Lloyds Court
78 Grey Street
Newcastle Upon Tyne
NE1 6AF

Chris Watts
RIIO Implementation Team
Ofgem
9 Millbank
London
SW1P 3GE

8 January 2016

Dear Chris

DPCR5 Closeout Methodologies - further changes since informal consultation (the Further Consultation)

1. Thank you for your letter dated 2 December and further letter dated 14 December 2015 addressed to Keith Noble-Nesbitt. We have set out below our response to the Further Consultation on both fault rates and material changes.

2. Your second letter, and the meeting which followed, were helpful in giving additional clarity to your revised intentions and have enabled us to respond better to your Further Consultation. However, we still had difficulty in understanding some aspects of the proposals. For example the brief description provided of the network outputs assessment of material changes does not:

    a. distinguish between different network outputs (even though their characteristics differ);
    b. provide details of the circumstances in which adjustments would be made; or
    c. indicate the *direction* in which certain adjustments may be made.

3. While this means that we remain unable to take an adequately informed view of whether the proposals represent good regulation, or quantify the impact they may have on Northern Powergrid, we are still able to provide relatively high-level observations that may help inform your further thinking.

4. Firstly, significant detail was already developed during the final DPCR5 licence modification process. This detail supersedes any less precise statements in the DPCR5 *Final proposals*.

5. Secondly, there are significant differences between each of the three network outputs which are apparent in the detail of the settlement. These differences must be recognised in the close-out; a one size fits all approach is not appropriate. Importantly, fault rates were placed on an entirely different footing from other network outputs. Moreover, other mechanisms were designed in the DPCR5 *Final proposals* to cater for certain circumstances that could arise in relation to loading, and Ofgem should be careful to avoid unpicking these mechanisms via the network outputs methodology.

6. Thirdly, Ofgem made a number of process commitments in relation to material changes. It must now reconcile any adjustments it wishes to make with these commitments.

7. In addition to the high level items set out above, below is a summary of the key detailed points that we would draw to your attention. Further information supporting each of these is also provided in a series of appendices:

    a. ***The Network Asset Data and Performance Reporting (NADPR) RIGs are a key source of detail on output assessment calculations:*** As Ofgem recognises, the DPCR5 settlement on network outputs is more complex than the DPCR5 *Final proposals* themselves set out.

        i. The DPCR5 *Final proposals* stated that the detailed calculations were being set out in the NADPR RIGs.
        ii. Shortly after, Ofgem stated that DNOs should consider their licence modification in light of the proposed NADPR RIGs, effectively making the NADPR RIGs a key part of the DPCR5 settlement on the items they covered.
        iii. The NADPR RIGs were themselves accompanied by detailed reporting templates, which detail the specific information Ofgem expected that it would need to operate the network outputs regime.
        iv. Ofgem also issued a 'comfort letter' emphasising the limited circumstances in which Ofgem would modify the NADPR RIGs.

    Appendix A sets out the relevant extracts of each of these documents.

    b. ***The output delivery assessment is a single, in the round, pass or fail test:*** The test of network output delivery described in the DPCR5 *Final proposals* and NADPR RIGs is a qualitative, in the round, assessment of health indices, network outputs and fault rates **taken together**. This means that:

        i. a missed target in one category does not lead to an output gap clawback for that category; and
        ii. over-delivery in one category of network output can compensate for under-delivery in another in the overall pass or fail test.

    Appendix B provides further background on the relevant aspects of the DPCR5 settlement.

    c. ***There is a single output financial claw-back calculation for DNOs which fail the qualitative assessment:*** The DPCR5 *Final proposals* stated that the detailed calculation of the clawback for network output delivery failure would be set out in the NADPR RIGs. The RIGs state that:

        i. There is a **single** financial clawback calculation, meaning over-delivery in one output can financially compensate for under-delivery in another.
        ii. The **calculation** of the financial clawback involves **only** health indices and load indices.

    Appendix C sets out the relevant content from these RIGs.

    d. ***Health index (HI) targets and delivery tracking were expressly developed to separate out the impact of material changes:*** Unlike the load index and fault rates:

        i. The HI reporting spreadsheets were developed to capture all kinds of material changes in a separate log.
        ii. The HI tracking calculations separate out the impact of material changes from the HI delta delivered through investment.

