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Dear Steve,

Consultation on a potential RIIO-ED1 Mid-Period Review

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.

We believe the following issues fall within the MPR scope as defined in the consultation and set out in the RIIO-ED1 Strategy Decision:

- **Smart meter rollout:** A new output relating to DNO performance in facilitating the smart meter rollout is required as DNO interventions directly affect the customer experience and customer engagement.

- **Rail electrification:** There has been a clear change in government policy which has resulted in a material change in the outputs required to be delivered by WPD.

- **Interruptions Incentive Scheme and other relevant incentives:** where an incentive scheme ceases to be effective, there is a clear consumer need for it to be reviewed.

- **Radio Tele-Switching Service:** A new output may be required to continue to run the service beyond March 2020 to meet the needs of consumers.

There are other issues for which it would be practical to use the MPR process to address:

Network load indices:
We recommend formalising the load index outputs DNOs are expected to deliver by the end of RIIO-ED1 as part of the MPR process. This will provide transparency ahead of the close-out of the price control.

Data series for the cost of debt index:
We believe the MPR is an appropriate process to make changes to the RIIO-ED1 Price Control Financial Handbook to make clear that revenue adjustments will be made to account for the relevant year(s) affected by data not being available for use in the cost of debt indexation model.

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Directly remunerated services revenue:
At RIIO-ED1 Final Determinations, Ofgem changed its policy regarding some Directly Remunerated Services, to make a 100% RAV deduction for top-up and standby revenues that some DNOs treated as excluded services during DPCR5[1]. We would welcome confirmation that the same necessary RAV deductions have been made to fast-track licensees.

Business rates:
There has been a clear change in government policy which will reduce the level of business rates. The MPR process provides an opportunity to consider whether resetting allowances is appropriate.

We hope you find these comments helpful. Answers to the consultation questions are attached. Please do not hesitate to contact me if you have any questions.

Yours sincerely,

Andy Manning
Director - Network Regulation, Forecasting and Settlements

[1] RIIO-ED1: Draft determinations for the slow-track electricity distribution companies Overview; paras 5.39-5.44: https://www.ofgem.gov.uk/sites/default/files/docs/2014/07/riio_ed1_draft_determination_overview_30072014.pdf

Answers to the consultation questions

Chapter 1 Question 1: Do you have any comments on the scope of the ED-MPR?

The scope of the MPR as defined in the RIIO-ED1 Strategy Decision is valid. Also, we agree there is no meaningful distinction between the introduction of new outputs and changes to existing outputs.

Chapter 1 Question 2: Do you have any comments on the preliminary information on company performance provided in this document?

We welcome the high-level information provided in the consultation on company performance, which is an improvement on the information provided for previous MPRs. Our preference remains that a full and detailed assessment of performance, including the drivers for out- and under-performance, should be provided to inform stakeholders' views.

Chapter 2 Question 1: Do you agree with the initial view we set out in this section against each individual issue?

We agree with the conclusions reached except for those relating to Smart Meters and Rail Electrification.

Smart Meters:
We remain of the view that an output relating to the DNO performance in facilitating the smart meter rollout is required by consumers. DNO interventions directly affect the customer experience and customer engagement and so this is a necessary new output.

We note that, in the initial assessment of the need for a new output for Smart Meters, Ofgem indicates it will be considering whether the funding for Smart Meters has been efficiently used. We welcome this, but believe it would be in the interests of all parties that this assessment is as transparent as possible. Setting an explicit output would provide this transparency as the level of performance must feature in an assessment of the efficient use of funding (i.e. if a company has spent less by providing a lower level of service this is not 'efficiency' and should not be rewarded as such).

We also note that Ofgem views that the service level agreement (SLA) provides a framework within which performance can be considered. In practice, however, under the current SLA networks are generally released from the obligations and so the SLA is ineffective. The proposed modification to DCUSA[2], adjusting when DNOs are released from the obligations so the SLA is effective more often, would need to be approved for the SLA to provide a framework for performance to be considered. Further, even if the modification is approved, given that no

[2] DCP297

functioning performance management has been in place to date, and that all DNOs have voted to reject one being put in place, the DCUSA may not be sufficient to manage performance alone.

Rail Electrification:
As set out in more detail in our response to question 2 of chapter 3 below, there has been a clear change in government policy which has resulted in a material change in the outputs required to be delivered by WPD. Therefore, we believe this issue is within the scope of the MPR.

Chapter 2 Question 2: Have you identified any other issues not covered in this section that should be considered within the scope of the ED-MPR process?

