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Our ref

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Date

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Dear Chris,

DPCR5 Closeout Methodologies – Ofgem’s proposed further changes since initial consultation

I am writing on behalf of Western Power Distribution (South Wales) plc, Western Power Distribution (South West) plc, Western Power Distribution (East Midlands) plc and Western Power Distribution (West Midlands) plc in response to Ofgem’s letter dated 2nd December 2015, which outlines proposed changes to the close out methodologies for the DPCR5 Price Control, further to the initial consultation that closed in November 2015.

The proposed changes relate to:-

- **Fault Rates:** introduction of a financial adjustment associated with performance against the DPCR5 Agreed Network Outputs for Fault Rates; and
- **Material Changes:** adjustments to the DPCR5 Agreed Network Outputs for Load Indices and Health Indices to take account of material changes.

Please find, below, our comments in relation to these proposed changes.

Fault Rates

In principle, the introduction of a financial adjustment based on underperformance against the DPCR5 Agreed Network Outputs for Fault Rates is reasonable.

However, there are a number of considerations that need to be addressed in the derivation of the methodology for implementation of such an adjustment. We have outlined these in Appendix A. These issues need to be considered in the development of the DPCR5 closeout methodology for the Fault Rates Network Output Measure, through discussion at the existing DPCR5 Closeout Methodologies working groups, so that a practical implementation can be determined.

Material Changes

Any adjustment to the Agreed Network Outputs should take account of only those Material Changes reported in the DPCR5 period that actually impact upon the delivery of the originally agreed outputs, not the underlying data.

As a result only information relevant to the impact of Material Changes upon the delivery of the outputs should be required as part of the Performance Assessment Submission. We have outlined a number of points in relation to this matter in Appendix B.

Furthermore, the current proposal is to use material changes both as part of:-

- a quantitative assessment: to restate the original outputs into adjusted outputs which would then be used as the reference for assessing delivered outputs; and
- a qualitative assessment: where Ofgem form a qualitative view on whether there is an outputs gap based on the information submitted.

The derivation of adjusted outputs, within the quantitative assessment, introduces an unnecessary complication and there is a risk that these adjusted outputs will be derived using inconsistent approaches requiring a more complex assessment by the Authority. It may be prudent to consider an approach where the quantitative assessment is performed using the original outputs, as agreed with the Authority, remaining in place. DNOs could then use material changes, qualitatively within this assessment, to explain why the delivered outputs are different. This approach would lead to a simpler comparison of a start and end position, rather than a more complicated three position analysis.

If material changes are to be considered in both the quantitative and qualitative assessments, the assessment methodologies must ensure that adjustments for a particular material change do not result in an adjustment being double counted.

It is important that adequate guidance on the types of Material Changes considered and the type of information required to be submitted as part of the Performance Assessment Submission needs to be developed, with the DNOs, through the existing DPCR5 Closeout Methodologies working groups.

WPD will continue to support the further discussions through the working groups to develop the DPCR5 Closeout Methodologies and assist developments to incorporate the proposed methodology changes.

Should you wish to discuss any aspects of this response please contact amichalowski@westernpower.co.uk or pmann@westernpower.co.uk.

Yours sincerely



ALISON SLEIGHTHOLM
Regulatory & Government Affairs Manager

Appendix A – Considerations In Relation To The Introduction Of A Financial Adjustment For Performance Against The DPCR5 Agreed Network Outputs For Fault Rates

There are a number of considerations that need to be addressed in the derivation of the methodology for implementation of a financial adjustment based upon performance against the DPCR5 Agreed Network Outputs for Fault Rates:-

