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Dear Patrick,

Northern Powergrid'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

As you are aware from our letter dated 5 May 2021, the distribution network operators (DNOs) requested that the Authority provides the necessary directions such that the 15 months' notice period for changes to distribution use of system (DUoS) charges need not apply for the regulatory years commencing 1 April 2023 and 1 April 2024.<sup>1</sup>

Due to the conflict between the timetable for the remainder of the RIIO-ED2 price control process and the obligations on the DNOs in respect of DUoS charge setting, the timeline will be as set out in the table below, if Ofgem does not intervene:

When	What
1 December 2021	DNOs submit final RIIO-ED2 business plans
No later than 31 December 2021	DNOs publish DUoS charges effective from 1 April 2023
Mid-2022	Ofgem publishes RIIO-ED2 draft determinations for consultation
December 2022	Ofgem publishes final RIIO-ED2 determinations and consult on licence changes
No later than 31 December 2022	DNOs publish DUoS charges effective from 1 April 2024
February 2023	Ofgem publishes final decision on licence changes

We will, therefore, be required to publish DUoS charges for regulatory year 2023/24 (the first year of the RIIO-ED2 period) around six months before Ofgem publishes its RIIO-ED2 draft

<sup>1</sup> [https://www.ofgem.gov.uk/sites/default/files/2021-07/DUoS\\_2023-24\\_Price\\_Setting\\_and\\_RIIO-ED2\\_v1.0.pdf](https://www.ofgem.gov.uk/sites/default/files/2021-07/DUoS_2023-24_Price_Setting_and_RIIO-ED2_v1.0.pdf)

determinations. We will also be required to publish DUoS charges for regulatory year 2024/25 (the second year of the RIIO-ED2 period) in the same month that Ofgem publishes its RIIO-ED2 final determinations.

Our views are summarised below:

- Ultimately, it is consumers that bear the risk of volatility regardless of whether it manifests through supplier margins or DUoS charges etc. It is our strong preference that appropriate intervention is put in place that ensures that the risk and reward is managed in a robust and transparent way in the best interests of consumers.
- Since the implementation of the 15 months' notice period in late 2015, volatility in DUoS charges has been relatively small.<sup>2</sup> As a result, the industry has benefited from longer notice of any potential volatility in DNOs' allowed revenue.
- RIIO-ED2 will not be a 'standard' price control period owing to the increased level of investment needed to facilitate decarbonisation. A significant increase in investment is needed to deliver net zero, whilst navigating both uncertain decarbonisation pathways and the absence of understanding how Ofgem will benchmark and set mechanisms for such investment.
- An added complication is that Ofgem's minded to positions on 'low-regret' areas of the Access and Forward-looking Charges Significant Code Review ('the Access SCR')<sup>3</sup> also have very close links with RIIO-ED2. The proposals are not final and there remains considerable uncertainty around the forward-looking DUoS price signals and, therefore, how customers will respond to the proposed reforms. DNOs are required to include the impact of these minded to positions in their RIIO-ED2 final business plans, which is not straight forward, and could easily and significantly over or under-estimate the impact; particularly the amount of upfront connection costs that Ofgem is proposing to socialise through DUoS from 1 April 2023.
- In any event, the start of a new price control period always results in greater charging volatility, but the significantly increased levels of uncertainty in respect of RIIO-ED2 should not be managed by reliance on effective forecasting. Shorter notice periods represent a viable, transparent, and reasonable solution.
- The proposed notice periods in our direction request are in line with those that the industry managed prior to the introduction of the 15 months' notice period in late 2015. Additionally, shorter notice periods have also been invoked in three of the five regulatory years since its introduction as a result of circumstances outside of the DNOs' control.<sup>4</sup> In these instances, the DNOs have sought to minimise disruption on industry through collaboration with stakeholders.

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<sup>2</sup> Subject to exceptions such as re-openers and uncertainty mechanisms, and the impact that COVID-19 has had lowering 'actual' revenue.

<sup>3</sup> <https://www.ofgem.gov.uk/publications/access-and-forward-looking-charges-significant-code-review-consultation-minded-positions>

<sup>4</sup> Since publishing 2017/18 DUoS charges in December 2015, DNOs have had to republish DUoS charges for the 2018/19, 2019/20 and 2021/22 regulatory years.

