Industry participants, stakeholders and interested parties

ofgem

Making a positive difference for energy consumers

Direct Dial: 020 7901 7159
Email: Andy.Burgess@ofgem.gov.uk

Date: 7 August 2015

Dear Stakeholders,

Losses Discretionary Reward (LDR) Guidance Document – changes in response to March 2015 consultation

In our RIIO-ED1 Strategy Decision, we said we would implement a mechanism to ensure Distribution Network Operators (DNOs) place an appropriate level of focus on activities to reduce losses.[1] Core components of this mechanism include a licence obligation, a requirement to maintain and act in accordance with a Distribution Losses Strategy and the LDR.

The aim of the LDR is to encourage DNOs to undertake additional actions to better understand and manage electricity losses. The reward is worth up to £32m across all DNOs and is available in three tranches over the eight year RIIO-ED1 price control (2015-2023).

March 2015 Consultation

On 26 March 2015, we issued a consultation seeking views on our draft LDR Guidance Document ('the Guidance Document').[2] The Guidance Document provides DNOs with an overview of both the submission and assessment process for the LDR. This includes details of the assessment focus for the first tranche, the reward allocation process, relevant criteria and the submission dates.

We received seven responses to our consultation letter.[3] All six DNO groups submitted a response as well as National Grid.

All respondents generally supported our draft Guidance Document. Annex 2 to this letter provides a summary of responses, our responses to them and any changes we have made to the Guidance Document as a result.

---

[1] https://www.ofgem.gov.uk/ofgem-publications/47068/riioed1decoutputsincentives.pdf
[2] https://www.ofgem.gov.uk/sites/default/files/docs/2015/03/consultation_on_the_draft_losses_discretionary_reward_guidance_document.pdf
[3] All the responses have been published on our website at the following address: https://www.ofgem.gov.uk/publications-and-updates/consultation-draft-riio-ed1-losses-discretionary-reward-guidance-document

Next Steps

A revised Guidance Document which incorporates a number of the suggested changes can be found at Annex 1 to this letter. Alongside this letter, for the purposes of Special Licence Condition CRC 2G.12, we have also published a Notice to all licensees to consult on the proposed text of the Guidance Document and the proposed date by which it should take effect.[4]

Any questions on this letter, the Notice or the revised Guidance Document should be directed to Matthew Berry at matthew.berry@ofgem.gov.uk or by phone on 0203 263 9626.

Yours sincerely,

Andrew Burgess
Associate Partner – Electricity Distribution, Smarter Grids and Governance

---

[4] https://www.ofgem.gov.uk/publications-and-updates/notice-under-part-c-charge-restriction-condition-2g-losses-discretionary-reward-consult-losses-discretionary-reward-guidance-document

Annex 1 – Draft Losses Discretionary Reward Guidance Document

1. Background

1.1. Electricity losses are an inevitable consequence of transferring energy across electricity networks. Electricity losses have a significant financial and environmental impact upon consumers. Effective losses management can therefore protect consumers from unnecessary increases to the distribution costs that they pay.

1.2. Distribution Network Operators (DNOs) do not pay for electricity lost on their network and therefore have no inherent incentive to manage losses efficiently. We believe a strong incentive is required to ensure that DNOs place an appropriate level of focus on losses reduction activities.

1.3. There is currently no reliable source of data common to all DNOs for measuring electricity losses. Under RIIO-ED1 we introduced several mechanisms, including the Losses Discretionary Reward (LDR), to focus on actions undertaken by DNOs to manage losses.

2. Scope and aim of the LDR

2.1. The aim of the LDR scheme is to encourage and incentivise DNOs to undertake additional actions to better understand and manage electricity losses.

2.2. The LDR will not reward companies for simply listing the processes they are following in order to act in accordance with their Distribution Losses Strategy (Standard Licence Condition 49). DNOs must have a Distribution Losses Strategy in place that ensures that Distribution Losses are as low as reasonably practicable regardless of whether any LDR reward is received.

2.3. The reward is worth up to £32m across all DNOs and will be made available in three tranches over the eight year RIIO-ED1 price control. The reward amounts will be determined in the regulatory years highlighted in Table 1 and collected by DNOs through their network charges the following regulatory year.

