



# The DPCR5 close-out methodologies

*Northern Powergrid's response to Ofgem's consultation titled 'DPCR5 Close out: Informal consultation on changes to the RIIO-ED1 Financial Handbook'*

## KEY POINTS

- **The detailed methodologies Ofgem is consulting on largely reflect the content of the DPCR5 Final proposals; nevertheless it remains important during their implementation that Ofgem should respect its promise that there would be 'few surprises' from the close-out process.**
- In terms of the high value projects and load-related expenditure reopeners:
  - *The proposed definition of efficiency is an appropriate one for assessing costs which have actually been incurred; and rightly avoids the misuse of hindsight.*
  - *It is appropriate that Ofgem will not make any adjustments for unit costs; the DPCR5 benchmarks have served their purpose as a starting point for the sharing factor, and further unit cost adjustments would break this architecture.*
  - *Ofgem has rightly recognised the DPCR5 Final proposals provision that DNOs bear the risk of real price effects, and the methodology correctly implements this.*
- On network outputs:
  - *The approach to calculating Adjusted Network Outputs is sensible.*
  - *The approach to monetisation and materiality thresholds is broadly sensible.*
  - *We have some residual concerns that the outcome may not reflect Ofgem's DPCR5 NADPR RIGs promise that there would be 'few surprises' in the close-out. Ofgem should consider recognising this commitment in the drafting; if the process still leads to any material 'surprises' this should be considered in a lessons learned exercise.*
  - *Ofgem has endeavoured to respect the principle that the assessment must be made in the round, taking a holistic and balanced view of asset health, loading and fault rates, recognising that over-delivery in one category can offset any under-delivery in another.*
- Where high value projects have been delayed the interactions between DPCR5 and ED1 are complex; the drafting recognises this but Ofgem should consider a backstop to ensure the overall outcome is not more penal than if the whole project had fallen in the DPCR5 period.
- The varied approach to profiling any adjustments over time is justified in the circumstances; absent specific reasons to the contrary, the most sensible approach is to use the profile of allowances actually given at DPCR5 (so allowances are clawed back in proportion).

## 1. Overview

1. The DPCR5 close-out process is of fundamental importance in completing the package of price control mechanisms first set out in the DPCR5 *Final proposals*. The outcomes of the process are important not only for securing balanced outcomes between consumers and companies in relation to the DPCR5 period; they are also important for underpinning continued investor certainty in the sector, which will benefit future consumers through a continued appetite to provide capital to develop and maintain the networks in exchange for a reasonable rate of return.
2. Before RIIO-ED1, normal regulatory practice in Great Britain was to complete the close-out of the previous price control period at the time of the next price control review; thus the fundamental components of the close-out for the previous price control period became part of the licence modification resulting from the price control review, and licensees could accept or reject the overall package (or, since shortly before the first RIIO price controls, could appeal errors in the decision). There was a departure from this normal practice in the RIIO-ED1 price control. Close-out was instead deferred until after the price control had been completed. This took the close-out elements outside the ED1 licence modification. In the RIIO-ED1 licence Ofgem did however make a commitment to develop a detailed methodology for the close-out, and to incorporate this by modification of the licence. This had the benefit of reducing the extent to which the normal disciplines on due process could be weakened by the deferral of the close-out. It also underscores the importance of the current consultation.
3. Ofgem's informal consultation asks only one question; comments are invited on the proposed licence drafting for incorporation into the RIIO-ED1 *Financial Handbook*.
4. In giving our response to this question, we note that the consultation was preceded by an extensive series of working groups; first to discuss policy and then more lately to discuss the necessary licence drafting. Reflecting the fact we participated in this working group process there are many aspects of the drafting we support, although there are still some high level points we believe should be recognised. All these points are summarised in the key points section of this consultation response (above), and set out in more detail in the rest of this document under the following headings:
  - a. Reopeners;
  - b. Network outputs;

- c. High value projects; and
  - d. Profiling adjustments.
5. We also think that Ofgem should consider the DPCR5 close-out process as part of its ED1 lessons learned exercise. Our reasoning is set out in the section below titled 'overall process'.
6. As well as these headline points we also have many more detailed points on the drafting. These are provided in the marked up extract of the *Financial Handbook* accompanying this response. We have provided many of these points as comments on the document, rather than giving a detailed mark up, particularly where the complex nature of the point means that the 'fix' required will be dependent on whether other parts of the text are changing (and how). For the more straightforward points, which are less likely to be subject to inter-dependencies, we have tended to provide these as a mark-up. Our comments are extensive and we recognise that producing a revised and accurately drafted handbook that properly encapsulates Ofgem's policy intent will be very challenging in the timescale that Ofgem has set itself. We hope that by submitting our comments early we have given Ofgem a little more time to produce a revised text that is a suitable basis for a statutory consultation on a licence modification. The current draft does not meet that requirement.

