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

19th January 2015

Clothilde Cantegreil
Office of Gas and Electricity Markets
9 Millbank,
London, SW1P 3GE

Dear Clothilde,

British Gas response to the notice under section 11A(2) of the Electricity Act 1989 to modify the electricity distribution licences of the 'slow-track' DNOs

Introduction

1. 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.

2. This statutory consultation is the final step in a process that dates back to 2012, when Ofgem issued its 'open letter consultation' on the way forward for the RIIO-ED1, with various milestones including Ofgem's 'Strategy Decision' in March 2013 and its 'Final Determinations' in November 2014. We have been deeply engaged with RIIO ED1, having made formal responses throughout the process. Our objective throughout this process has been to ensure that the RIIO ED1 price controls are calibrated to protect the interests of consumers, consistent with Ofgem's principal statutory duty.

3. We remain concerned that the process to date has not been rigorous in addressing issues raised by non-DNO stakeholders. In particular, as we set out in more detail below, key issues we have raised on numerous occasions in the process to date are yet to receive a proper level of consideration by Ofgem. We therefore do not consider Ofgem's approach on these issues has been adequately justified.

4. We are also concerned that Ofgem's approach has not been appropriately focused on the relevant statutory criteria, including Ofgem's principal objective to "protect the interests of existing and future consumers". While the Electricity Act 1989 provides that Ofgem must have regard to the financeability of DNOs, and certain other objectives, it is clear that its principal objective takes primacy. Ofgem must also have regard to "the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed".

5. It is not apparent that, in reaching its decisions on various aspects of the Final Determinations, Ofgem has taken a disciplined approach to assessing the various options

against the statutory objectives and considerations. Indeed, we are concerned that Ofgem appears to have taken approaches that appear difficult to reconcile with the statutory objectives and considerations – such as applying certain benefits to all DNOs when, at best, only certain DNOs provided evidence that their circumstances warranted such benefits.

6. In our response to the RIIO ED1 Draft Determinations we highlighted a number of concerns with the proposed settlement for the slow track DNOs under the following headings:
   - The likely levels of returns to be made by DNOs
   - Unjustified changes to the RIIO ED1 Strategy Decision:
     - Cost of debt indexation
     - The IQI breakeven point matrix
     - Asset life transition
   - Improvements required to the implementation of the RIIO ED1 Strategy Decision:
     - Targets for the Interruptions Incentive Scheme
     - Directly remunerated services (ES4)
     - Transparency / Other issues – disposals
   - Cost of equity and having regard to the overall balance of risk and reward faced by DNOs

7. Below we set out for each area of concern how the RIIO ED1 Final Determination has failed to satisfactorily address the issues we raised. Partly as a result of this, we believe that the RIIO ED1 Final Determinations contain a number of errors that require correcting. Overall, this leads to a settlement that is overly generous to the DNOs. We therefore continue to believe that there are material and legitimate concerns that this price control determination, as given effect by these proposed licence changes, is flawed in the respects identified and does not protect the interests of existing and future GB consumers.

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

Concerns raised in our response to Draft Determinations:

8. In our response to the Draft Determinations we acknowledged Ofgem's policy (as set out in its Strategy Consultation and reiterated in its Draft determination for WPD) of calibrating the price control to reward DNOs for success through higher returns on regulated equity (RoRE) [1]:

> *"...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..."*[2,3]

[1] Page 2, British Gas response to RIIO-ED1: Draft Determinations: https://www.ofgem.gov.uk/ofgem-publications/90604/britishgasresponsetodraftdeterminationsconsultation.pdf

[2] Ofgem (2012), 'Consultation on strategy for the next electricity distribution price controls - RIIO-ED1 - Financial issues', para. 3.13. See: https://www.ofgem.gov.uk/ofgem-publications/47149/riioed1sconfinancialissues.pdf

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

9. In the Draft Determinations, Ofgem assumed a baseline Return on Regulatory Equity (RoRE) estimate of 6.0% and, in the course of assessing the financeability of the proposals, set out ranges of uncertainty in DNOs' RoRE. It estimated maximum downsides to be in the range of 1.6% - 2.6% across the DNOs and maximum upsides (i.e. which should in principle be available only to 'best performing' DNOs) to be in the range of 10.2% - 12.5%, ranges which implied that the price control package would be consistent with Ofgem's above-stated policy.

