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6th December 2013

Dear Tim,

Further consultation on restatement of 2009-10 data and closing out the DPCR4 losses incentive mechanism

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

We remain very concerned at the level of rewards being proposed. The proposed total incentive rewards that result from the restatements under the various assessments, ranging from £334m to £377m, are not credible given that DNOs have provided **no evidence** that their investment plans have been altered by the losses incentive, or that customers have received benefits, in a way which would warrant any significant reward under the scheme.

The importance of considering value for money for customers is highlighted in the current economic climate, with the necessity for strong justification of customer funding never clearer. We estimate that even only looking at the DNOs returning the £430m received would be worth £9 per household on average, before considering the further impact of the overall penalty that applies if the scheme is allowed to function as agreed (without data restatements).

We remain committed to finding a solution that provides an appropriate return for any progress DNOs made in reducing losses during the DPCR4 period, whilst protecting customers from excess rewards resulting from a flawed method of restating performance. We recognise that Ofgem has made good progress, through an engaged process, towards resolving this issue but continue to have a number of serious concerns with respect to Ofgem's proposals for the close out of the DPCR4 losses incentive. The most significant of these concerns being:

- Ofgem's vanilla assessment proposes an overall outcome to the DPCR4 losses scheme of a £334m[1] reward to DNOs. This represents a £473m increase in reward for the DNOs, compared to the outcome if no restatements were permitted and the scheme ran as intended and agreed at DPCR4.

[1] £334m is the £221m for the LRRM plus the £113m windfall received during DPCR4 for DPCR3 units which did not affect DPCR4 targets.

- The statistical test for abnormality presumes that there is a 'normal' level of settlement reconciliation. This fails to recognise that changes in the underlying level of demand are the primary driver for the volume of settlement reconciliations. Demand has been falling since 2005, and it is this falling demand which is the primary driver for the negative settlement reconciliations observed during DPCR4. Since there is no 'normal' level of settlement reconciliations, the 'SF adjustment' should not be applied. If networks can not demonstrate abnormality on unadjusted data then we consider the case for restatement is not proven.
- The proposed 'normal period' for restatement contains years with non-credible levels of losses for the majority of the DNOs applying for restatement. Ofgem has consistently stated that the normal period should not contain years with non-credible levels of losses.
- Without the application of the credibility cap, which itself is unduly lenient, the restatements lead to a total reward of **£537m** for the DPCR4 period, which is so implausible as to effectively discredit the SP method of restatement as it is being applied.
- The approach to the cap with respect to the two independent credibility thresholds (taking the lower of the two) results in outcomes which are not credible since any capped performance will always fail one of the credibility thresholds.
- Networks continue to be permitted to include non-settlement adjustments without evidence that such adjustments were performed in 2002/03. Evidence is necessary to demonstrate that the adjustments are consistent with how targets were set. UKPN are the most significant example of this, with these adjustments permitted giving a proposed DPCR4 reward for UKPN alone of **£233m**.

Our preference throughout this process, in order to preserve the integrity of the price control settlement and ensure regulatory certainty for all parties, has been for the incentive scheme to run as originally intended *in its' entirety* i.e. without changing any data. DNOs were (or should have been) well aware of the volatility of settlements data when the price control settlement was agreed. It is clear that once all the data has been amended from that originally specified, ensuring regulatory certainty, or honouring the original price control settlement, is no longer possible. If restatement is to be considered then we believe the following are key considerations towards achieving a fair outcome:

- If DPCR4 data is not viewed as sufficiently reliable to rely upon, and given that no party appears to be arguing that DNOs can, or have, had a significant impact on losses, a possible alternative approach would be to set the close out to ensure the overall rewards received for the DPCR4 period are zero.
- Data should be tested for abnormality before any adjustments are made to it and certainly before data is normalised, as this prejudges abnormality and we do not consider that a 'normal' level of settlement reconciliation exists.
- If any abnormality is then proved, the method for recalculating restatements must be sufficiently robust to justify the financial impact. The method selected is contentious at best and cannot be considered sufficiently robust to justify the massive rewards suggested.

- Again given that no party appears to be arguing that DNO can or have had a significant impact on losses, it is essential to have in place an effective 'credibility cap' on rewards, to protect customers and limit windfall gains. We consider the rationale for a credibility threshold with respect to the target to be robust, however in the absence of any evidence that DNOs investment plans have been altered by the losses incentive in a way which would warrant any significant reward under the scheme then we consider the appropriate credibility cap should be closer to 0% than the proposed 5% since the 5% threshold still translates to a significant potential reward of c. £250m.
- Given the lack of certainty surrounding any of the data from the DPCR4 period, we believe that the credibility threshold with respect to the DPCR4 period could be removed.

The remainder of our response is structured as follows:

Appendix 1: Detailed analysis of the close-out of the DPCR4 Losses Incentive Scheme
Appendix 2: Answers to consultation questions

If you have any questions in relation to any part of our response please do not hesitate to get in touch with me.

Kind regards,

Andy Manning
Head of Network Regulation, Forecasting and Settlements
British Gas
[via e-mail]

Appendix 1: Detailed analysis of the close-out of the DPCR4 Losses Incentive Scheme

We continue to believe that the proposed outcome for the DPCR4 losses scheme is not credible. We set out below our analysis of the factors that have contributed to this outcome. We group these into 4 categories:

(A) Ofgem criteria have not been fully adhered to
(B) The safeguards set out in the March and July 2012 documents have not been fully applied
(C) The statistical test does not take account of changes in the underlying level of demand
(D) The application of the credibility thresholds is inappropriate

(A) Ofgem criteria have not been fully adhered to

In their March 2012 and July 2013 decision documents Ofgem set out a range of criteria that they had regard to in discharging their primary statutory duty to protect customers in arriving at their decision to permit restatement using the SP method. We list the criteria below and provide our views on whether Ofgem's proposed close out the DCPR4 losses incentive mechanism aligns with this criteria.

Criteria 1: The purpose of the distribution losses incentive mechanism, which is to drive the DNOs towards achieving lower levels of losses on their distribution networks*:*
DNOs have still provided **no evidence** of any incremental investments they have made, over and above those funded through their base allowances, to achieve lower levels of losses on their distribution networks. We believe that DNOs would be highly likely to offer any evidence that would support a reward and so are of the view that no significant incremental investment has taken place.

Criteria 2: The principle that restatement in any given instance, will only be appropriate where the Authority is satisfied that there is a defect in the way in which the mechanism would operate in the event that restatement were not to be allowed, for instance by creating an inconsistency between target setting and performance monitoring*:*
Ofgem have put a heavy reliance on maintaining consistency between target setting and performance monitoring.

We have significant concerns over the approach being applied for UKPN. Ofgem's vanilla assessment will result in a net reward for UKPN of £233m for the DPCR4 period, compared to a net reward of £91m if no restatement was permitted. A reward of £233m with no evidence of any carbon reductions, or customer benefit, is not credible in and of itself. UKPN has been permitted to restate settlement data for 2009/10 to remove perceived negative data corrections made by suppliers and yet have then been allowed to add back a significant volume of its own positive data adjustments. We believe that unless strong evidence is provided that confirms that such data adjustments were performed in each of the UKPN licence areas in 2002/03 (the licence reference year for ensuring consistency with target setting) then they should not be permissible for inclusion for the close out of the losses incentive. Given the importance of this issue and the materiality of the proposed reward for UKPN, we consider such evidence, and its strength, to be crucial.

We consider the same issue applies to WPD South West and South Wales, albeit to a smaller degree. Ofgem have permitted WPD to make non-settlement adjustments for these two regions, stating that such adjustments were the practice reported under SLC47 (annual revenue returns) however we do

not believe this is fully accurate. Our understanding is that these non-settlement adjustments only began in 2009/10 (which we note was reported after DPCR5 Final Proposals). We therefore do not consider these adjustments to be consistent with the basis of target setting.

Our concerns with regards to SSE also remain. SSE did not use settlement data for their historical reporting, and targets were also set on this basis. Therefore settlement data reconciliations should have no effect on SSE's reported performance for the purposes of calculating the LRRM. However Ofgem's latest consultation continues to calculate the close out amounts for SSE purely on the basis of settlement data.

Ofgem's justification for this is approach is that it maintains regulatory certainty. However, we do not consider it to be fair for customers to argue that using pure settlement data for SSE, even though it is inconsistent with the basis on which its targets were set, maintains regulatory certainty, whilst simultaneously arguing that regulatory certainty is also maintained by permitting other DNOs, whose targets were set on the basis of settlement data, to adjust their pure settlement data.

Criteria 3: The need to ensure equality of treatment of licensees, with any difference in treatment as between licensees being objectively justified:

Ofgem are not treating UKPN equally compared to other networks. The DPCR4 losses incentive was only ever intended to remain open until DF settlement corrections were complete. This was clearly expressed in the proposals for DPCR5. This would mean that the incentive should have been closed by July 2012 (28 months after March 2010). This is consistent with Ofgem's original July 2012 data request. The delay since July 2012 has been caused by errors in the data provided by DNOs and misinterpretations of policy by DNOs. Therefore any changes to data from July 2012 should only be to correct for these issues. However in relation to UKPN Ofgem are now permitting the inclusion of non-settlement data adjustments (with no evidence that these adjustments were performed in 2002/03) up to March 2015 i.e. allowing units 'found' up to September 2013 and even including an estimate of units yet to be found up to March 2015. This is clearly inappropriate and is effectively allowing UKPN to claim incentive rewards for activities it undertook in response to the proposed DPCR5 losses incentive via the close out of the DPCR4 incentive. It is not clear to us why the DPCR4 incentive scheme has been extended for UKPN alone, especially given their proposed reward of £233m.

