

Legal & Regulatory 1st Floor, Lakeside West 30 The Causeway Staines Middlesex TW18 3BY

26th September 2014.

Anna Rossington RIIO-ED1 Ofgem 9 Millbank, London, SW1P 3GE.

Dear Anna,

Consultation on the RIIO-ED1 Draft Determinations for the slow-track electricity distribution companies

Thank you for the opportunity to respond to the consultation regarding the RIIO-ED1 Draft Determinations for the slow-track electricity distribution network operators (DNOs). This is a non confidential response on behalf of the Centrica Group, excluding Centrica Storage.

We welcome the expenditure reductions Ofgem proposes to apply to the resubmitted business plans. In particular, we support the commitment to address the issue of the distribution network operators (DNOs) being significantly over-compensated for the possibility of costs rising above inflation. We also support the imperative that customers see the benefits of smart solutions (for which DNOs have already received funding to develop). However, we remain concerned that these proposals are too generous to the DNOs and do not demonstrate good value for money for customers. Whilst the proposed settlements may be interpreted as tough on the DNOs, the impact on revenues resulting from reductions in expenditure has been more than compensated for by policy changes made by Ofgem. In fact, customers would pay less, over the RIIO-ED1 period, had Ofgem simply adhered to the previously-decided strategy and not disallowed any expenditure.

Our key areas of concern are:

(1) Likely levels of returns to be made by DNOs: our analysis shows that:-

- It is highly likely that most DNOs will, again, receive double-digit returns.
- It is almost inconceivable that any DNO will earn a return similar to the cost of debt because of underperformance.
- This settlement is significantly more generous than that recently offered to water companies (which demonstrate similar risk and investment profiles).
- (2) Network revenues are being increased by significant unjustified changes in policy: Ofgem proposes a number of changes to the RIIO-ED1 Strategy Decision, without offering clear and compelling evidence in support. We estimate these policy changes increase network revenues

during RIIO ED1 by up to £1.1bn, far in excess of the revenue savings delivered by the proposed expenditure reductions (which we estimate to be £0.7bn). Aside from the impact on consumers' bills, we are concerned at the regulatory implications, including the impact on regulatory certainty, of making such significant changes as the cost of debt proposals and the relaxation of the Information Quality Incentive (IQI) matrix at this late stage of the process.

- (3) Improvements to policy implementation that would benefit customers have not been accepted: We have previously identified a number of issues which we estimate that, if addressed, would reduce the revenues requiring funding by customers by a further £424m over the price control. We would welcome Ofgem's reasoning for not progressing these issues, when in our view the justification for making changes is far clearer than that accepted for increasing network revenues. Taking steps to resolve issues such as inappropriate targets for Interruptions remains aligned to the intent of the original Strategy Decision, as opposed to the fundamental changes in policy that are being proposed.
- (4) Expenditure reductions appear modest: The proportion of revenue disallowed by Ofgem is smaller than that proposed in Draft Determinations for comparator price controls (including all recent Ofgem price control determinations under the RIIO framework and the current water and sewerage PR14 review). Further, over the RIIO ED1 period customers will pay more as a result of the process of identifying expenditure reductions because the extra rewards to DNOs for providing what Ofgem views as good information **exceed** the reduction in revenues resulting from the cost benchmarking.

We consider each of these areas in more detail below, but would note that only making policy changes with compelling evidence would further reduce DNO revenues by up to ± 1.5 bn, saving customers around ± 5 pa¹ across RIIO-ED1.

We recognise that there may be evidence to justify additional revenues for some individual DNOs, but given that the expenditure reductions do not appear particularly challenging, we believe further reductions are achievable and necessary. In our submission to the Energy and Climate Change Select Committee we presented clear evidence of the high level of returns that have been enjoyed by virtually all network companies. We believe that this shows that the regulation of networks would benefit from independent scrutiny. Similarly, we believe there are material and legitimate concerns that this price control determination could operate, or be expected to operate, against the public interest.

(1) Likely levels of returns to be made by DNOs

We acknowledge Ofgem's policy of rewarding success through higher returns on regulated equity (RoRE):

"...we regard an appropriately calibrated price control package as one in which RoRE upside (ie the reward available for the best-performing DNOs) provides the potential for double-digit returns on

¹ Per domestic customer

(notional) equity, and RoRE downside (ie the penalties that would apply to the worst-performing DNOs) is at or below the cost of debt....^{n2,3,4}</sup>

We note that Ofgem assumes a baseline Return on Regulatory Equity (RoRE) estimate of 6.0% and estimates the maximum downsides for underperformance will be returns in the range of 1.6% - 2.6% while the maximum upsides for outperformance will be returns in the range of 10.2% - 12.5%, ranges which imply that this price control package is consistent with Ofgem's stated policy.

However we do not believe the ranges presented to be credible. By considering the likely level of performance of DNOs over ED1, and taking the policy decisions into account, we believe the proposed settlement provides for excessive returns that do not align with the above policy and are not needed to protect against threats to financial stability. We have analysed a scenario which we believe represents a reasonable central case for ED1, including conservative outperformance assumptions. This analysis is explained in further detail in Appendix 2 but essentially assumes that networks will continue to perform in line with performance in the current price control period (DPCR5). This shows that an *average-performing* network will make returns in excess of 11% and the majority of networks will make double-digit returns (not just the best performing). By contrast we believe the worst-performing DNO is likely to earn a return of no less than 8%.

It is not credible that any network will receive returns equivalent to the Cost of Debt as this would require overspending against allowances to an unprecedented extent (around 16%, when *all* networks are expected to *under*-spend during DPCR5).





CHART 1: RIIO-ED1 Return on Regulated Equity by DNO – Central Case

publications/47149/riioed1sconfinancialissues.pdf

² Ofgem (2012), 'Consultation on strategy for the next electricity distribution price controls - RIIO-ED1 - Financial issues', para. 3.13. See: <u>https://www.ofgem.gov.uk/ofgem-</u>

³ Ofgem (2013), 'RIIO-ED1: Draft Determination for Western Power Distribution Ltd', page 27. See: <u>https://www.ofgem.gov.uk/ofgem-publications/84602/draftdeterminationsmaster.pdf</u>

⁴ Ofgem (2012), 'RIIO-GD1: Final Proposals - Finance and uncertainty supporting document', para. 4.34. See: <u>https://www.ofgem.gov.uk/ofgem-publications/48156/3riiogd1fpfinanceanduncertainty.pdf</u>

We, again, draw attention to the recent draft determinations in the water sector. Ofwat estimates the central point RoRE estimate for the slow-track companies to fall in the range of 5.3% to 6.2% while the maximum upside for the best-performing company will be a RoRE of 9.2%. This reinforces the conclusion that the RIIO-ED1 price control package has not been appropriately calibrated.

