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Dear Hannah,

Assessment of RIIO-ED1 Business Plans and fast tracking decision

1. Thank you for the opportunity to respond to Ofgem's assessment of the RIIO-ED1 business plans and fast tracking consultation. This is a non-confidential response on behalf of the Centrica Group, excluding Centrica Storage. We answer the question from the Draft Determination in the appendix, below.

2. As a large energy company that does not own any network assets we remain committed to engaging in RIIO-ED1 as we believe we are well placed to offer our views on what gives customers value for money from the price review process. It is particularly clear at the current time how important it is that networks are not over-rewarded and so customers do not overpay.

3. We believe that the decision to fast-track is generous to WPD in a number of aspects. We do accept that WPD's business case should be viewed as a package and so issues with individual aspects should not necessarily prevent fast-tracking. However, the benefits on offer for fast-tracking are such that Ofgem need be very confident that the business plan overall is justified.

4. While we accept that Ofgem's analysis shows that WPD perform favourably to other networks, we are unable to conclude, from the evidence presented, that it represents good value for customers. In particular, although the revised targets for reliability are more challenging than Ofgem's requirements we do not believe they are challenging in themselves and so are not evidence that the package represents good value.

5. The main categories within WPD's business plan that appear to be less well-justified are:

   - Cost of Equity

- Financeabilty transition
- Real price effects (RPEs)
- Interruptions Incentive Scheme

Cost of Equity

6. The Cost of Equity is the subject of a recent consultation on the appropriate equity market return, but the WPD bid is 0.4 percentage points or £88m as a cost to consumers over RIIO-ED1, above the central estimate of 6.3% given by Ofgem in their decision. Ofgem stated that a 6.7% cost of equity would only be '*satisfactory for a company that commits itself to especially tough cost efficiency assumptions'.*[1]
7. Ofgem has suggested that WPD would be offered the opportunity to accept an adjusted cost of equity for fast-tracking if Ofgem's assessment changed. If Ofgem adjusts its cost of equity allowance downwards, it would be completely unjustified for WPD to retain a 6.7% cost of equity. Even with Ofgem's higher, current cost of equity central estimate, the WPD proposal is high before the additional income from the IQI mechanism feeds directly into a cost of equity. This was set out in our August 2013 response on the RIIO-ED1 Business Plans consultation, stating that the effective cost of equity would be 7.7% when taking this into account.
8. As discussed in the Ofgem cost of equity consultation, the equivalent cost of equity from the Competition Commission (CC) provisional determination for NIE would be 5.5%.

Financeability transition

9. We do not understand the requirement for transitional arrangements. In the change to 45 year asset lives for new assets (previously 20 years), WPD has requested an eight year transition period. The SPEN network, for example, did not request a transition period for switching to the new asset lives. Ofgem noted credit metrics that '*by WPD's own assessment, already look comfortable without transition. The one credit metric which looks stretched in WPD's assessment – PMICR – is specifically calibrated to be neutral to changes in depreciation profile*.'[2]
10. It is therefore puzzling why this is required and it prevents tariffs from reducing more at the start of RIIO-ED1 when arguably customers need it most. This is a further concession which Ofgem have made in granting WPD fast-tracking status. This would have intergenerational

[1] Ofgem (2013) Assessment of RIIO ED1 business plans and fast tracking p3.
[2] Ofgem (2013) Assessment of the RIIO ED1 business plans, p58.

equity impacts and does not appear to be justified by credit metrics, so it is difficult to understand why this concession was required.

Real Price Effects (RPEs)

11. We feel that the RPEs are too generous and should not be used as a precedent for setting the 'slow tracked' packages. Ofgem's assessment is critical of WPD's RPE and ongoing efficiency estimates. This comes from a presentational, methodological and estimation viewpoint. Ofgem states that[3]:
    i. '*we question the validity of the choice of cost indices and time periods used to base the RPE assumptions on;*'
    ii. '*the business plan also does not clearly set out how its RPE assumptions were derived from this report*;' and
    iii. '*while WPD's assumptions for ongoing efficiency are comparable to other DNOs, they are slightly reduced as they are not applied across all cost areas and it is unclear whether they are applied to the forecast costs in the DPCR5 period.'*
    iv. WPD has +0.4% RPE assumption, which compares to a -0.1% for SPEN. It does not therefore appear to be a frontier company on this measure.
12. This may create a knock-on effect to non fast-tracked companies, who in revising their business plans, may assume that the above assumptions contained with the WPD business plan are acceptable for them to adopt going forward. This would amplify the effect of the decision of Ofgem to allow these items to be permitted as part of fast-tracking.

