



Making a positive difference  
for energy consumers

To: Electricity Distribution  
Network Operators; interested  
stakeholders

Email: [RIIO.ED1@ofgem.gov.uk](mailto:RIIO.ED1@ofgem.gov.uk)

Date: 15 August 2019

Dear Company Secretaries and stakeholders,

**Proposal to make modifications to the Losses Discretionary Reward Guidance Document**

We propose to make changes to the Losses Discretionary Reward (LDR) Guidance Document. These modifications are to clarify and set out the criteria for tranche three of the LDR. Submissions for tranche three should be made by 29 February 2020 and we expect to publish a decision in summer 2020. Please find enclosed a Notice, issued pursuant to Part C of the Charge Restriction Condition (CRC) 2G.

We welcome comments on our proposed modifications. The details for responding to this letter are contained in the enclosed Notice.

Yours faithfully,

**Steve McMahon**  
**Deputy Director, Electricity Distribution & Cross Sector Policy**

**To: Electricity North West Ltd  
Northern Powergrid (Northeast) Ltd  
Northern Powergrid (Yorkshire) plc  
London Power Networks plc  
South Eastern Power Networks plc  
Eastern Power Networks plc  
SP Distribution plc  
SP Manweb plc  
Scottish Hydro Electric Power Distribution plc  
Southern Electric Power Distribution plc  
Western Power Distribution (West Midlands) plc  
Western Power Distribution (East Midlands) plc  
Western Power Distribution (South Wales) plc  
Western Power Distribution (South West) plc**

**Notice as required under Part C of Charge Restriction Condition (CRC) 2G (the Losses Discretionary Reward)**

Each of the companies to whom this document is addressed is the holder of an electricity distribution licence granted or treated as granted under section 6(1)(c) of the Electricity Act 1989 (the Act).

The Gas and Electricity Markets Authority (the Authority<sup>1</sup>) hereby gives Notice pursuant to Part C of CRC 2G (the Losses Discretionary Reward) as follows:

1. The Authority proposes to modify the Losses Discretionary Reward Guidance Document (the Guidance Document)<sup>2</sup>.
2. The proposed modified Guidance Document is set out in Schedule 1 to this Notice.
3. The reasons why the Authority proposes to modify the Guidance Document is to provide:
  - clarification on what information we want licensees to submit for tranche 3 of the Losses Discretionary Reward (tranche 3);
  - clarification on timelines for tranche 3; and
  - details on the submission and assessment process.
4. Further information on the Losses Discretionary Reward is set out in a number of published documents, including:
  - Strategy decision for the RIIO-ED1 electricity distribution price control – Outputs, incentives and innovation;<sup>3</sup> and

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<sup>1</sup> The terms “we”, “us”, “Ofgem” and “the Authority” are used interchangeably in this letter. The Authority is the Gas and Electricity Markets Authority.

<sup>2</sup>[https://www.ofgem.gov.uk/sites/default/files/docs/2015/10/losses\\_discretionary\\_reward\\_guidance\\_document\\_1.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2015/10/losses_discretionary_reward_guidance_document_1.pdf)

<sup>3</sup> RIIO-ED1 Strategy Decision – Outputs, incentives and innovation, 4 March 2013.

<https://www.ofgem.gov.uk/ofgem-publications/47068/riioed1decoutputsincentives.pdf>

- Decision on the RIIO-ED1 Losses Discretionary Reward Guidance Document.<sup>4</sup>
5. The Authority proposes to issue the Guidance Document in a direction on or after 26 September 2019. We propose that the modifications to the guidance will take effect from that date.
  6. Any representations must be made in writing on or before 12 September 2019 to Chris Haworth at Ofgem, Commonwealth House, 3rd Floor, 32 Albion Street Street, Glasgow, G1 1LH, or by email to [christopher.haworth@ofgem.gov.uk](mailto:christopher.haworth@ofgem.gov.uk).
  7. All responses will be published on our website. However, if you do not wish your response to be made public then you should clearly mark your response as not for publication. We prefer to receive responses in an electronic form so that they can be published easily on our website.

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**Steve McMahon**  
**Deputy Director, Electricity Distribution & Cross Sector Policy**  
**Duly authorised on behalf of the Authority**

**15 August 2019**

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<sup>4</sup> <https://www.ofgem.gov.uk/publications-and-updates/direction-under-part-c-charge-restriction-condition-2g-losses-discretionary-reward-issue-losses-discretionary-reward-guidance-document>

# Losses Discretionary Reward Guidance Document

## 1. Background

1.1. Electricity losses are an inevitable consequence of transferring energy across electricity networks. Electricity losses have a significant financial and environmental impact upon consumers. Effective losses management can therefore protect consumers from unnecessary distribution costs for which customers otherwise have to pay.