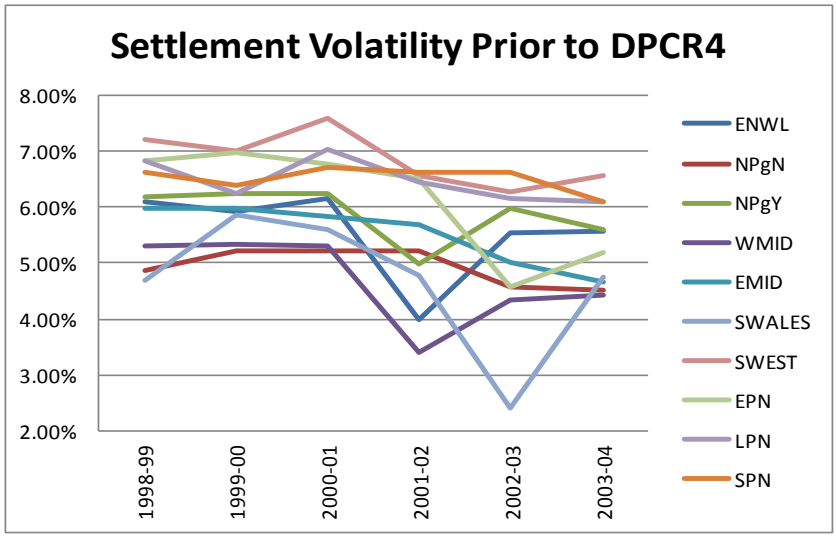
UKPN also seem to be testing for abnormality by first removing their own non-settlement data adjustments, then calculating the resulting adjustment via the restatement process, and then adding back their own non-settlement data adjustments. This is inconsistent with the approach adopted by WPD, the other DNO who have included non-settlement adjustments in their restatement data, and is also inconsistent with the approach previously applied by UKPN in their July 2012 restatement application. No objective justification has been provided for allowing this change in approach over time by UKPN or for allowing a different approach between DNOs.

Clearly, in the case of SSE, Ofgem are not treating licensees equally since other licensees are being held to their reporting methodology for the close out of the DPCR4 losses incentive whereas SSE are using a data set (pure settlement data) to measure 2009/10 losses to compare against targets which were set on the basis of their reporting methodology which ignored settlement data. We do not believe that providing SSE with an overall losses reward of £89m for performance measured on a basis wholly inconsistent with the basis on which targets were set can be objectively justified.

Criteria 4: The desirability of promoting regulatory certainty, for the benefit of industry and the public:

Settlement volatility is not new, as evidenced by some of the unfeasibly large swings in annual losses reported during DPCR3. Chart 1 below shows the volatility in reported losses in the years preceding their decision to accept the DPCR4 price control for those DNOs applying for restatement.[2]

Chart 1: Settlement Volatility Prior to DPCR4



We estimate that DNOs benefitted substantially from this settlement volatility during DPCR3. Our calculations suggest that overall rewards relating to the DPCR3 period are likely to have been over **£400m**, of which c. £200m was not taken account of in the setting of targets for DPCR4.

The Sohn Associates report on Non-Technical Losses published on the Ofgem website[3] explains that these kinds of changes in reported losses are not technically feasible. Therefore DNOs, who are the experts on distribution losses, would have been fully aware when they accepted the DPCR4 price control i.e. they had regulatory certainty, of both the ability and the likelihood of settlement volatility to cause large swings in reported losses. **Regulatory certainty therefore requires that the DPCR4 losses incentive is closed out in the manner agreed at DPCR4 and DPCR5**.

The un-restated 2009/10 data would result in an overall penalty of £253m for the DPCR4 LRRM, therefore our calculations suggest that for the combined DPCR3 and DPCR4 period networks would still be receiving a reward of over £150m despite providing no evidence that their investment plans have been altered by the losses incentive in a way which would warrant any significant reward under the schemes.

For clarity, although this may appear obvious, to allow DNOs to restate performance when they were fully aware of, and accepted, the volatility of settlements as part of DPCR4 is completely contrary to promoting regulatory certainty. Indeed, the evidence of the estimated rewards under DPCR3 indicates that to allow substantial rewards from such restatements would undermine the

[2] Data for DNOs applying for restatement sourced from Ofgem's supplementary data '*DPCR4 losses targets.xlsx'. We exclude SP as we understand the data changed as a result of the 2005-06 investigation.*

[3] https://www.ofgem.gov.uk/publications-and-updates/electricity-distribution-systems-losses-non-technical-overview

value of incentive schemes in general to customers. In DPCR3, where data was in the favour of the DNOs, it went unchallenged. If when data is adverse it can simply be restated, incentive schemes become one-way in nature and so the customer can only lose out.

Criteria 5: Our assessment of the merits of addressing any particular defect and the qualities of the methodologies proposed to achieve this, for instance, the relative accuracy of the data that result from the adjustments:

We have identified a further weakness in the statistical test in that it fails to recognise that the level of settlement reconciliations is fundamentally driven by changes in the underlying level of electricity demand. Since demand has been falling since 2005 it is entirely normal to observe continued negative reconciliations. In our response to question 1 of Chapter 3 (in appendix 2) we estimate the expected levels of reconciliations given the observed changes to underlying demand and we conclude that the negative settlement reconciliations observed during DPCR4 are not inappropriate given the observed changes in demand. We believe our analysis demonstrates that the conclusions previously drawn by Ofgem and the DNOs from the cusum analysis are flawed. It also casts significant doubt on the entire premise of the statistical test for abnormality.

With respect to "***the relative accuracy of the data that result from the adjustments"***, we note that the outcome which would result from the uncapped DNO applications, a net reward for the DPCR4 scheme of **£537m**[4], and the implied reduction, is so implausible as to effectively discredit the method of restatement as it is being applied.

We believe a key driver for this inaccurate outcome from the restatement methodology is that Ofgem's proposed normal period for restatement contains non-credible levels of losses for the majority of DNOs, contrary to Ofgem's, quite correct and sensible, assertion that the normal period must contain only credible losses.

(B) The safeguards set out in the March and July 2012 documents have not been fully applied

In their March 2012 document entitled "**Further information on requirements when applying for restatement of 2009-10 distribution losses data**" Ofgem stated that they would apply a cap on restatement in instances where:

1. a licensee can identify abnormal activity affecting 2009-10, but is unable to establish a normal period
2. a licensee's restatement application accords with the tests and principles but the restated performance is not credible

In such circumstances any restatement application will be capped such that the **restated gross close out of DPCR4** may not be greater than if the average performance for the first three years of DPCR4 was maintained during 2008-09 and 2009-10.

We disagree with the use of the first three years performance as an arbitrary cap on the close out of DPCR4 since they are likely to contain years with abnormally low levels of losses and therefore will still result in unwarranted gains. In the data request of July 2012 Ofgem added further clarity to this safeguard by stipulating that only years with credible losses would be included in deriving the average performance for the purposes of the cap.

[4] £424m as per the DNO submissions plus £113m for residual DPCR3 units

In the July 2013 document Ofgem identify that 2005/06 contains abnormally low levels of losses and consistent with their July 2012 position remove this year from the period to be used for the cap – our analysis shows that more than half of the networks which have applied for restatement recorded non-credible losses in this year as assessed by Ofgem's credibility test on fully reconciled data.

However, whilst removing 2005/06 should, in theory, provide more protection to customer, in practice the protection has been weakened by taking the remaining two years in this period, 2006/07 and 2007/08, and *applying a 5% reduction* on the average of these years for the purpose of the cap. The result of this revised approach is to considerably soften the cap in most cases as highlighted by Table 1 below. The table shows the change in the value of the credibility cap between the July 2012 document and the July 2013 document. This analysis shows that in the July 2013 document Ofgem **increased** the potential maximum rewards by £374m compared to our view of the safeguard contained in their July 2012 document.

Table 1: Ofgem change in permissible rewards (cap) between July 2012 and July 2013

	Old Cap Jul-12	New Cap Jul-13	New Cap vs Old Cap	Max LRRM Old Cap	Max LRRM New Cap	New Cap vs Old Cap
	avg losses 2005/06 to 2007/08 excl. non credible years	Min (target, 06/07 - 07/08) * 95%	Jul-13 vs Jul-12	Jul-12 Max Reward £m	Jul-13 Max Reward £m	Change in Max Reward £m
ENWL	5.26% (excl. 05/06)	5.00%	Cap Softened	£21	£39	£18
NPgN	5.30% (excl. 05/06)	4.94%	Cap Softened	-£5	£12	£16
NPgY	No credible data	5.59%	N/A	£20	£20	£0
WMID	5.30% (excl. 05/06)	4.71%	Cap Softened	-£24	£17	£41
EMID	6.02% (excl. 05/06)	5.41%	Cap Softened	-£26	£22	£48
SWEST	6.49% (excl. 05/06)	6.16%	Cap Softened	£20	£33	£14
EPN	6.57% (excl. 05/06 & 06/07)	5.57%	Cap Softened	-£25	£74	£99
LPN	5.73%	5.53%	Cap Softened	£68	£85	£16
SPN	6.66% (excl. 06/07)	6.14%	Cap Softened	-£8	£25	£32
SPD	5.98%	5.13%	Cap Softened	-£33	£15	£49
SPMW	6.02% (excl. 07/08)	5.15%	Cap Softened	-£27	£12	£40
				-£19	**£356**	**£374**

We also believe that the safeguards outlined with respect to the choice of normal period for the purposes of restatement have not been fully adhered to, to the detriment of customers. Ofgem have been consistently clear that reported losses performance during the normal period must be credible. However, as demonstrated below, Ofgem's chosen normal period for restatement contains non-credible levels of losses for the majority of DNOs.

In Table 2 below, we look at the appropriateness of the common normal period by comparing the Approach C losses with the credibility cap and the reciprocal cap. We note that 8 of the 11 DNOs that have applied for restatement report losses in 2005/06 which would fail Ofgem's credibility test and 6 DNOs (still more than half) would fail the test in 2006/07. The final column confirms that the common normal period being used for restatement contains non-credible losses for 7 of the 11 DNOs applying for restatement, whilst there is not a single DNO for whom the common normal period results in losses above the reciprocal cap.

