

Legal & Regulatory
1st Floor, Lakeside West
30 The Causeway
Staines
Middlesex
TW18 3BY

12th January 2016.

Geoff Randall (Electricity Transmission) / Mick Watson (Gas)
Ofgem
9 Millbank
London SW1P 3GE.

Dear Geoff/Mick,

Consultation on a potential RIIO-T1 and GD1 mid-period review

Thank you for the opportunity to respond to the consultation regarding the mid-period review (MPR) for the T1 and GD1 price controls. This is a non confidential response on behalf of the Centrica Group, excluding Centrica Storage.

We support the objectives of the RIIO framework, which include the delivery of value for money for consumers. We are pleased to have the opportunity to contribute to the evaluation of whether mid-period reviews (MPRs) for the T1 and GD1 controls should be conducted and the definition of the scope of each. We recognise that much has changed since the first round of RIIO price controls were finalised which, in turn, has significantly impacted consumers' interests. We believe there is clear evidence that both Transmission and Gas Distribution should be included within this mid-period review and the scope should be much broader than that proposed. This evidence includes:

Expected performance over the T1 and GD1 price controls:

- By the network companies' own estimates, which are likely to be conservative, it is currently expected that total expenditure will be £1.8bn¹ below that allowed for T1 and £1.8bn² below for GD1. A significant part of these gains made by the network companies do not appear to necessarily result from efficiency gains, but from spending no longer being needed due to events out of the networks' control³⁴. In practice, this means that customers will fund networks for £2bn⁵ above the actual level of expenditure.

¹ 14/15 prices. Data obtained from the 14/15 Regulatory Reporting Packs (RRPs).

² 14/15 prices. Data obtained from the 14/15 RRP.

³ In its latest performance report, NGET state that changes in customer needs mean that only 11GW of the 33GW initially expected will be connected and only 48 of the 72 super-grid transformers initially expected will be required (http://consense.opendebate.co.uk/files/nationalgrid/transmission/NG_Electricity_Transmission_Our_Performance_Publication_2014-15.pdf).

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- Networks outperformed virtually all output measures from the outset of the period, where a symmetric distribution of performance around the output targets would be expected from well-calibrated settlement. Therefore, unless Ofgem publishes firm evidence of genuine high performance, a recalibration is appropriate for the remainder of the price control period.
- The effect of the current trajectory is that the average return on regulatory equity (RoRE) for the electricity transmission sector is expected to be 9.3%⁶ (compared a baseline of 7.0%). The RoRE for the gas distribution sector is expected to be 10.2%⁷ (compared to a baseline of 6.7%).

Significant changes in Government policy across the energy sector:

Changes in decarbonisation policy, brought about with the intention of helping to meet EU targets, have had a major impact upon the electricity and gas network sectors. The implications include:

- Cancellations in new network connections due to changes in new generation, affecting both gas and electricity networks;
- Impact on gas distribution networks of renewable heat policies and energy efficiency;
- Changes in renewable incentives affecting size and location of renewable energy sources compared to plans in place during the price reviews;
- Changes to gas distribution iron main replacement profile.

We disagree with the approach taken to this MPR. We note that a review of all elements of performance is not included within this consultation but, instead, information is restricted to the specific issues that Ofgem has identified. By restricting the information provided to stakeholders by Ofgem to the areas prejudged as being relevant, the approach is, *by design*, limiting the level and effectiveness of stakeholder engagement. This makes this consultation particularly difficult to engage with. This also makes it likely that relevant issues will not be identified. In pursuing this approach, Ofgem is effectively depriving itself of the ability to be adequately equipped when determining whether price controls are set in a way that genuinely maximises efficiency in accordance with Ofgem's duties and obligation. A more comprehensive approach to the MPR is necessary for stakeholders to engage fully as intended within the RIIO framework.

⁴ In the RIIO-GD1 Annual Report 2013-14, Ofgem states "*In the first year, companies also benefited from a mild winter, which reduced the adverse effects of cold weather on network assets.*"

⁵ 14/15 prices. This is based on the totex estimates in the 14/15 RRP and the sharing factors published in Final Proposals.

⁶ Data obtained from the "RIIO Electricity Transmission Annual Report 2014-15". RoRE across the sector have been weighted by the regulatory asset values (RAVs).

⁷ Data obtained from the "RIIO-GD1 Annual Report 2013-14". RoRE across the sector have been weighted by the RAVs.

We expand on these concerns within the answers to the consultation questions. In order to alleviate these concerns and to conduct a MPR that is credible and effective, in addition to being of more use to stakeholders, we ask that the approach to the MPR is adjusted in the following ways:

A full review of the performance of the existing controls is conducted and presented: This should involve stakeholders at the earliest stage and should include an assessment of any outperformance (or underperformance), an analysis of the underlying drivers and the extent to which the controls deliver value for money for consumers. As well as informing the MPR, this would be highly useful in improving stakeholder engagement and transparency.

Transmission and Gas Distribution price controls must be included within MPR: This is supported by our review of performance. We have also identified a number of significant issues, particularly with regard to Gas Distribution, that require further examination.

This MPR should be seen in the context of National Grid's planned disposal of a share of its Gas Distribution Networks: equity analysts are suggesting a premium to RAV above 40%. This may be indicative of how the price control arrangements are performing for customers.

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

CHAPTER: One

Question 1: Do you have any views on the additional clarity we have provided on the RIIO-T1 and GD1 MPR scope?

Purpose of the MPR:

When developing the RIIO regulatory framework, Ofgem identified the need to mitigate risk arising from forecasting uncertainty given the ex-ante nature of the RIIO price control framework and the lengthening of the price control periods. It was intended the price controls would not be designed to protect network companies against all forms of uncertainty and network companies would be expected to manage the uncertainty that they face. Mechanisms to accommodate uncertainty were introduced into the RIIO framework to mitigate risks such as:

- *Revenues raised from consumers could be higher/lower than necessary to cover the costs of network services, with consumers paying more/less for network services than was required; and*
- *The primary outputs (and potentially secondary deliverables) that we agree with network companies may turn out to be insufficient or inappropriate.*⁸

The mechanisms would operate by “...allow[ing] revenue to adjust during the price control period in response to changes in operating conditions”⁹ and their use “...should be limited to instances in which they will deliver value for money for existing and future customers while also protecting the ability of networks to finance efficient delivery”¹⁰. (Emphasis added.)

The mid-period review was one such mechanism and its purpose was explicitly linked to an examination of the suitability of existing outputs:

‘Given the potential for increased uncertainty under a longer control period, we proposed to provide clarity on when and how the price control would adjust during the period. This included provision for a mid-period review of output requirements to enable any fundamental change in what is expected of network companies, for example due to a change in government policy, to be taken into account quickly. The mid-period review of outputs would only result in changes to the price control should there be a material change in what is required of network companies. We would not look to change incentive mechanisms, the

⁸ Handbook for implementing the RIIO model, paragraph 11.1:

https://www.ofgem.gov.uk/sites/default/files/docs/2010/10/riio_handbook_0.pdf

⁹ Handbook for implementing the RIIO model, paragraph 11.3

¹⁰ Handbook for implementing the RIIO model, paragraph 11.28

*allowed return or other price control parameters through this mechanism, unless it was required due to a change in the outputs.*¹¹

Scope of the MPR:

It is proposed the scope of the MPR is limited to changes to outputs “...that can be justified by clear changes in government policy and the introduction of new outputs that are needed to meet the needs of consumers and other network users.”¹² It has also been stated that changes to outputs should satisfy the interests of these groups:

*‘When making a change at the mid-period review we will look to apply the latest information available to set the level of incremental revenue associated with changes to outputs driven by government policy or new outputs that are in the interest of consumers and other network users’*¹³

We have not identified a description of either ‘needs’ or ‘interest’ of consumers and other network users in the context of the MPR in documents published by Ofgem relating to the RIIO framework, the T1 price control and the GD1 price control. We suggest it is beneficial to stakeholders for these terms to be given practical effect and, as such, we outline our interpretation below. We assume equivalence between ‘needs’ and ‘interest’ for the purposes of this consultation and hereafter refer only to ‘needs’ in the interest of simplicity.

