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Electricity distribution networks,
electricity suppliers, electricity
consumers and other interested
parties

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Dear Stakeholder,

The timing of a decision on electricity distribution networks' revenue for 2015-16

This letter sets out our decision on when we will set the revenue that will be recovered[1] by electricity distribution network operators (DNOs) in 2015-16. This is the first year of the new electricity distribution price control (RIIO-ED1) which starts on 1 April 2015. The current timeline for the RIIO-ED1 price control review means that 2015-16 revenue will be decided when we publish the Final Determination (FD) for the DNOs in November 2014.

Suppliers are concerned that this does not provide them with adequate notice to accurately price the resulting network charges into the contracts that they offer electricity consumers. Some suppliers have indicated that in order to compensate for the risk of unexpected changes in charges they include a risk premium in consumers' energy bills.

In October we consulted on three options for when we could provide notification of the revenue to be recovered in 2015-16:

- *Option (a)*: Revenue for all DNOs finalised at FD in November 2014 reflecting the current RIIO-ED1 timetable.
- *Option (b)*: For slow-tracked DNOs 2015-16 revenue would be finalised at the slow-track DD in July 2014. For fast-tracked DNOs 2015-16 revenue would be finalised at the fast-track FD in February 2014.
- *Option (c)*: All DNOs' 2015-16 revenue would be notified as part of our decision to this consultation. Each DNOs' revenue would therefore be based on its July 2013 business plan submission rather than our subsequent assessment of efficient costs.

We also outlined options for when the difference between the revenue set and the actual revenue allowed in FD could be recovered.

We have decided to set 2015-16 revenue for each slow-tracked DNO[2] based on the Draft Determination (DD) in July 2014. For fast-tracked DNOs[3] we will fix 2015-16 revenue at the fast-track FD in February 2014. We have decided that suppliers, and in turn consumers, will benefit from this additional period of notice. However, we have decided that the alternative approach, which would provide greater notice, would not benefit consumers. It could result in consumers paying more in 2015-16 than they would otherwise. We consider that this

[1] DNOs recover revenue through network charges to suppliers. In turn, suppliers may pass this charge on to their customers as part of the electricity bill.
[2] Slow-tracked DNOs are those that must resubmit their business plans in 2014 for further assessment.
[3] We are currently consulting on fast-tracking four DNOs owned by Western Power Distribution.

would leave consumers worse off as the benefit of increased predictability would be diminished.

We have also decided that any deferred revenue from 2015-16 will be recovered over the remaining years of RIIO-ED1. This revenue deferral could be either positive or negative, ie revenue may go up or down between DD and FD. The impact of deferring revenue will be net present value neutral by uplifting it by the weighted average cost of capital (WACC).

This decision only affects the timing of our decision on revenue for 2015-16 and not any other aspect of the RIIO-ED1 timetable. The outcome of the RIIO-ED1 review will be a decision on the outputs that DNOs will need to deliver and related revenue for the eight year RIIO-ED1 price control period. This decision does not change the DNO settlements arising from RIIO-ED1.

Our decision is informed by stakeholders' views provided through engagement as part of the RIIO-ED1 review and responses to our consultation. Responses are published on our website and summarised in Appendix 1. We provide further detail of the reasons behind our decisions in the following sections.

Reasons for our decision: timing of a decision on revenue for 2015-16

There was no clear preferred option amongst responses. Some favoured option (a) on the basis that there would be limited identifiable merit in departing from it. Others were in favour of fixing earlier, and were split between options (b) and (c). Those that preferred option (b) felt it represented a balanced approach, providing benefits of earlier notification while ensuring that revenue would be set following a review of the efficiency of the business plans. Respondents in favour of option (c) argued that it would provide the longest notice period and therefore achieve the greatest benefit.

In our consultation we asked respondents, in particular suppliers, to provide information on the impact that each option would have on the value of the risk premium included in consumers' bills. There was limited additional quantitative evidence provided. One stakeholder referenced a report from consultants CEPA.[4] The report estimates the cost of bearing the risk of charging volatility to suppliers, consumers and DNOs based on modelled assumptions. The cost benefit analysis suggests that there would be an overall benefit to consumers from increasing the notice period for changes to network charges. The report was broader than the focus of this decision and considered the timing of announcements on network charges not just revenue. It did not consider the trade-off between a longer notice period and revenues being set based on plans which had not yet been assessed.

We have assessed the options based on the criteria outlined in our consultation. Specifically, which option is likely to achieve the most efficient allocation of risk between the different parties involved, and which option adds least complexity to the price control framework.

We have decided that earlier notification of revenue for 2015-16 is likely to benefit consumers versus option (a). The responses to our consultation and the evidence presented as part of our previous work on volatility indicate that increased predictability of revenue improves suppliers' ability to accurately price network charges into consumers' bills and will therefore benefit consumers.