- The DNOs have already engaged with industry regarding the issues, on which Ofgem is now consulting. As noted in our letter to Ofgem dated 5 May 2021,<sup>5</sup> we intended to raise a Distribution Connection and Use of System Agreement (DCUSA) change proposal to develop options with industry in a transparent manner. We would remind Ofgem that it did not want us to pursue this option at that stage. It is now not a viable option as it cannot reasonably be expected to be concluded in the required timescales (i.e. implemented in advance of setting DUoS charges in December 2021).
- We have investigated and assessed various options but we firmly believe that the requested directions are necessary and that Ofgem's apparent preference to issue a 'letter of comfort' is unsatisfactory and unnecessary (assuming existing licence provisions endure in RIIO-ED2), and does not address the problem that the directions seek to address (i.e. that volatility in DUoS charges will unfairly and unduly impact all industry parties).
- The directions should apply to both regulatory years 2023/24 and 2024/25 to avoid a perverse outcome where the DNOs publish DUoS charges for the second year of RIIO-ED2 before they do so for the first year of RIIO-ED2. We believe that temporarily reintroducing 'draft' and 'final' DUoS charges can mitigate some of the concerns Ofgem has raised.
- It should also be noted that, whilst the DNOs provide 15 months' notice of DUoS charges, other sectors (e.g. electricity transmission and gas distribution) continue to provide only two months' final notice of their use of system charges.

We expand on these points in Appendix 1 to this letter which provides our response to the specific questions in Ofgem's consultation.

Yours sincerely,



Lee Wells

Commercial Manager - Regulated Revenue

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<sup>5</sup> See 'recommendation' in Appendix A of the 5 May 2021 letter.

## Appendix 1 - Northern Powergrid's response to each 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?

Yes, we agree with Ofgem that reducing the notice period would better address our concerns by mitigating the risk of excessive price volatility. Whilst we recognise the concerns raised by Ofgem that the requested directions may transfer risk to suppliers, ultimately it is consumers that bear the risk regardless of whether it manifests through supplier margins or volatility in distribution use of system (DUoS) charges etc. It is our strong preference that appropriate intervention is put in place that ensures that risk and reward is managed in a robust and transparent way. We do not believe that supplier 'offerings' can satisfy this test given the competitive environment in which they operate.

We agree that consent to not provide 15 months' notice of DUoS charges requires a direction that clause 19.1A of the Distribution Connection and Use of System Agreement (DCUSA) does not apply and that, under clause 19.1B of the DCUSA, the alternative notice period is 40 days.

Additionally, standard licence condition (SLC) 14.11 of the distribution licence requires the DNOs to publish DUoS charges no later than three months before the start of the charging year. Hence, without consent to not provide less than three months' notice, we agree that it would most likely result in the DNOs using Ofgem's RIIO-ED2 draft determinations as the basis of the DUoS charges to be effective from 1 April 2023, which we would need to publish by 31 December 2022.

We do not agree with Ofgem's implication that there will not be significant changes between the RIIO-ED2 draft and final determinations and we provide more information in that respect in response to consultation question 3. In any event, the immediate concern is that, in the absence of appropriate intervention, the DNOs would need to set DUoS charges for the 2023/24 regulatory year based on a set of assumptions that could have a significant impact on customer bills, if there is significant change between the final business plan submission and the draft determinations.

Unless Ofgem can provide assurances that the RIIO-ED2 final determinations will be published early in December 2022 (at the very latest, but preferably late November) to give the DNOs sufficient opportunity to use those final determinations when setting DUoS charges for the 2023/24 regulatory year, we believe that the directions should apply to both the DCUSA requirement to provide 15 months' notice and the licence requirement to provide three months' notice of DUoS charges.

