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

Dear Patrick,

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 the above consultation. This is a non-confidential response on behalf of the Centrica Group.

It is disappointing that it appears that Ofgem and the Distribution Network Operators (DNOs) have been in discussion surrounding this issue since February and it is only now that other stakeholders are being presented with a range of options, all of which we believe have drawbacks. As a result of this lack of proper engagement we believe an option has been missed which provides a more sensible approach, mitigating the risks faced by DNOs, suppliers and customers.

- **Allowed revenues for 2023/24 to be finalised at RIIO-ED2 Draft Determinations**
- **Charges for 2023/24 to be published 20 working days after Draft Determinations**
- **A DCUSA change may be necessary**

Allowed revenues for 2023/24 to be finalised at RIIO-ED2 Draft Determinations

We believe that finalising 2023/24 allowed revenues at Draft Determinations strikes the right balance between providing early information to stakeholders, allowing Ofgem appropriate time to review the efficiency of DNOs' proposed expenditures, and minimising any necessary true-ups following Final Determinations. Any differences in allowances between Draft Determinations and Final Determinations for 2023/24 can be recovered over the remaining years of the RIIO-ED2 price control.

Importantly, we note that this is the same approach that Ofgem applied, following consultation, to set first year revenue allowances in RIIO-ED1. In the RIIO-ED1 consultation¹ Ofgem highlighted the concerns raised by suppliers regarding the need for adequate notice to accurately price the

¹ <https://www.ofgem.gov.uk/publications/timing-decision-electricity-distribution-networks-revenue-2015-16>
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network charges resulting from RIIO-ED1 into the contracts that they offer consumers without the need for unnecessary risk premiums. Ofgem consulted on three options for setting the first year RIIO-ED1 revenues:

- Option (a): 2015/16 revenue set at Final Determinations (Dec-14)
- Option (b): 2015/16 revenue set at Draft Determinations for slow tracked DNOs (Jul-14)
- Option (c): 2015/16 revenue set earlier based on DNO business plan (Dec-13)

Ofgem decided to implement Option (b), concluding that the additional notice period, compared to Option (a), would benefit suppliers, and in turn consumers. Ofgem also concluded that option (c), whilst providing greater notice, would not benefit consumers and could result in consumers paying more in 2015/16 than they would otherwise, which it considered would leave consumers worse off as the benefit of increased predictability would be diminished.

Whilst the RIIO-ED1 consultation was limited to revenues and did not extend to DUoS charges (DCP178 had not yet been implemented), there is a clear overlap with the issues being considered as part of this consultation for the revenue assumptions to be used to set 2023/24 DUoS charges. However, the key omission is that the options being presented in this latest consultation correlate most closely with Options (a) and (c) of the RIIO-ED1 consultation, despite these options being rejected by Ofgem for RIIO-ED1 in favour of Option (b).

We find it surprising that neither Ofgem nor the DNOs explore the option of setting final 2023/24 allowances at Draft Determinations, which would facilitate earlier charge setting. We question why this RIIO-ED1 precedent has been ignored and ask Ofgem to justify why RIIO-ED2 is different to RIIO-ED1 and how the RIIO-ED1 discussion and responses are no longer relevant. If this was an oversight, it is one which would have been quickly identified with earlier engagement with wider stakeholders.

Charges for 2023/24 to be published 20 working days after Draft Determinations

Once Draft Determinations have been published, we believe charges for 2023/24 should be published within 20 working days. This represents the timescales that the DNOs have stated would be required between Final Determinations and charge publication, and so we believe it could be equally applied following the publication of Draft Determinations.

If 2023/24 revenue allowances are finalised at this point, it will provide more certainty to suppliers and DNOs. Suppliers will have confidence that DUoS charges for 2023/24 will reflect a reasonable view of efficient cost allowances as they assess the risk associated with 2023/24 charges when entering into contracts with customers. DNOs will be able to set 2023/24 charges using a definitive revenue allowance, whilst not implicitly accepting Ofgem's price control proposals.

We also recognise that Ofgem could direct that charges be published within 20 workings days of Draft Determinations even if 2023/24 revenues are not finalised at that point. As Ofgem points out in the consultation, Draft Determinations can provide enough certainty to be a basis for 2023/24 charges. However, under such an approach, we are not convinced that DNOs would be compelled to use the Draft Determination 2023/24 revenue allowance for tariff setting, particularly if they did not want to give the impression of implicitly accepting the proposals, and so they may continue to set charges based on their own business plan submissions.

A DCUSA change may be necessary

Whilst we appreciate that the DCUSA change process can be resource heavy, we are concerned that the present governance arrangements only facilitate either a 15 month notice period or a 40 day notice period.