The legislative framework applicable to the Gas and Electricity Markets Authority (GEMA) can provide perspective. The powers of the Authority are provided under various statutes such as the Electricity Act 1989, Gas Act 1986 and the Utilities Act 2000. Its principal objective is set out in the Electricity Act 1989 and is:

*‘...to protect the interest of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems...’*¹⁴

That Act also sets out duties that GEMA must comply in relation to its principal objective and some specific groups of consumers whose interests it should have regard to. Ofgem must also give regard to the strategic priorities identified in the Secretary of State’s Strategy and Policy Statement. Ofgem has distilled these requirements into the following statement:

¹¹ RIIO: A new way to regulate energy networks, paragraph 5.9: https://www.ofgem.gov.uk/sites/default/files/docs/2010/10/decision-doc_0.pdf

¹² Consultation on a potential RIIO-T1 and GD1 mid-period review, page 4: https://www.ofgem.gov.uk/sites/default/files/docs/2015/11/151112_mpr_consultation_document_final.pdf

¹³ Decision on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Uncertainty mechanisms, paragraph 7.9: https://www.ofgem.gov.uk/sites/default/files/docs/2011/03/t1decisionuncert_0.pdf

¹⁴ Electricity Act 1989 section 3A(1).

'We interpret our duties as:

*Our priority is to protect and make a positive difference for all energy consumers. We work to promote value for money, security of supply and sustainability for present and future generations. We do this through the supervision and development of markets, regulation and the delivery of government schemes. We work effectively with, but independently of, government, the energy industry and other stakeholders. We do so within a legal framework determined by the UK government and the European Union.'*¹⁵ (Emphasis added.)

We infer the acknowledgement of value for money as one of the primary needs of consumers that Ofgem should seek to achieve in fulfilment of its statutory obligations.

Value for money is a primary objective Ofgem intended the RIIO regulatory framework to satisfy:

'The overriding objective of the RIIO model is to encourage energy network companies to:

- play a full role in the delivery of a sustainable energy sector*
- deliver long-term value for money network services for existing and future consumers.'*¹⁶ (Emphasis added.)

These objectives have also been referred to as "...the cornerstone of the regulatory regime"¹⁷. Value for money was highlighted as ongoing consideration for the regulator in the operation of each RIIO price control rather than a concept simply designed into the regulatory framework:

*'Extending the price control period provides a further strong signal that we... will focus on long-term value for money.'*¹⁸ (Emphasis added.)

AND

*'We will decide the primary output level that network companies should deliver based on the case put forward in their business plans, the views of stakeholders, and our assessment of what represents value for money for existing and future consumers.'*¹⁹ (Emphasis added.)

This is reinforced by Ofgem's expectations of network operators to deliver primary outputs and secondary deliverables that demonstrate value for money, which align with the output levels set by Ofgem intended to represent value for money:

'Network companies will be responsible for network planning, stewardship of their assets and operational decisions over time, to ensure any risk to delivery of primary outputs is managed and that they deliver long-term value for money for existing and future consumers.'

¹⁵ "Our strategy": https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/corporate_strategy_0.pdf

¹⁶ RIIO: A new way to regulate energy networks, page 8.

¹⁷ Handbook for implementing the RIIO model, paragraph 6.3

¹⁸ Handbook for implementing the RIIO model, paragraph 5.7

¹⁹ Handbook for implementing the RIIO model, paragraph 6.55

*Network companies will need to work out how best to deliver primary outputs over time and at long-term value for money...*²⁰ (Emphasis added.)

AND

*'Secondary deliverables are not the 'ends' relating to consumer experience of network services but are the 'means to the end'. They are needed to ensure delivery of primary outputs over time and that long-term value for money is not put at risk. We expect the network company to continue to seek out better ways of delivering during the price control, changing the proposed approach relative to the plan where this is expected to be better for long-term value for money.'*²¹ (Emphasis added.)

We suggest value for money is a consumer need Ofgem should pursue in order to fulfil its statutory obligations. It has also been identified as a primary objective of the RIIO framework, an ongoing consideration for the regulator in the operation of each price control and an explicit expectation on network operators to deliver. As such, we believe value for money is a factor that must be considered when evaluating whether changes should be made at the MPR that meet the needs of consumers and other network users.

We agree there may be some instances in which there is not a meaningful distinction between the introduction of new outputs and changes to existing outputs. We support the revision of those existing outputs that do not adequately meet consumers' needs. Again, we believe value for money is factor that must be considered as a part of that assessment.

Question 2: Do you consider the issues we have identified for RIIO-T1 and GD1 in this consultation fall within this scope?

As far as we have been able to ascertain from the limited information provided, the issues identified fall within the scope. However, the assessment provided is insufficient to stakeholders to conclude this with any degree with confidence. For this (and any future) MPR to be effective a comprehensive review of performance is required to be undertaken, with the involvement of stakeholders, and presented.

Question 3: Are there any other issues within the defined scope that we have not included when assessing the need for an MPR for RIIO-T1 and GD1?

²⁰ Handbook for implementing the RIIO model, paragraph 6.26

²¹ Handbook for implementing the RIIO model, paragraph 6.29

The approach being taken to this MPR should be revised. The current approach limits the extent of stakeholder engagement *by design* and is neither demonstrably comprehensive or robust. As such, it is likely to lack credibility.

The process for an effective mid-period review should contain the following the steps:

- Presentation of performance, including against outputs, to date
- Identification of drivers for outperformance and underperformance
- Assessment of these drivers against the MPR criteria

The nature of consultation is that stakeholders will naturally comment primarily on the content of the consultation. By presenting a selection of prejudged issues for the transmission sector, and, in the case of Gas Distribution, no issues were identified for inclusion in the MPR, the consultation is guiding stakeholders towards evaluating those issues in isolation. The initial stage of the MPR should be to provide stakeholders with all the information required about performance under these price controls and then allow stakeholders to form their *own* judgement about where issues may be. In contrast to this, the section within this consultation on Gas Distribution, with revenue allowances of over £29bn²² funded by customers over the price control, is less than 4 pages long. This is very little assistance to stakeholders in understanding potential issues. In this context it is disappointing that this consultation does not seek to outline how gas distribution operators (GDNs) are performing. This seems an obvious and essential piece of analysis to be included in any review of a price control. The separate annual report on performance in Gas Distribution is not expected to be published until after this consultation has closed.

As well as allowing stakeholders to assess performance, and whether this identifies issues, it is also required that Ofgem explains the reasons for out-performance (under-performance). To conduct a more rigorous and meaningful review, it is required to explain the drivers behind performance and then assess whether these present issues suitable to be captured under the MPR. Currently, no reference is made to the fact that customers are expected to fund networks at a level billions above the costs networks are facing. There is a requirement, not least in terms of transparency, for Ofgem to expand on this, providing detailed, specific reasons if it does not believe these issues are suitable for the MPR. Ofgem has presented the MPR as a review of whether outputs remain suitable without an assessment of the achievement of outputs. Again, performance against outputs needs to be assessed and analysed.