Table 2: Credibility of Approach C losses

		Approach C Losses (%)				Common 'Normal' Period
		2005/06	2006/07	2007/08	2008/09	
ENWL	ENWL	4.7%	5.1%	4.8%	5.2%	4.9%
NPg	NPgN	4.7%	4.5%	5.2%	5.0%	4.8%
	NPgY	3.1%	4.6%	5.9%	5.4%	5.2%
WPD	WMID*	4.4%	4.9%	5.7%	5.1%	5.3%
	EMID	3.4%	5.7%	6.1%	5.9%	5.9%
	SWALES					
	SWEST	5.5%	5.6%	6.6%	5.9%	6.1%
UKPN	EPN	3.9%	5.3%	5.2%	5.2%	5.3%
	LPN	5.9%	5.3%	5.4%	5.9%	5.4%
	SPN	6.0%	5.3%	6.7%	5.8%	6.0%
SP	SPD	6.0%	6.2%	5.7%	6.8%	6.0%
	SPMW	6.2%	5.8%	6.5%	7.3%	6.1%
SSE	SSES					
	SSEH					

Below Ofgem's Credibility Cap
Above Ofgem's Reciprocal Cap

We believe that this inclusion of non-credible losses, contrary to safeguards outlined in previous documents, is the primary driver for the implausible outcome for the scheme if DNO submissions were accepted in full (a £537m reward). Whilst we acknowledge that the above table suggests that very few DNOs would be able to choose a normal period which is two years long which was also a criteria for the normal period, we consider that the need for a normal period to be at least two years long can only be desirable, whereas the need for it contain credible levels of losses is essential.

(C) The statistical test fails to take account of changes in the underlying level of demand

The statistical test for abnormality presumes that there is a 'normal' level of settlement reconciliation. This fails to recognise that changes in the underlying level of demand are the primary driver for the observed level of settlement reconciliations. Demand has been falling since 2005, and it is this falling demand which is the primary driver for the negative settlement reconciliations

observed during DPCR4. Chart 2 below takes data from the Digest of UK Energy Statistics (DUKES)[5] and shows the overall levels of demand (consumption) from 1987 to 2012. We plot three series:

Total Production: We include production to show that the level of change in total UK consumption is also observed in UK production, which is not affected by supplier settlement corrections.

Total Consumption: Changes in total UK consumption over time showing that demand has been falling since 2005.

Domestic Consumption: We include domestic consumption from the same source to show that NHH demand has shown a similar pattern to total UK demand.

Chart 2: GB Electricity Demand over time

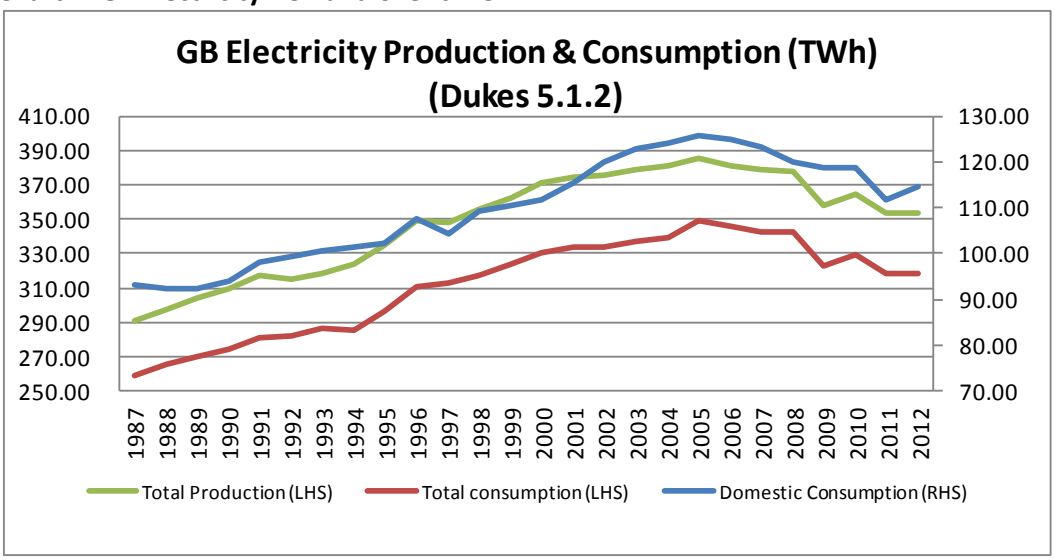
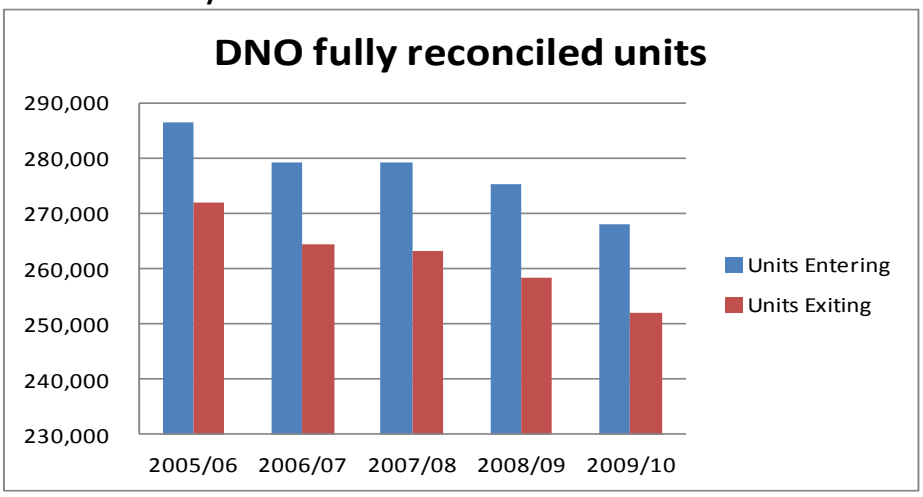


Chart 3 below confirms that this pattern of falling demand is also observed in the data reported by those DNOs applying for restatement, as we would expect to be the case.

Chart 3: DNO fully reconciled units



[5] https://www.gov.uk/government/publications/electricity-chapter-5-digest-of-united-kingdom-energy-statistics-dukes

Falling levels of underlying demand will logically lead to continued negative levels of settlement reconciliations. The following extract from section 4.2 of the Engage Consulting "Explanation of the SP Methodology" paper explains why:

"*Whenever an AA is calculated, an annualised estimate of future consumption is also calculated. This Estimated Annual Consumption (EAC) is determined from the AA and the previous EAC. This has the effect of "smoothing" changes to EACs. These calculations are undertaken by Supplier agents, using industry standard EAC/AA software provided by ELEXON*."

The "smoothing" referred to above means that changes to the true level consumption for any NHH site is always lagged in settlements. Therefore in a scenario with sustained reductions in overall levels of demand this will naturally lead to continuous negative levels of reconciliations from the SF data (based on the "smoothed" EAC) to the later runs (based increasingly on the updated AA's).

Given that changes in the underlying levels of demand are the key driver to the extent of settlement reconciliations, we do not consider that a 'normal' level of settlement reconciliations exists.
If Ofgem insist on the current statistical test, looking at settlement reconciliations, then data should be tested for abnormality before it is 'normalised', as this prejudges abnormality.

(D) The application of the credibility thresholds is inappropriate

Given that no party appears to be arguing that DNOs can or have had a significant impact on losses, it is essential to have in place an effective 'credibility cap' on *rewards*, to protect customers and limit windfall gains. We therefore consider the most appropriate credibility test is relative to the target losses.

Ofgem's rationale for the threshold with respect to the target is contained in paragraph 2.49 of the consultation document:
"*2.49 In terms of the target, while outperformance to this degree is not exceptional in statistical terms, we feel that it reflects what is plausible in terms of performance in the absence of abnormal levels of data cleansing and what is reasonable in terms of protecting consumers from unusually low restated losses. This is particularly important given the monetary value attached to the losses incentive for the close out of DPCR4*."

We consider the rationale for a credibility threshold with respect to the target to be robust, however in the absence of any evidence that DNOs investment plans have been altered by the losses incentive in a way which would warrant any significant reward under the scheme then we consider the appropriate credibility cap should be closer to 0% than the proposed 5%, since the 5% threshold still translates to a significant potential reward of c. £250m across the DNOs.

The justification for the cap relative to the normal period is weaker and we do not believe that the current credibility cap with respect to the normal period is appropriate. It must be the case that if there was abnormal levels of settlement corrections taking place during 2009/10, then there must have been erroneously low levels of losses observed in earlier years of the DPCR4 period (or else there would have been nothing to correct during 2009/10). At the very least this means using any of the earlier years of data during DPCR4 must be approached with extreme caution. Given the likelihood that the earlier years of DPCR4 will contain abnormally low-level of losses, it is even more

challenging to justify reducing by a further 5%. We note that in all instances where the cap has been applied in Ofgem's assessment, it is the normal period cap which has been applied. Therefore the cap with respect to the target level of losses has provided no assurance.

We are content that the threshold which relates to the 'normal' period is removed. Since targets were based on a long term average, they are less affected by the settlement volatility in any individual year or years and represent the most valid credibility test subject to a reasonable band for potential improvement.

However, this is only a material issue because of an error in how the cap is currently specified. Independent justifications are provided for the two credibility tests employed but then the cap is set at the most lenient of the two. This means that any capped performance will always fail one of the credibility tests. In practice, all the capped rewards in this instance fail the credibility test comparing against targets and so will not be "*plausible in terms of performance in the absence of abnormal levels of data cleansing"* or "*reasonable in terms of protecting consumers from unusually low restated losses"*.

Therefore if there are to be two credibility thresholds then the cap must be set at the more stringent of the two values.

Appendix 2: Consultation Questions
CHAPTER: Two
Question 1: Do you have any views on whether any DNO should be able to use a different normal period based on strong evidence that 2006-07 and 2007-08 are inappropriate? What evidence should be considered?

We believe there is strong evidence that 2006/07 and 2007/08 are inappropriate to be used as a normal period, but in the context that they are inappropriate for Ofgem to select for use, rather than for DNOs to select alternative periods they may prefer.

In the November 2012 consultation it was clear to us that DNOs, who obviously have a vested interest, will cherry pick a normal period to provide a preferred outcome. Ofgem shared these concerns and this was the rationale for stipulating a common normal period in its July-13 document.

Whilst we have argued for the need for Ofgem to define the normal period, we are not convinced that a 'common' normal period is appropriate. It is quite feasible that for some DNOs the stipulated normal period will not be appropriate because it may contain years with non-credible levels of losses (either too high or too low). However, it clearly is not fair on consumers for Ofgem to permit those DNOs for whom the common period results in an adverse outcome to use a different period, whilst allowing those DNOs that benefit from the common period to retain those benefits.

