

Decision on close out methodologies for the DPCR5 Price Control

Final decision

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Overview:

The fifth electricity distribution price control (DPCR5) ended on 31 March 2015. The Final Proposals for DPCR5, published at the start of the price control, set the outputs companies were expected to deliver over the price control period and also the associated revenue allowances. They also included mechanisms to deal with uncertain costs. There were five areas where we said that more detailed arrangements (methodologies) for assessing output delivery and expenditure in specific areas would be set after the price control had ended. This decision document sets out our decisions on the detail of these methodologies.

In September and December 2015, we consulted on the draft methodologies. This document sets out our methodology decisions following these consultations.

The final versions of these methodologies will be included in the Financial Handbook. We have published the Statutory Consultation on the Handbook changes alongside this decision. The modifications will be made to the Handbook by 31 July 2016 and will come into effect 56 days after publication.

If any adjustments are required to the DNOs' RIIO-ED1 allowances then these will take place as part of the 2017 Annual Iteration Process (AIP).

Context

In February 2015, we modified the Distribution Network Operator (DNO) licence to incorporate arrangements for closing out the fifth electricity distribution price control (DPCR5). These arrangements are governed by special licence condition CRC3A *Legacy price control adjustments* and Part 3 of the RIIO-ED1 Price Control Financial Handbook (the Handbook) *Legacy price control adjustment methodologies*.

Special condition CRC 3A and Part 3 of the Handbook include methodologies for closing out most outstanding elements for the DPCR5 price control. However, for five more complex areas, we have committed to define detailed methodologies for their assessment. These are:

- Network Output Measures relating to Health Indices (HIs), Load Indices (LIs) and Fault Rates;
- Load Related Re-opener;
- High Value Projects (HVP) expenditure Re-opener and outputs assessment;
- DPCR5 Traffic Management Act Permit Costs reopener; and
- DPCR5 flood prevention.

We have committed in the Handbook to develop these methodologies and formally incorporate them in special condition CRC3A and Part 3 of the Handbook by way of licence modification by 31 July 2016.

Associated documents

- [Electricity Distribution Price Control Review Final Proposals - Allowed Revenue - Cost assessment](#)
- [Electricity Distribution Price Control Review Final Proposals - Incentives and Obligations](#)
- [Network Outputs Data and Performance Reporting \(NADPR\) Regulatory Instructions and Guidance \(RIGs\)](#)
- [RIIO-ED1: Modifications to special conditions of the electricity distribution licences held by the slow-track licensees](#)
- [Modifications to special conditions of the electricity distribution licences held by WPD licensees to incorporate DPCR5 Close out provisions](#)
- [Consultation on the methodologies for DPCR5 Close out](#)
- [Update on DPCR5 Close out Methodologies - further changes since informal consultation](#)

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Executive Summary

The fifth electricity distribution price control (DPCR5) ended on 31 March 2015. The Final Proposals for DPCR5 (DPCR5 FPs), published at the start of the price control, set the outputs companies were expected to deliver over the price control period and the associated revenue allowances. They also included mechanisms to deal with uncertain costs. There were five areas where we said that more detailed arrangements (methodologies) for assessing output delivery and expenditure in specific areas would be set after the price control had ended. This decision document sets out the detail of these methodologies.

In the next few months we will be asking companies to provide further information on the outputs they delivered and their expenditure in specific areas. We will assess this information and consider whether the DNOs have delivered on their commitments and taken investment decisions which will provide long term benefits to customers. If we find otherwise, we could take back some of the associated funding so it can be returned to customers. Any adjustments will be made to allowed revenues in the RIIO-ED1 price control.

Having taken into consideration respondents' views to our September 2015 and December 2015 consultations, the methodologies we are putting in place in the five areas are as follows:

- **Network Output Measures (NOMs)** – This enables us to assess whether the DNOs have delivered a package of outputs in relation to asset health, asset loading and fault rates on their networks and to adjust their revenue downwards where they have failed to deliver those outputs or equivalent outputs. Key elements of the methodology include:
 - a quantitative and qualitative assessment of DNO performance;
 - materiality thresholds that must be met before any adjustments will be made to DNOs' allowances; and
 - arrangements to enable us to monetise Fault Rates and therefore adjust DNOs' allowances if appropriate having assessed overall performance.
- **Load Related Re-opener** – This enables us to adjust the DNOs' revenue upwards or downwards depending on whether their expenditure for demand growth was materially higher or lower than provided for in allowances at DPCR5 FPs. Key elements of the methodology include:
 - materiality thresholds that must be met before the re-opener is triggered and also before any adjustment is the made to a DNO's allowances;
 - provisions to avoid double counting between the Load Related Re-opener and the asset loading assessment under NOMs; and
 - offsetting the impact of any efficiencies that the companies have made through innovative techniques.
- **High Value Projects (HVP)** – This area comprises two separate methodologies: (1) HVP Re-opener - enables us to adjust DNOs revenue upwards or downwards depending on whether their expenditure on specific projects over £15m which they committed to deliver during DPCR5 was higher or lower than provided for in allowances at DPCR5 FPs; and (2) HVP outputs adjustment – enables us to assess whether DNOs have delivered specific



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outputs they committed to deliver for HVPs in DPCR5 FPs. Key elements of the methodologies include:

- materiality thresholds that must be met before the re-opener is triggered and also before any adjustment is made to the DNOs' allowances;
 - removing the possibility of double counting between the HVP Re-opener and HVP outputs adjustment;
 - taking into account the fact that projects may be at different stages in their delivery; and
 - offsetting the impact of any efficiencies that the companies have made through innovative techniques.
- **Traffic Management Act Permit Costs reopener** – This enables DNOs to recover costs they incurred for permits when working on roads and highways which were not provided for in allowances at DPCR5 FPs. Key elements of the methodology include:
 - that costs will be assessed using a combination of qualitative and quantitative methods; and
 - that there will be a materiality threshold before any additional revenues are provided.
 - **Flood Prevention Re-opener** – This enables Scottish and Southern Electricity in its Hydro region (SSEH) to recover money spent on flood prevention that was not in its baseline expenditure allowance for DPCR5. Key elements of the methodology include:
 - a cap (£2.7m in 2012/13 prices) on allowed expenditure; and
 - a test based on the level of risk reduced associated with SSEH's expenditure on flood prevention measures.

Next steps

These methodologies will be included in the RIIO-ED1 Financial Handbook. The Statutory Consultation on the Handbook changes is published alongside this decision. The modifications will be made by 31 July 2016.

We will make any adjustments to DNOs' RIIO-ED1 allowances as part of the 2017 Annual Iteration Process.

1. Background and overview

Chapter Summary

Background on the DPCR5 price control and the elements of the policy to be implemented by Close out methodologies.

Background

1.1. DPCR5 was the fifth electricity distribution price control which ran from 1 April 2010 to 31 March 2015. As part of DPCR5, the DNOs committed to delivering specific outputs relating to network investment, and we put in place mechanisms to deal with areas of uncertainty.

1.2. At DPCR5 Final Proposals (DPCR5 FPs) we explained that some of these mechanisms would need to be settled (“closed out”) ex post at RIIO-ED1. These include Re-openers which deal with under or overspend, and output mechanisms which enable us to impose a penalty on DNOs if they have not delivered the outputs they originally committed to. Adjustments will be made to ED1 allowed revenues. They are governed by special licence condition CRC3A of the distribution licence and Part 3 of the RIIO-ED1 Price Control Financial Handbook (the Handbook).

1.3. We are making changes to the Handbook for the purpose of introducing new and providing clarification for existing methodologies to close out the following five elements of DPCR5:

- DPCR5 Network Output Measures (NOMs) - NOMs are a key indicator of asset health used during DPCR5. There are three measures of asset health within the NOMs: Health Indices (HIs), Load Indices (LIs) and Fault Rates. The DNOs have committed to delivering specific outputs relating to NOMs. This will enable us to adjust DNOs’ revenue downwards where they have failed to deliver outputs;
- DPCR5 Load Related Re-opener - applies to uncertain costs relating to increasing capacity on the network. It can be triggered upwards by the DNOs or we can trigger it downwards;
- High Value Projects (HVP) – this has two components:
 - an outputs mechanism - the DNOs have committed to delivering specific outputs relating to their DPCR5 High Value Projects and enabling us to adjust DNOs’ revenue downwards where they have failed to deliver outputs;

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- an expenditure Re-opener that applies to uncertain costs relating to individual high cost projects which the DNOs planned to undertake which can be triggered upwards by the DNOs or we can trigger it downwards;
- DPCR5 Traffic Management Act Permit Costs reopener - applies to uncertain costs relating to costs associated with permits that DNOs require when working on roads and highways. This can only be triggered upwards by the DNOs as no allowance was made for these costs as part of DPCR5 base revenue; and,
- DPCR5 flood prevention expenditure – this methodology solely applies to Scottish and Southern Electricity in its Hydro region (SSEH) and allows SSEH to recover costs for DPCR flood prevention that were not in its baseline expenditure allowance for DPCR5.

1.4. The effect of our proposed methodologies is to clarify how we will assess DNO performance under each mechanism and calculate any associated RII0-ED1 revenue adjustments.

Overview of the DPCR5 Close out process

1.5. In February 2015, we modified the Distribution Network Operator (DNO) licence to incorporate arrangements for closing out DPCR5. These arrangements are governed by special licence condition CRC3A *Legacy price control adjustments* and Part 3 of the Handbook.

Consultation process

1.6. In September 2015 we published a consultation (the 'September 2015 consultation') setting out high-level draft methodologies. We noted that our starting point for each of the methodologies has been what was set out in our DPCR5 FPs and the Network Outputs Data and Performance Reporting (NADPR) Regulatory Instructions and Guidance (RIGs). The NADPR RIGs were developed in cooperation with the DNOs after DPCR5 FPs were published and reflect evolutions in our thinking. We further noted that in some case we had to make changes to reflect what is practical for each of these assessments and further work that we have done in discussion with the industry since DPCR5 FPs.

1.7. Having considered responses to the September 2015 consultation, we published a further consultation in December (the 'December 2015 consultation') in which we noted we had reconsidered our approach to assessing the NOMs from the position we set out in the September 2015 consultation in respect of Material Changes and Fault Rates. In addition, we noted that we proposed to include an additional methodology for assessing the amounts that Scottish and Southern Electricity had spent on flood prevention in its Hydro region (SSEH). In each case, the changes were proposed to better reflect the policy intention in DPCR5 FPs.

1.8. Having considered the responses to our December consultation, in April we published an Informal Consultation on the full suite of changes to the Handbook and special condition CRC3A for the DPCR5 Close out. This was to provide an additional opportunity to comment on the drafting in advance of our 28 day Statutory Consultation which we are publishing alongside this document.

Working Group

1.9. We created a Working Group (WG) comprising members of the Ofgem team, DNO representatives and British Gas. This group has met regularly to review and develop the DPCR5 Close out methodologies. Notes of the meetings of the working group are published on our website¹.

Purpose of this document

1.10. The purpose of this document is to set out our methodology decisions on the various aspects of the DPCR5 Close out that we consulted on in the September 2015 consultation and the December 2015 consultation. We received seven responses to the September 2015 consultation, none of which were identified as confidential and all of which are published on our website². We received a further six responses to the December 2015 consultation, five of which were not marked as confidential, while one response was marked as confidential. The five non-confidential responses can be found on our website³.

1.11. The document summarises the responses we received to the September and December 2015 consultations and sets out our decisions on the methodologies and views in response to key consultation responses.

1.12. This document does not summarise responses to the Informal Consultation as these relate specifically to the Handbook drafting. Those responses are summarised in the Statutory Consultation.

General responses on the DPCR5 Close out process and our views

1.13. We have also received general comments on the process for closing out DPCR5. These do not relate to any specific methodology and are summarised here along with our views.

¹ <https://www.ofgem.gov.uk/publications-and-updates/dpcr5-close-out-working-group>

² <https://www.ofgem.gov.uk/publications-and-updates/consultation-methodologies-dpcr5-close-out>

³ <https://www.ofgem.gov.uk/publications-and-updates/update-dpcr5-closeout-methodologies-further-changes-informal-consultation>

Timetable for review

1.14. In response to the September 2015 consultation, a number of respondents expressed concerns with the timing of submissions for DPCR5 Close out and in particular interactions with Data Assurance Guidance and the submissions of RIGs.

1.15. On the basis of the concerns identified and recognising the work required to complete the development of the methodologies we changed the timetable for publishing our decision on the methodologies from the previous date of 31 March 2016 to 31 July 2016. This decision was widely supported by respondents.

Transparency of the process

1.16. One respondent to the September 2015 consultation expressed concern that the process of the development of these draft methodologies had consisted of discussions between DNOs and Ofgem. They argued for full transparency of the process.

1.17. We note the concerns raised by one respondent regarding the transparency of the process but do not agree with the view that the process followed has not been transparent. The process we have followed has to date involved the September 2015 consultation and the December 2015 consultation, a further consultation on the timetable for the review and an Informal Consultation on licence drafting in advance of our Statutory Consultation. In addition to this, we established a Working Group to support the development of the methodologies, attendance at which was not limited to DNOs and British Gas has attended all meetings since December. To further aid transparency, notes of each meeting have been published on Ofgem's website.

1.18. We will also consult on our proposed adjustment to DNO revenues following our Performance Assessment. To aid transparency we intend to publish our Preliminary Views on DNO close out positions as part of the industry consultation expected May 2017.

Overarching principles of the DPCR5 Close out process

1.19. There are a number of overarching principles of the DPCR5 Close out process that impact a number of the methodologies. We reflect respondents' comments on these here rather than repeat them in different chapters.

No 'hindsight regulation'

1.20. There was generally support for avoiding hindsight regulation and support for the view that decisions taken during DPCR5 should be viewed based on information available at the time.