Interruptions Incentive Scheme and other relevant incentives:
The Interruptions Incentive Scheme (IIS) requires reviewing. In particular for the MPR, the performance for a number of networks is already beyond the level where rewards are capped[3]. A number of networks will potentially be performing beyond the level where rewards are capped, or close to it, in the second half of RIIO ED1[4]. This means that for some networks, there is no or very limited incentive to improve performance, or even to maintain performance levels. The consumer need for this incentive was established by the inclusion of the scheme in RIIO ED1. It follows that there is a clear consumer need for the effectiveness of this incentive to be maintained

Reviewing the design of an incentive scheme to ensure its effectiveness for consumers is maintained is within the scope of the MPR process. The RIIO-ED1 Strategy Decision is clear that the scope of the MPR includes '*introducing new outputs that may be needed to meet the needs of consumers and other network users*'. We also agree with Ofgem that there is no meaningful distinction between the introduction of new outputs and changes to existing outputs. Therefore, changing the interruptions incentive scheme to ensure that its effectiveness for consumers is maintained qualifies as a change to existing outputs that is needed to meet the needs of consumers and other network users.

This principle could also be applied to other incentives where DNOs may be achieving performance beyond the level where rewards are capped. For instance, there are areas of the Broad Measure of Customer Satisfaction incentive and Time to Connect incentive where many networks are already achieving performance well beyond the level that would provide the maximum reward.

Radio Tele-Switching Service:
The need for the provision of the Radio Tele-Switching Service (RTS) should be examined as part of the MPR, to determine whether an output is needed to meet consumers' needs. The service is currently procured by the Energy Networks Association (ENA) on behalf of the DNOs,

[3] Five networks have already achieved performance beyond the level where rewards are capped.
[4] Two networks would be capping out in 2019/20 if they simply maintained 2016/17 performance. This would become six networks if others improved performance in line with long term improvement rates.

and one DNO requires the service for load management[5]. The ENA recently agreed to extend its contract with the BBC to provide the RTS to March 2020, however it has also been clear that it has no intention of running the RTS past 31 March 2020.

Energy UK is currently carrying out analysis to investigate the extent to which the RTS will still be required beyond March 2020. If it is determined that the RTS is still needed, then the industry, with Ofgem, should work together to agree the optimum solution to ensure that customers do not suffer undue detriment. Obviously one option would be to maintain the status quo. This would require an obligation on DNOs to continue to provide the service.

To assess the options, it will be necessary to understand the current costs of the RTS service and how these are recovered. There is a lack of transparency here, with some DNOs charging explicitly for the service and some not, presumably on the basis that the cost is socialised through DUoS. However, in the latter case, this may suggest DNOs have already been funded through RIIO ED1 to provide the service. Ofgem is best placed to assess these considerations and provide the necessary transparency.

As a part of the MPR, the need for the continuation of the service and, if so, the parties best placed to be responsible for its provision should be investigated. As this could result in a new output required to meet the needs of consumers it is within the scope of the MPR.

Directly Remunerated Services:
At RIIO ED1 Draft Determinations, Ofgem proposed a change in its Strategy Decision policy regarding some Directly Remunerated Services. The proposal was to make a 100% RAV deduction for top-up and standby revenues that some DNOs treated as excluded services during DPCR5. Ofgem confirmed this policy change at Final Determinations[6]. Whilst not within the scope of the MPR, we would welcome confirmation that the same necessary RAV deductions have been made to fast-track licensees. The ED-MPR process is a transparent route to providing this confirmation.

Cost of debt indexation model:
As Ofgem identified during the 2017 Annual Iteration process[7], a data series used in the cost of debt indexation model has not been published by the Bank of England since May 2017. It is stated in the RIIO-ED1 Price Control Financial Handbook[8] that Ofgem will consult on alternatives and any reconciliations that may be needed, However, it is not clearly stated that revenue adjustments

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[5] SSEPD response, page 60: http://www.energynetworks.org/assets/files/news/consultation-responses/ENA%20Response%20to%20Consultation%20on%20RTS%20Future-with%20Appendix1.pdf
[6] RIIO-ED1: Final determinations for the slow-track electricity distribution companies: Overview; para 5.42: https://www.ofgem.gov.uk/sites/default/files/docs/2014/11/riio-ed1_final_determination_overview_-_updated_front_cover_0.pdf
[7] Amendments to Cost of Debt Indexation Model, para 1.2: https://www.ofgem.gov.uk/system/files/docs/2017/11/amendments_to_cost_of_debt_indexation_model_memo_0.pdf
[8] ED1 Price Control Financial Handbook (slow-track licensees), para 5.10: https://www.ofgem.gov.uk/system/files/docs/2017/08/ed1_handbook_v3_slowtrack_0.pdf

will be made to account for the relevant year(s) affected by data not being available for an entire trading days period. Again, whilst this issue is not within in the scope of the MPR, we believe the ED-MPR process is an appropriate route through which this change can be made to the Handbook.