This approach will help to ensure that all relevant issues are identified and that the review is more comprehensive. On the more limited data available to us, we have conducted our own initial review of performance and assessment of issues that this may present. Through this, we have identified a number of issues in Gas Distribution, for example, that are clearly necessary to be included within the MPR. These issues, such as how the exit capacity incentive is operating, are relatively obvious

²² Opening Base Revenue Allowances in 2014/15 prices.

from a review of performance. It is therefore surprising that Ofgem did not identify these issues and so underlines that the more rigorous approach outlined, in addition to the current approach, is required to ensure an effective review.

CHAPTER: Two

Question 4: Based on our current assessment there may be some issues in Electricity Transmission that could be addressed through an MPR. Do you agree with this assessment?

As far as we have been able to ascertain from the limited information provided, the issues identified fall within the scope. However, the assessment provided is insufficient to stakeholders to conclude this with any degree with confidence. For this (and any future) MPR to be effective a comprehensive review of performance is required to be undertaken, with the involvement of stakeholders, and presented.

Question 5: We ask for detailed views, particularly from the TOs, on how the operability of the RIIO-T1 NOMs incentive mechanism could be improved. As part of this, we would like evidence on the manner in which any potential revisions may better facilitate the delivery strategy of outputs, in line with current needs of consumers and network users, and the materiality of such change.

This consultation does not contain sufficient information for stakeholders to arrive at informed views. Ofgem should seek to actively engage with all types of stakeholders if improvement of the incentive is required.

Question 6: We are seeking views on whether the Environmental Discretionary Reward is driving the right business changes within the companies and providing the outputs that consumers and network users need.

This incentive was designed to “sharpen transmission companies”...*focus on strategic environmental considerations and organisational and cultural change to facilitate growth in low carbon energy*²³. Transmission operators (TOs) have been increasingly participating in the low carbon sector since the introduction of this incentive and this has started to become the norm instead of being perceived as behaviour that is needed to be encouraged. In this circumstance, the thresholds for reward should be increased to reflect the integration of low carbon activity into business-as-usual process. It may also be appropriate to redirect the focus of the scheme to other aspects of environmental performance that should be encouraged.

²³ Decision on the concept for the implementation of the Environmental Discretionary Reward for the electricity transmission owners and system operator: https://www.ofgem.gov.uk/sites/default/files/docs/2012/07/riio-t1---environmental-discretionary-reward-%28edr%29-decision-letter_0.pdf

Question 7: We are seeking views on whether the stakeholder incentives are driving the right behaviours to get the outputs that consumers and network users need.

Stakeholders other than TOs raised concerns that the proposed calibration of the stakeholder satisfaction incentive was likely to result in poor value for money for consumers²⁴. In particular, we stated:

“We have a number of significant concerns with the values proposed. The values for 2013-5 are likely to provide poor value for money for customers and we are unable to assess whether the values for the remainder of the period will do so.”

AND

“The TOs cannot have reasonably expected to receive rewards based upon values within annual reporting that were not consulted upon and were described by Ofgem as not based on evidence and ‘conservative’. To be considered for use, these values need to be justified on their own merits and not because they appeared elsewhere, without consultation and without formal standing”.²⁵

We believe that views sought on stakeholder incentives should not be limited to considerations of whether the right behaviours are being encouraged. Further, we believe stakeholders should be invited to comment on whether these incentives demonstrate value for money for consumers, especially in light of the fact that it is a consumer need.

We continue to be concerned the calibration of the stakeholder satisfaction incentive is likely to result in poor value for money for consumers. As such, we recommend that stakeholders’ views on the extent to which this incentive represents value for money for consumers are sought and value for money is a criterion used to assess the performance of the incentive at the MPR. We also recommend stakeholders are given the opportunity to directly contribute to future independent panel assessments.

Question 8: We have set out some initial thinking on the following issues: submission quality for Strategic Wider Works projects, further guidance on monitoring needs cases for projects in construction, the potential need for an availability incentive for Scottish island links, and potential funding requirements for NGET’s enhanced SO function, as well as on onshore competition roles. What are your views on these?

We consider the enhanced system operator (SO) function represents a fundamental change to the assumptions upon which the T1 settlement was based and, as such, meets the criteria for inclusion in the MPR. A benefit of the proposed function is the delivery of value for money for consumers by way of efficient infrastructure expenditure:

²⁴ British Gas and Citizens’ Advice responded to the “Consultation on values within the stakeholder satisfaction output arrangements” (<https://www.ofgem.gov.uk/publications-and-updates/consultation-values-within-stakeholder-satisfaction-output-arrangements>)

²⁵ British Gas response to the “Consultation on values within the stakeholder satisfaction output arrangements”: https://www.ofgem.gov.uk/sites/default/files/docs/2015/10/britishgas_response_0.pdf

*'We are giving the SO additional responsibilities in planning the GB electricity transmission network and potential new interconnection with other countries. This will help ensure that the network is planned and operated in an efficient, economic and coordinated way. We expect this to create benefits for consumers in the long term...'*²⁶

AND

*'As GB consumers ultimately bear the costs of the transmission network, they will benefit from the cost savings that can be achieved from a more efficiently designed and coordinated network. Our decision will lead to more efficient transmission costs which will feed through to lower network charges to help keep consumer bills down, while a network that efficiently meets the needs of its users will ensure consumers' electricity supply is secure as it decarbonises over time.'*²⁷

We support the principle that the efficient, economic and coordinated planning of the transmission network should lead to lower costs for consumers. This may involve the deferment or the cancellation of infrastructure upgrades that are no longer necessary. TOs should not benefit in those scenarios because the efficiencies have been brought about by an 'external' factor. We recommend the MPR is used as an opportunity to further consider how consumers can fully benefit from the efficiencies delivered by the enhanced SO function, including the associated TOs allowances that no longer need to be committed.

Question 9: We wish to understand if there has been a material change in outputs due to the changes in government policy related to renewables subsidies. We ask that the TOs provide information on which connections and wider works are being taken forward compared to the ones that the unit costs were based upon and whether any variation is within the bounds of what was expected to be captured.

This consultation does not contain sufficient information for stakeholders to arrive at informed views. A full analysis of the operation of the existing revenue driver should be undertaken. Ofgem should also seek to actively engage with all types of stakeholders if improvement of the mechanism is required.

Question 11: We welcome views on whether there needs to be clarification of output requirements and treatment of activities (load related projects in particular), that sit outside of the revenue drivers, where they are no longer required or have been substituted.

It should be in the interest of customers that activities that are no longer required are not undertaken. However to ensure this is the case it is essential that revenue allowances are considered alongside any clarification of output requirements. Whilst networks should have incentives to not

²⁶ Integrated Transmission Planning and Regulation (ITPR) project: final conclusions, paragraph 2.1:
https://www.ofgem.gov.uk/sites/default/files/docs/2015/03/itpr_final_conclusions_decision_statement_publication_final.pdf

²⁷ Integrated Transmission Planning and Regulation (ITPR) project: final conclusions Enhancing the role of the System Operator – Supporting Document, paragraph 2.17:
https://www.ofgem.gov.uk/sites/default/files/docs/2015/03/itpr_final_conclusions_eso_document_publication_final.pdf

complete activities that are no longer required, the totex efficiency incentive mechanism is not suitable for this purpose. If the sharing factors are relied upon, the rewards for not doing an activity outweigh the rewards for delivering an activity efficiently. This is likely to mean that over-forecasting the level of activities would be significantly rewarded.