1.21. We retain the view of the need to avoid hindsight regulation. This remains one of the key principles underpinning our assessment. We are looking for information

from the DNOs which was available at the time they made the decisions. This is important as any assessment must be based on information that was available to the DNO at the time of making its decision.

Real Price Effects (RPEs)

1.22. A number of respondents sought further clarity on the treatment of Real Price Effects (RPEs). In particular, respondents noted Ofgem's intention to give further thought to the treatment of RPEs and that it could be implied that Ofgem planned to make a generic assessment of outcomes where RPEs were lower than allowances. Another respondent noted that the principle should be stated as described in the DPCR5 FPs, which was that DNOs should retain the risk associated with RPEs.

1.23. As set out in DPCR5 FPs, we consider RPEs are for DNOs to manage. We have reflected this in the Handbook drafting by adjusting actual costs to the level that would have been experienced had RPEs been at the level assumed in the DPCR5. As a result, we have discounted the impact of RPEs from any adjustments applied under both the HVP Re-opener and the Load Related Re-opener.

Assessment of efficiency

1.24. We note that a number of respondents expressed concern regarding the approach Ofgem would adopt for its efficiency assessment under the Load Related Re-opener, the HVP Re-opener and the DPCR5 Traffic Management Act Permit Costs reopener and sought further clarity on both the scope of the efficiency assessment and the principles that Ofgem would apply in assessing efficiency. We address each of these points below.

Scope of efficiency assessment

1.25. Due to the tighter scope of the DPCR5 Traffic Management Act Permit Costs reopener, we have outlined a specific definition of efficient traffic management permitting expenditure in the Handbook drafting, separate to the areas of load related expenditure and HVP expenditure.

1.26. The focus of the ex post assessments, and any efficiency adjustments that we will make, are limited in scope. They will apply only to the efficiency of a licensee's expenditure for the areas of load related expenditure and HVP expenditure that were considered uncertain at DPCR5 FPs and, as a consequence, created the need for re-openers in these areas in the first place.

1.27. Our ex post assessment for each of these re-openers will, as a consequence, be proportionate. It will not include elements of expenditure that:

- were fixed at DPCR5 FPs and expected to be a risk for DNOs to manage within the overall package of the regulatory settlement, in particular RPEs and unit costs – this is to ensure that the DPCR5 price controls retain their incentive properties; or,



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- are considered to be immaterial for the purposes of the ex post efficiency assessment given their impact on customers – to avoid incurring investigative costs that are likely to be greater than any inefficiency to be found.

Principles of the efficiency assessment

1.28. Our separate definition of efficiency for traffic management permitting expenditure, as outlined in paragraph 1.25, specifies a set of principles similar to those used for load related and HVP expenditure.

1.29. There are a number of principles that we will apply in the ex post assessment of the DNOs' incurred expenditure for load and HVP. These include that Ofgem will:

- (a) not apply hindsight in the ex post assessment, and will only base the assessment of the efficiency of DNOs' incurred expenditure in the context of the information that the DNOs had available, or should reasonably have had available, at the time of making their investment decisions during DPCR5; and
- (b) ensure that there is no double counting of adjustments between the Load Related Re-opener ex post assessment and the NOMs LI assessment and between the HVP Re-opener and the HVP outputs adjustment.

1.30. Given these principles and in the defined context of these re-opener assessment processes, Ofgem will interpret efficiency to mean:

- investment decision making by a licensee that took into account all information that could reasonably have been expected to be available to the licensee at the time of making the decision; and which,
- resulted in expenditure during DPCR5 that would reasonably, at the time of making the investment decision, be expected to be required to meet the changing and uncertain needs and requirements of the licensee's electricity distribution system.

1.31. For the avoidance of doubt, this definition of efficiency is narrow in scope and applies only within the context of the ex post efficiency assessment under the DPCR5 re-openers. We do not intend it to set a precedent for future electricity distribution price controls, or any other future regulatory determination made by the Authority.

Structure of this document

1.32. Chapters 2 to 6 set out further detail of the proposed methodologies, , our views on key consultation responses and our decision on each of the methodologies.

1.33. Chapter 7 sets out our next steps in the DPCR5 Close out process.

1.34. Appendix 1 sets out a summary of the responses we received to the September 2015 and December 2015 consultations.

1.35. Appendix 2 sets out an Impact Assessment in relation to Fault Rates and Material Changes, the two key areas where our thinking developed between the September 2015 consultation and the December 2015 consultation.

1.36. Alongside this document we have published our Statutory Consultation on changes to the Handbook, a supplementary annex setting out the draft text of the DPCR5 Close out methodologies – Supplementary Annex 1 and a consultation on changes to special licence condition CRC 3A of the DNO licences. We are publishing these under a single Notice.

2. Network Output Measures

Chapter Summary

In our September 2015 consultation we gave an explanation of our key principles for assessing the Network Output Measures and a summary of our proposed methodology.

This chapter outlines our decision on the proposed methodology.

What are Network Output Measures?

2.1. Network Output Measures (NOMs) are indicators of the performance of network assets. There are different ways to measure the performance of assets including the health of assets, the loading on assets and the levels of faults experienced. These factors are all impacted by network expenditure.

What we set out in DPCR5 FPs

2.2. As part of our DPCR5 FPs, we stated that in return for the revenues received from customers over DPCR5, DNOs were required by the end of the price control period (2015) to have delivered a “package of output measures”, including:

- **Health Indices (HIs)** - measures of the health of the DNOs’ assets. They are based on a combination of age, condition data and fault history. Asset categories range from HI1 assets, which are new or “as new” assets at the beginning of their asset lives, to HI5 assets which are towards the end of their asset lives. HI4 and HI5 assets may require replacement or refurbishment.
- **Load Indices (LIs)** - measures of the loading on primary substations on the DNOs’ networks based on peak demand at each substation site and firm capacity. Asset categories range from LI1 with a relatively low level of loading to LI4 and LI5 which represent peak loading above firm capacity and which may require adding additional capacity through network reinforcement.
- **Fault Rates** – measures of asset reliability in terms of the number of faults which occur annually and over a number of years. They only apply to assets which presently have no HIs. For this reason, Fault Rates are referred to as a ‘secondary’ network output measure.

2.3. Using these indicators we can seek to distinguish between DNOs that have innovated and found alternative methods to deliver customers’ needs more efficiently and those who have deferred investment at the expense of asset health, loading and performance.

Summary of methodology and key principles of the assessment

Summary of the methodology

2.4. The proposed methodology set out in the September 2015 consultation built on the approach set out at the DPCR5 FPs and the NADPR RIGs. The September 2015 consultation outlined a five stage assessment process. The methodology maintained the three stages included in the DPCR5 FPs:

1. DNOs will be required to submit a 'performance assessment submission' setting out whether they consider they have met the NOMs requirement and providing further information to explain and justify their performance.
2. We will assess whether the DNO has met its NOMs deliverables or whether there is an outputs gap.
3. If there is a gap, we will determine the value and apply a revenue adjustment. This will be calculated by multiplying the outputs gap by the Network Outputs Incentive Rate.⁴

2.5. In the September consultation we also proposed a number of changes to the approach set out at the DPCR5 FPs and the NADPR RIGs for the NOMs assessment methodology. The changes proposed are noted below:

- Quantitative and qualitative assessment of DNO performance rather than just carrying out qualitative assessment of the NOMs.
- A threshold for materiality (DPCR5 FPs stated that significant and material issues need to be identified before we made a financial adjustment).
- Not to make changes to the HI NOMs deliverables for Material Changes, despite this being stated in DPCR5 FPs.
- Not to apply financial adjustments for Fault Rates. While we recognised that the original intent of DPCR5 FPs had been to apply financial adjustments for Fault Rates, we did not consider at the time it was possible to establish a clear link between costs and Fault Rates.

⁴ The Network Outputs Incentive Rate is equal to the DPCR5 IQI efficiency incentive rate times 1.025. The marginally higher incentive rate is to ensure that DNOs have a stronger incentive to deliver their outputs rather than under deliver.

2.6. Having considered responses to the September 2015 consultation, in the December 2015 consultation we noted we had reconsidered our approach to assessing the NOMs from the position we set out in the September 2015 consultation, in two key respects:

- Material Changes – we outlined our intention to make appropriate adjustments to the agreed outputs to take account of Material Changes in line with the original intent in DPCR5 FPs and the NADPR RIGs.
- Fault Rates – we outlined that we had identified ways in which we could monetise Fault Rates and we were developing tools which will enable us to do this. We further noted that monetising Fault Rates was in line with the original intention of DPCR5 FPs by ensuring a consistent approach to performance assessment for all asset classes.

2.7. Recognising that these are areas where our thinking developed between the September and December 2015 consultations, we have undertaken an Impact Assessment specifically in these two areas. This is published in Appendix 1 of this document.

Principles of our assessment

2.8. In the September 2015 consultation we set out a range of principles for the NOMs assessment. These principles were derived from the policy decided at DPCR5 FPs, the NADPR RIGs and the ongoing development of the approach to NOMs during DPCR5. These can be summarised as follows:

- Principle 1: DNOs should retain a share of genuine efficiency improvements and should not benefit from not doing work or deferring work that benefits customers.
- Principle 2: We expect and encourage efficient reprioritisation of asset management activities in the NOMs. DNOs must retain the flexibility to respond quickly to new information and will not be penalised for doing the right thing in the interests of customers.
- Principle 3: We will assess whether companies have met or failed to meet the NOMs deliverables at an overall level for each of the HIs, LIs and Fault Rates.
- Principle 4: We encourage further improvement and innovation in asset management techniques and will not discourage these through our performance assessment process.
- Principle 5: The efficiency of significant decisions related to the timing of interventions (eg replacement/refurbishment; reinforcement/load transfers) must be justified, where appropriate, through whole life Cost-Benefit Analysis.
- Principle 6: We need to find significant and material issues with the NOMs at an overall level rather than on a line-by-line basis before we can determine that a DNO has not met its NOMs deliverables.

Summary of respondents' views

2.9. In the case of NOMs (specifically Fault Rates and Material Changes) we sought respondents' views in both the September 2015 consultation and the December 2015 consultation. In the case of these areas we summarise views separately for each consultation.

September 2015 consultation

2.10. Seven respondents commented on Ofgem's proposed Network Output Measure methodologies as part of the September 2015 consultation. A detailed summary of responses is set out in Appendix 1. The key points raised were as follows:

- **Principles:** The seven respondents were generally supportive of the principles for the NOMs assessment but additional clarity was sought in a number of areas.
- **Cost-Benefit Analysis:** Three respondents expressed concern about the use of current CBA tools and that they must avoid take into account the information and tools available at the time.
- **Re-prioritisation of asset management activities:** Two respondents noted that there would inevitably be changes to DNOs investment programme and the NOMs framework should allow DNOs to make the correct asset management decisions in the interests of customers.
- **HIIs:** Six respondents broadly agreed with our approach to assessing performance on HIIs. Further clarity was sought, particularly regarding the use of sensitivity analysis and the use of CBAs. Two respondents commented specifically on the weightings of the proposed mechanism, with one suggesting that the base weightings used should be the DPCR5 FP unit costs and the other noting it was unclear how consideration of alternative HI band weightings improves the robustness of methodology. One respondent commented that HIIs are only defined at a high level and DNOs have exercised considerable discretion in terms of interpreting the definition of HIIs, i.e. some DNOs use the HI5 category to highlight their very worst assets whereas others have lower qualification criteria.
- **HI outputs gap:** There were different views on the approach to valuing the HI outputs gap. Two respondents considered option one (*Detailed valuation on each HI asset category*) to be the most appropriate approach as being consistent with the principles outlined within the NADPR RIGs and providing an appropriate penalty for non-delivery of outputs. Four respondents considered option two (*High level valuation of the outputs gap*) to be the most appropriate approach as being more holistic and recognising that targets were not set at a disaggregated level for each asset type and that they would deliver the investment that produces the most value for customers overall.

- **LI outputs gap:** Five respondents agreed with Ofgem's approach to assessing performance and valuing any outputs gap. However, two noted that some DNOs report on a substation on a Group basis and therefore take a network wide view of LI risk based on substation groups is not possible for DNOs that have populated substation group data by exception.
- **Fault Rates (no financial adjustment):** Six respondents agreed on the grounds that it was not feasible to make a link between Fault Rate performance and investment levels. One respondent strongly disagreed with the proposal on the basis that it would soften the commitment to the Fault Rates output.
- **Material changes:** One respondent did not agree with the proposal not to account for Material Changes in the HI performance assessment. They argued Ofgem should consider whether the extent and direction of Material Changes has made it easier for a DNO to achieve a particular level of risk delta.
- **Materiality thresholds:** Most respondents supported the use of materiality thresholds as being consistent with the view that adjustments to allowances should only be made where significant and material issues are identified. One respondent noted the risk of applying a blanket threshold and proposed applying a sliding scale of materiality thresholds which incorporated under spend to the outputs gap.

December 2015 consultation

2.11. Six respondents commented on our proposed Network Output Measure methodologies as part of the December 2015 consultation. One of the responses was marked as confidential. The key comments raised by respondents were as follows:

- **Fault Rates (financial adjustment):** There were very different views on financial adjustments for Fault Rates. Four respondents disagreed with introducing financial adjustments for Fault Rate performance. They argued that Fault Rate performance is difficult to quantify and already reflected in the Interruption Incentive Scheme (IIS) and highlighted that Ofgem previously classed Fault Rates as a 'secondary' network output. On the other hand, one respondent strongly argued for financial adjustments for failure to deliver required performance on Fault Rates.
- **Material changes:** There were mixed views on our proposal to make changes to the agreed DPCR5 HI and LI outputs to account for Material Changes. One supported the proposal as ensuring DNOs should be held to delivering their outputs. Two supported taking account of Material Changes for HIs but that Ofgem's assessment should be limited to considering whether each change meets the 'Target Delta'. Two respondents disagreed with applying Material Changes to LI outputs as there were lower requirements to report for LI Material Changes and that it may distort efficiency incentives if used with the Load Related Re-opener.

