



Making a positive difference
for energy consumers

All electricity distribution network operators, all electricity suppliers, all electricity generators and other interested parties

Email: FutureChargingandAccess@ofgem.gov.uk

Date: 12 July 2021

Dear stakeholder,

Consultation on DNOs' request for directions to disapply the notice periods set out in the electricity distribution licence SLC 14.11 and in clause 19.1A of DCUSA Section 2A in regulatory years 2023/24 and 2024/25

On 5 May 2021, the electricity Distribution Network Operators (DNOs) wrote to us requesting formal directions to relieve them of their obligations in respect of the notice periods for changes to distribution use of system (DUoS) charges for the first two years of the next price control (RIIO-ED2), which commences from 1 April 2023.

The DNOs raised concerns that, if they were required to publish DUoS charges for 2023/24 and 2024/25 with 15 months' notice, they would have to set prices before final determinations on allowed revenue under RIIO-ED2 are published. This could require large corrections being made in later years when the final determinations are known, resulting in significant price volatility. To mitigate any associated risks, DNOs are asking that we¹ issue the following directions for 2023/24 and 2024/25:

¹ References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.

- Direction under clause 19.1B² of the Distribution Connection and Use of System Agreement (the DCUSA) that the periods of notice described in clause 19.1A of Section 2A of the DCUSA need not apply
- Consent under electricity distribution Standard Licence Condition (SLC) 14.12³ that SLC 14.11 need not apply.

If these directions were made, DNOs have proposed that they would publish:

- DUoS charges for 2023/24 with 60 days' notice or 20 working days after we publish RIIO-ED2 final determinations – whichever is later (e.g. assuming final determinations are published by 31 December 2022, then charges would be published by 31 January 2023)
- DUoS charges for 2024/25 with at least three months' notice and no later than 31 December 2023.

In 2015, we approved a modification to DCUSA (known as DCP178⁴) to increase the notice period for DUoS changes from 40 days to 15 months, because we concluded that the benefit of earlier notice of DUoS charges for suppliers and large customers outweighed the forecasting risk faced by the DNOs. We are not reopening the overarching decision, but we acknowledge that the start of a new price control period can create significantly more uncertainty than within a price control period, potentially leading to greater charging volatility.

We have considered the issues identified by the DNOs in their letter and we give our initial views below. Although we have also considered the implications of issuing the proposed directions for other stakeholders, we recognise that there may be other factors or stakeholders may give different weights to the issues than we have done. Therefore we are inviting responses to the consultation questions set out in this letter to better inform our final decision.

Background

Applying the current 15 month notice period for DUoS charges in conjunction with the start of RIIO-ED2, would mean that:

² https://www.dcusa.co.uk/dcusa-digital-document/DCUSA/DCUSA_Section_2A/DCUSA_Section_2A.htm

³ <https://epr.ofgem.gov.uk//Content/Documents/Electricity%20Distribution%20Consolidated%20Standard%20Licence%20Conditions%20-%20-%20Current%20Version.pdf>

⁴ <https://www.ofgem.gov.uk/ofgem-publications/93572/dcp178d.pdf>

- **December 2021** – DNOs submit their final business plans and publish their DUoS charges for 2023/24
- **Mid-2022** – we expect to publish our RIIO-ED2 draft determinations for consultation
- **December 2022** – we expect to publish our final determinations on the DNOs' allowed revenue and a statutory consultation on the licence changes;
by 31 December 2022 DNOs publish their DUoS charges for 2024/25
- **February 2023** – we expect to publish our final decision on RIIO-ED2 licence condition changes
- **September 2023** – if DNOs appeal the RIIO-ED2 final determinations to the Competition and Market Authority, final revenues would not be known until this stage.⁵

DNOs highlight that this combination of events means that they will have to base their 2023/24 charges on the revenue forecasts in their final business plans. Additionally, if final determinations are not published until the end of 2022, they will also have to base 2024/25 charges on allowed revenues in our draft determinations.⁶ DNOs note that for both years, therefore, charges may need to be set when there is still significant uncertainty around final allowed revenues, due to the start of a new price control period.