The directions should also apply to both regulatory years 2023/24 and 2024/25 to avoid a perverse outcome where the DNOs have to publish DUoS charges for the second year of RIIO-ED2 before they do so for the first year of RIIO-ED2. We believe that publishing DUoS charges for two years at the same time is viable and has been done previously.<sup>6</sup>

The above is predicated on the assumption that we would use either Ofgem's draft or final determinations as the basis of the DUoS charges for both periods. Whilst we are open to using the draft determinations when setting 2023/24 DUoS charges, we do not believe that it is appropriate to use them for 2024/25. If this was the case, it would mean that we would not use the final determinations until the middle year (i.e. the third year) of a five-year price control period, for the purpose of setting the most accurate DUoS charges. We are also not convinced by Ofgem's implication that draft and final determinations will not be significantly different given the greater levels of uncertainty in RIIO-ED2 compared to previous price control periods.

As communicated to Ofgem in our letter dated 5 May 2021, it would be our intention to publish DUoS charges for the 2024/25 regulatory year as soon as practicable after publication of the RIIO-ED2 final determinations, subject to possible appeals to the Competition and Markets Authority (CMA). Whilst the requested directions would move from a requirement to provide 15 months' notice to 40 days under the DCUSA (i.e. it is binary and anything in between is not bound by licence or code), we believe that there is a compromise where we agree to publish DUoS charges as soon as is practicable based on the latest information that is available, whilst providing a minimum of three months' notice for 'final' DUoS charges in the 2024/25 regulatory year and a minimum of 60 days (but ideally three months') notice for 'final' DUoS charges for the 2023/24 regulatory year. Such approach may look like this:

When	What
1 December 2021	DNOs submit final RIIO-ED2 business plans
Mid-2022	Ofgem publishes draft RIIO-ED2 determinations for consultation
Q3 2022 <sup>7</sup>	DNOs publish 'draft' DUoS charges effective from 1 April 2023
December 2022	Ofgem publishes final determinations and consultation on licence changes
31 January 2023 <sup>8</sup>	DNOs <i>may</i> publish 'final' DUoS charges effective from 1 April 2023, and would publish 'draft' DUoS charges effective from 1 April 2024
31 December 2023 <sup>9</sup>	DNOs <i>may</i> publish 'final' DUoS charges effective from 1 April 2024

Such an approach is more complicated and, therefore, risks confusing industry with 'draft' and 'final' DUoS charges, which may be subject to change between the two. However, provided that a 'tolerance' is determined by the DNO (whereby the DNO only changes DUoS charges

<sup>6</sup> In December 2015 when we set DUoS charges for both regulatory years 2016/17 and 2017/18.

<sup>7</sup> DNOs would need at least one month from publication of the RIIO-ED2 draft determinations.

<sup>8</sup> Or within 20 working days of the final determinations being published, but no later than 31 January 2023.

<sup>9</sup> No later than, but subject to CMA appeals considerably sooner than.

between draft and final determinations if the movement is material enough to warrant re-publication), we believe that this approach is achievable.<sup>10</sup>

The DNOs have investigated and assessed various options and their pros and cons are contained in the paper submitted to Ofgem in February 2021 (please see Appendix A of our letter to Ofgem dated 5 May 2021, for more information).

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

We consider that this question is primarily aimed at suppliers and/or large customers. However, the impact of varying the notice periods can be seen in the volatility of our allowed revenue adjustment relating to the 'correction' of previous years' over or under-recovery. The table below shows our actual and forecast correction allowance based on our May 2021 forecasts, which were shared with and presented to the industry.<sup>11 12</sup>

Prior to the introduction of 15 months' notice, the RIIO-ED1 price control settlement resulted in minimal volatility in over or under-recovery due to the lagged recovery of incentive performance and pass-through costs etc.

Since then, the volatility has increased significantly from regulatory year 2018/19, reaching a peak in 2020/21 due to the impact of the COVID-19 pandemic, as we published DUoS charges for that period in December 2018 (i.e. before the pandemic was on anybody's radar).

£m	Actual correction					Forecast correction		
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Northeast	1.5	(1.9)	2.5	15.2	11.3	20.4	9.7	(4.5)
Yorkshire	0.7	(3.1)	1.8	8.2	5.5	19.3	4.9	(10.5)

The requirement to provide 15 months' notice means that DNOs must forecast demand over three winter periods<sup>13</sup> and forecast costs and incentive performance despite a two-year lag.<sup>14</sup> Allowed revenue generally does not vary much between assumptions used for the purposes of setting DUoS charges and when allowed revenue is finalised. This is because the vast majority<sup>15</sup>

<sup>10</sup> Prior to the implementation of the 15 months' notice period, DUoS charges could vary between 'draft' charges published by 31 December each year (per the licence requirement), and 'final' charges published with a minimum of 40 days' notice (per the DCUSA requirement).

