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(By email)

8 May 2014

Dear James,

Stakeholder Engagement Incentive reward consultation

Thank you for the opportunity to comment on your proposed approaches to Stakeholder Engagement Incentive rewards.

Our understanding of the Stakeholder Incentive was that DNOs that met the minimum requirements would be eligible for a financial reward under the incentive mechanism. Overall we are concerned that Ofgem's overriding proposal is an approach is to erode the value of this important incentive. That said however, we are sympathetic to Ofgem's sensitivity to low scoring companies receiving a financial reward. Our proposals below provide a more balanced response and provide the right behavioral drivers for all network companies.

Our expectation is that it will be increasing difficult for network companies to improve scores over the RIIO-ED1 period. Our expectation is that we will need to continuously improve just to maintain the levels achieved to date. We note that the score of WPD, the best performing company, actually reduced from the previous year even though that had made improvements to their stakeholder engagement.

In response to the specific questions you asked in your consultation.

1. Do you consider that companies should meet a threshold level of performance before they are entitled to receive a reward? If so, what should the threshold score be and why?

If it is combined with a reduction in the level to achieve maximum reward then a minimum threshold would be acceptable. We would propose a threshold score of three needs to be achieved before any reward is received. When combined with our proposals for the incentive rate this means that a company scoring four would only receive a small value of reward.

2. Do you consider that companies should be able to receive their maximum reward for performance above a specified level? If so, what should the maximum reward score be and why?

We support the idea of having a maximum reward threshold. Companies have previously argued that the full value of this incentive is extremely unlikely to be realised as it would necessitate a score of 10 out of 10. We would propose that maximum reward should be available from a score of eight or greater.

3. What should the incentive rate be between the threshold score and the maximum reward score?

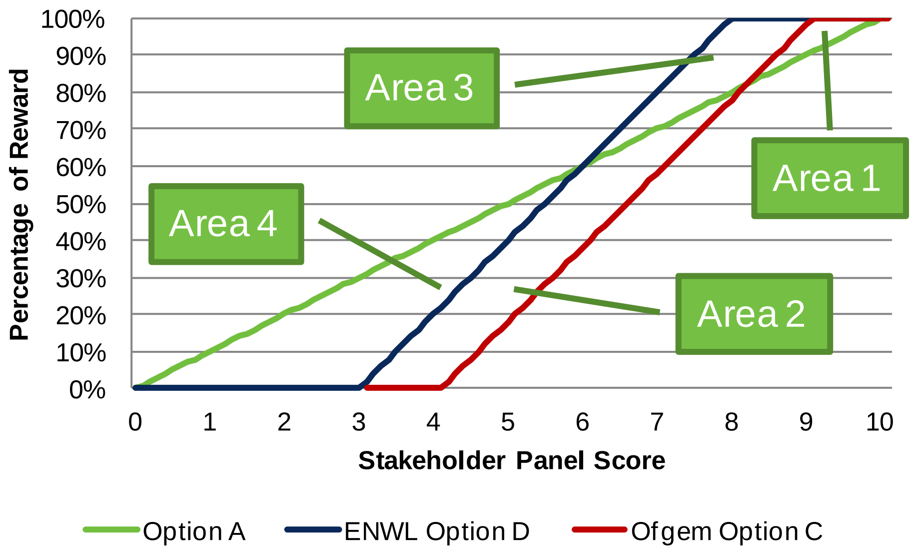
We agree with Ofgem that a rate as shown in ‘Option B’ creates an inappropriate ‘cliff edge’. This results in a disproportionate increase in reward once that threshold is reached. We believe that this can cause undesirable attributes for an incentive that has a high degree of subjectivity in its assessment.

We would support an incentive rate that is a straight line between the threshold score and the maximum reward score. Our proposal is shown as ‘Option D’ below.

As can be seen Option D has the same incentive rate shown by the gradient of the line between the threshold and the max reward. The gradient is steeper that Option A and therefore appropriately provides a stronger incentive for network company improvements for any incremental improvement.

The graph shows that for any score less than eight, the network company would be worse off than Option A. The area bounded by the red and green lines where Option C is greater than Option A (labeled Area 1) can be calculated as 10 whereas the area under the graph labeled as Area 2 is calculated as 160. Area 1 therefore represents the increase in potential value to the network company with Area 2 representing a reduction in potential value. This demonstrates that there is a significant erosion of the incentive.

Calculating the equivalent areas for Option D bounded by the blue and green lines gives a more balanced result. The area above the line has an area of 40 (labeled Area 3) and the area below the line has an area of 90 (labeled Area 4). Overall this still results in an overall diminution of the value of the incentive as the size of the reduction is larger than the increase but is now more appropriately balanced.



Overall we believe that this meets Ofgem’s desire to not reward lower performing companies but without resulting in such a material reduction in the incentive properties of the scheme.

We are seeking views on whether these values should be inflated using RPI.

Yes we believe that the values for the incentive should be inflated using RPI. The licence clearly sets out the value of the incentive in 2007-08 prices. It would seem illogical and inconsistent with other incentives to have a reduction in incentive strength over the DPCR5 period.

It is our understanding that RPI uplift has historically only been set out explicitly in algebra in those licence conditions where – because the adjustment is set out algebraically – it is important to know which aspects of the formula get uplifted by RPI and which do not.

There are other examples of DPCR5 conditions that do not explicitly include RPI adjustments where it is understood that RPI adjustments would be made, including all reopeners. In these cases it is made clear that the values quoted in the licence are in 2007-08 prices with an expectation of an RPI uplift – and in some cases a time value of money adjustment too – being applied as part of the Authority determining an adjustment.

We note that this has been applied in the licence drafting for the RIIO-ED1 licence. We would therefore expect an RPI adjustment made to the DPCR5 maximum value of the Stakeholder Incentive. We would expect there to be a retrospective adjustment made to compensate companies for this adjustment for the Stakeholder Engagement rewards directed by Ofgem in 2013.

If you require any further information, please do not hesitate to contact Brian Hoy or myself.

Yours sincerely,

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Paul Bircham
Regulation Director