The intent appears to be that HI material changes should generally not contribute to a company meeting its HI network outputs. Moreover, the approach to removing HI material changes from the delivered network outputs was also set out in the reporting spreadsheets, and Ofgem should take this into account in considering any departures. Further detail on the relevant aspects of the DPCR5 settlement, including the reporting arrangements, are set out in appendix D.

e. ***The load index (LI) architecture put in place with the DPCR5 licence modification places far less emphasis on material changes:*** There are significant differences between LI and HI when the DPCR5 settlement as a whole is considered:

   i. Only a sub-set of material changes are catered for in the LI reporting spreadsheets.[1]
   ii. A separate mechanism was explicitly put in place to cater for changes in expenditure arising from LI material changes due to external circumstances (the Load Related Re-opener).

   Ofgem should take this limited emphasis on material changes into account in how it administers the close-out. In particular, if material changes in relation to network loading were (retrospectively) evaluated and adjusted for in LI targets as part of the network outputs close-out, this would undermine the intended operation of the load related reopener. Further detail on the relevant aspects of the DPCR5 settlement are set out in appendix E.

f. ***Fault rates were placed on a less prominent footing than asset indices in the licence and NADPR RIGs:*** There are important distinctions in the DPCR5 settlement between fault rates and the asset indices:

   i. SLC44 of the licence, as modified to implement the DPCR5 settlement, stated that fault rates were 'secondary agreed network outputs' whereas HI and LI were termed 'primary agreed network outputs'.
   ii. Unlike HI and LI, fault rates **do not** feature in the calculation of the network output financial clawback set out in the NADPR RIGs.

   This distinction is reasonable; fault rates are a lagging (rather than leading) indicator of network health. Faults also directly impact on licensee financial performance though the IIS incentive and guaranteed standard payments, so associated clawback could result in double jeopardy. Ofgem must recognise this different footing in the close out.[2] Appendix F sets out further detail in relation to fault rates.

g. ***In making any adjustments for material changes, Ofgem should take into account the process commitments it made in the NADPR RIGs:*** These process commitments include:

   i. That Ofgem would discuss Material Changes with each DNO as these were raised.

[1] Ofgem's slides at the working group meeting 17 December 2015 erroneously stated that material changes were not reported for LI. To the contrary, certain types of material change were explicitly incorporated in the reporting spreadsheets, and were reported by Northern Powergrid against the years in which they occurred.

[2] There is also a flaw in Ofgem's proposed test for fault rate output delivery. The test does not appear to recognise that a mixture of over-shooting, and under-shooting, fault forecasts is to be expected across different asset classes given the natural volatility in fault rates. A DNO should only be considered to have missed its fault output if it has over-shot its target in a **majority** of asset classes.

ii. That there would be a mid-period review, allowing DNOs to understand progress towards their targets during the period.
iii. An intention that there would be 'few surprises' at the end with respect to Material Changes.

There was no mid-period review and we are not sure how much discussion there has been between Ofgem and DNOs in relation to specific material changes, prior to the close-out itself. Ofgem should take this into account in how it administers the close-out. We provide the relevant references in Appendix G.

h. ***Real price effects should be recognised in the financial re-openers:*** The discussion in the working group meeting on 17 December left us unclear as to whether Ofgem may be contemplating making no adjustment in the load related and high value project reopeners to reflect the lower real price effects that were experienced in the DPCR5 period compared to those forecast in the DPCR5 *Final proposals*. If this were the case, it would be contrary to the DPCR5 *Final proposals* which stated that DNOs would retain the risk associated with out-turn RPEs. Appendix H provides a worked example to illustrate this.

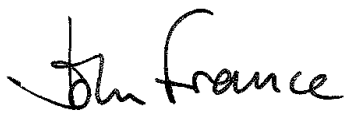
i. ***Other items:*** Ofgem's consultation and our response do not cover other important issues in the close-out, such as ensuring that any use of efficiency analysis recognises (and mitigates) the distortions that can be created by disaggregated analysis. We trust these matters are being taken into account in development of the methodologies following the original consultation.

8. We hope that these comments are helpful as you further develop your policy thinking in relation to these issues.

9. We also note that there remain some significant policy issues to resolve before a methodology for the close-out can be finalised. The current drafts of the financial methodologies will require significant work before they reach an adequate standard for incorporation into the licence (despite the combined efforts of Ofgem, its consultants, and the various interested parties to develop the drafting in tandem with the ongoing work on policy). Taken together, these points mean that we believe it will no longer be possible to modify the methodologies in the financial handbook within the timescales envisaged in the handbook.

