



Promoting choice and value
for all gas and electricity customers

Decision in relation to measures to mitigate network charging volatility arising from the price control settlement

Final decision

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Overview:

One of the key issues raised by stakeholders during the current price control reviews is network charging volatility arising from the price control settlement. We published a consultation on options to mitigate network charging volatility, and its effects, in order to seek respondents' views.

Following consideration of the responses to our consultation, we are now publishing this decision. In this document we outline our decision in relation to the five options set out in our consultation. We also set out how we intend to take these decisions forward in the context of setting price controls for the four regulated energy networks: gas transmission, gas distribution, electricity transmission and electricity distribution.

Associated documents

Consultation

- [Mitigating network charging volatility arising from the price control settlement \(ref 52/12\)](#)

Price control reviews

- [RIIO-GD1: Initial Proposals \(ref 103/12\)](#)
- [RIIO-T1: Initial Proposals for National Grid Electricity Transmission and National Grid Gas \(ref 104/12\)](#)
- [RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd \(ref 58/12\)](#)
- [RIIO-ED1: Consultation on strategy for the next electricity distribution price control \(ref 122/12\)](#)
- [Decision on strategy for the next transmission price control – RIIO-T1 \(ref 46/11\)](#)
- [Decision on strategy for the next gas distribution price control – RIIO-GD1 \(ref 47/11\)](#)
- [Decision on strategy for the next transmission and gas distribution price controls -RIIO-T1 and GD1 Uncertainty mechanisms \(ref 47/11\)](#)
- [RIIO price control glossary](#)

RPI-X@20

- [Regulating energy networks in the future: RPI-X@20 decision \(ref 128/10\)](#)



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Executive Summary

In April we published a consultation seeking views on network charging volatility arising from the price control settlement and the effect it is having on the efficiency of the energy market, notably, the impact on consumers' bills. We set out five options we considered could be implemented to improve the predictability and/or stability of network charges which could potentially benefit consumers.

We are currently undertaking price control reviews for the gas and electricity transmission networks (referred to as RIIO-T1), the gas distribution networks (RIIO-GD1), and the electricity distribution networks (RIIO-ED1). The decisions set out in this document will be adopted in finalising arrangements for the next price control periods.

Scope of our consultation and assessment

Volatility in network charges may result in higher bills for energy customers. Suppliers have told us that when offering fixed price contracts to customers they include a risk premium to compensate them for the risk associated with unexpected changes in network charges. Thus, a reduction in network charging volatility could reduce the network related risk premium, and reduce energy bills to customers. A reduction in network charge volatility could also reduce suppliers' cash-flow volatility, reduce the cost of entry to the supply market, and facilitate entry, particularly for small suppliers. We also note that reducing volatility in network charges could reduce administration costs, ie through reducing the frequency of bill changes. We also understand that customers on non-fixed price contracts value stability in network charges.

Our principal criterion in assessing options to address network charging volatility was to consider which party is best placed to bear the cash-flow risk associated with changes to network companies' (NWOs') allowed revenues. For example, improving the predictability of network charge changes or reducing the number of changes, will reduce the risk to suppliers and lead ultimately to lower customer bills. However, limiting NWOs' ability to recover costs when incurred may place additional cash-flow risk on them and lead to higher network charges overall. We consider that the options we will implement (as described below) will improve the predictability of network charge changes without any increase in risk for NWOs, and therefore result in lower overall customer bills.

Our consultation examined options for addressing network charging volatility arising from the price control settlement, ie the process for determining and adapting total revenue allowances. We did not address charging volatility arising from the application of the charging methodologies, ie how total allowed revenues are recovered from different customers. These methodologies are subject to separate network code governance processes and we are working with industry to address network charge volatility related issues through the respective codes.

Our decision on which options to take forward

The responses to our consultation broadly supported implementing changes to the price control settlement as set out in options 1 to 3 of our consultation. The views

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expressed in relation to implementing options 4 and 5 were more mixed. Following consideration of responses, we consider that there are a number of changes to the price control settlement that we can make to improve the predictability, and also the stability, of network charges. We have summarised our decision in Table 1 below.

Table 1: Options and our decision

Option	Our decision
1 Improved information for suppliers and customers	Implementing
2 Restricting the frequency of intra-year charge changes	Implementing
3 Increasing the lag on incentive rewards/penalties that networks recover through allowed revenues	Implementing
4 Increasing the lag on adjustments to allowed revenues from uncertainty mechanisms	Implementing for some types of uncertainty mechanisms
5 Imposing a cap and collar on changes to allowed revenues	Not implementing

We consider that improvements to the price control framework can be made in relation to implementing changes identified in options 1 to 4. These improvements are predominantly designed to improve the predictability of allowed revenues and therefore network charges, ie there will be a period of notice between knowing an adjustment will take place and it impacting network charges. In general, we expect our decision to result in greater certainty in relation to changes to allowed network revenues over a forward-looking two-year period.

In relation to option 5 we do not intend to implement caps and collars to allowed revenues. We do not consider a cap and collar would improve the allocation of risk, or be beneficial to customers, given the improvement to predictability being introduced under options 1 to 4.

Implementation and next steps

For the transmission and gas distribution sectors, we will implement this decision for the start of RIIO-T1 and GD1 on 1 April 2013. The changes to the licence required to enact this decision will be included in the ongoing RIIO-T1 and GD1 licence process, including an informal licence consultation in the autumn and a statutory consultation in December 2012.

The price control review for the electricity distribution sector, RIIO-ED1, has recently commenced with the publication of our strategy consultation in September 2012.¹ For this sector, our decision will be taken forward as part of the development of the next price control settlement, ie we will not be implementing any changes to the licence until 1 April 2015. However, we will consider whether there are any changes in relation to option 1 (improved information provision) that can be taken forward in advance of the new electricity distribution price control.

¹ See associated documents for a link to the RIIO-ED1 strategy consultation

1. Introduction

Chapter Summary

This chapter summarises the options set out in our consultation. We also discuss the scope of our consultation and this decision. We set out our characterisation of the problem associated with charging volatility, and our criteria used to assess the options, taking into account respondents' views.

Consultation options

1.1. We published a consultation on network charging volatility in April 2012.² The purpose of this consultation was to seek views from stakeholders on the causes and impact of network charging volatility, and their views on our proposed options for mitigating such volatility.

1.2. We set out five options that could potentially improve both the predictability and stability of network charges by making adjustments to the price control frameworks within which network companies (NWOs) operate. We set out our initial assessment of each option and sought views from respondents on these proposals. This is set out for information in Table 1.1 below. Our initial assessment suggested that: options 1 to 3 were likely to be beneficial to consumers; we would consider the lagging of uncertainty mechanisms – under option 4 – on a case-by-case basis; but the implementation of option 5 – a cap and collar on revenue changes – was unlikely to be beneficial. We set out the reasons for our initial assessment in chapter 3 of our consultation.

Table 1.1: Recap of consultation options and our initial assessment

Option	Initial assessment
1 Improved information for suppliers and customers	Reduces risk to suppliers, and reduces risk premium No additional risk for NWOs and low cost Implementation likely to be beneficial
2 Restricting the frequency of intra-year charge changes	Reduces risk to suppliers with limited additional risk for NWOs Implementation likely to be beneficial
3 Increasing the lag on incentive rewards/penalties that networks recover through allowed revenues	Reduces risk to suppliers with limited additional risk for NWOs Implementation likely to be beneficial
4 Increasing the lag on adjustments to allowed revenues from uncertainty mechanisms	Reduces risk to suppliers but at cost of increased risk for NWOs Consider changes on a mechanism-by-mechanism basis
5 Imposing a cap and collar on changes to allowed revenues	Reduces risk to suppliers but potential material additional risk for NWOs Implementation unlikely to be beneficial

² See associated documents for a link to 'Mitigating network charging volatility arising from the price control settlement' (ref 52/12)

Scope of our consultation and decision

1.3. Network charges account for around 23 per cent of the typical domestic electricity bill and 21 per cent of the typical domestic gas bill.³ These percentages will vary for non-domestic customers. The remaining proportion of the bill is comprised of a number of charges including the supplier's wholesale energy charge, supply costs and profit margin, and government environmental programmes.

1.4. The causes of network charging volatility (ie changes to around a quarter of a domestic customer's energy bill) result from changes in the allowed revenues that NWOs are able to recover through charges to consumers, and the application of the charging methodologies which set out how the total revenue allowance is recovered from different customer classes.

1.5. As set out in our consultation document, the scope of our consultation and this decision relate to charging volatility arising from the price control settlement. We acknowledge that the application of charging methodologies also leads to charging volatility (for individual customers, if not for revenues as a whole). However, a review of the charging methodologies lies outside the scope of this decision. As set out in our consultation, the methodologies are subject to open governance, that is, network users can raise changes to the methodologies for approval by us. We will continue to work with industry participants to bring forward modification proposals to improve the charging methodologies, including modifications aimed at addressing charging volatility.