Table 1: *Maximum value of the LDR across all DNOs as set out in Licence Condition CRC 2G (£m)*

	To be determined in Regulatory Year (ie t-1)							
Tranche	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23**
First		8.0						
Second				10.0				
Third						14.0		

3. Tranche focus

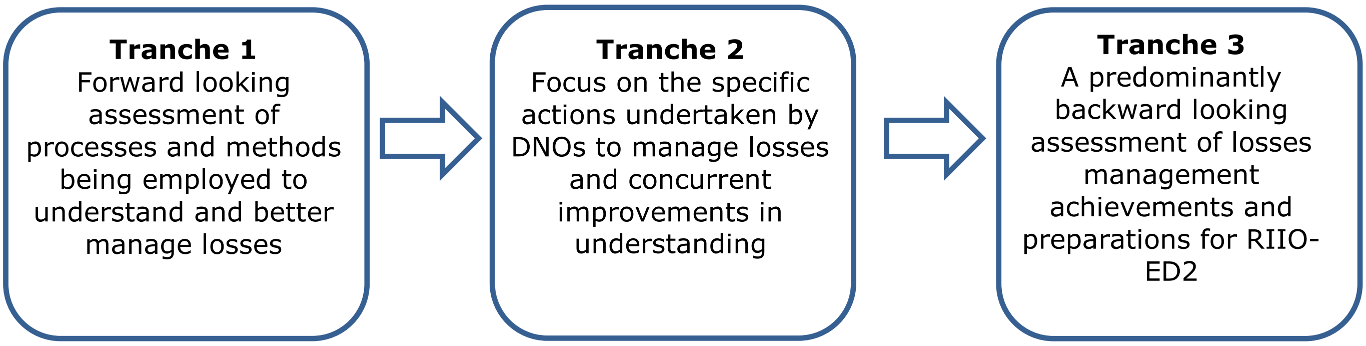
3.1. The focus of each tranche can change over time – this includes the criteria used to judge DNOs' LDR applications, any weighting of these criteria, and how the reward is allocated amongst DNOs.

3.2. This is to ensure the LDR continues to reflect the latest losses environment faced by the DNOs over the eight years of RIIO-ED1 and to accommodate lessons learnt and stakeholder feedback. For example to reflect:

- the likely increase in the availability of losses data (e.g. from the rollout of smart meters);
- the development of methodologies to estimate and/or measure losses; and
- increased evidence of additional losses reduction actions undertaken by DNOs that will become available during the price control.

3.3. Figure 1 below provides an indicative view of the main areas of assessment that each tranche may look to reward over the eight years of RIIO-ED1.

Figure 1: *Indicative areas of assessment for each LDR tranche*



Tranche 1

3.4. The assessment focus in tranche one is predominantly forward looking. As such, the focus will be on the *processes* and methods DNOs are employing to *understand* and ultimately *manage better* the losses on their networks. DNOs will have the opportunity to evidence *how* these processes and methods will (or have already) enable them to undertake additional losses reduction actions beyond those required to meet their general licence obligations.

3.5. The criteria against which DNOs will be required to provide evidence are set out in Section 4.

Tranches 2 and 3

3.6. In tranche two, as the price control progresses, we anticipate that the focus will shift from an assessment of processes and methods to one of specific actions undertaken and concurrent improvements in understanding. We would expect DNOs to be able to provide evidence of actions they have taken outside of business as usual activities to improve their operations in respect of managing losses including, where appropriate, demonstrating how they have built upon the processes set out in tranche one. As such, we expect the assessment process in the second tranche to be both forward and backward looking.

3.7. In tranche three we expect the assessment process to be predominantly backward looking with the focus on losses management achievements and the improvement in understanding of losses on networks. We also expect to see evidence of how DNOs are preparing for a measureable losses incentive in RIIO-ED2.

3.8. We recognise that in both tranches two and three we will need to assess the *potential* for DNOs to have undertaken additional cost-effective actions with the differences in local distribution networks in mind. In all three tranches we expect the sharing of best practice and stakeholder engagement to remain key criteria.

