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Dear Anna,

Ofgem's RIIO-ED1 Strategy

1. Thank you for the opportunity to respond to Ofgem's latest consultation, **Strategy consultation for the RIIO-ED1 electricity distribution price control**, document 122/12. As a large integrated energy company in Great Britain that does not own any network interests, Centrica is in an ideal position to provide an unconflicted perspective on the Distribution Network Owners (DNOs) giving consumers' value for money in the next price control.

2. This is a non-confidential response on behalf of the Centrica Group excluding Centrica Storage. Our response is structured with this letter giving our key views on Ofgem's strategy, with answers to Ofgem's questions in the appendices 1-7.

3. Network charges are an increasingly important area of cost for British Gas, with our customers paying approximately £1 billion per year in electricity distribution charges, making 18% of customers' bills[1]. At a time of continued concern about the prices consumers face, British Gas is committed to ensuring that our customers get the best value for money from the services we provide and those we procure on their behalf.

4. Our main priorities for RIIO-ED1 and Ofgem's strategy are:
    - **There is no compelling evidence that electricity distribution charges need to increase** over RIIO-ED1 – and many compelling arguments that suggest charges should decline:
        i. Investment requirements are unlikely to be higher than the record DPCR5 levels, which showed an unprecedented 25% increase;
        ii. Efficiency savings will be further enhanced by learning from the Low Carbon Network Fund (LCNF);
        iii. Operating networks 'smarter' will reduce costs;
        iv. Challenges imposed by Low Carbon Technology (LCT) are unlikely to drive significant costs during RIIO-ED1; and
        v. New investments will have a longer asset life, reducing fast money.

[1] Ofgem's household energy bills explained fact sheet, May 2012
http://www.ofgem.gov.uk/Media/FactSheets/Documents1/household-bills.pdf

- **DNOs need to keep costs low and deliver a safe and reliable network through innovation**. Therefore the role and responsibilities of the DNOs' remains unchanged over RIIO-ED1. Whilst we recognise DNOs will need to employ more innovative and smarter methods to deliver this, we do not believe significant up-front investment is required.

- **A competitive market will deliver demand side response (DSR) most efficiently and effectively**. We believe that consumers will not benefit from DNOs being funded to deliver DSR; a competitive market has the correct incentives to invest and deliver a workable solution. We would expect an economic Regulator not to interfere with competitive forces by funding one part of the industry to deliver this.

- **We need evidence that the incentive regime is delivering value for money**. The DNOs' incentive performance needs to be transparent and we urge Ofgem to review historic performance, particularly of the IQI mechanism. Ofgem needs to share the evidence with stakeholders, before finalising the incentive design for RIIO-ED1. It has not been demonstrated that a number of the current schemes have delivered value for money for customers.

- **Limiting price volatility remains an area for improvement** that can have real benefits to consumers at low or zero cost to networks. Ofgem has correctly identified predictability of price movements between price controls as an issue. We propose that setting the revenues for the first year of the price control at the draft determination stage, with reconciliation in later years, as an acceptable solution to this.

- **Further stakeholder engagement is essential for non-DNO parties**, as the working groups have had limited third party engagement and more active engagement is required to ensure the full details of proposals have proper scrutiny.

There is no compelling evidence that electricity distribution charges need to increase

5. DPCR5 saw unprecedented increases in the amount of capital expenditure allowed in electricity distribution networks, with the rate of investment some 25% higher than DPCR4. We view it as highly unlikely that additional investment, over and above this level, will be necessary in RIIO-ED1.

6. Assumptions made about load growth at the time of last price control, although reasonable at the time, now appear to be considerably over-stated. There remains considerable uncertainty around the base level of load growth for RIIO-ED1. Thus, it is expected the need to reinforce the network will be reduced compared to DPCR5, before even considering the more innovative techniques to be utilised by the networks. It is recognized that aging parts of the network will still require replacing, however it is not expected that this will be at a faster rate than currently.

7. Some £500m will have been invested, through the LCNF, into finding more innovative ways of managing networks. Given this level of funding from customers, the success of the LCNF can only be reasonably measured by the translation of the learning gathered into genuine

savings. This needs to be included in the level of ongoing efficiency gains assumed when setting DNO revenue allowances. Where projects have yet to complete and then proceed to offer opportunities for substantial savings, a robust method for reducing DNO allowances is necessary. As customers will have already largely funded these projects, it is not acceptable for customers to then only get a share of benefits through the IQI mechanism.

8. We recognise the use of networks will develop over the course of RIIO-ED1, in particular with higher levels of LCT, such as heat pumps and electric vehicles. We do not believe that the LCT will be a significant driver for increased network costs, with networks being able to cope with the likely penetration of low-level (domestic) and, under current connection arrangements, the costs attributed to bigger scales projects (e.g. wind-farms) being reflected back upon the generator. However there are likely to be issues arising from the clustering of LCT in particular areas, impacting network operations. Issues arising from non-developer clustering of LCT installations may be best addressed by cost effective and targeted smart grid applications, rather than more costly network reinforcement. In addition the competitive market should also be encouraged to provide demand-side response (see paragraph 16).

9. We note that the decision to profile revenues in DPCR5 meant that revenues were effectively delayed in DPCR5 until the later years. This means the revenues in the final year DPCR5, the year commencing April 2014, are significantly higher than the 'true', unprofiled, level. We estimate that if all other elements of the price control remain unaltered, when compared to the final year of DPCR5, prices should fall by 6.1% as the profiling unwinds, worth £7.22 per customer per annum[2]. Given that new capital expenditure will have asset lives of 45 years, it would take extraordinary levels of investment to offset this.

DNOs need to keep costs low and deliver a safe and reliable network through innovation

10. The DNOs' fundamental purpose remains the same, to run safe and reliable networks, and whilst we support DNOs realising the benefits of adopting innovative approaches, on behalf of society, RIIO-ED1 will not necessarily see the DNOs' roles changing significantly. We believe smart grids, established through the use of smart data, and flexibility balancing are expected sometime after 2023.

11. We would expect to see the DNOs' operating costs reduce through the use of smart meter data as DNOs' performance with off supply improves. Smart meter data should pinpoint power cuts more accurately and the DNOs may even gain notice of a power cut from the 'last gasp' dataflow. We also expect to see a step change in the DNOs' targets for customer minutes lost and interruptions to take account of the use of smart meter data from at least 2019, if not sooner. We believe that the DNOs should have enough data to improve their performance with national coverage of approximately 10%.

12. Further network intelligence from smart meter data will give planners and engineers more knowledge of what investment is needed where, when to extend the life of assets and to

[2] As stated in the final proposal financial model, real DUoS charges in 2014/15

repair equipment before it fails unexpectedly. Leading the DNOs to more effectively manage their workforce and contractors, leading to capital expenditure savings.

13. We can only support extremely well-justified spending to facilitate development of ways of working that deliver net benefits only in RIIO-ED2 (and beyond). Development of innovative solutions is already very well funded through the LCNF and NIC/NIA and we do not expect additional revenue to be significant.

A competitive market will deliver demand side response (DSR) most efficiently and effectively

14. We believe that DNOs should not be encouraged nor funded to establish themselves as system operators with end consumer relationships, i.e. to deliver DSR. Including such things as customer databases, call centres and back office processes within a DNO does not offer consumers value for money and DNOs could more efficiently utilise the suppliers' customer relationships through new contractual arrangements.

15. Giving DNOs an end user relationship will add to consumer detriment and their licence obligations do not give consumers protection against marketing or unwarranted sales activity.

16. We do not consider it appropriate to allow DNOs to pursue DSR with funding from consumers, when the market incentives give weight to a competitive regime being wholly more efficient. Suppliers and other parties offering DSR could reshape the peak demand, using their current portfolio of customers, leading to lower reinforcement costs and therefore lower distribution charges.

We need evidence that the incentive regime is delivering value for money

17. We find the incentive mechanisms unacceptably opaque as we receive limited information throughout the price control on the performance of the networks and there appears to be no published review of performance at the end of each price control. Given the significant outperformance against the Quality of Service (QoS) incentive and the chaos caused by the Losses incentive we feel that annual, timely, transparent reporting of DNOs performance is significantly over due.

18. DNOs should be required to report on the incremental investments made to improve performance against individual performance measures. This would then allow interested parties to compare the investment against the reward received, and so allow an assessment of the value for money of each scheme. It is expected for a DNO to make a healthy return on investment for the incentive to be effective, but, for example, we are now seeing rewards for the QoS of above £100m in a single year. It would be highly instructive to be able to see the investment made the networks in this area. The information received can then be used to design improvements to future schemes.

19. The IQI mechanism will have been in use for ten years, by the start of RIIO-ED1, therefore we hope Ofgem will review how well the incentive has worked compared to expectation and if it encourages the correct behaviour in the regulated networks. There is now an

opportunity to adjust the matrix, process and review underlying assumptions before the DNOs submit their business plans next summer and gain the best result for all parties, particularly consumers.

20. The outputs for RIIO-ED1 are broadly the same as DPCR5, even though Ofgem expect DNOs to assist with the smart meter rollout, deliver LCNF/NIC/NIA benefits and connect low carbon technology so Great Britain can move towards the carbon emission targets. We believe that consumers will benefit from the DNOs being measured on their success with all these projects and reported each year, as (untargeted) secondary deliverables. With regular and timely reported updates, stakeholders may be able to gauge how soon DNOs will invoke uncertainty measures, which in turn assists with pricing volatility.

21. A balanced scorecard showing the primary outputs alongside, smart meter rollout by network, LCT connections (split between solar PV, EV and other) and LCNF/NIC/NIA benefits with narrative on progress to date, would be very useful to all stakeholders, particularly if it was published in November each year, prior to indicative prices.

Limiting price volatility remains an area for improvement

22. We note the recent reopeners for DPCR5 and the considerable increase in distribution prices these will incur without warning from either Ofgem or the DNOs concerned. We welcome the commitments made in the recent charging volatility consultation to avoid these circumstances occurring in the future.