1.6. This decision applies to all four price controlled sectors. In relation to timing, we will ensure the new electricity and gas transmission, and gas distribution price controls (respectively referred to as RIIO-T1 and GD1) reflect our policy decisions on charging volatility set out in this document. The price controls will come into effect on 1 April 2013, and we expect to undertake a licence statutory consultation towards the end of 2012.

1.7. In relation to electricity distribution, we intend to introduce changes for the next price control (referred to as RIIO-ED1) which will come into effect on 1 April 2015. We consulted on introducing requisite licence changes for the remaining two years of the current price control (DPCR5). However, respondents raised concerns about making changes to the current regulatory framework. Consistent with respondents' views, we do not intend to introduce changes to the current electricity distribution price control to avoid changing the terms of the price settlement. We are also concerned that making licence changes mid-period could itself constitute a source of charging volatility. However, we expect that improvements can be made in relation to option 1, improved information provision, prior to the start of the next price control.

³ For further details see our factsheet, "Updated household energy bills explained" (May 2012): <http://www.ofgem.gov.uk/media/factsheets/Documents1/household-bills.pdf>

Why is network charging volatility a problem?

1.8. In our consultation document we set out our understanding of why network charging volatility presented a problem for suppliers and consumers. We invited respondents' views on whether we had correctly characterised the problem.

1.9. We noted that a number of suppliers had told us that when offering fixed price contracts to customers they include a risk premium to compensate them for the risk associated with unexpected changes in network charges. These are changes which they would not be able to recover from the customer for the term of the contract. Suppliers also stated that reduced network charge volatility could reduce their own cash-flow volatility and reduce the costs of entry (eg in terms of working capital), facilitating entry for new suppliers. Therefore, a reduction in charging volatility could reduce supplier risk, and customer bills, as well as improving competition in the retail market.

1.10. We also stated that we considered that the focus should be on developing options to improve the predictability of changes to charges as opposed to stability of charges. Our reason for developing options to improve predictability was based on the premise that if suppliers understand how charges will evolve, they can incorporate such changes in the contracts they offer customers and this should reduce any risk premium included in suppliers' contract offers.

1.11. We also noted in our consultation that stability of charges would also help improve the efficiency of energy markets by reducing administration costs, eg the costs of suppliers notifying customers of changes in charges. It would also help consumers to manage their budgets, especially consumers on contracts where network charges are directly passed on. However, we considered that stability of charges was a secondary objective relative to improving predictability of charge changes.

1.12. The majority of respondents agreed that improving the predictability of charges should be the primary objective, however some also noted the importance of stable charges particularly for those consumers on non fixed price contracts, where any change in network charges may be passed on to them by their supplier. One response suggested that we had not considered in sufficient detail the impact on end consumers and had focused on the impact to suppliers. Our principle concern is the impact that network charging volatility has on consumers. To address this we must address the impact on suppliers as the majority of consumers purchase energy, and therefore pay network charges, through a contract with a supplier.⁴

⁴ There are some consumers connected to the transmission and distribution networks who will contract directly with the NWO.

Assessment criteria

1.13. In our consultation document we set out proposed criteria for assessing the options and we invited stakeholders' views. The principal criterion we identified was the consideration of which party was best able to manage cash-flow risk in relation to network charges. We also identified secondary criteria to be the potential complexity of any changes and consistency of any changes with other Ofgem policy proposals. Broadly, we have undertaken our final assessment of options using our stated criteria.

1.14. We discuss each of these criteria in turn below including a discussion of points raised by respondents.

The allocation of risk

1.15. Our aim, in introducing any option to mitigate network charging volatility, is to reduce the overall level of risk or allocate risk to the party that can bear such risk most efficiently.

1.16. Suppliers have told us that when offering fixed price contracts to customers they include a risk premium to compensate them for the risk associated with unexpected changes in network charges. Thus, a reduction in network volatility could reduce the network related risk premium, and reduce energy bills to final customers. A reduction in network charge volatility could also reduce suppliers' cash-flow volatility, and reduce the cost of entry. This could therefore facilitate entry to the supply market, particularly for small suppliers.

1.17. In addressing network charge volatility and reducing risk to suppliers, there could however be an impact on the cash-flow risk of NWOs if they were unable to recover their costs in a timely way. This time delay could result in higher financing costs for the NWOs, and ultimately an increase in network charges.

1.18. We note that a number of respondents considered that the cost to a NWO of bearing this risk would always be lower than for a supplier, implying that we should allocate all cash-flow risk to NWOs. We acknowledge that the financing costs for NWOs are relatively low, and potentially lower than energy supply businesses. However, this does not imply that all risk should be allocated to NWOs. The marginal cost of financing for NWOs could be high if the price control arrangements did not allow NWOs to recover costs in a timely way, and the increase in NWOs' financing cost could be higher than the cost of managing the risk for suppliers (who can pass through network charges to end consumers). Overall, we consider that there is a balance to be struck between increasing the delay of cost recovery for NWOs, and the subsequent impact on their financing costs, and any network charge related risk premium included in contracts offered by suppliers.

1.19. For each option, we have considered who is best placed to manage cash-flow risk. We take into account the cost to suppliers (and ultimately their customers) and

the cost to NWOs of changing the allocation of risk. We note that option, improved information provision, does not reallocate risk, but instead should result in an overall reduction in risk and an overall benefit to consumers (assuming the information provision is not costly to provide).

1.20. Our assessment of the impact of each option on risk allocation is based on qualitative analysis. We do not consider that we can subject this to quantitative analysis as we cannot robustly estimate the main costs or benefits.⁵ However, our policy decision focuses on introducing changes where we consider the prospective benefits in terms of reduced supplier risk are likely to be large, and any offsetting cost in terms of NWO cash-flow risk is minimal.

Transparency and complexity of the regulatory framework

1.21. The RIIO framework provides rewards for NWOs that exceed prescribed output and service levels, and penalties for NWOs that fail to deliver the requisite output and services. One outcome of this framework is a more timely adjustment to revenues to reflect a NWO's performance. This provides a clearer view of performance to investors in the sector and provides a timelier signal to management to improve performance for the benefit of consumers. In assessing the options we have considered if there is any detrimental impact on the intentions of this framework.


1.22. We have also considered whether each option would introduce additional complexity to the price control framework, and whether this complexity is warranted. Additional complexity may reduce the transparency of the price control arrangements and this could undermine any intended benefits. Complexity may also introduce additional regulatory costs to participants.

Our wider objectives and related policy development

1.23. Our assessment of each option considers links to related Ofgem and wider policies, eg energy tariff simplification as part of our Retail Market Review and our work in relation to independent suppliers. We have evaluated the impact of our decision with this in mind. We consider that improved predictability will be beneficial by providing greater transparency around the network charge element of a consumer's energy tariff.

1.24. One respondent suggested that we consider links to wider policy, from bodies such as the Department of Energy and Climate Change (DECC) and the European

⁵ That is, a quantitative cost benefit analysis would need to estimate (i) the risk premium included in suppliers' tariffs to customers in relation to volatile charges; (ii) the expected reduction in supplier risk premium from the proposed measures; and, (iii) any perceived increase in NWO cash-flow risk and financing cost. We do not consider that we can estimate these elements quantitatively in a robust way.



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Parliament, that may impact on the way NWOs must charge for the services that they provide. We are aware of the current development of European network codes in relation to tariff structures. We consider that our decision in relation to each option does not have any detrimental impact on this work.

1.25. A number of respondents raised concerns that options to mitigate network charging volatility may have a detrimental impact on the cost reflectivity of charges. For example, restricting the amount of allowed revenues that can be recovered in any given year, or restricting the timing of network charge changes would impact how much a consumer pays for the services it receives in any given year. We have considered this interaction with the application of the charging methodologies when making our decision.

2. Decision on options

Chapter Summary

This chapter outlines our decision on each of the five options we set out in our consultation. We provide a brief summary of responses received and explain the reasons for our decision. We also discuss additional proposals brought forward by respondents.

2.1. Our consultation outlined five options to help mitigate volatility by improving the predictability of revenue adjustments and/or improving the stability of allowed revenues.

2.2. Our decision supports our initial assessment of the options put forward in the consultation. We intend to implement changes in relation to options 1 to 4. Our assessment of each option is against the criteria set out in chapter 1. Table 2.1 summarises this assessment.

Table 2.1: Our decision on the five options

Option	Assessment against criteria	Our decision
1 Improved information	Reduces overall risk Limited additional cost	Implement change
2 Intra-year charge changes	Improved balance of risk Simplifies arrangements	Implement change
3 Lagging incentive rewards/penalties	Improved balance of risk Framework not materially weakened	Implement change
4 Lagging uncertainty mechanisms	Improved balance of risk for some mechanisms May weaken signals to investors	Implement change: dependent on type of mechanism
5 A cap and collar allowed revenues	Does not improve balance of risk Adds complexity	Not implementing

2.3. We set out the detail of our decision in relation to each option below.

Option 1: Improved information provision

2.4. We sought views, under this option, on what information would be of most use to parties in order to improve the predictability of both changes to allowed revenues and network charges. We considered that there were improvements that both we and NWOs could make to improve information provision and therefore the predictability of charges.