We reproduce Table 2 below, which shows that 8 of the 11 DNOs that have applied for restatement report losses in 2005/06 which would fail Ofgem's credibility test and 6 DNOs (still more than half) would fail the test in 2006/07. The final column confirms that Ofgem's common normal period being used for restatement contains non-credible losses for 7 of the 11 DNOs applying for restatement, whilst there is not a single DNO for whom the common normal period results in losses above the reciprocal cap.

Table 2: Credibility of Approach C losses

		Approach C Losses (%)				Common 'Normal' Period
		2005/06	2006/07	2007/08	2008/09	
ENWL	ENWL	4.7%	5.1%	4.8%	5.2%	4.9%
NPg	NPgN	4.7%	4.5%	5.2%	5.0%	4.8%
	NPgY	3.1%	4.6%	5.9%	5.4%	5.2%
WPD	WMID*	4.4%	4.9%	5.7%	5.1%	5.3%
	EMID	3.4%	5.7%	6.1%	5.9%	5.9%
	SWALES					
	SWEST	5.5%	5.6%	6.6%	5.9%	6.1%
UKPN	EPN	3.9%	5.3%	5.2%	5.2%	5.3%
	LPN	5.9%	5.3%	5.4%	5.9%	5.4%
	SPN	6.0%	5.3%	6.7%	5.8%	6.0%
SP	SPD	6.0%	6.2%	5.7%	6.8%	6.0%
	SPMW	6.2%	5.8%	6.5%	7.3%	6.1%
SSE	SSES					
	SSEH					

Below Ofgem's Credibility Cap
Above Ofgem's Reciprocal Cap

We consider the above to be '**strong evidence**' that the common normal period is **inappropriate** for a number of DNOs, however not because it is adverse to them, but because it includes years with non-credible low levels of losses for the majority of DNOs. Ofgem has consistently stated that the normal period must contain only credible losses. We consider that the need for the normal period to contain credible losses must be more important than the need for it to be at least two years, especially given the small sample size.

Therefore, whilst we believe that it may well be justifiable for a DNO to be permitted to use a different normal period based on strong evidence that 2006/07 and 2007/08 are inappropriate, we consider it even more relevant and important for Ofgem to ensure that the normal period for all DNOs is appropriate by removing any years with non-credible losses in line with the policy it has stated on numerous occasions throughout this process.

In terms of the evidence required, we believe that at a minimum the years 2006/07 and 2007/08 need to be demonstrated to contain non-credible high levels of losses and we note that in the case of WPD East Midlands, this is not the case.

WPD appear to believe that GVC is the primary cause of negative levels of reconciliations. This is not the case, the level of reconciliations from SF is primarily driven by changes in the level of underlying demand with any GVC activity simply a secondary effect. We consider the reconciliations observed in the East Midlands to be reasonably consistent with the changes in the levels of demand that region has experienced. We also note that Central Networks, the previous owner of the East Midlands DNO region, published an article in Utility Week[6] which explained the reasons for the decrease in demand was directly correlated to changes in the retail price of electricity rather than any abnormal levels of settlement activity.

For any evidence to be 'strong' it should be accurate and robust enough to warrant the change in the level of reward and be presented in a balanced manner. Aside from the fact that negative levels of reconciliation are not abnormal in a scenario of reducing demand, we note that WPD are presenting comparisons of absolute levels of reconciliations between DNOs without taking any account of the relative size of those DNOs – this could easily be misunderstood.

In terms of the accuracy and robustness of WPDs evidence we note that in their application for a different normal period WPD provide the following statistics:

- 2009-10 **losses** for the Mid East are 133% greater than its 2006-07 losses compared with 503% for the DNO average; and
- 2009-10 **losses** for the Mid East are only 27% greater than its 2007-08 losses compared with 437% for the DNO average.

WPD argue that the above two statistics:

- show that levels of GVC in 2007-08 in the Mid East are very close to the levels of GVC applied in 2009-10
- provide strong evidence that the 2007-08 period is not normal for the Mid East.

[6] http://www.utilityweek.co.uk/news/demand-for-electricity-is-falling-even-without-the-credit-crunch/805392

We are unclear what WPD's statistics refer to – their 2009/10 losses are not 133% and 27% greater than their 2006/07 and 2007/08 losses. We believe WPD may instead be referring to their levels of settlement reconciliations.

However, even if we do assume that WPD mean the level of settlement reconciliations, it is not safe to assert, and certainly does not constitute evidence, that these negative levels of reconciliation are due to GVC activity. As we have already explained, the levels of settlement reconciliations are driven by changes to the underlying levels of demand.

WPDs evidence attempts to explain that the East Midlands region is different to the other regions, however it does not demonstrate why 2006/07 and 2007/08 is inappropriate for the East Midlands. We consider that if the 'evidence' does show anything it reinforces that 2006/07 and 2007/08 are not appropriate for the majority of the other DNOs, as losses as too low, consistent with our analysis that most DNOs reported losses in these years are not credible. By contrast the losses in these years for the East Midlands region are credible when tested against Ofgem's credibility thresholds.

Care is needed to ensure the WPD evidence is correctly interpreted, but, if it is, we believe clearly does not constitute strong evidence.

Question 2: Do you have any views on the suitable normal period to be used should a DNO demonstrate, based on evidence, that the stipulated normal period is inappropriate for the restatement process?

As we have highlighted above, we believe the normal period is inappropriate for the restatement process for the majority of DNOs since the levels of losses in these years fail the credibility tests for 7 of the 11 DNOs applying for restatement. Therefore Ofgem needs to review the normal period for all DNOs to ensure that it does not contain non-credible losses – either too low or too high. This may mean that the normal period is less than two years but we consider that the criteria that the normal period should contain credible levels of losses in much more important than the criteria that it should be at least two years in length.

If a different normal period is to be used then it is vital that it does not contain any years which can be demonstrated to be non-credible.

Question 3: Do you have any views on the application of the proposed credibility cap in relation to the restatement applications for both the annual incentive and the close out?

Given that no party appears to be arguing that DNOs can or have had a significant impact on losses, it is essential to have in place an effective 'credibility cap' on *rewards*, to protect customers and limit windfall gains. We therefore consider the most appropriate credibility test is relative to the target losses.

Ofgem's rationale for the threshold with respect to the target is contained in paragraph 2.49 of the consultation document:
"*2.49 In terms of the target, while outperformance to this degree is not exceptional in statistical terms, we feel that it reflects what is plausible in terms of performance in the absence of abnormal levels of data cleansing and what is reasonable in terms of protecting consumers from unusually low*

restated losses. This is particularly important given the monetary value attached to the losses incentive for the close out of DPCR4."

We consider the rationale for a credibility threshold with respect to the target to be robust, however in the absence of any evidence that DNOs investment plans have been altered by the losses incentive in a way which would warrant any significant reward under the scheme then we consider the appropriate credibility cap should be closer to 0% than the proposed 5%, since the 5% threshold still translates to a significant potential reward of c. £250m across the DNOs.

The justification for the cap relative to the normal period is weaker and we do not believe that the current credibility cap with respect to the normal period is appropriate. It must be the case that if there was abnormal levels of settlement corrections taking place during 2009/10, then there must have been erroneously low levels of losses observed in earlier years of the DPCR4 period (or else there would have been nothing to correct during 2009/10). At the very least this means using any of the earlier years of data during DPCR4 must be approached with extreme caution. Given the likelihood that the earlier years of DPCR4 will contain abnormally low-level of losses, it is even more challenging to justify reducing by a further 5%. We note that in all instances where the cap has been applied in Ofgem's assessment, it is the normal period cap which has been applied. Therefore the cap with respect to the target level of losses has provided no assurance.

We are content that the threshold which relates to the 'normal' period is removed. Since targets were based on a long term average, they are less affected by the settlement volatility in any individual year or years and represent the most valid credibility test subject to a reasonable band for potential improvement.

However, this is only a material issue because of an error in how the cap is currently specified. Independent justifications are provided for the two credibility tests employed but then the cap is set at the most lenient of the two. This means that since any capped performance will always fail one of the credibility tests. In practice, all the capped rewards in this instance fail the credibility test comparing against targets and so will not be "*plausible in terms of performance in the absence of abnormal levels of data cleansing"* or "*reasonable in terms of protecting consumers from unusually low restated losses"*.

Therefore if there are to be two credibility thresholds then the cap must be set at the more stringent of the two values.

Earlier in our response we have also highlighted that Ofgem's revised approach to the cap has **increased** the permissible rewards by £374m compared to the safeguard contained in their July 2012 document (see Table 1).

Question 4: Do you have any views on the suitable normal period to be used in the credibility criteria should a DNO convince us that the stipulated normal period is inappropriate for the restatement process?

We believe that the most appropriate credibility criteria should be relative to targets for all DNOs.

It must be the case that if there was abnormal levels of settlement corrections taking place during 2009/10, then there must have been erroneously low levels of losses observed in earlier years of the DPCR4 period (or else there would have been nothing to correct during 2009/10). At the very least this means using any of the earlier years of data during DPCR4 must be approached with extreme caution. Given the likelihood that the earlier years of DPCR4 will contain abnormally low-level of losses, it is even more challenging to justify reducing by a further 5%.

Question 5: Should we allow additional evidence for demonstrating abnormality for post 2009-10 years where a DNO fails the statistical test for these years (i.e. treat post 2009-10 years in the same way as 2009-10)?

Ofgem did not include an allowance for this in their July 2013 decision and therefore to allow additional evidence for year's post 2009/10 which do not pass the statistical test represents a potential further measure of leniency towards the DNOs, especially in any instance where the DNO has not passed the statistical test for 2009/10 as well. Given the level of rewards already received by the DNOs in question, without providing any evidence of any of any change in investment plans to reduce losses, the rationale for such leniency is unclear.

