Electricity Distribution Allowed Loss Percentages - Representation by ScottishPower EnergyNetworks

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Target audience: Network companies including electricity distributors, electricity suppliers, customers, customer representatives and other interested stakeholders

Overview:

ScottishPower EnergyNetworks have asked Ofgem to increase the allowed electricity loss percentages under their existing price control for their two electricity distribution network companies. Our decision on this matter will have significant financial implications for ScottishPower and electricity suppliers and customers. If we agree to SP's request this will increase their allowed revenue under their price control, which will allow them to increase their charges to suppliers and ultimately customers. We have set out the reasons why SP think that we should agree to an increase in their allowances, the arguments for and against doing so and the likely impact on SP, suppliers and their customers of doing nothing or agreeing to their request. The Authority is currently minded not to grant SP's request and we have explained why in this document. We welcome views from all interested parties on our 'minded to' position or the alternative of amending SP's allowed revenue and any other issues raised by SP's request. We aim to publish our final decision in May 2009 having carefully considered all of the responses to this consultation.

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Context

Ofgem's principal objective is to protect the interests of existing and future consumers. We do this by promoting effective competition wherever appropriate and through regulation where necessary. In carrying out its duties Ofgem is required to have regard to a number of factors including the need to secure that licence holders are able to finance their regulated activities[1]. Electricity distribution networks are natural monopolies and are consequently subject to price control by Ofgem[2].

ScottishPower ('SP') have two electricity Distribution Network Operators ('DNO') within their 'ScottishPower EnergyNetworks UK' business: SP Distribution Ltd ('SPD') and SP Manweb plc ('SPM'). Their distribution services areas cover the southern part of Scotland and the Merseyside and North Wales areas respectively.

A losses incentive scheme was put in place as part of the last distribution price control review (DPCR4) that runs from April 2005 to March 2010. It includes an allowed loss percentage (ALP) for each DNO based on that DNO's own historic performance. SP's ALPs were re-set at a lower level agreed by SPD and SPM in early 2006 following an investigation by Ofgem into compliance by SPM with licence requirements on the calculation and reporting of electricity losses which was closed with no finding of breach and no financial penalty.

DNOs receive a financial reward (about £53) for each megawatt hour (MWh) that their measured losses come in below their target level and pay a financial penalty for each MWh above this target level. SP have asked Ofgem to review and increase the ALPs for SPD and SPM and have put forward several arguments supporting their representation. However, on balance, the Authority is not currently persuaded of the merits of SP's case. We intend to publish our decision on this matter in May 2009. This will have material financial implications (£ millions) for SP and/or for suppliers and consumers in the SPD and SPM distribution areas.

Under section 5A of the Utilities Act 2000, subject to certain exceptions, we are required to carry out an impact assessment where we consider a proposal to be "important" within the meaning of that section. We consider the proposal meets the criteria under section 5A given the financial materiality of making a decision and the potential impact on SP, suppliers, and consumers. We also consider that conducting an impact assessment is consistent with best regulatory practice. This consultation and impact assessment document sets out the history of the issue, the options available for resolving the issue (including doing nothing), the impacts of adopting those options and Ofgem's provisional views in relation to SP's request.

[1] Further details on the Authority's statutory duties are set out at Appendix 4 of this document.

[2] Ofgem is the office set up by the Gas and Electricity Markets Authority to assist it in discharging its functions. The terms "the Authority" and "Ofgem" are used interchangeably in this document.

Associated Documents

a. Ofgem Factsheet - Electricity Distribution Units and Loss Percentages Summary

http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=70&refer=NETWORKS/ELECDIST

b. Statement Following SP Manweb Losses Investigation (Ref 07/06) - 10 January 2006

http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=2&refer=About%20us/enforcement/Investigations/ClosedInvest

c. Licence Modification Notice (SPD and SPM ALPs) (Ref 08/06) – 10 January 2006

http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=0806%20-%20Notice%20under%20section%2011%20of%20the%20Electricity%20Act%201989.pdf&refer=Licensing

d. Electricity Distribution Licence: Special Condition C1 (showing ALP values as at start of DPCR4)

http://epr.ofgem.gov.uk/document_fetch.php?documentid=10339

e. DPCR4 – Final Proposals (Ref 265/04) - 28 November 2004

http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=51&refer=NETWORKS/ELECDIST/PRICECNTRLS/DPCR4

f. Elexon BSC Panel – Standing Issue 34 Report - 12 June 2008

http://www.elexon.co.uk/changeimplementation/ModificationProcess/groups/issues/issues.aspx?issueID=36

g. BSC Auditor's Report for the year ended 31 March 2007

http://www.elexon.co.uk/documents/Participating_in_the_Market/Market_Guidance_-_Audit_Documentation_and_Reports/BSC_Auditors_Report_and_SSM_vFINAL.pdf

The items of correspondence listed below have been placed as associated documents with this paper on the following page of the Ofgem website:

Ofgem > Networks > Electricity distribution > Price Controls > Distribution Price Control Review 4 (DPCR4)

1. SP's letter to Ofgem dated 21 December 2005: Distribution Losses – SP Distribution and SP Manweb
2. SP's letters to Ofgem dated 6 February 2006: Section 11 Notice: Proposed changes to Special Condition C1 for SP Distribution and SP Manweb
3. SP's letter to Ofgem dated 12 October 2007
4. SP's letter to Ofgem dated 6 December 2007: Distribution Losses Incentive Scheme SP Distribution Ltd and SP Manweb plc ("SP")
5. Ofgem's letter to SP dated 18 December 2007: Distribution Losses Incentive Scheme - SP Distribution Ltd (SPD) and SP Manweb plc (SPM)
6. SP's letter to Ofgem dated 28 July 2008: Distribution Losses Incentive Scheme SP Distribution Ltd ("SPD") SP Manweb plc ("SPM") [without enclosures]
7. Ofgem's letter to SP dated 27 October 2008: Representation by ScottishPower on its Allowed Loss Percentages
8. SP's letter to Ofgem dated 4 November 2008: Allowed Losses Percentages (ALP) in relation to SP Distribution Ltd ("SPD") and SP Manweb plc ("SPM")

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Summary

There are 14 major electricity distribution networks in Great Britain, each covering a geographical area and operated by a licensed company referred to as a 'DNO' (Distribution Network Operator). The 14 DNO businesses are price controlled natural monopolies, owned by seven corporate groups as illustrated in the map at Appendix 4. Electricity distribution networks carry electricity from the high voltage transmission system (and from some embedded generators) to industrial, commercial and domestic customers. The DNOs' charges to electricity suppliers amount to about £3.7 billion annually and make up around 14 per cent of customers' electricity bills. Ofgem's price control sets a limit on the total revenue a DNO can charge electricity suppliers each year for using its distribution network to carry electricity to customers.

The current price control includes an incentive scheme to encourage DNOs to reduce electrical losses from their networks. Some electricity is inevitably lost during distribution but DNOs can reduce losses by, for example, procuring low-loss equipment and having accurate administration systems. Financial outcomes under the scheme can be substantial - the net level of reward for all DNOs in 2007/08 was £76 million. In early 2006, SPM and SPD agreed to their Allowed Loss Percentages (ALP) being reduced following an investigation by Ofgem into compliance by SPM with losses reporting requirements. In light of that agreement the investigation was closed with no finding of breach and no financial penalty.