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2.5. We did not identify any negative consequences of implementing improvements. We considered that improving the information provided would be relatively low cost but that the improvements in predictability would reduce the risk on suppliers and therefore reduce overall energy costs to consumers.

Respondent's views

2.6. The majority of responses were supportive of our view that improvements could be made to the provision of information regarding changes in allowed revenue and charges, although some respondents considered that existing process were already adequate in this regard.

Industry information

2.7. One of the intentions of our consultation was to gather views on existing processes to ensure that they are fit for purpose. Respondents provided comment on the current information requirements which we outlined in chapter 3 and appendix 3 of our consultation. Respondents also noted additional routes for information provision which we had not listed, namely:

- Electricity Distribution: Annual Review Pack produced in line with Schedule 20 of the DCUSA.⁶ It sets out historical and forecast (for a period of five years) allowed revenues and network charges for the majority of electricity consumers.⁷
- Electricity transmission: The System Operator (SO) –Transmission Owner (TO) Code (STC) sets out timescales for notification of revenues by the TOs to National Grid (in its role as SO).⁸ TOs (including offshore TOs (OFTOs)) are required to provide a best forecast of revenue for the following year by 1 November and a final forecast by 25 January.

2.8. Concerns were raised that additional information could become a burden on all parties, both on the NWO in providing the information and the supplier or consumer in interpreting the information. It was noted that this in itself could introduce inefficiencies to the process. It was also noted that there is a cost in the production of information.

⁶ The Distribution Connection and Use of System Agreement (DCUSA) is the industry code for the electricity distribution sector. See DCUSA document:

<http://www.dcusa.co.uk/Public/DCUSADocuments.aspx?s=c>

⁷ It covers those consumers whose distribution charges are set using the Common Distribution Charging Methodology (CDCM).

⁸ National Grid Electricity Transmission is responsible for calculation, development and invoicing of Connection and Transmission Use of System Charges across Great Britain. See

http://www.nationalgrid.com/NR/rdonlyres/194108E0-7791-4513-A568-048497F15739/36728/STCP141DataExchangeforAnnualChargeSetting_InclOffs.pdf

2.9. Making changes to the current information provision was considered by some respondents to be of limited benefit given it would have no impact on the volatility of network charges.

2.10. In our consultation we asked respondents to consider what information they thought NWOs could provide to improve predictability. There were a number of suggestions made both in terms of what information should be included in business plans submitted during a price control review, and throughout a price control. Suggestions included:

- Business plans should clearly set out evolution of revenues and charges preferably in a common format. This should include publication by the NWOs of the financial model alongside their plans. Changes in revenues or charges should be referenced against the final year of the current price control.
- Quarterly updates produced in the distribution sector should be replicated in the transmission sector. Quarterly updates should include revenue recovery performance, against allowed revenue.
- Charge notifications should include average change across all customers, changes for each tariff and reasons for both.
- Regular updates of future network charges, for a minimum of the following year but preferably for five years ahead.
- Robust and clear explanations of changes in charges, and differences between forecast changes. This should be explained in a manner appropriate for a consumer to understand.

Charge notification periods

2.11. There were mixed views from respondents on whether current differences between industry code and licence requirements within and across sectors caused specific problems in the charging process. The majority though considered that some standardisation, and learning from best practice, would be beneficial.

2.12. Particular note was made of the 40 day final charge notification requirement in the industry code for electricity distribution (the DCUSA) and how this comes too late for use in setting consumer energy tariffs from April. It was also noted that the 150 day indicative notice period in the gas sector and electricity transmission sector may not be appropriate once the RIIO framework is established, as the adjustment to revenues from the application of the annual iteration process will not yet be known. (The final notification of allowed revenues will take place on 30 November.) A number of distribution networks also noted that part of the charges they set rely on notification from TOs and so setting transmission charges earlier would be of help.

2.13. Some responses were concerned that issuing indicative notice of charges earlier than at present may result in greater changes between indicatives and final notification. Related to this, some respondents noted concerns with the accuracy of forecasts produced by the NWOs.

Information from Ofgem

- There were some suggestions made on what we could do differently to improve the information that we provide in relation to network charge changes. A number of responses supported us publishing the information we set out in our consultation. They also noted additional information that we could provide. This included: A timetable on when decisions will be made in relation to charging methodology proposals.⁹
- Monthly updates of incentive performance, provided by each NWO.
- Earlier notification of changes in revenues, and charges, at the start of a new price control period.
- More information in relation to OFTO revenue forecasts.

Our decision

2.14. We consider that improvements to the provision of information will make network charge changes more predictable and that this will bring benefits to the energy market. These benefits relate to a reduction in the risk faced by suppliers from changing network charges, with no concomitant increase in the risk faced by NWOs. This reduction in risk reduces the cost to suppliers and thus the cost that is passed to consumers in their energy bills. There may also be a reduction in the number of changes in charges and the associated administration cost of such changes.

2.15. We do not consider that there will be material costs to any party from making improvements. NWOs already produce most of the information required by suppliers to understand the expected change in network charges in their regulatory submissions to us. Working with the industry, we need to ensure that such information is published in an accessible format.

2.16. Below we provide the detail of our decision in specific areas.

Industry information

2.17. We consider that the onus, in relation to making improvements under this option, lies principally with the NWOs. It is their responsibility to respond to the needs of their stakeholders in providing relevant information that is clear and robust. Under the current electricity price control and the forthcoming RIIO price controls there is provision for a NWO to receive a financial reward if it can demonstrate it has improved the services it delivered for its stakeholders.

⁹ We note that this information is already published on our website. The timetable indicates when we expect to make a decision following receipt of the final report:
<http://www.ofgem.gov.uk/LICENSING/INDCODES/Pages/IndCodes.aspx>

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2.18. The principal conduit for providing information to suppliers on expected charge changes is through code processes. We understand that the code processes do not currently provide all of the information that would help suppliers forecast charge changes. For example, in the gas distribution sector, suppliers have expressed concerns with the level of detail in the UNC0186 quarterly reports. We encourage the code parties to come forward with improvements to the code processes.

2.19. During the price control review, we also consider that the NWOs should provide improved information about the potential magnitude of any changes in allowed revenues in their business plan proposals. These proposals should clearly set out the path of future revenue changes. A number of responses indicated that it would be advantageous to include a common format summary table in business plans. As part of RIIO-ED1 business plan guidance, we will require NWOs to set out the expected change in revenues on a common basis.

Charge notification periods

2.20. We noted in our consultation that charge notification periods varied by sector and between the licence and industry code in each sector. Table 2.2 summarises the current notice periods.

Table 2.2: Current charge notification periods¹⁰

Sector	Licence	Industry code
Gas distribution	Indicative: 150 days in advance Final: 1 month in advance	2 months in advance
Electricity distribution	3 months in advance	40 days in advance
Gas transmission	Indicative: 150 days in advance Final: 1 month in advance	2 months in advance
Electricity transmission	Indicative: 150 days in advance Final: 1 month in advance	2 months in advance

2.21. There were mixed views on whether the lack of commonality in notice periods was causing problems to suppliers and network users. A number of respondents indicated that they could manage the differences. Some concerns were raised on the amount of prior notice given of network charge changes and the scale of the change experienced between indicative and final notice of charges.

2.22. We do not intend, at this time, to make changes to the current licence requirements in relation to when charges are notified. The requirements are part of

¹⁰ There are also a number of additional clauses related to these notification periods, eg they can be shortened if the Authority consent.

established industry processes and respondents did not indicate a strong desire for them to be changed, or removed. We note that the 150 day notice period, in the transmission and gas distribution sectors, will fall prior to the result of each annual iteration process. We have considered the benefits of aligning these processes but consider that users will be better served by the established notification timetable. We would expect the NWOs to build in assumptions, of the potential magnitude of future adjustments, into the forecasts that they provide. As discussed earlier these assumptions should be clearly set out. It may be of benefit to build forecasts based around scenarios of potential outcomes.

2.23. The licence requirements should be seen as minimum requirements. The requirements in the licence do not preclude the establishment of more regular notification of indicative charges under the industry codes. We note that, in sectors other than electricity distribution, final charge notices are provided two months in advance, as per the requirements set down in the relevant industry codes.


2.24. There were a number of comments made in relation to the 40 day notice period in electricity distribution that suggested this timescale is not adequate for suppliers to factor into contracts with consumers. We would urge the industry to consider changes to this notice period if this is the case. We would expect changes between the notification provided to Ofgem, and users, three months in advance (as per the licence requirement) to not vary considerably from that provided 40 days in advance (as per the code requirement) but realise that this has not been the case historically. We would suggest that electricity distribution networks (DNOs), in making any changes between these notifications, bear in mind the requirements set out in their licence.¹¹

2.25. A number of DNOs and gas distribution networks (GDNs) raised concerns that they were not provided enough notice from TOs of charges that they need to factor into their own charges, as the notification periods are aligned. We discuss how we intend to address this point under option 4.