## 2. Reopeners

7. There are three key points we wish to draw out from our detailed comments in relation to the two reopeners.
- a. the definition of efficiency is appropriate;
  - b. it is right to avoid further unit cost adjustments; and
  - c. the correct approach is being taken to real price effects
8. We cover each of these points in more detail below.

### ***The definition of efficiency is appropriate***

9. The definition of efficiency used in the reopener assessment is of fundamental importance to the overall process.
10. The definition proposed by Ofgem is an appropriate one for assessing costs which have actually been incurred; and rightly avoids the misuse of hindsight. In particular the definition:
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- a. recognises that costs are efficient where a sound decision was taken based on the information that the licensee should reasonably have taken into account at the time;
  - b. gives Ofgem scope to find that costs were inefficient where a licensee:
    - i. failed to take into account information that it should reasonably have recognised, where this led to an inefficient decision; or
    - ii. took a manifestly inefficient course of action based on the information it did take into account; and
  - c. avoids the misuse of hindsight – by preventing a finding of inefficiency being established on the basis of information that a licensee could not reasonably have been expected to have taken into account at the time of taking the decision.
11. The definition is also well aligned with existing regulatory precedent on findings of inefficiency on the ex-post assessment of direct costs; in particular Ofgem’s determination that certain costs in relation to the St. Fergus exit point were inefficient because National Grid incurred those costs when it should not have done so based on the information it should have had available to it at the time of taking the decision.
12. For all these reasons we support the proposed definition of efficiency.
- It is right to avoid further unit cost adjustments***
13. It is appropriate that Ofgem will not make any further adjustments for unit costs.
14. The DPCR5 benchmarks were imperfect in many ways, since they were constructed in a way that did not allow them to recognise specifics of particular asset types anywhere that these were not adequately reflected in the cost categories being used at the time.
15. They did however serve their purpose as part of a price control package, in particular as a starting point for the sharing factor, and through their use in the ongoing assessment of the delivery of network outputs. These unit costs therefore formed the basis for the response by licensees to the targets they had been set in the price control. Further unit cost adjustments would break this architecture, by resetting the targets at a point in time when it is no longer possible for companies to respond to them.
16. Moreover, the normal price control approach to benchmarking unit costs would be manifestly inappropriate. There is a fundamental difference between an *ex ante* price control review applied to forecasts of costs yet to be incurred and an *ex post* close-out exercise taking place after licensees have actually incurred the costs while responding to strong cost saving incentives.
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17. For all of the above reasons, it is entirely right that Ofgem is not proposing the type of unit cost benchmarking exercise that sometimes takes place at price control reviews.

***The correct approach is being taken to real price effects***

18. The DPCR5 *Final proposals* stated that:

*7.22 ... Real Price Effects (RPEs) cannot be used as a justification for expenditure being greater than or less than the baseline - the risk of RPEs exceeding the assumptions included in the baselines is for the DNOs to manage in this area...*

*7.23: The reopener is symmetrical...<sup>1</sup>*

19. The intention is clear that, where RPEs did not equal the assumptions included in the DPCR5 baselines,<sup>2</sup> this risk was one for DNOs to manage. Moreover, the intent was for this to be symmetrical; in other words:
- a. RPEs higher than the price control assumptions would not be a reason for an upwards adjustment via a reopener; and
  - b. RPEs lower than the price control assumptions would not a reason for a downwards adjustment via a reopener.
20. The approach proposed in the Financial Handbook drafting achieves exactly this. It adjusts actual costs to the level that would have been experienced had RPEs been at the level assumed in the price control (rather than the level actually experienced) using an objective and defensible external benchmark. Once thus adjusted, any difference between the benchmark level of RPEs actually experienced and the price control assumptions makes no contribution whatsoever to the evaluation of the reopener thresholds. This ensures that all the RPE risk remains with DNOs.