23. We are supportive of Ofgem's decision in relation to the options that are to be adopted. We remain of the view that a well-designed cap and collar mechanism would have been a further benefit to customers, but we believe that, overall, Ofgem decision represents a sensible and balanced outcome to this issue.

24. In terms of volatility between price control periods, we believe the revenues for the first year of the price control should be finalised at the draft determination stage. Any differences with final determination can be reconciled in the later years. We recognise the commitment with RIIO for minimal change between draft and final determinations and so believe this will bring certainty to the industry with little impact to the DNOs. We are concerned at setting first year revenues to either the DNO submission or an arbitrary cap, as this, we believe, has the potential to affect the expectation of the final settlement.

25. We would welcome a similar approach following a mid period review to the first year of the price control, whereby year five revenues are held are final determination with revenue changes over the following three years.

Further stakeholder engagement is required for non-DNO parties

26. We welcome the increased stakeholder engagement by Ofgem and the network owners. However the number of working groups, events and consultations is likely to cause resource constraints for many organisations. We note that only the DNOs are able to attend all the working groups due to the level of resource they are able to give the price control process. This means, therefore, that progress to date is largely as a result of discussions between

Ofgem and the DNOs. This is perfectly acceptable but needs to be recognised as such and not perceived as any sort of general stakeholder, or industry, consensus.

27. We have concerns that all of Ofgem's stakeholder engagement is upfront and the process could effectively now be 'locked down', following the conclusion of the working groups and this consultation response. We also note that the RIIO-ED1 strategy consultation is extremely detailed, particularly for a strategy document, and has at least 229 questions. We are concerned that Ofgem may take silence as agreement, where an unformed view is closer to the truth. We trust that Ofgem will welcome and encourage iterative views as RIIO-ED1 progresses and be open to further developments.

28. We suggest Ofgem holds a series of workshops, primarily for the benefit of non-DNO parties, to discuss the *details* of a number of the key suggestions, particularly those that would benefit from further exposition, such as the incentive schemes and uncertainty mechanisms. This should be used to inform the Draft Determination.

Uncertainty Mechanisms are key to delivering the right balance of risk and reward

29. Given the progress RIIO-ED1 could make towards Great Britain's low carbon targets and the uncertainty surrounding the number of LCT connections in the eight years, we feel the uncertainty mechanisms are key to ensuring the right balance of risk between consumers and the DNOs.

30. We agree that a volume driver is appropriate for call outs associated with smart metering, but, noting the low level of call-outs from our smart trial, believe that this should be restricted, as a maximum level, to the additional cost burden of DNOs resulting from the shortening of the normal 20 year meter replacement cycle.

31. We feel that the impact of some customer premise LCTs, such as solar PV, on networks can be mitigated by directly associating them with demand-side measures to shift consumption – ranging from Time-of-Use tariffs, to home automation, to signals to customers to use otherwise exported electricity. Therefore we believe that the DNOs should be encouraged to continue with research into the penetration of LCTs on their networks and not wait for uncertainty mechanisms to 'kick in'. Perhaps DNOs would find statistical cluster analysis useful to determine which variables are highly correlated to consumers purchasing / installing LCTs, i.e. FiT levels and disposable income, and those that detract, i.e. planning permission requirements and conservation areas.

32. Also, the impact of different types and sizes of LCTs on each network will be marked and a simple volume driver will not highlight the true scope. For example, an EV charging point in a residential property will have a lesser impact than another based in a shopping centre, especially at the substation level.

33. We believe that a balanced scorecard report (as suggested above) produced annually, highlighting the different types of LCT connected by network alongside the impact on power quality and interruptions will help all stakeholders understand whether further investment is necessary. The DNOs will then have additional weight in an argument for a reopener and stakeholders will have more warning that a reopener is due.

Network Innovation Competition / Allowance (NIC / NIA) concerns

34. As commented in our NIA consultation responses we have concerns over the self governance of all the networks' NIA projects and as a minimum we would expect that the projects are open to public scrutiny and justification before work commences. Ofgem cannot expect the DNOs to be truly innovative without gaining regular feedback and involvement from stakeholders.

35. We would also welcome the opportunity for third parties to gain access to DNOs innovation funds and use of network assets from Ofgem's direction. Projects regarding power quality, in particular, have proved difficult to engage DNOs with and this could bring an improved service to the worst served consumers and non domestic customers that use certain electric motors and equipment, for example.

36. The proposal of an Innovation Roll-out Mechanism (IRM) recognises the potential for non-network benefits. This brings into question whether networks are best placed to lead such innovation and again emphasises the importance and value of extending access to funding to non-network companies.

Concerns remain over fast tracking and proportionate treatment benefits

37. We have reservations about the appropriateness of the fast tracking and proportionate treatment potentially given by Ofgem to the DNOs' business plans. We have yet to see the quantified benefits to consumers of fast tracking. Whilst given the longer price control period and uncertainty of key investment decisions, without smart meter data or any proven benefits from the LCNF, we feel consumers will bear the risk of higher prices and/or lower outputs.

38. We hope that each network will be given a good level of scrutiny by Ofgem as no other organisation has the resource or data required to carry this analysis out, particularly in the timescales Ofgem has published.

Financing

39. We welcome the continued use of cost of debt indexation as proposed by Ofgem, which strikes the appropriate balance between efficient financing and sufficient levels of allowance for the companies.

40. We are surprised by Ofgem's proposed range for the cost of equity of 6.0% - 7.2%. Such a range seems at odds with recent evidence and regulatory decisions, as well as the views of the Competition Commission. It seems that such a high top end can only be manufactured through a risk-free rate which allows for a rapid reversal in the downward trend in ILGs and an equity risk premium above the latest long term estimates

Conclusion

41. Much has been made of the role that the distribution networks will need to play to build towards the low carbon targets. However, we view the RIIO-ED1 price control as more business as usual, although working alongside the smart meter rollout and low levels of LCT connections, which does not require an increase in revenue nor prices. We feel that the DNOs can deliver the reliability and safety that consumers expect, with reduced investment and realising the benefits from the LCNF/NIC.

42. We hope you find our comments useful and would be happy to discuss further, if helpful.

Yours sincerely,

Andy Manning
Head of Network Regulation, Forecasting and Settlements
British Gas
[Via email]

Appendix 1: Overview questions

1. *Chapter 3. Do you have any comments on our stakeholder engagement approach?*

   We welcome the increased stakeholder engagement by Ofgem and the network owners. However the number of working groups, events and consultations is likely to cause resource constraints for many organisations. We note that only the DNOs are able to attend all the working groups due to the level of resource they are able to give the price control process. This means, therefore, that progress to date is largely as a result of discussions between Ofgem and the DNOs. This is perfectly acceptable but needs to be recognised as such and not perceived as any sort of general stakeholder, or industry, consensus.

   We also note that the RIIO-ED1 strategy consultation is extremely detailed, particularly for a strategy document, and has at least 229 questions. We are concerned that Ofgem may take silence as agreement, where an unformed view is closer to the truth. We trust that Ofgem will welcome and encourage iterative views as RIIO-ED1 progresses and be open to further developments.

2. *Chapter 3. Do you have views on how our engagement process or that of the DNOs could be made more effective?*

   We feel that the DNOs are reaching an appropriate level of engagement with stakeholders; we have been invited to large stakeholder events through to bilateral meetings. We have yet to see what has changed in the DNOs planning and thinking but hope our counsel has been heard.

   We have concerns that all of Ofgem's stakeholder engagement is upfront and the process could effectively now be 'locked down', following the conclusion of the working groups and this consultation response.

   We do not believe that the plethora of working groups was designed for non-DNO party interaction as these parties are unlikely to have the necessary resources. Recent experiences demonstrate very clearly that full understanding, and stakeholder review, of the *details* of proposals is essential. The DPCR4 Losses Incentive Scheme and DPCR5 Quality of Supply Incentive are both examples where at a high-level stakeholders may well be likely to support, as the intent of both was correct, but the detailed specification, for example the removal of the cap from the DPCR5 Quality of Supply, could result in an impact on customers of £100m's.

   We do not believe this consultation is sufficient to ensure the details of proposals have been scrutinised by stakeholders. Ofgem should be looking to actively engage on these issues, given their importance, rather than expect those impacted to join working groups or explore the appendices of this consultation. A number of these proposals, for example the Interruptions Incentive Scheme, are very difficult for most to engage with unless accompanied by further exposition. So we suggest that Ofgem holds a series of workshops,

primarily aimed at non-DNO parties as DNOs have been represented at the working groups, to explore the detail of certain elements in order to inform the Draft Determinations. It is noted that such a group has effectively been convened for the Losses Incentive, and believe that all the various incentives would benefit from such an approach.

2. *Chapter 4. Do you agree with our changes to the RIIO-ED1 timetable?*

We believe that the four week period between DNOs delivering their business plans to Ofgem and stakeholders' giving their comments is too short. We note in RIIO-GD1, the GDNs took up to two weeks to publish their second business plans on their websites. The DNOs need to publish earlier and the consultation period needs to be extended, to at least 8 weeks, if the deadline must remain the same.

We recollect that in RIIO-ED1 there would be only one business plan submission and we are surprised to see a second submission, for non-fast tracked DNOs in March 2014, and wonder if any parties will benefit from this.

3. *Chapter 4. Do you have any view on the materiality of potential changes in allowed revenues/charges between price controls? Do you have proposals to address this?*

Our modeling shows that prices are extremely likely to fall, on average, between the final year of DPCR5 and the first year of the new price control. This is due to profiling of revenues within the current price control period which generally 'back-loaded' the current price control.

We believe it is generally beneficial to avoid burdening customers with additional costs in the current economic environment and also see merit in reducing the impact on current customers of any up-front expenditure that it designed to reduce network spending in the longer term. However, it is the predictability of prices in the first year of the price control that it is of particular interest. Risk around the level of these prices impairs our ability to offer attractive fixed-price contracts to customers crossing April 2015.

In reality Ofgem has a number of levers available to it to manage this and has consistently chosen to profile the revenues of networks across a price control. However, we believe a more transparent approach would be to state, early in the process, that the first year revenues given in the Draft Determination would be maintained as the first year revenues for the Final Determination. Any differences in the 'true' levels of first year revenues could then be reconciled later in RIIO-ED1, either in the second year or certainly across the first half of the period.