1.2. Distribution Network Operators (DNOs) do not pay for electricity lost on their network and therefore have no inherent incentive to manage losses efficiently. We believe a strong incentive is required to ensure that DNOs place an appropriate level of focus on losses reduction activities.

1.3. There is currently no reliable source of data common to all DNOs for measuring electricity losses. Under RIIO-ED1 we introduced several mechanisms, including the Losses Discretionary Reward (LDR), to focus on actions undertaken by DNOs to manage losses.

## 2. Scope and aim of the LDR

2.1. The aim of the LDR ~~scheme~~ is to encourage and incentivise DNO groups to undertake additional actions to better understand and manage electricity losses.

2.2. The reward is worth up to £32m across all DNO groups and will be made available in three tranches over the eight year RIIO-ED1 price control. The reward amounts will be determined in the regulatory years highlighted in Table 1 and collected by DNOs through their network charges the following regulatory year. The reward is discretionary. If, in the Authority's view, none of the applications ~~in the Authority's view~~ meets the criteria, no reward it will not be award any reward awarded.

Table 1: *Maximum value of the LDR across all DNO groups as set out in Licence Condition CRC 2G (£m 2012/13 prices)*

Tranche	To be determined in Regulatory Year (ie t-1)							
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
First		8.0						
Second				10.0				
Third						14.0		

2.3. Standard Licence Condition (SLC) 49 requires DNOs to ensure that Distribution Losses from its Distribution System are as low as reasonably practicable, and to maintain and act in accordance with its Distribution Losses Strategy. ~~In reviewing their Strategies~~ we expect DNOs to modify and update ~~them~~ their strategies to reflect the latest losses environment and to accommodate lessons learnt and stakeholder feedback.

2.4. The LDR is not intended to reward DNOs for the activities associated with the ongoing review of their Distribution Losses Strategy. This is a requirement of their licence. DNOs must have a Distribution Losses Strategy in place that ensures that Distribution Losses are as low as reasonably practicable regardless of whether any LDR reward is received.

### 3. Tranche focus

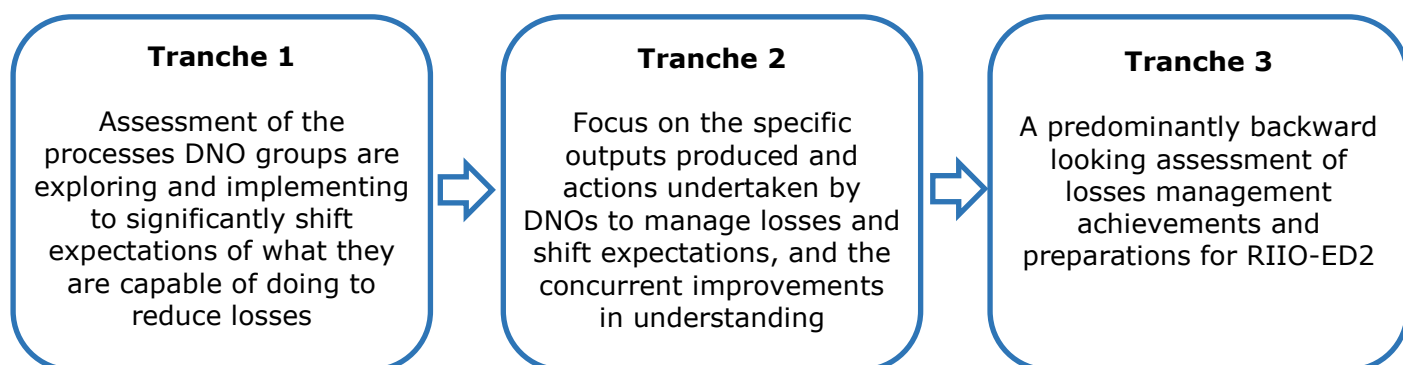
3.1. The focus of each tranche can change over time – this includes the criteria used to judge DNO groups LDR applications, any weighting of these criteria, and how the reward is allocated amongst DNO groups.

3.2. This is to ensure the LDR continues to reflect the latest losses environment faced by the DNOs over the eight years of RIIO-ED1 and to accommodate lessons learnt and stakeholder feedback. For example to reflect:

- the likely increase in the availability of losses data (e.g. from the rollout of smart meters);
- the development of methodologies to estimate and/or measure losses; and
- increased evidence of additional losses reduction actions undertaken by DNOs that will become available during the price control.