We would be happy to meet with any interested parties to explain our analysis in more detail.

(2) Network revenues are being increased by significant changes in policy:

Ofgem proposes to disallow approximately £1.4billion of expenditure relative to the DNOs' business plans, which results in modest reductions in revenue allowances of approximately £700m, or 2%, over the price control. However, DNOs will receive additional revenues far in excess of this if proposed changes to some elements of the RIIO-ED1 strategy are implemented:

- *Cost of debt indexation*: replacement of the fixed 10-year trailing indexation of the cost of debt with the 10-year to 20-year 'trombone' indexation. No new evidence has been provided to justify this. We estimate this change **will increase revenue allowances by over £120m** over the price control.
- Asset life transition: application of a transition period for the 45-year life for new assets for all DNOs instead of just those whose individual circumstances may warrant it. We estimate this blanket approach to transition **will increase revenue allowances by up to £675m** over the price control.
- Information Quality Incentive (IQI) break-even point: relaxing of the IQI break-even point from 100% to 102.9%. Ofgem has correctly noted previously: "...we do not consider that it is appropriate to relax the IQI matrix. To do so would increase the reward/reduce the penalties for all companies, including those who provide less challenging forecasts, without changing the incentives...⁵ We estimate this change will increase revenue allowances by about £339m over the price control.

The £1.1bn increase in RIIO-ED1 revenues that result from these strategy changes are significantly greater than the revenue reductions resulting from the disallowed expenditure in Ofgem's Draft Determinations, as demonstrated by the chart below.

⁵ Ofgem (2013), 'Strategy Decision for the RIIO-ED1 electricity distribution price control Overview', para. 6.22. See: <u>https://www.ofgem.gov.uk/ofgem-publications/47067/riioed1decoverview.pdf</u>



Chart 2: RIIO ED1 Revenues: A comparison of draft determination revenue allowances with allowances without any disallowed expenditure and without any changes to the RIIO-ED1 Strategy.

(3) Improvements to policy implementation that would benefit customers have not been accepted:

There are areas in which the baseline RIIO-ED1 strategy can be justifiably changed in order to ensure value for money for customers, including:

- Cost of equity: The estimate for the cost of equity should be set to no greater than 5.65%, in line with that used in the recent PR14 draft determinations for the water and sewerage sector. The estimate must also take account of emerging evidence being reviewed by Ofwat. We estimate the reduction of the estimate from the current value of 6.0% will **save customers approximately £203m** over the price control.
- Interruptions Incentive Scheme (IIS): We continue to believe rolling averages should be used to set network reliability targets in order to embed historic performance gains. At the very least, we believe the most recent data available (2013/14) should be included in the targetsetting. DNOs have received rewards in excess of £0.5bn due to too easily achievable targets set by Ofgem for DPCR5, often whilst spending less on their networks. We estimate that DNOs may once again earn over £0.5bn via this incentive during RIIO ED1 (we note that Moody's⁶ state that DNO outperformance on incentives is likely to increase for RIIO ED1).

⁶ Moody's (2014) Special comment: UK electricity networks – RIIO ED1 draft determinations in-line with expectations, 15 September 2014

Setting tougher targets that require improvements in performance over and above that observed (and rewarded) during DPCR5 **will save customers around £162m** over the price control for the slow track DNOs.

• Directly remunerated services (ES4): Revenues recovered from these services during DPCR5 over and above the costs of providing them should be returned to customers via an immediate rebate rather than through deductions from the regulatory asset values (RAV). We consider that the rules around these services laid out as part of DCPR5 were clear and where networks have double-recovered revenues from existing customers, monies should be returned to those existing customers. It cannot be in the interests of either existing customers, who have suffered the harm, or future customers, who have suffered no harm, to spread the return of these monies over 23 years. We estimate this improvement will save customers approximately £46m over the price control.



Chart 3: RIIO ED1 Revenues: Potential savings relative to revenues as per ED1 strategy

Chart 3 above shows the additional savings available to customers over the RIIO ED1 period if Ofgem were to reverse their unjustified changes to the Strategy Decision, whilst implementing changes which we believe are both justified and in the interests of consumers⁷. The resulting potential RIIO-ED1 revenue allowances (F) assume that no further expenditure reductions are applied by Ofgem for Final Determinations which we consider to be a conservative assumptions given the modest reductions applied at Draft Determinations.

⁷ The revenues labelled (B) and (D) are the same as those with the same label in chart 1 and are derived as illustrated in that chart.

(4) Expenditure reductions appear modest

Ofgem's best view of total expenditure (totex) compared to the slow-tracked DNO business plans represents a 10% reduction in the expenditure allowances prior to application of the IQI⁸. When compared to previous draft determinations by Ofgem, this reduction is less substantial than with previous controls. The table below shows the ratio of the Ofgem totex estimate relative to the company business plans at the equivalent stage of the price control process.

······································							
Price control	Sector	Regulator to company view at Draft Determination stage					
TPCR4	Gas and Electricity Transmission	67%					
GDPCR	Gas Distribution	82%					
DPCR5	Electricity Distribution	84%					
RIIO GD1	Gas Distribution	78%					
RIIO T1 (slow-track)	Gas and Electricity Transmission	80%					
RIIO ED1 (slow-track)	Electricity Distribution	90%					

Table 1: Ratio of the Ofgem totex estimate relative to the company business plans

Although we accept that the size of any reduction is dependent on the quality of the business plans submitted, it is difficult to conclude that the ED1 Draft Determinations are particularly challenging. It is also worth noting that the ratio for ED1 is still high when compared to just those price controls conducted under the RIIO approach, which aims to encourage truth-telling. If Ofgem had disallowed the level of costs seen for the highest ratio prior to ED1 (DPCR5 at 84%), there would have been a further reduction in Ofgem's totex view of £1.1bn, with even greater reductions if costs had been disallowed at the level of other RIIO controls. The most extreme reduction observed to date at TPCR4 would have led to a decreased cost allowance over RIIO ED1 of £6.2bn relative to the DNO business plans.

This is further emphasised when considering that the expenditure figures include reductions in Real Price Effects (RPEs), which Ofgem is consulting over, and smart grid savings over and above that realised through the relative cost assessment process. The reduction relative to DNO proposals excluding RPEs and smart grid savings is just 4% (i.e. a ratio of 96%). This translates to a reduction in revenues over ED1 of just £238m. Given that the relaxing of the IQI matrix, which is argued to be a reward for providing good information, awards the networks an additional £339m the result of the benchmarking process is customers paying an additional £101m over the RIIO-ED1 period.