We note that the only DNOs that this would potentially apply to are NPG and WPD. With respect to these two groups we have the following comments:

NPG:
For both NPgN and NPgY we note that the normal period for restatement for both areas contains years with non-credible losses and indeed the overall normal period losses under approach C contains average losses which would fail Ofgem's credibility test for both regions (see Table 2 above). It would not be appropriate therefore to allow NPG to replace data which has *not* been shown to be abnormal, through the application of the statistical tests, with data which *has* been shown to contain low levels of losses which are not credible. This is especially the case given the current approach to the credibility cap.

We estimate that Northern Powergrid received approximately **£28m** in rewards for losses during DPCR3 and that Ofgem's vanilla assessment would provide them with a further total losses reward for the DPCR4 period of **£46m**[7] (compared to an un-restated penalty of £26m). To permit further evidence for years post 2009/10 which have failed the statistical tests would result in Northern Powergrid receiving a further £8m, meaning a net reward of £54m for the DPCR4 period, despite providing no evidence of any change in investment plans to reduce losses which may warrant such a reward.

[7] £46m is the £24m for the LRRM plus the £22m received during DPCR4 for DPCR3 units which did not affect DPCR4 targets

WPD EMID:
The East Midlands region data does not show any abnormality in any year and the final fully reconciled level of losses for 2009/10 is credible at 6.00% (vs target of 5.69% and a normal period of 6.02%). The East Midlands licensee published an article in Utility Week in 2009 which demonstrates that it fully understood the reasons for its underlying levels of demand. Given that these reductions in demand occurred alongside the negative levels of reconciliations they observed, we conclude that they understood that the two were correlated.

Therefore, WPD's current view which seems to be that negative levels of reconciliation is only caused by GVC activity is not accurate, nor is it consistent with the licensee's view at the time they accepted the DPCR5 price control.

We also note that WPD EMID has been shown considerable leniency in this process already by being permitted to test for abnormality on a basis which is significantly inconsistent with the DPCR4 reporting methodology, whilst taking no account of the impact such a reporting method would have had on their revenues. The effect of the use of provisions accounts, which delayed the reporting of final data until 4 years after the settlement date, we estimate was that the East Midlands DNO has already received revenues which are £37m higher than the level they would have been, had it always reported on the basis it now wants to test for abnormality.

We estimate that the East Midlands licensee received approximately **£35m** in rewards for losses during DPCR3 and that Ofgem's vanilla assessment (no restatement permitted) would provide them with a penalty of **£2m**[8] for the DPCR4 period. To permit further evidence for abnormality for 2009/10 and beyond would result in the East Midlands receiving a further £17m, meaning a net reward of £15m for the DPCR4 period despite providing no evidence of any change in investment plans to reduce losses which may warrant such a reward.

We therefore consider it would not be justified for Ofgem to allow other evidence for abnormality in 2009/10 or for subsequent years for WPD EMID.

WPD WMID:
As with the EMID region, we note that for the WMID region the statistical test fails to recognise any abnormality in all years although we recognise that the final fully reconciled level of losses for 2009/10 is deemed to be non-credible at 5.60% (vs target of 4.96% and a normal period of 5.34%).

The West Midlands licensee published an article in Utility Week in 2009 which demonstrates that it fully understood the reasons for its underlying levels of demand. Given that these reductions in demand occurred alongside the negative levels of reconciliations they observed, we conclude that they understood that the two were correlated.

Therefore, WPDs current view which seems to be that negative levels of reconciliation is only caused by GVC activity is not accurate nor is it consistent with the licensee's view at the time they accepted the DPCR5 price control.

We also note however that the West Midlands region has already been shown considerable leniency by being permitted to test for abnormality on a basis which is significantly inconsistent with the

[8] £2m is the £24m penalty for the LRRM plus the £22m reward received during DPCR4 for DPCR3 units which did not affect DPCR4 targets

DPCR4 reporting methodology. The effect of the use of provisions accounts, which delayed the reporting of final data until 3 years after the settlement date, we estimate was that the West Midlands DNO has already received revenues which are **£20m** higher than the level they would have been if the DNO had always reported on the basis it now wants to test for abnormality.

We estimate that the West Midlands licensees received approximately **£43m** in rewards for losses during DPCR3 and that Ofgem's vanilla assessment would provide them with a penalty of **£21m**[9] for the DPCR4 period (compared to an un-restated penalty of £26m). To permit further evidence for abnormality for years beyond 2009/10 would result in the West Midlands receiving a further £18m, meaning a net penalty of £3m for the DPCR4 period.

We also note that the average level of reconciliations for 2010/11 is in line with the reconciliations observed during the normal period. Therefore, whilst it may be appropriate to permit restatement for 2009/10 on the basis that the reconciled losses are not credible compared to the cap, we consider it would be not be justified for Ofgem to allow other evidence for abnormality in subsequent years.

Question 6: Do you consider that permitting restatement, based on exceeding the reciprocal cap thresholds with fully-reconciled un-restated data for 2009-10, is a fair and appropriate means of protecting consumers and DNOs from unreasonable outcomes in the close out process?

It is not fair on consumers to allow a single year of data being above the reciprocal cap to be enough to justify restatement, whilst permitting the 'normal' years being applied in the restatement process across the DNOs to contain numerous instances of losses which are below the level of the credibility cap as shown in our Table 2 above.

If the normal period were revised to remove **all** instances of losses below the level of the credibility cap across the DNOs, then it may be more acceptable to consider permitting restatement for those DNOs whose fully reconciled 2009/10 losses are above the reciprocal cap – however in the absence of the removal of non-credible low losses from the normal period for restatement we do not believe that any network should be allowed to restate losses because they are deemed to be non-credibly high.

Question 7: Do you consider that 'reported-equivalent' data compared with the reciprocal cap should be applied to post-2009-10 years as evidence that contributes to a case for identifying abnormality in those years?

As we have stated in response to question 6, it is not fair on consumers to allow restatement if the level of losses in a year is above the reciprocal cap when the 'normal' years being applied in the restatement process across the DNOs contain numerous instances of losses which are below the level of the credibility cap. This is especially the case in instances where the data that is being restated for an individual DNO uses years which are below the credibility cap.

[9] £21m penalty is the £43m for the LRRM plus the £21m received during DPCR4 for DPCR3 units which did not affect DPCR4 targets

In the absence of the removal of non-credible low losses from the normal period for restatement we do not believe that any network should be allowed to restate losses because they are deemed to be non-credibly high.

CHAPTER: Three
Question 1: Do you have any comments on the submissions from DNOs?

As we have previously informed Ofgem, falling levels of underlying demand will logically lead to continued negative levels of settlement reconciliations. The following extract from section 4.2 of the Engage Consulting "Explanation of the SP Methodology" paper explains why:

"*Whenever an AA is calculated, an annualised estimate of future consumption is also calculated. This Estimated Annual Consumption (EAC) is determined from the AA and the previous EAC. This has the effect of "smoothing" changes to EACs. These calculations are undertaken by Supplier agents, using industry standard EAC/AA software provided by ELEXON*."

The "smoothing" referred to above means that changes to the true level consumption for any NHH site is always lagged in settlements. Therefore a scenario with sustained reductions in overall levels of demand will naturally lead to continuous negative levels of reconciliations from the SF data (based on the "smoothed" EAC) to the later runs (based increasingly on the updated AA's).

Given that changes in the underlying levels of demand are the key driver to the extent of settlement reconciliations, we do not consider that a 'normal' level of settlement reconciliations exists. It is therefore inappropriate to "normalise" data before testing for abnormality, as this prejudges abnormality.

This also means that the CUSUM graph currently proposed as "further evidence" by Ofgem is not fit for purpose because it only looks at the amount of NHH reconciliations from the SF data without investigating whether such levels of reconciliations are to be expected given the background movement in overall levels of demand.

It is fairly straightforward to produce a measure of this background movement in levels of demand. Indeed, because the close out data includes both Units entering and HH units exiting we can go further and produce a reasonable measure of expected movements in NHH levels of demand which is independent of NHH settlement data and so cannot be claimed to be distorted by any abnormal settlement activity.

To do this we simply subtract the HH units exiting the network from the units entering the network which gives us a view of 'true' NHH units exiting (plus 'real' losses). For each month we then compare this estimate of NHH units with the estimate from a year before. The prior year figure is a proxy for the level of demand that will be inherent in the EAC from which the SF data for the current year will be based, and the current year figure is a proxy for the true level of NHH demand which settlements should eventually arrive at. Therefore one minus the other is a reasonable proxy for the level of reconciliations we would expect to observe through the settlement process.

For each DNO applying for restatement we provide a chart which compares our estimate of the expected level of NHH settlement reconciliations (CUSUM BG Est.) with the level of settlement

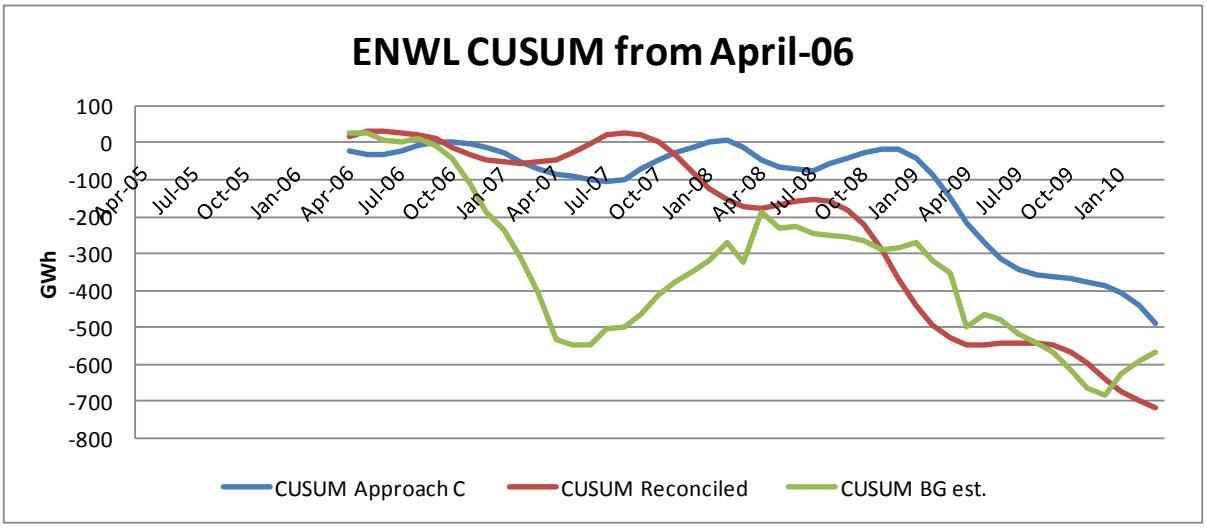
reconciliations included in the DNO submissions on both a fully reconciled basis (CUSUM reconciled) and approach C basis (CUSUM approach C, where provided).

