

Patrick Cassels
Head of Electricity Network Access
The Office of Gas and Electricity Markets
10 South Colonnade,
Canary Wharf,
London,
E14 4PU

Electricity North West
Hartington Road, Preston,
Lancashire, PR1 8AF

Email: enquiries@enwl.co.uk
Web: www.enwl.co.uk

Direct line: 07879 115204

Email: paul.auckland@enwl.co.uk

Sent by email only to: FutureChargingandAccess@ofgem.gov.uk.

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Dear Patrick,

Electricity North West's response to Ofgem's 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

Thank you for the opportunity to respond to our collective request for a direction to disapply the notice periods for amending DUoS prices for regulatory years 2023/24 and 2024/25.

The urgent need for a direction is to remove the obligation to publish DUoS charges for 2023/24 in December 2021 when the allowed revenue is uncertain. In this context we believe a direction is preferable to either a letter of comfort or a DCUSA Code Modification. In the discussions with Ofgem prior to submitting the direction request, it was agreed to narrow the focus of the request to only address this short-term issue though it was raised consistently that the requirement for a 15-month notice period would need to be revisited. The need to revisit the principle of the approach is both in the context of any charging reforms emerging from the Access & Forward-Looking Charges Significant Code Review and the ED2 Price Control process where the application of uncertainty mechanisms and the need to meet rapidly evolving customer needs such as through the challenges of Net Zero targets will require prices to be adjusted with shorter notice periods (3 months ahead).

We see no justification for the different approach between DNOs, who are required to give 15 months' notice, and other networks operators (e.g. GDNs) who have shorter notice periods. We note Ofgem's decision on DCP178 (Notification Period for Change to Use of System Charges), however looking ahead to RIIO-ED2 there are different circumstances, and we consider that consumers would benefit overall should the notice period be 3 months for all tariffs set for the ED2 period. We are therefore surprised by the statement that you are not reopening the overarching decision to require 15 months' notice because with the Ofgem Access SCR underway and the proposals for fast acting uncertainty mechanisms in ED2 that your statement should be carefully caveated to ensure it is understood that a review is needed. We suggest this consultation would have been a valuable opportunity to ask for views on a longer-term change without necessarily needing to decide now, though we think this would be desirable to give stakeholders as long notice as possible of the potential for a change. Whilst not revisiting the DCP178 Overarching decision is acceptable in the narrow context of this direction request, we suggest there needs to be a full re-examination of the



issues prior to the start of ED2, and likely as part of Ofgem’s own SCR charging review work and considering DNOs in a tighter price control with more uncertain needs and the these being met by mechanisms.

An illustration of how annual forecast spend updates, in the context of an uncertainty mechanism, could feed into price setting under both 15 months notice and 3 months notice is presented on the table below. For this example, we anticipate consolidating annual reforecasts of consumer needs and the associated spend required in July each year during ED2, with the timing aligned to the current annual regulatory reporting requirements.

Annual forecast update	15 months notice of DUoS Charges	3 months notice of DUoS Charges	Potential cash flow delay if 15months notice is retained
Changes to current year (T) spend forecast	Prices adjusted in T+2 through K factor adjustment	Prices adjusted in T+1 through K factor adjustment	1-year
Changes to next year (T+1) spend forecast	Prices adjusted in T+3 [^] .	Prices adjusted in T+1	2-years
Changes to following year (T+2) spend forecast	Prices adjusted in T+2	Prices adjusted in T+2	No change

[^]T+1 prices are already set. The change in spend impacts under/over recovery in T+1 and is adjusted in T+3 prices.

It is clear that 15 months notice results in additional timing delays between the network investment spend and the revenues received through price setting. This delay represents a potentially significant financing challenge for networks in ED2:

- Firstly, there is a high degree of uncertainty regarding Future Energy Scenarios and the timing of spend required to support the delivery of net zero. This could lead to material revisions to ED2 spend forecasts during the price control.
- Secondly, the change to 45-year asset lives in ED1 has reduced the rate of **return of capital** flowing to networks in ED2. When combined with sharply lower proposed **returns on capital**, particularly from Ofgem proposals for much lower equity returns, there is a reduced cash flow capacity within networks to fund investment in advance of receiving revenue.
- Thirdly, Ofgem is proposing to reduce the notional gearing level to 60% in ED2, from 65% in ED1, exposing networks to potential tax clawback penalties if actual gearing levels are above the new, reduced notional gearing level. This limits the ability of networks to source additional debt funding to bridge any cash flow delays.

These issues are accentuated for us - the sector-average approach to setting the debt allowance is effectively requiring our shareholders to subsidise approximately £80m of efficiently incurred debt costs in ED2¹, potentially impacting our ability to respond to increases in totex spend within the price control.