The remainder of this response is structured as followed: Appendix 1 – consultation question responses Appendix 2 – Return on Regulatory Equity (RORE) analysis

Annex – CEPA Financial Issues paper

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

⁸ The expenditure allowance gives a weighting of 75% to Ofgem's view and 25% to the DNO's view.

Appendix 1 – consultation question responses

OVERVIEW

Chapter Four Question 2: Do you agree with our disaggregated benchmarking? Whilst it is very difficult for any non-network stakeholder to comment on the details of benchmarking, we do have some concerns about ensuring that even when costs are viewed as efficient, this is translated into good value for customers.

Key to RIIO is the concept of networks delivering a defined set of Outputs in an efficient fashion. To ensure this is the case, it is vital that all allowed expenditure can be clearly mapped onto a defined output. For example, we noted with concern the following observation made by ENW in response to the WPD fast track licence consultation:

'...We note that WPD's Network Asset Workbooks take no account of WPD's proposed refurbishment of a number of items of 33kV and 132kV plant. As these asset classes are included in WPD's proposed asset health movements due to Asset Replacement, the exclusion of the health index movement due to refurbishment of these assets from the Network Asset Workbook could result in WPD being given a reward under CRC5D at the next price control of the 102.5% of the cost of the refurbishment despite this movement already being funded in its opening base revenues...'⁹

We have no comment on WPD's situation, and have no sight of the slow-track Network Asset Workbooks but ask that is confirmed that all allowed reinforcement and refurbishment expenditure is linked to an appropriate Output (e.g. an improvement in the Health Index). Clearly if expenditure was allowed without this secondary deliverable this would be an opportunity for unearned outperformance. We believe it is also necessary to ensure the secondary deliverables are consistent in scale with the volume of work and unit costs found in Ofgem's modelling.

Chapter Four Question 3: Do you agree with our forecast of RPEs?

We have responded separately to the consultation on the treatment of real price effects (RPEs) for the slow-track DNOs. We support the development and implementation of an appropriate indexation mechanism instead of the provision of ex-ante allowances, thereby obviating the need for a detailed analysis of the forecast presented. In summary, we support:

- Ex-ante allowances based on the best information available.
- Annual indexation of the composite RPE index.
- True-up of revenue with a two-year lag.

We also support the 0.4% adjustment that neutralises the impact of the change in the way in which the Office for National Statistics (ONS) calculates price increases for some items that make up the RPI measure of economy-wide inflation. This ONS change has led to an enduring increase of around 0.4 per cent per annum in the RPI relative to underlying cost inflation. It is the underlying cost of inflation in the economy that RPEs should be measured against and therefore we agree with the conclusions contained in the consultation:

⁹ ENWL (2014), Letter: 'Statutory consultation on proposed modifications to electricity distribution licences', para. 4.1. See: <u>https://www.ofgem.gov.uk/ofgem-publications/87505/enwlresponsefasttrackstatcon.pdf</u>

- RPEs for 2010-11 to 2013-14, when expressed relative to RPI, will understate the true RPE relative to underlying cost inflation in the economy by approximately 0.4%; and,
- since allowances are indexed by RPI, forecast RPEs need to be reduced by 0.4% per year in order to reflect the likely RPE cost relative to underlying cost inflation in the economy.

DNOs will have made windfalls during DPCR5 from the change in the measurement of RPI and it is appropriate to ensure that allowances for RIIO ED1 do not similarly provide windfalls through the RPI formula effect.

Chapter Four Question 4: Do you agree with our assessment of potential smart savings?

We share the view that DNOs have proposed very modest savings to be achieved through the deployment of smart technologies. Ofgem have presented evidence, often using DNO sources, for potential smart savings over the RIIO ED1 period of more than £1bn. Given the significant levels of funds (Ofgem quote £450m by 2016) which consumers have already provided to DNOs through the LCNF and innovation allowances, and given that DNOs themselves estimated potential savings of around £2bn over the RIIO ED1 period in their LCNF project justifications, we agree with Ofgem that the £405m savings included in DNO business plans is not sufficient and we support the imperative that customers see the benefits of Smart solutions.

We welcome Ofgem's identification of this collective over-forecast on the part of the DNOs. The cost reductions that have been applied across all DNOs would not have been realised had Ofgem simply relied on a benchmarking approach. We broadly agree with the assessment made by Ofgem and consider the evidence presented to be the most robust available. We do note however that Ofgem have suggested additional savings of at least 1% of totex which can be expected as the understanding of smart grids solutions and benefits evolves and DNOs experience an increase in efficiency, in comparison to previous price controls, due to the embedding of innovation in standard business practices. This additional saving has not been removed from the DNOs expenditures and as such the reductions applied by Ofgem must be viewed as conservative.

We also note that the £396m removed by Ofgem is before interpolation and therefore the actual reduction in DNO expenditure will be 25% lower – further supporting our view that the reductions are conservative.

	Potential Savings	Included in	Potential				
	Identified	DNOs Plans	Additional				
			Savings				
Smart Metering Data	£190m	£27m	£163m				
Network Capacity	£653m	£363m	£290m				
Other Smart Grid	£137m	£15m	£185m				
Increase in Efficiency	£191m	£0	£122m				
Total	£1,171m	£405m	£742m				
Potential additional smart s	savings		£742m				
Expenditure removed by O	£396m						
Expenditure removed by O	fgem after interpol	ation	£297m				
Remaining potential smart sa	vings		£445m				

Table 2: Potential smart savings identified by Ofgem (incl. WPD)

Chapter Four Question 6: Do you agree with our design of the IQI?

There is no justification for adjusting the break-even point in the IQI matrix and we believe this change should be reversed. No arguments have been presented to challenge the rationale set out by Ofgem in the Strategy for RIIO-ED1:

...a company which submits a forecast of its expenditure requirements over the price control period that matches our own assessment of that company's efficient expenditure requirements... would be able to achieve a return equal to our estimate of its cost of capital, if it were then to spend, over the price control period, the amount it had forecast¹⁰

The IQI matrix will now *reward* companies for reaching Ofgem's view of the efficient level, without any compensating benefit for customers. This was made very clear in the Strategy Decision when considering calls for making the break-even point more generous to DNOs:

'...we do not consider that it is appropriate to relax the IQI matrix. To do so would increase the reward/reduce the penalties for all companies, including those who provide less challenging forecasts, without changing the incentives."