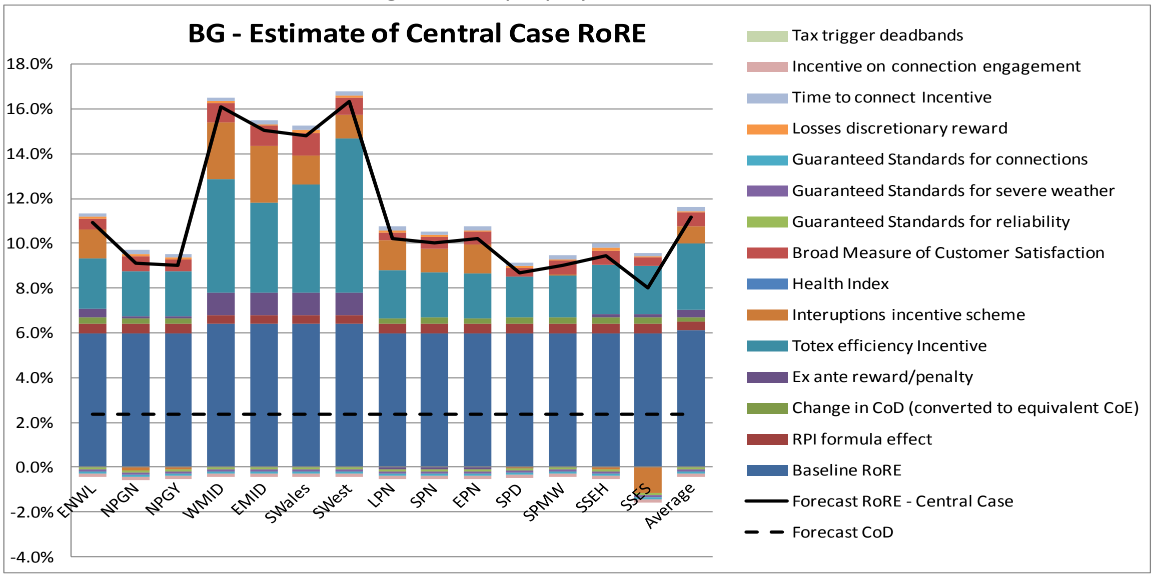
10. In our response to the Draft Determinations we provided evidence to demonstrate our belief that these ranges were not credible representations of the 'maximum' upside or downside returns that DNOs could achieve. [4] By considering the likely level of performance of DNOs over ED1, and taking the policy decisions into account, we demonstrated that the proposed settlement was likely to provide for excessive returns that did not align with the above policy and which were not needed to protect against threats to financial stability. We presented a scenario which we believed represented a reasonable central case for ED1, including conservative outperformance assumptions. Further detail was contained in our response to the Draft Determinations, but essentially this scenario assumed that networks would continue to perform in line with performance in the current price control period (DPCR5). Our analysis showed that an *average-performing* network would make returns in excess of 11% and the *majority* of networks would make double-digit returns (not just the best-performing) [see Chart 1, below]. By contrast the worst-performing DNO would be likely to earn a return of no less than 8%.

11. We showed that it was unlikely that any network would receive returns equivalent to, let alone below, 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). We concluded that the RIIO ED1 price control package had not been appropriately calibrated.

12. We also drew attention to the draft determinations in the water sector. In those proposals Ofwat estimated 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 would be a RoRE of 9.2%. This reinforced the conclusion that the RIIO-ED1 price control package had not been appropriately calibrated.

[4] See Appendix 2, British Gas response to RIIO-ED1: Draft Determinations: https://www.ofgem.gov.uk/ofgem-publications/90604/britishgasresponsetodraftdeterminationsconsultation.pdf

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



Ofgem reply in Final Determinations:

13. Ofgem has not addressed, or acknowledged, our concerns with regards to the calibration of the price control in Final Determinations. Instead, Ofgem has appeared to change the policy for an appropriately calibrated price control:

    "5.37 The RORE ranges shown in this chart are broadly consistent with our strategy decision that <u>outperforming</u> DNOs could have the potential to earn RORE above 10% while RORE for underperforming DNOs <u>could be below</u> the cost of debt. This indicates we have appropriately calibrated our package of risk and incentives." [Emphasis added]

    The Draft Determinations for the slow track DNOs and for WPD referred to only best performing DNOs achieving double digit returns, and that underperforming DNOs could achieve lower returns than their cost of debt.