In theory, the IQI should provide a 'truth-telling' incentive to guard against this. However, there is no evidence from either T1 or GD1 that this is the case in practice, with network companies being able to underspend against allowances, and business plan submissions, from the outset of the price control periods.

In order to address this, during the MPR Ofgem could conduct a first review of the totex expenditure to account for costs that will not be incurred. These cost savings would arise from either changes in legal/regulatory requirements (e.g. changes in health and safety) and/or elimination of certain projects (noting one needs to be careful that this does not exclude improvements in efficiency caused adopting new solutions that were not available during the price review as otherwise it would affect innovation).

As part of a more comprehensive approach to this MPR, this would be an opportunity for Ofgem to consider why the IQI appears to have failed. This is a key question for the future of the RIIO approach.

Question 12: How material do you consider the RIIO-T2 outputs issue to be? Do you consider this is an issue that we should take forward?

Insufficient information has been included in the consultation that would enable stakeholders to arrive at informed views. However, we raise concerns about the following:

- The relatively short MPR should not 'fix' anything before the more thorough assessment carried out during price control reviews e.g. unit costs should not be set before T2 price control review. Decisions about what might become a material proportion of expenditure in the next price control should not be made before the price control review starts.
- We expect significant forecasting uncertainty will continue to exist for the delivery outputs no earlier than the third year of the next price control. The time horizon is at least seven years from now, which is almost as long as a RIIO price control. Robust uncertainty mechanisms that provide customers with the appropriate protections need to be developed.

CHAPTER: Three

Question 13: Based on our current assessment there may be some issues in Gas Transmission that could be addressed through an MPR. Do you agree with this assessment?

As far as we have been able to ascertain from the limited information provided, the issues identified fall within the scope. However, the assessment provided is insufficient to stakeholders to conclude this with any degree with confidence. For this (and any future) MPR to be effective a comprehensive review of performance is required to be undertaken, with the involvement of stakeholders, and presented.

Question 14: We are considering undertaking a review of the requirement and associated output to deliver an Avonmouth pipeline solution. Do you agree with this?

The information provided indicates this issue falls within the scope. As discussed in Question 11, where networks have not delivered specific outputs, it is essential to protect consumer interest by reviewing revenue allowances.

Question 15: We are considering reviewing how National Grid Gas Transmission (NGGT) is meeting its output to maintain its 1-in-20 obligation for Scotland. Do you agree with this?

A review of outputs would be essential if NGGT has made any significant change to its approach to maintaining its 1-in-20 obligation so that revenue allowances are reviewed alongside any changes to requirements and outputs.

Question 16: We are considering reviewing how NGGT is meeting its output to deliver specific compressor projects. Do you agree with this?

As far as we have been able to ascertain from the information provided, this issue falls within the scope. In instances in which a network company has not delivered specific outputs, revenue allowances should be reviewed in order to protect consumers' interests.

CHAPTER: Four

Question 17: Based on our current assessment we have not identified any material issues for RIIO-GD1 which we think would require further examination through an MPR. Do you agree with this assessment?

Although the consultation states that a review was conducted, and then no issues were identified, there are no results provided from this review. Less than 4 pages of analysis are provided on Gas Distribution, much of which is preamble. This means that either that the results of the review are

not being shared with stakeholders, which would be concerning in terms of engagement and transparency, or that a meaningful review has not, in fact, taken place. It is not sufficient for Ofgem to simply state it has undertaken a review in any circumstances, without presenting the results of the review. However, where views are being actively sought on whether other issues exist, to fail to provide stakeholders with the required information to form such views undermines the purpose of consulting.

Analysis of performance, in GD1 and T1, shows that customers are being asked to fund levels of revenues significantly above those required to fund the cost of the activities undertaken. Also, virtually all output measures are being met, making it questionable how challenging these targets were. Overall, this means there are severe doubts over how effective these controls are being in protecting customers. Given this, and Ofgem's duty to ensure value for money, the process for this review should be actively seeking to find ways to restore some value for customers.

Our analysis of the GDNs' performance forecasts, which was conducted using publicly-available data, highlights a number of elements of the GD1 price control that may currently drive the wrong behaviours or do not operate in consumers' interests. The fact that our analysis identified elements of the GD1 price control that satisfy the criteria for inclusion in the MPR further support the need for Ofgem to conduct a comprehensive review of the control and share its findings with stakeholders. The issues we identified are:

- exit capacity incentive – we identified a number of issues including that the incentive can encourage GDNs to book exit capacity at more expensive offtake points
- broad measure of customer satisfaction – including the current calibration of the customer satisfaction survey incentive may give an incentive to the GDNs to worsen performance
- iron mains risk reduction programme – including the need for a review of the programme to examine whether the expenditure reductions brought about by the change in HSE policy are fully reflected in expenditure allowances.

Our analysis relating to the exit capacity incentive and the broad measure of customer satisfaction and our findings are discussed in detail in the appendix.

Question 18: Do you agree with our current assessment that there is no need to review the risk reduction output associated with the iron mains risk reduction programme, as part of an MPR?

Given the scale of funding that customers are providing for the iron mains risk reduction programme, over and above that required for the spending actually incurred, which we estimate at around £1.0bn over the 8-year period, for the MPR to be credible it needs to fully examine all related areas, including the risk reduction output. This additional cost to customers was caused by a

clear change to government policy when the HSE changed its approach to the iron mains risk reduction programme. It seems likely that the full change in costs caused by this change in policy was not reflected in Ofgem's assessment of efficient costs and was not revealed through the IQI. The reasons for this need to be fully explored through this MPR process and a detailed examination conducted, involving the engagement of stakeholders, of how this could be addressed through the MPR. No evidence is provided within the 4-page Gas Distribution section of this consultation that such a process has been undertaken.

Legitimate expectation of a review of outputs at MPR:

Stakeholders have held a legitimate expectation that aspects of this programme would be covered by the MPR. Ofgem's expectation with respect to the iron mains risk reduction programme was stated in the Strategy Decision:

*'As a longer term objective, the HSE anticipate initiating a wider consultation with regard to the future of the repex programme. They intend to consult on whether they should remove the current legal framework governing iron mains, and instead, replace this with a broader requirement on GDNs to achieve a safe network "so far as reasonably practical". We also intend to introduce an uncertainty mechanism to accommodate any future change to the HSE's policy arising from their proposed consultation.'*²⁸ (Emphasis added.)

The expectation of a more fundamental review of the Pipeline Safety Regulations (PSR) as they relate to iron mains was reaffirmed in RIIO GD1 Initial Proposals:

*'In June, the HSE announced a change to its iron mains replacement policy based on a 3-tier approach. As set out in our Strategy Document, and in recent letters from HSE to the GDNs, the HSE also proposes to undertake a more fundamental review of the Pipeline Safety Regulations (PSR) as they relate to iron mains, and the absolute requirement to maintain a safe network. The HSE has indicated to us that it will complete its review of the current statutory framework for 2015 to allow for any consequent changes to GDNs investment plans to be taken into account at the mid-period review.'*²⁹ (Emphasis added.)