As it is expected that no significant changes will take place between Draft and Final determinations, this will provide the industry with the necessary certainty without causing any significant impact on DNO cashflows.

A similar approach can be taken to handling uncertainty over the impact of the mid-period review. If allowances are to be reset at this point, the revenues for year 5 should be set at the earliest appropriate point in the process with reconciliations in later years.

2. *Chapter 5. Do you consider the proposed outputs and incentive arrangements are proportionate?*

It is not possible for us to assess fully the proposals as we have limited or no evidence of how the current package, the foundations of which the RIIO-ED1 is built upon, is performing. In particular, we believe a full review is required of how companies are performing within the IQI mechanism; including how close to Ofgem baseline companies chose to bid. We have limited data relating to a number of the incentives and concerns over where we do have data, where performance and incentive rewards against the Quality of Supply targets appear to be excessive.

Under the IQI mechanism any spending to secure a favourable outcome from an incentive scheme is shared between the networks and customers. The only incentive scheme value that explicitly recognises this is the IIS. We are concerned that customers may be funding both incentive payments and a share of the investment required to deliver them. When taking into account the IQI sharing mechanism, some of the potential incentive payments seem generous when compared to likely investment that the DNO itself will commit.

DNOs performance against incentive schemes should be published on an annual and include the incremental spending incurred.

Additionally, we note that learning from LCNF projects (and subsequently NIA/NIC projects) can be used to improve performance against incentive schemes and, indeed, could easily be targeted to do so. This is inherently a positive thing as incentive schemes will be focussed on areas customers' value. However, the customer should not be paying for the development of innovative methods through NIA/NIC and then paying again for the performance improvement resulting from the innovation. Some adjustment is required to the relevant incentive scheme to ensure the DNO is only rewarded appropriately, and not for investment already funded by customers through either the NIA/NIC or the IQI mechanism.

1. *Chapter 5. Do you have any views on the proposed outputs and incentives?*

Setting targets to last until 2023, and also potentially very early in the process, gives rise to the significant risk of the targets ceasing to be appropriate at some point during RIIO-ED1. Common sense and recent experience suggests that exposure to this risk is greater for customers than for DNOs. If a target becomes 'soft' we deem it highly unlikely that a network would seek any regulatory action to correct this. This is demonstrated by the returns some DNOs are currently enjoying from the DPCR5 Quality of Service Incentive. However when incentives schemes are adverse to networks, there is evidence that networks can be successful in securing changes to improve their position. The current Ofgem 'minded to' position on the DPCR4 Losses Incentive Scheme would indicate that DNOs may secure several hundreds of millions more revenue than if the scheme had been left to run as intended.

This asymmetry of risk is reduced somewhat if some form of rolling targets are used, which should be responsive to changes in industry performance.

1. *Chapter 7. What should be the funding threshold for the NIC be? Do you agree with our proposal to review after two years to reflect learning from the LCN fund?*

   Yes, agree with the review, we want to understand how the projected benefits from the LCNF and NIC projects will be captured and revenue reductions passed back to consumers.

1. *Chapter 9. Do you consider our proposed package of financial measures will enable required network expenditure to be effectively financed?*

   We continue to support the use of cost of debt indexation as proposed by Ofgem.

2. *Chapter 9. Do you have any views on our proposed approach to assessing the cost of equity and the associated range of 6.0-7.2 per (real post tax)?*

   Ofgem's proposed range for the cost of equity seems at odds with recent evidence and decisions. Ofgem proposes an ED1 range of 6.0% - 7.2%, so a top end of the range a full 50 bps above the GD1 Initial Proposals figure of 6.7% and an equal amount above the DPCR5 decision. It is also at odds with the Competition Commission's 7.0% market cost of equity as set out in the 2010 Bristol Water determination. It seems that such a high top end can only be manufactured through a risk-free rate which allows for a rapid reversal in the downward trend in ILGs and an equity risk premium above the latest long term estimates from DMS. Furthermore, we do not support a range for the risk-free rate of 1.7% – 2.0%. We are unclear as to how Ofgem has arrived at the bottom end of the range and recommend a range of 1.5% to 2.0% as the lower end is supported by market evidence and recent decisions from Ofcom and the Competition Commission. We have also seen no evidence for an equity risk premium of 5.5% at the top end which seems significantly overstated – a top end of 5% is more appropriate.

3. *Chapter 9. Do you have any views on the other elements of our financeability proposals?*

   We will review and comment on the appropriateness of the financeability package once the regulatory package has been finalised.

Appendix 2: Outputs, Incentives and Innovation questions

1. *Chapter 3. Do you agree that a specific output or incentive focused solely on the connection of low carbon technologies is not necessary?*

   Yes, network companies are already sufficiently incentivised to ensure that they facilitate the connection of LCTs. Though we do not consider a specific incentive to be necessary, there is a need for a requirement on DNOs to facilitate the connection of LCTs and not cause any unnecessary delay to these connections.

3. *Chapter 3. Do you agree that an uncertainty mechanism is required to manage the uncertainty around the penetration of low carbon technologies?*

   The uncertainty mechanism needs to be carefully set, as we consider that an uncertainty mechanism could simply discourage DNOs from investing in accurate forecasting and modelling of LCT penetration. If there is a generous uncertainty mechanism then this will incentivise DNOs to inadequately prepare for LCTs and recover the costs of late, and most likely costly, network upgrades through the uncertainty mechanism. DNOs should be encouraged to commission continuing research into LCT penetration (as has been prepared for Smart Grids Forum – Workstream 3), utilise the knowledge gained from Low Carbon Networks Fund projects and for these data to be integrated into their forecasted business plans for network upgrades. Even with meticulous planning, we recognise that accuracy can't be guaranteed so a tightly capped uncertainty mechanism may be needed.

4. *Chapter 3. Do you agree with the three tier approach we propose to introduce for the recovery of the DNO's costs during the smart meter rollout?*

   The three tier approach seems basically sound but needs further clarity including a definition of 'reasonable'. DNOs will already have business as usual costs for emergency/remedial work etc. Smart metering brings with it a change from a 20 year meter change cycle to approximately 5/6 years and so compresses 20 years worth of work into 5/6, but does not increase the overall volume of jobs. Costs should be reflective of the compression of jobs only. Where suppliers want a premium service in excess of that agreed under the proposed new SLAs then they would expect to pay the 'reasonable' costs of this.

5. *Chapter 3. Should costs of load and generation growth for existing customers in profile classes 1-4 be socialised, until smart metering data is available?*

   Yes, until smart metering data is available, it will be very difficult to prove which customers have caused network issues and therefore cost socialisation is a sensible approach. When the majority of customers do have smart meters installed, further consideration will need to be given to this issue. LCTs are a vital part of reducing GBs carbon emissions and there should not be incentives on DNOs to discourage their take-up and installation.

6. *Chapter 3. Should DNOs retain the ability to charge existing customers in profile classes 1-4 who install equipment which poses significant power quality issues for the network?*

   DNOs should be required to take all reasonable steps to accommodate the customer's appliances and the burden of proof for highlighting power quality issues should be firmly with the DNO. A better methodology for addressing these concerns is to ensure better

standards for LCTs so customers are not able to unwittingly purchase equipment that will cause power quality issues, though we recognise that this is outside Ofgem's remit.

7. *Chapter 3. If we socialise costs of existing profile classes 1-4 customers, will the use of system charging methodology need to be changed in order to protect IDNO margins?*

   We believe that the current approach to calculating discounted IDNO tariffs could be improved by calculating the IDNO discount (%) by dividing the p/kWh 'avoided cost' from the price control disaggregation model (PDCM) by the average p/kWh from the CDCM model, rather than by the total cost p/kWh calculated in the PDCM as is currently done. Calculating the discount percentage in this way maintains the avoided cost p/kWh calculated from the PDCM. I.e. if a CDCM methodology change reduces the LV DUoS charge by 10% then our suggested approach would increase the IDNO discount by 10% to maintain the absolute p/kWh avoided cost received. Under the current approach the IDNO discount (on an absolute p/kWh basis) would reduce by 10% because the percentage discount remains fixed.

1. *Chapter 5. Will our proposed approach ensure effective losses reduction actions?*

   The proposed approach is likely to be effective if Ofgem commit to audit the actions of DNOs annually to ensure that they have complied with their licence obligation and their losses strategy. Such a commitment from Ofgem is likely to ensure that the new licence condition and losses strategy is firmly embedded in DNO processes.

   We would also like to see some form of ex-post review of the low loss investment to ensure that the ex-ante cost/benefit analysis still holds true. This could be limited to higher voltage levels were the data will be more readily available.

   We do not believe that any reputational incentive will be effective in reducing losses.

2. *Chapter 5. Will our proposed losses discretionary reward provide the required incentive on DNOs to reduce losses? Should this be awarded twice during ED1 or more frequently?*

   With regards to the £32m discretionary reward, care would need to be taken to ensure that DNOs are not rewarded more than once for the same expenditure/innovation i.e. through the IQI mechanism or through the innovation stimulus mechanisms.

   Only awarding the reward twice during ED1 could lead to those DNOs behind the 'leader' from giving up - however on the other hand awarding it every year could dilute the incentive. Perhaps every two years might strike an appropriate balance. In awarding the reward Ofgem should bear in mind the impact on charging volatility and ensure sufficient notice is provided to the industry of any reward.

   The pot of money must not be viewed as an amount that must be given away - the default position should be that no DNO receives any of the award unless they can demonstrate they have reduced losses over and above that funded through base allowances. The level of reward awarded to a DNO should not be unduly disproportionate to the level of incremental expenditure that they have incurred.

3. *Chapter 5. Should DNO actions to identify and address electricity theft be encouraged through an approach outside of any losses reduction mechanism? Do you have any views on the proposed approach, or any alternate proposals, that we should consider?*

We take the theft of energy very seriously and support moves by Ofgem to increase incentives on suppliers to do more in detecting, preventing and investigating theft. We recognise that under the present electricity arrangements DNOs are incentivised to identify theft under their losses incentive scheme. We agree that an incentive scheme should be introduced for suppliers similar to the arrangements for tackling gas theft.