This could materially increase the risk that DNOs significantly over/under recover their allowed revenue. If this happens, the “true-up” in the following years could result in excessive price volatility. Under RIIO-ED1, if under-recovery or over-recovery exceeds the correction factor or ‘k-factor’⁷ tolerance limit (set at 6% of allowed revenue), the penal interest rate may be applied, and networks may be subject to a loss of revenue of 1.5% of the under/over recovery. Also, in case of significant under-recovery, DNOs could face some short term cash flow risk, due to timing factors beyond their control.

⁵ The CMA has six months to make a decision following an appeal, which they can extend by one month.

⁶ In the attachment to their request, DNOs note that final determination could possibly be used if this were available in early December, to allow sufficient time to produce charges and obtain the necessary internal approvals.

⁷ The calculation of the correction factor is set out in the Electricity Distribution Licence – Charge Restriction Condition 2A (Restriction of Allowed Distribution Network Revenue), Part E
https://www.ofgem.gov.uk/sites/default/files/docs/2015/02/crc_slow_track_master_0.pdf

Our initial views

Relieving the DNOs temporarily of the obligation to provide 15 months' notice would ensure they are able to reflect RIIO-ED2 final determinations on allowed revenue in charges for 2023/24 and 2024/25. This would mitigate the risk of excessive under or over recovery of revenue and any associated penalty rate and financeability risks, as well as limiting any increase in price volatility that could emerge from major "true-ups".

We also recognise the benefits for suppliers deriving from the increased certainty and predictability provided by the 15 month notice period. When we were considering DCP178,⁸ suppliers told us that the uncertainty around final DUoS charges meant that they were exposed to increased budgeting uncertainty because they did not have sufficient notice of DUoS charges to be able to reflect them in tariffs. As a consequence, they had to incorporate higher premium risks in their final tariffs, increasing costs faced by their customers.

In addition to this, we recognise that, were DUoS notice period to be reduced, some suppliers may need to revise their tariff offerings or product range, where they depend on a longer notice period (eg, non-pass through contracts for large customers). If this happens, this may also expose large customers to some budgeting uncertainty or higher tariffs (eg, if suppliers do not offer non-pass through contracts or only offer them under less favourable terms).

When we approved DCP178, we judged that, on balance, the benefits of increased certainty and transparency of tariffs would outweigh the risks of increased volatility arising from DNOs facing a higher number of unknowns at the point of setting tariffs 15 months in advance. However, we acknowledge that the movement between price controls can create additional complexity for the DNOs when setting charges and increases their risk.

Based on these considerations, we think there are two main options and an additional (less favoured) option available, on which we want to consult. The three options on which we provide more details below, are:

1. Directions
2. Letter of comfort
3. DCUSA Code modification

⁸ <https://www.ofgem.gov.uk/publications-and-updates/consultation-proposal-increase-significantly-notification-period-changes-distribution-use-system-charges>

1. Directions

We can reduce the notice period for DUoS charges by directing that DCUSA clause 19.1A does not apply. If required, we could also consent that SLC 14.11 does not apply and identify replacement notice periods for the relevant regulatory years.

Under clause 19.1B of DCUSA, if we direct that the 15 month notice period does not apply to 2023/24 charges, the alternate notice period is 40 days (without prejudice to any longer notice requirements prescribed by the Distribution Licence). Under the Distribution Licence, DNOs would still be bound by SLC 14.11, which requires them to publish their charges no later than three months before the start of a charging year (ie, by 31 December 2022). To comply with this, the DNOs would most likely have to base their charges for 2023/24 on the RIIO-ED2 draft determinations, due to the expected timing of final determinations and the time it takes for them to set their charges.

We note that in previous price controls we have not seen significant changes between draft and final determinations, and at this time we are not aware of any factors to suggest RIIO-ED2 could be more volatile. Therefore, our initial view is that draft determinations can provide enough certainty to be a basis for 2023/24 charges. However, if we receive compelling evidence of why basing charges on draft determinations creates too much volatility risk, we could also issue a direction that SLC14.11 does not apply to 2023/24 charges. Instead, DNOs would publish their charges 20 working days after we have made our final determinations.