The DCUSA arrangements in 19.1B are clear:

*Where the Authority directs the Company that those periods of notice need not apply, **the notice period shall be 40 days** (without prejudice to any longer notice requirements prescribed by the Distribution Licence). [emphasis added]*

In its consultation, Ofgem state that under the Distribution Licence, DNOs would still be bound by SLC 14.11, which requires them to publish charges no later than three months before the start of a charging year. However, in practice SLC 14.11 has only ever put an obligation on DNOs to provide three months **indicative** notice of a change in tariffs. This is made clear in SLC 14.12:

- 14.12 *Except where the Authority otherwise directs or consents, 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;*
 - (b) the amendment, when made, conforms to the proposals set out in that Notice (**except for any necessary revisions resulting from the occurrence of a material change after the Notice has been given, to any of the matters on which the assumptions set out in the statement under paragraph 14.11 were based, and then only to such extent as is necessary to reflect the change in such matters**) [emphasis added]; and*
 - (c) the amendment takes effect on 1 April of the relevant Regulatory Year.*

Prior to the implementation of DCP178, the conventional practice was that DNOs would provide indicative tariffs at the end of December, as required by SLC 14.11, and then final tariffs at 40 days' notice, as required by DCUSA. Changes between the two sets of tariffs were permitted by SLC 14.12(b). Since the implementation of DCP178, the licence obligations in 14.11 and 14.12 have effectively been redundant, since DCUSA requires final tariffs to be published with 15 months' notice. However, if Ofgem directs that the 15 month notice requirement set out in DCUSA does not apply for 2023/24, then our understanding is that obligations will revert to the pre-DCP178 arrangements i.e. indicative tariffs by 31 December 2022 and final tariffs with 40 days' notice in February 2023.

This would be unacceptable. As well as the negative impact on consumers from the higher levels of risk that will need to be factored into forecasts, 40 days' notice will not permit the final DUoS charges to be reflected in the supplier price cap. Any significant changes between indicative and final charges could result in suppliers operating under the cap not being funded for efficiently incurred costs.

We note that under SLC 14.12 Ofgem can direct a different notice period to that set out in SLC 14.11. We believe a direction is necessary, to set out that charges should be published within 20 working days of the publication of Draft Determinations and to make clear that such charges must be final (not indicative).

However, we are concerned that such a direction may not be consistent with the intent of SLC 14.12, as it would be directing a notice period greater than the baseline obligation of 3 months set out in 14.11.

If Ofgem considers that it does not have the power to direct anything other than a 40 day (DCUSA 19.1B) or three month (SLC 14.12) notice period, then we believe a DCUSA change is necessary to provide Ofgem with the ability to direct a notice period of its choosing. We believe the change could be simple enough to be fast tracked through the change process with minimal resource. To illustrate the change required we have included below a change tracked DCUSA clause 19.1B:

19.1B The periods of notice described in Clause 19.1A shall apply unless the Authority directs the Company that those periods of notice need not apply. Where the Authority directs the Company that those periods of notice need not apply, the notice period shall be 40 days or such alternative notice period as directed by the Authority (without prejudice to any longer notice requirements prescribed by the Distribution Licence).

This simple change should be uncontentious since it does not remove the 40 days or seek to fix an alternative notice period. It simply gives the Authority more flexibility if it is minded to direct that the current 15 month notice period should not apply for any year.

We provide answers to the consultation questions in the Appendix. We hope you find these comments helpful.

Please contact me if you have any questions.

Yours sincerely,

George Moran
Senior Regulatory Manager
Industry Transformation and Governance
Centrica Regulatory Affairs & Policy

Appendix: Consultation 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?

We agree that no direction(s) should be issued for 2024/25.

For 2023/24, we favour an option whereby DUoS charges are finalised 20 working days after publication of **Draft Determinations**. Our preference is for allowed revenues for 2023/24 to also be finalised at Draft Determinations, with any true-up between Draft and Final Determinations spread over the remainder of RIIO-ED2. This is the same approach that was applied at RIIO-ED1, however we acknowledge that this aspect is not strictly necessary to require final charges to be published 20 working days after Draft Determinations.

We believe finalising charges 20 working days after Draft Determinations strikes the right balance between providing early information to stakeholders, allowing Ofgem appropriate time to review the efficiency of DNOs' proposed expenditures, and minimising any necessary true-ups following Final Determinations. It also conforms to the timeline that the DNOs themselves have specified can be met to complete tariff calculations.

Our favoured option would require directions under both DCUSA 19.1B, to remove the need to provide 15 months' notice, and under SLC 14.12, to direct that charges are published 20 working days after Draft Determinations **and** to make clear that such charges must be final (not indicative). This last point is important since historically SLC 14.11 has only placed an obligation on DNOs to publish **indicative** tariffs due to 14.12(b) providing the ability to update the published tariffs prior to implementation to take account of any significant changes in assumptions.