Suppliers can currently choose whether to procure a revenue protection service from the DNO or to use other service providers. We agree that where suppliers are able to procure a service from the competitive market then the charges that the DNO levies for these services do not need to be regulated. However we note that some DNOs are starting to include charges in their Miscellaneous Charges Statement for "making safe". We do not agree that these services could be easily provided by another service provider and they are often provided without reference to the supplier at the time. In these cases the charges should subject to regulatory scrutiny.

We also note that as a result of the DCUSA modification DCP 80A "Theft in Conveyance" the responsibility for dealing with theft which can be directly attributed to a registered MPAN is now the responsibility of the supplier to resolve. This has resulted in DNOs charging suppliers for damage to equipment which previously has been recovered via distribution charges. We are concerned that DNOs are now in effect recovering these costs twice and would recommend that any money allowed for previously for these costs is now removed from the DNO price control.

We have the following specific comments in relation to the core elements of the package for electricity theft outlined in the consultation

- *To require DNOs to tackle theft where a supplier is "not responsible". This is based on our view that, where possible, the link between the supplier and the customer should be maintained. We are minded to clarify these responsibilities by amending the standard conditions of DNO and supplier licences. We also propose that DNOs should be able to recover their reasonable costs associated with this activity.*

  We agree that DNOs should be required tackle theft where a supplier in "not responsible" and they should be only able to recover their reasonable costs. Where DNOs provide services which cannot be provided by other parties such as "making safe" we believe these charges should be subject to regulatory scrutiny.

- *To introduce licence requirements for electricity suppliers, in relation to tackling theft, which are equivalent to our updated proposals for gas suppliers.*

We agree that electricity suppliers should have licence conditions which are equivalent to the proposals for tackling theft of gas.

- *To identify principles for a scheme to address the disincentives that suppliers face in detecting theft. Our initial view is that our proposals for the gas market would be*

appropriate and should be introduced by a modification to an industry code. For the avoidance of doubt, we are not proposing that DNOs should be incentivised.

We agree that an incentive scheme for suppliers similar to that proposed in the gas market would be appropriate for the electricity market. However this should not be implemented until the losses incentive scheme on DNOs is removed.

- *To require suppliers to put in place a central service (equivalent to the Theft Risk Assessment Service (TRAS) in the gas market) to analyse data and provide information to suppliers (and network companies) to help them meet their obligations to detect theft.*

  As highlighted in para 5.27 in the consultation document the number of theft cases in the electricity market is around ten times higher than cases identified in the gas market. It is therefore right that the main focus for industry reform should be concentrated on the gas market. We do not agree therefore that a Theft Risk Assessment Service (TRAS) would necessarily bring equivalent benefits to the electricity market as those anticipated for gas. We suggest that focus should remain on gas and suggest that the TRAS is implemented in gas market only and the benefits are measured and assessed before a similar service is introduced into electricity.

- *To require that DNOs should maintain current levels of support for tackling electricity theft until robust alternative arrangements are established. We consider that this is important in the context of the change to DNO incentives to detect theft and the materiality of this issue for consumers.*

  We agree that alternative arrangements for incentivising suppliers to detect theft should not be implemented until incentives on DNOs to detect theft are removed.

- *Suppliers and DNOs should move to implement, where appropriate, the additional measures that we identified as supporting the arrangements for tackling gas theft. We consider that these additional measures should be introduced through existing industry code governance arrangements.*

  We agree that a SETS scheme would be appropriate for the electricity market and could be introduced through existing code governance arrangements. However we believe more robust reporting of theft cases should be introduced initially before a SETS scheme is be introduced. This will enable Ofgem to understand more fully current levels of theft detection and calculate more accurately the levels at which to set any incentives for suppliers.

1. *Chapter 6. Do you agree with our proposal to retain the Broad Measure of Customer Satisfaction (BMCS) and increase the maximum revenue exposure?*

   We agree with the proposal to retain the BMCS but disagree with the increase to the maximum revenue exposure. The revenue DNOs can earn from an incentive needs to be proportionate to both the investment required from the DNO and the benefit customers realise from the incentive. The proposed maximum revenue exposure of 1.5% equates to

roughly £75m pa. We doubt that investment in this area will be of this scale and it is important to remember that any investment is already part-funded by customer through the IQI mechanism and so the investment requires by the DNOs to justify a £75m pay-out is even more sizeable. Given that the vast majority of customers have no interaction with the DNO, in any given year, it is again difficult to justify that £75m is an appropriate level of reward.

2. *Chapter 6. We seek views on the approach to setting targets for the RIIO-ED1 period, including whether these targets should be fixed for the price control period or should be responsive to changes in industry performance.*

   Setting targets to last until 2023, and also potentially very early in the process, gives rise to the significant risk of the targets ceasing to be appropriate at some point during RIIO-ED1, which as discussed earlier, we consider to be asymmetric.

   This asymmetry of risk is reduced somewhat if some form of rolling targets are used, which should be responsive to changes in industry performance.

3. *Chapter 6. We seek wider stakeholder views on whether interruption customers that have been proactively contacted by the DNO via new methods of communication (e.g. social media) should be included in the customer satisfaction survey*

   These customers will not have been included in the data used for target-setting and so clearly cannot be included in the survey for the purpose of calculating incentive returns.

   However, it is recognised that communication via these methods may become more commonplace and so it is suggested that these customers are surveyed additionally and then this data can be taken into account when targets are reviewed and potentially included in future

1. *Chapter 7. Are there additional social issues that the DNOs should address?*
2. *Chapter 7. Are there any specific outputs that the DNOs could be responsible for delivering?*

   [Answers questions 1 and 2 above]
   DNOs already have obligations to maintain a PSR and capture information on customers that are vulnerable to supply interruptions, offering them special services in the event of a supply interruption. Our suggestions for additional social issues that the DNOs should address fall into two broad categories: (i) those which seek to enhance the current obligation; and (ii) those which suggest additional issues that DNOs could address.

   In terms of the former, we suggest that there is scope to improve the data captured by DSOs about vulnerability. At present, we understand that DNOs currently only know that someone in the customer's household is vulnerable but they do not necessarily know who this relates to, nor – more importantly – are they aware of the nature of the customer's vulnerability. Ofgem is currently consulting on its Vulnerable Customer Strategy, a key plank of which involves proposals that suppliers and DNOs adopt a more dynamic interpretation of vulnerability. In line with this, we suggest that DNOs seek to enhance the data that they capture about vulnerability.

In relation to additional issues that DNO could address, we agree with the proposal featured in the consultation document that there is scope for DNOs to do more in the identification of customers in fuel poverty. This may be particularly the case for customers who are off the gas grid and who have a greater propensity to be in fuel poverty.

The Department for Energy and Climate Change (DECC) is currently consulting on a revised definition of fuel poverty to be used in England, based on the recommendations contained in the Hills Report. Regardless of the definition that is adopted, it should be recognised that although DNOs may have a role to play in identifying households that are potentially in fuel poverty, they are unlikely to be able to definitively state that this is the case since they will not possess information relating to the customer's income and expenditure. Careful consideration will also need to be given to the organisation or the mechanism through which DNOs should report information about customers who are potentially in fuel poverty.

More fundamentally, since the cost of transporting energy to customers' homes now accounts for approximately 25% of the average customer's dual fuel bill there may be merit in considering whether there is any scope to reduce this figure for customers who are identified as being in fuel poverty, and how this might be achieved.

3. *Chapter 7. Should a separate funding allowance be provided to enable DNOs to carry out activities in response to social issues?*

   If the industry can decide on a social issue that the vulnerable / fuel poor would genuinely benefit from if DNOs delivered, then there should be funding, however we can not think of an initiative that covers this.

1. *Chapter 8. Do you consider that our proposed package will drive the appropriate behaviour for connecting both demand connections and generation connections?*

   We fully support Ofgem's aim to make the connections process quicker and smoother for customers and consider that these proposals will enable this transition and result in a much more customer-focussed connections service.

2. *Chapter 8. Is it appropriate to remove the DG incentive?*

   We agree that the proposed approach to BCMS will ensure a louder voice for smaller customers and therefore DNOs will be incentivised to ensure that priority is given towards addressing common connection issues.

5. *Chapter 8. We invite views on our proposals for the Long Term Development Strategy (LTDS), Distributed Generation (DG) connections guide and Information Strategy*

   We support the proposals to retain the requirements for DNOs to produce an LTDS and placing a requirement on them to produce a DG connections guide. We suggest that this connections guide is subjected to scrutiny by service users so that it is fit for purpose and easy to follow.

   We are comfortable with removing the requirement for the Information Strategy.

6. *Chapter 8. Are additional or alternative incentives required to encourage the DNOs to provide better information to connection customers upfront? If so, what would these measures and incentives be?*

   The connections guide should be sufficient but an extra requirement to make the guide easy to locate on the DNOs website would also be helpful.

7. *Chapter 8. We seek stakeholders' views on the introduction of a new average time to connect incentive.*

   We support the average time to connect incentive and consider that it will drive down connection times. We also agree with Ofgem's view that speedier connections should not lead to a lower quality of service, thus we support the rationale requiring this incentive to be less than the BCMS incentive.

8. *Chapter 8. We seek views on which aspects of service should be measured, the approach used for target setting and whether exemptions should be applied under the average time to connect incentive?*

   We see the targets that Ofgem are proposing to adopt as sufficient.

1. *Chapter 9. Do you agree with our proposed range for the efficiency incentive rate?*

   The efficiency incentive rate for the RIIO-ED1 IQI at the break-even point is fifteen percentage points higher the equivalent figure contained in the DPCR5 IQI matrix (we note that only 85% of costs were included for DPCR5 so these figures are not directly comparable as such).

   We agree with having sufficiently high incentive strength to prevent perverse incentives to overspend, but a higher incentive strength also leads to increased volatility of cash-flows and therefore risk. Larger changes in incentive strength between columns means that risk falls more as you move to the right of the matrix, but also gives a stronger truth-telling incentive in financial terms. Without data showing how companies have responded to the IQI, a greater slope of efficiency incentive therefore could be construed as a reason for accurate cost estimates or as a reason for overestimating cost estimates.

