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2nd August 2013

Dear Anna,

Open Letter on RIIO-ED1 Business Plans

1. Thank you for the opportunity to respond to Ofgem's open letter regarding the RIIO-ED1 business plans, document reference 111/13. This is a non confidential response on behalf of the Centrica Group, excluding Centrica Storage.

2. As you will be aware we are fully engaged in the RIIO-ED1 process, as our goal is to ensure all elements of the electricity supply chain offer our customers value for money. Since electricity distribution charges are over £1bn per annum for British Gas and we have no network ownership, we feel we are well placed to offer our thoughts on the Distribution Network Owners' (DNOs') business plans published on the 1st July 2013.

3. With the limited time available to fully digest these business plans we have concentrated on a high-level review of the information available with a view to informing the assessment of suitability for fast-tracking. At this stage, given the level of confidence that would be required to justify the risk of fast-tracking a network, we do not believe any network has met the conditions required to justify their business plans being "fast-tracked", in particular we would note that:

   - A network should only be considered for fast-tracking if Ofgem are confident it is within upper-quartile in terms of cost efficiency.
   - The effective cost of equity proposed by networks (after allowing for an assumed related additional income uplift) is around 7.7%. This far exceeds the range of 6.0%-6.5% provided by our independent analysis and arises from an entrenched expectation of a higher required rate of return than the headline cost of equity.
   - Assessment of plans should not be overly positively influenced by initial price decreases. Initial decreases in prices can almost entirely be explained by prices in 2014/15 being artificially high due to the profiling of revenues during DPCR5.

- It is appropriate that no specific outputs are designed for the transition to a low carbon economy and agree that, as outlined in the ED1 Strategy decision, the existing outputs, particularly relating to efficiency and interruptions, should deliver the required DNO behaviours.

4. We expand on each of these points below.

Pre-condition of upper-quartile efficiency

- We believe it should be a pre-condition as part of fast-tracking assessment for a network to be assessed as within upper-quartile in terms of efficiency.
- The rewards from fast-tracking offer less efficient DNOs the potential to receive outsized benefits compared to the revenue allowances they may be expected to receive under a full IQI assessment. With the exception of networks that are upper quartile level efficient, this will automatically mean that customers are required to pay more than they necessarily need to, had a full IQI assessment process been adopted.
- Under certain conditions CEPA's analysis also shows that fast-tracking may create clear commercial incentives for DNO "padding" of bids if it is possible to be fast-tracked on factors more qualitative than efficiency. Working through an example, the analysis shows that a customer could pay nearly £18 additionally in each year of RIIO-ED1 if a less efficient DNO were fast-tracked. See annex 4, section 3 for further details and analysis.
- The concept of the IQI is to encourage 'truth-telling' given it is difficult for Ofgem to identify all padding in regulated companies' plans. By applying upper quartile cost efficiency as a challenging benchmark for the electricity distribution industry, Ofgem and customers who ultimately use and pay for the DNOs' networks, can be more confident that the risk of business plan padding is mitigated.
- This ensures consistency with Ofgem's policy of moving to an upper quartile cost efficiency baseline as the 'break-even' point for DNOs to earn their cost of capital under the ED1 IQI, which we understand and support as necessary, particularly when considering the returns seen in DPCR5.
- Outturn return on regulated equity analysis completed by Ofgem and its consultants shows that for the first two years of DPCR5, the DNOs have all outperformed their allowed cost of equity with five networks even achieving a (real) return on equity greater than 12 per cent for these two years. The move to upper quartile is necessary to provide confidence of a settlement that is a good value for customers.
- We note that 5 out of 6 DNO groups have benchmarked themselves as efficient, using differing methodologies and so Ofgem will need to ensure that it has a robust benchmarking methodology in place to make sure that it is able to identify those that perform the best, before it feels confident enough to fast-track a DNO.