British Gas conclusions:

14. Whilst the small change of phrasing in the Final Determination may appear inconsequential, it is in fact a significant change in policy and the wording change would appear to reflect an appreciation that many DNOs could earn returns in excess of the generous return on equity envisaged. Throughout the RIIO ED1 process, Ofgem's stated policy had been to calibrate the price control such that only the *best* performing DNOs could receive double digit returns while the *worst* performing DNO would receive returns at or below the cost of debt. This is the basis that the RIIO ED1 strategy was consulted upon, and we can find no reference to a strategy relating to "outperforming" and "underperforming" networks, as claimed in Final Determinations. This appears, therefore, to be a mistake.

15. The analysis we presented in response to the Draft Determinations clearly demonstrated that Ofgem had failed to focus on ensuring that only a reasonably efficient network earns its cost of capital, and higher returns require higher efficiency. If Ofgem has deliberately changed its policy, this could be viewed as an implicit acceptance that the settlement fails to

deliver on the original policy intent (and, certainly, no attempt was made to question our analysis). Additionally, our offer to discuss our analysis in further detail was not taken up.

16. The change in phrasing at Final Determinations to focus on *outperforming* and *underperforming* DNOs, as opposed to the *best* and *worst* performing DNOs, is a significant change in policy since it shifts away from a model that better reflects a competitive market (where the *most efficient* players in a market are rewarded) to one where Ofgem determines the measure of 'performance' and every DNO could conceivably be assessed against this criterion as *outperforming.* That this change in policy was made without any consequential changes to the settlement further suggests that the original policy intent is not met, and that Ofgem accepts this as such. No longer can stakeholders hold an expectation that average returns will be in line with the 6.0% baseline. Instead their expectations must be based on a probabilistic assessment of the performance of each individual DNO against the specific allowances and targets set by Ofgem for it. Ofgem has produced no such probabilistic assessment, despite being previously suggested to Ofgem as helpful by Citizens Advice[5]. Without this, the RoRE analysis presented by Ofgem is most accurately described as a sensitivity analysis. It does not give a guide to the returns to be expected over RIIO ED1, but brings a real risk that it will be interpreted by stakeholders as doing so. As stated above, the results of our own RoRE analysis showed that networks which were not highly efficient would make returns in excess of 11% and the majority of networks would make double-digit returns (not just the best-performing). Moreover, the worst-performing DNO would still be likely to outperform the baseline level of return.

17. We do not believe an approach where every DNO <u>can</u> (and, in our assessment, <u>is likely to</u>) obtain returns well above the 6.0% average proposed by Ofgem can possibly be in the interests of consumers. Ofgem has provided no evidence that such returns are necessary to serve the interests of UK consumers. We believe the interests of UK consumers are best served by a price control calibrated in the manner originally set out in Ofgem's Strategy Decision.

18. We therefore conclude that:

- Ofgem has not calibrated this price control appropriately or in line with the Strategy Decision;
- the change in policy in this area at Final Determinations (assuming, that is, that this change was not a mistake) was not flagged by Ofgem which is surprising given the significance of the change; and
- the resultant expected levels of returns are excessive.

(2) Cost of Debt Indexation

Concerns raised in our response to Draft Determinations:

19. In our response to the Draft Determinations we argued that the change to the cost of debt indexation proposed in Draft Determinations had not been justified and was in conflict with

[5] Citizen's Advice response to Revised RIIO:ED1 Business Plans - https://www.ofgem.gov.uk/ofgem-publications/87805/citizensadviceresponse.pdf

established regulatory principles. We noted that several DNOs had accepted the original index mechanism in their revised business plans.

20. We commissioned CEPA to look at the issue in depth and highlighted the following from their findings:

- the change in approach to the cost of debt was unjustified, and would lead to a forecast £120m in additional costs relative to the original 10 year trailing index for consumers in RIIO ED1, and a windfall for network companies.
- the change risked unintended consequences and raised concerns for subsequent price controls in the energy sector, including potentially creating windfall gains and asymmetric sharing of risks.
- there was headroom in the proposed cost of debt mechanism for a notionally efficient DNO that obviated the further increase in generosity under the proposed 'trombone' index. This headroom arose from the well-established halo effect, yield curve effects and the representativeness of the index during the Global Financial Crisis.