In late 2007 SP wrote to Ofgem asking for the ALPs for both SPM and SPD to be increased saying that they expected to suffer estimated total penalties of £65m during DPCR4 which would seriously affect their returns on capital. SP consider that they have a much lower chance of making returns under the losses incentive than other DNOs and that they are in effect being penalised. SP have also asked Ofgem to apply a separate increase to the ALP to correct a data issue relating to the transition from the Settlement Agreement for Scotland ('SAS') to the British Electricity Trading and Transmission Arrangements ('BETTA'). This would lead to an incremental increase in allowed revenue of about £2.4m per year for SP.

SP consider their re-set ALPs, agreed in the wake of the 2005 investigation, have proved to be too low because in their view Ofgem placed undue weight on the restated data for the three years from 2001/02 to 2003/04. They had initially argued that the targets should be recalculated in the same way as their original ALPs, but using the restated data. SP assert that the three years from 2001/02 to 2003/04 have turned out to have had exceptionally low reported losses for their areas, resulting from factors in the settlement process which are beyond their control. In particular SP make the point that the low level of reported losses in their areas for those years were not a result of any action on their part. SP argue that losses have reverted to a higher long term average.

If we were to agree to either or both of SP's requests there would be a significant financial impact on suppliers and customers, although SP have proposed a mechanism which would mitigate the price burden on customers. Under their proposals, SP would still be likely to incur an overall loss incentive penalty for the DPCR4 price control period.

In December 2007, we sent SP a letter saying we were minded not to increase their ALPs using either of the mechanisms suggested to us. This was because we considered that the approach taken at the time the investigation was closed was correct and, in all the circumstances including our careful consideration of the matters raised by SP in discussions and correspondence, remained correct (see Associated Document '5'). We agreed, however, in principle that some adjustment should be made in respect of the change in treatment of transmission-connected EHV units, although we have yet to decide whether this adjustment should be partially or fully backdated. At the start of 2008 we agreed to have a 'fresh look' at SP's case but, notwithstanding additional review work, we remain of the view that the thinking in our letter of December 2007 was correct.

SP formally responded to our 'minded to' position by letter of 28 July 2008 reiterating their case for increased ALPs. On 27 October 2008 we wrote to SP asking them to provide information which would illustrate the ALP changes they had requested, together with the likely impacts on loss incentive earnings and use of system charges (see Associated Document '7'). In a letter dated 4 November 2008 (Associated Document '8') SP again stated their request for increased ALPs, setting out specific proposals together with their assessment of the way in which those proposals would affect loss incentive earnings and customer tariffs. They suggested two ALP recalculation options together with a suggested approach to mitigate the impact on customers. They have referred to these as a 'Full Correction' and 'Limited Correction' respectively and we have set out details in Chapter 3 below.

Having considered SP's most recent proposals, which could lead to an increase in their allowed revenues of between £35m and £63m (SPD) and of between £19m and £71m (SPM) we are still minded not to increase their ALPs. Consultees are referred to our 'minded to' letter and the wider exchanges of correspondence (scheduled as associated documents above) and the views expressed in this document.

We are carrying out an impact assessment and consulting on the matters raised by SP as we consider they are important for the purposes of section 5A of the Utilities Act 2000, given their financial materiality and the potential impact on SP, suppliers and consumers. We also consider that conducting an impact assessment is consistent with best regulatory practice. Before making a final decision we are seeking views on the issues raised by SP's representation, our 'minded to' position and the impacts on different parties if we were to make any changes to SP's ALPs. We have decided that the consultation period for this impact assessment should, consistent with Ofgem's 'Guidance on Impact Assessments' (Ref: 33/08), last for a period of six weeks so that a formal decision on the matter can be taken by the Authority at its meeting in May 2009. This will clarify the regulatory position for SP and other interested stakeholders. We have also taken into account the fact that SP, as a key stakeholder, has had an opportunity to see and comment on this document during its development.

Where in this document we refer to Ofgem's or the Authority's view, this is a reference to our provisional view and is subject to further consideration of any points raised in response to this consultation process. The Authority intends to publish its decision in May 2009, and the responses received will be carefully considered and will inform the Authority's decision making process.

1. Introduction

Chapter Summary: This chapter outlines the background to and working arrangements for the DPCR4 losses incentive scheme.

Reason for the losses incentive scheme

1.1. Consumers pay for an element of electricity lost in transmission and distribution in their bills since suppliers have to buy enough electricity to meet their customers' needs including these losses. Electricity is lost in the process of distributing it mainly due to physical constraints, as heat from transformers and cables, and also because of theft of energy and inaccurate reporting of usage (non-technical losses). However, DNOs can reduce losses by, for example, procuring low-loss equipment and optimising their network operation. They can also reduce levels of 'non-technical' losses, due to theft of electricity and the inaccurate reporting of usage, by ensuring that the records and administration processes under their control are up to date and efficient. During DPCR4, under the losses incentive scheme, it is DNOs who gain or bear the cost of units[3] below or above a benchmark level which was set as part of their price control. Over longer periods, those benchmark levels should reduce as a consequence of improving performance by DNOs, which will ultimately lead to benefits for consumers due to lower losses.

1.2. Electrical losses typically account for over 90% of the carbon footprint of electricity distribution activity in Great Britain and account for about 1.6% of GB greenhouse gas emissions. If it is effective, the losses incentive should have significant environmental benefits.

How the losses incentive scheme works

1.3. The details of the scheme are set out in special condition C1 of each DNO's electricity distribution licence (see Associated Document 'd'). The condition includes an Allowed Loss Percentage ('ALP') for each DNO. At the end of each regulatory year that percentage is multiplied by the number of units distributed by the DNO concerned to establish the benchmark levels of losses for that year. That figure is compared to the actual level of losses (MWh entering the network minus MWh exiting at metered and unmetered exit points). The DNO receives a reward per MWh of losses saved if actual losses are lower than the benchmark and a penalty per MWh of additional losses if actual losses are above the benchmark; the reward and penalty rates are the same (£53/MWh).

[3] The incentive rate is a fixed amount (indexed by RPI) and does not fluctuate with the wholesale price of electricity

How the Allowed Loss Percentages for DPCR4 were originally set

1.4. At the outset of DPCR4 the ALP for each DNO was set as the average percentage of its reported losses for the ten regulatory years from 1994/95 to 2003/04, although some variations were applied to allow for particular factors. DNOs are not directly compared with each other in respect of losses mainly because of the varying physical and geographical characteristics of networks around the country and legacy issues associated with their construction. The ALPs for ScottishPower were 6.45 for SPD and 7.52 for SPM.

Difficulties in measuring the number of units distributed in a given year

1.5. Losses are calculated as the difference between units entering and units exiting a DNO's network each year.

1.6. The number of units entering a DNO's network during a regulatory year can be easily obtained since there are real time meters at each entry point from the National Grid transmission network and embedded generation sites. However, the number of units exiting must be calculated from settlement[4] data flows. Settlement data is primarily used for the wholesale trading of electricity – its use in loss incentive calculations is a derivative one.