The expectation was confirmed in Final Proposals:

'The HSE has also stated that it will undertake a more fundamental review of the Pipeline Safety (Amendment) Regulations 2003 (PSR) as they relate to iron mains, and has indicated to us that it will complete its review in time for our mid-period review. We set out in our

²⁸ Decision on strategy for the next gas distribution price control - RIIO-GD1, paragraph 2.12-2.13:

https://www.ofgem.gov.uk/sites/default/files/docs/2011/03/gd1decision_0.pdf

²⁹ RIIO-GD1: Initial Proposals Supporting Document – Finance and uncertainty, paragraph 8.72:

<https://www.ofgem.gov.uk/sites/default/files/docs/2012/07/gd1-finance-initial-proposals-270712.pdf>

*Finance and Uncertainty Supporting Document how we will accommodate any changes to PSR at the mid period review.*³⁰

HSE's intention to undertake a more fundamental review of the repex programme was also explicitly stated in May 2012 when it implemented the new policy following the joint HSE/Ofgem "10 year review of the Iron Mains Replacement Programme":

*'HSE will undertake a review of the Pipeline Safety Regulations 1996 Regulations 13 and 13A as they bear upon iron mains risk reduction programme and the absolute requirement to maintain network pipes. HSE anticipates that this work will inform decisions on how best to approach the management of risk from the iron mains network, what the GDN operators need to do to discharge their duties and if any changes of approach are appropriate as part of the Ofgem mid-term price review in 2017. Subject to HSE Board and Ministerial approval it is our intention that, by this time, the GDN operators will be required to maintain all of the iron pipes within their networks (along with pipes made from other materials and operated at below 7 bar) to a 'so far as is reasonably practicable' standard.'*³¹

We conclude that Ofgem (at the GD1 Strategy Decision, Initial Proposals, Final Proposals) and the HSE were clear that HSE was expected to conduct a "wider" and "more fundamental" consultation on whether to move to a requirement to provide a safe network 'so far as reasonably practical'. In this context it is clear the *specific* uncertainty mechanism that Ofgem introduced with respect to the iron mains risk reduction programme in RIIO GD1 was limited to changes arising as a result of HSE's expected "wider" and "more fundamental" consultation.

Significant change in Government policy – a fundamental review and wider consultation of the IMRRP has not occurred:

Whilst we accept the anticipated legislative changes have not materialised, there has been a significant change in Government policy: the wider consultation and fundamental review that were expected and signalled throughout the GD1 price control review have not taken place. Instead, bilateral exchanges between the HSE and GDNs appear to have occurred without other stakeholders. That HSE did not undertake such a "wider" and "more fundamental" consultation is itself a significant change in policy and there are no restrictions in RIIO GD1 Final Proposals on how Ofgem should take account of this.

³⁰ RIIO-GD1: Final Proposals - Supporting Document – Outputs, incentives and innovation, paragraph 6.5: https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/2_riiogd1_fp_outputsincentives_dec12_0.pdf

³¹ <http://www.hse.gov.uk/Gas/supply/mainsreplacement/10-year-review.htm>

We consider this represents a sufficiently large change in policy that warrants a review of the IMRRP as part of the MPR.

Developments have not included stakeholders:

We raise concerns about the lack of transparency in the decision-making process relating to some elements of the IMRRP. Non-GDN stakeholders have now been made that the HSE notified Ofgem that they had consulted the GDNs on this matter in 2013. The GDNs responded:

‘...unanimously rejecting any proposals to amend the regulation on the basis of reasonable practicability and stating that in their view the current system under IMRRP remained fit for purpose and cost effective. At the HSE’s request the GDNs produced robust evidence supporting their views.’³²

As a result, the HSE has decided the current policy should remain unchanged. We are not aware of the HSE consultation, the GDNs’ responses or the supporting evidence submitted (particularly relating to the cost-effectiveness of the current approach) being in the public domain. We believe it is inappropriate that non-GDN stakeholders (and Ofgem as it would seem) have not been given the opportunity to comment on the potential legislative changes, especially since repex is the single largest component of expenditure over the GD1 price control which customers are required to fund. Further, it is inappropriate that non-GDN stakeholders have not been given the opportunity to comment of the GDNs’ submissions and the cost-effectiveness of the proposals to customers, especially in light of the significant repex underspend projected. For example it is not known whether the GDNs’ evidence of cost-effectiveness was based on cost to the GDNs or cost to consumers (which will be £1.0bn higher since GDNs keep 63% of the under spend against allowances).

We consider the failure by HSE to undertake the fundamental review and wider consultation clearly signalled at the time repex allowances were set represents a sufficiently large change in policy to warrant a review of the iron mains replacement programme as part of the MPR. In light of the significant repex underspend of about 21% projected by the GDNs, as shown in the table below, Ofgem should review the outputs and allowances associated with the programme to ensure the needs of customers, including value for money, are being met.

GDN	Submissions (adjusted) (£m)	Expenditure Allowance (£m)	Projected expenditure (£m)	Underspend (£m)	Underspend %
EA	1,098	1,038	792	246	23.7%
LO	1,535	1,324	962	362	27.3%
WM	723	675	494	181	26.9%
NW	887	830	647	183	22.0%
Sc	549	563	457	107	18.9%

³² Consultation on a potential RIIO-T1 and GD1 mid-period review, paragraph 4.5

So	1,689	1,580	1,357	223	14.1%
NO	806	806	674	132	16.3%
WW	801	751	594	157	20.9%
TOTAL	8,087	7,567	5,977	1,589	21.0%

We note the considerable concern surrounding the quality of data held by GDNs expressed in the review of the Iron Mains Replacement Programme³³ commissioned jointly by Ofgem and the Health and Safety Executive (HSE). Reviewing the IMRRP as part of the MPR would also allow Ofgem to take account of any improvements in the quality of asset data.

CHAPTER: Five

Question 20: Do you agree that we should clarify some areas where it isn't clear how late or non-delivery will be treated? If so, which areas do you consider would benefit from such clarification?

It should be in the interest of customers that activities that are no longer required are not undertaken. However to ensure this is the case it is essential that revenue allowances are considered alongside any clarification of output requirements. Whilst networks should have incentives to not complete activities that are no longer required, the totex efficiency incentive mechanism is not suitable for this purpose. If the sharing factors are relied upon, the rewards for not doing an activity outweigh the rewards for delivering an activity efficiently. This is likely to mean that over-forecasting the level of activities would be significantly rewarded.

³³ CEPA report: 10 year review of the Iron Mains Replacement Programme

Appendix – Issues identified in the RIIO:GD1 price control

RIIO GD1 Issue: Exit Capacity Incentive

NTS exit capacity is separated into 2 areas in the GDN licence:

- **Exit capacity costs** – GDNs pay for capacity rights to flow gas through their NTS offtake sites to meet their 1 in 20 peak day demand obligation. Exit capacity costs are treated as pass-through costs.
- **Exit capacity incentive** – whilst exit capacity costs are a pass through item reducing this cost *should* benefit end customers and networks are given incentives to reduce the bookings compared with the original license allowed volumes.

We would expect an appropriately structured exit capacity incentive would aim to encourage GDNs to be efficient with their capacity bookings such that if they are able to beat appropriately calibrated targets, then they are able to retain a share of such outperformance, with the remaining share being passed to customers.

However, based on our analysis of the information available to us, it seems clear that the exit capacity incentive is failing customers and Ofgem should use the mid-period review to fully investigate why this is the case. Our own analysis has raised the following areas of concern which should be investigated more fully by Ofgem:

- Gives incentives to book capacity at more expensive offtake points
- GDNs appear to have significantly changed their approach to delivering their 1 in 20 peak day obligation.
- The use of forecast prices can create inappropriate incentive rates.
- The incentive is delivering poor value for money for customers.