10. We look forward to meeting with you on a number of occasions over the coming weeks in order to bring this work to a close. A substantive discussion may well be necessary as you consider potential methodologies for adjustments, given the scope for unintended consequences.

Yours sincerely



John France
Regulation Director

APPENDIX A: THE ROLE OF THE NADPR RIGs IN THE DPCR5 SETTLEMENT

11. Ofgem's stated intent in the further consultation is to 'be consistent with the intent of DPCR5 FPs and the NADPR RIGs'.

12. In the DPCR5 *Final proposals*, Ofgem stated that:

> '19.14. Since Initial Proposals, and in consultation with the DNOs, we have developed comprehensive RIGs covering network outputs…
>
> …
>
> 19.16. The RIGs also contain details on the scope and consequences of our qualitative outputs performance assessment process, which will take place at the end of DPCR5.'[3]

13. Ofgem subsequently went on to say that:

> 'We hope to publish the draft RIGs in late February to enable the DNOs to have a draft of the RIGs to review alongside their draft licence conditions, which will by that time be going through the statutory consultation stage. We will publish the final version of the RIGs by the end of March.'[4]

14. In other words, the contents of the RIGs were explicitly an integral part of the DPCR5 *Final proposals*, to be considered alongside the licence modification which enacted the price control. In particular, they set out detailed methodologies in areas where these were absent from the DPCR5 *Final proposals* themselves.

Furthermore, on 18 March 2010 Rachel Fletcher sent licensees a letter of comfort, prior to the making of the licence modifications, stressing that Ofgem would not change its approach in future revisions to the RIGs.

> 'I am writing in response to your concerns regarding the removal of paragraph 12 of SLC 44A from the draft distribution licence. This paragraph prevented any changes to the introduction, use of network outputs and networks performance assessment sections of the Networks Outputs RIGs which now form part of the overall Network Asset Data and Performance Reporting (NADPR) RIGs.[5]
>
> ….We assure you it is not Ofgem's intent to deviate from this policy in updates to the NADPR RIGs.' [6]

15. We will therefore assess Ofgem's proposed modifications to the close-out methodologies by reference to whether we think that the modified methodologies remain true to the intention to carry out a fair and balanced qualitative assessment of our stewardship of the asset.

16. We hope we can look forward to your making it clear in the revised methodologies that this is how you will approach this task.

[3] DPCR5 Final proposals, December 2009, Incentives and Obligations document, pages 100-101

[4] Ofgem, December 2009, Update on the regulatory instructions and guidance (RIGs) for DPCR5, page 2

[5] Rachel Fletcher, March 2010, letter titled 'Para 12 of SLC 44A Network Output RIGs – letter of comfort', para 1

[6] Rachel Fletcher, March 2010, letter titled 'Para 12 of SLC 44A Network Output RIGs – letter of comfort', para 4

APPENDIX B: THE IN THE ROUND NATURE OF THE OUTPUTS TEST IN THE DPCR5 SETTLEMENT

17. The assessment of whether a licensee had delivered its outputs was intended to be a qualitative, in the round assessment. Only where a licensee failed that assessment would a mechanistic determination of the outputs gap be undertaken. A qualitative assessment was clearly envisaged at DPCR5 as was indicated by the first version of the NADPR RIGs which stated that:

> '2.8. While the Agreed Network Outputs are not a "hard target' for DNOs to meet, they will form the baseline against which each individual DNO's future performance will be assessed at an overall level by Ofgem. There will be financial consequences for a DNO that Ofgem qualitatively determines has not Delivered Network Outputs which reflect the change in the level of network risk funded by customers via the DPCR5 settlement.'

18. And:

> '2.12. As part of the DPCR6 process Ofgem is to conduct a Network Outputs performance assessment. The purpose of the performance assessment is to determine whether or not a DNO has satisfactorily delivered a package of outputs consistent with the change in the level of risk funded by its customers through the DPCR5 settlement. At a high level, this requires DNOs to provide information to demonstrate that the program of work actually delivered over DPCR5 was in customers' best interests, and **for Ofgem to qualitatively determine whether or not this is the case**.' [emphasis added]

19. The sense is that Ofgem will conduct a proper qualitative assessment of the broad package of outputs that looks at the stewardship of the asset and whether the right decisions were made that were in the interests of customers. A proper qualitative assessment cannot be carried out by making the presumption that the valuation of an outputs gap can be determined (as your letter of 14 December suggests) simply:

> '…by multiplying the differences in planned and actual volumes of asset replacement by the unit costs for that asset category…on an individual basis for all asset lines to which fault rates apply and then summed.'[7]

20. That would be completely mechanistic and it would fail to recognise the distinction between the primary measures of LI and HI and the secondary measure of fault rates. These RIGs stipulate that in determining whether or not a DNO has met its 'Adjusted Network Outputs' the key consideration will be the change in the overall level of network risk provided by the DNO's 'Delivered Network Outputs' compared to the change in the level of network risk implicit in the 'Agreed Network Outputs'. Importantly these RIGs state that:

> 'The conclusion is to be a qualitative 'pass/fail' at the overall level, however it is to be informed by the data and commentary provided for the individual Tier 2 Network Output Measures.'[8]

21. Significantly, these RIGs also stipulate:

> 'There is to be no specific and quantitative thresholds [sic] adopted to identify areas for further consideration - the outputs data is intended to be a useful resource to assist DNOs in justifying, and for Ofgem in assessing, the efficiency and efficacy of asset management decisions.[9]

22. Moreover, the RIGs state that:

[7] Chris Watts, December 2015, letter titled 'Further changes to DPCR5 Closeout Methodologies – your letter dated 4 December 2015'

[8] NADPR RIGs v1, pages 28-29, para 2.79, high level principle 2

[9] NADPR RIGs v1, pages 28-29, para 2.79, high level principle 3

'there needs to be significant and material issues with the Delivered Network Outputs at the overall level before it can be qualitatively determined that a DNO has not delivered… the Adjusted Network Outputs'.[10]

[10] NADPR RIGs v1, pages 28-29, para 2.79, high level principle 6

APPENDIX C: THE OUTPUT GAP CALCULTION

23. The RIGs state that if Ofgem 'qualitatively determines that a DNO has satisfactorily met its Adjusted Network Outputs, there will be no further action'.[11]

24. If, however, Ofgem determines that the DNO has not satisfactorily met its 'Adjusted Network Outputs' the RIGs go on to say that that there will be an adjustment and stipulate the precise manner in which 'the relevant adjustment is to be calculated'.[12]

25. This part of the exercise values the difference between the DNO's 'Delivered Network Outputs' and the 'Adjusted Network Outputs' and calls this difference the 'Network Outputs Gap'. This part of the calculation is mechanistic and is precisely set out at paragraphs 2.83 - 2.85 of these RIGs:

> '2.83 On a line-by-line basis, Ofgem is to calculate the difference in volumes implicit in the DNO's Delivered Network Outputs with the volumes implicit in the Adjusted Network Outputs. For the HI this is to be in terms of the number of assets replaced for each Health Index Asset Category, and for the LI this is to be in terms of the Distribution Asset volumes delivered by the general reinforcement schemes carried out. In determining the volume gap on a line-by-line basis, Ofgem is to remove the impact of any volumes implicit in the DNO's Delivered Network Outputs that are deemed to be unjustified based on network need.
>
> 2.84 Then, for the volumes calculated at paragraph 2.83, Ofgem is to determine the appropriate unit cost assumption to apply (i.e. £/Distribution Asset Category), which is to be the higher of:
>
> - The DNO's outturn unit costs, and
> - Ofgem's forecast unit costs (underpinning the DPCR5 allowance) adjusted for outturn RPI.
>
> 2.85 To calculate the Network Outputs Gap, Ofgem is to take the sum of the volume differences in paragraph 2.83 multiplied by the relevant unit costs assumption determined in paragraph 2.84.'[13]

26. Significantly, **fault rates play no part in this calculation**. Indeed, it is clear that only the primary output measures of HI and LI are used in the calculation of the 'Network Outputs Gap'. Fault rates may inform the first qualitative judgement (whether the DNO has delivered its outputs), but they play no part in the second exercise (the valuation of the gap and the determination of the monetary adjustment).[14]

27. The Further Consultation, and other associated materials, suggests an approach that is inconsistent with the approach set out in the RIGs. In particular:

    a. there appeared to be no recognition of the two stages to the process, where the quantitative valuation of the outputs gap is undertaken only when the DNO has failed the qualitative assessment; and

    b. the proposal to monetise fault rates in determining the value of any adjustment contradicts the RIGs which limit this calculation to the LI and HI components.