### 3. Network outputs

21. There are four key points we wish to draw out from our detailed comments in relation to reopeners.
- a. The approach to calculating adjusted network outputs is sensible.
  - b. The approach to monetisation and materiality thresholds is broadly sensible.

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<sup>1</sup> DPCR5 *Final proposals*, Cost assessment document, page 93. The same approach is set out for HVPs at paragraphs 7.29 and 7.31.

<sup>2</sup> These assumptions are documented in the DPCR5 *Final proposals*, cost assessment document, pages 81-85

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- c. We are not sure the proposed approach ensures the ‘few surprises’ promise will be met.
  - d. Ofgem is endeavouring to respect the ‘in the round’ nature of the assessment.

22. We cover each of these points in more detail below.

***The approach to calculating adjusted network outputs is sensible***

23. During the course of the DPCR5 period, DNOs were able to make and report material changes to their asset health and load indices, for example where they incorporated new data on the condition of assets or where they changed the methodology by which the asset index was calculated for particular classes of assets.
24. These changes are an inevitable feature of the proper management of a diverse asset base using such indices. No model can perfectly track reality, and over time new information will suggest changes that would improve how well the model is matching the assets actually present in the field. If a company did not reflect this new information in its use of asset indices to help in its decision making, then the resulting decisions would become increasingly flawed over time.
25. However, the effect of material changes themselves could be to make it easier (or harder) to hit a particular target ‘delta’ on the asset health index, or a particular absolute target on the load index. The original calculations already stripped out the direct effect of the material changes in relation to asset health indices. But there would also be an indirect effect, coming from any systematic worsening (or improvement) of the index score for the overall population of assets, since this would have a knock-on effect on the index delta achieved by an unchanged programme of asset replacement and refurbishment. Ofgem’s proposal to take this a step further in the close-out exercise, and also strip out the indirect effect, is sensible.
26. Although the proposal restricts the extent that DNOs can benefit from material changes, it is important that it still incentivises DNOs to optimise their decisions across different asset classes. This is central to the network outputs framework and the incentives it places on DNOs to take good asset management decisions in future. It also helps to place the onus on DNOs to take those decisions, and helps to minimise the risk that Ofgem effectively steps in to micro-manage the businesses.

***The approach to monetisation and materiality thresholds is broadly sensible***

27. The in the round nature of the assessment, both within network output categories (across different asset classes) and across network output categories, requires to some extent that the

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different components are placed in a common currency. The approach to monetisation suggested is broadly sensible.

28. The overall exercise is however an imprecise one, and there will always be some uncertainty in the results. The use of materiality thresholds is a sensible response to this issue.
29. We do have some residual concerns at the use of an asset replacement cost to value deviations of fault rates from the forecasts made by licensees at the time of the price control review. Faults carry their own cost, and there is some logic in using the cost of fixing a fault in the assessment (rather than full asset replacement, which might involve more extensive work). In many cases the right response to a prospective fault, from an asset management point of view, is to let it happen and then fix it (since this would be more cost effective than replacing assets beforehand, since the location of the fault cannot be predicted precisely).
30. But broadly speaking, the overall approach proposed (recognising the fact that the materiality thresholds help to offset the imperfect nature of the unit costs used for monetisation) is one we think can be made to work.

***We are not sure the proposed approach ensures the ‘few surprises’ promise will be met***

31. The DPCR5 NADPR RIGs<sup>3</sup> are an integral part of the DPCR5 price control settlement, since the DPCR5 *Final proposals* cross referred to these RIGs for the detail of the approach to network outputs.
32. The NADPR RIGs highlighted an intent to have an ongoing dialogue regarding material changes and the company’s re-prioritisation in response to them. They said it was *‘important that the reasons for changes in the outputs delivered during DPCR5 relative to the Agreed Network Outputs are tracked and well understood through constructive dialogue between the DNOs and Ofgem’*.<sup>4</sup>
33. While Ofgem reserved the right to make its final assessment at the end of the price control period, it acknowledged that there was *‘a clearly established intent to work bi-laterally in developing the use of outputs during the DPCR5 period and the inappropriate use of hindsight in judging performance at DPCR6 is to be avoided. DNOs can expect a substantive discussion with Ofgem following provision of each Annual Submission, during the course of which Ofgem will set*

