ofgem
Making a positive difference
for energy consumers

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

Email: FutureChargingandAccess@ofgem.gov.uk

Date: 20 September 2021

Dear colleagues,

Decision on DNOs request for directions to temporarily disapply the current DuoS charges notification periods

On 5 May 2021, we received a request from the Distribution Network Operators (DNOs) to temporarily disapply the notice period for distribution use of system charges (DUoS) during the first two years (2023/24 and 2024/25) of the next price control (RIIO-ED2). The DNOs raised concerns that the current 15-month notice period requires them to set prices before final determinations on allowed revenues were known.

This letter sets out our decision to reject the request on the basis that issues associated with the shortened notice periods would outweigh its benefits.

Background and consultation

DNOs are required under the Distribution Connection and Use of System Agreement (DCUSA) to publish final DUoS charges for the forthcoming year (1 April – 31 March) 15 months in advance. The 15-month notice period was introduced in 2015 as part of a DCUSA modification (DCP178[1]) and is set out in clause 19.1A of DCUSA Section 2A. We approved DCP178 having concluded that the benefit of earlier notice of DUoS charges for suppliers and consumers outweighed the forecasting risk faced by the DNOs.

[1] https://www.ofgem.gov.uk/sites/default/files/docs/2015/02/dcp178d.pdf

We are not reopening the overarching decision on DCP178 at this stage, but we acknowledge that the start of a new price control can create significantly more uncertainty than within a price control period.

On 12 July 2021, we issued a consultation[2] to allow all stakeholders the opportunity to provide feedback and evidence of impacts on their business for a number of options we were considering:

(1) **Directions.** We would direct that the 15-month notice period does not apply for up to the first two years of the RIIO-ED2 price control (2023/24 and 2024/25)

(2) **Letter of comfort.** We would retain the current notice period but would provide reassurance to DNOs that we would not apply the penalty interest rate in regulatory year 2023/24 if their under or over recovery exceeds the k factor bands[3] and any forecasting errors are due to the difference between expected and final allowed revenue, rather than poor quality estimates in general

(3) **DCUSA code modification.** This would utilise the open governance process to introduce changes to the notice periods for 2023/24 and 2024/25 DUoS charges. We noted in our consultation that we did not favour this option due to the lengthiness and resource intensity of a full code-modification process.

Consultation responses

We thank all parties for their considered responses to our consultation. We received 20 responses and we have published those that are non-confidential alongside this decision. Overall, respondents were equally split in favour of the first two options, with DNOs supporting 'directions' and suppliers supporting the 'letter of comfort'. Respondents identified a range of potential costs and benefits associated with our proposed options.

Directions

- Respondents who favoured this option argue that final business plans for RIIO-ED2 are not the right basis on which to set network charges, and setting in accordance with Ofgem's final determinations would be more appropriate
- There is a perception that RIIO-ED2 is fundamentally more uncertain than RIIO-ED1 due to increased need for investment linked to net-zero and the associated rollout of low carbon technologies as well as the potential impact of key policy reform

[2] https://www.ofgem.gov.uk/publications/consultation-dnos-request-directions-temporarily-disapply-current-duos-charges-notification-periods
[3] 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

programmes, for example, the Access and Forward-looking Charges Significant Code Review (SCR)

- Over/under recovery in years one and two of RIIO-ED2 would result in charging volatility during the latter years of the price control
- Several DNOs raised concerns of cash-flow risks associated with mismatches between expenditure and revenue recovery
- DNOs' collective view is that the 15-month notice period requirement should be reviewed within the wider context of DUoS reforms and the implementation of RIIO-ED2 uncertainty mechanisms, suggesting that increased uncertainty warranted shorter notice periods

Letter of comfort

- This position was favoured by suppliers and large user groups who argue DNOs are better placed to manage uncertainty over the price control period: DNOs are regulated businesses, with large balance sheets and guaranteed revenues resulting in overall lower risk than suppliers, which means they can better manage any risk of forecasting error
- Shortening the notice period only serves to transfer risks associated with forecasting error to suppliers and customers on pass-through contracts, who will have even less of a view than DNOs of final allowed revenues for RIIO-ED2 15 months before charges are set
- The reasons that the 15-month notice period was introduced are still valid, i.e. avoidance of high risk-premia in consumer contracts and costs certainty for larger customers on pass-through contracts

Decision

We have decided not to grant the request to disapply the current DUoS notice periods.