1.7. The accuracy of settlement data flows for any given period can be affected by a number of factors[5] including:

- Timing differences – whilst some customer meters are read on a half hourly basis, most domestic meters are only read periodically and settlement data for a given day is not deemed to be 'finalised' until 14 months have elapsed, and longer in some circumstances;
- Defective meters;
- Customer database 'cleansing' by suppliers to improve data accuracy;
- Inaccuracies in the inventory of unmetered supplies (mainly streetlights); and
- The DNO's methodology for processing settlement data into reported totals (for example using trend analysis to predict 'finalised' settlement numbers).

[4] The settlement system is administered by Elexon [www.elexon.co.uk], who are the Balancing and Settlement Code Company for Great Britain

[5] Further background information can be found in Ofgem's paper: Electricity Distribution Losses Initial proposals - June 2003: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=118&refer=Networks/ElecDist/Policy/DistChrgs

1.8. The setting of original ALPs based on a long run ten year average was intended to address the degree of volatility arising in annual numbers caused by these factors. Ofgem considers that across a five year price control period rewards and penalties should reflect underlying performance.

Use of provision accounts

1.9. DNOs have to base use of system bills for suppliers on the latest available settlement data flows. Suppliers are referred to as 'super-customers' because they are billed on the basis of meter readings or estimates for all their retail customers. If a DNO considers those data flows are 'over-reading' the number of units distributed they may allocate some units/revenue to a provision account pending confirmation of the final position. A number of DNOs make use of such accounts, often referred to as under/over-billing accounts. The sums allocated to these accounts should be relatively small and stable over time.

The 'losses roller' mechanism

1.10. To ensure that the losses incentive remains effective throughout DPCR4 and does not discourage investment later in the price control period, a 'roller' mechanism applies. It ensures that the reward or penalty for an improved aspect of performance instigated in any given year of the price control period, even the last year of DPCR4, will be treated the same as if it had been instigated in the first year, and reflected over a full five year period. Details can be found at Table A1.2 in Associated Document 'e'.

Changes made to other DNOs' ALPs

1.11. Since April 2005 when the current price control period began, Ofgem has changed the ALPs of two other DNOs (Electricity North West Ltd and Southern Electric Power Distribution plc). In both cases the ALPs were reduced because the DNO concerned informed Ofgem that they had identified specific data issues which showed that the original ALPs had been incorrectly calculated. In both cases the ALPs were reduced (i.e. the target was tightened) so that, all other things being equal, the DNO could expect to earn less money under the losses incentive scheme going forward[6]. On that basis Ofgem proposed that the changes should be backdated to the start of DPCR4, being most beneficial for consumers. SP believe that Ofgem should treat potential increases and decreases in ALPs in the same way including considerations regarding the backdating of changes.

[6] In the case of Electricity North West the DNO was allowed to recoup additional earnings relating to the previous price control period (DPCR3) implied by the data correction.

1.12. SP have expressed the view that SPD and SPM are the only DNOs to have been subjected to any alteration to ALPs at the instigation of Ofgem during DPCR4 (see Associated Document '6'). We do not agree with this opinion. In the two cases referred to above, Ofgem proposed appropriate ALP changes to the DNOs concerned which they consented to; in that respect Ofgem instigated the changes. However, in those cases the factors which warranted the ALP changes were brought to Ofgem's attention by the DNOs and the circumstances were not subject to investigation.

2. Investigation into ScottishPower's losses reporting in 2005

Chapter Summary: This chapter outlines the investigation into SP's losses reporting which took place in 2005/06. The conclusion of the investigation led to a reduction in SP's allowed loss percentages (ALPs).

Background to the investigation

2.1. In March 2005, we launched an investigation into SPM prompted by high loss incentive earnings and feedback from suppliers about the level of SPM's use of system charges. SP advised us that they had changed the way they worked out the number of units they were distributing and hence the number of units lost. They had previously applied overall line loss factors to the totals for units entering their networks but had switched to using settlement data flows which they adjusted using trend analysis. SP said they had done this because they had regained confidence in the stability of settlement data and asserted that the validity of data had not been affected. The change was applied to SPM from regulatory year 2003/04 and to SPD from 2004/05.

What the investigation found

2.2. For the period from 2001/02 to 2003/04 SP moved a significant number of units to their provision account because they were observing what they believed to be anomalously low loss levels, which they expected would increase when settlement data was later finalised. It can take 14 to 28 months for settlement data to be finalised and the numbers can change significantly in updated data flows during this period.

2.3. In the event, however, finalised settlement data confirmed the low loss levels and SP subsequently 'released' the units concerned from their provision account back to their profit and loss account and regulatory reporting.

2.4. In 2004/05 when the ALPs for DPCR4 were originally being set, the units in the provision account were not visible to us. This depressed SP's apparent performance under the losses incentive in DPCR3 as they did not include the units in their regulatory returns. This meant that the average loss levels Ofgem used to set the ALPs for SPD and SPM were higher than they would have been if we had been aware of these adjustments and SP was set a looser losses target than would otherwise have been the case.

Basis for closing the investigation

2.5. The investigation was closed (see Associated Document 'b') on the basis of a compromise agreement under which SP agreed to accept reduced ALPs calculated on a revised basis and with reasonable knowledge of the reductions in allowed revenue which could flow from them[7]. SP also agreed to formally restate their losses information for regulatory years 2001-02 to 2004-05[8]. At the time SP asked Ofgem to note that, in accepting the proposals to close the investigation, they were not admitting any breaches of their distribution licences. They point out that they reluctantly accepted the ALP changes bearing in mind the time and resource implications if the matter continued and the misleading impression given by the poor quality of the data at the time (see Associated Document '6'). They say that they did not accept that they were fixing the targets for DPCR4 immutably.

Rationale for adjusting SP's ALPs using data for the three years from 2001/02 to 2003/04 ("the three years")

2.6. If we had not revised SP's original ALPs, SPD and SPM would have obtained significant financial gains under the DPCR4 losses incentive scheme. We decided that it was appropriate to reduce the original DPCR4 ALPs by a number of percentage points.

2.7. The rationale for this approach was that if the drop in reportable losses for the three years from 2001/02 to 2003/04 had been visible to Ofgem when the original ALPs were set then it would have been taken into account and would have resulted in lower ALPs being set than were actually set.

2.8. The amount of the reduction we applied to the original ALPs was the difference, in percentage points, between the average reported losses percentage before and after restatement for the three years from 2001/02 to 2003/04.

2.9. Our choice of method for adjusting SP's ALPs deviated from the normal 10 year average method but in our view was justified. We considered this approach was relatively straightforward to implement, addressed the units that SP had taken to a provision account and took into account the change in the way SP reported units distributed so that they would not receive excess rewards under the scheme. We also considered it doubtful, at the time, that ten years valid data could be made

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[7] For a given ALP it is relatively simple to model the financial outcomes which could arise under the losses incentive for a range of possible values for the two variables involved (units entering and units exiting the network)

[8] Standard condition 47.17 of the Electricity Distribution Licence (formerly Part G of standard condition 50) refers to the circumstances in which regulatory revenue returns should be restated

available by SP for the purposes of a revised ten year calculation on the original DPCR4 basis. Such a calculation would have given SPD and SPM ALPs which were lower than the original values, but higher than those ascertained under the approach which was used (see table below).