[11] Ofgem, May 2010, NADPR RIGs v1, page 29, para 2.80

[12] Ofgem, May 2010, NADPR RIGs v1, page 29, para 2.82

[13] Ofgem, May 2010, NADPR RIGs v1, page 30

[14] Faults are of course to be taken into account in the qualitative assessment of whether a licensee has met its outputs overall (including via a quantitative, monetised, calculation to help trade off the value of the fault rate network outputs with other types of network output).

APPENDIX D: HI

28. Below are references to support the properties of HI reporting arrangements, and the distinctions we draw between HI and LI, and HI and fault rates, that are highlighted in our covering letter.

The HI reporting spreadsheets were developed to capture all kinds of material changes in a separate log

29. When making their HI submission, DNOs were required to populate and submit the spreadsheet "Material Change Log". This spreadsheet relates specifically to HI since:
    a. the header row in cell G9 includes a reference to HI, since it reads 'Description of effect of change on His'; and
    b. it is submitted with the HI submission, while the LI submission happens at a different time of year.
30. Equivalent spreadsheet do not exist for LI or fault rates.

The HI tracking calculations separate out the impact of material changes from the HI delta delivered through investment.

31. DNOs were required to report and track their HI network output performance in the file originally published with the title 'network-outputs-reporting-workbook-hi-tracking.xls'. This tracking file separated out variance in HI due to material changes, in rows titled 'Variance due to Material Changes'. [15]
32. This is in contrast to LI, where the reporting spreadsheets only captured certain types of material change (see Appendix E), and these material changes were not separated out in the calculation of LI.
33. It is also in contrast to fault rates, where material changes were not reflected in the reporting templates in any way (see appendix F).

[15] For example, row 40 in the template published with the v1 of the NADPR RIGs in May 2010

APPENDIX E: LI

34. Below are references to support the properties of LI reporting arrangements that are highlighted in the letter, along with references to demonstrate that the load index close-out should not be operated in a way that undermines other elements of the DPCR5 *Final proposals*.

Only a sub-set of material changes are catered for in the LI reporting spreadsheets.[16]

35. When making their LI submission, DNOs were required to populate and submit the spreadsheet originally titled 'Network outputs reporting workbook'[17], with a populated version of the worksheet 'LI data'.

36. This worksheet did require reporting of certain types of material change by requiring DNOs to 'Briefly explain the nature / category of any Material Change affecting Firm Capacity for this Demand Group (detail in commentary accompanying the submission)' and immediately below this providing DNOs with cells in which to give a 'commentary'.[18]

37. The reporting spreadsheet did not provide a template for Ofgem to gather any information on material changes that would not affect firm capacity (for example changes in demand relative to forecast, or changes in asset management strategy).

A separate mechanism was explicitly put in place to cater for changes in expenditure arising from LI material changes due to external circumstances (the Load Related Re-opener).

The DPCR5 *Final proposals* stated that:

> '7.2 First, for some categories of expenditure there are volume uncertainties where we acknowledge that volumes are partially outside of the control of the DNOs and consider some protection to be appropriate both on the upside to protect the DNOs and on the downside for the benefit of customers. An example of costs falling into this category is general reinforcement and low-volume high-cost connections expenditure where we are proposing an ex ante allowance with a reopener to protect against large deviations from expected demand and connection volumes.'[19]

38. Ofgem therefore explicitly considered that DNOs, and customers, should be provided with some protection from deviations in load growth, and the number of connections, relative to the forecasts in the DPCR5 Final proposals. This protection was provided for via the load related re-opener, not any other mechanism.

39. The DPCR5 Final proposals went on to say that:

> '7.22 The DNOs will be required to justify this increase in efficient expenditure requirement through use of the load index output measures and the volume of high cost connections.'[20]

40. They also went on to say that the first 20% of variation in expenditure (including due to changes in demand) would not result in a true-up.

> 'No adjustment would be made for the efficient expenditure up to the 20 per cent threshold beyond the usual operation of the rolling incentive scheme which means

[16] Ofgem's slides from the 17 Dec 2015 working group meeting erroneously state that material changes were not reported for LI. To the contrary, certain types of material change were explicitly incorporated in the reporting spreadsheets, and were reported by Northern Powergrid against the years in which they occurred.
[17] Ofgem, May 2010, published alongside NADPR RIGs v1
[18] LI data, Cells AP 8 and AP 9
[19] Ofgem, December 2009, DPCR5 Final proposals, costs assessment document, page 91
[20] Ofgem, December 2009, DPCR5 Final proposals, cost assessment document, page 95, para 7.22

that in practice the DNOs are only really exposed to around 10 per cent (assuming a 50 per cent incentive rate) of the Ofgem baselines due to demand risks.'[21]

Yet if DNOs were held to delivering a specific **change** in load index under the network outputs methodology, with an attempt by Ofgem to strip out changes that resulted from demand variations, DNOs would be penalised for reducing volumes of activity, or reprioritising work, in light of new information on loading conditions. This would be contrary to explicit statements in the DPCR5 *Final proposals* and therefore inappropriate.