Incentives to book capacity at a more expensive offtake point:

We are concerned that the use of different prices for the purposes of the incentive and those actually faced by the GDNs create an incentive to book capacity at offtake points not because they are the most efficient but rather because they give more reward through the incentive.

Such incentives are created when the actual prices faced by the GDNs differ substantially, particularly in relative terms across their offtake points in a region, compared with those which were forecast 3 years previously and which are used for the purposes of the incentive. We have identified that for 33% of offtake points the 'actual' regional price rankings for offtake points are not aligned with the 'incentive' price rankings.

Such differences in price rankings can create significant conflicts in the incentives faced by GDNs. For example, in May 2011 NTS published a forecast price of 0.0143 p/kWh/day for 2014/15 for the Humbleton offtake point in the Northern region. This was the sixth highest ranked price of the 15 offtake points in the Northern region. However the actual NTS price for the 2014/15 gas year for Humbleton was only 0.009 p/kWh/day and it was the cheapest offtake point in the region. If we consider an extreme hypothetical scenario with no constraints other than price, the most efficient option would be for Northern Gas Networks to book all of its capacity through this offtake point. However this would lead to it suffering a significant incentive penalty (c. £3.7m) as the incentive would deem this to be a relatively expensive offtake point based on the May 2011 forecast prices.

Whilst the example above is an extreme one, there is a clear concern that where GDNs have the ability to rebalance their exit capacity bookings across a region, the current incentive scheme creates incentives to do so in a way which does not encourage efficient behaviour and which does not minimise the cost to the customer. This is because there is no incentive to minimise the actual costs faced by the GDNs since these are fully passed through to customers, but instead GDNs are given incentive to minimise a notional measure of cost based on forecast prices set 3 years ahead of time. As noted above, these forecast prices have had a different regional ranking to actual prices in 33% of instances.

Significant changes in GDNs approach to delivering their 1 in 20 peak day obligation:

It would seem that some GDNs are benefitting through the incentive by significantly changing their approach to delivering their 1 in 20 peak day obligation to rely more on flexibility capacity. For instance National Grid, in their 2014/15 RRP supporting narrative commented:

"We complied with our obligations to ensure that capacity was available to meet a level of demand that is not likely to recur more often than once in every twenty years.

In meeting these obligations we completed a significant re-appraisal of our requirements for NTS flat and flexibility capacity. As a result we were able to safely reduce our bookings and this will result in lower customer bills in the future" [emphasis added]

Similarly, Northern Gas Networks state in their RIIO GD1 year 2 report that “Following a detailed review of offtake capacity levels we have significantly reduced bookings through the July 2015 window”. [emphasis added]

We consider that if GDNs have significantly altered their approach to meeting their 1 in 20 peak day demand obligation compared to the approach assumed at the time of RIIO GD1 then this in itself would be grounds for revisiting the assumed flat capacity baselines. This is because the GDNs, by procuring more flexible capacity, are providing a different service, of potentially lower value to customers, to that assumed under this scheme. We also note that Ofgem is considering to include a review of the way that NGGT is delivering it’s 1 in 20 obligation as part the MPR.

The use of forecast prices can create inappropriate incentive rates:

The incentive rates are based on forecast prices published by NTS 3 years in advance of the actual performance year. These forecast prices can prove to be inaccurate, not least because they are based on allowed revenue assumptions yet to be finalised. This can lead to large discrepancies between the NTS prices being used for the purpose of the incentive and those actually being faced by the GDNs and can therefore create inappropriate incentive rates.

This is particularly observable in the NTS prices used for the incentive for 2015/16 which were the forecast prices published in May 2012. These forecast prices were based on National Grid Transmission’s business plan submission and were set using a target revenue assumption of **£598m**. The final target revenue for the actual October 2015 price setting was only **£288m**, meaning that the effective incentive rates were overpowered by **108%**.

These price discrepancies can be exasperated by the use of only the Oct-Mar prices for the purpose of the incentive. It is a known feature of the NTS charging arrangements that setting prices on a gas year basis (Oct-Sep) to recover allowed revenues set on a regulatory year basis (Apr-Mar) can result in large swings in the revenue targets, and therefore prices, used for the gas year prices.

It seems sensible to normalise any forecast prices used for the incentive for differences in the revenue assumptions used in deriving those incentive prices compared to those that are actually set 3 years later.

The incentive is delivering poor value for money for customers:

Exit capacity bookings do indeed seem to have reduced in RIIO GD1, however customers in RIIO GD1 are worse off as a result. This is because the incentive payments being made to GDNs from reductions in capacity bookings are greater than the actual cost savings from these same capacity reductions. This is demonstrated using the first three years of performance in the table below:

2013/14 - 2015/16 exit capacity (£m)		
Allowed costs	£596	Allowed peak day volume x actual NTS prices From GDN Mod 186 reports (Allowance yr t + True-up yr t+2)
Actual costs	£558	
GDN cost reduction	-£39	
GDN Incentive Payment	£57	
Net cost to customers	£615	For actual exit capacity costs of £558m

Based on the first three years of the scheme (2013/14 to 2015/16), GDNs are expecting to receive c. £57m in rewards from this incentive, however this level of reward has been achieved with cost savings of just £39m compared to their baseline allowances which means that customers are £18m worse off compared to a scenario where there was no incentive regime and, despite the reduction in observed levels of demand, GDNs simply maintained their baseline capacity bookings and therefore made no capacity reductions at all. It is also worth noting that the £39m above is not a true customer 'saving'. Although, the GDNs will pay less to the National Grid Gas Transmission (NGGT) for exit capacity, and so customers will pay less for exit capacity, NGGT's allowed revenue is unaffected. Hence, the shortfall in NGGT revenue caused will be recovered through the exit commodity, and so the amount customer pay overall is unchanged except for the additional £57m in rewards (with some distributional effects also).

It also seems to be likely that the exit capacity baselines were not appropriately calibrated in such a way that the changing needs of customers are not reflected. In their RIIO GD1 business plans GDNs set out their forecasts of changes in peak day demand over RIIO GD1 as per the table below.

Table 7.2: Summary company demand forecast

GDN	Peak day gas demand
NGGD	Decline by 8% over RIIO-GD1 period
NGN	Decline by 3% over RIIO-GD1 period (annual demand forecast to fall by 5%)
SGN	Increase over period 2010/11-2020/21: - 1% (Scotland) - 1.9% (Southern)
WWU	Overall decline in peak demand comprising: - 0.7% increase for Wales South Dist Zone, - 2.3% decrease in SW Dist Zone, - 1.3% decrease in Wales North Dist Zone.

It can be seen that at the time of their Business Plan submissions, in aggregate GDNs were expecting demand to decline over the RIIO GD1 period (by c. 3% overall but in some cases quite significantly i.e. NGGD initially forecast an 8% decline over the RIIO GD1 period). However, Ofgem accepted revised higher capacity forecast from some GDNs between Initial Proposals and Final Proposals with

the result being that the baseline exit capacity allowances increase over RIIO GD1. It seems that the rewards being received now are at least in part being driven by over forecasting of peak day demand by some GDNs.

It is also apparent that the exit capacity baselines did not take any account of the reductions in peak day capacity that would naturally result from the decreases in leakages that were expected and funded over RIIO GD1.

The exit capacity baselines clearly do not reflect the changing needs of customers as they do not reflect the reduction in peak capacity requirement from customers.

Recommendations:

It is clear that the exit capacity incentive is not providing the correct incentives and does not reflect customer needs. This scheme needs to be included in the MPR especially given the number of separate issues that are present.