3.9. We consider that the adaptability of the tranche focus is important and we will provide stakeholders with the opportunity to comment on this prior to the second and third tranche assessments.

4. Submission process for first tranche

4.1. DNO submissions for tranche one will be due by 31 January 2016 (see Figure 2 below).

4.2. The assessment focus in tranche one is predominantly forward looking. We expect DNOs to provide evidence that they have effective processes in place that will allow them to fully meet **<u>all</u>** of the criteria below. DNOs should demonstrate they have considered each of the points listed under each criterion. DNOs may, however, present additional information they consider relevant to meeting the criteria.

4.3. As noted in Section 2, the LDR will not reward companies for simply listing the processes they are following in order to act in accordance with their Distribution Losses Strategy.

4.4. If DNOs include processes in their LDR submission that are referenced in their Distribution Losses Strategy it must be made clear why these are going above and beyond the licence requirements and are therefore eligible for reward under the LDR.

4.5. Equally, the same applies to any processes listed in an LDR submission that do not form part of a DNO's Distribution Losses Strategy – it must be clear why employing them goes above and beyond what is required under the licence.

4.6. The criteria against which the submissions will be assessed are:

a. Understanding of losses
- Are companies able to demonstrate how they are improving their understanding of the current level and sources of losses on their networks (including through the use of smart meter data)?
- Are companies considering the network in a holistic manner and making efforts to understand how losses on their network affect others e.g., those on the transmission and/or other distribution networks?

b. Effective engagement and sharing of best practice with stakeholders on losses
- How are companies planning to utilise stakeholder engagement to inform their losses management actions and allow them to understand their impact?
- How are/will companies engage with stakeholders (e.g. suppliers, distributed generators, the TSO, TOs etc.) to develop relevant partnerships which may help to manage losses (e.g. opportunities to use Demand Side Response)? This could include initiating a joint project where

a reduction in losses is the primary driver or identifying opportunities within existing projects to help manage losses.
- Are companies able to demonstrate that they have processes in place to share their own best practice with relevant stakeholders? This could include engaging with one another, the Transmission System Operator (TSO) and the Transmission Owner (TO) to facilitate a holistic and co-ordinated approach to losses management.
- DNOs must verify that any stakeholder engagement actions are not already rewarded under the Stakeholder Engagement incentive that forms part of the Broad Measure of Customer Service to ensure the same activity is not rewarded multiple times.[5]

c. Processes to manage losses

- Have companies looked at best practice, both nationally and internationally, when considering processes and methods to manage losses on their networks?
- How are companies preparing to effectively use smart meter data to develop specific actions to manage losses?

d. Innovative approaches to losses management and actions taken to incorporate these approaches into business as usual activities

- How are companies planning to use innovative approaches to manage losses (including through the use of smart meter data) outside of projects funded through the RIIO-ED1 price control and the innovation stimulus mechanisms?
- How will companies incorporate these approaches into "business as usual" activities?
- DNOs must verify that the innovative activities are not funded under any other RIIO-ED1 financial initiatives. This is to ensure DNOs are not rewarded multiple times for the same activity.

5. Assessment Process and reward allocation

Assessment Process for tranche one

5.1. In the first tranche of the reward, each of the criteria will have equal weighting. Companies must therefore provide an appropriate level of evidence under each category to be considered for a reward.

5.2. Each submission received will initially be assessed by Ofgem to ensure this is the case and that the requirements set out in Section 4 have been met. If required, we will ask companies supplementary questions to clarify aspects of their submissions. We would not expect this process to result in any changes being made to the submissions.

5.3. Once we have sought any further clarification we will publish the submissions on our website and invite views from stakeholders. Stakeholders will have at least 28 days to respond. We will publish all non-confidential responses.

[5] https://www.ofgem.gov.uk/ofgem-publications/87494/edseincentive-guidancedoc.pdf

5.4. Following this consultation period, if we judge a DNO to have failed to provide sufficient evidence under one or more of the criteria, it will not be eligible to receive a reward under this tranche of the LDR and the submission will be deemed unsuccessful. This is to ensure DNOs provide a well-rounded submission addressing all the relevant areas outlined above.