Our views and decision

2.12. There are a range of issues that were highlighted by respondents' comments. We address these under the headings below.

Principles of the review

Principle 2 - Re-prioritisation of asset management activities

2.13. Regarding the re-prioritisation of asset management activities, we agree that there will inevitably have been changes to the DNOs planned investment programme and that the NOMs framework should allow DNOs to make the correct asset management decisions in the interests of customers. For that reason, the approach we have outlined in the methodology reflects the position set out in DPCR5 FPs that we will look at the "package of outputs" delivered. This is explained in more detail in responding to the views on Principle 3 below.

Principle 3 – Assessing whether companies have met their NOMs deliverables

2.14. We note that some respondents highlighted the importance of Ofgem conducting a proper qualitative assessment of the broad package of outputs to determine whether the right decisions were made that were in the interests of customers.

2.15. In both DPCR5 FPs and the NADPR RIGs we set out that the NOMs represented a "package of outputs" and that we would conduct a qualitative assessment "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".

2.16. The approach we have outlined in the methodology reflects this position as it outlines our intention to "assess the licensee's aggregate performance across all three NOMs component", as envisaged in DPCR5 FPs, which stated that '*A mechanistic 'pass/fail' approach should not be applied to each individual output, rather there will need to be a programme-level assessment of performance against the outputs*'.

2.17. In assessing DNO performance under the NOMs, a key consideration will be whether or not the package of outputs delivered was in the interest of customers. We consider that significant unjustified under-delivery in a particular NOMs category should be penalised, regardless of performance in other areas.

2.18. The approach in the methodology enables this and reflects the policy intention in DPCR5 FPs.

Principle 5 - Cost-benefit analysis (CBA)

2.19. Regarding the use of CBA, we accept that the CBA methodology has developed further over recent years. We expect the licensees to have followed a robust decision making process and we propose to assess CBA or other related financial justification submitted.

Decision on the principles

2.20. In light of comments we propose that Principles 1, 2, 3, 4 and 6 remain as set out in the September 2015 document and as reflected in paragraph 2.8 above.

2.21. We have decided to amend Principle 5 to the following:

- Principle 5: The efficiency of significant decisions related to the timing of interventions (eg replacement/refurbishment; reinforcement/load transfers) must be justified, where appropriate, through the technical and economic needs case (Cost-Benefit Analysis or other related financial analysis).

Health Indices (HIs)

Innovation and asset health

2.22. Regarding the interaction between innovative solutions and asset health, we note that different DNOs are on different development cycles regarding the deployment of Innovative Solutions for reducing asset risk, for example asset refurbishment. It is not the intention of the Authority to inhibit innovation. Where we see a large proportion of the HI risk points reduction is being delivered through the application of Innovative Solutions, we will ask the licensee to provide background information regarding the technology/solution in order to understand how the Innovative Solution is able to deliver a reduction in asset health risk.

2.23. We agree that where Material Changes have arisen from DNOs acting on the latest asset health data or through the development of asset management techniques, DNOs should not be penalised for this. However, we may ask the DNO to provide additional explanation regarding Material Changes and may invite the DNO to submit a set of Adjusted Network Outputs to reflect the changes in the risk profile of their assets due to Material Changes. This will ensure that the HI Target Delta remains equally challenging and reflects a set of outputs consistent to that which was funded through the DPCR5 price control.

2.24. Where Material Changes have not been reported to the necessary level of detail to allow the Authority to make its assessment, Ofgem may make a request for additional information as part of the Performance Assessment Submission.

2.25. We note that, in undertaking any comparison between DNO performance on HI delivery, Ofgem needs to recognise the differences in the HIs amongst the DNOs.

Valuing the HI Network Outputs Gap

2.26. In relation to the approach to valuing the HI Network Outputs Gap, the approach we have outlined in the methodology reflects the position we set out in DPCR5 FPs. In DPCR5 FPs we stated that '*To value the network outputs gap, we will calculate the difference in volumes delivered compared to the volumes implicit in the adjusted baseline,*'. This is calculated by converting any HI Risk Point outputs gap back into a set of volumes, '*and then multiply this by a unit cost assumption that maintains the incentive to deliver outputs,*' which we have chosen as the higher of either the DNO's submitted DPCR5 forecast unit cost (taken from their FBPQ submissions) and their DPCR5 outturn unit costs.

2.27. We understand the views of some respondents on the risks associated with imposing financial consequences. However, rather than an argument against imposing financial consequences for a failure to deliver, we see this as an argument for allowing sufficient flexibility and scope for DNOs to respond to new information and to further improve their asset management practices over the DPCR5 period. Provided that a DNO is able to explain its investment decisions in terms of customers' interests, we believe the qualitative assessment process provides ample protection to both customers and the DNOs.

HI risk score unit costs

2.28. In relation to unit costs we note the concerns that were raised about undertaking a unit cost benchmarking exercise. Having undertaken sensitivity analysis we have decided to use the unit costs set out in DPCR5 FPs i.e. the PB Power replacement unit cost. We recognise that these were the basis on which the DNOs built their tracking and assessment processes.

Classification of assets as HI5

2.29. We note the comment raised regarding the discretion adopted by DNOs in interpreting the definition of HI5 assets. Our current drafting reflects the DPCR5 FPs and the NADPR RIGs in that we would conduct a qualitative assessment 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". Therefore, DNOs may have different interpretations and make different investment decision but the key consideration is that they deliver their outputs (or equivalent outputs) and the outcome is in the interest of customers.

Load Indices (LIs)

2.30. Regarding Load Indices (LIs) we note that the majority of the responses agree with our approach.

2.31. In relation to the treatment of substation groups, we acknowledge the issue that certain licensees have populated substation group data by exception. We also note the view that LIs need to take substation group information into account. We

intend to be consistent with our approach throughout DPCR5 and calculate LIs risk points only for substations. Substation group is an area we are working with the DNOs to improve for RIIO-ED1. We will use the LI substation group information for our assessment of the Load Related Re-Opener

2.32. Some DNOs have raised an issue on the need for different weightings for the LI Bands. We agree with comments raised and, as specified in our methodology, we will run sensitivity analysis during our performance assessment using different weightings. We have also accepted the comment on the LI methodology output and our updated drafting includes both the LI Band Profiles and the LI Risk Points.

2.33. Regarding the comment on normalising the agreed LI Band Profiles to take account of changes in the observed level of demand, we do not believe there is a need for such an adjustment. As we stated in DPCR5 FPs we have introduced the Load Related Re-opener as *'an uncertainty mechanism to protect against large deviations from expected demand and connection volumes for the DPCR5 period'*. We will make adjustments for Material Changes on LIs and HIs as described below.

Fault Rates

2.34. We note there are differing views from respondents on the treatment of Fault Rates as part of the DPCR5 Close out. This is an area where our own views have developed over the course of the DPCR5 Close out review.

2.35. In DPCR5 FPs we set out the need for financial incentives to drive efficient network investment. Fault Rates were identified as a component of the NOMs package DNOs committed to deliver in exchange for their revenue. As a result, our intention at DPCR5 FPs was to make financial adjustments for Fault Rate performance just as we intended to for HIs and LIs.

2.36. In the September 2015 consultation we did not propose a financial adjustment for Fault Rates on the grounds that we did not consider it possible to establish a clear link between costs and Fault Rates. We recognised at the time that this position was a departure from DPCR5 FPs.

2.37. We note that there were a range of views in response to the September 2015 consultation. While a number of respondents agreed with the view that Fault Rates should not be monetised on the basis of the view that it was not feasible to make a link between Fault Rate performance and investment levels, one respondent strongly argued that the DNOs committed to delivering the Agreed Network Outputs (including Fault Rates) as part of the DPCR5 settlement and had been funded by customers to do so. We agreed with this latter view and, in light of these comments and in the December 2015 consultation, we noted that we had further considered the approach to Fault Rates to identify ways in which to monetise Fault Rates. In particular, we noted that "having financial consequences in place where DNOs have failed to deliver protects customers and incentivises genuine efficiencies".

2.38. In response to this position we note that a number of respondents raised concerns about monetising Fault Rates in response to our December consultation. In relation to the view that they should be treated as a 'secondary output', we recognise that we classified Fault Rates as secondary in DPCR5 FPs but note that they were only considered 'secondary' in that they apply to those assets for which HIs are not available. This does not constitute a reason to not monetise Fault Rates. In response to the view that an expectation was set that Fault Rates would not be monetised or indeed that monetising Fault Rates goes against the principle of 'few surprises' in the DPCR5 Close out process, we do recognise that the position on Fault Rates did develop during the DPCR5 period and indeed that in the September 2015 consultation we set out that we had not identified a way to monetise Fault Rates. However, in DPCR5 FPs we were clear on the need for financial incentives to drive efficient network investment. Fault Rates are identified as a component of the NOMs package DNOs committed to deliver in exchange for their revenue. Therefore, reflecting on responses to the September consultation and having now identified a way to do so, we have returned to the position of monetising Fault Rates. This is consistent with the intention of DPCR5 FPs.

2.39. On this basis, we have decided to attach financial consequences to a failure to deliver on Fault Rates. This provides a strong signal of the consequences of the failure to deliver outputs and drives efficient behaviour in line with the policy intent set at DPCR5. However, we do recognise respondents' concerns that there is more volatility in Fault Rates due to the variability of the measure associated with external factors. In recognition of this we have increased the quantitative materiality threshold to 10% for Fault Rates.

Material Changes

2.40. We note there are differing views from respondents on the treatment of Material Changes. Again, we note this is an area where our own views have developed over the course of the DPCR5 Close out review.

2.41. At DPCR5 FPs we noted that we would "determine at a high level the outputs that should have been delivered (the 'Adjusted Network Outputs') given the impact of all Material Changes identified." In the September 2015 consultation we sought views on an approach whereby we would consider Material Changes only in our qualitative assessment of whether a failure to deliver outputs was justified. Respondents to the September 2015 consultation highlighted the importance of Material Changes in understanding and assessing DNO performance. We agreed with the views set out by respondents to that document and, in light of this, in December we sought views on our proposal to make adjustments for Material Changes. Having considered responses to the December 2015 consultation, we retain this view.

2.42. On balance, we consider that Material Changes should be taken into account in our assessment of NOMs, in particular HIs and LIs. Using Material Changes as a key component of our assessment means that DNOs do not get to keep allowances where improvements in HIs and LIs were the result of other factors (eg changes in assessment methodology). As a result, we have decided to use Material Changes to allow DNOs to restate their outputs agreed at DPCR5 to obtain new targets which are as challenging as the original. Our assessment will focus on determining whether

DNOs have delivered their outputs based on these revised targets (unless they can justify why there is no need for their targets to be revised). Ultimately, while our view has developed in this area, we consider our treatment of Material Changes to be consistent with DPCR5 FPs. This approach also encourages DNOs to adapt their interventions where necessary and results in more efficiently run networks.

2.43. Specifically in the case of LIs, we note that one respondent considered that these should reflect Material Changes in capacity and demand. We note that Material Changes relating to drop in demand are dealt with under the Load Related Re-opener. This is consistent with DPCR5 FPs where we noted that demand side risk should be captured under the Load Related Re-opener. Therefore, while we will be adjusting LIs to account for Material Changes, we do not propose to account for changes in demand as part of this process. To do otherwise would create potential for double counting.

Materiality Thresholds

2.44. We noted the general support from respondents for the application of materiality thresholds. However, we also note that one respondent had some concerns that materiality thresholds could create an incentive for DNOs to under-deliver against their Agreed Network Outputs and suggested a sliding scale approach. We do not consider that a sliding scale is necessary. While the NADPR RIGs state that 'there is to be no specific and quantitative thresholds adopted to identify areas for further consideration' we consider that the introduction of materiality thresholds is appropriate to identify material under-delivery and account for volatility. In the September 2015 consultation we set out a quantitative materiality threshold using the risks points approach. We retain the view that this provides a fairer and more transparent way of assessing materiality.

2.45. The one area where our view on materiality thresholds has developed is in relation to Fault Rates where, as noted above, we have increased the quantitative materiality threshold to 10% reflecting respondents concerns regarding volatility.

Performance Assessment Submission

2.46. We note that clarity was sought on the stages and timetable of the Performance Assessment Submission. We have added new sections to Chapters 15 and 16 of the Handbook which set out the timetable and explains the stages.

Other

2.47. In relation to other points raised on NOMs, our views are as follows:

- we note that greater clarity was sought on the interaction of the quantitative and qualitative assessments and we have sought to provide this in our drafting of the DPCR5 NOMs Failure to Deliver Outputs Methodology;



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- in relation to unit costs we note that concerns were raised about undertaking a unit cost benchmarking exercise. We recognise these concerns and therefore, for the purposes of our assessment we have decided to use the unit costs set out in DPCR5 FPs.

3. Load Related Re-opener

Chapter Summary

In our September 2015 consultation we gave an overview of the DPCR5 Close out Load Related Re-opener mechanism and a summary of our proposed methodology.

This chapter outlines our decision on the proposed methodology.

What is load related expenditure?

3.1. Load related expenditure is the cost of adding more capacity to the distribution networks to connect more customers and to accommodate increased demand.

3.2. When we set the DPCR5 price control we recognised that there was significant uncertainty in economic conditions which could impact on forecast load growth. This in turn would impact the volume of new connections and therefore the need for investment.