- Whilst DNO activities do influence observed fault rates, external influences (such as weather) can also influence them. This needs to be taken into account when assessing whether a DNOs performance has triggered a financial adjustment. This can be achieved by applying a suitable materiality threshold within the assessment. This needs to also be taken into account when evaluating any Outputs Gap;
- There are low volumes of faults in some asset categories covered by the Fault Rate outputs and consequently minor changes in fault volumes can lead to significant variances in fault rates. Performance against the DPCR5 Agreed Network Outputs must be assessed on the total overall performance across all asset categories, rather than on a category by category basis, in order to limit the impact of such sensitivities upon the performance assessment;
- There was no clear linkage between the DPCR5 Agreed Network Outputs for Fault Rates and DPCR5 allowances in Final Proposals. The valuation of any financial adjustment based on the levels of activity required to close any Outputs Gap will therefore be extremely difficult to justify. In particular:-
 - The Agreed Network Outputs only comprise the forecast annual fault rates for each asset category. They do not include all the information necessary to identify the quantum of improvement that was forecast for a given level of expenditure. This is because the Agreed Network Outputs did not include the forecast annual fault rates that would have been expected had no asset replacement or refurbishment interventions had been undertaken. Similarly it is not possible to identify the actual quantum of improvement in fault rates that was made by actual asset replacement, or refurbishment, expenditure because this would require the number of faults that were avoided because of intervention to be identifiable. As a result a quantum of improvement per unit of expenditure cannot be directly determined;
 - Whilst the prime driver for asset replacement activity is asset condition, other drivers such as obsolescence, safety and environmental factors also affect levels of asset replacement expenditure. Consequently not all asset replacement expenditure would be expected to target fault rate improvements;
 - Observed fault rates are subject to external factors, other than the DNOs own interventions. The impact of such factors cannot be disaggregated from the actual observed fault rates; and
 - In Final Proposals Ofgem made an adjustment to allowances for asset replacement activity for some DNOs based upon volume reductions determined from Ofgem's own modelling. These reductions were never quantified in terms of 'allowed' volumes for specific assets. Therefore, for

DNOs where such adjustments were applied, the linkage between allowance and activity volumes cannot readily be identified (except for asset categories covered by Health Indices).

Appendix B – Adjustment Of The DPCR5 Agreed Network Outputs For Material Changes

Any adjustment to the Agreed Network Outputs should take account of only those Material Changes reported in the DPCR5 period that actually impact upon the delivery of the outputs.

Whilst the reporting of Material Changes in DPCR5 related to a number of areas, namely:-

- changes to input data;
- changes to the assessment techniques/calculation methodology;
- changes due to external factors; and
- changes to DNO asset management strategy and approach

not all these types of Material Changes impact upon the deliverable. For example, whilst changes to a DNO's asset management strategy, such as reprioritisation of risk, may impact upon the DNO's selection of interventions undertaken, this would not change the overall agreed deliverable, only the way that the DNO has elected to deliver it.

In each of the areas listed above, some Material Changes may impact upon the deliverable, whilst others may not. For example, for Health Indices some DNO's may have reported as Material Changes to input data:-

- changes to the type of data used in the assessment of asset health; and/or
- changes to the Health Index for individual assets relating to availability of new data indicating changes to the condition of the asset.

Only the first of these changes will impact upon the deliverable itself. Changes to input data relating to the observed condition of individual assets form part of the natural deterioration of assets that was accounted for in the forecast profiles.

When specifying the types of Material Changes to be considered in the adjustment of the Agreed Network Outputs, it will be necessary to give consideration of the different types of changes that would be included in each of the four areas listed above.

Also, when specifying the requirement for further information, or restatement, in relation to Material Changes, consideration should be given to the relevance of the information to the performance assessment or the calculation of the financial adjustment. Where Material Changes have no impact upon these areas, it is unnecessary for information to be provided as part of the Performance Assessment Submission.

In particular, an adjustment should only be made to the deliverable determined from the Agreed Network Outputs, rather than the full set of information that is reported as the Agreed Network Outputs. For example, for Health Indices the Agreed Network Outputs include the forecast profiles for the 31st March 2015, both with and without intervention. The deliverable, however, is the change in these profiles delivered through asset replacement or refurbishment activities (the 'delta'). Some Material Changes will impact the 'with intervention' and 'without intervention' profiles equally and therefore will not impact upon the actual deliverable.

It would be sensible to limit the submission of further data in relation to the Material Changes, and subsequent assessment and agreement, to only those Material Changes that impact the deliverable, or the financial adjustment methodology. For Health Indices this would be achieved by submitting data on the Material Changes in relation to their

impact upon the delta rather than on the overall profiles. However, for Load Indices the deliverable is the profile and consequently Material Changes need to be explained in terms of their impact upon the profile itself.