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Dear Steve,

I am writing in response to your call for evidence on a potential RIIO-ED1 mid-period review. This submission is entirely non-confidential and may be published on your website.

Citizens Advice would support the use of an ED1 mid-period review that focussed on resolving the problems of over-remuneration identified in our recent report, Consumers Missing Billions, which is appended to this submission.

Consumers Missing Billions identified deficiencies in the parameterisation of five key aspects of the ED1 settlement:

- The cost of equity;
- The risk free rate;
- The equity beta;
- The cost of debt; and
- The calibration of incentives, including on totex.

If unchecked, these deficiencies will result in consumers bearing the costs of significant excess profits that are entirely unjustified, unreflective of performance and in excess of what is required to stimulate investment in the sector. They may also undermine the credibility and durability of the regulatory regime.

Our central forecast was that these deficiencies would result in consumers paying £7.5bn more than they needed to over the course of the RIIO1 price controls, of which £2.3bn related to the electricity distribution networks.

The Strategy Decision for the RIIO-ED1 price control sets out narrow constraints on what a mid point review could cover:

> “The scope of this review will be restricted to material changes to outputs that can be justified by clear changes in government policy, and the introduction of new outputs that are needed to meet the needs of consumers and other network users.”

Those constraints are inconsistent with Ofgem’s past decisions on re-opening electricity distribution price controls. In 2012, it took the decision not to activate the electricity distribution losses incentive in DPCR5[1] following concerted campaigning by a number of distribution network operators (‘DNOs’). The DNOs argued that data cleansing activities conducted by suppliers in the preceding years had had the effect of altering their losses position for reasons outside their control, and that they would be unreasonably penalised as a consequence. Several DNOs[2] argued that the incentive largely rewarded or penalised them for factors that were outside their control - a point they were silent on when uncomplainingly receiving several hundred million pounds in rewards under the preceding DPCR4 losses scheme.

In explaining its choice not to activate the DPCR5 losses incentive, Ofgem signalled that the manifestation of material windfalls - of a network being rewarded or penalised for factors outside its control - could justify the modification of a price control that was ongoing.

[1] DPCR5 covered the years April 2010 - March 2015.
[2] ‘We do not believe that the DPCR5 mechanism provides any incentive for DNOs to invest in losses reduction as the outcome is largely outside their control.’ - Electricity North West, in its response to the July 2012 consultation on whether the incentive should be scrapped. ‘The DPCR5 losses incentive mechanism does not incentivise a DNO to reduce losses because any decisions that a DNO may make that could lead to reduced or increased electrical losses are swamped by the impact of decisions that are made by suppliers about how to report or adjust settlements data.’ - Northern Powergrid, in its response to the same consultation.

'Suppliers and DNOs have highlighted that DNOs have no influence or control over the way in which settlement data affects losses performance.

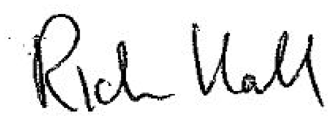
Neither Ofgem nor the DNOs can have certainty that measurement of losses using settlement data reflects any loss reduction actions taken. [...]

We cannot continue to support an incentive mechanism that results in unpredictable rewards and penalties of the scale seen and we have therefore decided not to proceed with activating the DPCR5 losses incentive mechanism.[3]

In our view, the only difference between the windfalls that would have materialised under the distribution losses incentive and those that are identified in Consumers Missing Billions is their direction. In both cases, they are unconnected to network performance. Having stepped in to protect networks from windfall losses under the DPCR5 losses regime, Ofgem should now step in to protect consumers from windfall losses under the ED1 regime.

We would be happy to discuss any issues raised in this submission in more depth.

Yours sincerely,



Richard Hall
Chief Energy Economist

[3] 'Decision not to activate the Losses Incentive Mechanism in the Fifth Distribution Price Control,' Ofgem, 16 November 2012. http://tinyurl.com/ydxkca5j