What we set out in DPCR5 FPs

3.3. The Load Related Re-opener is the mechanism we put in place to address the uncertainty for load growth in DPCR5 FPs. It enables Ofgem to review the expenditure of DNOs if actual expenditure was either greater than 120% of the ex-ante allowance or below 80% of its ex-ante allowance.

Summary of methodology and key principles of the assessment

3.4. The proposed methodology set out in the September 2015 consultation built on the approach set out at the DPCR5 FPs and the NADPR RIGs. The September 2015 consultation outlined a five stage assessment process.

1. DNOs will submit a Performance Assessment Submission.
2. We will carry out an assessment of efficient load related expenditure under the Load Related Re-opener. We will carry out variance analysis to determine the difference between baseline expenditure and actual expenditure.
3. We will compare DNOs' efficient expenditure to the thresholds i.e. $\pm 20\%$ of the load related expenditure baseline and for the amount above/below the threshold to be greater than 1% of base revenue.
4. If the Load Related Re-opener is triggered, we will carry out further work to calculate and apply a revenue adjustment based on efficient

expenditure. This should also reflect where expenditure is lower due to innovation.

5. We will ensure DNOs are not penalised twice, under the Load Related Re-opener and under LI NOMs, by offsetting any double counting.

September 2015 consultation – proposed changes to the methodology

3.5. In the September consultation we also proposed a number of changes to the approach set out at the DPCR5 FPs and the NADPR RIGs for the Load Related Re-opener assessment methodology. The changes proposed are noted below:

- *Interactions between the two mechanisms:* DPCR5 FPs do not provide a clear indication on how these should be treated. We will carry out the load related expenditure efficiency analysis together with the LI NOMs assessment to ensure that there is no doubling counting.
- *Avoided reinforcement methodology:* In DPCR5 FPs we had only specified avoided reinforcement through demand side management (DSM). We propose to include smart grids, energy storage or any other innovative technique that the DNOs used to avoid network reinforcement during DPCR5.

Principles of our assessment

3.6. In the September 2015 consultation we set out a range of principles for the Load Related Re-opener assessment. These principles were derived from the DPCR5 FPs, the NADPR RIGs and the ongoing development of the approach to load related expenditure during DPCR5. These can be summarised as follows:

- Principle 1: DNOs should retain a share of genuine efficiency improvements under the efficiency incentives and should not benefit from not doing work or deferring work that benefits customers.
- Principle 2: DNOs must provide robust information justifying the efficiency of their load related expenditure with reference to suitable supporting information that was used at the time including appropriate Cost Benefit Analysis, output, secondary deliverable information and management information on efficiency.
- Principle 3: DNOs must provide robust information on avoided reinforcement or LVHC (low volume high cost) connections expenditure with reference to suitable supporting information that was used at the time including appropriate Cost Benefit Analysis, output, secondary deliverable information and management information on efficiency.
- Principle 4: Where possible we will make use of comparative information to assess the efficiency of this load related expenditure.
- Principle 5: Where comparative assessment is not possible, we will make use of other quantitative and qualitative assessment tools to assess the reasonableness of the DNOs' expenditure including but not limited to techniques developed at DPCR5 and RIIO ED1.

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- Principle 6: We will ensure there is no double counting of adjustments between the Load Related Re-opener ex post assessment and the NOMs LI assessment.
- Principle 7: As part of our assessment, we will consider any offsetting impact from the DNOs undertaking innovative activities to avoid General Reinforcement or LVHC connections expenditure such as efficient DSM, smart grid solutions or energy storage to ensure we do not discourage such activities.
- Principle 8: As part of our assessment, we will consider any offsetting impact from delivery efficiencies for General Reinforcement or LVHC connections work to ensure we do not discourage efficiency.
- Principle 9: We will consider any inefficiencies due to projects being carried out where they were no longer needed or for an inefficient level of costs.
- Principle 10: We will consider any changes in the proportion of costs that are recovered upfront from customers through connections charges as they do not represent changes in efficiency. We want to ensure that DNOs do not benefit through the efficiency incentives from changes in net costs that have been funded through connection charges.
- Principle 11: We consider the risk of RPEs exceeding, or dropping below, the levels assumed in our baselines was for the DNOs to manage. As such we will discount the impact of Real Price Effects (RPEs) from any adjustments applied under the Load Related-Re-opener.

Summary of respondents' views

3.7. Six respondents commented on Ofgem's proposed Load Related Re-opener mechanism and methodology. A detailed summary of these responses is set out in Appendix 1. The key issues raised by respondents were as follows:

- **Principles:** All respondents generally agreed with the principles for the Load Related Re-opener assessment. However some respondents commented that further clarity was needed.
- **Efficiency assessment:** Three respondents expressed concerns about an inappropriate efficiency assessment and in particular the need for avoid hindsight and the limitations of comparative analysis e.g. for LVHC connections. Further detail was sought on Ofgem's proposed approach to the assessment of efficiency.
- **Assessing expenditure on low volume high cost (LVHC) connections:** Two respondents argued that the 'net to gross ratio' was mostly outside a DNOs control and therefore mechanistic adjustments should be avoided.
- **Assessing expenditure on General Reinforcement:** Three respondents generally agreed with our approach but there was some concern about the complexity of the proposed assessment.

- **Avoided reinforcement:** Six respondents agreed with our approach to assessing avoided reinforcement although further guidance was welcomed. One respondent welcomed the proposal to broaden the innovation offset beyond DSM schemes as being reflective of the effort invested in innovative demand management techniques over DPCR5. However, another respondent questioned how this would affect incentives or behaviour. A third respondent noted that since many of the innovative schemes were still under-development in DPCR5, there should be a limited number of occasions where such evidence is required.

Our views and decision

Principles

3.8. We note that, in most cases, respondents supported the principles outlined in the September 2015 consultation for the Load Related Re-opener. However, we recognise that there were some areas where respondents either sought further clarity in the principles or that they be reworded. We have addressed these below.

Principle 4 – Use of comparative analysis/ Principle 5 –Use of other assessment tools

3.9. We recognise the concerns expressed regarding the limitations of comparative tools, particularly in assessing LVHC connections. As a result, we have updated our assessment methodology focusing on sample scheme review for primary reinforcement and narrative review for secondary reinforcement.

*Principle 3: DNOs must provide robust information on avoided reinforcement/
Principle 7: Offsetting impacts from undertaking innovative activities*

3.10. We note from responses to the September 2015 consultation that more guidance was sought on the approach to avoided reinforcement. In a similar vein we recognise there are different views on whether to widen the definition of innovation from just DSM which was the definition we provided at DPCR5 FPs.

3.11. On balance, we consider it is appropriate to widen the definition to include smart grids, energy storage or any other innovative technique used to avoid network reinforcement. The rationale for this is that, by definition, the scope for innovation is difficult to foresee at the start of a price control period. There are a number of different ways that Innovative Solution could be applied. We consider that widening the definition of Innovative Solutions takes account of the development of technologies during the period. We have sought to build this additional clarity into the methodology drafting.

Principle 10 - Treatment of costs recovered through connection charges

3.12. We note the concerns expressed regarding our proposal to consider the proportion of costs that have been recovered upfront through connection charges (the 'net to gross ratio') to assess changes in LVHC connections expenditure.

3.13. Reflecting on responses, our thinking has evolved in this area and we have modified our methodology accordingly. On LVHC we will review only whether there has been any under-recovery in costs to be recovered from connection customers and the justification for this. Regarding the net to gross ratio, an adjustment would not be needed to reflect a change in the proportion of gross connection costs that are recovered through connection charges relative to our DPCR5 Final Proposals as such a change is already reflected in actual net expenditure within the Load Related Re-opener mechanism.

Decision on the principles

3.14. In light of comments we have decided that Principles 1, 6, 8, 9 and 11 remain as set out in the September 2015 document and as reflected in paragraph 3.6 above.

3.15. We intend to amend Principles 2, 4, 5, 7 and 10 to the following:

- Principle 2: DNOs must provide robust information justifying the efficiency of their load related expenditure with reference to suitable supporting information that was used at the time including appropriate Cost-Benefit Analysis or other related financial analysis, output, secondary deliverable information and management information on efficiency.
- Principle 4: For assessing primary reinforcement we will focus on scheme review, for secondary reinforcement our assessment will focus on a qualitative review of the submitted information. Where applicable we will make use of comparative information to assess the efficiency of these load related expenditures.
- Principle 5: We will make use of quantitative and qualitative assessment tools to assess the reasonableness of the DNO's expenditure.
- Principle 7: As part of our assessment, we will consider any offsetting impact from the DNOs undertaking innovative activities to avoid General Reinforcement or LVHC connections expenditure such as demand side management (DSM), smart grid solutions or energy storage or other Innovative Solution to ensure we do not discourage such activities.
- Principle 10: For LVHC connections we will consider potential under-recovery of costs that are recovered upfront from customers through connections charges, as they represent changes in efficiency.

3.16. We have also decided to remove Principle 3 (avoided reinforcement) as we consider this is already captured by the combination of the revised Principle 7 (innovative solutions) and Principle 2 (DNOs must provide robust information).

3.17. In addition, we note that a number of respondents expressed the need for further clarity on the approach Ofgem would adopt for its efficiency assessment. The scope and principles for our efficiency assessment reflect those for the HVP Re-opener and are set out in paragraphs 1.24 - 1.31 of this document.

Assessing expenditure on General Reinforcement

3.18. We note the concerns that there was not enough detail around how the assessment of efficient costs would be undertaken. We have sought to provide further clarity by clearly defining efficiency and the associated principles (see epigraphs 1.24 -1.31 in this document) including on the unit cost assessment the avoidance of hindsight.

3.19. We also note the concerns about the use of high level ratio and benchmarking. As such and as noted above, we have updated our assessment methodology focusing on sample scheme review for primary reinforcement and narrative review for secondary reinforcement. In addition for primary reinforcement we will make use of the LI NOMs but also will ensure no double counting in case of under delivery.

Other

3.20. In relation to other points raised by respondents on the Load Related Re-opener, our views are as follows:

- we note that respondents sought clarity that the materiality threshold for the Load Related Re-opener should be 1% of 2010-11 Base Revenue. We can confirm that this is the case and this is reflected in the methodology drafting;
- we note the boundary issue between the Load Related Re-opener and our DPCR5 Distributed Generation incentive and will take this into account in our assessment; and
- we note the use of CBA as justification and we have modified our methodology accordingly. We accept that the CBA methodology and templates have been developed in the last years of the DPCR5 period and the DNOs could have used other relevant financial analysis to justify their expenditure.

4. High Value Projects

Chapter Summary

In our September 2015 consultation we gave an overview of the DPCR5 Close out High Value Project outputs mechanism and expenditure re-opener and a summary of our proposed methodology for both.

This chapter outlines our decision on the proposed methodologies.

What are High Value Projects?

4.1. High Value Projects (HVPs) were defined in DPCR5 as discrete projects with a value of more than £15m over the lifetime of the project.

What we set out in DPCR5 FPs

4.2. At DPCR5 there were a range of large projects with high costs which we considered separately as part of the cost assessment. We included an assumption for the costs associated with these projects in the DPCR5 FPs allowed revenues on the basis that we would hold the DNOs to specific outputs associated with them. We recognised that there was uncertainty as to the need and costs of this work and therefore we also included an expenditure re-opener for HVPs (HVP Re-opener).

Summary of methodology and key principles of the assessment

4.3. The proposed methodology set out in the September 2015 consultation built on the approach decided at the DPCR5 FPs and the NADPR RIGs. The September 2015 consultation outlined a five stage assessment process:

1. DNOs will submit a Performance Assessment Submission.
2. We carry out a project by project efficiency and outputs assessment. This will require variance analysis to determine the difference between baseline allowances and actual expenditure and take into consideration any inefficiencies and efficiencies (including from innovation).
3. Determine if the HVP Re-opener has been triggered by summing our view of efficient costs of each project to achieve a total efficient value of costs and then compare the DNO's efficient expenditure to the thresholds (i.e. $\pm 20\%$ of the DPCR5 FP baseline and 1% of 2010-11 base revenue post-application of the efficiency incentive rate).
4. Where there is an outputs gap, the total value will be calculated from adding up all the output gaps assessments. This will then be multiplied by the network output incentive rate (penalty) to reach a final value. In some



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cases however, we may decide not to apply a penalty rate, eg where the decision to cancel a project was in the interest of customers.

5. Ensure DNOs are not penalised twice, under the HVP Re-opener and the outputs mechanism, by offsetting any double counting.

September 2015 consultation – proposed changes to the methodology

4.4. In our September 2015 consultation, we proposed a number of changes to the High Value Projects Outputs mechanism and HVP Re-opener methodologies as set out in DPCR5 FPs, these changes were noted:

- *Interactions between the two mechanisms:* DPCR5 FPs do not provide a clear indication on how these should be treated. We propose a methodology for ensuring that there is no double counting between the HVP Re-opener and HVP output adjustments.
- *Project status:* DPCR5 FPs do not take into account the fact that projects may be at different stages in their delivery. Table 4.3 summarises our approach for dealing with projects at different stages of delivery.
- *Bespoke outputs assessment:* DPCR5 FPs state that where possible, we should use existing methodologies (for example HIs) in our assessment of High Value Projects. In addition, we propose to develop individual methodologies applying to other types of projects.
- *Partial delivery and/or change in outputs:* DPCR5 FPs are not explicit on how a partial delivery of outputs and/or a change in outputs should be treated. We are suggesting we make a partial adjustment in the case of partial delivery and that we assess any changed outputs to determine whether they are equivalent to outputs initially agreed at DPCR5 FPs.

The rationale for these changes was noted in the consultation.