We appreciate that by issuing a direction with regards to regulatory year 2023/24 only, DNOs will still have to publish charges for 2024/25 by 31 December 2022, which is also when charges for 2023/24 would be due under a DCUSA direction. We think it would be acceptable for DNOs to publish both set of charges together, based on either draft determinations or final determinations if available sufficiently in advance⁹.

We have already outlined above our initial views on the direction option: although reducing the notice period for 2023/24 would better address DNOs' concerns and mitigate the risk of excessive price volatility, there are potential impacts on suppliers and large customers that need to be carefully considered. In particular, we recognise that reducing the notice period may just transfer financeability risk from DNOs to suppliers, if they cannot factor the changes in charges into their contracts.

⁹ It is our understanding that there is a precedent to this: following the implementation of DCP178 in November 2015, adopting the 15-month notice period meant that DNOs had to publish both charges for 2016/17 and 2017/18 by 31 December 2015.

Additionally, we also notice potential interactions with the implementation timings of the tariff price cap. For the cap period 1 April–30 September, we require all costs incurred in that period to be published by the end of January at the very latest. If these figures are not made available by this stage they cannot be fed through to the price cap for that period, meaning that suppliers would not be able to recover these costs for an additional six months. This would mean that issuing a direction disapplying SLC 14.11 as described above – with DNOs publishing 2023/24 charges 20 working days after final determinations – could further increase supplier risks.

Consultation Question 1: Do you agree with our initial views on whether to issue directions that the relevant DCUSA and licence conditions do not apply? Please provide evidence to support your views, including on whether any or some directions should be issued and the benefits and risks with each option. If we do issue a direction (or directions):

- (i) Should these apply for 2023/24 and 2024/25, or just 2023/24?,**
- (ii) Should it be a direction only disapplying DCUSA Section 2A clause 19.1B or also electricity distribution licence SLC 14.11?**
- (iii) If both, what should the notice period be and why?**

Consultation Question 2: Can you provide any specific evidence about the impact of varying notice periods on contractual arrangements and budgeting?

2. Letter of comfort

We may finally decide to retain the current notice periods if we assess that, on balance, the issues associated with directions would outweigh the benefits. We can still mitigate some of the risks associated with the timings of RIIO-ED2 by issuing a letter of comfort to DNOs confirming that we would not apply the penalty interest rate in regulatory year 2023/24. Under this option, as DNOs will still have to publish charges for this year by 31 December 2021 based on more uncertain estimates in their final business plans, we would provide reassurance that, if their under or over recovery exceeds the k factor bands¹⁰ and any forecasting errors are due to the difference between expected and final allowed revenue, rather than poor quality estimates in general, they would not be penalised. We notice, however, that as the penalty interest rate is intended to incentivise the DNOs to provide robust consumption and other forecasts, this is a tool we may want to still have available to address obvious cases of underperformance.

¹⁰ See note 7 above.

We could extend this comfort to regulatory year 2024/25, although there is less of a strong argument for this: charges for this year would be in all likelihood based on RIIO-ED2 draft determinations¹¹ and allowed revenue estimates based on these may be sufficiently firm. In fact, although each price control is different, we note that, at the start of RIIO-ED1, allowed revenues increased by only 1% between draft and final determinations.

This would address some of the DNOs' concerns and retaining the 15 month notice periods for 2023/24 and 2024/25 has the benefit of maintaining greater budgeting certainty for suppliers, which may translate into lower tariffs for customers (where suppliers reduce their risk premiums) and more certainty for larger customers.

However, even if this option would reduce the risk of penalty rates, where revenue variance may be due to regulatory uncertainty, it would not necessarily address the potential increase in charge volatility, as charges would still be set in advance of draft or final determinations.

This means that the DNOs could still face some financeability risk associated with short term cash flow volatility. We note, however, that we have not seen any quantitative evidence of the potential impacts on DNOs' overall financial position in RIIO-ED2, which would allow us to assess the materiality of the financeability risk. We would also like to gain a better understanding of the extent to which a significant volatility in charges prolonged over years can be detrimental to suppliers and large customers.

