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The Office of Gas and Electricity Markets  
9 Millbank  
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7 September 2015

Dear Matt

### **Draft losses discretionary reward guidance document**

I am writing to you on behalf of Northern Powergrid Holdings Company and its wholly owned electricity distribution licensees Northern Powergrid (Northeast) Ltd and Northern Powergrid (Yorkshire) plc. This letter provides our response to Ofgem's notice of 7 August 2015 under part C of CRC 2G of the electricity distribution licence (The Losses Discretionary Reward).

We have commented previously on the proposed losses discretionary reward scheme (LDR) when Ofgem consulted with the DNO community. At that time we expressed a number of concerns and all but one of these have been addressed: however, we believe that the remaining concern is absolutely fundamental to the soundness and viability of the proposed scheme.

Our concern here is that, due to the competing requirements of SLC49 and the LDR, an application that was able to satisfy the scheme criteria to qualify for a reward under the LDR would also inevitably deliver evidence that the licensee had breached SLC49.

Our rationale here is as follows:

- At RII0-ED1 the DNOs were instructed to use Ofgem's cost benefit analysis (CBA) in the assessment of the worth of investment initiatives. The CBA captured amongst other things expenditure invested and the monetised value that society puts on losses reduction.
- If a losses scheme came back with a positive net present value (NPV) based on this, we were expected to put it forward as worth doing (i.e. put it in our submitted business plans) with a view to seeking allowances for it. Even if we did not put it forward, it would still be something that might be considered reasonably practicable.
- We understand that, to assess a DNO's compliance with its SLC49 obligation to do what is reasonably practicable, Ofgem would resort to this same CBA, where a positive NPV would mean reasonably practicable and a negative NPV would mean not reasonably practicable - and this seems entirely reasonable.
- Now, given that losses projects generally balance expenditure invested against the monetised value of the societal benefit, then a negative NPV also means investment to a level that society does not value.
- Consequently, as the LDR asks us to go beyond what we are obliged to do by our licence obligation, it means that we would have to make investments with negative NPVs to qualify under the LDR, which by definition means investment society does not value. As

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an aside we believe a neutral NPV is positive for the purposes of an “as low as reasonably practicable” obligation, so it is only the negative NPVs that we are talking about.

In our previous exchanges Ofgem has acknowledged that this was not the intention, but this is nevertheless what the words add up to at present. Ofgem has also clarified that it is seeking to reward financially those DNOs that work hard to discover new things that are worth doing to reduce losses - and we agree wholeheartedly with this intention. The problem is that any process improvement that had a clear link to a value-for-money investment, or to something that was reasonably practicable, would not qualify for the LDR (because it would already be within the scope of the SLC49 obligation). Unfortunately in relation to the LDR, but not SLC49, this appears to be a ‘Catch 22’ situation, in that as soon as it becomes worth doing it falls under the ‘reasonably practicable’ licence obligation and is no longer eligible.

To conclude, we believe that insufficient consideration has been given to how the discretionary reward interacts with the obligations under SLC49 and that this problem could be addressed fairly easily by revising the additionality criteria in the guidance.

I hope that you will find these comments constructive. I should be happy to meet with you or speak on a call to enlarge upon any of the points that I have set out here.

Yours sincerely

A handwritten signature in black ink that reads "John France". The signature is written in a cursive style with a large initial 'J' and 'F'.

John France  
Regulation Director