Principles of our assessment

4.5. In the September 2015 consultation we set out a range of principles for the HVP Re-opener assessment. These principles were derived from the DPCR5 FPs, the NADPR RIGs. They also reflected the proposed changes to the methodology set out in the September 2015 consultation. These can be summarised as follows:

- Principle 1: DNOs should retain a share of genuine efficiency improvements under the efficiency incentives and should not benefit from not doing work or deferring work that benefits customers.
- Principle 2: DNOs must provide robust information justifying the efficiency of their HVP expenditure with reference to suitable supporting information that was used at the time of the DPCR5 price control review, including appropriate Cost-Benefit Analysis, output and secondary deliverable information, and management information on efficiency.
- Principle 3: DNOs must provide robust information on HVP expenditure avoided through innovation and efficiencies in delivery of HVP with reference to suitable supporting information that was used at the time of the DPCR5

price control review including appropriate Cost-Benefit Analysis, output and secondary deliverable information, and management information on efficiency.

- Principle 4: Where possible we propose to make use of comparative information to assess the efficiency of HVP expenditure.
- Principle 5: Where comparative assessment is not possible, we will make use of other quantitative and qualitative assessment tools to assess the reasonableness of the DNOs' expenditure including but not limited to techniques developed at DPCR5 and RIIO-ED1.
- Principle 6: As part of our assessment, we propose to consider any offsetting impact from the DNOs undertaking innovative activities to avoid HVP expenditure to ensure we do not discourage such activities.
- Principle 7: As part of our assessment, we intend to consider any offsetting impact from delivery efficiencies for HVPs to ensure we do not discourage efficiency.
- Principle 8: We intend to consider any inefficiencies due to projects being carried out where they were no longer needed or for an inefficient level of costs.
- Principle 9: The risk of RPEs exceeding or dropping below the levels assumed in our baselines was for the DNOs to manage. As such we will discount the impact of RPEs from any adjustments applied under the HVP Re-opener.

Summary of respondents' views

4.6. Six respondents commented on Ofgem's proposed HVP methodologies. A detailed summary of responses is set out in Appendix 1. The key issues raised by respondents were as follows:

- **Proposed approach and principles:** Six respondents generally supported the proposed approach and the general principles but there was a view that more detail was required to make specific comments on the approach.
- **BT 21 CN costs:** Respondents cautioned about the use of comparative unit costs and the benchmarking given the varied nature of the projects proposed by DNOs.
- **Double counting:** There was support for addressing double counting but concern that Ofgem's proposed approach would not achieve the desired outcome.
- **Materiality threshold:** One respondent highlighted that materiality threshold needed to be clarified as it should be one per cent of 2010-11 revenues.
- **Innovative Solutions:** One respondent cautioned that offsetting impact from the DNOs undertaking innovative activities would be difficult to assess. While another considered that avoided investment due to Innovative Solutions should be included against the HVP baseline.

- **Changes to the assessment approach from DPCR5:** All respondents supported the four changes Ofgem proposed to the assessment. In particular, there was support for the proposal to recognise where projects were 'in-flight' in DPCR5 and which have no further funding allowed for in the RIIO-ED1 settlement should be assessed to ensure that they remained properly funded.

Our views and decision

Principles

4.7. We note that there was general support for the principles set out for the assessment of HVPs. We received a number of specific points and have addressed these below.

Principle 4 – Use of comparative analysis/ Principle 5 –Use of other assessment tools

4.8. We note the concern expressed regarding the assessment of BT 21CN costs and in particular the fact that companies were not directly comparable as they had completely different legacy communications networks. We recognise this point and we have ensured that our drafting enables us to take network differences into account.

4.9. More broadly, we acknowledge that we need to take into account the specificities of individual DPCR5 HVPs and our methodology enables us tailor our assessment and assessment tools for this purpose.

Principles 6 – Offsetting impact of innovative activities

4.10. We note the view that avoided investment due to innovative activities should be included against the HVP baseline in a manner similar to that proposed for the Load Related Re-opener. We agree and have widened the definition from that used in DPCR5 FPs and aligned the wording with the Load Related Re-opener.

4.11. We also note that one respondent suggest an assessment of the offsetting impact of innovative activities could be challenging. We agree that some types of delivery efficiencies may be easier to quantify than others. However, where appropriate we expect a DNO to be able to quantify the impact as part of their Performance Assessment Submission.

Decision on the principles

4.12. In light of comments we have decided that Principles 1, 2, 3, 7, 8 and 9 remain as set out in the September 2015 document and as reflected in paragraph 4.5 above.

4.13. We intend to amend Principles 4, 5 and 6 to the following:

Decision on close out methodologies for the DPCR5 Price Control

- Principle 4: We will take into account the specificities of individual DPCR5 HVPs and will tailor our assessment and assessment tools for this purpose. Only, where applicable we will make use of comparative information.
- Principle 5: We will make use of quantitative and qualitative assessment tools to assess the reasonableness of the DNO's expenditure.
- Principle 6: As part of our assessment, we will consider any offsetting impact from the DNOs undertaking innovative activities to avoid HVP expenditure such as DSM, smart grid solutions or energy storage or other Innovative Solution to ensure we do not discourage such activities.

4.14. In addition, we noted that a number of respondents expressed the need for further clarity on the approach Ofgem would adopt for its efficiency assessment of HVPs. The scope and principles for our efficiency assessment reflect those for the Load Related Re-opener and are set out in paragraphs 1.24 - 1.31 of this document.

Assessing outputs under different project categories

Different project status of HVPs

4.15. We agree with respondents on the importance of recognising the different status of HVP projects. We note there was specific interest in the treatment of HVP projects due to be delivered in ED1 but not funded in ED1. We set out in the September 2015 consultation that we would reflect the project status in undertaking our assessment. Our methodology drafting clarifies that we will take into account HVP expenditure not funded through ED1, where the licensee has provided evidence that the outputs will be delivered during RIIO-ED1 and that this is in the interest of customers.

Changes to the proposed methodology from DPCR5 FPs

4.16. We note there was broad support for the proposed changes to the proposed methodology.

4.17. We note that concerns were expressed regarding the potential for double counting between any adjustment to revenues made under the HVP Re-opener and any output adjustment. We have designed the HVP methodology so that there is no double counting between the efficiency (HVP Re-opener) and output adjustments and reflected this in the revised Handbook drafting.

Other

4.18. In relation to other points raised on HVPs, our views are as follows:

- we note that respondents sought clarity that the materiality threshold for the Load Related Re-opener and HVP Re-opener should be 1% of 2010-11 Base Revenue. We can confirm that this is the case and this is reflected in the methodology drafting;



Decision on close out methodologies for the DPCR5 Price Control

- it is not our intention to re-visit the original justification of and allowance for HVPs; and
- we have clarified that the penalty for failure to deliver outputs should not apply to situations where the failure to deliver outputs was in the interest of customers (eg. where the need for a project has disappeared). This is in line with the incentives placed on the DNOs at DPCR5 FPs.

5. DPCR5 Traffic Management Act Permit Costs

Chapter Summary

Our September 2015 consultation gave background and principles to the DPCR5 Traffic Management Act Permit Costs reopener and set out further details of our proposed clarifications to this methodology for adjusting licensees' allowances to account for Permitting Scheme costs.

This chapter outlines our decision on the proposed methodology.

What are Traffic Management Act Permit Costs?

5.1. DNOs require permits when working on roads and highways. Permit costs are the costs of complying with the Traffic Management Act 2004, or the Transport (Scotland) Act 2005. For example, it includes the cost of administering notifications of street works, suspensions and closures of the highway such as traffic signals, the cost of inspections undertaken by the highway authority, and congestion charging.

What we set out in DPCR5 FPs

5.2. The introduction of permit schemes is entirely at the discretion of the local authorities. Therefore, when we set allowances for traffic management costs at DPCR5, we did not include the costs of permit schemes as there was insufficient information on these costs at the time.

5.3. In DPCR5 FPs we put in place a logging up mechanism to allow companies to log up the costs they incurred in securing permits to enable those costs to be reclaimed at the end of the period subject to an efficiency assessment.

Summary of methodology and key principles of the assessment

5.4. The proposed methodology set out in the September 2015 consultation built on the approach set out at the DPCR5 FPs, the DPCR5 Cost and Revenue Reporting RIGs and used for the DPCR5 Traffic Management Act Permit Costs reopener window that ran from 1 July to 31 July 2012. The September 2015 consultation outlined a three stage assessment process:

1. The DNOs inform us if they will trigger the DPCR5 Traffic Management Act Permit Costs reopener by 31 October 2016.
2. Using cost and volume data on the Permitting Schemes provided by the companies in their Regulatory Reporting Packs, we undertake a detailed review to determine efficient levels of costs at a disaggregated level.

3. We apply the materiality test - 1% of the licensee's 2010/11 base revenue - using our efficient view of total costs rather than the DNOs' submitted view. Only if the efficient view of costs meets the materiality test will we make an adjustment to that efficient amount.

September 2015 consultation – proposed changes to the methodology

5.5. No changes were made in the approach set out in DPCR5 FPs. The consultation provided clarification for the first two of these stages by outlining the efficiency assessment process in a new annex, Traffic Management Permit Costs Legacy Assessment Methodology. The consultation also provided clarification on the third stage through minor text changes to the existing handbook methodology in relation to the DPCR5 Traffic Management Act Permit Costs adjustment.

Principles of our assessment

5.6. In the September 2015 consultation we set out a range of principles underpinning our determination of an adjustment to a licensee's allowance in accordance with DPCR5 Traffic Management Act Permit Costs. These can be summarised as follows:

- Principle 1: It is appropriate that allowances are adjusted when sufficient evidence of DPCR5 Traffic Management Act Permit Costs incurred becomes available.
- Principle 2: These costs should be material to justify additional price control allowances. If immaterial, the companies should bear a share of these costs as normal under the efficiency incentives.
- Principle 3: All DPCR5 Traffic Management Act Permit Costs are subject to an efficiency assessment. Companies should be protected from the costs incurred as a result of local authority practices but customers should only pay for costs efficiently incurred.
- Principle 4: DNOs must provide robust information justifying the efficiency of their DPCR5 Traffic Management Act Permit Costs.
- Principle 5: Where possible we propose to make use of comparative information to assess the efficiency of DPCR5 Traffic Management Act Permit Costs.
- Principle 6: Where comparative assessment is not possible, we intend to make use of other quantitative and qualitative assessment tools to assess the reasonableness of the DNOs' expenditure including, but not limited to, techniques developed at DPCR5 and RIIO-ED1.
- Principle 7: DNOs should only recover efficient DPCR5 Traffic Management Act Permit Costs that are within the price control and not for those Permitting Schemes that have been funded through customer funded connection or recovered through customer connection charges.

Summary of respondents' views

5.7. Six respondents commented on Ofgem's proposed methodology. A detailed summary of responses on this methodology is set out in Appendix 1. The key points raised were as follows:

- **Overall support for the methodology:** All respondents agreed in principle with the proposed methodology.
- **Comparative analysis/ volume of information requested:** A number of respondents questioned the value of comparative analysis/ benchmarking in assessing efficient costs. Some respondents also questioned the need for placing an additional information burden on companies as Ofgem should already have considerable data.
- **Settling the re-opener mechanism early:** While most respondents agreed with this aim, one respondent raised concern that the timescale was impractical as there would only be a month between triggering and providing data. They proposed a later date.

Our views and decision

Principles

Decision on the principles

5.8. In light of comments we have decided not to make any change to the Principles set out in the September 2015 document and reflected in paragraph 5.6 above.

5.9. We noted that a number of respondents expressed the need for further clarity on the approach Ofgem would adopt for its efficiency assessment of DPCR5 Traffic Management Act Permit Costs, including the need for information to supplement a quantitative analysis. The scope and principles for our efficiency assessment are set out in Annex D of Supplementary Annex 1 to our Statutory Consultation which we have published alongside this document.

Proposed methodology

5.10. We note the broad support for further details to be added to our proposed methodology for adjusting licensees' allowances to account for Permitting Scheme costs. We recognise the point made by respondents about the scale of information to be requested by Ofgem. In light of this we have made changes to reduce the scale of the potential information which we may request under the Performance Assessment Submission. This reflects both our intention to be proportionate in the information we collect and that we recognise we already collect a significant volume of data on

DPCR5 Traffic Management Act Permit Costs from all DNOs and therefore have a significant amount of the required information.

5.11. We recognise the point made that Permit Costs are set by the Local Authorities and therefore comparative analysis is not appropriate in this regard. In the new methodology, we have outlined that Permit Costs are deemed efficient as these are mandatory requirements.

Timetable for settling the DPCR5 Traffic Management Act Permit Costs adjustment

5.12. We recognise the concerns regarding the proposed timetable for the assessment. We note that we have changed the application window for the TMA Permitting Re-opener Notice to October 2016 to reflect the change to the overall timetable for the publication of our decision on the revised DPCR5 Close out methodologies.

6. Flood prevention

Chapter Summary

In our December 2015 consultation we sought views on the introduction of a methodology to enable Scottish and Southern Electricity in its Hydro region (SSEH) to recover costs for flood prevention that were not in its baseline expenditure allowance for DPCR5.

This chapter outlines our decision on the proposed methodology.

What is flood prevention?

6.1. One of the issues faced by network companies is the need to protect their assets from flood damage. We provide the DNOs allowances to invest in flood defences.

What we set out in DPCR5 FPs

6.2. Scottish and Southern Electricity in its Hydro region (SSEH) was not given any baseline expenditure allowance for flood prevention works in DPCR5 because information was not available in time for an assessment of expenditure requirements to be carried out. As a result, SSEH was allowed to log-up its expenditure to allow for the subsequent award of expenditure allowance amounts.