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<sup>3</sup> The *Electricity Distribution Price Control Network Asset Data and Performance Reporting - Regulatory Instructions and Guidance*

<sup>4</sup> NADPR RIGs version 1, page 20, Para 2.35 (also retained in subsequent versions)

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*out its opinion at that time on the progress being made in the context of the 5 year outcomes being pursued.*<sup>5</sup>

34. There was also an intent to hold a mid-period review during the DPCR5 period, which would provide Ofgem with the opportunity to *'provide specific guidance on those aspects of the submission it considers could be relevant for the purposes of setting the Adjusted Network Outputs as part of the end-of-period performance assessment process, including any specific concerns'*.<sup>6</sup>
35. Given all this, it is not surprising that the RIGs said that, by the time licensees came to make their performance assessment submissions, there should be *'few surprises'*.<sup>7</sup> Indeed, DNOs should have had the opportunity to respond to any issues which were identified during the period, if they thought it appropriate, or otherwise have an ongoing dialogue with Ofgem as to why the suggested course of action would not be suitable.
36. Yet some of the changes being introduced in the network outputs close-out assessment, relative to Ofgem's work within the price control period tracking licensee delivery, could create the risk of surprises. The monetisation of fault rates, in the overall assessment of delivery, and potentially in the penalty, is one such example (since the NADPR RIGs used faults only in a holistic qualitative assessment, and did not suggest incorporating them in any penalty calculation). This point is explained in detail in appendix F to Northern Powergrid's response to Ofgem's consultation entitled *DPCR5 Closeout Methodologies - further changes since informal consultation*.
37. We have some residual concerns that this approach may not reflect Ofgem's DPCR5 NADPR RIGs expectation that there would be *'few surprises'* by the time companies came to make their performance assessment submissions. To the contrary, the changes in approach relative to the annual process within the period could lead to some material surprises.<sup>8</sup>
38. Ofgem should therefore consider recognising its various commitments in the NADPR RIGs, and the expectation that there would be *'few surprises'* at this late stage, in the licence drafting. Either way, if the process still leads to any material *'surprises'* this should be considered in a lessons learned exercise.

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<sup>5</sup> NADPR RIGs version 1, page 21, Para 2.39 (also retained in subsequent versions)

<sup>6</sup> NADPR RIGs version 1, page 22, Para 2.49 (also retained in subsequent versions)

<sup>7</sup> NADPR RIGs version 1, page 26, Para 2.68 (also retained in subsequent versions)

<sup>8</sup> We are unable to confirm whether they will as this depends on the position of every company

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***The 'in the round' nature of the assessment has been respected***

39. The NADPR RIGs incorporated a principle that the assessment must be made in the round, taking a holistic and balanced view of asset health, loading and fault rates, recognising that over-delivery in one category can offset any under-delivery in another. The relevant supporting references are set out in appendix B to Northern Powergrid's response to Ofgem's consultation entitled *DPCR5 Closeout Methodologies - further changes since informal consultation*.
40. In the draft revisions to the *Financial Handbook* Ofgem has endeavoured to respect this principle, which we do not expect to be contentious as it was an explicit commitment given by the Authority at DPCR5. The proposed drafting sets this out very clearly in relation to the step where the Authority undertakes its overall assessment (step 4), and we have proposed some minor revisions to the text to give greater clarity over how this assessment is informed by the preceding steps of the analysis, and how the overall principle is given effect through every step of the process.

## 4. High value projects

41. High value projects are, by definition, large and complex. This means they will frequently take several years, and consequently there is a high chance their start and completion times will not respect the arbitrarily imposed boundaries of price control periods. Since there are relatively few of them, there is also less scope for variation in one project to be expected to offset variation in another.
42. Moreover, the elapsed time between the RIIO-ED1 price control review and the close-out assessment means that the prospective RIIO-ED1 allowances were established using a different information set to that which will be used in determining the outcome of the close-out. This raises the possibility of a mismatch between the two (for example where actual costs moved from the DPCR5 period, and into the RIIO-ED1 period, at a late stage, or vice versa). Ofgem should be conscious of this possibility in determining both:
- a. whether to impose a failure to deliver outputs adjustment; and
  - b. the quantum of any such adjustment.<sup>9</sup>