Information from Ofgem

2.26. We will continue to seek stakeholders' views in relation to potential material adjustments to NWOs' allowed revenues from additional funding decisions, eg as a result of reopener mechanisms and within period determinations. As part of the RIIO framework we will make available, each November, the updated financial model setting out the revenue adjustments for the following year, beginning 1 April. This

¹¹ Standard Licence Condition 14.12: "Except with the Authority's consent, the licensee may only amend its Use of System Charges in respect of any agreement for Use of System if: (a) it has given Notice of the proposed amendment in accordance with paragraph 14.11; and (b) the amendment, when made, conforms to the proposals set out in that Notice (except for any revisions made necessary because there has been a material change since the Notice was given in any of the matters on which the assumptions set out in the statement under paragraph 14.11(a) were said to be based)."



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model will set out adjustments in relation to financial parameters, uncertainty mechanisms and the totex incentive mechanism.

2.27. We also intend to publish data provided to us as part of the annual returns of each NWO. We will consult on the precise scope of the information we publish as part of our forthcoming RIIIO-T1 and GD1 informal licence and associated documents consultation (to be published 30 October 2012). At a minimum, we expect to publish information in relation to NWOs costs, performance against incentive mechanisms, as well as adjustments for uncertain costs eg, cost pass through and revenue drivers. Such information will help suppliers model expected changes in allowed revenues given our proposal under options 3 and 4 to introduce a time lag for incentive rewards/penalties and some uncertainty mechanisms. We would also expect NWOs to provide such information to their stakeholders at the earliest opportunity, ie prior to the publication of annual returns to help suppliers and customers understand changes in allowed revenues.

2.28. A number of responses noted concerns in relation to the adjustment to revenues as a result of a new price control period. We discuss this later in this chapter when considering further options proposed by respondents.

Implementation

2.29. We consider that changes can be made in all sectors from publication of this decision. Implementing this decision does not require changes to current licence requirements.

2.30. It may involve changes to the industry codes which should be progressed under the usual open governance framework. We are aware that some changes have already been raised to the industry codes and we encourage code parties to come forward with modifications to improve existing processes.

Option 2: Restricting the frequency of intra-year charge changes

2.31. Under this option we considered introducing changes in a number of areas:

- restricting the number of times a NWO can change charges within a year
- widening the band prior to the application of a penalty for over or under recovery of revenues in a given year
- implementing a lag to the adjustment of allowed revenues for the over or under recovery in the previous year
- introducing a penalty in cases where an error is made when calculating network charges.

2.32. We considered that there were merits in restricting the frequency of intra-year charges, in term of reduced risk to suppliers with minimal detriment to NWOs. We noted that this change would likely require a change in the calculation of the penalty

for over or under recovery of revenues. We sought views from respondents on any existing processes that may prevent us from implementing this change.

2.33. We also considered introducing a lag to the adjustment for over or under recovery of revenue because it would improve the predictability of such adjustments, an identified cause of volatility. We sought views on the frequency and impact of charging errors so that we could assess the appropriateness of a penalty in relation to such errors.

Respondents' views

2.34. Responses indicated that in the last five years across all sectors there have been changes to charges outside of 1 April. The materiality and frequency of these changes has been varied. The reasons stated for these changes were mixed but generally they were to update forecast position and therefore avoid the over or under recovery penalty by the end of the year, or for changes in the charging methodologies. In the electricity distribution sector there were also changes in 2011 to correct for charge calculation errors. It was also noted that in gas transmission some charge changes occur in October each year as standard because the process relies on information relating to the gas year, which starts each October.

2.35. The majority of respondents favoured restricting the number of times network charges can change in a year. The reasons for support of this option reflected our own. There were mixed views in relation to allowing for exemptions to this rule. Those in support of exemptions considered it would provide for flexibility if the need materialises. Others considered that it would undermine the intent of such a restriction.

2.36. In relation to the penalty for over or under recovery of revenues, the majority of responses supported a widening of the band in which no penalty is applied. It was noted that if a NWO was prevented from making intra-year charge changes then a widening of the band would be appropriate to compensate for the increase in forecasting risk. It was also noted that widening the band may be beneficial even if NWOs still had the ability to change charges intra-year because it would reduce the incentive to do so.

2.37. Some respondents also considered that the licence requirement to use "best endeavours" to ensure charges are set to recover allowed revenues and no more or less should be loosened. We consider that this licence requirement should remain. A NWO should still be using its best endeavours to ensure that its charges are set using the most robust forecasts available in order that revenues, as calculated in the licence are recovered, irrespective of its ability to change charges intra-year.

2.38. There was also support for introducing a two year lag on the adjustment for over or under recovered revenues. Currently any over or under recovery impacts on allowed revenue in the following year. We consulted on delaying this adjustment for an additional year to improve predictability. Some respondents proposed that the

adjustment be smoothed over a number of years, ie impose a cap and collar on the magnitude of the adjustment.

2.39. There were mixed views related to the introduction of a penalty for making errors when calculating charges. No response indicated that this had been an issue historically in sectors other than electricity distribution.

Our decision

Intra-year changes

2.40. We consider that reducing the ability of a NWO to change charges intra-year will reduce the risk faced by suppliers and therefore reduce the cost imposed on consumers. We therefore intend to amend licence requirements in order to limit network charge changes to once per year on 1 April. We also consider this will reduce direct costs associated with administering charge changes for both NWOs and suppliers.

2.41. We intend to implement this change from 1 April 2013 in gas distribution and electricity transmission only. This is in line with current standard practice in these sectors, ie charges are set on 1 April for the year ahead, although changes are also made intra-year. We intend to implement licence changes to the electricity distribution sector for the start of RIIO-ED1 on 1 April 2015.

2.42. We do not consider that it is appropriate to mandate such a change for the gas transmission sector at this time.¹² As discussed in the consultation, gas transmission capacity charges are set each October (in line with the gas year). We welcome that the gas industry has begun to consider the pros and cons of moving to an April change as standard to align with other sectors. We will consider any restriction on intra-year charges once the industry has resolved the issue of aligning the gas and regulatory years.

2.43. We consider that in all sectors there is benefit in allowing for exemptions to this requirement. We intend to include provision, within the licence, for the Authority to allow for changes outside of 1 April if NWOs can provide reason why it would be beneficial. For example, it may be necessary for a DNO or GDN to change its charges as a result of the supplier of last resort requirement,¹³ for important changes to the charging methodologies or to correct for material charging errors.

¹² The current gas transmission licence stipulates that reasonable endeavours should be used not to change charges more than twice a year on 1 April and 1 October.

¹³ See standard licence condition (SLC) 38 of the electricity distribution licence and SLC 48 of the gas distribution licence.

Over or under recovery adjustment

2.44. We consider that there are benefits in changing the current requirement, and associated penalty, not to over or under recover allowed revenues in any year. By restricting the ability of a NWO to change its charges intra-year we are removing a level of risk protection. We therefore intend to widen the band for over or under recovery. This will be implemented when changes are made in relation to restricting intra-year charge changes, ie for electricity transmission and gas distribution this will apply from 1 April 2013 and for the other sectors this will apply at a later date. For the avoidance of doubt we do not intend to widen the band for gas transmission until a change is made to restrict that ability to change charges only once per year.

2.45. We propose to double the current band that applies in each sector, eg if there is a penal interest rate applied for over recovering by three per cent or more this will be increased to six per cent. We consider that doubling the penalty free band is appropriate because under current arrangements if a NWO decides to change charges intra-year it is normally done on 1 October. This amounts to updating forecasts every six months. By restricting charges to 1 April we are therefore doubling the length of time that the forecast is set for. We also intend to ensure that an additional penalty is imposed for persistent over or under recovery. However, this is our minded to position. We intend to consult on the precise size of the deadband for RIIO-T1 and GD1 as part of our second informal licence consultation.

2.46. We also intend to apply an additional lag to the adjustment for over or under recoveries, ie over or under recovery in year t-2 will impact charges in year t. This will improve the predictability of the adjustment, and we consider will have limited detrimental impact on NWO cash-flow risk. We do not intend, as proposed by some respondents, to smooth this adjustment. We consider that improved predictability is of more benefit, with limited additional cost, than smoothing.

Charging error penalty

2.47. We do not intend to introduce a penalty for errors made when calculating charges as part of this decision. We are aware that these errors have had an impact on the efficient running of the electricity market as it has resulted in intra-year changes to electricity distribution charges. Based on the evidence seen we do not consider this issue to be wide spread across all sectors and therefore consider a penalty to be disproportionate to the issue. We are currently developing a data assurance licence condition which will require NWOs to undertake data assurance processes and activities for the purpose of reducing the risk of inaccurate or incomplete reporting in the data which they are required to provide to Ofgem. While the precise details of what will be included under this requirement are not yet finalised, the publication and application of the charging methodologies may form part of this over-arching requirement. We will continue to monitor NWOs', and in particular, DNOs' performance in this regard, and may consider the requirement of a penalty at a future date.