Entrenched expectation of returns from incentives

- Our interpretation of the DNOs' business plans is that they are seeking to justify their required return on equity based on maintaining the status quo (i.e. DPCR5) equity returns package, including from totex incentives, rather than evidence on their real stand-alone cost of capital.
- All DNOs were allowed positive expected returns from IQI additional income at DPCR5 provided they met their expenditure allowances. However this benefit will be removed for slow-tracked companies in ED1. At least five of the six company groups explicitly state that their cost of capital proposals are contingent, therefore, on being fast-tracked.
- By claiming that an additional income uplift (consistent with DPCR5) must be permitted through the IQI (as is the case with the fast-track process and the DNO business plan proposals) or recognised in the baseline cost of equity, the companies are effectively arguing the expected, normal rate of return, from electricity distribution is higher than the headline 6.7 percent cost of equity quoted in their plans.
- The additional income uplift of 2.5% is estimated to be equivalent to around 100 basis points. This would make the effective cost of equity around 7.7%. This compares to the range of 6.0%-6.5% provided by our independent analysis and is equivalent to around £2 per annual household bill.
- We do not believe the DNOs approach is justified or consistent with the regulatory objectives of the IQI mechanism.
- Overall we would expect (given the uncertainties and adjustments in the cost assessment process) that the value from efficiency incentives (with the exception of leading industry performers that qualify for the fast-track rewards) should on average be zero across the DNOs. In this regard we have real concerns that the Interruptions Incentive Scheme appears to be calibrated to provide an overall average benefit for DNOs - without any improvement in performance. It is difficult to see how this represents an appropriate balance of risk and reward for the DNOs, or value for money for consumers.

Artificial price reductions

- Most DNOs are reporting real price decreases for the first year of the new price control period, when compared to the final year of DPCR5, and subsequent increases that could also be viewed as modest.
- It is important to note that this is largely due to the profiling of revenues within DPCR5, which generally had the effect of artificially increasing the revenues at the end of the period. All parties reviewing these business plans should not view these plans any more positively therefore as a result of these price decreases or interpret them as necessarily implying cost reductions or improved efficiencies.
- Overall, in fact, it would appear that annual revenues are increasing on average between controls with total expenditure remaining roughly flat.
- As we have noted before, we believe, when discussing price increases figures should be included in money-of-the-day (i.e. including an assumption of inflation). It is clearly misleading to the casual reader to only consider in real terms and gives a false impression of the prices customers will actually face.

‘Business as usual’ business plans appropriate for delivering smarter networks

- Roll out of smarter markets will transform the sector over the ED1 and ED2.This will have fundamental implications for the DNOs – but the exact nature and timing of these is uncertain. Given this, it is appropriate that there are no specific outputs defined on which DNOs are seeking allowances.
- This is particularly the case because growth of smarter markets is an industry-wide issue, for which all parties will take major roles. For example, we are expecting suppliers to take a leading role in developing demand side response, given we already have the infrastructure in place to deliver this (which will be highly effective, judging by the enthusiasm generated by early announcements of mainstream time of use tariffs (e.g. our plans for a “free Saturday” proposition for customers with smart meters).
- Allowing funding for networks to develop parallel capabilities to build customer relationships, for example, would only lead to inefficiency and ultimately higher bills for consumers

5. We feel that the incentive rewards from being fast tracked and the RIIO-ED1 package more generally, are already very high and we urge Ofgem to ensure that consumers receive value for money from all aspects of the price control and additional rewards are not given away. We highlight that all DNO stakeholder engagement found that value for money / keeping the costs as low as possible was the top priority.

6. The remainder of this consultation answers Ofgem’s specific questions from the open letter consultation and includes annexes covering:
   a. Annex 1, Analysis of Interruptions Incentive Scheme
   b. Annex 2, CEPA’s analysis of the Weighted Average Cost of Capital
   c. Annex 3, CEPA’s review of business plans’ incentives and outputs
   d. Annex 4, CEPA’s review of the business plans’ cost efficiency and expenditure

7. We hope you find our comments and analysis helpful and we look forward to discussing with you in the future.

Yours sincerely,

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

Consultation Questions

Overall quality of the plans:

Do you consider that the plans are comprehensive and well justified? Do they provide a clear understanding of what the DNO will deliver over the price control period?

8. We consider that the business plans are an improvement on the plans submitted for RIIO-GD1 and our understanding of what the DNOs will deliver has been improved by greater stakeholder engagement and the better use of executive summaries. However to be well-justified and therefore fast tracked, the DNOs must prove their costs and financing arrangements are efficient. We find it hard to reconcile that 5 out of 6 DNO groups appear to be claiming to be efficient and the DNOs are requesting a cost of equity beyond the range produced from our CEPA assessment, despite expected rewards from incentives, especially the Interruptions Incentive Scheme.

9. CEPA have analysed the benchmarking and efficiency claims of the DNOs, and it appears that each DNO group has used a different methodology to claim to be efficient. This highlights that major differences still exist between the DNO groups and Ofgem must be very confident in the benchmarking methodology employed to ensure that only a truly efficient DNO is considered well justified. The CEPA analysis demonstrates the risk that fast tracking companies that are not upper quartile efficient could be a significant detriment to customers. Full details are contained within annex 4.