3.3. Figure 1 below provides an indicative view of the main areas of assessment that each tranche may look to reward over the eight years of RIIO-ED1.

Figure 1: *Indicative areas of assessment for each LDR tranche*



#### *Tranche 1*

3.4. The assessment focus in tranche one was predominantly forward looking. As such, the focus was on the *processes* and methods DNO groups are exploring and implementing to *understand* and ultimately *manage-better manage* the losses on their networks. DNO groups had the opportunity to evidence *how* these processes and methods may be enabling (or have already enabled) them to significantly shift the expectations of what DNOs are capable of doing to reduce losses. Over the course of RIIO-ED1, this work may reveal activities that we will then expect to see incorporated into the Distribution Losses Strategies of all DNOs in accordance with their licence.

#### *Tranche 2*

3.5. In tranche two, as the price control ~~progresses~~progressed, the focus ~~will~~ shift~~shifted~~ from an assessment of the processes outlined above, to one of specific actions undertaken and concurrent improvements in understanding. We ~~would expect~~ expected DNO groups to be able to provide evidence of actions they have taken to improve their operations in respect of managing losses including, where appropriate, demonstrating how they have built upon the processes set out in tranche one. Again ~~we'd expect~~we expected to see evidence of how these actions ~~are~~were significantly shifting the expectations of what DNO groups should be doing to keep losses as low as reasonably practicable. As such, we ~~expect~~expected the assessment process in the second tranche to be both forward and backward looking.

3.6. The criteria against which DNO groups ~~were~~ will be required to provide evidence are set out in Section 4. We ~~do did~~ not ~~intend to reward submissions which have not provided~~ consider sufficient evidence was provided for each criterion to justify a reward for each DNO.

### *Tranche 3*

3.7. Although we did not consider sufficient evidence was provided for each criterion to justify a reward for each DNO in tranche 2, there is still the potential for awards to be made in tranche 3 if a DNO group shows that it has fully met all the four criteria for the work already undertaken, and for how that will feed into RIIO-ED2. Please note each Appendix states where it was felt each DNO fell short in its tranche 2 submission.

~~3.7.3.8.~~ In tranche three we expect the assessment process to be predominantly backward looking with the focus on losses management achievements and the ~~improvement~~improved in understanding of the impacts of losses on networks. We also expect to see evidence of how DNO groups are preparing for a measureable losses incentive in RIIO-ED2.

~~3.8.3.9.~~ We recognise that in ~~both tranches two and~~tranche three we will also need to assess the *potential* for DNO groups to have undertaken additional cost-effective actions with the differences in local distribution networks in mind. In all three tranches we expect the sharing of best practice and stakeholder engagement to remain key criteria.

3.10. If there are particular steps being taken collectively through the Energy Networks Association (ENA), rather than individually, then this can be highlighted, with evidence, in the DNO groups submission.

## **4. Submission process for ~~second~~third tranche**

4.1. DNO submissions for tranche ~~two~~three will be due by ~~29~~28 February ~~2018~~2020 (see Figure 2 below). If Ofgem requires any clarification on points in the submissions, we will raise this with the DNOs by April 2020. After assessing the submissions, our decision will be published in summer 2020.

4.2. We continue to expect DNO groups to provide evidence that they have effective processes in place that will allow them to fully meet **all** of the criteria below. DNO groups should demonstrate they have considered each of the points listed under each criterion. DNO groups may, however, present additional information they consider relevant to meeting the criteria.

4.3. If DNO groups include processes in their LDR submission that are referenced in their Distribution Losses Strategy it must be made clear how these processes are (or are expected to) shifting the expectations of what DNOs are capable of doing to reduce losses (as noted in section 2). The same applies to any processes listed in an LDR submission that do not form part of a DNO's Distribution Losses Strategy.

4.4. The four criteria against which the submissions will be assessed are set out below. For each criterion DNOs ~~DNO groups~~ must demonstrate they are shifting the o expectations of what they are capable of doing to reduce losses:

**a. Understanding of losses**

- Are DNO groups able to demonstrate how they are continuing to improve their understanding of the current level and sources of losses on their networks (including through the use of smart meter data)?
- Are DNO groups considering the network in a holistic manner and making efforts to understand how losses and their actions to manage losses on their network affect others e.g., those on the transmission and/or other distribution networks in an integrated way with their network capacity management and considering the needs of their stakeholders?
- What improvementsprogress have DNO groups made since tranche enetwork and how has their understanding of losses developed? Can they identify areas (from tranche enetwork) that have allowed them to improve their understanding of losses?

