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 distribution costs for which customers otherwise have to 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 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. The reward is discretionary. If none of the applications in the Authority's view meets its criteria, it will not award any reward.

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		

2.3. Standard Licence Condition (SLC) 49 requires DNOs to ensure that Distribution Losses from its Distribution System are as low as reasonably practicable, and to maintain and act in accordance with its Distribution Losses Strategy. In reviewing their Strategies we expect DNOs to modify and update them to reflect the latest losses environment and to accommodate lessons learnt and stakeholder feedback.

2.4. The LDR is not intended to reward DNOs for the activities associated with the ongoing review of their Distribution Losses Strategy. This is a requirement of their licence. 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.

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

Assessment of the processes DNOs are exploring and implementing to significantly shift expectations of what they are capable of doing to reduce losses

Tranche 2

Focus on the specific outputs produced and actions undertaken by DNOs to manage losses and shift expectations, and the concurrent improvements in understanding

Tranche 3

A predominantly backward looking assessment of losses management achievements and preparations for RIIO-ED2

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 exploring and implementing to *understand* and ultimately *manage better* the losses on their networks. DNOs will have the opportunity to evidence *how* these processes and methods may be enabling (or have already enabled) them to significantly shift the expectations of what DNOs are capable of doing to reduce losses. Over the course of RIIO-ED1, this work may reveal activities that we will then expect to see incorporated into the Distribution Losses Strategies of all DNOs in accordance with their licence.

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 outlined above, 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 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. Again we'd expect to see evidence of how these actions are significantly shifting the expectations of what DNOs should be doing to keep losses as low as reasonably practicable. 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. We expect DNOs to provide evidence that they have effective processes in place that will allow them to fully meet **all** 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. If DNOs include processes in their LDR submission that are referenced in their Distribution Losses Strategy it must be made clear how these processes are (or are expected to) shifting the expectations of what DNOs are capable of doing to reduce losses (as noted in section 2). The same applies to any processes listed in an LDR submission that do not form part of a DNO's Distribution Losses Strategy.

4.4. The four criteria against which the submissions will be assessed are set out below. For each criterion DNOs must demonstrate they are shifting the expectations of what they are capable of doing to reduce losses:

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.[1]

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

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

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.

5.4. 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.

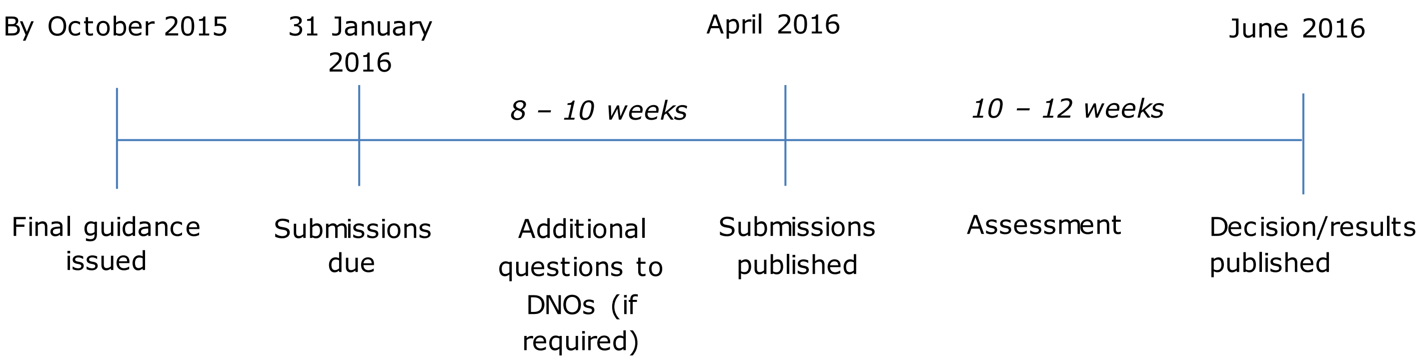
Reward allocation

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.

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



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.

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 PDF 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 group, 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 tranche one submissions should be emailed to RIIO.ED1@ofgem.gov.uk by 31 January 2016.