10. We support a cost of equity range between 6.0-6.5%, as demonstrated by the CEPA analysis. This shows that the allowed risk-free rate should be between 1.5-1.75% rather than the DNOs’ 2.0%. to reflect current market evidence, whilst taking a long term view of the market cost of equity and allowing a degree of headroom. See paragraph 28 and annex 2 for further analysis on the weighted average cost of capital.

11. Again, we urge Ofgem to publish the annual reports showing the historical performance of the DNOs so all stakeholders can gain a better understanding of the current trends and assist our benchmarking analysis of their business plans. The last published annual report relates to 2010/11 and we expected the 2011/12 version to have been published in March 2013.

12. We have had great difficulty understanding the business plans in terms of the assistance DNOs will offer suppliers with the smart meter rollout and the evolution of smart grids. It is not clear to us whether all the benefits from smart meter data have been thought through and captured, given the different varying values and reasons for cost saving or cost avoidance. We discuss this further in the next answer.

13. We remain concerned that the quality of supply outputs and incentives will give DNOs large rewards for no real improvement in service. DNOs are currently significantly outperforming their DPCR5 targets. Based on DNOs own latest forecast information, distributors will receive rewards in excess of £500m from the Quality of Supply Incentive for performance in the DPCR5 period. The magnitude of these rewards demonstrates the risk associated with setting targets up front based on lagged performance data.

14. Based on the targets published by Ofgem in the March-13 Strategy decision document, we estimate that by simply maintaining DPCR5 levels of performance networks would receive over £100m in rewards during RIIO ED1. This does not seem appropriate and reinforces our view that the rate of return being requested by the DNOs is not acceptable given that additional return is being presented through this incentive.

Do the plans include relevant information necessary for you to understand the impact of these plans on your interests?

15. As active members of the Smart Grids forums and having just installed our millionth smart meter, we are very keen to understand how the DNOs will support the smart meter rollout and what changes they will make to their organisations to develop the opportunities from smart data, grids etc. We are disappointed by the lack of information from some DNOs about this key project for Great Britain and what appears to be lack of thought about the benefits and uses arising from smart data.

16. We note that 3 DNO groups have included approximately £130m savings from smart meters / grids but these DNO groups range from 2 – 4 regions and their cost savings arise from differing areas with little consistency. For example, UKPN expects to save £135m from reduced fault finding costs and site visits avoided, whilst WPD have forecasted £130m savings from reduced reinforcement. We strongly believe that even these savings are underestimated and could either lead to serious inefficiency by DNOs not taking advantage of the data by changing their working practices, or unwarranted gains through the IQI mechanism.

17. We also have concerns over the role DNOs will take or be encouraged to take with Demand Side Response and it is not clear what position each DNO is pursuing for RIIO-ED1. We strongly feel that a competitive environment will enable the benefits of DSR to be passed down to consumers and without suppliers and third party aggregators involvement consumer detriment will be significant. We are concerned that the DNOs will be funded to build DSR/DSM offerings to customers via the LCNF and that the resulting products and services will not be as consumer engaging or efficient as a competitive market would develop.

Reflecting what customers value / stakeholder engagement:
Have the views you provided to the DNOs been reflected in their plans? If not, has the DNO explained why?

18. We have attended several DNO stakeholder events (but not all), responded to draft business plans and online surveys (where we have received notification in good time) and met with two DNO groups bilaterally. We have also participated in the DNO/supplier forums organised by the ENA. The stakeholder engagement appears to be wide ranging and attempts to be inclusive; however as a stakeholder with interests in every region giving significant resource to the DNO events has been difficult. Our own experience is that Northern Powergrid and UK Power Networks have held the most comprehensive direct engagement with us, with WPD also seeking active engagement and take a leading role in engagement with suppliers as a group.

19. Our views have been predominately related to ensuring value for money for our customers, including being able to predict the movement in prices and understand the benefits being passed back to consumers from smart data and the Low Carbon Networks Fund.

20. Whilst we welcome the price reductions, from all but one electricity distribution region, at the start of RIIO-ED1, the reductions are much smaller than we expected and we are not confident at this stage, particularly before effective benchmarking, that they offer customers value for money. The business plan reductions are compared to the final year of DPCR5,

which had the highest revenues following profiling by Ofgem. We feel there are further areas that need to be recognised in ED1, which will lower costs to customers. These include:

a. Reduced reinforcement costs arising from lower demand growth
b. Benefits from smart metering and emerging smart grids
c. Benefits arising from the customer funded LCNF projects, and
d. Impact of reducing depreciation for new assets from 20 to 45 years to be realised, with transition only when fully justified.