	1. Original DPCR4 ALPs	**2.** ALPs as reset (2005/06 only)	**3.** ALPs under 10 year average (using data restated after investigation)	Notional positive movement in loss incentive adjustment (£m) for Regulatory Years 2005-06 to 2007-08 (column 3 versus column 2)
SPD	6.45	5.13 (5.41)	5.81	19.0
SPM	7.52	5.32 (5.85)	6.77	33.3

2.10. Our approach sought to set ALPs for SP consistent with the ones which would have been set if we had been aware of their change in reporting approach and, in particular, of the substantial number of units which had been taken to a provision account. We also sought to avoid the potential complications associated with calculating and comparing losses reported under different approaches which appeared at the time to be inconsistent. That is to say, our approach, at the time, avoided the need to revisit data for the period from 1994/95 to 2000/2001 which had been reported under SP's previous approach.

Treatment of loss incentive earnings for DPCR3

2.11. In accordance with the investigation closure agreement, SP retained the DPCR3 loss incentive earnings relating to the low loss levels reported for 2001/02 to 2003/04 as restated after the investigation (see figure A2.2). SP assert that the present issue should not be linked to their losses incentive earnings for 2001/02 to 2003/04 since they derive from finalised data for those years and are in accordance with the price control regime which was in place for that period.

ScottishPower's position

2.12. ScottishPower have said that their changed approach to losses reporting was sensible and prudent in the circumstances at the time and did not amount to a change in 'methodology'[9]. They have also argued that restatements after the investigation showed their action did not in itself cause a downward step change in reported loss levels, although it delayed visibility of the real data for three years.

Licence modifications

2.13. The licences of SPD and SPM were modified in order to introduce the revised ALPs, which both parties agreed to. A copy of the licence modification document can be seen at Associated Document 'c'. The investigation closure agreement did not make any stipulation concerning the level of earnings/penalties going forward under the losses incentive scheme with the revised ALPs.

[9] Special Condition C1 para 9 requires the licensee to retain the same losses calculation methodology for the price control period except where the Authority has agreed to a change. The broadly equivalent provision at the time of the change by SP was contained in Schedule A (paragraph 10 in Part E) of the Special Conditions of the Electricity Distribution Licence in effect at that time. It required a licensee to provide a statement after the end of each year giving the calculation of adjusted distribution losses and, where appropriate, an explanation of any changes in the basis of calculation.

3. ScottishPower's arguments for higher ALPs

Chapter Summary: This chapter summarises the arguments SP have raised in support of their claim for higher ALPs.

Question box

Question 1: Do you think that the ALPs agreed to by SPM and SPD in 2006 should be revisited in light of information now available from SP?

Question 2: What are your views on the recalculated ALPs proposed by SP?

Question 3: Do you think a change to SP's ALPs, if made, should be backdated?

Question 4: What are your views on the approach suggested by SP to mitigate the effects of changes on suppliers and consumers?

SP's representation

3.1. SP wrote to Ofgem in late 2007 making a case for the ALPs for SPD and SPM to be increased (see Associated Documents '3' and '4').

3.2. Ofgem responded with a 'minded to' letter dated 18 December 2007 (see Associated Document '5'). SP deferred a response to that letter pending the work to reconcile samples of SP's finalised distribution figures for 2001/02 to 2003/04 to Elexon's records[10]. Following a meeting with Ofgem in July 2008, SP provided a formal response dated 28 July 2008 (see Associated Document '6').

3.3. Details of SP's representation are below.

SP's earnings so far in DPCR4 compared to other DNOs

3.4. SP (SPD and SPM) have incurred penalties totalling £42m in the first 3 years of DPCR4 (see figure A2.1 at Appendix 2). Based on their current predictions they will incur losses totalling £74m for the whole of DPCR4 across both DNOs if their ALPs are not increased. The average reward achieved by each of the other DNOs so far in DPCR4 is £27.5m (£330m in total).

[10] The reconciliation work was carried out by SP and Elexon staff in relation to SPM only for 2003/04 and 2005/06

3.5. SP say that in the present circumstances the purpose of the losses incentive scheme has been undermined for their DNOs. They argue that the present situation amounts to discrimination against them and needs to be corrected because they cannot achieve the financial outcomes agreed to in the overall DPCR4 price control settlement. They say that as a consequence, their return on capital stands to be reduced by 0.6 percentage points, which will have implications for investment in their networks. On this basis they do not consider that Ofgem's 'minded to' position is in the interests of consumers or the wider economy. They assert that when they accepted a reduction in their ALPs when the investigation into SPM was closed, they were mindful that the Authority could further revise those ALPs at a later date, if appropriate, under paragraph 7 of special condition C1, which says:

"The Authority, having due regard to the purpose of this condition, and being satisfied, following consultation with the licensee, that there has been a material change (whether an improvement or a deterioration) in the quality of the information used to derive the adjusted system entry volumes or adjusted units distributed, may, with the licensee's consent (which shall not be unreasonably withheld), direct the licensee to change the value of ALP, to which paragraph 6 refers, to a different value specified by the Authority."

3.6. SP say that the low losses observed in the period 2001/02 to 2003/04 have proved to be abberationally low and, under the recalculated approach, have resulted in inappropriately low ALPs. They believe that they now need to be put back on the same footing as the other DNOs and cite article 3 of the Internal Markets Electricity Directive (IMED) which deals with non-discrimination[11].

Assertion of flaws in Ofgem's approach to re-setting SP's ALPs

3.7. SP contend that Ofgem must have assumed that their changed approach to loss reporting and use of a provision account had, of itself, caused a step change down in the level of their reportable losses. However, they now observe loss levels to be 'trending' back up and say that their ALPs were therefore set too low to generate an achievable level of benchmark losses.

[11] Article 3(1) of the IMED provides that 'Member States shall ensure, on the basis of their institutional organisation and with due regard to the principle of subsidiarity, that, without prejudice to paragraph 2, electricity undertakings are operated in accordance with the principles of this Directive with a view to achieving a competitive, secure and environmentally sustainable market in electricity, and shall not discriminate between these undertakings as regards either rights or obligations'. We broadly deal with this issue under the heading 'Even handed approach as between licensees' in Chapter 5.

Material change in the quality of information used to set SP's ALPs

3.8. SP make the point that the reasons for the abberationally low losses in the period from 2001/02 to 2003/04 are outside their control. They point out that during that period, the official audits of settlement data (the BSC Audit[12]) had been 'qualified' whereas now the audit reports are not qualified.

3.9. SP set out some detailed arguments for Ofgem to use its discretionary powers to increase their ALPs in their letter dated 28 July 2008 (see Associated Document 6). We broadly consider these arguments in Chapter 5, albeit that we do not directly cross refer to SP's letter.

SP's submission for this impact assessment/consultation

3.10. SP sent Ofgem a letter dated 4 November 2008 (see Associated Document '8') putting forward two possible options for increasing their ALPs for consideration in the context of this consultation and impact assessment.

3.11. SP have made an assessment of the financial impact of both options presented. In both cases SP have had to make an assumption of the level of losses in the last two years of the price control period. The revenue numbers are therefore based on a forecast of losses for 2008/09 and 2009/10.

3.12. The inclusion of these options should not be read by consultees as limiting the possible range of options available to the Authority in reaching its final decision, and in this respect the options proffered by SP are indicative outcomes only. However, the Authority will carefully consider all responses to the consultation, including views expressed on indicative options, in reaching its final decision.