We consider that option (c) will result in consumers paying more in 2015-16 than they would otherwise. In our assessment of the business plans submitted in July 2013 we concluded that the DNOs not proposed for fast-tracking had not provided sufficient justification for us to assess their proposed expenditures as efficient. It is therefore likely

[4] RIIO-ED1: Managing Volatility (September 2012):https://www.ofgem.gov.uk/ofgem-publications/50525/cepa-edf-volatility-reportfinal-260912.pdf

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that expenditure will change prior to DD.[5] We therefore consider that the potential cost of option (c) is greater than that of option (b). One DNO also noted that this option would only provide benefit to a limited number of additional consumers. Without clear evidence of the increased benefit that option (c) would create our decision is that the net benefit will be greatest by applying option (b). This will minimise the amount of deferred revenue because revenue will be fixed following our assessment of the revised business plans.

We consider that providing four months additional notice (nine months for fast-tracked DNOs) strikes the right balance between providing earlier information to stakeholders while allowing appropriate time for us to review the efficiency of DNOs' proposed expenditures.

In reaching our decision we have considered whether reducing suppliers' risk could lead to a disproportionate increase in the risk DNOs face. DD revenue could be lower than revenue set at FD. DNOs would therefore be required to fund output delivery in 2015-16 from sources other than through charges to consumers. Equally, DD revenues could be higher, and DNOs would be required to compensate consumers in future years. As we discuss below, DNOs and consumers will be compensated for any temporary cash-flow risk by uplifting any revenue deferred by WACC. Our decision to choose option (b) reduces, when compared to option (c), the potential difference between the revenue set earlier and FD revenue. We do not consider that our decision creates any additional longer term risk in the price control framework that the DNOs should be compensated for.

One stakeholder proposed an alternative option - fixing 2015-16 revenue for all DNOs at the fast-track FD in February 2014. We do not consider this to be an alternative as it would still result in 2015-16 being based on the business plan submissions and therefore result in the same outcome as option (c).

Reasons for our decision: how to treat deferred revenue

We outlined three options for how deferred revenue could be recovered:

1) all deferred revenue recovered in 2016-17
2) deferred revenue recovered over the remaining seven years of RIIO-ED1
3) deferred revenue recovered in 2016-17 unless it breached a specified threshold in which case the remainder would be spread over future years.

There was no consensus view amongst respondents on the most appropriate treatment of deferred revenue. Those in favour of option 2 or 3 considered that this would minimise the impact on network charges. Those in favour of option 1 noted that this would be the simplest approach and minimise any cash-flow risk introduced. One response proposed an alternative approach which would result in a different treatment depending on whether revenue was deferred or brought forward.

Our decision to fix revenue following an assessment of the business plans means that we expect the amount of deferred revenue to be smaller than would have been the case had we fixed revenue earlier. In our consultation we noted that option 1 would be the simplest approach. We have now considered in more detail the process of recovering deferred revenue and how existing mechanisms in the price control framework can be utilised. On this basis we now consider that option 2 represents the simplest approach.

Based on this and the responses received we have decided that deferred revenue, whether it is positive or negative, will be spread over the remaining years of RIIO-ED1. We will utilise the revenue profiling mechanism in the Price Control Financial Model (PCFM). We explain the process in more detail below. Our decision means that any reprofiling of revenue which we decide to implement, noting that the majority of DNOs proposed some

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[5] RIIO-ED1 Business plan assessment and fast-tracked consultation (November 2013): https://www.ofgem.gov.uk/publications-and-updates/riio-ed1-business-plan-assessment-and-fast-tracked-consultation

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form of profiling in their business plans, can be broadly maintained. An adjustment for WACC is incorporated into the revenue profiling mechanism to ensure the impact of the deferred revenue adjustment is neutral.

Some responses noted that WACC may not adequately compensate consumers for any temporary cash-flow risk. The uplift for WACC is intended to compensate all parties for the short-term risk, ie parties will be net present value neutral to when the timing of any adjustment. We recognise that WACC may not equally compensate all parties as different parties will have different financing costs. However, we note that this is an established discount rate used for similar revenue deferral in the price control framework. We therefore consider it the most appropriate discount rate to use here.

How we will apply this decision

We set out below the steps that we will take to implement this decision:

- At the fast-track FD in February 2014 and the DD for other DNOs in July 2014 we will set, and publish, the opening base revenue allowance (known as the "PU" value in the licence) for 2015-16.
- FD and the update of the fast-tracked DNOs' settlements[6] will occur, as planned, in November 2014.
    - This will set out the opening base revenue allowance for 2016-17.
- The revenue profiling mechanism (in the PCFM) will be used to ensure that the opening base revenue allowance for 2015-16 remains the same as that previously set. Revenue profiling from 2016-17 onwards will automatically include the revenue deferred from 2015-16.
    - The revenue profiling mechanism takes into account the time value of money.

Scope of this decision

This decision impacts on the notification of the opening base revenue allowance in 2015-16 for each DNO. Network charges will be derived by DNOs based on this revenue, however this decision does not impact on the process of setting network charges. The process is set out in the Distribution Connection and Use of System Agreement (DCUSA).