21. We argued that Ofgem should maintain its focus on the notional efficient company, and that at most actual debt costs should be used as a cross-check. We stated that any analysis of actual costs should include an assessment of whether these were consistent with the behaviour of a notionally efficient DNO. We highlighted that Ofgem had previously rejected uplifts for higher embedded debt costs in their DPCR5 decision and we stated our belief that there was no rationale for an uplift for all companies in this case.

Ofgem reply in Final Determinations:

22. In paragraph 5.14 of Final Determinations Ofgem stated:

"*5.14 One non-DNO thought we should maintain our focus on the notional efficient company, and that actual debt costs should only be used to cross-check.*"

23. We assume that this sentence refers to our response to Draft Determinations and represents Ofgem's acknowledgement of the evidence and arguments presented by our response and the CEPA report that accompanied it. Ofgem provided no further comment on any of the arguments made in our response or the CEPA report we commissioned.

British Gas conclusions:

24. As our legitimate concerns have not been addressed, we remain of the view that this change ought to be reversed. The Ofgem Strategy Decision for RIIO ED1 with respect to the Cost of Debt allowance stated:

"*2.14. Our decision is as follows:*

- *to set the cost of debt assumption in the WACC based on a 10-year simple trailing average index (with provision for companies to justify alternatives in exceptional circumstances)…"*

2.15. However, <u>if a company can show in its business plan that the 10-year simple average index is not appropriate for its circumstances, it can propose modifications</u>. We will consider the merits of such a proposal when evaluating the business plan <u>and would need to satisfy</u>

ourselves that the adoption of a different approach is both robust and justified." [Emphasis added]

25. This strategy decision was arrived at following extensive consultation and took account of the arguments made by DNOs on whether the 10-year simple trailing average was reflective of the actual maturity of network company debt and whether it took into account the cost of embedded debt. In the Strategy Decision Ofgem also acknowledged, and rejected, the proposal from several network companies to use a trombone index extending to 20 years similar in form to the one proposed now proposed by Ofgem:

   "2.17 *Several network companies have proposed using a longer average of yields commencing from the start of the iBoxx data in 1998 which increases in length until there is sufficient data to construct a 20 year trailing average. DNOs argue that this would smooth movements in interest rates, especially since interest rates are currently at historical lows, and more closely match the maturity of DNO debt.*"
   "2.22. Based on the feedback we have received during the consultation process, we do not believe any new arguments have been raised that materially change our assessment on the methodology for calculating the cost of debt utilised in RIIO-GD1 and RIIO-T1. We will therefore retain our approach of annually updating the cost of debt estimate based on the simple 10-year simple trailing average of the iBoxx indices, with no adjustments to the index."[6]

26. We have therefore held reasonable expectations throughout the RIIO ED1 process that the cost of debt allowance would be based on the 10-year simple trailing average index contained in the Strategy Decision – unless a DNO, in its business plan submission, provided robust evidence of specific circumstances which justified an alternative. Further, in the Final Determinations, Ofgem appears to have assessed the merits of a tromboned index only against financeability criteria, noting that a trombone index will offer the sector significant protection against market interest rate uncertainty.

27. Ofgem did not consider whether this approach reflected best regulatory practice, including being an approach that reflects the benefits of consistency, transparency and predictability. A fixed term trailing average should in principle allow DNOs to recover their efficient costs of debt over the long term, and is an approach that is durable, consistent and certain. A trombone index adds regulatory complexity and gives greater weight to early years and less weight to later years – leading to a skewed approach that appears designed to minimise the impact of periods when the market cost of debt was lowest. This cannot be a sustainable regulatory approach or one which reflects current market debt costs. The conclusion is therefore that the approach is inherently asymmetrical in benefiting DNOs will provide DNOs with a one-off opportunity to over-recover.

28. Ofgem also did not consider whether the action was targeted only at DNOs for which action is needed. Indeed, since 3 of the 5 DNO groups (SP, SSE and UKPN, representing 7 of the 10 licensees) accepted the proposed 10-year simple trailing average in their March 2014 business plans, this suggests that there can be no reasonable justification for changing the index for those DNOs. With regards to the other two DNOs, we have not seen sufficient

[6] See para's 2.17 and 2.22 of Strategy Decision for the RIIO-ED1 electricity distribution price control: Financial issues: https://www.ofgem.gov.uk/ofgem-publications/47071/riioed1decfinancialissues.pdf

evidence to be able to conclude that their debt financing decisions can be considered efficient (and hence, that there can be any case for a change to the cost of debt index mechanism).