Proposed ALP levels for SPD and SPM

<u>Option 1 – "Full Correction"</u>

3.13. This option is to recalculate the ALPs for SPD and SPM using the original DPCR4 approach. In this option ALPs are calculated based on the average of losses for the ten years ending in 2003/04 but using the corrected regulatory submissions made after the investigation for the losses in 2001/02 to 2003/04. The data used also takes into account additional restatements for the latter years to reflect all finalised settlement runs and, for SPD, adjusts the data for the transmission-connected EHV

[12] The BSC Audit is carried out in accordance with Section H of the BSC. The BSC Auditor will 'Qualify' its audit opinion if it cannot provide reasonable assurance that the total level of error in Settlement is less than the Materiality Threshold (see Elexon website).

units referred to below and in Chapter 4. This option also allows full feed-through (including full backdating of financial outcomes) to the beginning of the DPCR4 period (April 2005)[13].

3.14. Under this approach they expect the following incremental change in loss incentive earnings (and therefore allowed revenue) for the DPCR4 period:

- SPD +£63m (ALP increases from 5.13 to 6.32 for the full DPCR4 period)
- SPM +£71m (ALP increases from 5.32 to 7.00 for the full DPCR4 period)

3.15. They would agree to limit the immediate impact by restricting any change to use of system charges in 2009/10 to an incremental 4% increase (above any increase which would otherwise apply) and propose to recoup the balance of additional allowed revenue in the DPCR5 settlement. They propose to spread the impact of collecting the outstanding balance from consumers by separately deferring income from asset depreciation allowances (extending their RAV depreciation period from 20 to 22.75 yrs for SPD and 22.25 yrs for SPM), giving an off-setting reduction in overall allowed revenues in the years when the additional losses incentive earnings are being collected.

Option 2 – "Limited Correction"

3.16. SP have put forward this alternative, notwithstanding their view that the appropriate adjustment is the one given by Option 1 – Full Correction. Under this option their ALPs would be reset based on average losses for the three years from 2005/06 to 2007/08. Although this would use a shorter-run three year average, SP believe that reported loss levels in these three years are more typical than the three years previously used by Ofgem. They point out that settlement data for the 2005/06 to 2007/08 period was not subject to a qualified audit opinion. Furthermore, the financial outcomes under this option would not be backdated before 2007/08. This proposal also adjusts the data for SPD in respect of the transmission-connected EHV units referred to below and in Chapter 4.

3.17. Under this approach they expect the following incremental change in loss incentive earnings (and therefore allowed revenue):

- SPD +£35m (ALP increases from 5.13 to 6.00 for 2007/08 to 2009/10)
- SPM +£19m (ALP increases from 5.32 to 6.00 for 2007/08 to 2009/10)

[13] This option does not involve any claw-back of loss incentive earnings in the DPCR3 period

3.18. They would agree to limit the immediate impact by restricting any change to use of system charges in 2009/10 to an incremental 4% increase (above any increase which would otherwise apply) and propose to recoup the balance of additional allowed revenue in the DPCR5 settlement. They propose to spread the impact of collecting the outstanding balance from consumers by separately deferring income from asset depreciation allowances (extending their RAV depreciation period from 20 to 21 yrs for SPD and 20.5 yrs for SPM), giving an off-setting reduction in overall allowed revenues in the years when the additional losses incentive earnings are being collected.

3.19. Under both options increases in use of system charges would be spread across all customer tariffs with the initial 4% increment in 2009/10 equating to about a 0.7% increase on a domestic customer's final electricity bill (about £3.40 per annum).

Sensitivity to variance in predicted distribution/loss levels

3.20. In order to provide an indication of the sensitivity of these options to actual variance in losses, SP have calculated that a movement of +/- 10% in loss levels (versus predictions used in the options above) for the last two years of DPCR4 could of themselves make incremental differences to allowed revenue of about £14m to SPD and £12m to SPM as set out below:

	Number of units lost 10% lower than predicted	Number of units lost 10% higher than predicted
SPD	£14m more revenue	£14m less revenue
SPM	£12m more revenue	£12m less revenue

3.21. To put this into context, SP's reported losses have varied by the percentages shown in the table below in recent years. It should be noted that the figures reported by DNOs for any given year include adjustments relating to finalised settlement data for earlier regulatory years. The total number of units distributed by DNOs has also been affected by varying levels of consumer demand over the last few years.

	2005/06	2006/07	2007/08
SPD			
Losses (GWh)	1277	1213	1307
Year on year change		-5.0%	+7.7%
SPM			
Losses (GWh)	1069	936	1180
Year on year change		-12.4%	+26.1%

Transmission-connected EHV units issue affecting SPD

3.22. SP say that this issue reflects a manifest error in the ALP calculation for SPD. They hold the view that there are clear precedents for an adjustment to be fully backdated in effect to the start of DPCR4. Further detail relating to this issue is provided in Chapter 4 below. It should be noted that SP's "Full Correction" proposal outlined above incorporates a fully backdated adjustment in respect of the transmission-connected EHV units issue.

The losses incentive rolling retention mechanism

3.23. SP consider the losses roller should be switched off in relation to them because of the flawed setting of their loss targets. Furthermore, because the losses roller adjustment would be made as part of the DPCR5 settlement they consider it should be reconsidered as part of the DPCR5 process. As their ALPs presently stand they predict they will incur further penalties of £19m in DPCR5 adjustments (versus £13m penalty adjustment under the "Full Correction" option / £9m reward adjustment under the "Limited Correction" option).

4. SPD adjustment for transmission-connected EHV units

Chapter Summary: This chapter describes a separate ALP adjustment issue relating to SPD only and concerning distribution to transmission-connected EHV customers in the south of Scotland.

Question box

Question 1: Do you think an increase in the ALP for SPD in respect of transmission-connected EHV units should be backdated? And if so should this be partial or full backdating?

Background

4.1. SP have also asked Ofgem to apply an increase to the ALP for SPD (only) to correct an omission in the initial calculations relating to transmission-connected EHV sites.

4.2. Before 1 April 2005, the settlement of distributed electricity in Scotland was managed under the Settlement Agreement for Scotland ('SAS'). However, from 1 April 2005 the SAS was ended in accordance with the introduction of the British Electricity Trading and Transmission Arrangements ('BETTA'). Under the SAS the EHV units concerned were deemed to have been distributed by the DNO, but under BETTA they are deemed to be distributed from the transmission network.

4.3. Because the large industrial customers concerned are situated very close to the 'grid supply point' they have very low levels of distribution losses associated with them which tended to reduce overall loss percentages slightly. Therefore, they ought to have been excluded from the original ALP calculations for SPD so that performance is measured on the same basis as the one on which the ALP (targets) were set.

SP's proposal

4.4. The number of units distributed to these EHV sites is about 900 GWh per year and SP have calculated that an appropriate adjustment would increase SPD's ALP by 0.21 percentage points (0.23 for 2005/06 only). All other things being equal, this adjustment would increase SPD's earnings under the losses incentive scheme by about £2.4m for each year that the higher ALP applied – about £12m if fully backdated to the start of DPCR4.

Full or partial backdating of adjustment

4.5. SP argue that the adjustment should be fully backdated and say that if this total were recovered in 2009/10, there would be an incremental charge increase of less than 3.6% (£3 per annum for a domestic customer). The Overall increase in allowed revenue would be approximately £12m.