Our decision does not impact on the timing of a decision on revenue in relation to other adjustments that may impact revenue in 2015-16. For example, some incentives earned in the current price control will impact revenue in 2015-16 because they operate with a lag. This includes the incentives related to quality of service[7] and the Low Carbon Networks (LCN) Fund Second Tier competition[8] which will be run in 2014. Suppliers should continue to seek information on the expected materiality of these adjustments from DNOs.

Yours sincerely,

Hannah Nixon
Senior Partner – SG&G: Distribution

[6] The fast-track settlement will be updated including for relevant financial parameters and reprofiling.
[7] See Charge Restriction Condition 8 of the electricity distribution licence: https://epr.ofgem.gov.uk/Document
[8] For further information on the competition see: https://www.ofgem.gov.uk/electricity/distribution-networks/network-innovation/low-carbon-networks-fund

Appendix 1 – Responses to the consultation

We received responses from suppliers, DNOs and Energy UK. All responses are published on our website.[9]

Timing of a decision

Stakeholders had different views on the most beneficial option for when 2015-16 revenue could be set. From the three options we presented in the consultation, there was no clear majority preference from respondents.

Some were in favour of option (a), keeping with the current process of fixing revenue in November 2014, on the basis that there is limited identifiable merit in departing from it. They explained that this option would be in the best interests of consumers as it would provide the most accurate tariffs and minimise cash flow volatility associated with the recovery of deferred revenue. These respondents also explained that without quantification of the risk premium that suppliers may include in energy bills there should be no change to the current process.

Stakeholders in favour of option (b), fixing revenue by July 2014, stated that this option would provide the most appropriate balance between the benefits of early notification and the setting of revenue following an evaluation of the business plans. One stakeholder discussed the limited additional certainty provided by option (c), fixing revenue now, compared to option (b). It highlighted that only a small portion of consumers would additionally benefit. In comparing option (b) and (c) respondents also highlighted that option (c) could result in consumers paying more in the first year of the price control than they would other the other options. One response also raised concerns that implementing option (c) could set a precedent that network companies effectively set their own revenue for the first year of a price control period, as revenue would be based on the business plans they submit.

There were an equal number of stakeholders in favour of option (c). Their primary argument was that it provides the longest notice period for suppliers and consumers and therefore more certainty on network charges.

One stakeholder also suggested an alternative option - to use the fast-track Final Determination (FD) in February 2014 to also publish the 2015-16 revenue for the non-fast-tracked DNOs.

Relevant information

We asked respondents to provide information to improve our analysis of the net benefit of each option. In particular, we asked suppliers for information to help us make an assessment of the potential risk premium included in energy contracts and the resulting cost and benefit of each option.

Respondents provided limited additional quantitative information to support their preferred option. One stakeholder referenced a report from consultants CEPA, which estimates the cost to suppliers, consumers and DNOs of bearing the risk of charging volatility by modelling the expected reduction in the risk premium under different scenarios.

One stakeholder explained that information regarding the risk premium could not be provided as the effects of individual components used to calculate retail pricing are not separately quantified. However, they estimated that the risk premium would be approximately 3% of the total bill, costing a typical SME around £300-500 per year.

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[9] See: https://www.ofgem.gov.uk/publications-and-updates/consultation-timing-decision-electricity-distribution-networks%E2%80%99-revenue-2015-16

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Evaluating the cost

The majority of stakeholders agreed with the potential costs that we identified. One respondent noted that consumers are likely to have higher financing costs than DNOs and therefore applying a WACC adjustment to any deferred revenue may not adequately compensate consumers.

One stakeholder suggested that the DNOs are in a better position to manage and finance risk associated with deferring revenue as they can recover any cost through the price control. They also challenged the assumption that consumers may over-pay in the first year, under option (c).

Recovering deferred revenue

There was no consensus view on the most appropriate treatment of deferred revenue. Some respondents agreed that the simplest approach would be for all deferred revenue to be recovered in 2016-17. It was suggested that deferring over a longer period would also increase DNOs' cash flow risk resulting in increased financing costs. One DNO noted that recovery should be implemented consistently with the standard approach to revenue profiling.

Those stakeholders that preferred option (c) were more supportive of deferred revenue being recovered over a number of years. They explained that this would minimise the impact. Those that particularly favoured recovery in 2016-17 unless the amount breached a threshold explained that the threshold would protect against a large impact on consumers' bills in one year.

One stakeholder suggested that the treatment of deferred revenue should be different depending on whether revenue was deferred or brought forward. If revenue is deferred, it should be recovered in 2016-17 unless it breached a threshold. If revenue is brought forward it should be returned to consumers as soon as possible and therefore all be recovered in full in 2016-17.

We asked stakeholders to propose an acceptable threshold. One respondent suggested that the threshold should be determined by an expert industry group. Others proposed that the threshold be set based on a proportion of the fixed revenue. Suggestions ranged from +/-1% to +/-6% of 2015-16 revenue.

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