2. *Chapter 9. Do you agree with our proposed approach to the calibration of the IQI?*

   The theory underpinning the IQI mechanism is not a concern, but without further information on how the IQI has worked in practice, any view on the proposed approach will be constrained. Our concerns are that companies have other forces acting on their decision, such as managerial incentives to deliver proposed numbers, lower risk appetite and the ability to influence Ofgem's baseline, which go against the profit maximisation motive and independence of baseline assumed within this mechanism and each could result in padded cost estimates.

   Data from DPCR4 and DPCR5, as well as other Ofgem price controls utilising the IQI, must be made available as part of a complete review of the IQI mechanism prior to the commencing of detailed incentive design work in ED1 if these concerns are to be allayed. The continued

use of the IQI mechanism has the potential to deliver significant benefits for the consumer if the choices regarding calibration of the matrix are made appropriately, and it is our view that these choices should potentially include the use of deadbands and asymmetric matrices, especially if there is evidence the behaviour differs from what is expected. There does not though appear to be a reason to change the baseline being representative of upper quartile performance.

3. *Chapter 9. What are your views on the indicative IQI matrix?*

   As noted, without sufficient information on historic behaviour, it is difficult to reach a view on the indicative IQI matrix. With any matrix, optimal functioning of the IQI will of course occur with a baseline that is as independent and accurate as possible. A baseline that is set too low will leave companies facing lower than anticipated incentive rates and this may leave companies worse off if incentives are insufficient to prevent increased expenditure. Alternatively, a baseline that is set too high (i.e. too generous for a company), firms should be towards the left of the IQI matrix and have the capacity to make large gains, which actually may cost consumers in comparison to an accurate baseline, despite notionally sharing a percentage of the 'out performance'.

   The opportunity for a revised business plan for non-fast tracked DNOs means that companies will logically submit inflated cost estimates should they hold the perception that they can influence the baseline. This is not an unreasonable assumption to hold as resolving some of the information asymmetry between regulator and company is the basis for using the IQI.

4. *Chapter 9. What do you consider are the appropriate rewards for fast-tracked companies compared to non fast-track companies? Should we have a differential between the two?*

   At this stage, compelling arguments to give a non-fast tracked DNO a positive additional income for bidding and delivering the Ofgem baseline have not been presented. The decision to award an additional reward to fast-tracked companies depends on the certainty around this baseline and how Ofgem react to the business plans of non-fast tracked DNOs. Should business plan information influence Ofgem's view on baseline costs, it is appropriate for fast-tracked companies to receive a positive amount to try and prevent attempts to influence. If there is significant uncertainty over the baseline, then this risks giving a company who has over-estimated their costs and been fast-tracked, further reward via additional income and a higher proportion of retained out performance, so any decision must be well-thought out in the context of independence of baseline.

5. *Chapter 9. Do you agree with our proposals for the same efficiency incentive rate to apply to all areas of expenditure that will be included within the IQI?*

   The calibration of the matrix must be such that incentives do not exist for firms not to give a true reflection of costs or not to operate efficiently. Therefore, we agree with the general approach to include all areas of expenditure to prevent any gaming. In the water sector for example, there has been a concern that separate incentives for capex and opex have led to a capex bias. The exclusion of items such as business rates is also appropriate given that these items have their own incentives attached and the inclusion in the IQI would change the effective rate faced.

6. *Chapter 9. Do you agree with our proposed treatment of DNOs within a single ownership group?*

   The use of a single ownership group again prevents boundary issues and we agree with the continuation of this principle.

2. *Chapter 10. Do you agree that the level of funding for the rest of the ED1 period should be reviewed in 2016 following a review of the LCN fund?*

   Yes, the level of funding for the rest of the RIIO-ED1 period should be reviewed following a review of the LCN Fund because the regulator should review how network companies are integrating the results of the LCN Fund and how much has become "business as usual" innovation.

3. *Chapter 10. What are your views on the information DNOs should provide in their innovation strategies? How can DNOs best demonstrate that their approach to innovation is sufficiently well justified and robust?*

   DNOs should prepare cost benefit analysis or similar comparisons between the innovation that they have chosen and the other options. Similar comparisons should be required for when innovative solutions are not chosen in favour of traditional approaches. Evidence for the comparison should include pilot projects by the DNO themselves or companies elsewhere in the world. DNOs should demonstrate that they are regularly reviewing the results of LCNF and other trials and have clear procedures for integrating learning from past experiences, including successes and failures.

   To show that their approach to innovation is robust, they should be able to demonstrate that they are implementing business change and embedding learning from their own and others' trial work. They should be able to demonstrate that they have regular stakeholder engagement sessions, especially with other members of the value chain, to ensure that innovations that might require cross-company collaboration are also duly considered. As DNOs write their innovation strategy, they should be clear to indicate how the benefits will be delivered into BAU.

4. *Chapter 10. Do you agree that it would be valuable for DNOs to consult and update their innovation strategies regularly during the price control period?*

   Yes, it would be valuable for DNOs to consult and update their innovation strategies regularly in order to build in the lessons learned and solutions from the Low Carbon Network Fund projects as they become available.

Appendix 3: Uncertainty Mechanism questions

1. *Chapter 2. Are there any additional criteria that we should take into account to guide the appropriate use of uncertainty mechanisms?*

   We fully support the recent decision on Charging Volatility that lags revenues arising from uncertainty mechanisms by 2 years. However, it is worth noting that, in practice, this does not necessarily give users the amount of certainty or notice that it may appear. Assuming that the revenues arising from an uncertainty mechanism in year t is not known until the end of year t, it is likely that significantly less than 1 year's notice will be available. Indeed, it is the intention to not finalise these numbers until the November before revenues are included for price-setting purposes the following April - a period of less than 6 months. It is therefore essential that DNOs consistently inform the industry of their current 'best-view' of these revenues throughout the period in question.

2. *Chapter 3. Do you have any views on the design of the proposed low carbon technologies volume driver?*

   We have concerns over the design of the low carbon technologies volume driver. This policy does not do anything to create a level playing field or equivalent incentive for DNOs. There are simply too many differences in the impact of a low carbon technology in central London and rural Wales. Also, the impact of an EV charge point at a residential home and one at a public shopping mall are likely to be quite different, especially as the main impact is at substation level. For that reason, we would like to see separate business cases submitted by the DNO to provide evidence of how different low carbon technologies (and in what quantities) impact their own networks. They should also prove that a smart grid approach such as demand management is insufficient in delaying that reinforcement.

3. *Chapter 3. Do you have any views on the design of the proposed smart meters volume driver?*

   We agree that a volume driver is appropriate for call outs associated with smart metering, but, noting the low level of call-outs from our smart trial, believe that this should be restricted, as a maximum level, to the additional cost burden of DNOs resulting from the shortening of the normal 20 year meter replacement cycle. We agree that where DNOs are mandated to pay for DCC service under licence conditions these be treated as pass through items.

8. *Chapter 3. Do you have any views on the design of the proposed innovation roll out mechanism reopener?*

   The design of a proposed innovation roll out mechanism also seems to require some additional thinking. There are no actual drivers to encourage innovation - simply because they would be paid for their additional efforts doesn't mean they will do it. The first line of the requirement "the innovative solution has been proven to be beneficial to facilitating the low carbon energy sector" is too vague and would be better to point to the government's legally binding carbon targets. Also, it does not say who would determine that the measure

would be beneficial. Would the DNO have discovered this, or perhaps another energy player, consumer group, or Ofgem after having reviewed LCNF findings? There needs to be some clarity to this. In principle, if a low carbon method of innovation has been found and proven cost effective, we would like to see the DNOs required to do it unless they can prove otherwise.

2. *Chapter 4. Do you have any views on the proposed cost of debt indexation mechanism*?

   We welcome the continued use of cost of debt indexation as proposed by Ofgem, which strikes the appropriate balance between efficient financing and sufficient levels of allowance for the companies.

3. *Chapter 4. Do you have any views on the proposed pass through of Ofgem licence fees and business rates?*

   The proposal to treat Ofgem licence fees as pass-through is appropriate. With regards to business rates however, whilst we understand the intent of switching the pass-through adjustment off unless DNOs can show they have acted to minimise their rateable revaluation, care needs to be taken with this approach as it could lead to perverse incentives i.e. if DNOs/Ofgem over forecast business rates in the base allowances for RIIO-ED1 then there is no incentive on the DNO to minimise their rateable revaluation since the outcome of doing so would be to pay back the excess allowance.

Appendix 4: Financial Issues Questions

1. *Chapter 2. Is our approach for setting the allowed return appropriate, particularly in the context of an eight year price control?*

   We support Ofgem's general approach to setting the allowed WACC for an eight-year price control, including use of debt indexation and a CAPM approach to the cost of equity, cross checked to market evidence.

   As a point of detail, we agree with Ofgem's caution in linking potential rises in interest rates to increased risk through arguments about procyclicality of returns. We note that the evidence on returns and growth is unclear. For example, DMS state that

   '*Real dividends have generally grown more slowly than real GDP per capita, and real dividend growth does not appear, as is often assumed, to be positively correlated with GDP growth – if anything, the correlation is negative.* ***The same finding applies to the correlation between GDP growth and total equity returns****. Over time, the path of real dividend growth rates appears to approximate a random walk, and growth rates have been quite volatile.'*[3]

   The Competition Commission further supports the need for caution on linking growth to returns:

   'We agree with the authors of the Bank of England Quarterly Bulletin article that it is essentially arbitrary to assume future long-run growth in dividends per share equal to potential economic growth. Indeed, we see both theoretical and empirical reasons for expecting long-run growth in dividends per share to be less than potential economic growth.'[4]

   In general, we are wary of 'cherry-picking' of often poorly supported theories to adapt the CAPM in one direction, and that it is more important to cross-check CAPM to market evidence obtained from transactions, share price data and City equity analyst comment.