We would make the following recommendations based on our analysis:

- The scheme should be restructured to better align incentive rewards with **actual** cost reductions rather than notional cost reductions.
- If GDNs have significantly altered their approach to compliance with their 1 in 20 peak day obligation, for instance by changing their use of flat vs flexibility capacity or by changing their forecasting methodology, then the flat exit capacity allowances should be rebased.
- The flat exit capacity baselines should be rebased as a result of the reductions in demand relative to the forecasts provided by GDNs, reflecting the changing needs of customers.
- The exit capacity baselines should be rebased to take account of the reduction in peak day demand that would automatically follow from the funded reductions in leakages over RIIO GD1.

This all indicates that the rewards received to date by GDNs have been achieved in a manner which is not consistent with the intent of the scheme.

RIIO GD1 Issue: BMCS

The broad measure of customer service (BMCS) was introduced at the start of the current price control to drive gas distribution networks to provide customers with a good level of service³⁴. It is comprised of a customer satisfaction survey, a complaints metric and a stakeholder engagement component.

Based on our analysis of the information available to us, it seems that the BMCS is failing customer needs by:

- failing to provide value for money due to the asymmetric calibration of the scheme; and,
- some elements are so inappropriately calibrated that they may provide signals to GDNs to worsen performance

Ofgem should use the mid-period review to fully investigate whether the BMCS is delivering the outputs customer desire at sufficient value for money.

Asymmetric calibration of the BMCS delivering poor value for money for customers

The table below sets out the revenue exposure associated with the BMCS.

Broad Measure of Customer Satisfaction (BMCS)	Maximum reward/penalty (per cent of annual base revenue)
Customer Satisfaction Survey	+0.5 / -0.5
Complaints Metric	-0.5
Stakeholder Engagement	+0.5
Overall BMCS	+1.0 / -1.0

The BMCS was presented by Ofgem to Stakeholders as a symmetric incentive:

*Our approach also ensures that the overall broad measure of customer satisfaction is symmetric i.e. at +/- one per cent of revenues.*³⁵

We agree with this principle of a symmetrical incentive. In a competitive environment, businesses with good customer service would be expected to benefit commercially at the expense of businesses with poor customer service, by gaining market share, but not at the expense of customers. It is therefore appropriate for the BMCS arrangements to be symmetrical.

³⁴ FP Outputs 3.1

³⁵ FP Outputs 3.37

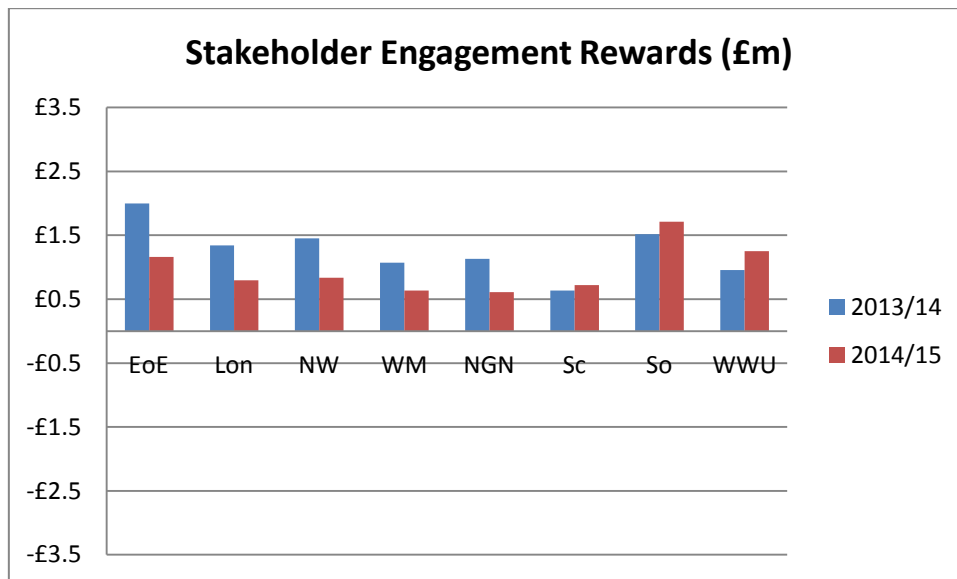
However, incentive symmetry is only achieved if both the revenue exposure is symmetrical *and* the incentive targets are calibrated such that expected rewards are symmetrical on the upside and downside.

Our assessment of performance to date shows that that the current calibration of the elements of the BMCS results in asymmetric performance in favour of the GDNs:

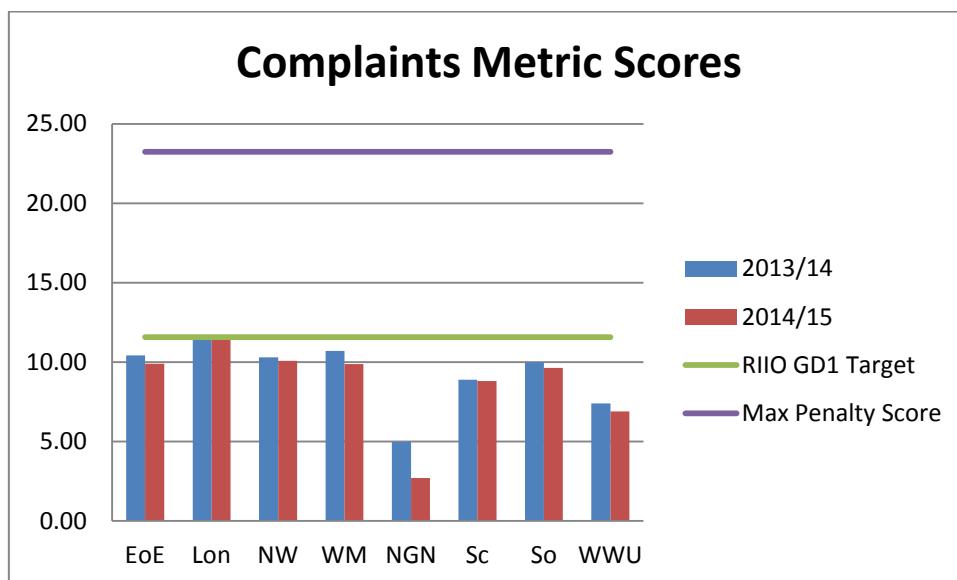
- On the Customer Satisfaction element, with a +/- 0.5% revenue exposure, targets have been immediately exceeded by seven of eight licensees. This means that customers would pay £68m over the course of the RIIO GD1 price control even if performance levels did not improve on the level achieved in the very first year.



- On the Stakeholder Engagement Incentive, with a 0.5% reward only revenue exposure, scores have average 6.4 over the first two years of the price control and customers would pay £77m over the course of the RIIO GD1 price control even if performance levels did not improve on the level achieved in the very first year.