21. We have asked several times, to numerous DNOs for an understanding of the benefits from the LCNF and have yet to obtain a clear explanation, except where innovation funding has helped the DNOs to improve their environmental emissions and hence gain on this incentive. We remain hopeful that Ofgem will monitor the LCNF benefits closely and commence reopeners if innovation benefits exceed thresholds to be passed back to customers.

Do you consider that the plans reflect the interests of both existing and future customers?

22. The DNOs' innovation strategy is key to future customers and reaching the low carbon targets by 2050, we understand that the networks find predicting the future difficult but we feel that assuming 1% load growth and carrying on as normal will not address these issues. The majority of innovation strategies appear nondescript; not really telling their readers what they should expect from future plans.

23. We concur with the findings from the Consumer Challenge Group (as expressed at the Price Control Review Forum) that the innovation strategies' purpose are unclear and we have yet to see customer benefits from innovation.

Expenditure proposals

Do you consider that the DNOs have clearly justified and identified their operating and capital expenditure requirements to deliver the required outputs?

24. Unfortunately we have had limited time and resources to analyse the DNOs' expenditure plans to the depth we would consider appropriate enough to comment. However we hope that Ofgem are willing to listen to stakeholders' views leading up to the fast track and initial assessment, giving us more time to digest and compare the business plans fully.

Do you consider that the DNOs have adequately considered the potential efficiency gains from:

- *LCNF*
- *Future innovation*
- *Smart solutions (i.e. DSR)?*

25. No, we are very disappointed by the lack of information in the DNOs expenditure plans, particularly the benefits arising for customers from the consumer funded LCNF projects. The amount of benefits explicitly shown in the expenditure plans is extremely small and either not thought through or ignored within the business plan process. For example, there is limited consistency between the DNOs on how any benefits will arise from smart meter data and the values do not seem to correspond to the relative size of the network.

26. As for smart solutions, most of the DNOs have not expressed an opinion about Demand Side Response, let alone calculated the potential savings and benefits to consumers. Others have buried it along with their IT and customer strategies making understanding of their plans very difficult.

27. We are extremely concerned that innovation will be limited to where improvements will help with other incentives as we have seen with the GDNs. This would lead to triple rewards for the DNOs; for example, innovation that helps with environmental emissions, which in turn is more capex or opex efficient and paid through the LCNF. There is also potential for LCNF to improve customer satisfaction scores and increase rewards, via funding customer databases and we hope Ofgem remains vigilant for triple gains by the DNOs.

Financial Proposals

Do you have any views on the package of finance measures proposed by the DNOs?

28. We feel that the financial proposals from the DNOs are higher than we would expect from an efficient plan. We therefore asked CEPA to analyse the financial packages requested and have attached annex 2 to fully answer to this question. The highlights however are:

    - The cost of equity requested is too high and should lie between 6.0-6.5%. The main difference arises from the risk-free rate, where CEPA have calculated a range between 1.5-1.75%. This is within the context of an equity risk premium assumption of 5.0% and a long term view of the market cost of equity of 6-7%. Current market evidence would suggest that the market cost of equity is likely to be in the low to middle end of this range for ED1. A risk-free rate of 1.5-1.75% alongside a 5% equity risk premium assumption, takes account of current market evidence whilst allowing a sufficient degree of headroom.
    - The proposed cost of debt indexation mechanism contains implicit headroom and we foresee the DNOs continuing to outperform this index
    - We note that the financial packages requested are all dependent on the DNO being fast tracked, which would add on average 36 basis points to the total return. Our cost of equity range above is independent to returns from other mechanisms (such as incentives). We do not believe that a company that is 'slow' tracked should receive a higher cost of capital.

29. We do not believe that allowances should be granted for real price effects (RPEs). Wages in both the private and public sectors remain consistently below inflation and it is unclear why networks should be protected from this economy-wide effect. All recent price control settlements can now be seen to have been overly generous in this area and it is important that the lessons are being learnt from those experiences.

Uncertainty and risk

Do you consider that the plans present a comprehensive consideration of the sources of uncertainty they face, including uncertainty in relation to the low carbon future?

30. The load growth assumptions for DPCR5 have turned out significantly higher than was expected in 2008/09 and we could have the same situation again if DNOs are overcompensated based on their estimations of economic recovery.