5.5. We may use expert help at any point in the process to help inform our assessment. Our decision will be published in the summer following the assessment window. Our decision will set out which DNOs have been judged as successful and unsuccessful as well as the level of reward for each applicant.

Reward allocation

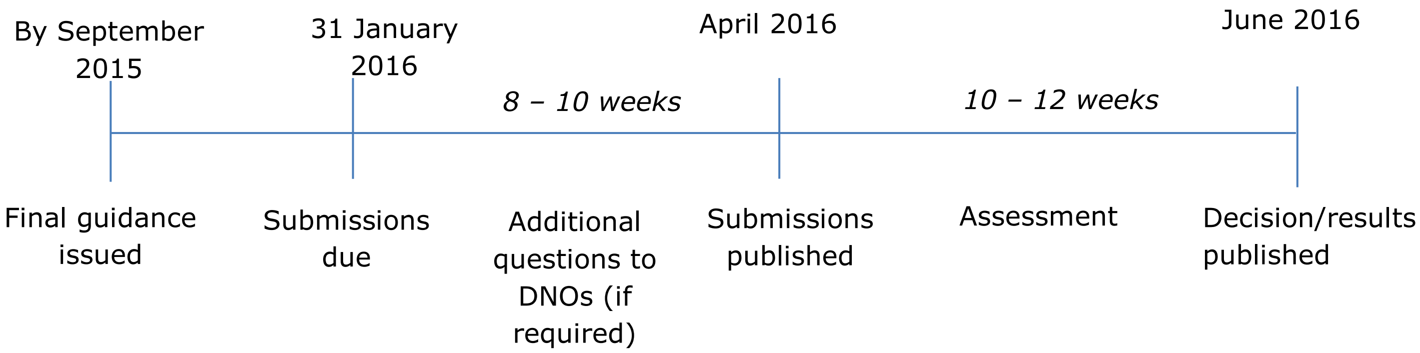
5.6. In the first tranche the total reward pot is £8m as outlined in Table 1 above. This reward pot will be divided equally between each submission deemed successful following the assessment process outlined above. For example, if we receive six submissions but judge only four to have provided adequate evidence under each category then the maximum reward amount for each company will be £2m (£8m divided by four).

5.7. When allocating the reward amounts for successful submissions, the amount of money awarded could be set at, or below, the maximum amount available for a DNO group. This will be dependent on the extent to which we consider DNOs are meeting and exceeding the criteria set out above.

5.8. If a DNO is successful and rewarded under the LDR, the reward will be spread equally across each of its licensees unless it is made clear in the LDR submission that certain parts of the submission do not apply to all of the licensees within the group.

5.9. The assessment process and allocation of the reward pot between DNO groups may change for tranches two and three. A DNO’s performance in a prior tranche will not affect how we assess subsequent submissions.

Figure 2: *Indicative timetable for Tranche 1 of the LDR*



5.10. We expect the process and timeline for consultation on the guidance that has been followed for tranche one to remain the same for future tranches.

5.11. We will review the guidance in the January of the year before submissions are due (i.e. 2017 and 2019). Following engagement with DNOs an updated version will be produced and circulated before a formal consultation on the guidance is published in the spring. A revised version will be consolidated over the summer and published by September.

6. Format of application

6.1. The LDR application should take the format of a Word Document and the main body of the application is limited to 20 pages. There is a minimum permitted font size of ten.

6.2. Network companies can include images and tables where appropriate. If evidence is required that cannot be referenced or succinctly included in the application, this evidence should be added as an appendix to the application. The appendix should not exceed an additional 20 pages.

6.3. Submissions must be made on a company, rather than licensee, basis.

6.4. DNOs must structure their LDR application under each of the criteria headings specified in section 4.

6.5. All submissions should be emailed to RIIO.ED1@ofgem.gov.uk by 31 January 2016.

Annex 2 – Summary of responses to the March 2015 consultation

On 26 March 2015 we published a consultation seeking views on our draft Guidance Document. We asked six questions on the LDR guidance and received seven responses from all six DNOs and also National Grid.

This Annex summarises the stakeholder responses under each of the six questions asked. We also provide our response to the points raised.