Summary of methodology and key principles of the assessment

6.3. There is no existing methodology on flood prevention in the Handbook. In our December 2015 consultation we proposed that such a methodology be introduced as DPCR5 FPs had identified the need for such a methodology on the grounds that SSEH had been unable to provide sufficiently detailed information in time for us to include forecast flood prevention expenditure in their DPCR5 allowances.

Summary of respondents' views

6.4. Only one respondent commented on the proposal to introduce a flood prevention methodology. A more detailed summary of their response was set out in Appendix 1. The key points raised were:

- **Support for the methodology:** The respondent supported the methodology on the ground that a commitment to develop one was made at DPCR5 FPs.
- **Proportionality:** The respondent considered the methodology and its associated data requirements should be proportionate to the relatively small amount of money involved.

Our views and decision

6.5. In light of responses to the December 2015 consultation, we retain the view that a methodology should be included in the Handbook in respect of flood prevention expenditure in DPCR5. Reflecting respondents' views we have sought to develop that methodology in a way that is proportionate to the materiality of the mechanism and is consistent with the drafting of similar methodologies in the existing Handbook.

6.6. In line with DPCR5 FPs, the methodology retains:

- a cap of £2.3 million, in 2007-08 prices (£2.7m in 2012/13 prices), on allowed expenditure relating to the protection of substations against flooding during DPCR5; and
- a test that SSEH's expenditure represents a cost 'per risk reduced' that is above the 'upper quartile £ per risk reduced'.

7. Next Steps

Chapter Summary

This chapter sets out the next steps in the process for DPCR5 Close out.

7.1. The timetable for making the necessary changes to the Handbook to incorporate the DPCR5 Close out methodologies is set out in Table 1.

Table 1: Timetable for DPCR5 Close out methodology development

Stage	Date
Decision document and 28 day statutory licence modification consultations	20 June
Statutory consultation closes	18 July
Licence modification decisions and modifications published	29 July
Licence changes come into force	23 Sept

7.2. Alongside the publication of this decision document a 28 day statutory licence modification consultation has been published. All responses to this must be provided by 18 July.

7.3. In line with the deadline set out in the Handbook, we will publish our licence modification decisions by 31 July 2016. The modifications will come into effect 56 days from the date of publication, in accordance with the Electricity Act 1989.

7.4. In the next stage of the process we will undertake an assessment of each licensee's performance to determine whether we will be making any adjustments to the revenues of the DNOs. The DNOs will be required to submit their Performance Assessment Submissions currently by 31 October 2016. We will then commence our assessment of each licensee's performance, in order to reach a final decision on any revenue adjustment for the November 2017 AIP.

Appendix 1 – Summary of Consultation Responses

1.1. This appendix sets out a summary of the responses we received to the September 2015 consultation and the December 2015 consultation.

1.2. For clarity the responses are summarised by subject area and in relation to the questions we asked in the consultation documents.

Network Output Measures (NOMs)

1.3. In the case of NOMs and specifically Fault Rates and Material Changes, we sought respondents' views to both the September 2015 consultation and the December 2015 consultation. In the case of these areas we summarise views separately for each consultation.

September 2015 consultation

1.4. Seven respondents commented on Ofgem's proposed Network Output Measure methodologies as part of the September 2015 consultation. The questions we set out and respondents' views are summarised below.

Question 1: Do you agree with the principles for the NOMs assessment?

1.5. The seven respondents were generally supportive of the principles for the NOMs assessment. One respondent noted that more clarity was needed in certain areas before more specific comments could be made.

Cost Benefit Analysis (Principle 5)

1.6. Three respondents commented specifically on the CBA tools. One respondent cautioned the use of the CBA tools as this is an area that has moved on significantly in recent years and that reliance in these tools must take into account the information and tools available at the time rather than the information and models that are in place going into ED1. Another respondent noted that justification for changes to asset management strategy should be supported by appropriate analysis rather than use of an Ofgem CBA template as this was developed during the ED1 process. The third respondent noted that Principle 5 should remain broad for various different justifications, not just CBA.

Re-prioritisation of asset management activities (Principle 2)

1.7. Two respondents commented specifically on Principle 2. One respondent commented that this principle should be limited to assessing that DNOs have broadly met the agreed deliverables as the DNOs were funded to deliver an agreed set of deliverables; therefore there should not be an expectation that these deliverables have been exceeded. Another respondent commented that the NOMs framework should allow DNOs to make the correct asset management decisions in the interests of customers. They noted that there will inevitably have been changes to the DNOs planned investment programme over DPCR5 but they agreed that overall investment programme should have delivered at least the same level of risk reduction and the DPCR5 Agreed Outputs.

Question 2: Do you agree with our approach to assessing performance on HIs?

1.8. Six respondents broadly agreed with our approach to assessing performance on HIs. One respondent believed that further clarity was needed. The respondent highlighted that they believe that Ofgem should provide greater clarity around its proposed sensitivity analysis and have also asked for clarity on what Ofgem's expectations are with regards to any CBA that may be required.

1.9. One respondent commented that allowances should be made for situations where risk on the network is being managed by innovative solutions where justified by an appropriate assessment. They noted that this will avoid delivery of NOMs hindering the use of innovative technologies that deliver long-term benefit to customers. Another commented that DNOs should not be penalised where Material Changes have arisen from DNOs acting on the latest condition data or through the development of asset management techniques.

1.10. One respondent noted that stage 1 of the process set out in the consultation should have consideration to the Material Changes logged with Ofgem through the DPCR5 annual reporting process. The NADPR RIGs stated that Ofgem would review the annual submission, have a substantive discussion with the DNOs and provide opinion on progress. They therefore note that Ofgem should not use inappropriate hindsight in the assessment of Material Changes reported over the DPCR5 period.

1.11. One respondent noted that in doing any comparison between DNOs on delivery performance Ofgem should be careful of differences between DNOs in their health index methodologies, for example differences in health index band mappings leading to a perception of more value being delivered. This may have been caused by one DNO placing an asset in a higher banding when compared to another DNO facing the same condition asset.

1.12. Two respondents commented specifically on the weightings of the proposed mechanism. One commented that they were subject to significant discussion in 2010 and 2011 and they were happy with the overall principles applied. They have suggested that the base weightings used should be those reflective of the discussions, i.e. the DPCR5 FP unit costs, as these are the basis on which they built

their own tracking and assessment process, consistent with what they believed to be Ofgem's preferred method at the time. Another respondent commented that it is unclear how consideration of alternative HI band weightings improves the robustness of methodology.

1.13. One respondent commented on HI5 assets which have not been replaced. They noted that in DPCR5, HIs are only defined at a high level and DNOs have exercised considerable discretion in terms of interpreting the definition. They stated that some DNOs use the HI5 category to highlight their very worst assets whereas others have lower qualification criteria. They further note that some DNOs use the HI5 category to deterministically drive interventions whereas others use it as a trigger for intervention to be considered but not necessarily required. They noted that it was unhelpful in the absence of an understanding of how each DNO has interpreted its HI scales.

1.14. Two respondents commented on the Performance Assessment Submission. One commented that it suggests that DNOs should justify why further interventions were not undertaken if 'the number of risk points is higher'. They noted that this seems to confuse a delta target with an absolute one as the risk points may be higher either due to Material Changes or because they were always forecast to be so. They then went on to say this confusion is also evident in the requirements of A2.15 where reference is made to the asset risk delta being 'worse' than assumed at DPCR5. If this relates to a shortfall in the delta, then it is already covered by the other points; if it refers to the reported absolute level of risk being worse than forecast, then this seems to be confusing the nature of the Output target. The second respondent noted that it was not clear to them the timing of the performance assessment submissions and that further details were needed on how the qualitative and quantitative assessments interrelate or which takes precedence.

Question 3: Which of the two approaches to valuing the HI outputs gap do you consider to be more appropriate?

1.15. Two respondents considered option one (Detailed valuation on each HI asset category) to be the most appropriate in the approach to valuing the HI outputs gap. One respondent noted that the second option could be used as a cross check of the more detailed approach set out in option one. The other respondent stated that the first option is consistent with the principles outlined within the NADPR RIGs and provides an appropriate penalty for non-delivery of outputs.

1.16. One respondent believed that the second option is flawed as it calculates a '£ per risk point' value based on a DNO's delivery during DPCR5. They noted that if a DNO changes its plans from the agreed outputs to focus on undertaking low risk point movements during DPCR5 and deferred high cost movements it will get a relatively low '£ per risk point' value which doesn't align with the agreed outputs. They noted that the second option could be improved by calculating a '£ per risk point' based on allowances rather than delivery. This would allow the value of the outputs gap to be calculated in a similar way to the load index approach.

1.17. Four respondents considered option two (High level valuation of the outputs gap) to be the most appropriate approach to valuing the HI outputs gap. One respondent noted that option two recognises that targets were not set at a disaggregated level for each asset type and that they would deliver the investment that produces the most value for customers overall. Another noted that further understanding of option one would be needed, but option two at this stage would be most appropriate. The third respondent suggested that both approaches are workable however they would prefer the more holistic approach indicated in option two. The fourth respondent noted that option two would ensure the DNOs are not discouraged from improving their approach to asset management to reduce risk in the optimal way based on the information available to them.

Question 4: Do you agree with our approach to assessing performance on Load Indices and valuing any associated outputs gap?

1.18. Five respondents agreed with Ofgem's approach to assessing performance and valuing any outputs gap. Two of the respondents did however note, that it should be taken into account in the assessment that some DNOs report on a substation or a Group basis. Therefore, a network wide view of LI risk based on substation groups is not possible for DNOs that have populated substation group data by exception.

1.19. Two respondents specifically commented on the weighting of the load index bands. One respondent commented that it may not be appropriate to use a single form of load index weighting. The respondent noted that the logic used for load indices was different between DNOs for DPCR5. They suggested that any increase in the band weighting from a default value of 1 should occur when a substation starts to become over 100% of firm capacity. Another respondent highlighted that assigning a weighting of '1' to the LI1 band results in a false zero in the assessment. As the vast majority of customers are fed by both EHV and 132kV substations, this results in a minimum risk point score of 2x the DNO's number of customers (even if there was no load on the network at all). If concepts such as a 5% materiality threshold are to be applied to the risk points score, they proposed that this will be more appropriately implemented by assigning a weighting of '0' to the LI1 category.

1.20. One respondent noted that the LI Networks Output workbook commits to delivering an improvement in Lis based upon the number of LI4s and LI5s remaining at the end of the DPCR5 period. Therefore, they do not believe that the development of the Risk Points methodology for measuring 'load at risk' should be applied retrospectively to measure performance during DPCR5.

1.21. One respondent remarked that, in order to establish whether the DNOs have achieved genuine efficiency improvements and any share of the under-spend they are allowed to retain, it is necessary to normalise the agreed LI profiles, and for HI if applicable, to take account of changes in the observed level of demand.

Question 5: Do you agree with our approach to assessing Fault Rate performance?

1.22. Six respondents agreed with our approach to assessing Fault Rate performance. However, one of these respondents highlighted that although Fault Rate is a useful secondary measure where health index data is not available, however they are a lagging indicator and do not provide a direct correlation with expenditure. Therefore a qualitative approach is more appropriate. Another respondent agreed with the quantitative assessment but should be supplemented by a narrative in the Performance Assessment Submission. Also to widen the scope to include categories where Fault Rates have materially improved compared to forecast. A third respondent would welcome the scope for individual DNO justification/assurances where there is reason to suspect under-delivery.

1.23. Two of the respondents specifically commented on the Risk Point Methodology. They noted that it should not apply to Fault Rate performance. One noted that it was inconsistent with the Fault Rate methodology described in Appendix 1 of the September 2015 consultation.

1.24. One respondent noted their agreement with submitting a performance assessment that details the trends in Fault Rate performance over the DPCR5 period; they believe the analysis should be in the spirit of the annual Medium Term Performance Reports compiled by DNOs for Ofgem over the DPCR4 period. Therefore giving consideration to movements in fault causes such as third party interference, weather and asset deterioration etc. They noted that explanation should be given for damage and non-damage fault trends.

Question 6: Do you agree with our proposal not to make any financial adjustments associated with Fault Rate performance?

1.25. Six respondents agreed with Ofgem's proposal not to make any financial adjustments associated with Fault Rate performance. A number of respondents noted that it was not feasible to make a link between Fault Rate performance and investment levels. One respondent noted that although DNO activities do influence Fault Rates, external influences (such as weather) can also influence them. Therefore, the results are not fully influenced by the activities of the DNOs.

1.26. One respondent noted that fault rate performance seen by customers is inherently part of the Interruptions Incentive Scheme (IIS), they agreed that no further financial adjustments are necessary. They also agreed with this as no additional financial adjustment (beyond IIS) was signalled in the DPCR5 Final proposals.

1.27. One respondent strongly disagreed with the proposal to not make any financial adjustment for Fault Rates. They argued that to do so would soften the commitment to the Fault Rates output and that a monetised assessment of any outputs gap relating to Fault Rates was necessary in order for an assessment of the delivery of NOMs at an overall level.

Question 7: Do you agree with the changes we have made to the assessment approach from DPCR5 FPs and the NADPR RIGs?

1.28. Five respondents agreed with the changes made to the assessment approach. One respondent agreed with the proposals for Material Changes and set out the view that is an improvement on what was proposed at the start of DPCR5. Another respondent thought the proposed changes were a sensible approach but considered that they would need more detailed development in some areas.

1.29. One respondent did not agree with the proposal not to account for Material Changes in the health index performance assessment. They noted that the underlying profile pre-intervention has changed over DPCR5 as a result of Material Changes and that Ofgem should consider whether the extent and direction of Material Changes has made it easier for a DNO to achieve a particular level of risk delta.