It is stated in the Draft Determinations that:

We think that it is right to reward companies that have provided good information that has helped our comparative benchmarking'

The incremental benefit that a network receives for forecasting closer to Ofgem's view of efficient is virtually unchanged by the relaxation of the IQI matrix. This is to be expected because, as recognised in the Strategy Decision, the incentive properties are unchanged. In any case, even if Ofgem does believe that moving the break-even point will affect network bidding behaviour, it makes no sense to apply this retrospectively. This is the worst possible scenario for customers – by proposing this change after business plans have been submitted means customers will pay additional money to networks without any possibility of any compensating impact resulting from a change in network bidding behaviour.

We are also unsure, given that it has been assessed that all the networks have submitted inefficient business plans, how 'good information' is being defined. At the time of submission of revised business plans DNOs would have had full access to data, including that referenced by Ofgem, with regards to Real Price Effects. For example, numerous HMT reports¹¹ pre-dating the revised business plan submission confirm Average Earnings growth significantly below RPI. Similarly, the networks will have been well aware of, and had access to, all sources used in the Draft Determinations to assess the appropriate level of smart grid savings. It is noted in various places with the Draft Determination documents that the networks should have taken account of these sources. For example: 'In light of the available evidence that significant benefits to DNOs are achievable on the back of the smart meter roll-out DNOs should have reflected these savings in their plan.¹², This confirms that DNOs can

¹⁰Ofgem (2012), '' Strategy consultation for the RIIO-ED1 electricity distribution price control Outputs, incentives and innovation' para. 9.17. See: https://www.ofgem.gov.uk/ofgempublications/47144/riioed1sconoutputsincentives.pdf . ¹¹ https://www.gov.uk/government/collections/data-forecasts.

¹² Para. 11.18 of the Business plan expenditure assessment

reasonably have been expected to have made use of these sources of information and certainly should not be rewarded, or receive increased revenue, for failing to do so.

In terms of comparative benchmarking, as noted above, the reduction relative to DNO proposals excluding RPEs and smart grid savings is just 4% (i.e. a ratio of 96%). This translates to a reduction in revenues over ED1 of £238m. Given that the relaxing of the IQI matrix, which is argued to be a reward for providing good information, awards the networks an additional £339m the result of the benchmarking process is customers paying an additional £101m over the RIIO-ED1 period. We do not believe this can be in the interest of customers.

We do not believe that any changes to the IQI matrix as set out in the Strategy Decision are justified. However, if it is viewed that the collective over-forecast through RPEs and smart grid savings requires adjusting for there are more sensible ways to do this than that proposed. The simplest would be to adjust the totex submitted by the DNOs to align with Ofgem's efficient view of RPEs and smart grid savings. This is equivalent to a scenario where DNOs were allowed a further submission to correct for the collective over-forecasts. The original approach to the IQI matrix would then be followed, with 'underlying' or comparative efficiencies being represented. We have estimated the impacts of this in the table below.

	TOTEX							IQI	
								Adj. Ex-ante	
	DNO	Efficient RPE/SG	Adj. DNO	Ofgem Efficient	Adj. Totex	Change vs Draft	Adj. Efficiency	reward (original	Change vs Draft
	Submitted	adjusmtent	submitted	Totex	Allowance	Determination	Score	break-even)	Determination
ENWL	1,877	-126	1,751	1,766	1,762	-32	99%	1	-11
NPG	3,172	-242	2,930	2,846	2,867	-61	103%	-19	-14
UKPN	6,585	-379	6,206	5,800	5,902	-95	107%	-83	-50
SP	3,491	-259	3,232	3,111	3,141	-65	104%	-26	-16
SSE	3,635	-240	3,395	3,319	3,338	-60	102%	-18	-23
TOTAL	18,760	-1,246	17,514	16,842	17,010	-312	104%	-145	-115

Table 3: Alternative treatment of efficient RPE/Smart Grid adjustment

This further emphasises that the current proposed approach to the IQI is not credible as it shows that DNOs will receive an additional £312m in totex compared to if the forecasts for RPEs and smart grids had matched Ofgem's. This occurs because by choosing to adjust the IQI matrix, rather than the submitted totex values, networks receive 25% of the over-forecast through the process of interpolation. The treatment of the DNO forecasts for RPEs and smart grid savings needs to consistent. If they are to be effectively ignored for assessing appropriate rewards, they should not be included for interpolation. Whilst the justifications for interpolation could be argued about generally, they do not apply in this instance. Firstly, Ofgem state that interpolation means 'we are assuming that the DNOs would close 75 per cent of the assessed gap between their forecasts and our efficiency benchmark¹³. The gap between the forecasts and the efficiency benchmark for RPEs is caused by the DNO forecasts not using the appropriate indices and so is completely closed by updating these. Further, it is stated: 'Our proposed approach to closing the gap and the use of the UQ rather than the frontier acknowledges that a part of the difference in costs across the DNOs relates to factors other than DNOs' relative efficiency (e.g. statistical errors)¹⁴. The smart grid savings are explicitly acknowledged as having been reduced to allow for this type of issue (risk of doublecounting etc.), so it would not be correct to make a second adjustment.

¹³ Para. A2.23 of the Business plan expenditure assessment

¹⁴ Para. A2.23 of the Business plan expenditure assessment

Chapter Five Question 1: Do you agree with our cost of equity proposals?

Although there has been downward movement in the cost of equity estimate (influenced by the Competition Commission's determination relating to Northern Ireland Electricity), we believe the estimate still remains generous. Ofgem's assessment suggests there may scope for further reductions:

"... These two factors mean there is headroom in our cost of equity estimate..."¹⁵

We also note that the cost of equity in the water sector for the upcoming PR14 price control is materially below the determination for RIIO ED1. It is our view that changes to allocate risk to consumers away from companies should be reflected in the cost of capital that the DNOs receive (from consumers). This would also be the case for the change in the cost of debt indexation mechanism.

Chapter Five Question2: Do you agree with our cost of debt proposals?

Whilst we agree with the continued use of cost of debt indexation, we do not think that Ofgem has justified the change in calibrating this mechanism for the RIIO ED1 Draft Determinations and that such a change is in conflict with established regulatory principles. We note that several DNOs had accepted the original index mechanism in their revised business plans.

CEPA has looked at this issue in depth in support of this response. Their analysis finds that a change in approach is not justified, and that this will lead to a forecast £120m in additional costs for consumers in RIIO ED1, and windfall for network companies. The change also risks unintended consequences and raises concerns for subsequent price controls in the energy sector, including potentially creating windfall gains and asymmetric sharing of risks.

The CEPA analysis finds headroom in the current cost of debt mechanism for a notionally efficient DNO that would go against a further increase in the generosity under the proposed 'trombone' index. This headroom arises from the well-established halo effect, yield curve effects and the representativeness of the index during the Global Financial Crisis.