[21] Ofgem, December 2009, DPCR5 Final proposals, cost assessment document, page 95, para 7.22 continued

APPENDIX F: THE DIFFERENT FOOTING OF FAULT RATES

41. SLC44A from the licence, as it was modified to implement DPCR5, is the concrete expression of the DPCR5 arrangements with respect to fault rates.

42. In this condition fault rates are described as 'the secondary Agreed Network Outputs', whereas HI and LI are described as a 'primary' output measures. SLC44A distinguishes between these two categories deliberately and for good reason. Whereas the LI and HI metrics lend themselves to the creation of indices that show a score for the utilisation and the health of the asset, fault rates do not lend themselves to such a treatment.

43. Whilst we agree that fault rates are something that should be considered by Ofgem in the close-out assessment, the mechanism that is set out in your letter of 14 December is inappropriate. Indeed, it would obviously be wrong for Ofgem's close-out methodology to treat something that is referred to in the licence as 'secondary' as essentially the same as something that is stated in the licence to be 'primary'. We expect to see some recognition of this difference in the close-out arrangements.

44. This different footing was already recognised in the DPCR5 NADPR RIGs which, as set out in Appendix A above, are an integral part of the DPCR5 price control settlement. While fault rates form part of the overall, qualitative, pass or fail assessment of whether a licensee has met its DPCR5 network outputs (see appendix B), they do not form part of the calculation of any financial clawback (see appendix C).

45. Lastly, Ofgem stated in supplementary materials to the Further Consultation that, with respect to fault rates, 'we will only apply a financial adjustment if there is an outputs gap at an aggregate level and a DNO has not met its Fault Rate requirements for a number of asset categories.'[22] There are two issues in this proposed approach:

    a. It is not clear in this statement whether an 'outputs gap at an aggregate level' means an outputs gap across all network outputs taken together (as set out in the NADPR RIGs – see appendix B) or some other level of aggregation.

    b. There is a potential flaw in the test that a 'DNO has not met its Fault Rate requirements for a number of asset categories'. The fault rate forecasts included in the DPCR5 business plan questionnaire responses were expected levels of faults. They were not ceiling levels, or minimum requirements. Given natural volatility between asset classes, a DNO would be expected to exceed its fault rate forecasts in approximately 50% of asset categories, and under-shoot its fault rate forecast in the other asset categories. So 'a number of asset categories' must involve materially more than 50% of asset categories before a DNO is considered to have not met its fault rate network output.

[22] Letter from Chris Watts to Keith Noble-Nesbitt,14 December 2015, page 2, para 12

APPENDIX G: PROCESS COMMITMENTS IN THE NADPR RIGs

46. Ofgem made numerous commitments in the NADPR RIGs as to how it would monitor and evaluate DNO performance on their network outputs.

47. There was an explicit expectation that there would be a two way dialogue during the DPCR5 period itself, so DNOs and Ofgem would both understand any issues that were emerging while they were still possible to address.

> '2.3. The Network Outputs reporting is intended to form the basis for informed discussions both during and at the end of a price control period on the benefits delivered by the level of investment undertaken during the price control period.'[23]
>
> …
>
> '2.20. It is important that the reasons for changes in the outputs delivered over DPCR5 relative to the Agreed Network Outputs are tracked and well understood through constructive dialogue between the DNOs and Ofgem.'[24]

48. A mid-period review of outputs was also planned, where greater focus was expected to be brought to changes in asset management approach (compared to in the dialogue relating to annual reporting).