1.30. One respondent noted that the NADPR RIGs contained various principles that should remain in place. And that the original process described in the NADPR RIGs were developed towards the end of the DPCR5 price control process, therefore were the best view at the time of how an assessment may be carried out.

1.31. One respondent argued that the threshold for what constitutes a significant and material issue needs to take account of the overall expenditure against allowances, to ensure that where networks are likely to benefit by under-spending against allowances, the customers expectation on outputs is fully delivered. They suggested that the undesirable effects of the application of a blanket threshold could be addressed by applying a sliding scale of materiality thresholds which incorporate under spend to the outputs gap.

December 2015 consultation

1.32. Six respondents commented on Ofgem's proposed Network Output Measure methodologies as part of the December 2015 consultation. One of the responses was marked as confidential. We did not set out specific questions in the December 2015 consultation and therefore respondents' views are summarised by subject area.

Fault Rates

1.33. One respondent agreed with the proposal to monetise Fault Rates. They set out the view that a monetised assessment of any outputs gap relating to Fault Rates was necessary in order for an assessment of the delivery of NOMs at an overall level.

1.34. Three respondents disagreed with the proposals to introduce financial adjustments for Fault Rate performance. It was noted that the proposals contradict and diverge from the DPCR5 RIGs. One respondent noted that it would be inappropriate to include an adjustment that has not been discussed with the licensees during DPCR5. It was noted that a range of factors can affect Fault Rates such as exceptional events or third part cable damage.

1.35. Two respondents noted that Ofgem had previously classified Fault Rates as a secondary measure and highlighted the reason why they considered this was appropriate. Specifically, they noted that Fault Rates were a lagging indicator and could be influenced by external factors. On a related point, two respondents noted that faults also directly impact on licensee financial performance through the Interruptions Incentive Scheme (IIS) incentive and guaranteed standard payments. On this basis, one of the respondents noted that any associated clawback could result in double jeopardy. It was further noted that Fault Rates did not feature in the calculation of the network output financial clawback set out in the NADPR RIGs. On this basis, the respondents argued that Ofgem should recognise this different footing for Fault Rates in the DPCR5 Close out process.

1.36. One respondent noted that the introduction of a financial adjustment based on underperformance against the DPCR5 agreed Network Outputs for Fault Rates was reasonable but that there were a number of factors that needed to be addressed in the methodologies, specifically:

- 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; and
- there is not clear linkage between the DPCR5 Agreed Network Outputs for Fault Rates and DPCR5 allowances in DPCR5 FPs which would make it difficult to justify the valuation of any financial adjustment to close an output gap e.g. cannot quantify quantum of improvement in Fault Rates from asset replacement.

1.37. Two respondents noted that Ofgem had not shared its proposed methodology for monetising Fault Rate performance with DNOs and therefore could not comment on it.

1.38. Two respondents noted that Fault Rates are influenced by external factors and can be volatile. They argued this should be taken into account when assessing whether a DNO's performance has triggered a financial adjustment. It was also noted that a materiality test should be included to ensure only statistically significant differences are monetised.

1.39. One respondent commented that a Fault Rate adjustment should only be applied where other incentives have not acted to influence DNO behaviour, there is clear evidence that a DNO could have made rational economic decisions to influence the Fault Rate and the difference in the Fault Rate is large enough to be considered statistically significant.

Material Changes

1.40. One respondent supported our proposal to make changes to the agreed DPCR5 HI and LI outputs to account for Material Changes as long as the principles set out in

the September 2015 consultation were achieved by the DNOs. They noted that DNOs should be held to output delivery or funding returned to customers.

1.41. Two respondents disagreed with Ofgem's proposals to apply Material Changes to LI outputs. The respondents noted that there were lower requirements to report for LI Material Changes. Also both noted that that if Material Changes were applied to LI outputs then this would distort efficiency incentives if used with the Load Related Re-opener or undermine the Load Related Re-opener.

1.42. Two respondents supported Ofgem's proposals to take account for Material Changes for HI as set out in the DPCR5 FPs. One respondent noted that Ofgem should take account of Material Changes in its assessment but the decision should be based on whether each change affects the target delta. They noted that if a DNO could have achieved its delta without the material change, no adjustment is needed. The other respondent noted that for HI outputs Material Changes should generally not contribute to a company meeting its HI network outputs.

Load Related Re-opener

1.43. Six respondents commented on Ofgem's proposed Load Related Re-opener mechanism and methodology. The questions we set out and respondents' views are summarised below.

Question 1: Do you agree with the principles for the Load Related Re-opener assessment?

1.44. Six respondents generally agreed with the principles for the Load Related Re-opener assessment. However some respondents commented that further clarity was needed. One respondent commented that more clarity was needed before they could provide specific comments. In particular Ofgem need to set out in the close-down methodologies how it will ensure that the Load Related Re-opener process does not create an incentive to spend inefficiently to avoid future re-openers. Another noted that comprehensive guidance should be given to DNOs to show the level of information to be provided if a re-opener has been triggered, and that the information is proportionate.

1.45. Three respondents commented specifically on efficiency assessment. One noted that they are concerned over the risks on inappropriate efficiency assessment and potential for re-opening the basis of the original price control settlement. They noted that the proposed methodology needs to account of the other existing price control mechanisms and avoid potential double jeopardy with other DPCR5 Close out consultations. They suggested that the 'expectation' set out in 3.18 of the consultation, that 80% of load related expenditure should compromise General Reinforcement should be removed. One respondent commented that although they generally supported the use of comparative analysis, its value is more limited in relation to lower volume project. They noted that the principles recognise this, but reference other tools and techniques, not necessarily developed at DPCR5 and ED1, may be used to assess the efficiency of expenditure. The respondent did not consider this to be appropriate as they were not developed at the time. The third respondent

commented on principle 9, where we will consider inefficiencies due to projects being carried out where they were no longer needed for an inefficient level of costs, they noted that it is important for assessments to consider if a reasonable decision has been made based on information available at the time. They flagged that we should note that economic swings are complex to predict and that the decision to abandon a project versus delay or to part complete is not simple.

1.46. One respondent noted that the principles should not depart from the mechanics of the Load Related Re-opener mechanism set out in the DPCR5 FPs, or add to the complexity of the assessment. The respondent considered that some of the principles do this. For example, in relation to Principle 10, the respondent noted that the DPCR5 FPs stated that Ofgem may consider it inefficient if DNOs 'under-recovered' their high-cost connection charges from the connectees. The respondent set out the view that, provided a DNO has not 'under-recovered' there should be no finding of inefficiency and no impact on the Load Related Re-opener assessment. They further highlighted that the principle states that Ofgem wishes to 'ensure DNOs do not benefit through efficiency incentives from changes in net costs that have been funded through connection charges'. The respondent noted that this was not indicated in the DPCR5 FPs, they therefore believe the principle should be rephrased.

Question 2: Do you agree with our approach to assessing expenditure on low volume high cost (LVHC) connections?

1.47. One respondent did not agree with Ofgem's approach as they did not feel there was enough clarity in Ofgem's approach to dealing with the proportion of costs recovered through connections charges.

1.48. One respondent commented that they thought the proposed quantitative and qualitative assessment based on change in volume and proportion of cost that has been recovered upfront through connection charges seems reasonable, only if the qualitative assessment ensures DNOs are not unfairly disadvantaged.

1.49. Three respondents commented specifically on benchmarking. One respondent noted that the LVHC connections are extremely variable in unit cost, which was acknowledged in the consultation. The proposed benchmarking uses median unit costs, the respondent warned that they need to be used with great care for LVHC connections as they are 'lumpy' and job specific. Another respondent also noted that using the industry mean may unreasonably disadvantage some of the DNOs due to individual connection specifics that have appropriately benefited customers. They therefore welcomed the approach providing qualitative adjustments are made where appropriate. The third respondent noted that Ofgem should ensure it had robust evidence of inefficiency before it adjusts actual expenditure for the purposes of applying the Load Related Re-opener. They noted that the benchmarking will highlight areas for Ofgem to consider, but warned that it is unlikely to give a definite answer as to what the level of efficient costs should have been.

1.50. Two respondents commented specifically on the net to gross ratio. One respondent noted that the process considers volumes and net to gross ratio. They commented that net to gross ratio is mostly outside a DNOs control and therefore

mechanistic adjustments should be avoided. Another noted that references were made to potential adjustments to LVHC for changes in the net to gross ratio, but these were not included in the DPCR5 FPs. They questioned if these should be used, but instead use total gross load as the denominator in the test as this will provide a better test of whether there has been a Distribution Use of System (DUoS) to connectee shift.

1.51. One respondent, recognised comparative analysis as a driver, but showed their concerns around the additional workload for DNOs who do not trigger the Load Related Re-opener but have to provide a performance assessment submission. They also noted that it was unclear how much benefit can be obtained from comparative analysis and benchmarking of low volume connection activities. However they have stated that they support the proposal that the level of information expected from the DNOs should be proportionate to the DNO's exposure under the Load Related Re-opener.

Question 3: Do you agree with our approach to assessing expenditure on General Reinforcement?

1.52. Three respondents generally agreed with our approach however some respondents commented on the scope/detail of the assessment. One respondent felt that there is not enough detail for the financial methodologies on how the assessment of efficient costs and output delivery will be undertaken. One respondent noted that the actuals and baselines should be placed on an equivalent basis at the outset to be able to make comparisons. They think this would warrant another stage, or could be incorporated as part of stage 3. The third respondent remarked that it is a complex assessment and will vary, therefore DNOs should be given the opportunity to review and feedback on the draft output of the assessment before adjustments are made.

1.53. One respondent commented that it is key for Ofgem to review the decisions made in DPCR5 against the information that was available at the time.

1.54. One respondent noted that much of the proposed approach is for LI-related aspects which will be a variable component of companies LRE expenditure and needs to be considered in parallel with the NOMs assessment. They remarked that the techniques used in the analysis, which were developed at DPCR5 and RIIO-ED1 should be used with caution as they are biased towards capacity construction, which may not be the most efficient solution to solving load issues.

1.55. One respondent asked for further guidance on what is expected depending on the level of the DNOs actual expenditure. They have noted that paragraphs A3.6 and A3.9 contradict each other. They have also noted that the scope of what is included within the Load Related Re-opener needs to be clearer. For example, should include General Reinforcement for demand and generation, excluding reinforcement associated with specific DG connections.

1.56. One respondent highlighted the challenges of the proposed approach, where the consultation places emphasis on quantitative as well as qualitative means of assessing disaggregated expenditure:

1.57. Disaggregated assessment will suffer from the differences in costs across the companies which may not be driven by genuine differences in efficiency, such as cost drivers and business models.

1.58. The quantitative approaches available for assessing load related expenditure at voltages above HV involve significant approximations to the actual cost drivers face by companies.

1.59. There is no reliable quantitative approach to assessing LV or HV load related expenditure, or for LVHC connection costs.

Question 4: Do you agree with our approach to assessing avoided reinforcement?

1.60. Six respondents agreed with our approach to assessing avoided reinforcement. One respondent welcomed more general guidance on its expectations in this area. Another respondent commented that the assessment must take account of reinforcement on an overall basis as the requirement of the level and location of reinforcement will have changed over the DPCR5 period.

1.61. Three respondents commented on the treatment of efficiencies through innovation. One respondent noted that the DPCR5 FPs promised any reinforcement expenditure avoided by DSM techniques would be added to the amount used in the calculation of whether the Load Related Re-opener threshold is met but noted that the consultation appeared to broaden the scope to include any innovation. The respondent noted that, since this is taking place after the DPCR5 period ended, it was not clear how this would affect incentives or behaviour. Another welcomed the proposal to broaden the innovation offset beyond DSM schemes as being reflective of the effort invested in innovative demand management techniques over DPCR5. The third respondent noted that since many of the innovative schemes were still under-development in DPCR5, there should be a limited number of occasions where such evidence is required.

Question 5: For non-DNO interested parties, do you have any evidence you can provide that would support our assessment of the Load Related Re-opener?

1.62. Five respondents noted that this question was not applicable to them.

High Value Projects

1.63. Six respondents commented on Ofgem's proposed HVP methodologies. The questions we set out and respondents' views are summarised below.

Question 1: Do you agree with the principles and general approach in this chapter?

1.64. Six respondents generally supported the proposed approach and the general principles. One noted that more detail was required to make specific comments on the approach. Another noted that the efficiency assessment for DPCR5 Close out should be primarily against the basis on which the projects were allowed rather than an ex post view generated from comparator data. A third respondent noted that most of the outputs would not be binary and therefore that most project outputs should be considered on an incremental rather than absolute basis.

1.65. Three respondents commented specifically on the proposed approach for assessing BT 21CN costs. One respondent cautioned strongly against the use of comparative unit costs for assessing BT21CN due to the varied nature of the projects proposed by DNOs and noted that use of a benchmarking approach was deemed unsuitable when setting the DPCR5 allowances in this area. Another respondent noted that, while cross DNO cost benchmarking is possible in this area, care should be taken in order to ensure that the benchmarking is on a like for like basis and reflects previous Ofgem guidance. A third respondent noted that where solutions had been identified for BT 21CN which were more cost effective on a whole-life basis, the resulting reduction in costs should be treated as efficient.

1.66. One respondent agreed with the proposal to remove scope for double counting but did not consider that the approach set out by Ofgem achieved the desired outcome and therefore sought further clarity from Ofgem on its expected interaction between the HVP Re-opener and the HVP output mechanisms. Another respondent also highlighted that the interaction between outputs non-delivery and HVP Re-opener needs to be defined, because where outputs are not delivered there is a high likelihood of expenditure falling below thresholds.

1.67. One respondent highlighted that materiality threshold needed to be clarified as it should be one per cent of 2010-11 revenues.