Ofgem should maintain its focus on the notional efficient company and actual debt costs should at most be used as a cross-check. Any analysis of actual costs should include an assessment of whether these are consistent with the behaviour of a notionally efficient DNO, for example with use of junior debt, bonds driven by shareholder rather than company objectives and an adjustment for funged bonds. Ofgem had previously rejected uplifts for higher embedded debt costs in their DPCR5 decision and there is no rationale for an uplift for all companies in this case.

Chapter Five Question3: What are your views on our assessment of financeability?

We agree with the principles behind Ofgem's financeability assessment and the use of financial ratios from credit rating agencies as part of this analysis. However, we are not certain that the adjustments made, for example the transition for asset lives, are consistent with these principles.

¹⁵ Para. 5.8 of the Overview

Ofgem had originally set out that adjustments would be made in exceptional circumstances, however it is not clear that this has been demonstrated. Ofgem had also set out, consistent with the Competition Commission Northern Ireland Electricity determination, that the onus should be on the company when facing possible financeability issues.

Despite being NPV-neutral adjustments, the bringing forward of revenues from future periods increases the risk of future financeability problems and increases cost for consumers in RIIO ED1. Ofgem's financeability analysis is based on their Return on Regulated Equity (RoRE) estimates, but we expect companies on average to outperform these estimates by over 500bps, with Moody's similarly pointing out expected positive rewards for the DNOs through incentive mechanisms. This reinforces the concern that Ofgem's proposals on cost of capital allowances are too generous and to the detriment of customers.

Chapter Five Question4: Do you agree with our proposals to modify the three financial policies?

Directly remunerated services:

Revenues recovered from these services during DPCR5 over and above the costs of providing them should be returned to customers via an immediate rebate rather than through deductions from the regulatory asset values (RAV). We consider that the rules around these services laid out as part of DCPR5 were clear¹⁶ and where networks have over recovered revenues from existing customers, monies should be returned to those existing customers rather than spread over 23 years. We estimate this improvement will reduce revenue allowances by approximately £46m over the price control.

Disposals:

We are concerned with the change to the Strategy Decision with regards to disposals. We consider that monies recovered from disposals belong primarily to the customer since it is the customer who will have funded the assets in the first place.

Whilst we accept that there may be value to customers in placing an incentive on DNOs to maximise recoveries from disposals, we believe the change to the Strategy Decision suggested by Ofgem would only be appropriate if the initial RIIO ED1 DNO expenditure allowances include reductions from a robust estimate of the forecast recoveries from disposals. The incentive which Ofgem is seeking to place on networks would then operate around a central view forecast of total expenditure taking additions and disposals together.

Clearly it is not in consumers' interest to move from a policy of consumers receiving 100% of monies recovered from disposals to one where they receive only around 45% unless the initial allowed expenditure also takes additions and disposals together. If Ofgem proceed with this change, we would expect transparency surrounding the deductions from totex allowances assumed due to expected recoveries from disposals during RIIO ED1.

¹⁶ See paragraph 3.9 of DPCR5 Final Proposals, Appendix 1 of Charge Restriction Condition 15, and paragraph 6.105 of Electricity Distribution Price Control Cost and Revenue Reporting - Regulatory Instructions and Guidance

Chapter Six Question1: Do you agree with our acceptance of the DNO specific uncertainty mechanisms?

We believe the proposed scope of factors to be handled by way of uncertainty mechanisms appears reasonable. However, we suggest the following principles are adopted for the design of each specific uncertainty mechanism:

- Revenue and, by extension, network charging volatility should be minimised
- Efficiency and performance incentives must not be weakened
- Triggers for reopeners must be symmetrical if ex-ante allowances are made both over- and under-spends must be considered

Chapter Six Question2: Do you agree with our proposal to give all DNOs an uncertainty mechanism for rail electrification?

We believe the proposal is sensible because ex-ante allowances would otherwise be 'converted' into windfalls for the DNOs if the projected expenditure does not materialise. We note that the 'return' clause incorporated into the recently-modified Western Power Distribution licence offers customers protection from funding unnecessary revenue allowances only if the projected expenditure is funded by third parties. We suggest a similar mechanism should be introduced for slow-track DNOs but must be extended so that 'claw-backs' are activated if the projected expenditure does not materialise for any reason. We, also, urge Ofgem to proactively engage with the relevant stakeholders to limit customers' exposure to the costs of rail electrification.

SUPPORTING DOCUMENT: Assessment of the RIIO-ED1 resubmitted innovation strategies Chapter 2 Question 1: Do you agree with our assessment of each DNO's innovation strategy?

We agree DNOs must maximise the learning from innovation trials and make full use of smart metering data to deliver cost savings. However, we are concerned DNOs may disproportionately benefit from these allowances because of the following statement that appears in the assessment:

"...Companies can use the NIA to help them achieve and potentially surpass the efficiency targets which we have set..."¹⁷

This appears to represent an asymmetric inconsistency in favour of DNOs: customers are required to fund the NIA allowances AND the rewards for surpassing efficiency targets through methods funded by the allowances. We seek confirmation the expected efficiencies to be gained from the rollout of the relevant innovation schemes are accounted for in some way, noting that the smart savings identified by Ofgem's expenditure assessment do not appear to take account of the additional innovation funding provided during ED1.

¹⁷ Ofgem (2014), 'Assessment of the resubmitted RIIO-ED1 innovation strategies', page 3. See: <u>https://www.ofgem.gov.uk/ofgem-publications/89066/assesmentoftheinnovationstrategies.pdf</u>

Appendix 2 – Return on Regulatory Equity (RORE) analysis

We have analysed the potential returns available to networks over the RIIO ED1 period as a result of the Draft Determination and conclude that the current proposals do not align with Ofgem's stated policy of rewarding success through higher returns on regulated equity (RoRE):

"...we regard an appropriately calibrated price control package as one in which RoRE upside (ie the reward available for the best-performing DNOs) provides the potential for double-digit returns on (notional) equity, and RoRE downside (ie the penalties that would apply to the worst-performing DNOs) is at or below the cost of debt...."18,19,20

We agree with clear implication of this statement that generally it is the relative performance of the network that is important. It is not possible to conclude whether a network outperforming its targets and allowances is a genuinely 'good' performer or whether a network underperforming against its targets is a 'poor' performer, due to difficulties in setting robust targets. We agree that, as indicated above, rewarding the best performers and penalising the worst performing is the correct approach. However, we do not believe that this price control package is likely to achieve this.