We consider that with the possible exception of the UKPN EPN region the charts demonstrate that the observed aggregate levels of negative NHH reconciliations over the DPCR4 period are reasonably in line with what would be expected given the observed changes in the level of underlying demand (and indeed for some areas they are considerably lower than what would be expected). Certainly we believe that the CUSUM chart cannot be counted as evidence of abnormal supplier settlement corrections.

Note that the analysis only takes approach C and reconciled reconciliations from April 2006 (since the BG estimate requires a full year of data before an estimate can begin to be made)

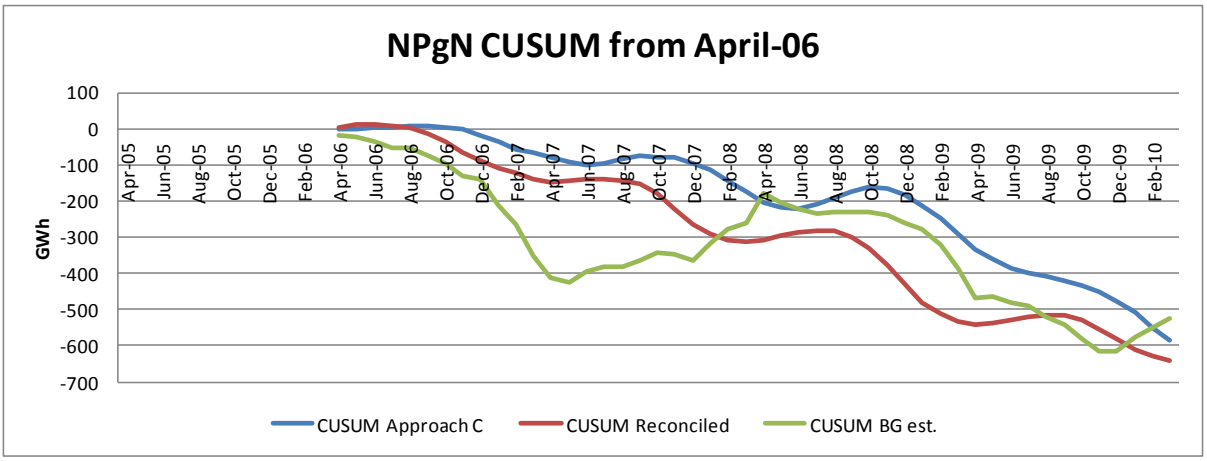
ENWL:
Does the normal period contain credible levels of losses? No, the overall normal period being used for restatement for ENWL does not contain levels of losses that are credible when measured against Ofgem's credibility thresholds.

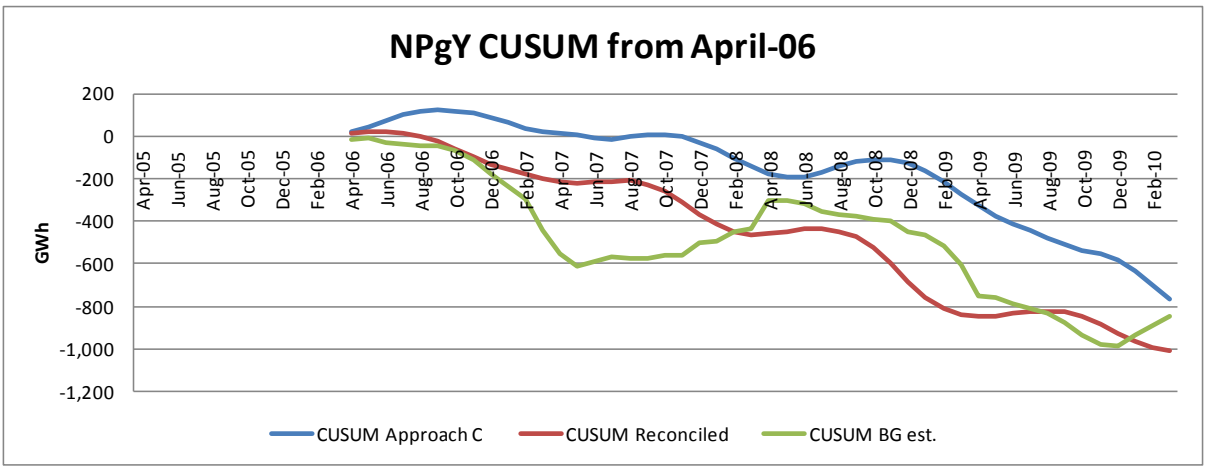
CUSUM Chart:



NPG:
Does the normal period contain credible levels of losses? No, the overall normal period being used for restatement for both NPG regions do not contain levels of losses that are credible when measured against Ofgem's credibility thresholds.

CUSUM Charts:

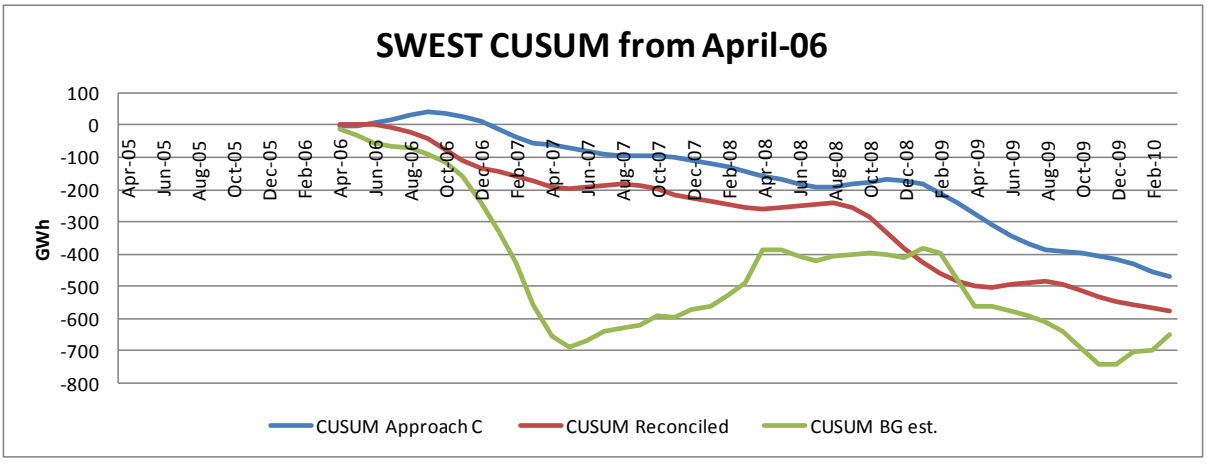


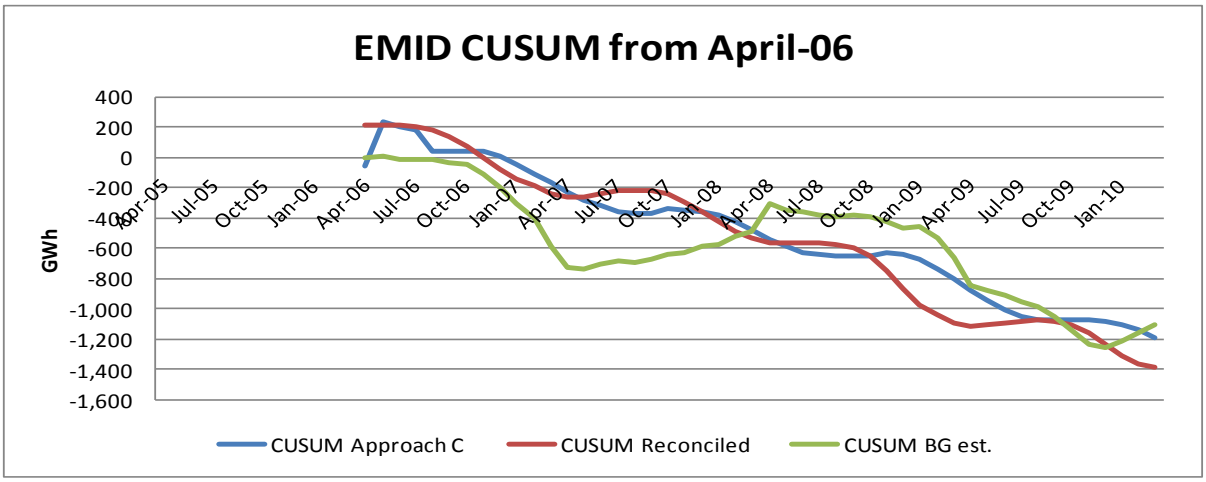


WPD:

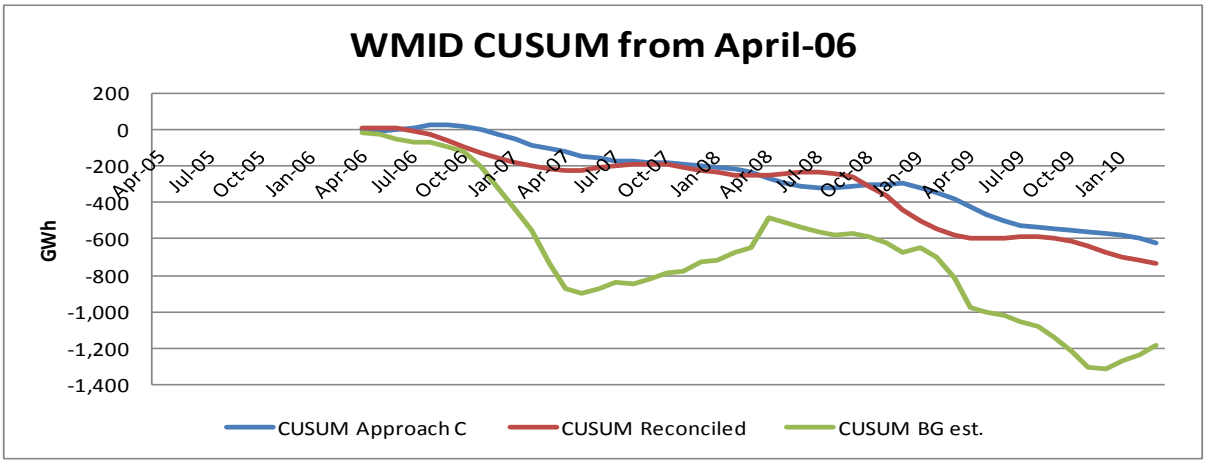
Does the normal period contain credible levels of losses? The overall normal period being used for restatement for the WMID and EMID regions contain levels of losses that are credible when measured against Ofgem's credibility thresholds. However the normal period for SWEST does not.