2. *Chapter 2. What considerations do we need to take into account when setting the notional gearing level?*

   We have some concern about the approach to setting notional gearing, and wonder whether there is a step missing. Ofgem's 'principles-based' approach to gearing focuses on general risk and cash flow risk to the company, as captured by key credit metrics. We agree that risk exposure and credit metrics should be considered, but that it will be appropriate to consider as well the wider factors taken into consideration by credit rating agencies. These factors are likely to enable a notionally efficient regulated entity to support a higher level of gearing than a typical company with an investment grade rating. Ofgem should consider a relatively high starting point for its analysis of gearing, and consider downward adjustments only where clearly warranted by material financeability concerns.

[3] DMS Triumph of the Optimists p155
[4] CC Bristol Water pN24

3. *Chapter 2. Is our proposed mechanism for annually updating the cost of debt assumption based on an index appropriate?*

   We support Ofgem's general approach to setting the allowed WACC for an eight-year price control, including use of debt indexation and a CAPM approach to the cost of equity, cross checked to market evidence. We would expect the cost of debt update to be run in a consistent process with the RPI indexation updates.

4. *Chapter 2. Does our range for the cost of equity capture the DNOs' probable cost of equity in RIIO-ED1?*

   Ofgem's proposed range for the cost of equity seems at odds with recent evidence and decisions. Ofgem proposes an ED1 range of 6.0% - 7.2%, so a top end of the range a full 50 bps above the GD1 Initial Proposals figure of 6.7% and an equal amount above the DPCR5 decision. It is also at odds with the Competition Commission's 7.0% market cost of equity as set out in the 2010 Bristol Water determination. It seems that such a high top end can only be manufactured through a risk-free rate which allows for a rapid reversal in the downward trend in ILGs and an equity risk premium above the latest long term estimates from DMS. Furthermore, we do not support a range for the risk-free rate of 1.7% – 2.0%. We are unclear as to how Ofgem has arrived at the bottom end of the range and recommend a range of 1.5% to 2.0% as the lower end is supported by market evidence and recent decisions from Ofcom and the Competition Commission. We have also seen no evidence for an equity risk premium of 5.5% at the top end which seems significantly overstated – a top end of 5% is more appropriate.

1. Chapter 3. Have we identified the correct equity and credit metrics?

   We consider that Ofgem has identified appropriate credit metrics. We note that Ofgem states that

   'All three rating agencies told us that they do not expect every issuer to meet every ratio at all times.'[5]

   and that

   'The major credit rating agencies have historically had a favourable view of the regulatory framework in GB and this has allowed companies to maintain investment grade credit ratings, even where credit ratios may have fallen outside the ranges set out for the relevant rating category under an agency's methodology'[6]

   We are highly supportive of an approach to financeability that is not overly mechanistic and that takes into account the perceived robust regulatory framework for GB networks.

[5] Ofgem, Financial Appendix, para 3.6
[6] Ibid para 3.8

We note that Ofgem states that rewards for best performing companies have the potential to be *'double-digit returns on (notional) equity'*[7]. Whilst we consider that companies should face appropriate incentives, the key is symmetric downside risk, and that companies are actually exposed to such risk.

1. *Chapter 4. Do you agree with our approach for the calculation of the percentage to Totex allowed into RAV?*

   The approach for the calculation of the percentage of totex allowed in the RAV seems rather vague. This is an important item which stakeholders should be consulted upon. It is unclear as to why Ofgem would move away from an approach based on best estimates of the opex and capex split, and such a move away might impact efficient financing decisions. Furthermore, consumer preferences and the impact on charges should be fully understood and taken into account.

7. *Chapter 5. Do you agree with our proposal for funding business rates?*

   With regards to business rates however, whilst we understand the intent of switching the pass-through adjustment off unless DNOs can show they have acted to minimise their rateable revaluation, care needs to be taken with this approach as it could lead to perverse incentives i.e. if DNOs/Ofgem over forecast business rates in the base allowances for RIIO-ED1 then there is no incentive on the DNO to minimise their rateable revaluation since the outcome of doing so would be to pay back the excess allowance.

1. *Chapter 6. Do you agree that the fast money true-up adjustments for DPCR5 should be spread over the eight years of the RIIO-ED1 price control if they exceed £1m per DNO? If not, which alternative option do you prefer?*

   Yes, it would seem appropriate to spread it over the eight years of the RIIO-ED1 price control if it exceeds £1m per DNO to prevent undue charging volatility. This option could be slightly altered to spread the 'excess' amount over the remaining 7 years of the price control to avoid a DNO with a £0.9m true up receiving more of that in year 1 than a DNO with a £7m true up.

3. *Chapter 6. We invite views from interested parties on how we conducted the latest pension reasonableness review, with a view to understanding what elements of the review were conducted well, what could be improved and what should be done differently in future reviews.*

   The GAD review appears to be fairly simplistic and it is not clear that it provides a good test of whether or not:
   - the benefit packages are 'competitive', and
   - the costs arising from the schemes' funding arrangements are 'efficient'.

   In particular:

   Benefits

[7] Ibid para 3.13

- The brief analysis of benefit provision looks only at a simple table of very high level comparators (see page 10 of the GAD report) and compares the Gas and Electricity arrangements with those of a "'Typical' UK scheme" as derived from the OPS Annual Report 2010. The simplicity of the table, and the fact that the OPS report will have been based on data collected some time before the reporting date, means that the comparison will not have reflected many of the changes that have been made more recently to DB schemes in the UK.
- The analysis acknowledges the changes that Centrica has made to member contribution rates, but does not explain the much more significant changes which Centrica has been able to make (in particular, the recent introduction of a cap on pensionable salary growth). It is interesting to note that "no licensees have made significant changes to their original schemes' benefits since my [ie GAD's] previous report.

In summary therefore, as we noted at the time of the previous July 2009 GAD report, we feel that the question of whether the level of benefit provision by the NWOs is competitive deserves greater focus.

Funding and investment arrangements

- Again, the analysis in the GAD review is simplistic. Rather than trying to assess some individual assumptions, a more interesting analysis might have been to consider the overall strength of the NWO schemes' technical provisions relative to their solvency (or 'risk free') liabilities and compare these ratios with those of private sector schemes generally (ideally with schemes of similar maturity). This would have provided a good indication of the overall strength of their funding bases. Some analysis we undertook a year or two ago suggested that the NWOs were targeting higher levels of funding than typical UK schemes, notwithstanding the likelihood of them having stronger employer covenants backing them (given that the employers are effectively regional monopolies in an essential industry).
- Strong funding bases produce relatively high deficits which are then factored into the allowable pension costs. However, the actual funding contributions paid by the NWOs presumably reflect the assumptions underlying their individual recovery plans which, in turn, reflect discount rates inflated by an element of 'out-performance'. This outperformance allowance is justified, we suspect, by the actual investment strategies pursued by the schemes, which may explain the higher proportion of assets identified by the GAD as being allocated to return-seeking investment. If so, then the effect could be that <u>allowable</u> costs are based on very conservative measures while the <u>actual</u> costs paid by the NWOs are not.

4. *Chapter 6. We invite views on which of the options for pension scheme administration costs and Pension Protection Fund levies we should adopt; and, if our preferred approach were adopted, the methodology itself, and the level of the de minimis thresholds*

We have previously noted that making PPF levies and pension scheme admin costs subject to separate allowances, with incentive mechanisms or true-ups, has some appeal although it seems somewhat over-complex given the quantum of those levies/costs. In that context we do not have a strong view on which of the two proposed options is adopted, nor on the level of the de minimis threshold (although £1m does not seem unreasonable). The key is for these costs to be "economic and efficient" – we are not aware of how Ofgem ensures that this is the case.

5. *Chapter 6. Do you agree that companies must demonstrate a robust approach as to how their de-risking strategies, especially if aggressive, are protecting future scheme funding and that they should clearly demonstrate the benefits that they expect to flow to consumers?*

   To the extent that the NWOs can pass on pension costs to consumers, they have a strong incentive to de-risk their pension schemes, as they do not have the financial downside (of higher expected pension costs) faced by other commercial pension scheme sponsors. We agree that Ofgem should require the NWOs to demonstrate the potential benefits of de-risking strategies to consumers – and if they cannot do so satisfactorily, the pension costs passed on to consumers should be adjusted accordingly. Ofgem should also require the associated costs of any de-risking exercise to be identified and justified, in conjunction with the benefits.

6. *Chapter 6. Do you agree that the costs of contingent assets be funded if clearly demonstrated to be in consumer's interests?*

   Use of contingent assets is becoming more widespread and can be an effective tool in managing pension costs. To that extent, their usage should be supported. We think Ofgem's suggestion that "the costs of [such vehicles] should be funded if demonstrated to be in consumers' interests" seems entirely reasonable, but it is not at all clear what would constitute a valid demonstration in this regard. How is it proposed to be assessed and, if done on a case by case basis, as seems to be suggested, how can there be clear transparency of the assessment so that it can be challenged if it is felt to be too generous?

7. *Chapter 6. We invite views on whether the revised guidance to our pension principles and the methodology is comprehensive and adequate for DNOs and stakeholders to understand how the principles will be applied in RIIO controls and for network companies to prepare their business plans.*

   The guidance is certainly lengthy, but whether it is "adequate for DNOs and stakeholders to understand how the principles will be applied" is unclear. Given that the methodology and guidance appears not to have changed materially, it seems unlikely that a request to make the guidance more straightforward would be viewed as helpful. We would reiterate the point that there seems to be insufficient attention paid to the principles which relate to levels of benefit provision compared with competitive private sector practice and to the relative efficiency of the allowable pension costs.

Appendix 5: Business plans and proportionate treatment Questions

1. *Chapter 3. Do you have any comments on the timing and stages of the assessment process?*

   We feel stakeholders will not have enough time to review and assess the DNO business plans following the first submission in July 2013, a four week 'invitation for comments' is too short. We also have concerns that the initial assessment and fast tracking draft determination are simultaneous. Stakeholders will need to see the initial assessment and review themselves before being able to comment on any fast tracking proposals. Normally the initial assessment is the first time stakeholders will see the data Ofgem has relied upon to benchmark and make decisions.