Reverting to 3-month notice would help to alleviate some of these challenges, allowing networks to respond more easily and quickly to changing network investment demand.

We also highlight that should Ofgem de-risk the delivery of net zero by providing networks with ex-ante allowances, then a 3-month price setting would also return any under-spend to customers far more quickly than under a 15-month price setting process.

¹ As outlined in our Draft ED2 Business Plan submission

Suppliers said during the process to approve DCP178 that moving to the 15-month notice period would result in them reducing the risk premiums included in their tariffs. If the 15-month period is to be retained, we expect suppliers to provide hard quantifiable evidence of the benefits customers have received from this approach during ED1 and how these benefits cannot be maintained. Supplier prices are currently subject to regulation so we think suppliers might be able to take some comfort from a price cap adjustment should Ofgem see robust evidence of needing to make an appropriate allowance.

Please find attached our response to the consultation questions, which are to read in the context of this direction request only. We suggest Ofgem to conduct a wider review of the 15-month notice period next year and that transparency around the need to do this is laid out as part of your decision on this consultation.

Yours sincerely

Paul Auckland
Head of Economic Regulation

c.c. James Veaney, Stephen Henderson, Patrick Cassels

RESPONSE TO CONSULTATION QUESTIONS

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?

We agree with the need to issue directions to DNOs to remove the obligation to publish charges for 2023/24 in December 2021 and for 2024/25 in December 2022 since these charges would need to be set on DNO Final Business Plans and six months before Ofgem publish their draft determinations and nearly twelve months before it publishes its final determinations on these plans. Such early publication would also prevent potential changes to DUoS which may emerge when considering the implementation of Ofgem's Access SCR Minded-to Consultation, though it is acknowledged that the wider reform of DUoS Charges under the Access SCR are likely to be delayed.

We believe that the direction must apply to both the DCUSA and Licence obligations to be effective unless Ofgem can guarantee that its Final Determination on ED2 is published with sufficient notice to allow charges for April 2023 to be issued with the three months' notice specified in the Licence.

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

We are a distribution business though our observations are energy costs and other policy costs certainly vary materially and suppliers can manage these. Ofgem's work setting the retail price cap and into supplier costs in recent years may have identified the overall supplier cost reduction when DCP178 was implemented as a result of that change. We suggest Ofgem might be able to look back and see what benefits were conferred to customers when the move to 15 months took place to get a view of what moving to 3 months' notice might be. Suppliers themselves may also have evidence to submit from the time as to how the change to 15 months directly led to customer cost reductions. We encourage confidential responses to be made to Ofgem and/or for Ofgem to make carefully designed and proportionate data requests of suppliers to seek to identify the consumer impacts of DCP178.

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?

No, we do not believe a letter of comfort to be sufficient. This would still require charges to be published this December for 2023/24 and in December 2022 for 2024/25. As stated in our response to question 1 it would effectively mean that charging structures would also remain fixed over those periods also and inhibit the ability to implement consequential changes that may be beneficial from any changes coming from the Access SCR. Additionally, we are unsure if this would actually help suppliers because our experience is the price control process does have impacts on allowed revenues which as a DNO are impossible to predict. We are confident of the value and legitimacy of our business plan submission(s), but we do still experience adjustments being made as we continue through the price control process. The Ofgem consultation on draft ED2 determinations and subsequent final determinations all mean the allowed revenue for 2023/24 is likely to be subject to direct influence by Ofgem.

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.

We have not seen any evidence of the benefits that the advance notice to suppliers, trialled over ED1 by DNOs, has resulted in gains for customers. If there are such benefits to customers in such long notification periods, we question why they are being provided solely by DNOs and not by other network owners. For the avoidance of doubt, we do not recommend rolling out longer notice to other network sectors as the consumer case is not proven.

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?

We agree that using the code modification process is inappropriate at this stage in removing the requirement for DNOs to publish prices for 2023/24 in December 2021 and in December 2022 for 2024/25.

We do believe that code modifications are essential to remove the 15-month notice period and revert to 3-months for ED2. The work undertaken to date on the Access SCR indicates that more responsive pricing signals are likely to be needed to support the achievement of Net Zero targets and the current DCUSA arrangements do not facilitate this. The Net Zero targets are also likely to mean greater volatility in load related expenditure and the need to adjust DNO revenues more rapidly to address the level of uncertainty. Again, the 15-month notice period is not consistent with these potential new realities.

6. Do you have any further evidence or information that you think is relevant and can help inform our decision?

We suggest Ofgem uses its information gathering powers to request data and information from Suppliers if it does not already have the data needed to understand the likely quantum of benefit / cost change for suppliers of moving to a 3 months' notice period from 15 months.