CUSUM Charts:





We observe that for the East Midlands region, there is what would appear to be a manifest error in the SF/R1 data for April 2006.



WPD appear to have the impression that ***any*** GVC activity in 2009/10 warrants restatement. The following extracts are taken from their submission documents:

"*The factual evidence therefore clearly demonstrates that GVC adjustments were made in 2009/10 and that a process for adjusting for GVC must be applied in order more accurately to reflect WPD's actual losses*" – taken from the WPD document entitled: "Commentary on factual evidence"

"*The intention of this process is to identify GVC where it occurred and use the SP method to remove it*" – taken from the WPD document entitled: "Reasons for using actual report date data in the GVC approach C v2".

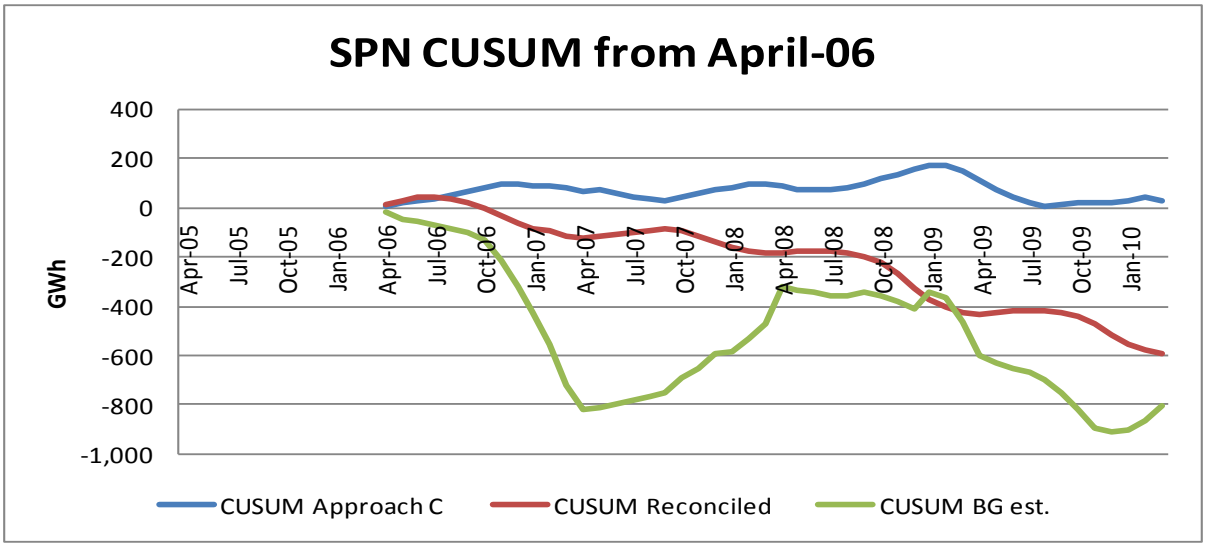
By contrast, paragraph A4.5 of Ofgem's consultation confirms our own understanding of the current process:
"*It is worth noting that our efforts are focused on addressing **abnormal** levels of data cleansing, rather than any level of data cleansing, since data cleansing has been long used historically by suppliers to correct settlement data.*"

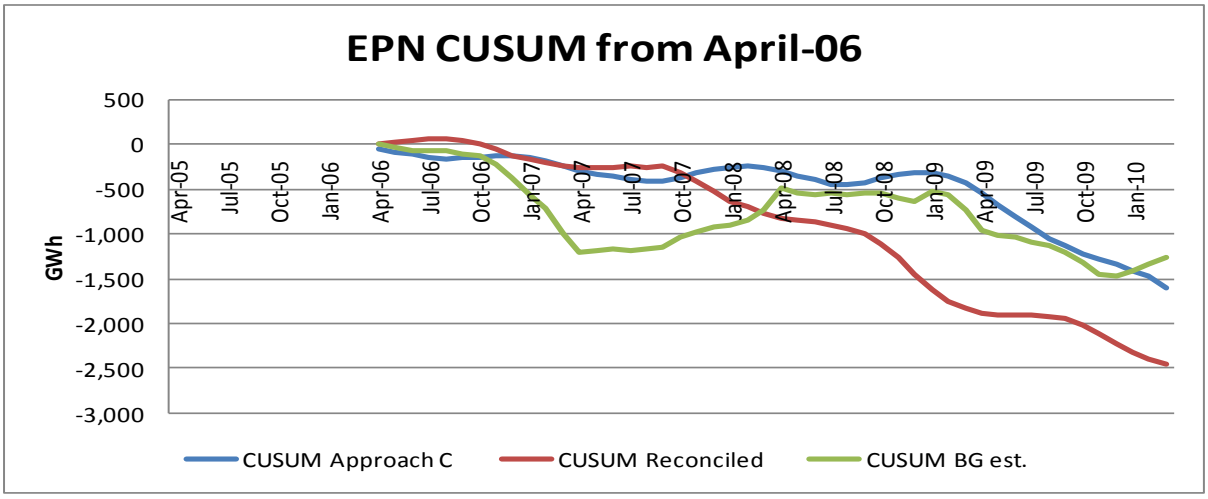
GVC was a normal part of settlements during DPCR3 and DPCR4, and the process we are currently going through is only looking at whether levels of settlement correction were abnormal. In our opinion, WPDs submission fails to address this issue.

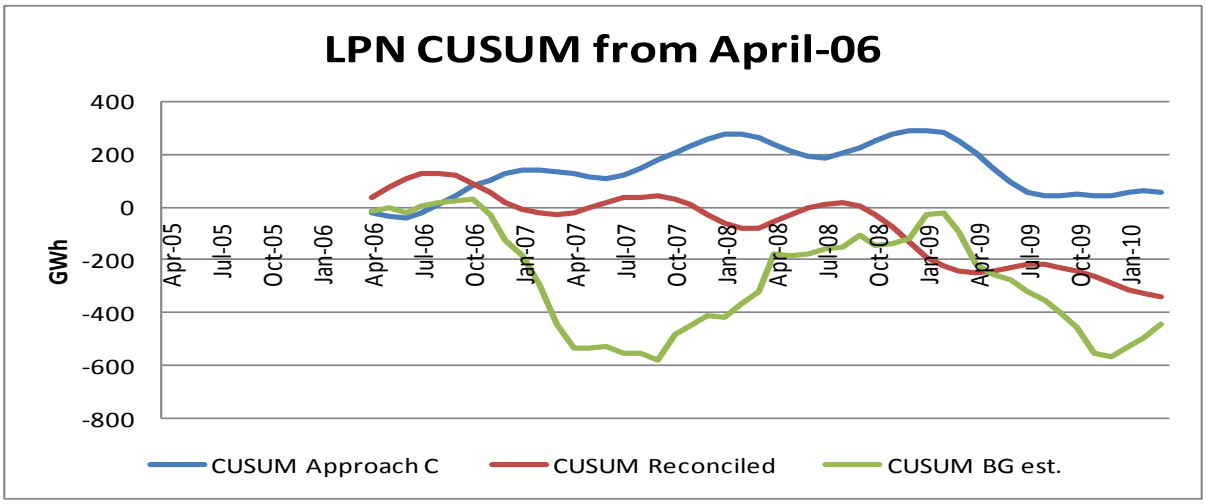
UKPN:

Does the normal period contain credible levels of losses? No, the overall normal period being used for restatement for all UKPN regions do not contain levels of losses that are credible when measured against Ofgem's credibility thresholds.

CUSUM Charts:



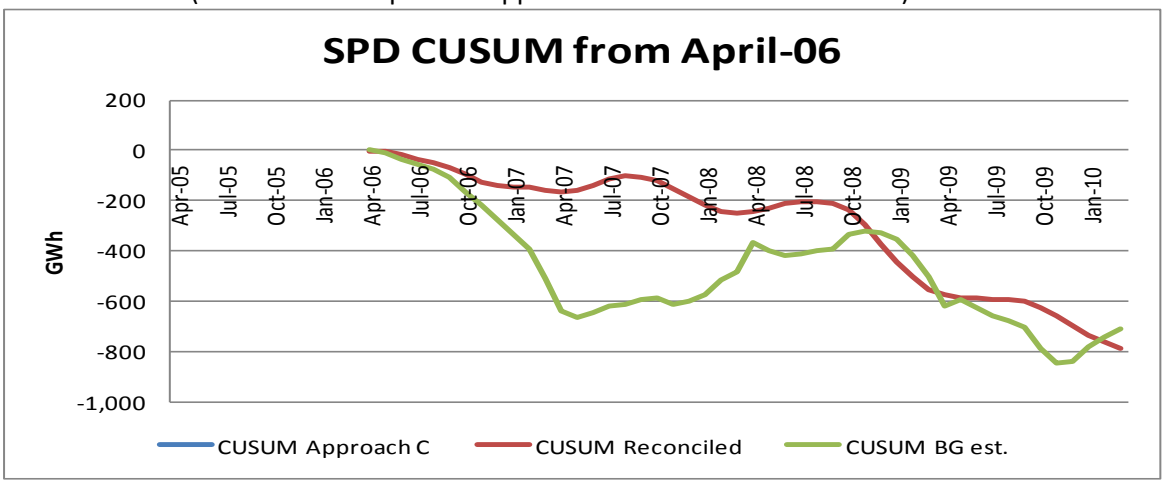


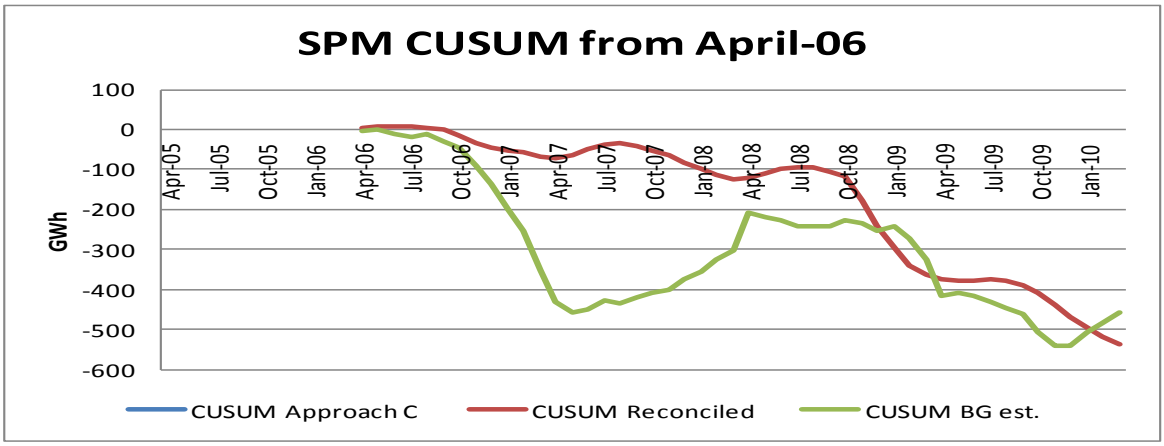


Treatment of DMU:
In their application UKPN have stated that they have removed their own non-settlement data adjustments prior to testing for abnormality and calculating the restatement, and then added their own data adjustments back at the end of the process. We consider this to be inappropriate, especially given that Ofgem's assessment provides UKPN with a total DPCR4 reward of £233m.

SP:
Does the normal period contain credible levels of losses? Yes, the overall normal period being used for restatement for the SP regions contain levels of losses that are credible when measured against Ofgem's credibility thresholds.

CUSUM Charts: (note: SP do not present approach C reconciliations as GWh)





Question 2: Do you consider that DNOs have fulfilled the requirements set out in our July 2013 document?

We are not of the opinion that UKPN have provided satisfactory evidence to justify including non-settlement units found in post-DPCR4 years that relate to energy flowing in 2009-10. Evidence is necessary to demonstrate that the adjustments are consistent with how targets were set.

UKPN have also provided no evidence to justify the inclusion of any data adjustments discovered after July 2012, which was the date that the DPCR4 incentive was intended to be closed.

We consider that the WPD submission of 'other evidence' to demonstrate abnormality fails to address the key issue of whether levels of correction activity were abnormal, and in terms of the evidence provided in support of an alternative normal period, we do not believe this constitutes strong evidence.

Question 3: Do you have any comments on our assessment of the submissions?
We continue to have a number of serious concerns with regards to Ofgem's proposals for the close out of the DPCR4 losses incentive. In the previous sections we have provided details of these concerns.

Question 4: Do you have any comments on the steps we have taken to calculate values of the draft PPL terms?

The calculations seem appropriate however obviously they will now need to be uplifted for indexation and the application of the WACC.

Question 5: Do you agree that the cap has been applied equitably to relevant parties? Please provide evidence to support your argument.

See appendix 1 where we have expressed our significant concerns, with supporting evidence, with regards to:

- The safeguards regarding the cap, set out in the March and July 2012 documents, which have not been applied
- The inappropriateness of the application of the credibility thresholds

Therefore, for the reasons set out in appendix 1, we do not consider the cap has been applied equitably to relevant parties equitably from the viewpoint of the customer.

Question 6: Do you consider that, more generally, the approach and calculations have been applied equitably in all circumstances?

Ofgem's vanilla assessment proposes an overall outcome to the DPCR4 losses scheme of a £334m[10] reward to DNOs. This represents a £473m increase in reward for the DNOs, compared to the outcome if no restatements were permitted and the scheme ran as intended and agreed at DPCR4. For all the reasons we have previously stated we do not believe the approach and calculations have been applied equitably in all circumstances. We do not consider the approach and calculations have been applied equitably from the viewpoint of the consumer.

Question 7: Do you have any views on the appropriate period for recovery of the PPL based on the draft PPL terms?

The recovery of the PPL should begin in 2015/16 and the final PPL amounts need to take account of the assumptions already made by DNOs in their current and historic DUoS charges.

We consider that it is appropriate to recover the final adjusted PPL amounts over two or three years depending on the materiality of the final adjusted PPL values. If the adjusted PPL values are less than 6% of base revenues then they should be recovered over two years, however if they are above 6% then it is appropriate to recover it over three years. However, given the delay experienced to date in the close out of the incentive, we do not consider it appropriate to spread the payback beyond 2017/18.

Our views in this area are dependent on the appropriate treatment of RPI and (real) WACC. Consumers should have begun to receive their over-payments back from 2012/13. The delay since 2012/13 has been as a result of data inaccuracies and policy misinterpretations on the part of the DNOs. Consumers must be NPV neutral (as indeed should DNOs who have been under rewarded to date) to the delay in receiving monies back for the losses incentive. Otherwise they must be made whole as soon as possible (no spreading of the recovery).

Question 8: Do you have any views on the way that indexation and the weighted-average cost of capital (WACC) should be applied when the close out values are recovered?

At the recent losses workshop held by Ofgem, we noted that a number of DNOs were suggesting that simple interest rate and RPI adjustments would be appropriate for the close out values. This is clearly inappropriate as it takes no account of the fact that consumers have over paid for the losses incentive to date and therefore they should be made right on an NPV neutral basis (a similar

[10] £334m is the £221m for the LRRM plus the £113m windfall received during DPCR4 for DPCR3 units which did not affect DPCR4 targets.

argument can made where networks have been under rewarded). We note that even using the DNO WACC for this purpose is likely to lead to a shortfall for consumers as we consider that consumers cost of capital will be much higher than DNOs. We also note that consumers should have expected to be refunded through the close out mechanism from 2012/13 in line with the licence condition agreed at DPCR5, and that the delay since that date has been a result of data inaccuracies and policy misinterpretations by DNOs. It is therefore certainly not credible to suggest that consumers should not be made to be NPV neutral for the delay in the return of their monies since 2012/13.

We believe that one of the intentions of the LRRM was to make DNOs neutral to **when** investments were made to reduce losses and consider that in theory this would require the close out of the scheme to take account of all previous rewards and penalties on an NPV neutral basis. This would require the application of RPI and (real) WACC to all amounts received during DPCR4 as well as the application of RPI and WACC to the recovery of the close out values.

An alternative approach (more lenient to the DNOs) would be to calculate the close out amount in 2009/10 prices as Ofgem have currently done. These close out amounts could then be uplifted by RPI and base rate interest to get to 2012/13 equivalent values – the date when consumers would have expected to begin to have their previous over payments returned (the licence agreed at DPCR5 set PPL to zero for 2010/11 and 2011/12 only). The rationale for RPI and interest only adjustments until 2012/13 could be that this was the length of time required to allow the settlement data to be finalised (in the same way, for instance, as only RPI and interest is applied for quality of supply rewards).

Naturally however, any delay in the return of monies since 2012/13, or any further delay resulting from the payback being spread over a number of years must be done on an NPV neutral basis to protect both consumers and DNOs.

We therefore suggest the following methodology as a balanced approach for the recovery of the PPL amounts.

Methodology & Rationale

1. DPCR4 close out term (PPL) was always intended to be calculated in 2012/13
2. From 2009/10 to 2012/13 there are parallels with other incentive true ups (e.g. Quality of Supply) – so apply RPI and interest only to get from 'pure' PPL in 2009/10 prices to 'pure' PPL in 2012/13 prices
3. Post 2012/13, Customers and DNOs should be protected on an NPV neutral basis from any delay in revenue recoveries or payback – so apply RPI and WACC to recoveries/payments post 2012/13
4. Ofgem requested that DNOs set 2013/14 DUoS charges based on PPL assumption contained in May 2012 DCP-66 forecast – so appropriate to apply RPI and WACC to this amount to net off 'pure' PPL value
5. Any PPL assumption for charge setting made by DNOs other than in 2013/14 was at their own discretion and we believe for their own benefit, therefore apply RPI only to these to net off 'pure' PPL amount
6. Calculate 'Net' PPL amount as sum of 'pure' PPL in 2012/13 prices (interest adjusted to 2012/13 and WACC adjusted to 2015/16) plus adjustment for prior year recoveries in 2012/13 prices (2013/14 PPL recovery assumption WACC adjusted to 2015/16)

7. If Net PPL in 2012/13 prices WACC adjusted to 2015/16 is > 6% or less than -6% of 2015/16 Base Revenues then recover over 3 years, else recover over 2 years, in each case applying further WACC adjustments as necessary
8. Convert these net PPL values in 2012/13 prices to nominal values using licence definition of RPI

CHAPTER: Four

Question 1: Do you have any comment on our assessment of the restatement applications for the purpose of the 2009-10 annual incentive and the proposed changes to the growth term figures?

We are disappointed that Ofgem's approach to the restatement for the annual incentive is limited to 2009-10 only and consider that this to be an example of leniency being shown to DNOs. The data audit revealed a number of instances where as a result of a change to the standard reporting methodology DNOs have received additional rewards through the growth term during DPCR4. Whilst allowing networks to restate 2009/10 data for the close out of the losses incentive Ofgem are not requiring networks to restate prior year annual incentive data where the audit has revealed that it may be appropriate to do so.

Question 2: Do you have any views on the way that indexation and the WACC should be applied when the changes to revenue as a result of changes to the growth term are recovered?

At the recent losses workshop, it was suggested that any change to the 2009/10 growth terms could be included as part of the close out calculation rather than requiring resubmission of 2009/10 to 2012/13 revenue returns. We are sympathetic to including the impact on the growth term as part of close out calculation to prevent such an administrative burden.