Ofgem assumes a baseline Return on Regulatory Equity (RoRE) estimate of 6.0% and estimates the maximum downsides for underperformance will be returns in the range of 1.6% - 2.6% while the maximum upsides for outperformance will be returns in the range of 10.2% - 12.5%.



CHART4: Ofgem's view of plausible ranges for the Return on Regulated Equity²¹

¹⁸ "Consultation on strategy for the next electricity distribution price controls - RIIO-ED1 - Financial issues" https://www.ofgem.gov.uk/ofgem-publications/47149/riioed1sconfinancialissues.pdf

¹⁹ "RIIO-ED1: Draft Determination for Western Power Distribution Ltd" <u>https://www.ofgem.gov.uk/ofgem-</u> publications/84602/draftdeterminationsmaster.pdf ²⁰ RIIO-GD1: Final Proposals - Finance and uncertainty supporting document

https://www.ofgem.gov.uk/ofgem-publications/48156/3riiogd1fpfinanceanduncertainty.pdf

²¹ See Figure 5.1, page 44 of Draft Determination Overview document

However, by considering the likely level of performance of DNOs over ED1, and taking the policy decisions and incentive targets into account, it can be demonstrated that under the Draft Determination proposals returns can be expected to be much higher. We have analysed a scenario which we believe represents a reasonable central case for the expectation of performance over ED1, including conservative outperformance assumptions. This shows that an *average-performing* network will make returns in excess of 11% and the majority of networks will make double-digit returns (not just the best performing). By contrast we believe the worst-performing DNO is likely to earn a return of no less than 8% in our Central Case. Also, it is not credible that any network get returns equivalent to the Cost of Debt as this would require overspending against allowances to an extent (around 16%) without precedent (*all* networks are expected to under-spend during DPCR5). Chart 5 below shows our Central Case forecast of RoRE for each network and Table 4 below it contains our assumptions behind the forecast.



CHART 5: RIIO ED1 Return on Regulated Equity by DNO - Central Case

Table 4: British Gas Central Case estimate of likely RoRE – industry average value assumptions

Driver	Central Case Value	British Gas - Central Case Assumption
-	(average)	
Baseline RoRE	6.1%	6.0% for slow track DNOs and 6.4% for fast tracked DNOs
RPI formula effect	0.4%	Adds 0.4% to RoRE due to higher indexation of RAV
Change in CoD (converted to equivalent CoE)	0.2%	Average impact on returns of proposed change to Cost of Debt indexation – adds an equivalent of c. 0.3% to RoRE for slow tracked DNOs. Derived using forecasts of the two approaches provided by CEPA.
Ex ante reward/penalty	0.3%	Based on previous distribution price control negotiations. Networks have generally been able to 'pushback' on expenditure reductions proposed at Draft Determination. Our Central Case assumption is a small 1.1% pushback which increases Ofgem's view of efficient costs and therefore the ex-ante reward.
Totex efficiency Incentive	2.9%	Based on DPCR5 performance to date, networks have been able to under spend allowances by c. 10%. We assume the same level of under spend for RIIO ED1 compared to the allowances calculated at Draft Determination.
Interruptions incentive scheme	0.8%	For each network we deem 2014/15 performance based on forecast rewards published by the DNOs. We then assume an average industry improvement factor each year based on the last 3 years of DPCR5 (1.8%/yr for CML and 1.2%/yr for CI). We only use the last 3 years to determine the improvement factor to be conservative - we estimate the average industry improvement factor for the whole of DPCR5 would be 5.2%/yr for CML and 2.9%/yr for CI, whilst the improvement factor since 2005/06 would average 3.2%/yr for CML and 2.4%/yr for CI.
Health Index	0.0%	we make no assumption for Health Index
Broad Measure of Customer Satisfaction	0.6%	For each network we take published scores from 2012/13 and, where available, 2013/14 to derive expected annual improvement in scores, but we reduce improvement rate by 1%/yr to reflect expected diminishing returns.
Guaranteed Standards for reliability	-0.1%	Equates to a conservative estimate of approximately £1.5m/yr/DNO, or 0.3% of
Guaranteed Standards for severe weather	-0.1%	RORE, across all guaranteed standards. The only data available relates to 2010/11 and shows an average payment per DNO of £0.13m (including ex-gratia
Guaranteed Standards for connections	-0.1%	payments).
Losses discretionary reward	0.0%	We assume potential share of discretionary reward for any DNO of c. 10% (£3.2m). For the average DNO we assume 75% of total reward is awarded (£24m)
Time to connect Incentive	0.2%	We assume 75% of reward is achieved - consistent with the reward elements in BMCS.
Incentive on connection engagement	-0.1%	We assume 25% of penalties paid - consistent with penalty elements in BMCS.
Tax trigger dead bands	0.0%	We assume no change to tax arrangements
Forecast RoRE – Central Case	11.2%	

The RoRE figures above are the industry average. Our estimates for each DNO are provided in Table 5 below:

Table 5: British Gas Central Case estimate of RoRE by DNO

Central Case	ENWL	NPGN	NPGY	WMID	EMID	SWales	SWest	LPN	SPN	EPN	SPD	SPMW	SSEH	SSES	Average
Baseline RoRE	6.0%	6.0%	6.0%	6.4%	6.4%	6.4%	6.4%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.1%
RPI formula effect	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%
Change in CoD (converted to equivalent CoE)	0.3%	0.3%	0.3%	0.0%	0.0%	0.0%	0.0%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.2%
Ex ante reward/penalty	0.4%	0.1%	0.1%	1.0%	1.0%	1.0%	1.0%	-0.1%	-0.1%	-0.1%	0.0%	0.0%	0.2%	0.2%	0.3%
Totex efficiency Incentive	2.3%	2.0%	2.0%	5.1%	4.0%	4.8%	6.9%	2.1%	2.0%	2.0%	1.8%	1.9%	2.2%	2.1%	2.9%
Interuptions incentive scheme	1.3%	-0.1%	-0.1%	2.6%	2.5%	1.3%	1.1%	1.3%	1.1%	1.3%	0.0%	0.0%	-0.1%	-1.1%	0.8%
Health Index	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Broad Measure of Customer Satisfaction	0.5%	0.7%	0.5%	0.9%	0.9%	1.0%	0.8%	0.4%	0.5%	0.6%	0.4%	0.6%	0.7%	0.4%	0.6%
Guaranteed Standards for reliability	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%
Guaranteed Standards for severe weather	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%
Guaranteed Standards for connections	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%
Losses discretionary reward	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.0%	0.1%	0.1%	0.1%	0.1%	0.0%
Time to connect Incentive	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Incentive on connection engagement	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%
Tax trigger deadbands	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Forecast RoRE - Central Case	10.9%	9.1%	9.0%	16.1%	15.1%	14.8%	16.3%	10.2%	10.0%	10.2%	8.7%	9.0%	9.4%	8.0%	11.2%