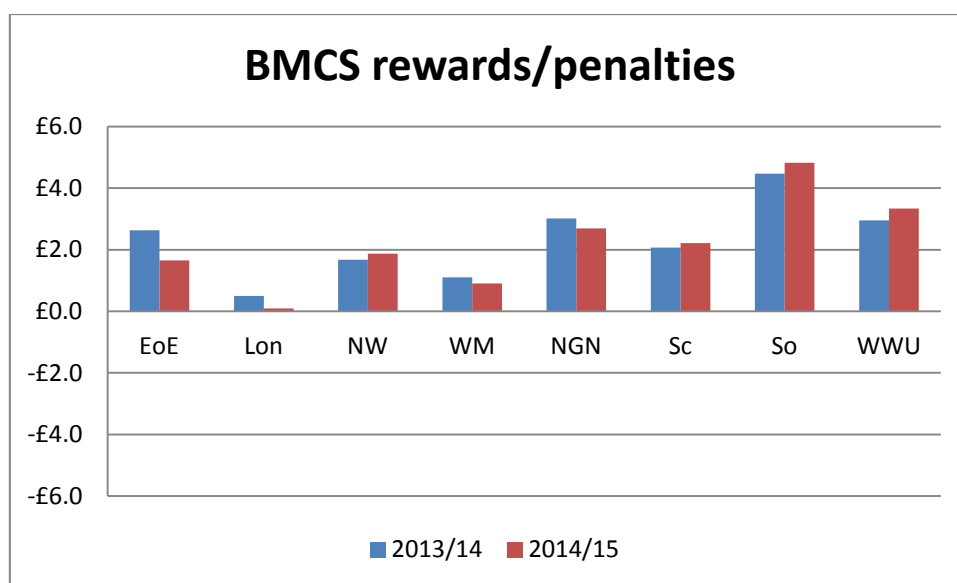


- On the complaints metric, a penalty only scheme with revenue exposure up to -0.5%, no GDN has incurred any penalty in the first two years. On average, GDN performance would need to deteriorate by 25% on the performance achieved in the first year of the price control before *any* penalty was realised, whilst performance would need to deteriorate by 151% on average before the maximum penalty was achieved.



Our overall assessment of the BMCS shows that all eight GDNs received rewards in both of the first two years of the scheme. These rewards have totalled £36m to date and even if GDNs simply maintained performance levels at those achieved in 2013/14, the very first year of the price control, customers would be required to fund £144m in BMCS rewards over the course of RIIO GD1. It seems self evident that such levels of rewards for merely maintaining performance levels achieved in the very first year of RIIO GD1 is likely to be in large part due to a failure to calibrate targets

appropriately such that they were sufficiently challenging so as to provide value for money for customers. This failure should be addressed as part of this MPR.



Some elements of the BMCS are so inappropriately calibrated that they may provide signals to GDNs to worsen performance

As well as providing poor value for money to customers, we believe elements of the BMCS have been calibrated in a manner which has weakened the incentives on GDNs to deliver improvements over the duration of the price control.

At Final Proposals, it was stated that the targets for the customer satisfaction survey are sufficiently challenging:

*To provide certainty we have decided to fix the targets and maximum reward/penalty scores for the price control period. We are satisfied that these fixed values are at a sufficiently high level and we consider that it will remain a challenge for GDNs to meet these levels of satisfaction during RIIO-GD1.*³⁶

It was also stated that rewards would be driven by a material improvement in performance across the sector:

*Overall, our proposals meant that at an aggregate level the industry will need to improve its performance materially to gain a reward*³⁷

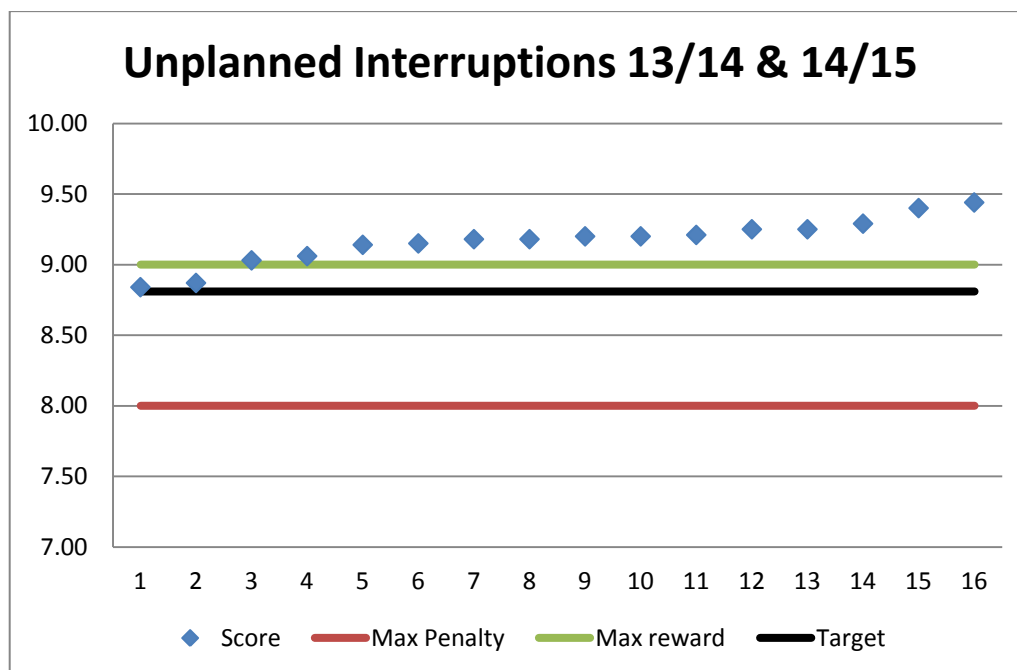
Our assessment of the performance in the unplanned interruptions category in the first two years of the price control does not support these claims. The profile of scores achieved in 2013/14 and

³⁶ FP Outputs 3.27

³⁷ PF Overview 2.24

2014/15, shown in the chart below, highlights the fact that seven of eight licensees achieved the maximum reward available in each of those years.

CHART: 13/14 & 14/15 unplanned interruptions performance, max reward, max penalty



Targets that result in maximum rewards for seven of eight licensees from the first year of the price control are indicative of an incentive scheme which is unchallenging.

There are two reasons for this unsatisfactory outcome for customers:

- (1) The level of the target. Ofgem had limited data with which to set targets at the time of the price control and it is now clear that the level at which the target was set was not sufficiently challenging.
- (2) The level of improvement required to achieve the maximum reward. Whilst the target score has clearly been set at a level that is unchallenging at 8.81, the score at which GDNs receive the maximum reward available has been set at a score of 9.0, just 0.19 survey score points higher than the target score. This means that a GDN can move from zero reward to maximum reward with an improvement of less than 0.2 survey score points. Such a narrow band for improvement above the target places an effective incentive rate of c. £4.2m/point for every additional survey score point above target. This contrasts with an effective incentive rate for every survey score point below the target of c. £1.0m/point.

The combination of easily achievable targets and a threshold for the maximum reward so close to these easy targets has resulted in an incentive which is poor value for money for customers. Furthermore, it creates a disincentive to the GDNs to deliver any improvement in performance beyond that attracting the maximum reward and may even give an incentive to worsen performance if this results in expenditure savings with no impact on incentive rewards.

Similarly, our assessment of performance against the complaints metric (penalty only incentive) suggests that targets were not challenging enough. No licensee will incur a penalty throughout RII0 GD1 simply by maintaining its performance achieved in either 2013/14 or 2014/15 for the remainder of the price control. The manner in which this component of the mechanism is calibrated acts as a disincentive to the GDNs to deliver any improvement in complaints performance and could encourage GDNs to reduce performance to the minimum level that would result in no penalty being incurred if this results in expenditure savings. As highlighted previously, on average GDN performance in complaints could deteriorate by 25% before *any* penalty was incurred.

The evidence suggests the calibration of some elements of the BMCS could reduce the incentive to the GDNs to deliver improvements. We conclude this incentive as currently calibrated does not satisfy the policy objective and does not act an incentive for the GDNs to deliver improvements. This might drive the wrong behaviours and, as such, should be reviewed.