<sup>11</sup> DCUSA Schedule 15 'Cost Information Table' quarterly forecasts: <https://www.dcusa.co.uk/wp-content/uploads/2021/05/DNO-Cost-Info-Northern-Powergrid-Schd-15-May-21.zip>

<sup>12</sup> For simplicity, the adjustment is shown in the year to which it relates e.g. 2015/16 represents the adjustment to allowed revenue in 2017/18. A number in brackets represents the correction of over-recovery i.e. a need to return excess revenue collected.

<sup>13</sup> For example, when we published 2022/23 DUoS tariffs in December 2020, we had to forecast customer behaviour over the 2020, 2021, and 2022 winter periods.

<sup>14</sup> For example, 2022/23 allowed revenue includes pass-through costs and incentive performance relating to 2020/21, but DUoS tariffs for 2022/23 were published in December 2020 before the performance was final.

<sup>15</sup> Generally, >90%.

of allowed revenue relates to 'base revenue'<sup>16</sup> which is locked down at the beginning of a price control period.<sup>17</sup>

It should also be noted that the requirement to provide 15 months' notice and to accurately forecast allowed revenue would become exponentially more difficult, if the lagged true-ups are removed, which appears to be Ofgem's preference for RIIO-ED2.<sup>18</sup>

**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 consider that Ofgem's apparent preference does not sufficiently address the underlying risks and issues and, therefore, does not represent an appropriate intervention.

RIIO-ED2 will not be a 'standard' price control period. DNOs will play a leading role in meeting the UK's target of reducing carbon emissions by almost 80 per cent by 2035 and, like other DNOs, our network requires significant investment to facilitate this change. Our RIIO-ED2 draft business plan<sup>19</sup> proposes to facilitate this by increasing investment by 36 per cent i.e. to over £600m per annum, to ensure that our network can support the expected growth in electricity demand that will come from the anticipated electrification of heat and transport.

Decarbonisation investment may, therefore, result in significant volatility for customer bills, subject to how Ofgem benchmarks our business plans and, consequently what, the RIIO-ED2 final determination is.

Further, Ofgem recently published its minded to positions on 'low-regret' areas of the Access SCR, which has close links with RIIO-ED2. Ofgem requires that DNOs include this reform within their RIIO-ED2 business plans, primarily to reflect the impact of changes to the connection boundary where connecting customers will fund less network reinforcement (demand customers funding none and generation customers funding less) meaning an increase in connection costs socialised through DUoS charges. Taking a simplistic assessment of Ofgem's Access SCR proposals, in the absence of clarity on any DUoS reforms, we believe that they will result in an increase in network connections and, potentially, in constrained areas of network due to the removal of the upfront locational cost signal. Consequently, our reinforcement costs will increase, which we will need to recover from the generality of customers through DUoS charges.

In its supporting impact assessment, Ofgem recognises a number of 'hard-to-monetise impacts' where DNOs will have additional opportunities to facilitate new connections by the most efficient means (e.g. through flexibility rather than reinforcement). Therefore, Ofgem recognises that valuing the impact of this decision in our RIIO-ED2 final business plan is extremely challenging. Hence, we do not agree with Ofgem's implication that there will not be

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<sup>16</sup> Base revenue represents (depreciated) efficiently incurred costs plus allowances for cost of equity, cost of debt and taxation.

<sup>17</sup> Albeit subject to some annual 'true-ups' via the 'annual iteration process'.

<sup>18</sup> Following precedent set in the Authority's decision on changes to the RIIO-2 cross sector licence conditions ahead of RIIO-ET2 and RIIO-GD2: [https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/riio-2\\_licence\\_drafting\\_modifications\\_-\\_reasons\\_and\\_effects.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/riio-2_licence_drafting_modifications_-_reasons_and_effects.pdf)

<sup>19</sup> <https://ed2plan.northernpowergrid.com/>



significant changes between RIIO-ED2 draft and final determinations. Regardless, the primary concern is the potential for significant changes to occur between final business plan submissions and the draft determinations such that the DNOs would need to set 2023/24 DUoS charges based on a set of assumptions that could have a significant impact on customer bills.