Question 1: Is the Guidance clear and comprehensive, covering all relevant matters. If not, what specific information have we missed?

a. Several respondents sought further clarity as to whether we would allow activities detailed in licensees' Distribution Losses Strategies to be taken into account during the assessment of LDR submissions.

Ofgem response: The aim of the LDR is to encourage and incentivise DNOs to undertake additional actions beyond those required to meet their general licence obligations, including to maintain and act in accordance with a Distribution Losses Strategy. We have revised paragraph 2.2 of the guidance to make it clear that DNOs must have a Distribution Losses Strategy in place that ensures that Distribution Losses as low as reasonably practicable regardless of whether any LDR reward is received.

The assessment focus in tranche one is predominantly forward looking and focusing on the processes DNOs have/are employing to better understand and manage losses over RIIO-ED1, beyond what is required to meet their general licence obligations.

As such, we will not reward a DNO under the LDR for simply listing the processes they are following, in order to act in accordance with their Distribution Losses Strategy.

If DNOs do include processes in their LDR submission that are referenced in their Distribution Losses Strategy it must be made clear why these go above and beyond the licence requirements and are therefore eligible for reward under the LDR.

Equally, the same applies to any processes listed in an LDR submission that do not form part of a DNO's Distribution Losses Strategy – it must be clear why employing them goes above and beyond what is required under the licence.

It is worth noting that as RIIO-ED1 progresses, we expect the focus of tranches two and three to shift from an assessment of processes to looking at the outcomes of specific actions undertaken and concurrent improvements in understanding. We will provide stakeholders with the opportunity to comment on this prior to the second and third tranche assessments.

b. One respondent suggested the LDR is incentivising DNOs to go beyond what is reasonably practicable with respect to managing losses on their networks. They also stated that in the current guidance, it is unclear how the value of any benefit is being assessed.

The aim of the LDR is to encourage and incentivise DNOs to undertake additional actions beyond those required to meet their general licence obligations. It is a discretionary reward and DNOs are not obliged to make a submission if they are not undertaking any of the processes that the LDR aims to incentivise.

For tranche one, we consider that it is the responsibility of the DNO to articulate the value of the potential benefits of the processes detailed in their LDR submission.

However, it is worth noting again that the focus in tranche one is on *process* rather than specific *outputs*.

c. One DNO highlighted that some DNOs have been awarded funding for losses management actions as part of their RIIO-ED1 settlement and that these activities should not be eligible for consideration under the LDR. They also raised the question as to whether another DNO, which did not receive funding for such activities, should be entitled to receive a reward for the same actions under the LDR

Under the LDR we will not reward DNOs twice for the same losses activities, e.g. rolling out low-loss transformers in line with their RIIO-ED1 settlement. However if, for example in tranche one, a DNO was able to justify that the processes they have put in place, or may do in the future, move the industry benchmark in a particular losses area(s) (regardless of whether a DNO has been funded for a specific losses activity) we may consider this to be eligible under the LDR.

Question 2: We have provided details of how we envisage the focus of each tranche changing over the course of RIIO-ED1. Do you agree with what we are proposing?

a. Most respondents agreed with the proposed focus of the future LDR tranches, however, several respondents called for further clarity on any change process in advance of the guidance being updated. This included a request for more detailed timeframes.

We have updated paragraphs 5.10 and 5.11 of the guidance to provide more clarity about the future timeframes both for submission, any prior consultation on the assessment scope of future tranches, and the guidance document itself:

'We expect the process and timeline for consultation on the guidance that has been followed for tranche one to remain the same for future tranches'

'We will review the guidance in the January of the year before submissions are due (i.e. 2017 and 2019). Following engagement with DNOs an updated version will be produced and circulated before a formal consultation on the guidance is published in the spring. A revised version will be consolidated over the summer and published by September.'

b. One DNO stated that despite tranche one focusing on process rather than output, we should still recognise that DNOs will have differences in network losses due partly to differences in system design and differences in the nature of the customers that they serve.

We acknowledge this point about network differences between DNOs and believe the guidance already recognises this in Paragraph 3.8:

'We recognise that in both tranches two and three we will need to assess the potential for DNOs to have undertaken additional cost-effective actions with the differences in local distribution networks in mind. In all three tranches we expect the sharing of best practice and stakeholder engagement to remain key criteria.'