**b. Effective engagement and sharing of best practice with stakeholders on losses**

- How are DNO groups planning to utilise stakeholder engagement to inform their losses management actions and allow them to understand their impact? How have DNO groups already engaged with stakeholders in this regard?
- How are DNO groups engaging with stakeholders (e.g. suppliers, distributed generators, the TSO, TOs etc.) to develop relevant partnerships which may help to manage losses (e.g. opportunities to use Demand Side Response)? This could include initiating a joint project where a reduction in losses is the primary driver or identifying opportunities within existing projects to help manage losses.
- Are DNO groups able to demonstrate that they have processes in place to share their own best practice with relevant stakeholders by identifying any outcomes of tranchetranches one and whattwo that they intend to do/carry on doing. This could include engaging with one another, the Transmission System Operator (TSO) and the Transmission Owner (TO) to facilitate a holistic and co-ordinated approach to losses management as they transition to DSO roles.

- DNO groups must verify that any stakeholder engagement actions are not already rewarded under the Stakeholder Engagement incentive that forms part of the Broad Measure of Customer Service to ensure the same activity is not rewarded multiple times.<sup>5</sup>
- Following tranche ~~one~~two, what collaboration have DNO groups had with each other and other stakeholders? How have they ensured and how will they continue to ensure collaboration on losses management?

**c. Processes to manage losses and proposals for RIIO-ED2**

- Do DNO groups continue to look at best practice, both nationally and internationally, when considering processes and methods to manage losses on their networks? What have DNO groups learned from tranche one and two, which they have used or will intend to use going forward?
- How are companies preparing to effectively use smart meter data to develop specific actions to manage losses? What processes do the DNOs have in place now, following tranche one and two submissions?
- Have the DNO groups considered whether any of the actions they have taken from ~~tranche~~tranches one ~~and tranche~~, two and three will help feed into RIIO-ED2 on losses?
- What have the DNO groups considered for RIIO-ED2 when understanding and managing losses? We expect DNOs to have taken learning from the LDR in RIIO-ED1 to create proposals for how losses incentives should be managed in RIIO-ED2.

**d. Innovative approaches to losses management and actions taken to incorporate these approaches into business as usual activities**

- How are DNO groups planning to use innovative approaches to manage losses (including through the use of smart meter data) outside of projects funded through the RIIO-ED1 price control and the innovation stimulus mechanisms? What innovative approaches have DNO groups identified from ~~tranche~~tranches one and two?
- How will DNO groups incorporate these approaches into “business as usual” activities? Have the DNO groups incorporated any innovative approaches set out in ~~tranche~~tranches one and two to BAU?
- DNO groups must verify that the innovative activities are not funded under any other RIIO-ED1 financial initiatives. This is to ensure DNOs are not rewarded multiple times for the same activity. The aim of the LDR is to encourage DNO groups to undertake additional losses reduction actions over and above those set out in their business plans. For example, these might include identifying more cost effective and innovative ways of utilising the allowed revenue to enhance the reduction of losses.

**5. Assessment Process and reward allocation**

*Assessment Process for tranche ~~two~~three*

<sup>5</sup> <https://www.ofgem.gov.uk/ofgem-publications/87494/edseincentive-guidancedoc.pdf>



5.1. In the secondthird tranche of the reward, we expect each of the criteria will have the weightings<sup>6</sup> set out in table 2 below: we will consider any arguments proposed for amending the weighting based on their merits.

Table 2: Weightings for tranche two of the LDR

Criteria	Weighting
Understanding of losses	<del>30%</del> <u>25%</u>
Effective engagement and sharing of best practice with stakeholders on losses	<del>25%</del> <u>20%</u>
Processes to manage losses <u>and proposals for RIIO-ED2</u>	<del>30%</del> <u>40%</u>
Innovative approaches to losses management and actions taken to incorporate these approaches into business as usual activities	15%

5.2. DNO groups must provide an appropriate level of evidence under each category to be considered for a reward. If DNO groups fail to meet one or more of the criteria, they will not be entitled to any of the reward.

5.3. Each submission received will initially be assessed by Ofgem to ensure this is the case and that the requirements set out in Section 4 have been met. If required, we will ask DNO groups supplementary questions to clarify aspects of their submission. We would not expect this process to result in changes being made to their submission.

5.4. The submissions will be published on our website.

5.5. If we judge a DNO group to have failed to provide sufficient evidence under one or more of the criteria, it will not be eligible to receive a reward under this tranche of the LDR and the submission will be deemed unsuccessful. This is to ensure DNO groups provide a well-rounded submission addressing all the relevant areas outlined above.

