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2nd June 2016

Dear Grant,

DPCR5 Close out: Informal consultation on changes to the RIIO-ED1 Financial Handbook

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

These efforts to ensure that DNOs are held accountable for the package of outputs they were funded to deliver, as part of the fifth electricity distribution price control (DPCR5), are important as a provisional estimate of returns on equity for DCPR5 for all DNOs is 11.8% (significantly in excess of the 6.7% baseline[1]). The main area in which the DNOs have outperformed the price control assumptions is expenditure in network investment: the DNOs have spent 10% less (£823m[2]) than cost baselines[3]. The downturn in economic conditions during the period is cited as a contributing factor and, in some instances, DNOs have not delivered against their commitments even though allowances have not been spent[4]. As returns have been achieved largely through significant levels of under-spending of the allowances provided, it is essential that the DNOs are held fully accountable for delivery of the outputs agreed at the outset of the price control and, to the extent that outputs have not been delivered, funding allowances should be returned to customers.

We remain broadly comfortable with the principles set out in the September 2015 *Consultation on close out methodologies for the DPCR5 Price Control.* However, we are concerned that, in some areas, the proposed Handbook drafting does not fully reflect the overarching policy intent or may not achieve the principles set out in the September 2015 consultation. We believe:

- **Network outputs delivered over DPCR5 should be demonstrated to have been in customers' best interests.**
- **Changes should be made to the agreed DPCR5 HI and LI outputs to account for material changes, external factors and changes in asset management approaches.**
- **The original policy to levy penalties for under-delivery of network outputs in a NOMs category (independent of performance in the other two categories) should be retained.**

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[1] Electricity Distribution Company performance 2010 to 2015, paragraph 2.36: (https://www.ofgem.gov.uk/publications-and-updates/electricity-distribution-company-performance-2010-2015)
[2] 2012/13 prices
[3] Electricity Distribution Company performance 2010 to 2015, paragraph 2.18
[4] Electricity Distribution Company performance 2010 to 2015, paragraph 2.18

These issues are discussed below.

We also recommend that, in the upcoming decision document on the DPCR5 close out, the detailed data that supports the DPCR5 close out assessments is published in a clear and transparent manner. This should include data tables that set out DPCR5 allowances, actual expenditure, efficiency gains, savings and the customer share of those savings for each of the close out mechanisms. Additionally, to aid transparency and engagement, Preliminary Views on DNO close out positions should be published within the industry consultation expected in May 2017 (along with summaries of DNOs' representations and reasons for any revision of the Preliminary Views).

Network outputs delivered over DPCR5 should be demonstrated to have been in customers' best interests:

We continue to support the fundamental principle that the assessment of network outputs should explicitly consider both customers' best interests and efficiency. This principle was stated at DPCR5 Final Proposals and has been restated several times since, such as in the RIGs and in the September 2015 consultation. We also agree with the principle, stated at DPCR5 Final Proposals and restated in the September 2015 consultation, that DNOs should retain a share of genuine efficiency improvements but should not benefit from not doing work or deferring work that benefits consumers. Further, we believe the rewards available to DNOs for realising genuine efficiency improvements should always be greater than rewards due simply to circumstances meaning investment was not required (i.e. due to 'good luck'). We also believe there should not be any rewards for over-forecasting.

The consideration of customers' best interests in the proposed Handbook drafting is not as heavily emphasised as it has been at DPCR5 Final Proposals, or in various versions of the DPCR5 RIGs or even in the September 2015 consultation. An assessment of the efficiency of an investment decision in isolation cannot always be considered to be the same as an assessment of whether the decision was in customers' best interests. For example, if a decision was taken to defer the reinforcement of a substation from 2014/15 to 2015/16- because the demand did not materialise as quickly as expected- this could be considered, in isolation, to be an efficient investment decision. However, this would not represent customers' best interests if they receive only a share of savings that accrue from the deferment but are required to fund the full cost of the same substation during RIIO-ED1.

The assessment of the efficiency of an investment decision is separate from an assessment of whether the decision represents customers' best interests. Both assessments should be conducted for the close out of DPCR5. We attach a track-changed version of the proposed Handbook drafting capturing where customers' best interests should be referred to in order to remain consistent with the policy intent set out at DPCR5 Final Proposals.

We also note the requirements of the Performance Assessment Submissions and the analyses that form part of the Authority's assessment are not as stringent as those detailed in the September 2015 consultation, which we do not think is appropriate if customers' best interests are to be represented.

Changes should be made to the agreed DPCR5 HI and LI outputs to account for material changes, external factors and changes in asset management approaches:
In our response to the September 2015 *Consultation on close out methodologies for the DPCR5 Price Control*, we raised concerns about the proposals not to normalise agreed LI profiles (and, if applicable, HI profiles) to take account of changes in the observed level of demand (Material Changes). Following responses to the September 2015 *Consultation on close out methodologies for the DPCR5 Price Control*, it was made clear, in the December 2015 document *DPCR5 Closeout Methodologies - further changes since informal consultation,* that changes would be made to the agreed HI and LI outputs:

> *...We therefore propose to make changes to the agreed DPCR5 HI and LI outputs to account for material changes (eg changes in input data, methodologies) external factors (eg changes in demand growth) and changes in asset management approach. 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....*[5]

We agree with this position and welcome efforts made to incorporate it into the close out methodologies and suggest this is made more explicit in the relevant sections in the Handbook drafting.

The original policy to levy penalties for under-delivery of network outputs in a NOMs category (independent of performance in the other two categories) should be retained:
The proposed approach to identifying and monetising outputs gaps for HIs and LIs was set out in Appendix 2 of the September 2015 consultation. Financial penalties would be levied once outputs gaps relating to each of these NOMs categories were identified (independent of performance in the other two categories). In the December 2015 consultation, it was confirmed that fault rates would be treated in the same way:

> *After further discussions with stakeholders we have identified ways in which we could monetise fault rates, and we are developing tools which will enable us to do this. 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.*[6]

[5] DPCR5 Closeout Methodologies - further changes since informal consultation (https://www.ofgem.gov.uk/sites/default/files/docs/dpcr5_closeout_methodologies_followup_letterfinal_2_0.pdf)
[6] DPCR5 Closeout Methodologies - further changes since informal consultation

However, a new approach, involving an additional 'test' to be satisfied, has been proposed[7]. It is now proposed that performance in aggregate across all three NOMs categories will be considered before financial penalties are calculated, instead of calculating financial penalties once outputs gaps relating to each of the three NOMs categories is identified (independent of performance in the other two categories). While it was proposed in the September 2015 consultation that the trading of risk within each NOMs category could be permitted, the trading of risk across NOMs categories was not considered. This appears to be a material change in policy.

The additional 'test' is not appropriate because the NOMs categories target different measures of network health and can require different behaviours and interventions. By way of a simple example, the refurbishment of an asset may not be substitutable for the reinforcement of the same asset. It is for this reason it cannot be assumed that the trading of risk across categories can result in qualitative equivalent outputs and, as such, the original policy of independent monetisation and adjustment should be retained. It should also be noted that, if a material change in policy has been signalled, this was not consulted on.

We hope you find our comments helpful. Please do not hesitate to contact me if you have any questions.

Yours sincerely

Andy Manning
Head of Network Regulation, Forecasting and Settlements

[7] In paragraphs 1.59-1.62 of Annex A1: DPCR5 NOMs Failure to Deliver Outputs Methodology