Implementation

2.48. To implement this decision changes to licence conditions are required. We will take this forward for electricity transmission and gas distribution as part of the current licence drafting process for RIIO-T1 and GD1. As stated above we do not intend to implement changes for electricity distribution or gas transmission at this time. We will implement our decision as part of the licence drafting process for RIIO-ED1. For gas transmission we will reconsider licence requirements in light of industry developments in this area.

2.49. We note that changes to the industry codes may be required in order to bring code requirements in line with licence requirements. We would expect these to be progressed by parties to the respective codes.

Option 3: Increasing the lag on changes due to incentive rewards or penalties

2.50. Under this option, we considered introducing, or increasing, the lag in adjustments to allowed revenues as a result of the application of incentive mechanisms. Under the incentive framework these adjustments can result in both increases and decreases in allowed revenues, ie to reward good performance or to penalise poor performance.

2.51. We considered that a two year lag struck the right balance of improving the predictability of the adjustment to allowed revenues without weakening the incentive framework or increasing network companies' cash-flow risk.¹⁴ We considered that the proposed lag would have no or minimal effect on the strength of NWOs' incentives as there would be no change to the value of the reward/penalty (or certainty with which the reward or penalty would be incurred). Where the reward/penalty is based on an economic value (eg a carbon price) then we would increase the reward/penalty by the time-value of money. We also considered that the proposed lag would have minimal impact on cash-flow risk as the reward/penalty is not a payment for actual costs incurred by NWOs' (or alternatively a penalty for avoided costs).

Respondents' views

2.52. The majority of responses supported our initial assessment that there would be a benefit in ensuring there is a lag between an incentive reward or penalty being known and it impacting allowed revenues, and thus network charges.

¹⁴ By two year lag, we mean that allowed revenues are adjusted in year t for NWO performance in year t-2. In general, NWOs will report performance from year t-2 in year t-1, and thus the proposed lag provides one years notice of the proposed change.

2.53. Those that were not supportive raised concerns that it would weaken the incentive framework and signals to investors. One DNO noted that incentives were already operating with a two year lag and that extending this period would be unreasonable. We agree that in many cases existing incentive schemes do operate with a two year lag. By concluding that this should be the case for all incentives we are setting principles for the design of future incentive schemes, and ensuring a common approach.

2.54. There was also concern that a time delay between performance being measured and a NWO facing the financial impact of its performance will impact cash-flows. We disagree with this statement. An incentive reward is not a direct payment for costs incurred (or in the case of a penalty, costs avoided). Therefore introducing a lag should not materially impact NWOs' cash flows.¹⁵ Some respondents proposed introducing lags on a case-by-case basis based on the potential magnitude of the adjustment. As incentives are based on actual NWO performance it is difficult to make an assessment of what an adjustment will be in order to make such a case-by-case assessment. Although many incentives have an upper and lower limit there is likely to be variation in the magnitude between NWOs in a sector. We also consider that a common approach improves the transparency of the price control framework.

2.55. In our consultation we asked respondents to list any incentive adjustments that should be exempt from being lagged. A number of GDNs proposed that the gas shrinkage incentive should not be lagged.¹⁶ We note there are two elements to the revenue allowed in relation to gas shrinkage, revenue to protect against changes in the price of gas, and an incentive element. One respondent also requested clarification on what would or would not be included. We can confirm that only changes to allowed revenues are included within scope. Therefore other payments, eg enforcement penalties or payments to consumers in relation to guaranteed standards of performance, are not within the scope of this decision as they do not form part of allowed revenues.

Our decision

2.56. We still consider that the benefits of a two year lag on incentive mechanism adjustments outweigh any costs in terms of blunted incentives or NWO cash-flow

¹⁵ To explain in more detail, we acknowledge that the reward/penalty will be equal to NWOs' costs for the marginal improvement in output performance, assuming NWOs optimise the level of outputs. However, the total value of any reward will always be greater than costs incurred (otherwise NWOs would not have incurred the costs), and likewise, the value of any penalty will always be less than NWOs' avoided costs (otherwise NWOs would have chosen to incur such costs to avoid the penalty). Hence, overall, the reward/penalty is not directly linked to costs incurred/avoided unlike, say, an uncertainty mechanism which compensates NWOs for actual costs incurred.

¹⁶ Shrinkage refers to the gas which is lost on the transportation network. This includes gas leakage from pipes, theft and own use gas.

risk.¹⁷ Lagging incentives by two years will both improve the predictability of revenue adjustments and reduce the number of adjustments, as no forecast of performance is required when setting charges, with a later true up once actual performance is known. A two year adjustment means that a NWO's performance from year t-2 will be reflected in allowed revenues, and network charges, in year t. In most cases this will mean that performance, and the resulting magnitude of the revenue adjustment, will be known at the beginning of year t-1. We discuss how suppliers can be informed of such adjustments under option 1.

2.57. We acknowledge that in some cases the notice period will be shorter, eg for discretionary rewards that are decided by the Authority. We will endeavour to make these decisions in a timely manner in order to provide as much notice as possible. We do not consider that it would be beneficial to delay the recovery of revenues in these cases further and note that these adjustments are relatively small.

2.58. We have considered the merits of introducing a longer lag which would provide a greater improvement in predictability. However, we consider that a two-year lag, which effectively provides suppliers and customers with predictability at the beginning of time period t-1 (provided NWOs' share this information) for the next two year period, strikes the correct balance between addressing charging volatility and timely rewards/penalties for NWOs.

Implementation

2.59. As per option 2, we intend to introduce changes at the start of the next price control periods, ie 1 April 2013 for RIIO-T1 and GD1, and 1 April 2015 for RIIO-ED1.

Option 4: Increasing the lag on changes due to uncertainty mechanisms

2.60. Under this option we consulted on the principle of introducing lags on uncertainty mechanisms. Implementation would result in a longer notice period between a decision on the magnitude of an adjustment and an adjustment being made to allowed revenues, and therefore when network charges would change.

¹⁷ We need to define an incentive mechanism as discrete from an uncertainty mechanism. This is easiest to do by way of example. For example, the "shrinkage mechanism" is an uncertainty mechanism. It protects GDNs against commodity price risk while leaving them with volume risk. It is true that GDNs have the incentive to minimise both the cost of the gas purchased and transport losses; but this is a consequence of the price cap rather than the shrinkage mechanism per se. By contrast, the environmental emissions incentive (EEI) is an incentive mechanism as it provides for a reward or penalty to GDNs according to the level of gas transport losses relative to forecast levels set at the price review.

2.61. We considered implementing a lag in each sub-category of uncertainty mechanism: indexation, pass through costs, revenue drivers, within period determinations, reopeners and innovation funding.

2.62. In our consultation, we concluded that some categories of uncertainty mechanisms contributed to charging volatility more than others, eg reopeners, and within period determinations. We noted that in such areas we had introduced mechanisms to address charging volatility, such as materiality thresholds and application windows. We also noted that NWOs would carry such costs for a period of time before being able to recover such costs. Thus, for such mechanisms, we did not consider that we should introduce a further lag between the NWOs application and our decision. We considered that the cash-flow risk and financing costs to networks could be greater than the prospective benefit in terms of improving predictability.

2.63. For other (more mechanistic) uncertainty mechanisms, such as RPI indexation and cost of debt indexation, we considered that such mechanisms were unlikely to be a key source of charging volatility because of the availability of independent forecasts. For pass through costs and revenue drivers, which are mechanistic but where there are not independent market forecasts for such values, we proposed to consider the merits of introducing lags on a case-by-case basis.

2.64. Thus, overall we considered that – unlike incentive mechanisms – we would not introduce a standardised lag to uncertainty mechanisms. However, we would consider whether there was a case to lag any specific mechanism on a case-by-case basis


Respondents' views

2.65. Around half of respondents considered that we should not introduce lags to uncertainty mechanisms. The other half was divided in their support for the introduction of lags for all mechanisms and for consideration of lagging on a case-by-case basis.

2.66. For those respondents that supported lags, some considered that our argument for the additional cost to NWOs (and ultimately consumers) of delaying revenue collection was weak given that the NWOs are subject to price regulation and are considered low risk.

2.67. We agree that NWOs are relatively low risk. However, this does not imply that delays to NWOs cost recovery, and consequent divergence between NWOs costs and revenues is costless.¹⁸ We consider that there is a balance to be struck between

¹⁸ NWOs would need to finance any cash-flow deficit resulting from delayed cost recovery, and normally licence provisions provide for NWOs to recover both the initial (uncertain) cost plus financing costs. The delay to cost recovery is not necessarily neutral in net present value terms. There is a risk that the marginal financing cost, faced by NWOs, increases if cost



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addressing network charging volatility faced by suppliers and their customers, and allowing NWOs to recover their costs in a timely way.

2.68. One respondent proposed that adjustments be smoothed across a number of years. This would have the same effect as lagging the recovery of uncertain costs, although the effect on NWOs cash-flow risk and financing costs would depend on the period over which cost recovery were smoothed.