<u>Question 3. Is the submission process clear for the first tranche?</u>

No substantive comments.

<u>Question 4. Do you agree with the four criteria DNOs will be required to provide evidence?</u>

a. One DNO expressed concern about our intention to reward companies able to develop 'relevant partnerships' under the 'Effective engagement and sharing of best practice with stakeholders on losses' criterion. The response stated that suppliers and generators are unlikely to engage in partnership with DNOs for the primary purpose of reducing losses i.e. a reduction in losses may be an additional benefit delivered through a project with a different primary driver.

We have updated the 'effective engagement and sharing of best practice' assessment criterion to clarify what is meant by relevant partnerships and what the LDR would look to reward:

'How are/will companies engage with stakeholders (e.g. suppliers, distributed generators, the TSO, TOs etc.) to develop relevant partnerships which may help to manage losses (e.g. opportunities to use Demand Side Response)? This could include initiating a joint project where a reduction in losses is the primary driver or identifying opportunities within existing projects to help manage losses.'

b. A number of respondents asked us to recognise the importance of a holistic and increasingly co-ordinated approach to losses management amongst all DNOs, and with the Transmission System Operator (TSO) and the Transmission Owner (TO), in the assessment criteria.

We have updated several of the assessment criteria to explicitly recognise this.

c. Several respondents also asked for more detail under the 'innovative approaches' assessment criterion. In particular, that DNOs will not all be starting from the same point in respect of using innovative approaches to manage losses.

It is worth noting again that the focus in tranche one is on process rather than specific outputs. We would expect all DNOs to be able to provide information on the processes they are putting in place to ensure their approach to managing losses captures innovative actions regardless of their 'starting point'.

d. One DNO was concerned that the guidance seemed to indicate that the LDR could reward one DNO for simply replicating the actions of another. This was in relation to the 'processes to manage losses' assessment criteria, where we stated that we would consider rewarding actions that other companies consider "business as usual" but may not be employed by the DNO making the application under the LDR.

We will not reward a DNO for simply replicating the actions of another. We have updated the 'processes to manage losses' assessment criterion to reflect this. However, DNOs are encouraged to have processes in place to understand actions being taken by others and whether these can be adopted as part of the 'Effective engagement and sharing of best practice' criterion.

Question 5: Is the assessment process clear?

a. One DNO stated that the process being used to score submissions is unclear and that this should be improved to allow a licensee/interested party to take a view on the objectivity/fairness of the process. The same DNO also questioned our decision to fail a submission if it does not provide adequate evidence under one assessment criterion but excels in other areas.

We believe our assessment approach is justified as we want DNOs to provide a well-rounded submission addressing all relevant assessment areas. We believe it would be difficult for a submission to provide adequate evidence to justify a reward in some areas and not in others given the assessment criteria are, to a degree, interdependent.

As the guidance indicates, we may use expert help at any point in the process to help inform our assessment of submissions. The scoring of the submissions is discretionary, however, as part of any decision to issue a reward (including no reward), we will provide feedback on how we arrived at our decision.

Question 6: Do you agree with the process for allocating the reward amount between successful submissions?

a. One DNO raised concerns over our proposed method for allocating the reward amount between successful submissions. They believe the proposed method is over simplistic and does not take into account the relative size of each DNO.

There is no evidence that the costs of process improvements are relative to the size of each DNO. All others DNOs were supportive of this approach. In addition, we are looking to reward those DNOs taking a holistic approach to losses management and engaging with one another such that good ideas can benefit all DNOs.

The Guidance notes that the assessment process, and the allocation of the reward pot between successful submissions, will be subject to consultation ahead of tranches two and three.

b. A second DNO noted that any spirit of cooperation amongst DNOs would be undermined by the fact that one DNO could potentially receive the total reward pot in tranche one, should all other submissions fail.

We do not agree that cooperation between DNOs will be undermined by taking this approach. Our assessment criteria make specific reference to the sharing of best practice and we will look to reward companies who are proactively engaging with one another.