4.6. We are minded to agree to SP's request that an adjustment should be made to SPD's ALP in the circumstances outlined above and we consider SP's calculation of the ALP change and revenue effect to be accurate. However, given the potential impact on suppliers and consumers, we want to consider views on whether the adjustment should, in fact, be fully or partially backdated.

4.7. While we fully backdated ALP adjustments in the two previous data correction instances referred to in Chapter 1, we consider that there are two factors which ought to be considered in respect of backdating in this instance:

- In this case the adjustment involves an increase in ALP which would have an adverse effect on consumers through increased charges. Backdating an adjustment would increase the adverse effect on consumers since it would lead to an increase in the total amount of extra revenue SP could collect. On the previous occasions which involved reductions to ALPs, it was clearly appropriate to fully backdate the adjustments and associated reductions in allowed revenue, consistent with our principal objective to protect the interests of consumers.
- The issue of transmission-connected EHV units ought to have been visible to SP at the time when data was being collected by us for the original DPCR4 ALP calculations. We reasonably expect DNOs to be responsible for raising with us issues that may have a bearing on the calculation of an incentive, particularly where they are in a better position to comment. In these circumstances it may not be appropriate to backdate the effect of any revision since the issue has been raised part-way through the price control.

4.8. We welcome views on whether this adjustment should be made and whether it should be partially or fully backdated and any associated impacts to parties from such an adjustment. In addition we would be interested in any opinions respondents may have on the time-scale over which any additional allowed revenue should be recovered through use of system charging. We also invite comment on whether it would be right to ask consumers using the SP networks after 2009/10 to pay the cost of incentive adjustments relevant to the DPCR4 period.

4.9. Although a dissimilar scenario in some ways, in a recent instance of an increase to allowed revenues for several DNOs to cover the costs of complying with the Electricity Safety, Quality and Continuity Regulations 2002 (under special condition A3 of their electricity distribution licences), we decided that the revenue adjustments should be limited to 4% in real terms each year, after other adjustments to revenue. Amounts in excess of the 4% level in any year will be deferred to the following year on an NPV neutral basis (using the DPCR4 cost of capital). The adjustments related to five DNOs and the average adjustment was £10.9m. The relevant decision letters can be viewed on the DPCR4 page of the Ofgem website.

5. Ofgem's views

Chapter Summary: This chapter gives Ofgem's provisional views on the issues raised in this consultation and impact assessment.

Question box

Question 1: What are your views on Ofgem's 'minded to' position in respect of the main ALP issue?

Question 2: What are your views on whether an adjustment to the ALP for SPD in respect of transmission-connected EHV units should be partially or fully backdated?

Question 3: Which option do you think Ofgem should pursue in responding to SP's representation for higher ALPs?

Question 4: Do you think there are any additional options/factors Ofgem should consider?

Question 5: Do you think Ofgem is right in drawing a distinction between this case and other cases where a DNO's ALPs have been changed by direction?

Question 6: Do you think there are any wider implications for the losses incentive scheme in the current or future price control periods?

Introduction

5.1. We have set out our 'minded to' position to SP on both the wider ALP issue and the EHV transmission units issue. This was explained in our December 2007 letter. We looked at the matter afresh in 2008, carrying out a data review with SP and Elexon. However, we consider that the work carried out to reconcile SP's loss reporting to settlement data supports the position set out in our 'minded to' letter that the data used in 2006 was fit for purpose[14]. Since then, SP have responded to our 'minded to' position in a letter of 28 July 2008 but nonetheless we remain of the view that we should not amend SP's ALP on the basis of their representations. Consultees are referred to our 'minded to' letter (see Associated Document 5) and the wider exchanges of correspondence (see Associated Documents), and the views expressed in this document. Since that time we have decided that it is appropriate for us to carry out an impact assessment as we consider that the issues raised by SP's representations are important and meet the test set by section 5A of the Utilities Act, specifically in respect of the potential financial impact on the market

[14] SP had previously carried out a thorough internal review in 2007 to ensure that no factors within their control had been affecting the accuracy of settlements data flows used for losses reporting. They presented a report on this exercise to Ofgem confirming that they had identified no such factors.

participants and on the wider public. We also consider that conducting an impact assessment is consistent with best regulatory practice.

5.2. The purpose of this consultation is to seek views on the case made by SP and the potential consequences of increasing the ALPs for SPD and SPM which will inform us in making our decision on SP's representation. This chapter sets out in more detail some of our thinking on the specific issues raised by SP.

Adjustment to ALPs

5.3. In order to assess SP's general request for increased ALPs, we consider it is appropriate to bear in mind three areas of concern. These are that:

i. There should be a comparison of 'like with like'. The basis used to set the benchmark level of losses for a DNO should be sufficiently equivalent to the basis used to calculate the out-turn loss levels which are compared to that benchmark
ii. The data used to set the benchmark and measure out-turn performance should be sufficiently accurate
iii. The approach to setting benchmark losses and measuring performance should be 'even handed' as between different DNOs with any differences in treatment being objectively justified

5.4. We consider SP's representation in relation to these concerns and outline our provisional views below. We note that we have powers under paragraph 7 of special condition C1 of the electricity distribution licence to make changes to SP's ALPs. We also note that we have powers under section 11 of the Electricity Act 1989 to modify the ALPs through a licence modification.

5.5. Paragraph 7 of C1 gives the Authority discretion to amend ALPs if it is satisfied that there has been " a material change (whether an improvement or deterioration) in the quality of the information used to derive the adjusted system entry volumes or adjusted units distributed....."

Targets and methodologies on a like for like basis

ALPs set after the 2005/06 investigation

5.6. We consider that the ALP levels agreed with SP for SPD and SPM at the closure of the investigation in early 2006 were and remain valid. Although the approach used deviated from the ten year average calculation (see paras 2.6 to 2.10) the revised approach sought to ensure that SPs ALP's going forward generated an appropriate benchmark for the purposes of the losses incentive scheme, given the changes to the way in which SP ascertained reportable losses. If we had not revised SP's original ALPs, SPD and SPM would have obtained significant financial gains.

5.7. SP have made the point that Elexon's audits for the period of the 2001/02 to 2003/04 period were qualified whereas now they are not (see para 3.8). However, this does not affect our view that the data used in setting the ALPs was appropriate, nor does it show that there has been a material change in the quality of the information used to derive the adjusted system entry volumes or adjusted units distributed. The settlement data regime applies to all fourteen distribution network operators and there have been no other representations concerning a change in the quality of data.

Transmission-connected EHV units (SPD)

5.8. We concur with SP's representation that the ALP for SPD should be increased in line with a recalculation approach that excludes transmission-connected EHV units. However, as indicated in Chapter 4, we have not decided whether it would be appropriate to backdate the effect of such an increase.

Accuracy of data

ALPs set after the 2005/06 investigation

5.9. The work that we have carried out with SP and Elexon during the course of 2008, although limited in scope, indicates that the losses data reported by SP for the three years in question was (and remains) the best available and no new data issues have been found. We have not become aware of any factor which could have been discovered in 2005 and which might have changed the decision which was reached at that time, nor any factor which could not have been discovered in 2005 but which would now persuade us that the 2005 decision should be revisited. We do not consider that either SP's poor outturn performance or the change in status of the Elexon audit demonstrate a material change in the quality of information used to derive system entry volumes/units distributed. We had informed SP ahead of the work carried out with Elexon that simply validating the losses numbers which had been reported (confirming the unusual pattern observed) would not of itself be enough to persuade us that their ALPs should be changed, being aware of the time and resource input which the work with Elexon would entail. SP, however, consider that we may have set a threshold requirement for categorical new information (as opposed to 'better' information) - see Associated Document '6'. We do not agree with their understanding of the position in this regard.