-

-

_

We have also constructed plausible High and Low cases for RoRE performance. Table 6 below shows our range for RoRE under these scenarios:

E

	High	Central	Low
AVERAGE	14.0%	11.2%	6.9%
BEST PERFORMING	18.0%	16.3%	12.2%
WORST PERFORMING	12.0%	8.0%	3.6%
ENWL	14.3%	10.9%	6.0%
NPGN	13.7%	9.1%	4.5%
NPGY	13.7%	9.0%	4.7%
WMID	17.6%	16.1%	12.2%
EMID	16.6%	15.1%	10.7%
SWales	16.5%	14.8%	9.8%
SWest	18.0%	16.3%	11.7%
LPN	12.4%	10.2%	6.0%
SPN	12.1%	10.0%	6.0%
EPN	12.3%	10.2%	6.2%
SPD	12.4%	8.7%	4.7%
SPMW	12.0%	9.0%	5.2%
SSEH	13.2%	9.4%	5.3%
SSES	13.1%	8.0%	3.6%

Table 6: BG plausible ranges for RoRE

We believe that the ranges presented above are more representative of likely performance for RIIO ED1 than the ranges presented by Ofgem in the Draft Determination which we conclude are not credible. Below we highlight the key areas where our assumptions differ to Ofgem:

Cost of Debt:		
RoRE	British Gas	Ofgem
Central	+0.2%	0.0%
High	+0.2%	0.0%
Low	+0.2%	0.0%

Ofgem have not included the impact on returns or revenues during RIIO ED1 of their proposed change to the cost of debt indexation. CEPA have provided us with a forecast of the new 'trombone' debt index compared to original proposal, which has allowed us to calculate the impact on returns that this proposed change in policy would have. We calculate this impact at c. £120m over the price control period for the slow track DNOs, which converts to 0.3% on RoRE. This means that the effect of the proposed change to the cost of debt indexation is to negate the impact of Ofgem's recent decision on the Cost of Equity (reducing their central reference point from 6.3% to 6.0%).

Table 7	Forecast cost	of debt allow	wance under	Ofgem	'trombone'	mechanism	versus original
				- 0 -			

%	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Trombone	2.54	2.43	2.37	2.34	2.32	2.31	2.30	2.31
Original	2.54	2.43	2.37	2.31	2.20	1.97	1.96	1.98

Source: Markit, Bloomberg, CEPA analysis

Ex ante reward:

RoRE	British Gas	Ofgem
Central	+0.3%	+0.2%
High	+0.5%	+0.2%
Low	+0.2%	+0.2%

From Ofgem's chart it would seem that they assume no change in the ex ante rewards contained in Draft Determination. Whilst we understand that the regulator may not wish to indicate the potential for movement at this stage in their negotiations with networks, we note that history suggests that networks are able to push back on the reductions proposed in Draft Determinations. Our low case assumption for the ex ante reward therefore assumes no pushback and equates to 0.2% of RoRE (consistent with Ofgem's view). In our central case we assume a small push back by DNOs of 1.1% of totex, which increases Ofgem's view of efficient costs and therefore the ex ante rewards equating to 0.3% of RoRE. Our 1.1% central case assumption represents the movement that would be required to align the ratio of network submitted totex to Final Determination totex for RIIO ED1 with that observed with the most recent distribution price controls (RIIO GD1 and DPCR5). In our high case, we assume a push back of 5.1% which assumes the network pushback is proportional to the pushback observed between Draft Determination (Initial Proposals) and Final Determination (Final Proposals) for RIIO GD1 and DPCR5.

Totex Efficiency Incentive:

RoRE	British Gas	Ofgem	
Central	+2.9%	+0.3%	
High	+3.5%	+1.8%	
Low	+0.8%	-1.2%	

Ofgem previously assumed a historical estimate of plus or minus 10% for totex efficiency. This has been lowered in the Draft Determination to plus or minus 7.5% (equating to an approximate range of +1.8% to -1.2% on RoRE according to Ofgem's chart). We do not consider that a 10% under spend on totex has become implausible. We believe this is the level of actual performance shown by data from DPCR5 to date and so we consider a 10% under spend on allowances calculated at slow track to represent the central case (2.9% RoRE). This is supported by early evidence from RIIO GD1 where National Grid has under spent their RIIO GD1 allowances by almost 12% indicating there is no evidence to suggest that the RIIO regime has altered the pattern of under spending allowances. Our high case assumes a 12% under spend which we believe is also consistent with the first three years of DPCR5. Our low case assumes that a DNO spends the allowance calculated at slow track. We do not consider it credible to assume any overspends on allowances and certainly we are not aware of any evidence which would support a 7.5% overspend as being plausible over a price control period.

RoRE	British Gas	Ofgem
Central	+0.8%	0.0%
High	+1.7%	+2.5%
Low	+0.2%	-2.5%

Interruptions Incentive Scheme:

Ofgem assume a range of plus or minus 2.5% of RoRE, which simply represents the cap and collar for the scheme. Ofgem take no account of likely levels of performance compared to the proposed targets. We have modelled rewards based on plausible performance scenarios which provide a more robust range of RoRE outcomes. The charts below show the path of average industry performance for each of our scenarios. We also include a performance path which would equate to Ofgem's high and low ranges for impact on RoRE which demonstrates that Ofgem's low case is implausible:

CHART 6: Interruptions Incentive Scheme: Average industry performance Customer Minutes Lost

CHART 7: Interruptions Incentive Scheme: Average industry performance Customer interruptions

In our central case, for each network we deem 2014/15 performance based on forecast rewards published by DNOs. We then assume an average industry improvement factor each year based on the last 3 years of DPCR5 (1.8%/yr for CML and 1.2%/yr for Cl). We only use the last 3 years to determine the improvement factor to be conservative - we estimate the average industry improvement factor for the whole of DPCR5 would be 5.2%/yr for CML and 2.9%/yr for Cl, whilst the improvement factor since 2005/06 would average 3.2%/yr for CML and 2.4%/yr for Cl. Our central case average RoRE estimate on this basis is on 0.8%.

Our low case scenario assumes no improvement in performance compared to the average observed from 2011/12 to 2014/15. Given the observed long term trend of improved performance by networks, this is likely to be quite a pessimistic scenario, and yet even in this scenario the average RoRE impact is +0.2%. We are unable to perceive any turn of events which would result in a low case equating to Ofgem's RoRE impact of -2.5%.