We considered the concerns raised in the DNOs' original request and the responses to our consultation, and concluded that, on balance, issues associated with shortening the notice periods outweigh the benefits at this time. We acknowledge that there could be merit in reviewing the 15-month notice period going forward in order to improve cost reflectivity of DUoS charges. While this is not a decision that we are prepared to take today, it is something that we could look to revisit as part of a wider review of DUoS.

For the initial years of RIIO-ED2, DNOs will still have to publish changes to DUoS charges with a 15-month notice period. However, to mitigate some of the risks associated with setting charges before final allowed revenues are firm, we confirm that we will not apply penalty interest rates on any excess over/under recovery eventually incurred by DNOs as a result of differences between expected and final allowed revenue for regulatory years 2023/24 and 2024/25.

Reasons for our decision

We consider that the risks associated with shortening the notice period outweigh the benefits at this time for the following reasons.

a) Reducing the notice periods represents a transfer of risk from DNOs to suppliers and consumers

When DCP178 was approved, we recognised the benefits suppliers could derive from the increased certainty and predictability provided by the 15-month notice period. For many suppliers, forecasting errors are directly linked to lost revenue as many customer contracts are fixed 12-24 months in advance, with no ability to "true up" in the future. Suppliers have told us that the certainty derived from the 15 month notice period benefits consumers via reduced risk premia applied to customer contracts. Large consumer groups who responded to our consultation have suggested that the risk of over/under-recovery is significantly outweighed by the benefit of certainty in budgets afforded by the longer notice period.

We consider that current conditions of high consumer prices and challenging supplier markets make it difficult to justify any action that increases risk to suppliers and consumers. We therefore agree with suppliers and large consumer groups that the 15 month notice period provides more certainty and predictability, even where adjustments will have to be made later in the price control.

b) DNOs are better placed to manage forecasting risks associated with RIIO-ED2 than suppliers and consumers

We acknowledge the challenges associated with charge setting where final allowed revenues for the next price control period are not yet firm. However, we consider that DNOs are better placed to manage the risks associated with uncertainty in between price control periods than suppliers who have even less visibility into DNOs' final allowed revenue. We share DNOs' concerns that this could potentially lead to the need for adjustments in the latter years of RIIO-ED2 but do not consider that we have received sufficient evidence of the impact of this volatility on final consumers to support a shortened notice period. We would welcome further engagement with the DNOs to consider other avenues to mitigate emerging risks and manage price volatility associated with charge setting.

When DCP178 was approved, we considered similar concerns to those outlined above. At the time, we concluded that, although the DNOs will have to base their final charges on forecast allowed revenue, they would still reflect the costs that they reasonably expect to incur. While there are valid arguments that RIIO-ED2 is inherently more uncertain, we still consider that DNOs have control over their expenditure and are able to reflect reasonably expected costs in their charge setting.

Some DNOs have raised concerns that the longer notice periods coupled with greater uncertainty could result in financeability issues due to mismatches between expenditure and revenue recovery. However, we do not consider that we have received sufficient evidence to assess the materiality of this risk. We would also like to reassure DNOs that there are sufficient mechanisms within the price control to true-up any over or under recovery. In RIIO-ED2, we are also proposing to introduce mechanisms that will reduce the lag between under-recovery and when a DNO can true-up, which should mitigate this cash flow risk. We are proposing to allow networks to recover any forecast over/under-recovery with a one year lag, rather than the current 2 year lag [4].

Next steps

We expect the DNOs to continue to publish DUoS charges with 15 months notice. We confirm suspension of the penalty interest rate associated with any over/under-recovery exceeding the k-factor bands in the first two years of RIIO-ED2 (2023/24 and 2024/25), where this would result from the lack of information on final allowed revenues at the time of setting charges, rather than obvious cases of forecast underperformance on the part of DNOs. We will set out the required licence changes as part of the RIIO-ED2 licence consultation in 2022.

Yours faithfully,

Patrick Cassels

Head of Electricity Network Access - Energy Systems Management and Security

[4] For further details, please see paragraph 8.87 of the RIIO-ED2 SSMD Finance Annex https://www.ofgem.gov.uk/publications/riio-ed2-sector-specific-methodology-decision