5.6. We may use expert help at any point in the process to help inform our assessment. Our decision will be published in the summer following the assessment window. Our decision will set out which DNO groups have been judged as successful and unsuccessful as well as the level of reward for each applicant.

#### *Reward allocation*

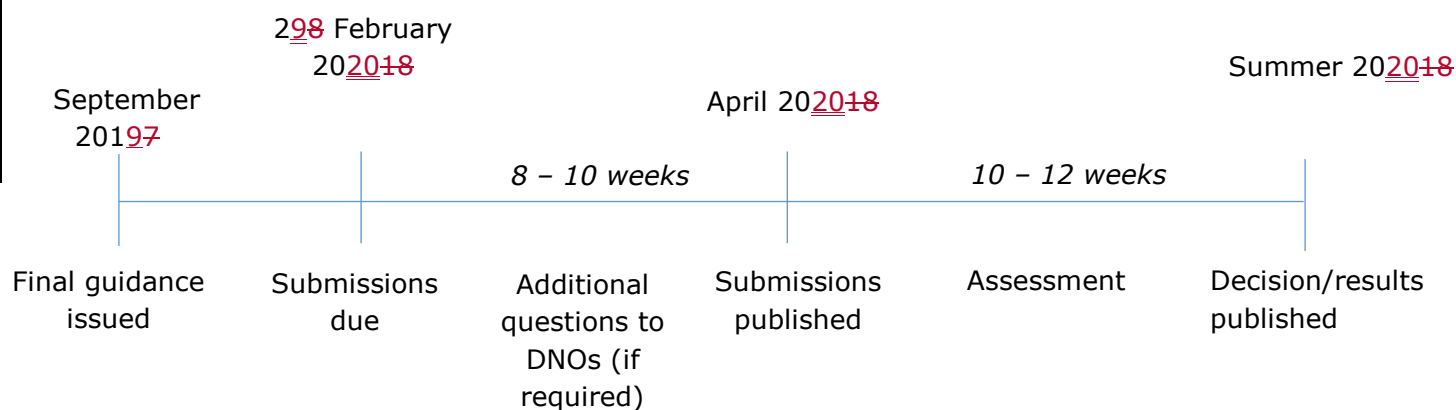
<sup>6</sup> The weightings set out the share of the reward available to the DNO groups under these criteria.

5.7. In the ~~second~~third tranche the total reward pot is ~~£10m~~£14m as outlined in Table 1 above. This reward pot will be divided equally between each submission deemed successful following the assessment process outlined above. For example, if we receive six submissions but judge only four to have provided adequate evidence under each category then the maximum reward amount for each DNO group will be ~~£23.5m~~ (~~£10m~~£14m divided by four).

5.8. When allocating the reward amounts for successful submissions, the amount of money awarded could be set at, or below, the maximum amount available for a DNO group. This will be dependent on the extent to which we consider DNO groups are meeting and exceeding the criteria set out above.

5.9. If a DNO group is successful and rewarded under the LDR, the reward will be spread equally across each of its licensees unless it is made clear in the LDR submission that certain parts of the submission do not apply to all of the licensees within the group.

Figure 2: *Indicative timetable for ~~Tranche two~~tranche three of the LDR*



5.10. The assessment process and allocation of the reward pot between DNO groups may change for ~~tranches two and~~tranche three. A DNO's performance in a prior tranche will not affect how we assess subsequent submissions.

~~We will review the guidance in the January of the year before submissions are due (2019) for tranche 3. Following engagement with DNO groups an updated version will be produced and circulated before a formal consultation on the guidance is published in the spring. A revised version~~A revised version of the guidance will be consolidated over the summer and published by September 2019.

## 6. Format of application

6.1. The LDR application should take the format of a PDF Document and the main body of the application is limited to ~~20~~25 pages. There is a minimum permitted font size of ten.

6.2. The DNO groups can include images and tables where appropriate. If evidence is required that cannot be referenced or succinctly included in the application, this evidence should be added as an appendix to the application. The appendix should not exceed an additional ~~2015~~ pages.

6.3. Submissions must be made on a group, rather than licensee, basis.

6.4. DNO groups must structure their LDR application under each of the criteria headings specified in section 4.

All tranche ~~two-three~~ submissions should be emailed to [RIIO.ED1@ofgem.gov.uk](mailto:RIIO.ED1@ofgem.gov.uk) by ~~298~~ February ~~2018~~2020.