5.10. We note the issues raised by SP with the quality of the settlements data including raising 'standing issue 34' through Elexon (see associated document 'f'). The BSC panel agreed that market wide volatility subsists in settlements data which is caused by inaccuracies and features of the current profiling arrangements. It acknowledged that SP's loss pattern was unusual but did not identify any specific data issues in that respect. Our view is that profiling accuracy issues might cause short run volatility within settlements data but would be unlikely to have a significant effect on annual reporting by DNOs.

5.11. From this we consider that the data and information on which we made the decision in 2006 to close the investigation and propose an adjustment to the ALPs, which SP agreed to at that time, has not changed. The changes made to SP's ALPs at that time reflected the use of a materially improved dataset which became available after conspicuous, new factors were taken into account. We have not identified any equivalent factors in relation to SP's present representation.

Transmission-connected EHV units (SPD)

5.12. SP have used data on the number of units distributed to transmission-connected EHV customers for the years from 1999/00 to 2004/05 to calculate the incremental increase which would have applied to SPD's ALP if that category of units had been excluded from the original calculation. As indicated in Chapter 4 we consider SP's calculation of the required ALP change to be accurate.

Even handed approach as between licensees

ALPs set after the 2005/06 investigation

5.13. We acknowledge that the basis on which the revised ALPs were set in 2006 was to make an adjustment to the 10 year rolling average based on the difference (in percentage points) between the reported losses before and after restatement for the three years 2001/02 to 2003/04. This is a different method to other DNOs, but we consider it was appropriate at the time as it addressed both the change in approach by SP in reporting units distributed and also addressed the units that SP had taken to a provision account. We also note that SP accepted the licence modification at the time to make the changes to their ALPs in 2006.

5.14. Although the basis of calculation used did vary from that used in the original calculation of ALPs for DPCR4 we consider the approach was objectively justified for the reasons set out at paragraphs 2.6 to 2.10 above.

5.15. We note that the outcome to date for SP under the DPCR4 losses incentive has been a significant financial penalty compared to other DNOs. However, we consider the outturn numbers are not outside the range of possible outcomes that might be expected under a symmetrical incentive scheme.

5.16. It is relevant to note the circumstances in which the adjustments to SP's ALP were made. The adjustments were made as part of an agreement which SP signed up to and accepted in early 2006 in the context of a formal investigation into SPM. In summary, SP agreed to their ALPs being reduced coincidentally with the closure of our investigation into their losses reporting. This had the effect of removing their exposure to a possible finding of licence breach[15]. As part of the agreement, SP also retained the significant financial benefits from the low levels of losses reported in the three years from 2001/02 to 2003/04 (Figure A2.2) through the previous price control losses incentive mechanism.

5.17. We do not currently believe that there has been a material change in the quality of the information since 2006 for the purposes of recommending to the Authority that it should exercise its discretionary power under paragraph 7 of Special Condition C1 to reset SP's ALPs. As stated in our 'minded to' letter we consider that a shift in the level of performance would not in itself be a cause for re-visiting the target.

5.18. The essential point being raised by SP is as to the use of the three year methodology, and following recent work by Ofgem, SP and Elexon to check SP's reported losses for the three years concerned, we consider that there has been no material change to the quality of relevant data since their acceptance of the revised ALPs in 2006 as part of the compromise agreement which brought to an end the then ongoing Ofgem investigation (see above).

5.19. We also do not consider that SP are being discriminated against compared to other DNOs, as the SP DNOs signed up to the current ALPs as part of the 2006 compromise. We consider any apparently different treatment to be objectively justified – we had good reasons for the differential treatment of SP viz the other DNOs arising from their change in reporting approach and the settlement of the investigation into SPM by way of a compromise outcome, which SP accepted. We welcome views on this and on our 'minded to' position.

5.20. It is also important to consider the mechanics of the scheme. The scheme is effective whether the DNO is receiving rewards or incurring penalties – it still incentivises the DNO to make the marginal improvement to their losses performance, which should lead to an improved performance under the incentive - whether to reduce penalties or increase rewards.

Transmission-connected EHV units (SPD)

5.21. The issue of transmission-connected EHV units only affected the two DNOs whose distribution services areas are in Scotland: SPD and Scottish Hydro Electric Power Distribution plc. We agree that the ALPs for both those DNOs should reflect the fact that the customers concerned are now deemed to be connected to the transmission system.

[15] If a licence breach is found against a licensee, the Authority can impose a fine of up to 10% of turnover which is payable to the Treasury

Conclusions

5.22. SP have suggested two approaches to recalculating ALPs in Chapter 3. There are other possible approaches as shown at figure A2.3 in Appendix 2. It should be noted that for each additional percentage point increase in ALP generated under a recalculation option, levels of allowed revenue would increase incrementally by about £11m per annum for SPD and £9m per annum for SPM.

5.23. There are a number of important issues which we have set out in this document that we will need to take into account in making our decision. Responses to this consultation and impact assessment will provide important information which will help us in making our decision. However, at present our provisional view is that we are not persuaded of SP's case for increasing their ALPs, whether that increase is made pursuant to paragraph 7 of special condition C1 or section 11 of the Electricity Act 1989.

5.24. Our provisional view is based on the following points that relate to the concerns outlined above and the preceding discussion. First, in our view SP's current ALPs were appropriately re-set based on three years worth of data considered representative of their revised approach to calculating losses. To rely unduly on data prior to SP's change in approach would not accord with the principle of using like for like methodology and data. Second, whilst SP consider that the data used to re-set their ALPs represent aberationally low levels of losses, analysis performed in conjunction with SP and Elexon has not identified any issues in relation to the quality of the data used.

5.25. The SP DNOs openly agreed on an informed basis, with the benefit of their industry expertise, to the changes in their ALPs in 2006. As part of the agreement, the investigation was closed with no finding of a licence breach and SP also received the significant financial benefits from the losses reported in the three years (Figure A2.2) through the previous price control losses incentive mechanism. Had this compromise outcome not emerged, the investigation into the SP DNOs would have continued with the potential consequences of a finding of licence breach.

Return on regulatory equity

5.26. SP have said that their present ALPs mean that they will suffer a reduction in their expected return on capital under the DPCR4 price control settlement which would impact on their network investment. A representation of the forecast return on regulatory equity (RORE) for each DNO in DPCR4 was given at Figure 1.2 of Ofgem's DPCR5 policy paper (Ref 159/08)[16]. It showed SPD to have the second

[16] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=132&refer=Networks/ElecDist/PriceCntrls/DPCR5

lowest and SPM significantly the lowest forecast RORE of the fourteen DNOs (7.85% and 5.95% respectively versus an assumed return of 7.5% used in setting allowed revenues). Further information is contained in Appendix 11 of the Appendices to the DPCR5 policy paper[17]. It should, however, be noted that we have received updated forecast cost data from all DNOs since the RORE figures in the DPCR5 policy paper were calculated and this, together with amendments to the calculation approach, will change the DNOs' RORE figures. In the DPCR5 policy paper we acknowledged that performance under the losses incentive is a key driver of returns, with an average of 107 basis points riding on this mechanism.

