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Dear Chris,

Consultation on close out methodologies for the DPCR5 Price Control

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group, excluding Centrica Storage.

We welcome efforts to ensure distribution network operators' (DNOs') accountability for the package of outputs they have been funded to deliver as part of the fifth electricity distribution price control (DPCR5). On average, DNOs stand to have earned around an 11% return on equity, which is significantly in excess of the 6.7% baseline. As these returns have been achieved largely through significant levels of under-spending of the allowances provided, it is essential that the DNOs are held *fully* accountable for delivery of the outputs agreed at the outset of the price control and, to the extent that outputs have not been delivered, funding allowances must be returned to customers.

We are broadly comfortable with the principles set out in the consultation. However, we believe changes to the proposed methodologies are required if the principles are to be achieved in practice:

- **In order to establish whether the DNOs have achieved genuine efficiency improvements and, by extension, any share of the under-spend they are allowed to retain, it is necessary to normalise the agreed load index (LI) profiles (and, if applicable, health index (HI) profiles) to take account of changes in the observed level of demand.**
- **It is not appropriate to soften the commitment to the fault rates output at this stage. A monetised assessment of any outputs gap relating to fault rates is necessary in order for an assessment of the delivery of NOMs at an overall level.**
- **Where networks are likely to benefit by under-spending against allowances, at the expense of customers, then customers have a legitimate expectation that outputs should be *fully* delivered. The threshold for what constitutes a significant and material issue needs, therefore to take account of the overall level of expenditure against allowances.**

Further, an additional key principle should be that the close-out process is fully transparent. We are concerned that the process of the development of these draft proposals to date has consisted of discussions between DNOs and Ofgem. The timetable provided in the consultation suggests that such Ofgem/DNO meetings will continue and four of the five bilateral meetings are likely to have occurred before responses to this consultation have been considered. This creates the impression of a discussion between DNOs and Ofgem, which can then be consulted upon, as opposed to a process that has actively sought stakeholder engagement. Full details of discussion held to dates should be provided, with full transparency of the process from this point onwards.

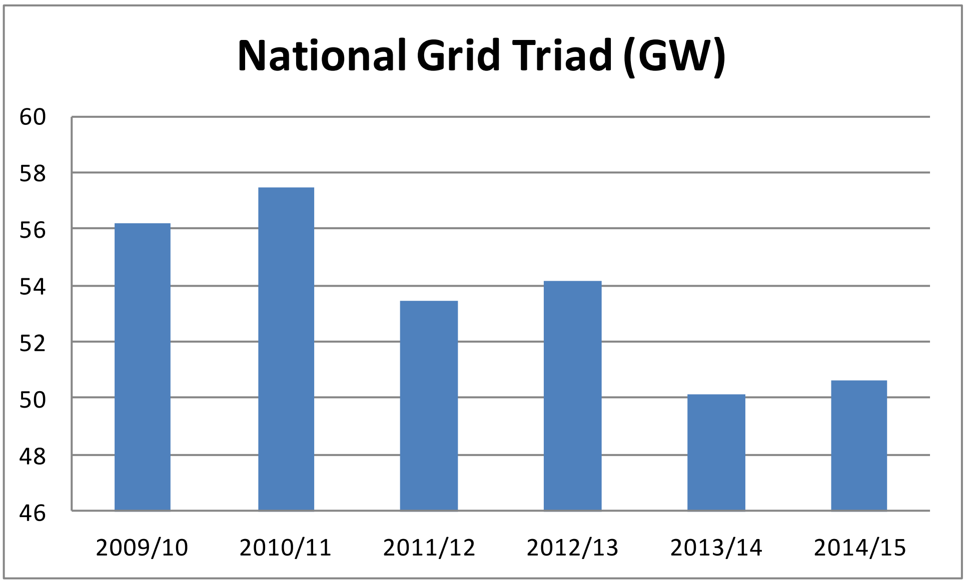
Further comments are provided in the attached appendix. We hope you find our comments helpful. Please do not hesitate to contact me if you have any questions.

Yours sincerely,

Andy Manning
Head of Network Regulation, Forecasting and Settlements

Normalisation of the agreed LI profiles to take account of changes in demand:
There has a sustained reduction in the level of demand on the DNO networks over DPCR5. National Grid Triad values (the three half-hour settlement periods with highest system demand between November and February) in 2014/15 were 10% lower than in 2009/10, as shown in the chart below. Industry settlements data (D0276 data) covering the same period also demonstrate a similar proportionate reduction in annual consumption: from 298.4 TWh in 2009/10 to 269.6 TWh in 2014/15.