2.69. Respondents that considered lags should not be automatically introduced supported the reasons that we stated in our consultation. These include the ability to accurately forecast some adjustments, eg indexation, and the restriction on timing of adjustments already in place, eg reopeners. It was also noted that the decision must take into account the materiality of the adjustment and the additional complexity created which may introduce limited benefit if the revenue adjustment is relatively small. The potential for NWOs to face cash-flow risk or the potential to delay investment were also considered to be material issues, particularly if lags were introduced to within period determinations and reopeners.

2.70. Some DNOs considered it difficult to comment on the benefits or costs of introducing lags prior to seeing the detailed design of uncertainty mechanisms for future price controls. We agree that the merits of lags may be dependent on the specific circumstances of an individual uncertainty mechanism and therefore the timing of adjustments should continue to be a consideration in the design of mechanisms during future price control reviews.

2.71. One GDN also proposed that there be a review of the annual iteration of the financial model at the mid period review. It considers that the annual adjustment to allowed revenues as a result of the iteration process could have an impact on charging volatility. A number of annual adjustments to revenues occur in the current price control although there is no explicit iteration of the financial model. The annual iteration process will capture these already occurring adjustments and so in this respect it will not introduce volatility that is not currently present. The annual iteration process will also capture some new annual adjustments, namely changes in financial parameters and the application of the efficiency incentive rate. Currently adjustments from these sources occur at the start of the following price control, so in effect the RIIO process may be limiting any step change adjustment between price controls. The iteration process will also occur with a lag, ie performance in year t-2, will result in a change in allowed revenues in year t and so we consider there to be some predictability in the adjustment.

recovery is delayed, eg where the delay in cost recovery adversely affects NWOs' credit metrics. Such cash-flow risk and higher financing cost could eventually translate into higher cost of capital and higher allowed rate of return set at a price review, and thus higher overall network charges.

Our decision

2.72. Taking into account responses to our consultation, we do not consider that we should automatically lag all uncertainty mechanisms and so have considered what approach to take based on the type of mechanism applied. Below we detail our decision in relation to each type of uncertainty mechanism.

2.73. *Indexation*: We consider that the proposed design of indexation for inflation and cost of debt should not materially affect charging volatility as there are independent market forecasts of such values. We are therefore not proposing to introduce lags to these adjustments.

2.74. *Cost pass through*: We have decided that it would be beneficial to lag pass through costs. Currently the majority of adjustments for pass through costs occur within year. This means that NWOs must forecast the likely magnitude of the adjustment which means that any forecasting error leads to subsequent changes in revenues (captured by the over or under recovery adjustment). The magnitude of pass through cost adjustments vary, but we consider that there is merit in applying a consistent approach to all pass through costs.

2.75. For pass through costs that are forecast to be non-zero we intend to provide a base allowance for each year of the price control. The uncertainty mechanism will then operate by truing up this base allowance for actual costs relative to allowed costs (which could be a positive or negative adjustment) two years after the cost is incurred, with an appropriate adjustment to account for any additional financing costs.

2.76. *Revenue/volume drivers*: It is intended that under the RIIO framework adjustments from the application of drivers will impact allowed revenues through the annual iteration of the financial model each year. This will result in a lag to the adjustment which we consider will improve the predictability of the adjustment, with limited impact on the financeability of a NWO as financing costs will be reflected in the final adjustment. We do not consider it would be beneficial to introduce a further delay as this will provide at least one years notice of the impact on revenues and charges.

2.77. The process will work as follows:

- The NWO will incur costs in year t-2.
- These costs will be reported to us in year t-1 through the annual returns. The returns will show the magnitude of costs when compared with the base allowance provided.
- In November of year t-1 the annual iteration process will derive that adjustment to allowed revenues for year t. The adjustment will include financing costs.
- The adjustment will take effect the following April.

2.78. In principle therefore the NWO will be able to forecast the adjustment soon after the end of year t-2 and final notice of the adjustment will be available four months in advance of the charge changes.¹⁹

2.79. *Reopeners and within period determinations:* In the case of reopener mechanisms it is likely that a NWO that triggers a mechanism will have been carrying the costs for a number of years. We therefore continue to be of the view that introducing further lags to adjustments from these mechanisms will not provide benefits which will outweigh the costs. Principally, the concern is that delayed recovery of such revenues could result in financeability issues for the NWOs. This would not be beneficial to consumers as it will add additional cost to the process. These adjustments follow a consultation process and we are committed to consult all parties at the earliest opportunity. We also encourage NWOs to report their forecast position in relation to these adjustments.

2.80. *Innovation funding:* We do not consider it will be beneficial to introduce lags to adjustments related to innovation funding. These adjustments are likely to be stable and predictable as the maximum value of such adjustments will be set at the price control review.

Implementation

2.81. As per option 2 and 3, we will introduce these arrangements for transmission and gas distribution on 1 April 2013, and for electricity distribution on 1 April 2015.

Option 5: Imposing a cap and collar on allowed revenue changes

2.82. We consulted on three potential designs for caps and collars that could be introduced to limit the annual adjustment to allowed revenues. These three options were:

- Limiting the increase or decrease in allowed revenue when compared to the ex ante allowed revenues set at the price control review.
- Limiting outturn allowed revenue changes, when compared to a forecast of allowed revenues made the year ahead.
- Introducing a sliding scale for notice periods required for charge changes, the larger the change the longer the period of notice required.

¹⁹ We note that in gas transmission, revenue drivers in relation to incremental capacity will operate differently and are more akin to a within period determination. However, even though the final magnitude and timing of any adjustment may not be known until the November prior to the year an adjustment occurs, National Grid Gas should be able to forecast such adjustments and inform their stakeholders earlier than this.

2.83. Our initial conclusion was that caps and collars would not be beneficial given our other proposed changes under options 1 to 4. We considered that there would be a cost involved both in terms of financing costs of delayed revenue collection for a NWO and the potential for investors to view NWOs as more risky investments. We were also concerned that the introduction of such a mechanism would introduce added complexity which could reduce the transparency of the price control framework and potentially diminish signals relating to a NWO's performance.

Respondents' views


2.84. No NWO was supportive of introducing caps and collars and there were mixed views from other respondents although the majority of these respondents did favour some form of cap and collar.

2.85. Of those respondents that considered there were benefits from introducing a cap and collar it was considered that our view, that costs would outweigh the benefits, overstated the potential negative impact on NWOs. Some respondents considered that we had not fully considered the cost of the risk placed on suppliers of changes in network charges. One respondent consider that, given the other measures we were proposing to put in place, it would be unlikely that a cap would be breached. It still considered that introducing a cap would be beneficial as it would remove the tail risk (low probability but high impact revenue adjustments) from suppliers. We would agree that this may be the case. However, this does not change our view that the imposition of a cap and collar could result in greater costs, ie in terms of financing costs for NWOs, relative to the benefits in terms of improved predictability of charges. This is particularly true given our decision in relation to options 1 to 4.

2.86. Of the three options put forward there was more support for introducing a cap and collar based on a year ahead forecast. Respondents who favoured this approach considered that it would put the onus on NWOs to more accurately forecast movements in allowed revenues. We support the principle of NWOs improving the forecasts that they produce and discuss this under option 1.

2.87. Those respondents that supported a cap and collar also considered that the incentive framework would not be weakened, stating that caps and collars would simply smooth the profitability of NWOs. We agree that a delay to cost recovery should not undermine incentives materially; however, as set out above this is our secondary criterion relative to the optimal allocation of risk.

2.88. Of those that supported our initial assessment that caps and collars should not be introduced, the reasons reflected our own. It was noted that the other measures to improve transparency and predictability may make a cap and collar largely redundant. GDNs also noted that a cap and collar had already been discussed with industry in the Distribution Charging Methodology Forum and it was considered that it would cause significant delays in revenue recovery. It was also noted that caps may also increase instability (particularly between price controls) if material adjustments are required to recover uncollected revenues.



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2.89. The majority of respondents did not have a view on whether caps should work symmetrically, ie restrict increases and decreases, or asymmetrically, ie restrict only the magnitude of increases in allowed revenues. There was though more support for a symmetric cap and collar.

2.90. Some respondents proposed caps and collars on network charges. We note that we are not considering this as part of this decision as it requires changes to the charging methodologies which is not within the scope of this decision.

Our decision

2.91. We accept that implementation of this option would create more certainty for suppliers, and consumers, on the costs that they will incur from network use. However, we do not consider that these benefits will be outweighed by the potential costs particularly given the other options we are intending to implement.

2.92. We note that given our other proposals (ie in relation to options 1 to 4) the only material changes which will remain less predictable will be in relation to some uncertain costs. All other changes to allowed revenues should be predictable at the beginning of year t-1. We set out our arguments for not delaying the recovery of some uncertain costs under option 4. We consider these arguments are equally valid in our decision not to implement caps and collars. These arguments focus on the concern that the potential mismatch between a NWO's costs and revenue recovery may lead to higher financing costs for NWOs.


2.93. We have also considered how a cap and collar would work in practice and consider that implementation would introduce undue complexity to the regulatory framework. A cap and collar could also result in larger changes in network charges between price controls, if the cap is consistently breached.