29. Finally, Ofgem did not balance any perceived benefit in terms of financeability, together with considerations of regulatory good practice, against the additional costs faced by UK consumers in order to determine the correct approach.

(3) The IQI breakeven point matrix

Concerns raised in our response to Draft Determinations:

30. In our response to the Draft Determinations we challenged the decision to relax the IQI matrix, which was in direct contradiction to Ofgem's own previously stated, and correct, view that this simply gave away money to DNOs without improving any of the incentive properties.[7] Further to this, we explained that making an ex-post adjustment to the nature of incentives was the worst possible outcome for customers as this gives increased rewards (or reduced penalties) to networks with no chance of affecting bidding behaviour.

Ofgem reply in Final Determinations:

31. None of our objections have been addressed in the Final Determinations. The main justification given in paragraph 1.28 of the Final Determinations is '*we think that it is appropriate to reward companies that have provided good information that aided our comparative benchmarking'* and that the benefits also include *'preserving the incentive properties of the IQI for future price control reviews*'. Ofgem also noted that:

> "*The benefits of this proposed change include: - ensuring DNOs that have provided good quality information which has aided our comparative benchmarking receive a reward – in line with the original policy intent of the IQI. It maintains penalties for those DNOs who have provided less robust forecasts; - preserving the incentive properties of the IQI for future price control reviews. The potential downside of this proposed change is that it results in smaller overall penalties (and hence costs consumers more by approximately £290m). However we consider that this cost is more than offset by the benefits of this change including the savings delivered through effective comparative benchmarking in this and future price controls. The slow-track benchmarking has delivered cost savings of nearly £700m. We consider that our proposed rewards and penalties are proportionate to the robustness of the information that the companies have provided*".

British Gas conclusions:

32. This decision is a clear error. The justification does not hold up to scrutiny and is contradicted by the outcomes. In terms of aiding comparative benchmarking, there has been a very limited reduction in revenues resulting from comparative benchmarking of around £264m across the RIIO ED1 period. Ofgem estimates the additional costs to customers of

[7] See para 6.22 of Strategy Decision: https://www.ofgem.gov.uk/ofgem-publications/47067/riioed1decoverview.pdf

relaxing the IQI matrix alone as £290m. This means customers end up paying more as a result of comparative benchmarking. This is not a credible or acceptable outcome.

33. In addition to this, the combined effect of interpolation and the change to the IQI breakeven point is that slow-track networks receive around £261m more in revenues than if forecasts for RPEs and smart grid savings had been in line with Ofgem's estimates and so no change to the DNO submissions or the IQI matrix was required. (Ofgem state in its Draft Determinations that they *"have reviewed the design of the IQI in light of the cost adjustments we are making after setting the UQ efficiency benchmark (RPEs and smart grid savings)")*. So, far from being rewarded for providing good information, in practice networks have received substantial rewards for providing what appears to be viewed by Ofgem as very poor information. This is damaging to the incentive regime for future price controls as it signals that networks can be rewarded for collective over forecasts.

34. There is, therefore, strong evidence that the relaxation of the IQI matrix is an error.

(4) Asset life transition

Concerns raised in our response to Draft Determinations:

35. For Final Determinations, we asked that the application of a transition period for the 45-year life for new assets be limited to those DNOs whose individual circumstances may warrant it. We estimated that the blanket approach to transition would increase revenue allowances by up to £675m over the price control[8].

Ofgem reply in Final Determinations:

36. Ofgem has neither acknowledged nor addressed our concerns in this area. Its only previous consideration was given in its Draft Determinations – Financial Issues, where it noted that "The DNOs have all proposed transition arrangements for asset lives from 20 to 45 years in equal steps over the eight years of RIIO-ED1 to assist financeability. We consider their proposals are sensible." We do not consider that this represents an adequate or proper consideration of the issue.

British Gas conclusions:

37. The blanket approach to transition appears to be in contradiction with the Strategy Decision which states that companies would need to provide evidence that transitional arrangements 'are necessary to ensure financeability'. The RIIO Handbook is also clear that the responsibility for financeability lies with the companies[9]. It does not appear from the published material that any evidence of individual financeability requirements has been provided.