2. Chapter 3. Do you agree with the three stage assessment process for RIIO-ED1?

   We still have reservations over the fast tracking process and whether the DNOs should have less scrutiny given the considerable out performance by many DNOs currently being seen in DPCR5. Also, we have yet to see the quantified value consumers have benefitted from Ofgem giving proportionate treatment to the business plans versus the significant risk of over rewarding the networks. We welcome that third party stakeholders are now more involved in the price control than ever before, however we still do not have the level of data or access to the DNOs that gives us comfort that the business plans are genuinely 'well justified'.

5. *Chapter 5. What should be the common metric, calculation and assumptions for determining the impact of the DNOs' proposal on consumers' bill?*

   Yes. We would expect to see the annual pounds per customer impact, shown separately for average domestic and non domestic customers, with a percentage change by charge type by network. For the avoidance of doubt, the annual pounds per customer change should be shown for each year of the price control. All comparisons must be made against the current view of 12/13 and expected view of 14/15, in real terms. Diluting the change to the lowest denominator simply frustrates stakeholders, as it is not transparent and lowers the acceptance that the business plan is 'well justified'.

Appendix 6: Reliability and Safety Questions

1. *Chapter 4. Do you agree with our proposal to align the IIS incentive rates with those proposed as part of RIIO-T1?*

   The incentive rates should be reasonably aligned with current incentive rates, however with the application of the IQI efficiency rate this should effectively halve the rates compared to current levels.

2. *Chapter 4. What are your views on applying the efficiency incentive rate to the IIS incentive rates?*

   We agree with the rationale for applying the efficiency incentive rate to the IIS incentive rates. We also believe that the rationale provided is equally applicable to all incentives and should be applied to all RIIO-ED1 incentives.

   We do not agree with the suggestion of allowing DNOs to propose their own incentive rates as this will simply encourage DNOs to suggest high rates if they believe that they will outperform targets and low rates if they believe they will under perform (noting that due to 'soft' targets only one DNO is underperforming to date in DPCR5).

4. *Chapter 4. What are your views on the level of revenue exposure and do you believe we need to reintroduce a cap on out performance?*

   We believe all incentives/targets need to be symmetrical with caps and collars to protect the consumers and network companies alike.

   The proposed revenue exposure range of 250 to 300 RORE basis points is excessive, especially given our concern surrounding the easy targets Ofgem set some DNOs for DPCR5. This coupled with DNOs apparent ability to renegotiate incentives with Ofgem if they do not outturn favourably suggests that increasing the exposure will simply result in increasing the potential returns to DNOs with no corresponding increase in potential penalties protecting consumers.

   We see no need to change the revenue exposure from the DPCR5 value of 139 RORE basis points and note that the extended RIIO period will mean that the absolute revenue exposure over the RIIO period will automatically be adjusted for the additional years. We do not understand the arithmetic inherent in Ofgem's rationale for increasing the exposure to a range of 250 to 300 RORE basis points. Adjusting the DPCR5 exposure of 139 basis points for the longer RIIO period (8 vs 5 years) suggests a value of 222 basis points.

5. *Chapter 4. Do you agree with our proposal to set separate planned and unplanned interruptions and minutes lost under the IIS?*

   Yes, this seems appropriate.

6. *Chapter 4. Do you have a preference amongst the options which we have outlined for planned interruptions and minutes lost target setting in RIIO-ED1?*

We prefer rolling targets as this offers the best protection against the risk of easy targets being set up front. Our experience of DPCR5 rewards to date is that the up front targets have been set at an unduly easy level for some DNOs. We do not support the option of DNOs proposing their own targets - we find it highly unlikely that DNOs will propose targets that may result in penalties and therefore targets set on this basis are unlikely to produce a symmetrical incentive.

7. *Chapter 4. Do you have a preference amongst the options which we have outlined for unplanned interruptions and minutes lost target setting in RIIO-ED1?*

DNOs are currently significantly outperforming their DPCR5 targets and therefore we do not believe that setting targets early in the RIIO ED1 process is appropriate. The step change in performance from 2011/12 onwards forecast by DNOs must be captured in the targets for RIIO ED1 to prevent locking in rewards for DNOs without any incremental improvement in performance.

Setting targets up front:
We do not support the setting of upfront targets in the same manner as DPCR5. The target setting for DPCR5 has been shown to produce unduly easy targets for some DNOs. With rewards of £120m forecast by DNOs for performance in 2011/12 alone it is unsurprising that DNOs are comfortable with this approach. We estimate that by simply maintaining CI/CML performance at average 2011/12 and 2012/13 levels DNOs could stand to receive c. £0.75bn in rewards for the remainder of DPCR5 (£0.2bn) and during RIIO ED1 (£0.55bn). Our analysis assumes RIIO ED1 targets are based on current 2014/15 targets and include an annual improvement factor of 1.5% for CML and 1% for CI. Therefore whilst Ofgem's concerns about setting upfront targets are reduced by the inclusion of an annual improvement factor, our own significant concerns with this approach remain. Ofgem need to ensure that targets are robust and do not result in rewards to DNOs for making no incremental improvements to performance. We do not believe setting targets up front and early in the price control process will achieve this.

Rolling Targets & Capped Rolling Targets:
We prefer rolling targets for the unplanned targets as this offers the best protection against the risk of easy targets being set up front. We have sympathy with the concerns raised with the 'best rolling average' approach and therefore we suggest the 'capped rolling average' approach is the most appropriate basis for RIIO ED1 target setting. Given the size of rewards currently being received by DNOs we do not consider a four year lag appropriate - we believe a two year lag, consistent with the proposal for planned interruptions, is more appropriate. We also believe that the rolling target should be based on a relatively short performance timeframe (4 years) for all voltage levels. Given the consistent reductions in CI/CML figures year after year it is inappropriate to set targets using 10 year average data for the higher voltage levels (EHV and 132kV).

DNOs Setting their own Targets:
We do not support DNOs setting their own targets. We do not believe it is credible to assume that a DNO may suggest targets that it considers it will not achieve and therefore this option seems highly likely to result in an asymmetrical incentive.

8. *Chapter 4. Do you agree with our proposals on exceptional events?*

These seem reasonable.

9. *Chapter 4. Do you agree with our proposed approach to smart electricity meters?*

   We agree that in the early stages of smart meter roll out data will have a limited effect on unplanned interruption performance. However, we believe that even coarse granularity of data should enable DNOs to identify network faults affecting multiple customers. Accordingly, once a basic threshold is reached, say 10% of GB coverage, we would expect to see an exponential improvement in DNO performance rather than simple pro rata increase.

   We therefore support the capacity to be able to rebase targets during RIIO:ED1, and consider it a necessary feature.

10. *Chapter 4. Do you agree with us not incentivising short interruptions in RIIO-ED1?*

    We agree that these do not need to be incentivised as is the case for DPCR5.

1. *Chapter 5. What are your views on our proposals on load indices (LIs)?*

   DNOs should be held accountable to deliver the improvements to their network that they have been funded to provide and if they fail to do so, the revenues should be returned to customers. Load indices seem to be one useful output measure that can be used to achieve this. Revenue adjustments should be one-way only i.e. a negative adjustment. DNOs should not be rewarded for over delivery (paragraph 5.17 mentions a 'penalty or reward adjustment').

   Any non-delivery of RIIO-ED1 LI outputs should result in downward adjustments to RIIO-ED2 revenue allowances. We disagree with the suggested option simply using the agreed LI at the end of RIIO-ED1 as the starting point for RIIO-ED2 - this would appear to merely delay the necessary payback for non-delivery to the end of RIIO-ED2 (and beyond).

2. *Chapter 5. Do you agree with our proposed common LI bandings?*

   We agree that it seems appropriate to us to use common criteria for the LI bands.

3. *Chapter 5. Of the two options outlined for determining the LI deliverable, which do you think is the most appropriate?*

   Ofgem state that option 2 caters better for the demand uncertainty in RIIO-ED1 and therefore we support this option.

4. *Chapter 5. Where significant numbers of substations that predominately cater for demand arise, do you agree that the development of a distributed Generation (DG) index for generation dominated substations would be feasible and appropriate to implement at the mid-period point of RIIO-ED1?*

   We presume this question intended to refer to the scenario where a significant number of substations that predominately cater for generation arise, and on this basis it would seem appropriate to develop a DG index at the mid-period review of RIIO-ED1.

1. *Chapter 6. What are you views on our proposals for health indices?*

We believe a random audit of 10% of DNOs' assets by an independent assessor with their results extrapolated over the entire asset base could protect consumers from funding asset replacement / reinforcement where subjective assessment by the DNO has given a borderline decision between further maintenance or funded replacement.

Consistent health index assessments are key to benchmarking costs between DNOs and help stakeholders to understand the risk profile each DNO assumes.

7. Chapter 7. What are your views on the feasibility and practicality of making payments to all customers automatic?

   We would not expect DNOs to make automatic payments to customers, as they generally do not know the customer's name, unless from the PSR or their bank details. The DNO can make compensation payments to the appropriate electricity suppliers, who in turn can either send cheques or credit the account directly. Currently where a GDN must pay compensation for failure to supply gas to a customer, this is achieved via the gas supplier, unless the customer has already complained directly to the network. We feel this process could work just as well for the DNOs.

8. Do you agree with our proposal to make payments to Priority Service Register customers automatic?

   Suppliers are already obligated to make automatic payments to customers where they fail to meet standards set as part of the Guaranteed Standards of Performance, for example in relation to missed appointments. In principle, we support a similar requirement being applied to distributors. However, distributors are unlikely to have bank account details for customers who may be entitled to compensation. This issue will therefore need to be considered to identify the most suitable way to make automatic payments. As part of this, alternative provision of refunds should be considered for customers who may not wish to disclose bank account details or who do not have access to a bank account. This might include payment via Post Office or Paypoint outlets.