Business Rates – impact of change in Government policy and revaluation:
In the Autumn Budget of 2017, the Government announced that from 2018/19 it would uprate business rates in line with CPI rather than RPI. This significant change in government policy means that the current process of uplifting the ex-ante allowances by RPI is no longer appropriate. The impact of this change is exacerbated by inaccuracies in the ex-ante allowances, arising from difficulties in providing forecasts. DNOs adopted different assumptions with many simply holding costs flat in real terms and others forecasting large increases over the period (up to c. 60% in real terms).

In the event, the outcome of the 2017 revaluation exercise was to slightly reduce the aggregate level of business rates faced by DNOs. However, there are large regional differences and, taken together with the change in Government policy above, this means that in most cases the ex-ante allowance now bears little or no resemblance to the actual costs expected to be incurred. For example, in one area the ex-ante allowance is almost 80% higher than the expected level of business rates for the second half of the price control, resulting in customers in this area pre-funding this DNO by around £30m/yr. In other areas, the ex-ante allowance is c. 25% too low.

Whilst the existing pass-through cost true-up mechanism will still 'work' (i.e. consumers and DNOs will be made whole with a two-year lag), the scale of these variances produces inappropriate funding requests of consumers during RIIO ED1. It also adds unnecessary cash flow risk to the DNOs, which could add to the cost of capital, causing detriment to all consumers in the long term. It is in the interests of all parties that customers pay an appropriate amount for business rates.

As part of the MPR process, we believe that it would be appropriate to consider resetting allowances. This would require a rebasing the ex-ante allowances to reflect the change in Government policy to uprate annual costs by CPI rather than RPI, and to capture the impact of the 2017 revaluation.

To maintain the principles of Ofgem's decision of October 2012 to introduce measures to mitigate charging volatility, and noting that DNOs have already published final prices for 2019/20, we recommend that this rebasing of the ex-ante allowances should not take effect until 2020/21. We estimate this could save consumers around £200m over the remainder of RIIO-ED1.

Chapter 2 Question 3: What are your views on a discrete extension of the ED-MPR scope as described in paragraph 2.30 (rail electrification)?

Rail Electrification falls within the MPR scope as currently defined because of material changes to existing outputs arising from clear changes in government policy. In its RIIO-ED1 business

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plan, WPD committed to deliver outputs (diversion schemes) to support the Rail Electrification programme[9]. WPD also requested funding to deliver those outputs. The Authority consulted on its proposal to 'fast-track' WPD through the price control review and accept its business plan in full[10]. WPD was 'fast-tracked' through the price control review and its business plan, including outputs, was accepted in full[11]. This means that these diversions schemes can be considered to be existing output requirements.

Some diversion schemes which WPD committed to deliver and received funding for are no longer needed because the Government has scaled back the Rail Electrification programme. We agree customers should not be charged for rail electrification costs that have not been incurred. The MPR is an appropriate mechanism through which the funding provided for existing outputs no longer needed because of the clear change in Government policy can be removed.

Chapter 3 Question 1: What are your views on a potential significant extension of scope to capture financial and incentive performance and design?

We believe the issues we have identified fall within the MPR scope as defined in the consultation and set out in the RIIO-ED1 Strategy Decision.

Chapter 3 Question 2: Do you have any views on the other issues raised in this section?

We recommend formalising load index outputs DNOs are expected to deliver by the end of RIIO-ED1. Load indices are a measure of network expansion DNOs have received funding to deliver. This measure was introduced for the fifth distribution price control (DPCR5). The outputs DNOs were required to deliver were formalised in the DPCR5 Final Proposals[12]. These outputs formed the baseline against which performance was assessed for the DPCR5 close-out.

The load index outputs DNOs are required to deliver by the end of RIIO-ED1 have not been formalised. Formalising these outputs will provide transparency ahead of the close-out of the current price control. This is also important given under-spend of expenditure allowances for network reinforcement in RIIO-ED1 is largely explained by external factors outside the DNOs' control[13]. The MPR is an appropriate mechanism through which the load index outputs can be formalised, to ensure that DNOs can be held accountable for delivery of the outputs that consumers have funded them to deliver.

9 RIIO-ED1 BUSINESS PLAN SA-06 Supplementary Annex –Uncertainty para 17.12 - 17.14: https://www.westernpower.co.uk/docs/About-us/Stakeholder-information/Our-future-business-plan/Seperate-documents/Uncertainty.aspx
10 RIIO-ED1: Draft Determination for Western Power Distribution Ltd, para 1.3
11 Decision to fast-track Western Power Distribution, page 1: https://www.ofgem.gov.uk/sites/default/files/docs/2014/02/fast-track_decision_letter.pdf
12 See https://www.ofgem.gov.uk/publications-and-updates/electricity-distribution-price-control-review-final-proposals-allowed-revenue-cost-assessment
13 RIIO electricity distribution annual report 2016-17, para 4.14-4.15: https://www.ofgem.gov.uk/system/files/docs/2017/12/riio-ed1_annual_report_2016-17.pdf