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[8] Page 4, British Gas response to RIIO-ED1: Draft Determinations: https://www.ofgem.gov.uk/ofgem-publications/90604/britishgasresponsetodraftdeterminationsconsultation.pdf

[9] See paragraph 12.27 of Handbook for implementing the RIIO model: https://www.ofgem.gov.uk/ofgem-publications/51871/riiohandbook.pdf

38. It is not credible that all networks would require identical transitional arrangements to ensure financeability and so it is certain that the blanket approach to transition cannot be appropriate or necessary. Indeed, many DNOs appear to exceed almost all of the targets in all years. In the Final Determinations, Ofgem states that, in general, '*conventional accounts-based financial indicators are positive and well above levels that would threaten investment grade*'. It also does not appear that any assessment of financeability without transition has been undertaken by Ofgem.

39. The move to 45-year asset life is a welcome and sensible decision and should not be delayed without full justification, consistent with the regulatory principle in the Electricity Act 1989 that regulatory decisions should be targeted only at cases where action is needed. Although viewed as net present value neutral for networks, this is not the case for customers who are likely to have a higher effective cost of capital than that of the networks meaning this will be real cost to customers in addition to a timing issue. This is particularly unwelcome in the current economic environment, where all efforts should be made to help with affordability.

(5) Targets for the Interruptions Incentive Scheme

Concerns raised in our response to Draft Determinations:

40. In our response to the Draft Determinations we reiterated our consistent position[10] that rolling averages should be used to set network reliability targets in order to embed historic performance gains.

41. We called for targets that required improvements in performance over and above that observed (and rewarded) during DPCR5 and estimated that this would save customers around £162m over the price control for the slow track DNOs.

42. However, acknowledging where we were in the process, we argued that, at the very least, the most recent data available (2013/14) should be included in the benchmarking for target-setting. We highlighted that DNOs are expected to receive rewards in excess of £0.5bn due to too easily achievable targets set by Ofgem for DPCR5, often whilst spending less on their networks and we estimated that DNOs may earn over £0.5bn via this incentive during RIIO ED1. In the RoRE analysis we presented to Ofgem, our central case, which included a conservative estimate of performance, showed this incentive would add on average 0.8% to returns during RIIO ED1.

Ofgem reply in Final Determinations:

43. In its Final Determination, Ofgem noted that

"*One respondent thought the targets will be too easily achieved. Its view is that DNOs have gained significantly from this over DPCR5. It proposed targets based on rolling averages to include historical improvements in performance. Our approach to benchmarking reliability*

[10] Page 31, British Gas response to Strategy Consultation, supporting capped rolling targets with a 2 year lag: https://www.ofgem.gov.uk/ofgem-publications/47080/British Gased1stratresponsev2.pdf

performance includes historical performance and therefore sets challenging targets for RIIO-ED1. We have included improvement factors in the RIIO-ED1 targets to ensure the DNOs continue to be challenged by the IIS. We have also reintroduced the cap on upside performance to protect customers from DNOs making excessive returns".

British Gas conclusions:

44. The concerns we have repeatedly highlighted throughout the RIIO ED1 process, regarding the setting of easy upfront targets for this high cost incentive which fails to adequately acknowledge the step change improvements achieved by many DNOs during DPCR5, have not been addressed. Our analysis shows DNOs are expected to earn over £0.5bn from this incentive which emphasises the need to ensure a fair outcome for customers.

45. We do not believe it is appropriate to exclude 2013/14 and 2014/15 data from the benchmarking used to set targets to apply from 2015/16, regardless of the application of the proposed improvement factors. If Ofgem considers that the application of improvement factors to the benchmark derived from the 2009/10 to 2012/13 data addresses the concern we have raised by adequately reflecting performance improvement, then this would imply that there should be no objection to setting targets once all data for DPCR5 has been finalised. DNOs' incentives to improve performance are based on achieving higher performance, not generally the precise level of the target, so it does not matter if there is a short delay in the first year of the price control before that target is precisely specified. Setting initial benchmark targets for RIIO ED1 using the last four years of DPCR5 (as opposed to the four years 2009/10 to 2012/13) ensures that improvements in performance achieved and rewarded during DPCR5 are not remunerated again during RIIO ED1 and will save customers of the slow tracked DNOs around £162m over RIIO ED1. We believe this approach would clearly better protect the interests of UK consumers.

(6) Directly remunerated services (ES4)

Concerns raised in our response to Draft Determinations:

46. In our response to Draft Determinations, we argued that the revenues recovered from directly remunerated 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).

47. We set out that we considered 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.

48. We argued that it could not 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 estimated that an immediate rebate rather than the proposed correction would save customers of the slow tracked DNOs approximately £46m over the price control.