1.68. One respondent noted that there should be an additional principle that High Value Projects will be assessed over the entire project, so that the full financial cost, allowances and output delivery can be taken into account.

1.69. One respondent noted that the principle relating to efficiency assessment of load related expenditure and HVPs should be broadened in order to ensure that investor certainty over investment decisions is protected.

1.70. One respondent commented that the principles should not depart from the mechanics of the HVP Re-opener mechanism set out in the DPCR5 FPs, or overly add

to the complexity of the assessment. The respondent suggested some of the principles should therefore be amended for example they noted that the HVP Re-opener as set out in DPCR5 Final proposals did not suggest that there would be an assessment of offsetting delivery efficiencies. Principle 6 states 'As part of our assessment, we propose to consider any offsetting impact from the DNOs undertaking innovative activities to avoid HVP expenditure to ensure we do not discourage such activities.' The respondent noted that such an assessment could be challenging, for example, different types of delivery efficiencies may be easier to quantify than others.

Question 2: Do you agree with the changes we have made to the assessment approach from DPCR5 FPs?

1.71. Six respondents agreed with the proposed changes. One of those respondents noted that they had added clarity to the structure of the HVP Close out mechanism.

Question 3: Do you have any suggestions on how we can assess outputs under the individual project categories in this document?

1.72. One respondent considered that the assessment of HVP output delivery should be consistent with the approach adopted for DPCR5 Close out on NOMs for Asset Replacement and General Reinforcement projects. However, they noted that HVP projects undertaken under other drivers would require a bespoke assessment.

1.73. One respondent welcomed the proposal to account for the status of HVP when assessing efficiency of expenditure. In particular, the respondent noted that projects which are in-flight and which have no further funding allowed for in the RIIO-ED1 settlement should be assessed to ensure that they remained properly funded.

1.74. One respondent noted that Ofgem should not seek to re-open the price control by re-visiting the original justification of and allowance for HVPs.

1.75. A number of respondents commented on the definition of Innovative Solutions. One respondent noted that avoided investment due to Innovative Solutions should be included against the HVP baseline in a manner similar to that proposed for the Load Related Re-opener.

1.76. One respondent noted that the proposed methodology did not recognise where changes between baseline expenditure and actual expenditure are consistent with the DNO doing the right thing e.g. if a project need had changed and the outputs were no longer required.

1.77. One respondent noted that projects ongoing at the end of DPCR5 will present challenges. The respondent noted that output delivery and the HVP Re-opener thresholds, should be tested both on the basis of within DPCR5 period performance and on the basis of performance of the project over its full life.

1.78. One respondent suggested that, for reinforcement work in relation to HVPs, DNOs should be given the opportunity to clarify the outputs with reference to previous submissions as the determination of outputs at the start of DPCR5 was undefined.

1.79. Two respondents commented specifically on BT21CN projects. One respondent noted that the DNOs have proposed and implemented different solutions to provide the same functionality as dedicated BT communication lines. They noted that the wide mix of approaches would make disaggregated benchmarking difficult. The other respondent noted that while cross DNO benchmarking is possible in this area, care should be taken in order to ensure that the benchmarking is on a like for like basis and reflects previous Ofgem guidance regarding DPCR5 BT21CN projects.

Question 4: For non-DNO interested parties, do you have any evidence that would help with our assessment of HVPs?

1.80. Five respondents noted that the question was not applicable to them.

Traffic Management Act

1.81. Six respondents commented on Ofgem's proposed methodology. The questions we set out and respondents' views are summarised below.

Question 1: Do you agree with our proposed methodology for adjusting DNOs' allowances to account for permitting costs?

1.82. Six respondents agreed in principle with the proposed methodology.

1.83. One respondent noted that DNOs did not have any control over Permit Costs as they are set by the Local Authorities and therefore set out the view that comparative analysis was not appropriate in this regard. In a similar vein, another respondent noted the intention to use industry upper quartile benchmark cost in its assessment and cautioned that disaggregated benchmarking results could therefore lead to an inappropriate benchmark. It suggested that Ofgem may have to supplement its quantitative assessment from benchmarking with other sources of information to ensure that any finding of inefficiency is supported by robust evidence. In relation to the use of benchmarking, another respondent encouraged Ofgem to reflect the learning from the Gas Distribution Network applications made to date. A fourth respondent noted that only costs under the control of DNOs should be included in the efficiency assessment.

1.84. Two respondents commented on the intention to require all licensees to submit data relating to Permit Costs and Permitting Condition Costs. Both noted that Ofgem already collects considerable data from all DNOs in this area in annual submissions and therefore that the requirement for additional information was unclear. One of these respondents noted that Ofgem should avoid unnecessary additional burden on all companies and that this would be disproportionate to the size of any likely

adjustments. A third respondent noted that the collation of such data may prove challenging but that the rationale for doing so was understood.

1.85. One respondent noted that the methodology needed to be clear on what is being adjusted when efficient costs exceed the materiality threshold. The respondent noted that the adjustment should be made to allowances not the efficient costs.

1.86. Another respondent noted that Permit Costs should be clarified to ensure that they clearly consider the wider cost and operational efficiency implications of complying with the Permitting Scheme.

Question 2: For non-DNO interested parties – Do you have any information or evidence which would assist us in carrying out the Traffic Management Act Permit Costs reopener assessment?

1.87. Five respondents noted that the question was not applicable to them.

Question 3: Do you agree with our proposal to settle the Traffic Management Act Permit Costs reopener mechanism early as part of the 2016 annual iteration?

1.88. Five respondents agreed with this proposal. One respondent did not agree with the proposal to settle the DPCR5 Traffic Management Act Permit Costs reopener mechanism early on the grounds that the timescale was impractical as there would only be a month between triggering and providing data. The respondent suggested that a submission date of September 2016 or later would be more practical.

Flood prevention

1.89. Our consultation document sought views on the introduction of a flood prevention methodology.

1.90. Only one respondent commented on the proposal to introduce a flood prevention methodology. The respondent supported the introduction of the methodology on the grounds that a commitment was made to include a logging up mechanism for these costs in the DPCR5 FPs. The respondent further noted that, given that the cap on the maximum amount was relatively small, the methodology and its associated data requirements should be proportionate to the amount of money involved.

Appendix 2 – Impact Assessment

1.1. As noted in the main body of this document, our December 2015 consultation (the December 2015 consultation) highlighted that we have reconsidered our approach to assessing the NOMs from the position we set out in our September 2015 consultation (the September 2015 consultation). This appendix is an assessment of these two changes:

- the impact of reflecting Material Changes in assessing HI performance; and
- the impact of making financial adjustments for significant and material under-delivery on Fault Rates.

1.2. In the DPCR5 Final Proposals we concluded that an Impact Assessment (IA) was not necessary for the network outputs regime, as we did not believe it met the definition of important under section 5A of the Utilities Act 2000. However, in carrying out the close out of the Final Proposals we believe it appropriate, as a matter of good practice, to assess the potential impact of finalising the methodologies when they are applied in 2017.

1.3. This IA sets out the potential impacts, benefits, costs and risks of these two modifications to our network outputs regime, and builds on our extensive consultation undertaken throughout the DPCR5 review. The DPCR5 close out involves the implementation of existing policy and what we are deciding is broadly consistent with DPCR5 FPs and the spirit and intention of the price control settlement.

1.4. The primary objective of the network outputs regime is to ensure that DNOs undertake the necessary network investment to deliver what customers have paid for via the DPCR5 settlement. In the absence of such output measures, it is difficult to distinguish between those companies that have innovated and found ways to deliver what customers need more efficiently, and those that have deferred investment at the expense of network health and/or performance.

Options considered

1.5. After considering responses to the September 2015 consultation and the December 2015 consultation we remain of the view that it is important to have financial consequences in place for DPCR5 for a DNO who fails to deliver the agreed outputs (or an equivalent). On this basis, we have developed a methodology for determining financial consequences for under-delivery, which is a variant on one of the options set out in DPCR5 FPs.

Reflecting Material Changes in assessing HI performance

1.6. Material Changes are factors that have a significant impact on the DNOs' HIs. They include changes to input data, changes to the assessment technique and

calculation methodologies, changes due to external factors and changes to their asset management strategy.

1.7. We are proposing to take account of Material Changes for HI NOMs in our assessment of NOMs delivery. In the December 2015 consultation we identified that Material Changes are key to understanding and assessing DNO performance, in both the quantitative and qualitative assessment. This involves making appropriate adjustments to the agreed outputs to take account of Material Changes in line with the original intent in DPCR5 Final Proposals and the NADPR RIGs.

1.8. If the Material Changes have caused a significant increase in the delivered asset health delta without increasing activity the DNO should justify why it is appropriate for this to be factored into the assessment.

1.9. We assess the proposed change against a base case of not taking Material Changes into account, focusing on whether the DNOs have delivered their risk point targets.

Making financial adjustments for significant and material under-delivery on Fault Rates

1.10. Fault Rates are a measure of the number of unplanned faults occurring on the network which may or may not result in interruptions. Our decision is to attach financial consequences for failure to deliver on Fault Rates. The impact of this enables us to realign the Fault Rates methodology with our treatment of HIs and LIs and the intent of DPCR5 FPs.

1.11. After further discussions with stakeholders we have developed tools to monetise Fault Rates. With a NOMs methodology now available to us, our view is that having financial consequences in place where DNOs have failed to deliver protects customers and incentivises genuine efficiencies. Monetising Fault Rates also ensures a consistent approach to performance assessment for all asset classes where asset replacement or refurbishment expenditure was allowed in DPCR5.

1.12. We assess the proposed methodology change against a base case of there being no financial consequence for increased Fault Rates.

Impacts

Benefits

1.13. The overall objective of the network outputs regime is to protect the interests of customers, by ensuring that DNOs undertake the necessary network investment to deliver what customers have paid for via the settlement. DNOs will only be rewarded genuine efficiency gains, the DPCR5 RPI-X framework with network outputs was designed to bring clear benefits to customers relative to a framework without outputs.

1.14. By promoting long term asset stewardship and ensuring that DNOs are only rewarded for undertaking efficient network investment, we expect that these policies will help promote a reliable and secure electricity supply.

1.15. In the DPCR5 period we have placed a strong emphasis on the need for DNOs to develop and commit to delivering suitable network output measures as part of the DPCR5 settlement. Where we determine that a DNO has not met its outputs, the methodologies we are putting in place enable us to adjust DNOs' revenue downwards.

1.16. Under the current network outputs regime customers receive value for money today, and are protected from inefficient deferral of investment which could lead to a significant 'backlog' of network investment in the future. DNOs should not be allowed to keep allowances where improvements in HIs were the result of external factors. Our intention to reflect Material Changes was clearly signalled at DPCR5 FPs.

1.17. DPCR5 FPs stated that there should be financial consequences for a DNO who fails to deliver the agreed output. Making financial adjustments for under-delivery of Fault Rates signals a strong incentive to deliver outputs. We consider that our policy provides a strong signal of the consequences of the failure to deliver outputs and reflects the original intent of DPCR5 Close out.

1.18. If we are to claw back money from the DNOs due to under-delivery against their outputs this would be a benefit to customers in the form of lower bills reflecting the reduction in the amount of money DNOs can recover through their RIIO-ED1 allowances.

Costs and risks

1.19. In the long term we would expect impacts to customers in the form of higher bills if we do not take account of material changes or impose financial consequences for under performance of Fault Rates.

1.20. At a high level, the purpose of the NOMs assessment is to determine whether or not a DNO has satisfactorily delivered a package of outputs consistent with the change in risk funded by its customers through the DPCR5 settlement. The DNOs are required to provide information to demonstrate that the programme of work was in customers interests. We must take account of material changes in our assessment of NOMs delivery because if a DNO achieves its target delta due to a material change the full benefits of the output regime would not be passed on to customers.

1.21. There could be detrimental impacts passed on to customers through higher bills if we do not impose financial consequences for under performance of fault rates. The introduction of this measure delivers long term investment benefits to customers as it provides balance to another DPCR5 incentive, the Interruptions Incentive Scheme (IIS). It has been argued that the rewards from the IIS may have been earned by a greater focus on the reduction of the duration of interruptions after they have occurred rather than investment in network resilience to prevent faults

occurring in the first place. This approach may be appropriate in some circumstances but there is a risk that this may encourage a short-term focus on asset management as a DNO may focus investment to reduce the length of the interruption rather than make a long term decision on investment needs. By imposing financial consequences for under performance of fault rates we are providing a strong signal to DNOs to deliver long term benefits to customers and it encourages the adoption of improved working practices and solutions.

1.22. We understand the views of interested parties on the risks associated with imposing financial consequences in an untested area. The NOMs regime has been in place since the beginning of DPCR5. Rather than an argument against imposing financial consequences for a failure to deliver, we see this as an argument for allowing sufficient flexibility and scope for DNOs to respond to information and to further improve their asset management practices. Provided a DNO is able to explain its investment decisions in terms of the customer's interests, we believe the assessment process provides ample protection to both customers and the DNOs.

1.23. Without consequences in place, customers are not adequately protected. DNOs would continue to retain the full benefit from the cost incentive even if they are deemed to have under-delivered on outputs. Providing a strong incentive to deliver a set of outputs consistent with what customers have paid for via the DPCR5 settlement represents a significant step-forward in the regulatory framework, and results in a better alignment of the cost incentive.

Conclusions

1.24. In summary, we believe that the implementation of these methodologies will provide significant benefits to customers relative to the 'do-nothing' scenarios. Customers will receive value for money today, and are protected from inefficient deferral which could lead to a significant 'backlog' of network investment in future periods. For these reasons we think it is appropriate to take account of Material Changes when assessing performance and to make financial adjustment for significant Fault Rate under-delivery.

Appendix 3 - Feedback Questionnaire

1.25. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

Please send your comments to:

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