Appendix 7: Tools for Cost Assessment Questions

1. *Chapter 2. Do you consider our overall approach to cost assessment appropriate and what changes, if any, would you propose?*

   We consider that Ofgem's overall approach seems appropriate. The combination of econometric benchmarking with detailed analysis of the DNOs business plans with input from experts in each cost area should provide a comprehensive view of achievable efficient costs. Do you think Ofgem should take into account poor historical performance in its assessment of business plans, and if so, how?

   We think that Ofgem should consider a DNOs previous performance when considering business plans. This is particularly important when assessing whether the DNO's plans clearly show how they intend to improve their performance over RIIO-ED1.

1. *Chapter 3. Do you agree with the use of totex benchmarking for RIIO-ED1 and what are your reasons?*

   We agree with Ofgem's use of totex benchmarking and its continued use of the upper quartile as the efficiency target for the DNOs.

   We consider that comparative efficiency analysis is an important tool for Ofgem to use in conjunction with detailed analysis of business plans to ensure that operators' are undertaking least cost solutions (while still ensuring high levels of quality and safety).

   Totex benchmarking offers advantages over separate opex and capex benchmarking by ensuring that the least cost solution is chosen rather than encouraging a particular solution. For similar reasons we consider that focusing on top-down models is more appropriate than bottom-up or disaggregated models as the trade-off between expenditure types will be captured.

   We urge caution when benchmarking forecast data from the DNOs. The cost drivers and output forecasts may not be realisable and this could lead to DNOs being given allowances above that which the DNOs will require. While this can be partially offset through output linked uncertainty mechanisms and the TIM, basing cost levels on observed cost drivers and outputs seems more appropriate than using forecast data.

2. *Chapter 3. Do you agree with the use of a capital expenditure as opposed to capital consumption approach for measuring total cost?*

   We agree with Ofgem in that capital expenditure should be used rather than capital consumption. As Ofgem acknowledge some form of smoothing mechanism(s) will be required to reduce the lumpy nature of capex.

3. *Chapter 3. Do you agree with using a similar approach to the top-down model used in RIIO-GD1, considering the adjustment for regional factors, the use of a composite cost driver, and the use of the upper quartile (UQ) to determine efficient costs?*

   We agree that adjustments for regional factors should be made where they are considered appropriate, but DNOs should provide strong justification where they propose an adjustment for their costs. We also agree with making these adjustments pre- rather than post-modelling.

While we understand Ofgem's use of a composite cost driver in past price controls however, given the panel dataset now available to Ofgem, and hence the additional degrees of freedom, we consider that Ofgem should explore modelling without combining all or some of the cost drivers. There may exist some multicollinearity between the cost drivers which may lead to some drivers appearing insignificant but multicollinearity in itself is not an issue when viewing the model as a whole.

We support Ofgem's continued use of the upper quartile in setting the efficient cost targets. We consider that using the average would not set a strong enough target for the DNOs and the use of upper quartile to determine efficient costs allows for measurement error or negative cost shocks occurring for the lowest cost DNO.[8]

4. *Chapter 3. Do you believe it is appropriate to use a middle-up Totex model and if so, do you agree with following the principles of the GD1 approach?*

It is not clear to us what the benefits on undertaking middle-up totex modeling are for Ofgem. The top down modeling combined with bottom-up modeling should provide Ofgem with sufficient evidence for setting efficient cost targets for the DNOs.

[8] Politt,M., *The role of efficiency estimates in regulatory price reviews: Ofgem's approach to benchmarking electricity networks*, Utilities Policy, 2005

5. *Chapter 3. What level of disaggregation do you believe is appropriate for the middle-up model to provide a useful comparator to the top-down Totex model? (3.5)*

   See above.

6. Chapter 3. How do you believe lumpy expenditure should be treated in Totex modelling? (3.6)

   We believe that using some form of smoothing (e.g. moving average) is more appropriate than removing the expenditure altogether. However, we note that using a moving average will decrease the degrees of freedom available.

1. *Chapter 4. Do you believe it is appropriate to use bottom-up, disaggregated model to compare with the Totex model results?*

   We consider that the bottom-up modeling will provide Ofgem with further information on how the different DNOs perform in relation to different activities. However, careful consideration needs to given as to how these results can be interpreted against the top down approach. The DNO's will place pressure on Ofgem to use the results which are most advantageous for their allowances.

2. *Chapter 4. Do you agree with our approach to the disaggregated, bottom-up model?*

   See above.

1. *Chapter 5. Do you agree with our proposed approach to how the specific building blocks that make up load related expenditure interact as well as which categories are proposed to be included in a load related reopener?*

   We have no specific comments in relation to how the building blocks interact. We are not clear on why all costs categories aside from diversionary works and HVPs would be included in the load related reopener (paragraph 5.16) as it is proposed that general reinforcement (HV-LV), HVLC connections, and low carbon technologies will have mechanistic volume drivers.

2. *Chapter 5. Which of the three options set out for assessing connection-related costs within the price control do you feel is the most appropriate and why? Please reference the following in your answer:*

   - the gross cost assessment adjusted for net-to-gross ratio or just on the Distribution Use of system (DUoS) funded reinforcement costs
   - the most appropriate cost driver for connection reinforcement costs: Meter Point Administration Numbers (MPANs) or number of connection projects
   - the most appropriate for assessing cost of low volume high cost (LVHC) connections

   We consider that the first option (the same approach as DPCR5) should be used. However, we would recommend using a specific uncertainty mechanism for LVHC connections (similar to the for transmission generation connections) whether no ex-ante allowance is given and allowances can be given on an ex post basis through the MOD term. The gross cost of the connection should be assessed and adjusted for using the net-to-gross ratio. We also propose that a regular audit is carried out on the connections information,

particularly around the net-to-gross ratio. We have no comment on the most appropriate cost driver without the analysis of the unit costs.

3. *Chapter 5. Which of the three options set out for assessing wayleaves and diversionary-related costs within the price control do you feel is most appropriate and why?*

We agree with Ofgem's preferred option of an ex-ante allowance. As Ofgem state, the costs in relation to wayleaves and diversion works are small and having an uncertainty mechanism for these does not seem appropriate.

7. *Chapter 5. Do you believe that it is feasible and appropriate to set definitions and unit costs(s) for the following:*

   - The conversion of wayleaves to easements and injurious affection payments
   - load related interventions on the secondary network
   - fault level reinforcement

   For the latter two, we consider that it would be feasible setting a unit cost. However, we consider that it may be more difficult to set unit costs for the conversion of wayleaves and injurious affection payments.

8. *Chapter 5. What is the most appropriate funding mechanism for load related expenditure on the secondary network?*

   While we have not specific comment here, we would emphasis that consideration should be given to the variability in consumers' bills when choosing the funding option.

2. *Chapter 6. In light of our proposals, do you agree with our selection of risk removed as the primary output of the mains replacement programme?*

   Not applicable.

4. *Chapter 6. Do you agree with our proposed approach for assessing the DNOs' plans for expenditure on Legal and Safety? If not, what changes would you propose?*

   Yes, although we expect Ofgem to review any increase in costs (whether forecast or actual).

5. Chapter 6. Do you agree with our proposed approach for assessing the DNOs' plans for expenditure on ESQCR? If not, what changes would you propose?

   Yes, we agree that ESQCR should be treated as BAU, although would expect the costs to be benchmarked at upper quartile rather than mean.

6. *Chapter 6. Do you agree with our proposed approach for assessing the DNOs' plans for expenditure on flooding? If not, what changes would you propose?*

   Yes, we assume the whole life costs will be depreciated over 45 years, as appropriate.

7. *Chapter 6. Do you agree with our proposed approach for assessing the DNOs' plans not to fund Quality of Service (QoS) improvements during RIIO-ED1?*

   Yes.

8. *Chapter 6. Do you agree with our proposed approach to change Black Start and Rising and Lateral Mains (RLM) from reopener mechanisms to ex ante allowances?*

   Yes, we expect Ofgem to audit the ownership decisions and ensure the beneficiaries of these assets pay for via DUoS charges.

2. *Chapter 7. Do you agree with our approach to assessing Severe Weather 1 in 20 Events and do you*

have any preference between the options?

We have concerns that these costs are double counted with other reinforcement and capital investment, therefore the efficient spend of this allowance is important for stakeholders to understand.

4. *Chapter 7. Do you agree with our proposed approach for assessing the DNOs' plans for expenditure on Tree Cutting? If not, not changes would you propose?*

   We expect Ofgem to only allow efficient costs for tree cutting, benchmarked at the upper quartile.

5. *Chapter 7. Do you agree with our approach to assessing NOCs Other and do you have any preference between the options? Please separate your response by the following categories: dismantlement, remote location generation and substation electricity*

   Yes, looks reasonable for all three categories.

1. *Chapter 8. Do you agree with our proposed approach to assess CAIs? In particular, do you agree with our groupings of activities?*

   Yes, seems reasonable.

3. *Chapter 9. With regards to the non-fast track benchmarking, for those DNOs that report lower than benchmark costs which of these three options for setting cost allowances do you think is most appropriate and why? The options are: increasing allowances to the benchmark level of costs, giving the DNO their submitted level of costs and taking an average between the benchmark and the submitted costs.*

   We do not think DNOs should be given an uplift in their business support cost allowances if their submitted costs are lower than the benchmark cost. The second option, 'giving the DNO their submitted level of costs' seems the most appropriate. If a DNO considers that it can undertake its activities at its submitted cost level (i.e. they are above the upper quartile) then it does not seem consistent with Ofgem's aim of delivering value for customers to provide additional allowances for these activities.

1. *Chapter 11. Are there any additional analytical techniques that we should consider beyond those we have used at past price control reviews to assess RPEs and ongoing efficiency?*

   We have concerns with Ofgem's continued approach to set ex-ante allowances for RPEs. Evidence from GDPCR and DPCR5 indicates that network operators were given allowances for input prices well above what occurring in the rest of the economy. While Ofgem was not able to foresee the economic shocks which contributed to this difference, an alternative approach could be to have an uncertainty mechanism linked to the same indices used to set the RPEs. While DNOs may argue that this creates uncertainty, as these indices are based on historic data and as the DNOs would be able to observe real world trends there would be sufficient information to negotiate contracts accordingly.