Ofgem reply in Final Determinations:

49. In paragraph 5.46 of Final Determinations Ofgem acknowledge some DNOs have double recovered revenues associated with the ES4 excluded service:

"*5.46. We believe it is correct to make a 100% adjustment in relation to top-up and standby revenues that some DNOs treated as excluded services during DPCR5. The costs associated with these revenues were in our DPCR5 cost allowances. Adjusting for less than 100% would fund some DNOs twice.*"

50. However, Ofgem then goes on to maintain their proposal to return the monies by making an adjustment to the RAV rather than adjusting RIIO ED1 revenues, arguing that the proposals keep an appropriate inter-generational balance and also facilitate efficient financing for the benefit of consumers in the long-run.

British Gas conclusions:

51. The rules laid out as part of DCPR5 surrounding the treatment of ES4 directly remunerated service have been clear. Based on the information provided in DNOs business plans, it now appears that DNOs have recovered £147m in revenues from customers during DPCR5 through the ES4 excluded service for which no costs were incurred.

52. If this is the case then this is in direct contradiction with DPCR5 Final Proposals, the DPCR5 DNO licence conditions and the DPCR5 cost and revenue reporting rules, as discussed below. We assume that the revenue recovery represents an error on the part of the relevant DNOs which has not been noticed by Ofgem. However, regardless of the circumstances surrounding how this situation has arisen, it is clear to us that if customers have been erroneously overcharged by such a significant amount during DPCR5 it is imperative that they receive the money back immediately.

53. We draw attention to the following:

Paragraph 3.9 of DPCR5 Final Proposals contained Ofgem's assumption with regards to ES4:

"*Basis of charging for excluded services under categories ES1 to ES4*
3.9. Excluded services under categories ES1 to ES4 are characterised by a broad assumption that the costs (and charges) arise when the customer requiring the service places his or her order. They mainly involve the provision of new infrastructure or modification of existing infrastructure to meet the customer's requirements. The DNO's capex programme should have catered for underlying infrastructure development and the costs driven by the provision of these services should largely be incremental. This means that there is only a limited risk that a DNO could profit by diverting resources which have separately been funded by use of system income. ***Consequently we do not consider it would be appropriate to make any RAV adjustment in respect of outturn levels of activity for these services. The corollary of this treatment is that the charges levied by DNOs for these services should be set on a cost recovery basis. Since Initial Proposals and after considering feedback we have decided that top-up, standby and enhanced system security (ES4) should be treated in this way.***"

54. The assumption at DPCR5 Final Proposals is that the revenues associated with top-up, standby and enhanced system security would only recover the incremental cost imposed by a site

requesting an ES4 service at the time of requesting that service i.e. in a similar manner to a diversion request. As no associated costs have been presented, no charges can follow as charges are on a cost recovery basis. Final Proposals are also clear that this is a change in approach and so there is no obvious reason why DNOs continued with their previous treatment or why Ofgem failed to stop this charging practice.

55. Further to this, the DPCR5 licence conditions expressly preclude recovering revenues that are already remunerated through Use of System:

DPCR5 Licence: Charge Restriction Condition 15. Services treated as Excluded Services

15.2 Excluded Services are the services that comply with the General Principle set out at Part A below and include, without limitation, those services listed in Appendix 1.

15.6. ***The General Principle is that a service provided by the licensee as part of the normal activities of its Distribution Business within the Distribution Services Area is to be treated as an Excluded Service if and to the extent that the service so provided is not already remunerated under any of the charges mentioned in paragraph 15.7.***

15.7 The charges referred to in paragraph 15.6 are those charges that are levied by the licensee in respect of the provision of:

(a) ***Use of System****, in accordance with the relevant Charging Statement prepared and published by the licensee under standard condition 14 (Charges for Use of System and connection);*

56. RIIO:ED1 Draft Determinations confirm that these costs are covered by Use of System: 'Since the costs associated with these services cannot generally be distinguished from the costs of the distribution network, they would have been taken into account in full in our determination of DPCR5 allowed revenues.'

57. The DNOs' cost and revenue reporting rules make clear that the total revenue for ES4 should be in line with the total costs figure for the service and where there is a difference the DNO should refine its charges for subsequent periods. In practice, some DNOs appear to have repeatedly reported total revenue without any associated costs. Had this been rectified when the mistake first appeared in the Regulatory Reporting, customers would already have been returned the money (or not overcharged in the first place).