> '2.30. DNOs may provide information on their asset management approach as part of an Annual Submission however this is not expected to be a focus of discussions with Ofgem until the mid-period review. A full re-forecast of Network Outputs data, taking into account all forecast asset management Interventions, is not required until the mid-period review.'[25]

49. The importance of these discussions was further highlighted by the fact a formal record was to be kept.

> '2.37. The nature of any discussions between Ofgem and the DNOs with respect to the Material Changes identified and reported in an Annual Submission must be recorded in the Material Change Log.'[26]

50. While Ofgem did not commit that it would make **no** changes to its approach when it came to the DPCR5 close-out, it did commit to working bilaterally with DNOs during the DPCR5 period to develop the network outputs measures and reporting, and to providing DNOs with an opinion on their progress which they could take into account during the DPCR5 period, including highlighting any high-level areas of concern to Ofgem.

> '2.38. The information contained in an Annual Submission will be reviewed by Ofgem and recorded in the Material Change Log. However it should be noted that the contents of the Annual Submission will not be approved by Ofgem in the sense that a formal declaration of the acceptability or otherwise will be issued. Ofgem reserves the right to assess a DNO"s performance in delivering its outputs across the full period as part of the end-of-period performance assessment.
>
> 2.39. It is acknowledged, however, that there is a clearly established intent to work bi-laterally in developing the use of outputs during the DPCR5 period and the

[23] Ofgem, May 2010, NADPR RIGs v1, page 10
[24] Ofgem, May 2010, NADPR RIGs v1, page 17
[25] Ofgem, May 2010, NADPR RIGs v1, page 19
[26] Ofgem, May 2010, NADPR RIGs v1, page 20

inappropriate use of hindsight in judging performance at DPCR6 is to be avoided. DNOs can expect a substantive discussion with Ofgem following provision of each Annual Submission, during the course of which Ofgem will set out its opinion at that time on the progress being made in the context of the 5 year outcomes being pursued.

2.40. The purpose of the mid-period review is for DNOs to explain their progress towards achieving the Agreed Network Outputs. As part of the mid-period review a DNO must provide an updated forecast of their Network Outputs with further Intervention (i.e. as at 31 March 2015), which represents the DNO"s interim view of the Adjusted Network Outputs. Ofgem will note the data and commentary in the Mid-Period Review Submission for price control discussions, provide guidance to DNOs on their progress and highlight any areas of concern at a high-level.' [27]

51. Lastly, given all of the above, Ofgem expected that the DPCR5 close-out should hold few surprises.

2.68. There should be few surprises in the performance assessment submission – a consistent story is expected to develop over the period with respect to output performance, based on the information from previous submissions as well as that recorded in the Material Changes Log.[28]

52. Ofgem must take all of these commitments into account when deciding to make the changes proposed in the Further Consultation.

[27] NADPR RIGs v1, page 21
[28] NADPR RIGs v1, page 26

APPENDIX H: RPES IN THE FINANCIAL REOPENERS

53. The discussion in the working group meeting on 17 December left us unclear as to whether Ofgem may be contemplating making no adjustment in the load related and high value project reopeners to reflect the lower real price effects that were experienced in the DPCR5 period compared to those forecast in the DPCR5 *Final proposals*.

54. If this were the case, it would not be consistent with the statements in the DPCR5 *Final proposals* that DNOs would retain the risk associated with RPEs exceeding the assumptions in the baselines.[29] This appendix sets out a simple worked example to illustrate this.

Example 1: prices evolve in line with DPCR5 *Final proposals*

55. Suppose a DNO was given a total baseline of 100 for its expenditure covered by the Load related reopener.

56. Its actual expenditure in the category, which Ofgem judges to be efficient, was 80 thanks to an unexpected reduction in loading.

57. This is exactly equal to the first re-opener threshold, so the re-opener is not triggered.

58. There is no claw-back.

Example 1: prices are lower than assumed in the DPCR5 *Final proposals*

59. The scenario is identical to example 1 in the following respects:

    a. The baseline was 100;

    b. If prices had evolved in line with the assumptions in the DPCR5 *Final proposals* the DNO's expenditure would be 80.

    c. Its expenditure is judged efficient by Ofgem;

60. The only difference is that real prices were 20% lower during the period than those assumed in the DPCR5 price control review.

61. Its actual expenditure, which Ofgem judges to be efficient, is therefore 64, including negative RPEs of 16 (20% of 80).

62. This is beyond the 20% reopener threshold, and also the DNOs materiality threshold.

63. This leads to claw-back of 16, equal to the negative RPEs the DNO experienced, meaning that the DNO has not retained the risk of RPEs differing from those assumed in the DPCR5 baseline.

[29] DPCR5, Final proposals, cost assessment document, page 95, paras 7.22 and 7.23