29 August 2003

Mr C Altin
Head of Price Control Development
Ofgem
9 Millbank
London
SW1P 3GE

Dear Cemil

ELECTRICITY DISTRIBUTION LOSSES: INITIAL PROPOSALS

CE Electric UK Funding Company (CE) is the UK parent company of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL). The views expressed in this letter represent the response of CE, NEDL and YEDL to Ofgem's publication *Electricity distribution losses: Initial proposals*, published in June 2003 and also to the letter from Gary Keane, dated 22 July 2003, on the subject of embedded generation - saved losses.

Proposed Incentive Mechanism

From the range of options considered, we believe that the option proposed by Ofgem in this consultation document is the most appropriate approach for the next price control review, i.e. to modify the current incentive scheme by adopting an approach that seeks to match the relative strengths of incentives to reduce opex, capex and losses. We therefore support:

- the benchmark being changed from a ten year rolling average to a fixed benchmark for the duration of the price control based on the ten-year average;
- a review of the incentive rate in future consultations. Ofgem proposes that the value be based on the marginal cost of technical losses. We would suggest that it may be appropriate to set the rate according to the value of fossil-fuelled generation displaced. That is, the losses incentive should be set in line with the renewals obligation buy-out price (plus the wholesale price of energy);
- the removal of the distributed generation adjustment. However, we suggest that the losses benchmark be adjusted for distributed generation saved losses based on the actual saved losses for each year in the benchmark ten year period and not the average of 2003/04 and 2004/05; and
- for efficient losses investment, where this results in total capital investment being higher than the Ofgem allowances, this should be included in the RAV from the beginning of the next[1] price control period.

[1] The tension between the rolling capex and the losses incentive will determine the efficient level of investment if the incentives are balanced correctly.

Data volatility - Non-technical losses
For the incentive to be meaningful, it is important that it is based upon robust data. This is difficult with the known problems with the quality of trading data. We believe that suppliers and their agents still continually fail to address data quality and these issues need to be tackled. In particular:

- large erroneous Estimated Annual Consumptions (EACs);
- negative EACs;
- incorrect energisation status in MPAS;
- incorrect standard settlement configuration in MPAS;
- incomplete supplier registrations in MPAS;
- lack of adherence to industry baseline procedures;
- poor error handling business procedures (e.g. D0095 NHHDA exceptions);
- unclear business separation and poor contractual arrangements/enforcement between suppliers and agents;
- continual and endemic delays in suppliers updating their data items in MPAS in accordance with MRA requirements; and
- failure to meet the target for energy settled by metered data in the final reconciliation.

We support the reduction of trading losses. To help us in this, we request stronger tools to manage these issues, such as:

- stronger obligations on suppliers to secure robust data into settlements, and to ensure that adjustments are fed through the central process rather than being 'fixed' through bilateral arrangements; and

- tougher sanctions on unmetered supplies inventories to further assist this. We believe that there is a strong case to encourage suppliers to police losses, e.g. through ensuring correct registration of sites and pursuing other revenue protection activities. this might take the form either of an incentive or explicit penalties. We also note that half hourly and unmetered supplies losses are currently smeared to the non-half hourly market, and suggest that incentives might be more balanced if this were not the case.

Balance of incentives
We recognise that the proposals do affect the retention benefits balance between companies and customers and that they would increase the company share. However, this incentive cannot be looked at in isolation, and further work is needed to review incentives overall to ensure an appropriate balance between the losses, rolling opex and the rolling RAV incentives.

Value of incentive rate
As losses are primarily an environmental issue, there is a case for the losses incentive to be related to the renewables obligations. Specifically, a unit of 'dirty' generation saved should have an equal value whether displaced by renewable energy or not required though greater efficiency.

Inclusion in the RAV
As we stated in our response to the January consultation, it will take many years for investment in the system to make a material difference to the value of technical losses, even if significant investment is made in replacement low loss equipment.

If the incentives are based on the indicative incentive rates suggested in the consultation document, we do not think that the proposals will produce a significant change in the headline figures. If Ofgem wishes to stimulate a major change in the management of losses

the incentive rate needs to be sufficient for this to happen. Under the proposed mechanism, companies will make investment decisions regarding loss reduction based on the trade-off between the losses incentive and the rolling capex incentive. However, if the proposed losses investment were to push total investment higher than the Ofgem allowance, they also have the additional consideration on whether the losses incentive provides a sufficiently high return to fund the lost return and the depreciation on the asset before it is added into the RAV. If this is not the case, then the investment will not be made.

Other factors to consider
The proposals also need to consider the role of independent connection providers to ensure that DNOs do not have to accept the connection of high loss plant. There is a case for standards (e.g. DCUSC) for newly installed assets, with rebates/penalties for deviation from those standards. This aligns with the original principles for adoption, where Ofgem agreed that distributors could charge for abnormal maintenance costs of non-standard equipment: in this case, a charge (or, potentially, a rebate) would be levied according to the anticipated abnormal change in losses.

Distributed Generation (DG) Adjustment / Losses benchmark
We agree with the requirement for a DG adjustment but suggest a slightly alternative method for calculating the revised losses benchmark. The current proposal for the DG adjustment, to be implemented from 1 April 2005, suggests that a new fixed losses benchmark be established by utilising the average of the distributed generation – saved losses for the two years prior to that date and then adjusting each of the prior ten years' allowed losses by that average.

If the new fixed benchmark is to be based on the ten years up to and including 2002/03 we believe that it would be logical and preferable for Ofgem to utilise the *actual* saved losses adjustment relevant to each year in that ten year period and to calculate the new benchmark with the actual DG adjustment removed from each year. This data is available, is more accurate than the estimating method proposed, and therefore should be used instead.

The letter from Gary Keane, dated 22 July 2003, asked whether the trends in the level of saved losses for NEDL and YEDL are expected to continue up to April 2005. Both NEDL and YEDL saw a step change in these figures in 2002/03 but expect to see a steadily rising trend from the reported 2002/03 figures as more distributed generation is connected to the networks.

I hope that you find these comments useful and look forward to receiving your update paper in October 2003.

Yours sincerely

Phil Jones
Director of Strategy and Investment

cc: Gary Keane