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<sup>9</sup> These factors should also be taken into account when assessing the reopener, although the deadbands applied to the reopener make this less likely to be a significant issue (when compared to the outputs adjustment which has no deadband)

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43. The drafting already recognises the complexity of the interactions between the DPCR5 and ED1 periods, and it has specific provision to take these interactions into account.
44. But Ofgem should also consider introducing:
- a. a provision to take the quantum of unfunded costs in the ED1 period into account in the determination of the size of a failure to deliver outputs adjustment (if one is warranted); and
  - b. a backstop provision to ensure the overall outcome is not more penal than if the whole project had fallen in the DPCR5 period (assuming that any delay was justified).
45. We have suggested some drafting changes that would give this effect.

## 5. Profiling adjustments

46. Ofgem has proposed a mixed approach to profiling adjustments:
- a. for the reopeners, it has proposed using the profile of actual expenditure;
  - b. for the output delivery assessment, it has proposed using the profile of allowances.
47. This varied approach for different mechanisms is justified in the circumstances.
48. Absent specific reasons to the contrary, the most sensible approach is to use the profile of allowances actually given at DPCR5, so allowances are clawed back in proportion with the years in which they were originally granted. This has the benefit of placing the licensee in the position it would have been in had the allowance set at the DPCR5 period been set at the 'correct' level for the whole period. It also ensures that the other incentives built into the price control are preserved, and act in their normal manner, irrespective of whether the close-out mechanisms are triggered. Under the proposed drafting this is the approach being used for any network output clawback.
49. There are of course other approaches that can legitimately be taken. One of these is to maintain, as Ofgem is proposing to do, the approach which was built into the RIIO-ED1 *Financial Handbook* for any claw back under the reopeners (which will be profiled according to actual costs). Overall therefore we support this approach to profiling in the specific circumstances in which it is being used.
50. We do not believe that the other suggested approach, the use of under-and over-spend, would be appropriate, since it entails a fundamental re-sculpting of the DPCR5 allowance profile in the

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event that the network outputs or reopener mechanisms is triggered. There was no suggestion that this was the intent in the DPCR5 *Final proposals*, and it could lead to absurd outcomes such as an increase in allowances in some years with simultaneous reductions in others. Moreover, such an approach would introduce into this aspect of the close-out factors which were never intended to be fully trued up for (such as costs advancing or being delayed within the period, to the extent these had no net effect over the entire period). We therefore support Ofgem's decision not to use this approach.

## 6. Overall process

51. Northern Powergrid believes that Ofgem should consider the DPCR5 close-out process as part of its ED1 lessons learned exercise, or as a subsequent standalone lessons learned process.
52. Ofgem set itself a challenging task when it decided to delay the close-out calculations beyond the end of the DPCR5 price control period and the RIIO-ED1 review, and instead committed to incorporating a detailed methodology in the licence at a later date. The extensive work undertaken by Ofgem on this topic during the latter parts of 2015, and 2016 to date, reflects this.
53. A significant level of time and resource has so far been dedicated to the DPCR5 close-out, to the point that we believe this may be the most time- and resource-intensive close-out process in the history of British price control regulation. We expect this to continue through the assessment. This has costs as well as benefits. While the heightened scrutiny that can be applied to the calculations could bring benefit, the ongoing process reduces regulatory certainty as to the 'value' of the price control settlement for several years.
54. While this type of approach could potentially be used again for the close-out of the ED1 period, we believe it should be possible to approach the ED2 review with more certainty already established over the ED1 close-out calculations. This would allow the ED1 close-out to be implemented at the ED2 price control review with less need for extensive ongoing work after the price control review. This possibility should at least be debated as part of a lessons learned exercise, so it can be properly considered by all the interested parties.

## 7. Conclusions

55. In the sections above, we have drawn out and focussed on some of the key issues in the close-out methodology, both where we agree with the approach being proposed by Ofgem, and where we advocate a different (or modified) approach.
56. We have also attached a set of detailed comments on the proposed licence drafting.
57. We hope that these high level points and detailed drafting comments are useful to Ofgem as it finalises the licence modification for formal consultation. We are conscious that Ofgem has only a short window to adjust the RIIO-ED1 *Financial Handbook* drafting prior to formal consultation, and we would be happy to discuss any specific aspects of it with the Ofgem team if this would help address specific issues quickly.