Further options proposed by respondents

Revenue changes from the start of a new price control

2.94. A number of responses were concerned that the measures we were proposing in our consultation would not help suppliers mitigate the risk of step changes in allowed revenues between price controls. We acknowledge that the options we have outlined focus on within price control revenue changes. The proposals put forward by respondents include ensuring information on revenues is provided in a timely manner, smoothing any step change over a number of years, and fixing allowed revenues/charges for the early years of a new price control at an earlier stage in the price control review process.

2.95. We note that the RIIO price control contains a number of measures aimed at addressing the predictability of potential step change in revenues, including:



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- improved stakeholder engagement from both ourselves and the NWOs
- the fast-tracking process which allows NWOs to finalise their price control settlement earlier
- increasing the length of the price control to eight years and therefore limiting the number of price controls.

2.96. While we consider that these measures have resulted in improvements we acknowledge that some stakeholders' concerns remain. The price control review process must strike the right balance between providing information to stakeholders as early as possible while allowing for appropriate time to consider NWOs business plan proposals to ensure that they provide value for money for consumers.

2.97. We intend to consider in further detail the merit of these proposals for electricity distribution, and we have asked for respondents views as part of our recent strategy consultation.²⁰ Given we are in the final stages of concluding arrangements for the next transmission and gas distribution price controls, we do not consider that we should introduce changes to how we set price controls at this late stage for these sectors.

Fixing of network charges

2.98. A number of respondents considered there to be merit in fixing network charges in advance for periods of a few years. Our consultation and this decision focus on the price control settlement and measures that can be introduced to mitigate network charge changes that relate to changes in allowed revenues. As stated in our consultation, we have not considered charging methodologies as part of this consultation. However, as set out above, we would like to encourage code parties to come forward with changes to charging methodologies which address charging volatility issues.

²⁰ See chapter 4 of RIIO-ED1: Consultation on strategy for the next electricity distribution price control (ref 122/12).

3. Next Steps

3.1. For gas transmission, electricity transmission and gas distribution we intend to take this decision forward as part of concluding arrangements for RIIO-T1 and GD1. This will ensure that changes are in place from 1 April 2013, the start of the next price controls. We intend to include necessary licence changes in the second informal licence consultation for RIIO-T1 and GD1 that we will publish later this month.

3.2. For electricity distribution, we intend to implement our decision at the start of the next price control on 1 April 2015. In relation to option 1, we consider that steps can be taken to improve information provision from now and expect the industry to be proactive in ensuring improvements are made.

Appendices

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Appendix 1 – Summary of consultation responses

1.1. We received 23 responses from network companies (NWOs), suppliers, gas shippers, and an industry and consumer representative. The non-confidential responses are summarised below and published on our website.²¹

Scope of the problem


1.2. In relation to the characterisation of the problem of network charging volatility, respondents were generally supportive of us taking steps to address concerns that have been raised.

1.3. There was support for our view that it is the lack of predictability of network charges that is most detrimental to the efficiency of the energy market, rather than stability of network charges per se. However, some respondents considered that stability was equally, if not more, important. One respondent also noted that the scale of network charges was a concern for consumers.

1.4. Most respondents considered that all market segments are affected by network charging volatility. It was noted that consumers on site specific tariffs, or tariffs not used by many others, may experience more volatile network charges as changes to the charging methodology inputs are spread across a smaller number of consumers. One respondent considered that our consultation focused on the impact on suppliers and had not fully taken into account the impact on end consumers, and their ability to manage budgets when network charges are volatile. One respondent considered that measures to reduce year-on-year volatility may create larger, albeit less frequent, changes and that there was little evidence that this was preferred by consumers.

1.5. One respondent did not consider that network charging volatility was creating a barrier to entry as potential entrants have access to information on historical fluctuations and therefore are able to price their supply tariffs accordingly. Other respondents noted that smaller suppliers may have less access to working capital and therefore higher financing costs, and they may also have less resources available to forecast movements in network charges. One respondent noted that fluctuations in network charges may damage consumer confidence and therefore deter engagement in the supply market.

²¹ See: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=368&refer=Networks/Policy>



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1.6. A number of respondents raised concerns around volatility created by the charging methodologies and related processes. It was noted that addressing volatility in allowed revenues, only impacts one input into these methodologies. Concerns were raised by one respondent that we had not fully considered the implication of our options on National Grid Electricity Transmission (NGET) in its role to collect, from consumers, revenues in relation to not only its own business but also that of the other onshore electricity transmission owners and the offshore transmission owners.

1.7. A couple of respondents considered that the volatility created by the change from one price control period to another should also have been addressed by this consultation.

1.8. One response noted that we should publish an impact assessment alongside our decision.²²

Assessment criteria

1.9. The majority of responses considered our assessment criteria to be appropriate.

1.10. One NWO thought that our assessment criteria did not adequately take into account the impact on NWOs' earnings profiles from potential mismatches between costs and revenue. While another respondent considered that the impact on the financeability of NWOs was likely to be minimal, as revenue recovery for NWOs is guaranteed. Another considered that an assessment of the cost to consumers, of funding and managing network charge increases, was required.

1.11. A respondent considered that our assessment of the complexity created should be widened to take into account all aspects of the determination of final charges, eg the timing of changes and the determination of other inputs into the charging methodologies. This respondent raised concerns that without this wider consideration the measures implemented may be ineffectual.

1.12. One respondent noted that we should consider links to other policy making bodies such as the Department of Energy and Climate Change (DECC) and directives from the European Parliament. Some respondents encouraged us to also consider the impact on the cost reflectivity of the resulting charges as part of our assessment. It was noted that delays to revenue changes may result in a different consumer base paying for services than those impacted by performance.

²² In reaching our decision on implementation of each option we have outlined in chapter 2 our assessment of the costs and benefits based on qualitative analysis. We therefore do not consider that a separate impact assessment would provide any further information to that provided in chapter 2 of this decision.

1.13. One respondent stated that our proposals could result in collusive activity in “relevant markets”, namely supplier markets. The respondent considered that our proposals could improve the ability of suppliers to monitor each others’ prices, and increase the prospect that suppliers will coordinate to change prices.²³

Option 1: Improved information provision

1.14. There was general agreement from respondents that more/improved information would help improve the predictability of network charges. Respondents also considered that standardisation of information provided through industry code arrangements would be beneficial.

1.15. In relation to standardising arrangements across the sectors, it was noted that increasing the indicative charge notification period could increase volatility by increasing the likelihood of changes between indicative and final charges. Two respondents suggested that the notification period in the electricity distribution code (the DCUSA) was too late to use in contract renewals and tenders. They proposed that the arrangements of the DCUSA be aligned with the UNC and therefore a 2 month notice period be provided. Another respondent noted that the 150 day indicative notice period (in transmission and gas distribution) may not align with the annual iteration of the financial model as it would require indicative notice to be produced prior to the annual iteration process concluding.

1.16. NGET, in its role to set charges for electricity transmission across GB, suggested that improvements in the transfer of information from other transmission owners (TOs) to them would be helpful. Similarly, a number of gas distribution networks (GDNs) and electricity distribution network (DNOs) noted that the charges they set rely on information from the transmission sector and that more notice in these charges would improve the accuracy of the charges which they in turn set.

1.17. Four respondents considered that there would be limited benefit from this option, primarily because it was felt that information provision was already adequate. One respondent also noted that additional information can require additional resources to interpret and that it may therefore not always be possible to make best use of it. Another criticism of this option from some respondents was that it would not remove volatility, only improve the predictability of charges. There was also concern that the added bureaucracy would not be warranted given the limited benefits this option would provide and so could introduce inefficiencies. One DNO also noted the potential for any additional measures introduced to conflict or duplicate work already being progressed through the charging methodology open governance process.

²³ We do not consider that the respondent’s views are relevant. It is not clear that changes to the way NWOs communicate/set network charges, a charge common to all suppliers, has any relevance to the risk of coordinated behaviour in the supply market.

1.18. A DNO identified a further piece of information that they produce for suppliers and network users that we had not identified in our consultation, the annual review pack. A TO also drew our attention to the information provided through the System Operator-Transmission Owner Code (STC).

1.19. There was support for us providing the information which we outlined in our consultation. Respondents also noted a number of other provisions which would help them predict network charges. These included providing regular updates of NWO performance against incentives and further information on requests from NWOs to change allowed revenues.

1.20. Respondents also noted specific improvements that NWOs could make in both setting out the impact on network charges in their business plan proposals and providing improved information within price control periods, including improving forecasts.

Option 2: Restricting the frequency of intra-year charge changes

1.21. All, except one, non-NWO respondent supported the restriction of changes to charges to once per year. Responses from NWOs were more mixed.