Our high case scenario assumes that the step change in performance achieved in a single year by a number of DNOs in 2011/12 is replicated by the remaining networks once RIIO ED1 has commenced. Given that these step change improvements in performance were achieved at lower overall cost, it is very plausible that other networks will make similar changes to working practices to achieve similar step change improvements in performance. Our high case average RoRE impact on this basis is 1.7%.

Broad Micasure of Castollier Satisfaction.											
RoRE	British Gas	Ofgem									
Central	+0.6%	0.0%									
High	+0.8%	+0.9%									
Low	+0.2%	-0.9%									

Broad I	Measure	of	Customer	Satisfaction:
---------	---------	----	----------	---------------

Ofgem assume a range of plus or minus 0.9% of RoRE, which again simply represents the cap and collar for the various elements of the scheme, taking no account of the expected performance relative to targets. In our central case we take published scores from 2012/13 and, where available,

2013/14 to derive expected annual improvement in scores. However we reduce this improvement rate by 1%/yr to reflect expected diminishing returns i.e. if scores increased by 4% between 2012/13 and 2013/14 we forecast scores to increase by only 3% between 2013/14 and 2014/15 and by 2% in the following year and so on until the scores flatten out. Our low case assumes no improvement over the entire RIIO ED1 period relative to the latest available scores published by Ofgem. Even in this scenario, the impact on RoRE is +0.2%. Therefore, we do not consider that Ofgem's lower range for RoRE impact of -0.9% is plausible.

RoRE	British Gas	Ofgem									
Central	-0.3%	-0.4%									
High	-0.1%	0.0%									
Low	-0.5%	-0.8%									

Guaranteed Standards:

The only data we are able to source on payments under the Guaranteed Standards of Performance relates to 2010/11 and in that year the average payment across the DNOs was just £0.13m. We have been quite conservative in our central case in assuming average annual payments increase to c. $\pm 1.5m/yr/DNO$. Our low case assumes a payment of c. $\pm 2.5m/yr/DNO$, whilst our high case assumes an annual payment of $\pm 0.5m - all$ three scenarios therefore include significantly higher payments than suggested by the 2010/11 data. Ofgem's low case assumes an impact on RoRE of -0.8% which would equate to a payment of c. $\pm 4m/yr/DNO$ across the RIIO ED1 period. Whilst such levels of payment could conceivably occur in isolated years with instances of exceptionally severe weather, we do not consider it credible to assume such levels of payment on average across the RIIO ED1 period.

For reference we present below our High Case and Low Case RoRE estimates by DNO. We would happy to meet with any interested parties to explain our analysis in more detail.

CHART 8: RIIO ED1 Return on Regulated Equity by DNO - High Case

Table 8: British Gas High Case estimate of RoRE by DNO

High Case	ENWL	NPGN	NPGY	WMID	EMID	SWales	SWest	LPN	SPN	EPN	SPD	SPMW	SSEH	SSES	Average
Baseline RoRE	6.0%	6.0%	6.0%	6.4%	6.4%	6.4%	6.4%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.1%
RPI formula effect	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%
Change in CoD (converted to equivalent CoE)	0.3%	0.3%	0.3%	0.0%	0.0%	0.0%	0.0%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.2%
Ex ante reward/penalty	0.8%	0.4%	0.4%	1.0%	1.0%	1.0%	1.0%	0.3%	0.3%	0.3%	0.3%	0.3%	0.8%	0.8%	0.6%
Totex efficiency Incentive	2.8%	2.5%	2.5%	5.6%	4.6%	5.5%	7.5%	2.6%	2.5%	2.5%	2.3%	2.4%	2.7%	2.6%	3.5%
Interuptions incentive scheme	2.5%	2.4%	2.5%	2.6%	2.6%	1.3%	1.1%	1.4%	1.1%	1.3%	1.8%	1.0%	1.4%	1.6%	1.7%
Health Index	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Broad Measure of Customer Satisfaction	0.7%	0.8%	0.8%	0.9%	0.9%	1.0%	0.8%	0.7%	0.8%	0.8%	0.5%	0.8%	0.8%	0.6%	0.8%
Guaranteed Standards for reliability	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Guaranteed Standards for severe weather	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Guaranteed Standards for connections	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Losses discretionary reward	0.1%	0.2%	0.2%	0.1%	0.1%	0.2%	0.2%	0.2%	0.2%	0.1%	0.1%	0.1%	0.2%	0.1%	0.1%
Time to connect Incentive	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Incentive on connection engagement	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%
Tax trigger deadbands	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Forecast RoRE - High Case	14.3%	13.7%	13.7%	17.6%	16.6%	16.5%	18.0%	12.4%	12.1%	12.3%	12.4%	12.0%	13.2%	13.1%	14.0%

CHART 9: RIIO ED1 Return on Regulated Equity by DNO - Low Case

Low Case	ENWL	NPGN	NPGY	WMID	EMID	SWales	SWest	LPN	SPN	EPN	SPD	SPMW	SSEH	SSES	Average
Baseline RoRE	6.0%	6.0%	6.0%	6.4%	6.4%	6.4%	6.4%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.1%
RPI formula effect	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%	0.4%
Change in CoD (converted to equivalent CoE)	0.3%	0.3%	0.3%	0.0%	0.0%	0.0%	0.0%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.2%
Ex ante reward/penalty	0.3%	-0.1%	-0.1%	1.0%	1.0%	1.0%	1.0%	-0.2%	-0.2%	-0.2%	-0.1%	-0.1%	0.1%	0.1%	0.2%
Totex efficiency Incentive	0.0%	0.0%	0.0%	2.7%	1.5%	2.1%	4.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.8%
Interuptions incentive scheme	0.3%	-1.1%	-0.8%	2.3%	1.9%	0.3%	0.2%	0.9%	0.6%	0.7%	-0.4%	-0.2%	-0.4%	-1.8%	0.2%
Health Index	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%
Broad Measure of Customer Satisfaction	0.0%	0.2%	0.2%	0.6%	0.7%	0.8%	0.6%	-0.1%	0.1%	0.2%	-0.2%	0.1%	0.2%	-0.1%	0.2%
Guaranteed Standards for reliability	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%
Guaranteed Standards for severe weather	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%
Guaranteed Standards for connections	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%
Losses discretionary reward	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Time to connect Incentive	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Incentive on connection engagement	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%
Tax trigger deadbands	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%
Forecast RoRE - Low Case	6.0%	4.5%	4.7%	12.2%	10.7%	9.8%	11.7%	6.0%	6.0%	6.2%	4.7%	5.2%	5.3%	3.6%	6.9%