Figure 1 - Triads between 2009/10 and 2014/15



The first principle proposed to underpin the Network Output Measures (NOMs) assessment states that DNOs should retain a share of **genuine efficiency improvements**. The sustained reduction in demand over DPCR5 constitutes a material change and will have had the effect of reducing risk profiles without any intervention by the DNOs. As such, the LI profiles agreed at DPCR5 should first be normalised to reflect the sustained reduction in demand before any assessment of over- or under-delivery can be made so that the genuine impact of DNOs' interventions on risk can be measured. We believe this normalisation is straightforward: the demand growth assumptions upon which the agreed outputs were based can be replaced with the outturn load growth observed.

It is difficult to see how it could be assessed whether under-spends are genuine efficiency improvements without such a normalisation and, so, this is necessary to ensure adherence to the first principle. The normalisation is also necessary to ensure that the NOMs assessment is not affected by the different DNOs' forecasts of demand growth at DPCR5.

Fault rate outputs:
We disagree with the proposal to not apply any financial adjustments for outputs gaps relating to fault rates (which constitutes a change to the approach presented in the DPCR5 Final Proposals). The DNOs committed to delivering the agreed network outputs as part of the DPCR5 settlement, have been funded by customers to do so and accepted financial penalties being applied for under-delivery. In light of the fact that the DNOs have significantly under-spent their DPCR5 allowances, customers have a legitimate expectation that outputs should have been *fully* delivered. We believe

there is no justifiable reason for under-delivery given the under-spend and the DNOs must be held accountable for any non-delivery of the agreed outputs.

We estimate that DNOs will have received over £600m in rewards for the DPCR5 Quality of Service Incentive. These rewards may have been earned by a greater focus on the reduction of the duration of interruptions after they have occurred rather than investment in network resilience to prevent faults occurring in the first place. Such an approach may be appropriate in some circumstances. However, we are concerned that it could encourage a short-term focus to asset management. If calibrated correctly, the different elements of the price control settlement should combine to place the correct incentives on the DNOs, for the long-term benefit of customers. However, this is undermined if elements of the settlement are weakened or effectively removed. This is the case with the proposal not to value fault rate performance. This can be rectified by ensuring that the DNOs are held financially accountable for delivery of agreed outputs by conducting a monetised assessment of outputs gaps relating to fault rates. We are happy to engage with Ofgem on designing a sensible approach to this.

The threshold for what constitutes a significant and material issue should take account of the level of expenditure against allowances:
It is not appropriate to apply a blanket threshold without considering the extent to which allowances have been under-spent. If DNOs are likely to benefit from under-spending against allowances, at the expense of customers, then customers have a legitimate expectation that outputs should be *fully* met.

The proposed threshold also creates an incentive for DNOs to under-deliver against their agreed outputs. Based on the proposed threshold, DNOs could aim to deliver only 95% of their agreed outputs though they have been funded to deliver all their agreed outputs. In an extreme scenario, DNOs could spend none of their allowances but would only be accountable for 95% of the outputs gaps.

This incentive would contribute to the returns earned by the DNOs, as highlighted above, by allowing DNOs to not deliver the agreed outputs. We believe the undesirable effects of the application of a blanket threshold can be mitigated by taking account of expenditure compared to allowances. A simple approach would be to apply a sliding scale of materiality thresholds which incorporate under spend to the outputs gap. An example of such a sliding scale is shown in the table below. In circumstances in which DNOs have efficiently spent in line with their allowances, the sliding scale allows the application of a reasonable materiality threshold. The sliding scale also reduces the tolerance for the non-delivery for those DNOs that have spent significantly less than their allowances. This approach is consistent with the principle of assessing *"...significant and material issues with the NOMs at an overall level..."*.

Table 1- Example of a materiality threshold sliding scale

Actual Expenditure vs Allowance	NOM gap materiality threshold
0% or greater	5%
-1%	4%
-2%	3%
-3%	2%
-4%	1%
-5% or less	0%

Transparency:

As highlighted above, we are concerned that non-DNO stakeholders have not been engaged in the development of these draft proposals which involve significant changes to the DPCR5 Final Proposals and the NADPR RIGS, whereas DNOs have been involved. We are particularly concerned given that changes to the approaches agreed during the DPCR5 review reduce the DNO's accountability for the delivery of agreed outputs. We believe is it essential that records of discussions held to date and any data shared must be made available to non-DNO stakeholders and further development of the methodology must be conducted in an open and transparent manner. We also believe it is essential that any data submitted as a part of this process must be made available at a sufficiently disaggregated level on an annual that would facilitate independent interrogation. For example, we recommend annual load-related expenditure is presented in such a way that would non-DNO stakeholders to assess whether there was any acceleration of expenditure in the final year(s) of DPCR5.