1.22. If charge changes were to be restricted to once per year, there were mixed views on whether there should be exemptions. Some considered that exemptions, for example via application to Ofgem for approval, would leave some flexibility in the requirements. Others considered that allowing for exemptions would undermine the intention to remove risk. It was noted by some GDNs that they must now include in their customers' charges some charges set by the gas transmission network and that this charge is set in October each year (rather than April when the majority of charges are set). One respondent also noted that the provisions of standard licence condition (SLC) 38 of the electricity distribution licence allows for the recovery, through revenues, of compensation under the supplier of last resort requirement. It was also noted that some charges in the gas transmission sector are set from October as standard, in line with the gas year.

1.23. In support of limiting charge changes, shippers and suppliers indicated that there is significant administration costs in relation to charge changes that ultimately are paid by consumers. Therefore limiting changes in network charges may reduce the need to change consumers' energy tariffs and therefore reduce these costs.

1.24. Respondents replied that over the last five years there have been intra-year changes made in all network sectors. Intra-year changes have mostly occurred on 1 October. The most common reason for intra-year changes has been in order to limit exposure to the over or under recovery penalty rate that is applied to NWOs revenues, ie to update the forecasts used to set charges at the start of the year.

1.25. If the ability for NWOs to change their charges intra-year was removed then there was support for widening the band for over or under recovery before a penalty

is incurred. Those respondents not in favour of widening the band considered that the implementation of some of the other measures, eg lagging of adjustments, would limit NWOs exposure to this forecast error.

1.26. There was support for introducing a lag to the over or under recovery adjustment. Concerns were raised on the cost of delaying revenue recovery and how this adjustment would work across price control periods. One respondent favoured smoothing the adjustment for over or under recoveries noting that, even with notice, consumers may struggle with large changes in charges. One GDN also proposed removing the gas shrinkage allowance from the calculation of over or under recovery. It states that intra-year changes have been made due to unforeseen fluctuations in the gas price which they have no control over.

1.27. There were mixed views on the need to introduce a penalty for errors made when calculating charges, although the majority considered that a penalty was not required. Concerns were raised that introducing a penalty may discourage NWOs from admitting to such errors and resolving them.

Option 3: Increasing the lag on adjustments for incentives

1.28. The majority of respondents supported applying a lag to adjustments for incentive rewards/penalties. Only one network user was unresponsive as it considered it may weaken the signals to investors. A number of NWOs supported our proposed approach, although some responses suggested that if costs were incurred in relation to incentives then NWOs should be able to recover these through charges within year. Some responses suggested that treatment should be based on an assessment of the potential magnitude of the adjustment, the ability to predict the adjustment and whether it relates to matching cost exposure.

1.29. There were different views on the appropriate notice period for changes to allowed revenue. Responses from users of the network suggested that between 3 months and two years notice should be provided. One respondent noted the importance of NWOs making robust forecasts and it was noted that this has not always been the case historically.

1.30. The importance of not diminishing the incentive to improve performance was noted, but it was agreed that using actual rather than forecast performance data seemed appropriate. Others considered that any detrimental impact on the incentive strength would be minimal as the NWO will be guaranteed the reward/penalty, albeit at a future date.

1.31. Some NWOs noted that under the RIIO framework the annual iteration of the financial model will be a key determinant of allowed revenues for the following year and so changes would not be known until this process occurs.²⁴ It was noted that

²⁴ We note that the majority of adjustments related to incentives will not impact revenues

providing exemptions would diminish the benefits of ensuring a common lag was in place. A number of NWOs considered that the cost element of gas shrinkage, related to the price of gas, should be excluded from the approach proposed as it is directly linked to costs incurred by GDNs and so lagging could create significant cash-flow problems.

1.32. One respondent asked for clarification on whether enforcement penalties and guaranteed standards failures were being considered under this option.

Option 4: Increasing the lag on adjustments for uncertainty mechanisms

1.33. Respondents had mixed views on the benefits of introducing lags to uncertainty mechanism adjustments. Some considered that all mechanisms should operate with a lag as the benefits of a longer notice period would, in all cases, outweigh the additional cash-flow risk imposed on NWOs. Others considered that it was more appropriate to decide on applying a lag on a case-by-case basis. Others considered that lags should not be introduced to any mechanism due to the impact on an NWOs' cash-flow.

1.34. Those respondents who favoured lagging considered it would improve the predictability and transparency of adjustments. It was noted by one respondent that not applying the same approach to all uncertainty mechanisms would diminish the benefits. This respondent also favoured smoothing adjustments, ie for any adjustment to be spread over a number of years. It noted that this would help both predictability and stability.

1.35. Those that supported evaluation on a case-by-case basis considered the most important factors to be the magnitude and predictability of the adjustment. In cases where the adjustment may be large but unpredictable then there could be a case for applying a lag.

1.36. The majority considered that indexation (for inflation and the cost of debt) was relatively predictable and therefore the benefits of lagging were low. It was noted that NWOs should be able to include in their allowed revenue forecasts a reasonable prediction of such adjustments.

1.37. Some supported lagging pass through costs as there would be no detrimental impact from doing so. Others considered there was limited benefit in lagging these adjustments as they are fairly stable. A number of respondents considered that applying a lag to adjustments from revenue drivers should be on a case-by-case basis. A respondent raised some concerns that any proposal to lag the incremental

thorough the annual iteration process.

capacity revenue driver in the gas transmission sector may result in delays to delivery of capacity to new gas fired generation.

1.38. Lagging adjustments as a result of within period determinations was considered, by a number of respondents, to be unsuitable as it could deter or delay investment on the network. It was also noted by some that the delay could result in NWOs having to seek funding from other sources to bridge the gap between incurring costs and recovering costs from consumers. This was considered likely to increase the financing costs of NWOs and lead to higher network charges. It was noted that the impact of these adjustments could be mitigated if NWOs produce robust forecasts of their magnitude.

1.39. Some respondents considered that the design of reopeners, ie restricting the timing of adjustments, already introduced a lag and therefore an additional lag following a funding decision from Ofgem could increase NWOs' financing costs further. Another respondent considered that as part of Ofgem's decision on a reopener adjustment we should consider whether lagging is appropriate.

1.40. One respondent considered that lagging innovation funding would not weaken the incentive to invest as funding would be guaranteed. Another noted that these adjustments are likely to be predictable, and are relatively small.

Option 5: Imposing a cap and collar on allowed revenue changes

1.41. No NWO supported caps and collars and the views of other respondents were mixed, although the majority favoured some form of cap and collar.

1.42. Those that did not support a cap and collar reasoned that it may weaken the incentive framework and potentially impact the financeability of NWOs by leaving them consistently under recovering their revenues which could lead to significant carry costs. One respondent considered that caps and collars could leave them in breach of their charging obligations. While another raised concerns that it would negatively impact the cost reflectivity of charges. It was noted by some respondents that measures to implement lags, ie option 3 and 4, should improve the predictability of adjustments without the need for a cap and collar. Although it was also noted that this would rely on robust forecasting and information provision.

1.43. Those that supported a cap and collar reasoned that as NWOs are guaranteed to recover revenues they should be able to absorb the risk of a temporal mismatch of revenues and costs at a lower cost than suppliers or consumers. One respondent thought that given the other measures we were proposing to put in place it would be unlikely that the cap would be breached, but that introducing a cap would still be beneficial as it would remove the tail risk from suppliers and consumers.

1.44. Of the three options proposed, for a cap and collar, there was more support for introducing a cap and collar based on a band around a year ahead forecast. Respondents who favoured this approach considered that it would put the onus on

the NWOs to more accurately forecast movements in allowed revenues, and network charges.

Timing of implementation of the options

1.45. All respondents supported introducing any necessary changes for the transmission and gas distribution sectors from the start of the next price control on 1 April 2013. It was though noted that some gas transmission charges had already been published and would take effect from October 2012 and it may not be beneficial to change them again in April.

1.46. There were mixed responses on when to introduce changes for the electricity distribution sector. Some supported introducing changes as soon as possible, ie from 1 April 2013, while others considered changes should be aligned with the start of the next price control on 1 April 2015. For the electricity distribution sector it was considered by some respondents that options 1 and 2 could be introduced prior to the next price control but that implementation of the other options should wait until the next price control as they are linked to the price control settlement.

Other suggestions of how to mitigate network charging volatility

1.47. Some respondents made further suggestions of how charging volatility could be mitigated. These proposals dealt with both the price control settlement and charging arrangements.

1.48. In relation to charging arrangements suggestions included minimum notice periods for changes to network charges, the establishment of national distribution and transmission charges, ensuring that NWOs offer fixed network charges for longer than one year, limiting the year-on-year change in network charges, and an alignment of the process of reviewing capacity and setting charges in the gas industry.

1.49. In relation to the price control settlement suggestions included more reporting requirements to provide network users with further information on the potential path of revenues and charges, and a review of the RIIO annual iteration process at the mid point of the price control in order to evaluate its impact on volatility.

1.50. A number of respondents considered that we had not addressed the potential step change in allowed revenues between price control periods. Options proposed included ensuring information is provided in a timely manner, smoothing any step change over a number of years, and fixing allowed revenues/charges earlier in the process, eg fixing allowed revenues in advance of Ofgem's final decision on revenue allowances.

Appendix 2 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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