31. We would welcome a more comprehensive strategy of how the DNOs will flex their organisations to cope with changes to the low carbon future and innovation, at the moment the business plans remain unclear and very difficult to compare. Perhaps the ENA can help their members pull together either a consistent plan or at least help stakeholders understand the differences in approach.

32. We remain hopeful that a reopener is raised that actually returns money to consumers where the risk turns out to be favourable or not as significant as feared. There needs to be a mechanism where stakeholders can influence Ofgem to look into positive / favourable outcomes on behalf of consumers rather than the requests for money when incentive schemes or plans turn out not in the networks' benefit.

Other issues or aspects of the business plans welcome

33. We are concerned that the DNOs appear to be incorrectly claiming for excluded services within their business plans. For example, NPG and ENW are still claiming revenues for ES4 without any costs being incurred, whilst WPD are claiming the opposite (which we assume to be error). We are unsure why these DNOs are doing this as we believe the situation has been clear since the start of DPCR5. We urge Ofgem to investigate and ensure the DNOs are all excluding these costs and revenues correctly.

34. As for business rates, we can see a large increase in rates for WPD being assumed from 2017/18. We believe that it is more appropriate to hold these flat given the uncertainty surrounding what the new level of rates will be, noting that any variances will be settled through the pass-through mechanism. Setting upfront allowances for pass through costs which are so much higher than current levels could create a perverse incentive for DNOs to not fully engage in ensuring the actual level of business rates are no higher than they should be.

Annex 1: Analysis of Interruptions Incentive Scheme

1. We remain concerned that the quality of supply outputs and incentives will give DNOs large rewards for no real improvement in service. DNOs are currently significantly outperforming their DPCR5 targets. Based on DNOs own latest forecast information, distributors will receive rewards in excess of £500m from the Quality of Supply Incentive for performance in the DPCR5 period. The magnitude of these rewards demonstrates the risk associated with setting targets up front based on lagged performance data.

2. We estimate that that by simply maintaining DPCR5 levels of performance networks would receive over £100m in rewards, based on the targets published by Ofgem in March. This does not seem appropriate and reinforces our view that the rate of return being requested by the DNOs is not acceptable given that additional return is being presented through this incentive.

3. Ofgem have recognised this concern through the proposed use of improvement factors for the RIIO ED1 target setting however we don't believe this approach goes far enough to prevent excessive rewards once again. Our concerns in this regard are raised further by Ofgem's proposal to <u>increase</u> the lag between performance entering the target setting. In DPCR5 Ofgem used data from 2005/06 to 2008/09 to calculate targets to apply from 2010/11 (year t-5 to year t-2), and despite the expected rewards of £500m resulting from the soft DPCR5 targets, Ofgem are now proposing to use data from 2009/10 to 2012/13 to set RIIO ED1 targets, an increase in the lag to year t-6 to year t-3.

4. We continue to believe that setting targets so early in the RIIO ED1 process based on such lagged performance is inappropriate, even with the improvement factors assumed by Ofgem. The step change in performance from 2011/12 onwards by DNOs must be captured in the targets for RIIO ED1 to prevent locking in rewards for DNOs without any incremental

improvement in performance. This is clearly demonstrated by the following extract from the UKPN business plan:

Figure 2 EPN's unplanned interruptions performance

Figure 3 LPN's unplanned interruption performance

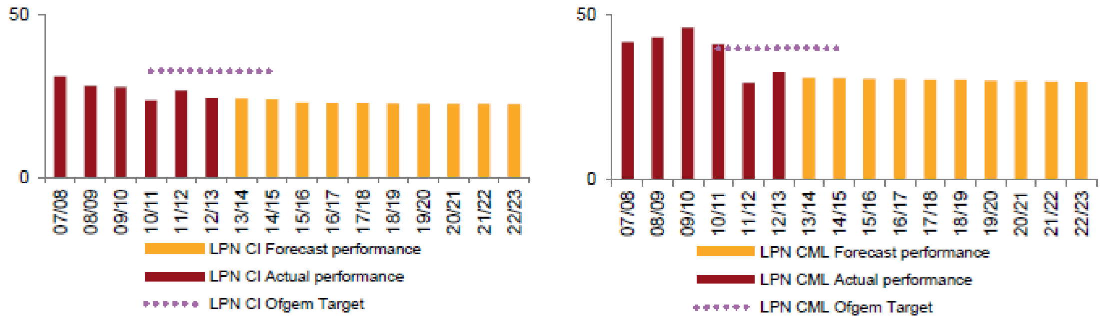
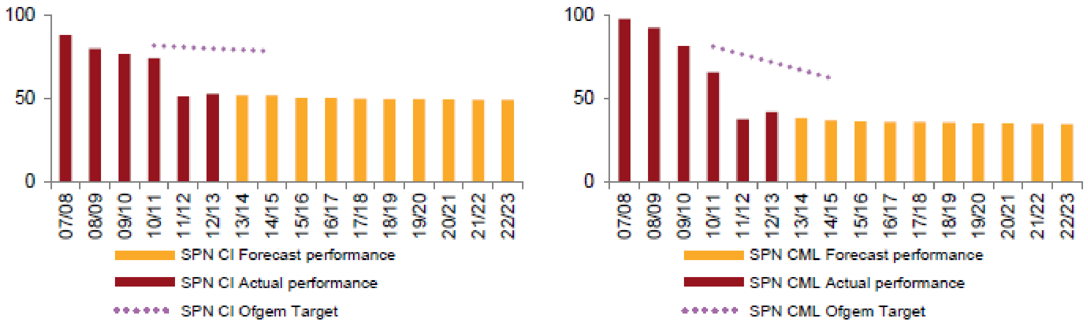


Figure 4 SPN's unplanned interruption performance



5. The above charts, taken directly from the UKPN business plan show that for all three licence areas, UKPN are simply proposing to broadly maintain the performance levels they have been achieving since 2011/12.

6. UKPN's allowed revenue forecast provided to the industry in May shows that the step change improvement in performance across the UKPN areas in 2011/12 resulted in rewards of c. £40m for that year alone. In that forecast of allowed revenue UKPN also forecast similar levels of rewards (c. £39m) in relation to 2012/13 performance and whilst the May forecast shows lower expected levels of rewards for 2013/14 and 2014/15 performance (c. £20m in each year), we note that these would now appear to be very conservative estimates given the charts above show that UKPN expect to maintain performance at 2011/12 and 2012/13 levels. Therefore, even on the conservative basis contained in UKPN's May allowed revenue forecast, the step change in performance made by UKPN in 2011/12 will result in a generous reward for the overall DPCR5 period of c. **£130m**.

7. Looking ahead to RIIO ED1, we have estimated the rewards that would be received by UKPN based on the above forecast performance using the proposed targets published by Ofgem in their Strategy decision document. Our calculations suggest that the forecast RIIO ED1 performance by UKPN, which broadly simply maintains performance at the levels achieved since 2011/12 would result in a further reward for UKPN over the RIIO ED1 period of c. **£220m**. Clearly such levels of reward for no improvement in performance are not appropriate.

8. Such a scenario is not limited to UKPN. WPD, following their purchase of Central Networks, also made a similar step change improvement in performance in 2011/12 in the East Midland and West Midland regions and to an even greater extent. Rewards received for 2010/11 performance totalled £12m for these two areas but WPD's May allowed revenue forecast shows expected rewards from 2011/12 to 2014/15 averaging £50m/yr so that in total WPD will have received an even more generous reward for performance in the DPCR5 period of **c. £215m.** By backward engineering the estimated CI/CML performance figures that would deliver such levels of rewards we estimate the reward for the RIIO ED1 period for these two regions to be c. **£160m**, assuming no improvement in performance from average 2011/12 to 2014/15 levels and the targets proposed by Ofgem in their Strategy decision.

9. We acknowledge that Ofgem will go through another round of refining the targets for RIIO ED1 to include 2012/13 performance but we do not believe this will go far enough to prevent unwarranted rewards for some DNOs. 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, especially given that the step change improvement achieved in 2011/12 by two of the six DNO groups is far in excess of the cumulative 8 year improvement that will be captured by the proposed improvement factors. 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 so early in the price control process will achieve this. Our preference for target setting continues to be a rolling average basis with an agreed lag between performance entering targets (we suggest 4 years), however at a minimum we would seek that any upfront targets for RIIO ED1 should take account of performance in the period 2010/11 to 2013/14 i.e. a similar lag to that used for DPCR5 up front targets, and still have improvement factors applied. This would at least capture more of the step change in performance in 2011/12.

10. We also consider that there should be significantly greater transparency and clarity surrounding the expected rewards for the interruptions incentive scheme. All DNOs should provide a detailed breakdown of their forecast annual CI/CML performance (as UKPN have done) and Ofgem should then be transparent about the effect of its targets on the expected revenues of the DNOs.