avoided because it is bad for regulatory certainty. This is a very powerful argument and we believe that in the vast majority of cases it should be

decisive. In the circumstances, however, it is clear that the incentive is so defective that the right decision now is to acknowledge that new information has emerged that has rendered the incentive as designed at DPCR5 manifestly inappropriate. Moreover, it is fortunate that the two year lag means that no money changed hands under this incentive during 2010-11 and 2011-12. A decision not to activate the incentive can therefore be made now without materially disturbing the electricity supply market.

CHAPTER 3

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

11. We agree with Ofgem that it would be inappropriate to do anything that has retrospective effect on the DPCR4 losses incentive, the final part of which is the close-out calculation. Determining that an incentive shall be changed with retrospective effect is to be avoided if possible because it is bad for regulatory certainty on which incentives depend. The DPCR4 period ended on 31 March 2010. Certain decisions on the adjustment of the 2009-10 dataset must still be made but there is no reason to declare void an incentive arrangement that operated throughout the entire DPCR4 period.

12. We appreciate that Ofgem's proposal not to activate the DPCR5 incentive also has elements of retrospection in it (because the incentive rate has already been set and the incentive has been assumed to be operating since 1 April 2010) and that this consideration weighs against the Ofgem proposal. However, there are important differences between the DPCR4 close-out and the DPCR5 incentive that lead us to conclude that a different response is appropriate in each of these cases.

13. In particular, the change in supplier behaviour that has given rise to Ofgem's reconsideration of the losses incentive occurred at the end of the DPCR4 period. Although there is clear evidence in Northern Powergrid's area that this new behaviour is continuing in the DPCR5 period, it will be difficult for Ofgem to be certain that there will not be further changes in behaviour that will affect reported losses in the DPCR5 period in ways that cannot now be predicted. This makes it challenging to set robust targets for the DPCR5 period. Moreover, now that it is clear that changes in behaviour

can and do occur, and that these changes can have a very considerable effect, it is likely that adjustments to the DPCR5 period dataset will be needed for the purposes of the DPCR5 close-out, if the incentive is allowed to activate. This would be necessary in order to ensure licensees are penalised and rewarded based on data that reflects the behavioural standard which applied when the deal was struck, and in particular in the data for 2009-10 that must now be used to calibrate the incentive if it is activated. Switching off the DPCR5 incentive also has the merit that it addresses the issue of the asymmetry between the un-capped interaction adjustment and the capped and collared annual incentive.

14. For these reasons we consider that it would be proportionate to conclude that the DPCR5 incentive which, if activated, would still have some years to run, should not be activated as originally planned but that the DPCR4 incentive, the entire period of which ended some years ago, must be closed out as intended using the dataset for 2009-10 reported data that best corresponds to the dataset that would have been received had suppliers continued to behave and to report as they were at the date when that deal was struck .

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

15. We do not think that there are any other options that Ofgem has not considered.

Question 5: Do you agree with Ofgem's preference for Option 3?

16. We agree with Ofgem's preferred solution, broadly for the reasons that Ofgem has set out in the Consultation. In particular:

- Option 1 (allowing the mechanism to activate as originally planned) would be perverse given what Ofgem now knows about the nature of the data on which the incentive mechanism rests. Moreover, option 1 requires Ofgem to make decisions on the nature of the 2009-10 dataset that should be used to set the DPCR5 period targets and the 2009-10 dataset that should be used for the interaction adjustment. These decisions amount to a guess about how suppliers' behaviour to date and in future will change the reported data from settlements in the DPCR5 period. It is possible to make an informed guess about such matters now but it is hard to argue that such a guess should be made by Ofgem when there are other options available. Moreover, there is no reason to suppose that a guess that is right for a DNO where one supplier's behaviour has dominated the data will be right for a DNO where another supplier's behaviour has dominated the data.

- Option 2 has one merit and that is that it avoids a retrospective change to the deal struck at DPCR5. There is still a material change to the DPCR5 deal, but the effect of that change would occur prospectively. However, all the other objections that apply to option 1 remain valid. In our view these objections are sufficient to outweigh any benefits from this option.

- Option 3 has the merits (and demerits) that we have discussed above. Taking all things into account we think this is the option that is the most consistent with the principal objective of the Authority.

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?

17. We see considerable merit in Ofgem imposing a new reporting requirement on DNOs if it decides not to activate the DPCR5 incentive as planned.

18. However, there is a difference between a requirement to provide Ofgem with information and a requirement to act in particular manner. For example, placing the DNOs under an obligation to report to Ofgem annually on how they are acting to 'reduce losses on their networks' (as suggested in the Consultation) would make more sense if DNOs had an obligation to reduce losses. At present the only obligation that might be said to encompass losses is the general duty imposed on distributors by section 9 of the Act. This does not mention losses specifically and to the extent that losses are assumed to be encompassed within the general duty (which we think they must be) they are balanced by other factors that bear on the economical nature of the

network. Moreover, the increased take-up of low carbon technologies may lead to an increase in losses. For these reasons it should not be assumed that an increase in real network losses is necessarily a bad thing or something that is inconsistent with good behaviour by distributors in relation to their duties under section 9 of the Act.

19. However, avoiding such mistaken inferences can easily be addressed by the design of the reporting template. Any league tables of losses performance that Ofgem might contemplate publishing should also have due regard to the considerations that have led Ofgem to a decision not to activate the DPCR5 incentive.

Question 7: Do you have views on the details of what DNOs would be required to report and the approach to publishing details?

20. The information that Ofgem proposes to gather seems to us to be appropriate. Collecting information on:

- individual measures or programmes of measures that DNOs will take to reduce losses on their networks in each of the remaining years of the DPCR5 period;
- the costs of those measures; and
- the expected effect on losses of those measures

should give Ofgem a better understanding of the scope that DNOs have to influence losses. This information could assist with the design of any future regulatory mechanism to address the issue of losses and it will send an important signal that a decision not to activate the DPCR5 losses incentive is not an indication that Ofgem has lost interest in the subject.

CHAPTER 4

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?

21. Ofgem has set out clearly why it believes that it is necessary to allow itself more time to make the important decisions that have a bearing on the value of the PPL term.

22. We believe that it is more important to get this right than to adhere to a timescale that was set before these problems had surfaced. If Ofgem needs more time to make this important decision we shall not object to the making of the licence modification that would facilitate this. In our view it is important that Ofgem is able to make a decision on the entire losses question that takes into account the DPCR4 close-out and the question of whether to activate the DPCR5 incentive. To do this the timetables that govern the different components need to be aligned. Certainly, we shall consider Ofgem's proposals as a whole and we shall support proposals from Ofgem that result in a balanced outcome for all stakeholders taking the issue in the round. Conversely, we would be unable to support proposals where the overall effect would be materially adverse for our shareholder even if we agreed that some parts of the package (such as the switching off of the DPCR5 incentive) had intrinsic merits when considered in isolation.

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.

23. We set out our answer to question 9 in a separate response that we sent to meet an earlier deadline for this question. Since Ofgem has now made its decision on this question we offer no further comments in this response.

Question 10: Do you have views about whether the PPL terms, 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?

24. The decision on this question should be made when it is known how material these amounts may be. We can see the case for spreading material amounts into future periods if the sums are large enough to be disturbing to suppliers or their customers.

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 20102 to 1 April 2013?

25. For the same reasons as are set out in relation to question 8, we think it is sensible to move this date forward in the manner proposed by Ofgem.

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 to this point by 24 July 2012

26. We set out our answer to question 12 in a separate response that we sent to meet an earlier deadline for this question. Since Ofgem has now made its decision on this question we offer no further comments in this response.