However, as we set out in more detail in our covering letter, we are concerned that a direction under SLC 14.12 requiring a greater notice period than the baseline obligation of 3 months set out in 14.11 may not be consistent with the intent of SLC 14.12. If Ofgem considers that it does not have the power to direct anything other than a 40 day (DCUSA 19.1B) or three month (SLC 14.12) notice period, then we believe a DCUSA change is necessary to provide Ofgem with the ability to direct a notice period of its choosing.

A 40 day notice period would be unacceptable. As well as the negative impact on consumers from the higher levels of risk that will need to be factored into forecasts, 40 days' notice will not permit the final DUoS charges to be reflected in the supplier price cap. Any significant changes between indicative and final charges could result in suppliers operating under the price cap not being funded for efficiently incurred costs.

With respect to the current 15 month notice period, we do not believe it would be appropriate for DNOs to set charges using revenue assumptions set out in their business plan submissions.

When Ofgem consulted on this similar issue for RIIO-ED1 it rejected the option of setting first year allowances based on DNO Business Plan submissions because it would result in consumers paying more in 2015/16 than they would otherwise. We believe the same adverse effect would result if 2023/24 charges were based on the revenues in DNOs RIIO-2 Business Plan submissions. Some of the adverse effect of setting charges based on DNO business plans could be mitigated if Ofgem sets out as part of its direction or letter of comfort the key assumptions that must be used regarding the cost of debt, cost of equity, gearing ratio and any other key revenue drivers. However, we cannot identify a satisfactory proposal to address the inevitable underlying inefficiency that will be included in the expenditure forecasts in some DNOs Business Plans.

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

Reducing notice periods will simply transfer risk from DNOs to suppliers and customers. The cost of this risk will be lower for DNOs since any forecasting error will be trued-up in a later year. The same cannot be said for suppliers offering fixed contracts to customers, for whom there will be a direct bottom line impact as a result of the forecasting error. For customers on pass-through or variable contracts, whilst the forecasting error may be trued-up in future tariffs, provided they maintain a similar contractual status over time, the cost of financing this forecasting error will be greater for these customers than for low risk regulated DNOs.

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?

We are concerned that the focus is on the risks to the DNOs rather than the risk to consumers. Basing charges on DNOs Business Plans is likely to result in customers paying more in 2023/24 than would otherwise be the case given that every price control process tends to result in expenditure allowances being reduced, at an aggregate level, from those requested in Business Plans.

We believe that the penalty interest rate is an important incentive to the DNOs to provide robust consumption and other forecasts and support the need to maintain this tool to address obvious cases of underperformance.

Some of the adverse effect of setting charges based on DNO business plans could be mitigated if Ofgem sets out as part of its direction or letter of comfort the key assumptions that must be used regarding the cost of debt, cost of equity, gearing ratio and any other key revenue drivers. However, we cannot identify a satisfactory proposal to address the inevitable underlying inefficiency that will be included in the expenditure forecasts in some DNOs Business Plans.

If a letter of comfort approach is taken, it must make clear that DNOs must use Ofgem's working assumptions on the key financial drivers for RIIO-ED2.

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.

Whilst maintaining the current 15 month notice period would reduce uncertainty for 2023/24 DUoS charges, if those charges are based on DNOs Business Plans then we believe this is likely to result in customers paying more in 2023/24 than would otherwise be the case given that every price control process tends to result in expenditure allowances being reduced, at an aggregate

level, from those requested in Business Plans. It could also lead to excessive volatility in charges in subsequent years.

Some of the adverse effect of setting charges based on DNO business plans could be mitigated if Ofgem sets out as part of its direction or letter of comfort the key assumptions that must be used regarding the cost of debt, cost of equity, gearing ratio and any other key revenue drivers. However, we cannot identify a satisfactory proposal to address the inevitable underlying inefficiency that will be included in the expenditure forecasts in some DNOs Business Plans.

We believe our proposed approach of finalising charges 20 working days after Draft Determinations strikes the right balance between providing early information to stakeholders, allowing Ofgem appropriate time to review the efficiency of DNOs' proposed expenditures, and minimising any necessary true-ups following Final Determinations.

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 have set out above our concerns regarding the ability of Ofgem to direct anything other than a 40 day (DCUSA) or three month (SLC 14.12) notice period. We would welcome a discussion with Ofgem on this point, but our view is that a small and uncontentious DCUSA change may be necessary and could be fast tracked to ensure Ofgem has the vires to decide an appropriate notice period as a result of the stakeholder feedback on this consultation.

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

We would again highlight that many of the issues in this consultation overlap with similar considerations which Ofgem consulted upon for RIIO-ED1. We question why this RIIO-ED1 precedent has been ignored and ask Ofgem to justify why RIIO-ED2 is different to RIIO-ED1 and how the RIIO-ED1 discussion and responses are no longer relevant.

<https://www.ofgem.gov.uk/publications/timing-decision-electricity-distribution-networks-revenue-2015-16>