DPCR5 Electricity Distribution Price Control Cost and Revenue Reporting - Regulatory Instructions and Guidance:

Top-up, standby, and enhanced system security (ES4)

6.103. The figure entered must be the total of revenue from charges for Top-up, standby and enhanced system security.

6.104. Charges made, and revenue received in this category should normally be referable to a written agreement with a use of system customer.

6.105. ***Since CRC 15.9 stipulates that charges for this service are to be set on a cost recovery basis, total revenue must be in line with the total costs figure for this service in the licensee's cost reporting return. To the extent that there is a difference between total costs and revenues (because estimates of cost or activity levels have been used to set elements of charges) the licensee is expected to use this information to refine its charges for subsequent periods.***

58. We highlighted the issue surrounding the double recovery of these revenues to Ofgem in May 2013. We are pleased that Ofgem has acknowledged the double recovery of revenues but any revenues recovered in error from customers in DPCR5 must be returned to customers immediately. We request full details from Ofgem of the DNOs affected by this issue and confirmation of the amounts recovered which need to be returned to customers – we expect these amounts to be returned via an immediate adjustment to allowed revenue.

(7) Transparency / other issues – disposals

59. In our response to the Draft Determinations we have raised questions as to Ofgem's treatment of disposals that have not been addressed by Ofgem:

- If DNOs make disposals they may receive a windfall gain unless the initial expenditure allowances have included a robust estimate of the forecast recoveries from disposals. We asked for transparency of these deductions however Ofgem has not said what it has done in this regard.

(8) Cost of Equity and the overall balance of risk and reward

Concerns raised in our response to Draft Determinations:

60. In our response to the Draft Determinations, we **S**tated our belief that the 6.0% estimate remained generous, and which must be judged by reference to the overall balance of risk and reward (as discussed above). We highlighted that Ofgem itself considered there to be headroom:

"...*These two factors mean there is headroom in our cost of equity estimate*..." [11]
"*We consider that any remaining under provision in the cost of debt is balanced by the headroom in our cost of equity estimate.*"[12]
"*Our analysis of the halo effect from paragraph 2.57 indicates that there is some headroom in our cost of debt allowances*."[13]

61. We noted that the cost of equity in the water sector for the upcoming PR14 price control was materially below the determination for RIIO ED1. We stated 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), highlighting that this would be the case for the change in the cost of debt indexation mechanism. We considered that the estimate for the cost of equity should be set to no greater than 5.65%.

62. We also presented our RoRE analysis showing that the overall price control package, after taking account of Ofgem's policy changes and proposed targets, had been calibrated such that *average* returns across the DNOs would be in excess of 11% in our central case scenario.

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[11] Para. 5.8 of the Overview document: https://www.ofgem.gov.uk/ofgem-publications/89076/riioed1draftdeterminationoverview30072014.pdf
[12] Para 2.46 of the Financial Issues document: https://www.ofgem.gov.uk/ofgem-publications/89072/riio-ed1draftdeterminationfinancialissues.pdf
[13] Para 2.48 of the Financial Issues document: https://www.ofgem.gov.uk/ofgem-publications/89072/riio-ed1draftdeterminationfinancialissues.pdf

Ofgem reply in Final Determinations:

63. Ofgem does not explicitly acknowledge our concerns around the generosity of the cost of equity estimate. However it does say in paragraph 5.19 that its cost of equity assessment is "*necessarily cautious*" in light of the uncertainty around the longer term outlook for market returns, how regulated businesses are exposed to systematic risk and the interest rate environment over the price control period.

British Gas conclusions:

64. We remain of the opinion that the cost of equity estimate is overly generous, especially in the context of the RoRE analysis we provided to Ofgem. Our central case scenario for RIIO ED1, including conservative outperformance assumptions, 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 the worst-performing DNO would be likely to earn a return of no less than 8%. Given the generosity of the overall package it is not necessary to be cautious; it is therefore not acceptable for the Cost of Equity to be high when compared to Ofwat or CC determinations. Ofgem's statutory objectives require it to make decisions by making the interests of consumers – not the interests of DNOs – paramount. It is not appropriate, in this context, for Ofgem to apply caution in a manner that provides a clear and substantial overall benefit to DNOs at consumers' expense.

Yours sincerely,

Andy Manning,
Head of Network Regulation, Forecasting & Settlements,
British Gas,
07789 575 553