Interruptions Incentive Scheme

13. The proposed targets for the interruption and incentive scheme (IIS) remain too lenient for WPD. Even with the voluntary targets proposed by WPD, we estimate the scheme would provide WPD with a reward of around £120m over the RIIO-ED1 period simply for maintaining performance at levels seen during DPCR5.

14. If we include the £50m that was included in DPCR5 base revenues, we estimate that WPD will receive in excess of £300m for the DPCR5 interruptions & incentives scheme. We support networks receiving rewards for improvements valued by customers. We consider the scale of DPCR5 rewards to be easily sufficient for the improvements made in interruptions performance in this case, especially considering that we understand these improvements have been made at lower overall cost in the East and West Midlands.

[3] Ofgem (2013) Assessment of the RIIO ED1 business plans, p57.

Therefore to set targets for RIIO-ED1, even the voluntary targets proposed by WPD, at a level which would bring a further reward of £120m for no further improvement in performance does not appear to be fair to consumers.

15. We would once again urge Ofgem to revisit its proposal to set targets using data only up to 2012/13 as this fails to appropriately take account of the step changes in performance achieved by a number of DNOs during DPCR5, resulting in significant rewards to these DNOs during RIIO-ED1 for no further improvement in performance for their customers.

16. Additionally, we are disappointed that no DNO committed to delivery of smart metering Service Level Agreements (SLAs) in their business plans and we need more information from all DNOs on how they will assist suppliers in rolling out smart meters to all customers. We have concerns that the current arrangements are not adequate to ensure the best experience for customers. Smart metering will benefit all parties involved, customers, suppliers and DNOs; however, there are no incentives on DNO's performance during rollout. We feel that there would be real customer benefit in an incentive regime to augment the SLAs currently being discussed within the industry, as it would potentially be more effective in driving performance improvements through comparison and competition between DNOs.

17. We believe this could work in a similar fashion to the telephony incentive in DPCR4, with a league table of performance against SLAs and the best performing networks receiving rewards and the worst performing penalties. This should be designed to be neutral (zero) in terms of overall reward.

18. We hope you find our comments helpful. Please do not hesitate to contact me if you have any questions.

Yours sincerely,

Andy Manning
Head of Network Regulation, Forecasting and Settlements

Appendix 1.

Question 1. Do you consider that WPD's business plans are suitable for forming the basis of its RIIO-ED1 price control settlement?

1. We believe the elements below need to corrected before Ofgem could accept WPD's business plan and fast tracked package:

    a. As we highlighted in our initial response to the business plans[4], we can see a large increase in business rates for WPD being assumed from 2017/18 and increasing yet further to a level in 2019/20 which is £44m/yr higher than the start of the period. 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.

    b. In our response to the business plans, we highlighted our concerns that that some DNOs appeared to be claiming for ES4 excluded services revenue within their business plans whilst showing no associated costs. Whilst Ofgem's Financial Model for WPD applies an appropriate treatment to ES4 over the RIIO period (no costs and therefore no revenue), we are concerned that the model also shows that there has been £45.7m of revenues recovered during the DPCR5 period without any associated costs. We understand these revenues have been recovered via general DUoS charges.

       We consider that the situation regarding the treatment of ES4 has been clear since the start of DPCR5 and has not changed for RIIO-ED1. Revenues received should only recover the reasonable costs of providing the service (and potentially a reasonable rate of return to account for the timing difference between the DNO expenditure and the customer payment). It is clear that if there have been no costs incurred then there should be no revenue recovered. Therefore an explanation is required for the anomalous revenues associated with ES4 during DPCR5. If any network has erroneously treated revenues as excluded which should not have been, then these revenues need to be returned to customers as soon as possible.

2. We agree with the Ofgem's assessment for the preferred treatment of funding for costs related to Network Rail's electrification programme. We are concerned, however, that placing this funding in WPD's allowances at this stage may make it more difficult to be moved later and would prefer the default position to be to exclude.

[4] https://www.ofgem.gov.uk/ofgem-publications/82719/bgresponseriioed1businessplans01.07.13.pdf, p9