Consultation Question 3: Do you agree with our initial views on the potential for a letter of comfort being sufficient to mitigate the main risk for DNOs? If no, please provide evidence of what the remaining risks are with this option?

Consultation Question 4: Do you think the benefit of advanced notice of charges outweighs the risk of significant under/over-recovery over multiple years? Please provide evidence to support your preference.

3. DCUSA code modification

Finally, we have also considered the possibility of following the DCUSA code modification process, if a DNO raised a proposal to introduce changes to the notice period for DUoS charges for 2023/24 and 2024/25. Although we recognise this would provide an

¹¹ Or even on final determinations, if made available sufficiently in advance. See note 6.

opportunity for industry parties to discuss and develop the change under an open governance process, we think there are major issues with this option:

- The DCUSA specifically includes a provision to allow us to issue directions to temporarily suspend the notice periods and so we think there would be limited value in undertaking a full code modification process to develop a proposal, which would still come to us for decision
- Code change proposals are resource and time intensive. By engaging with the present consultation, the industry has an opportunity to provide relevant evidence that is material to the decision making process in an effective way and quicker than through the normal code modification process
- In general, only code modifications that have been granted urgent status have statutory deadlines. Without presupposing the outcome of any assessment of urgency under clause 10.7 of DCUSA, should that status not be given, then the timetable for development of a modification is very uncertain
- The code modification proposal does not address the additional timing issue with 2023/24 charges, which would need to be published no later than 31 December 2022 to comply with electricity distribution SLC 14.11. This would still not allow the DNOs time to reflect final allowed revenues in charges.

Given these issues, and the fact we are providing industry parties with an opportunity to provide views on the proposed directions through this consultation, we do not think a full modification change process is a proportionate approach to addressing this issue.

Consultation Question 5: Do you agree with our views on the option to use the code modification process to address the timing issues between price controls? If not, can you provide any evidence regarding the benefit of applying a code change?

Our consultation questions

We are inviting your views on our initial assessment of the options available. In light of the considerations above, we strongly encourage suppliers to publicise this consultation to all of their affected customers so that they can have the opportunity to share their views. In particular, we welcome responses to the following questions:

1. Do you agree with our initial views on whether to issue directions that the relevant DCUSA and licence conditions do not apply? Please provide evidence to support your

views, including on whether any or some directions should be issued and the benefits and risks with each option. If we do issue a direction (or directions):

- i. Should these apply for 2023/24 and 2024/25, or just 2023/24?
 - ii. Should it be a direction only disapplying DCUSA Section 2A clause 19.1B or also electricity distribution licence SLC 14.11?
 - iii. If both, what should the notice period be and why?
2. Can you provide any specific evidence about the impact of varying notice periods on contractual arrangements and budgeting?
 3. Do you agree with our initial views on the potential for a letter of comfort being sufficient to mitigate the main risk for DNOs? If no, please provide evidence of what the remaining risks are with this option?
 4. Do you think the benefit of advanced notice of charges outweighs the risk of significant under/over-recovery over multiple years? Please provide evidence to support your preference.
 5. Do you agree with our views on the option to use the code modification process to address the timing issues between price controls? If not, can you provide any evidence regarding the benefit of applying a code change?
 6. Do you have any further evidence or information that you think is relevant and can help inform our decision?

Next steps

Please submit your response by 9 August 2021 to the following email address:

FutureChargingandAccess@ofgem.gov.uk.

We will use your responses to inform our final decision. We intend to publish this in time for DNOs to initiate their standard process for setting charges by 31 December 2021 (we understand this usually commenced in September), in the event that we decide not to issue directions regarding the notice periods.

If you would like your response to be kept confidential, you should mark it as such and outline your reasons for this. Any responses not marked confidential will be published on our website.

We recommend respondents, particularly suppliers, publicising this letter among their customers to encourage widespread engagement with this consultation.

Yours faithfully,

Patrick Cassels

Head of Electricity Network Access