We consider that a temporary removal of the need to provide 15 months' notice of DUoS charges is necessary, not to protect the DNOs from penal interest rates as a result of significant variance between 'actual' and 'allowed' revenue (for which we are already protected when the cause is "outside the reasonable control of the licensee"<sup>20</sup>), but to protect customers from unnecessary and potentially significant volatility in DUoS charges.

The DNOs have assessed various options and their pros and cons in the papers submitted to Ofgem in February 2021 and May 2021. One of the options considered was to retain the 15 months' notice but with a 'true-up' included within the RIIO-ED2 determinations. For example, the draft determinations could account for the difference between our final business plan view of allowed revenue in the 2023/24 regulatory year in future years, leaving allowed revenue in the 2023/24 period unchanged. We consider that this option presents a more effective solution than merely providing comfort that penal interest rates may, or may not, be applied to the correction of over or under-recovery, as it could profile variances over several regulatory years.

An example would be to assume that we set DUoS charges for the 2023/24 regulatory year to recover £500m and, for simplicity, that this is all base revenue (i.e. no incentives etc.). If the draft determination outturns at £460m flat profiled per annum (i.e. a total allowance of £2,300m over the five-year period), then base revenue for 2023/24 would remain at £500m but the remaining four regulatory years would reduce by £10m per annum to £450m, thereby retaining the same overall allowance for the full price control period:

£m	2023/24	2024/25	2025/26	2026/27	2027/28	Total
Draft determination	460	460	460	460	460	2,300
Adjusted	500	450	450	450	450	2,300

Ofgem used this approach in RIIO-ED1 whereby base revenue for the 2015/16 regulatory year was locked down at draft determinations, but this proposal also requires the draft determinations to be cognisant of final business plans and not simply defer true-ups to other mechanisms which create greater volatility for customers. An 'enhanced' RIIO-ED1 approach would, therefore, be needed, as the shorter notice periods for DUoS charges enabled this smooth transition into a new price control period.

For the avoidance of doubt, this is not our preferred approach, and Ofgem is yet to provide any views on this suggestion.

<sup>20</sup> Paragraphs 19 and 20 of Charge Restriction Condition 2A 'Restriction of Allowed Distribution Network Revenue'



**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.**

In simple terms, we believe this depends on the magnitude of over or under-recovery. As noted, we believe that this carries significantly greater risk going into RIIO-ED2 than in previous price controls.

**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 would remind Ofgem that the DNOs proposed raising a DCUSA change proposal to develop options with industry in a transparent manner but Ofgem requested that we did not proceed and preferred that we requested the formal directions on which it is now consulting instead.

At this stage, we do not consider that the timescales associated with enacting and completing a code modification process are now viable.

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

The proposed notice periods in our direction request are in line with those that the industry managed prior to the introduction of the 15 months' notice period in late 2015. The industry has also managed to adapt to reduced notice periods multiple times since then as a result of Last Resort Supply Payment claims (in both the 2018/19 and 2019/20 regulatory years, following the appointment of a Supplier of Last Resort) and the Authority approving code changes after DUoS charges for the period in which they were to be implemented had already been published (in the 2021/22 regulatory year). We are, therefore, not proposing a radical change. Rather, we believe that it is necessary to revert to previous arrangements during this transition between price controls because of the scale of change RIIO-ED2 presents.

It should be noted that, whilst DNOs provide 15 months' notice of DUoS charges, National Grid Electricity System Operator (NGESO) provides only two months' notice for varying its use of system charges and the Authority rejected a code modification to increase the notice period owing to its belief that it did not better facilitate the Connection and Use of System Code (CUSC) charging objectives.<sup>21</sup>

It is also our understanding that gas distribution network use of system charges are also provided with only two months' notice. Consequently, our proposal is more into line with other sectors as they transition into their respective RIIO-2 price control periods. However, we are proposing a temporary change only.

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<sup>21</sup> [https://www.ofgem.gov.uk/system/files/docs/2016/08/cmp244\\_256\\_decision\\_letter\\_final.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/08/cmp244_256_decision_letter_final.pdf)