5.27. SP make the point that links between loss incentive rewards/penalties and DNO performance in tackling technical and non-technical losses have not been firmly established so that some of the rewards earned by other DNOs may be undeserved. They have also drawn attention to our comment in the DPCR5 policy paper that there is volatility in settlement data, and that this volatility can have an impact on a DNO's performance under this incentive which is unrelated to the activities undertaken to reduce losses. We have also said that we will be reviewing the form of the losses incentive scheme for the next price control period (DPCR5). SP consider that penalties being incurred under the losses incentive and other factors mean that key financial indicators for SPM are falling below benchmarks consistent with an investment grade credit rating, although the effect is not as severe for SPD.

5.28. SP (in common with other DNOs) have submitted a price control re-opener application for SPD and SPM under special condition A3 of their distribution licences in respect of amendments to the Electricity Safety Quality and Continuity Regulations 2002 (ESQCR), the Traffic Management Act 2004 (TMA) and the equivalent in Scotland. When the DPCR4 price control allowances were set, costs associated with complying with this legislation were referred to as 'uncertain costs'. SP's application is currently under consideration by Ofgem and if it were to be granted it would mean that SP would be allowed to collect extra revenue in respect of 'uncertain costs' incurred during the first three years of the DPCR4 price control period and in respect of costs expected to be reported during the last two years of DPCR4. SP's application is considered by Ofgem to represent approximately £78m of additional expenditure (SPD £22m/SPM £56m).

5.29. All other things being equal, we would expect extra revenue allowances for 'uncertain' costs to incrementally increase SP's RORE figures as shown below. However that assumes that all the costs in SP's application are considered eligible when reviewed - if some of the costs were to be disallowed, then the incremental increases in RORE would be commensurately lower. SP have pointed out that RORE values for other DNOs will also vary as their respective re-opener applications are

[17] http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/POLICY%20PAPER%20APPENDICES.pdf

processed. However, the application lodged by SPM is for a particularly large amount of money.

	SPD	SPM
	RORE forecast change in basis points	
Ofgem's forecast of incremental change in RORE as a result of the ESQCR/TMA reopener, assuming all costs are considered eligible (see explanation at para 1.1 in Appendix 2)	+5	+60

5.30. Although we refer to an "allowed cost of capital" in the context of our duty to have regard to the ability of licensees to finance their licensed activities, that does not mean we would expect all DNOs to achieve or exceed that level of return in all circumstances. In particular, DNOs performing poorly against price control incentive mechanisms could expect to achieve lower rates of return. We would not adjust price control criteria just to support financial ratios so that a DNO can achieve the issuer grade credit rating required under its licence. Where issues have arisen because of poor management or inefficiency then it is a matter for the company's management, shareholders and/or bondholders to address.

Losses rolling incentive

5.31. SP have suggested that the losses incentive rolling retention mechanism should be disapplied under their two ALP revision proposals. We do not agree with this suggestion. Even if it were necessary to re-set SP's ALPs to achieve an even-handed approach, this does not imply that they should not be subject to the losses rolling retention mechanism in the same way that all other DNOs are. However, if there were to be a partial backdating of ALPs it might be appropriate to consider the application of the mechanism since it was not designed to cater for such a contingency.

Transmission-connected EHV units issue affecting SPD

5.32. We are minded to accept SP's arguments in relation to an adjustment for transmission-connected EHV units. If we had been aware of this data at the time it would have affected the level at which the losses target was set. It is also similar in nature to the cases detailed in Chapter 1 where we have used paragraph 7 of special condition C1 to make an adjustment. In those cases the adjustments were fully backdated.

5.33. In Chapter 4 we highlighted that the adjustment for SPD is different in two respects to these previous cases: adverse impact on suppliers and/or consumers, and the ability of SP to be aware of the data issue at the time the original ALPs were being set. We are minded to make an adjustment in this case to ensure that losses are being assessed on a like for like basis with targets but we are not currently convinced that this should be fully backdated. We consider that SP were in a position to know about this issue and bring it to our attention at the time of setting DPCR4 ALPs. Backdating the adjustment in this case may dampen the incentive on DNOs to forecast accurately and will have a larger impact on suppliers and consumers in SPD's distribution services area. We welcome views on this issue.

Possible implications for other DNOs' ALPs

Concerns about re-opening aspects of a price control settlement

5.34. Our concern is that accepting an adjustment as set out by SP could undermine the losses incentive mechanism for them and potentially more generally have implications for other DNOs, other incentives and the broader price control settlement. Re-opening price control settlements may also reduce the onus on DNOs to manage their costs and forecast accurately and is not something that we would do lightly.

5.35. Special condition C1 contains a discretionary power exercisable by the Authority. This power broadly provides that the Authority may amend an ALP with the licensee's consent where there has been a material change (whether an improvement or a deterioration) in the quality of the information used to derive system entry/exit volumes. As stated above, such an adjustment has been made on two previous occasions to address manifest errors.

5.36. Generally speaking, we believe that there would have to be clear, evidence based reasons to re-open elements of a price control, even where a specific mechanism is provided within the charge restriction conditions of a licence. This is important in the context of providing 'regulatory certainty'. We do not consider that such reasons have been shown in this case.

5.37. Our assessment of the transmission connected EHV units issue is that there has been a material change in the quality of relevant information and therefore it is appropriate to make some adjustment. As detailed above we consider the question is whether this adjustment should be backdated. However, the main ALP issue addressed in this consultation is not clear cut in the same way and could impinge on loss incentive reporting by other DNOs.

Robustness of losses incentive scheme

5.38. In support of their representation SP have suggested that there has been a material change in the quality of the information used to derive the adjusted system entry volumes or adjusted units distributed as between the period from 2001/02 to 2003/04 and the period from 2005/06 onwards.

5.39. The same 'raw' settlement data is used by all 14 DNOs in Great Britain for losses reporting purposes; so if SP were to be correct it would imply that the ALPs for each DNO should be re-evaluated. That is because, even though SP's current ALPs were re-set on a different basis from the other DNOs, the ALPs for all DNOs have been derived using data spanning the 1994/95 to 2003/04 period i.e. if the data flows for some or all of that period were deemed to be inherently unreliable we would be bound to consider whether the ALPs set for other DNO's should be reviewed.

5.40. Given the potential impact on DNOs, suppliers and consumers of such a re-evaluation and the potential regulatory uncertainty which could arise, we would welcome feedback from respondents on this aspect.

6. Potential impacts of a decision on SP's representation for increased ALPs

Chapter Summary: This chapter summarises the potential impacts of the various decisions Ofgem could make in response to SP's request for higher ALPs.

Question box

Question 1: How would you be impacted by an incremental change in SP's allowed revenues if ALPs were increased?

Question 2: Would any particular customer groups be affected?

Question 3: If SP's ALPs were to be increased, do you think that a cap on loss incentive earnings should be imposed?

Question 4: If SP's ALPs were to be increased, how do you think SP should be allowed to recoup incremental revenues?

6.1. We consider that there are two available options for addressing the issues explained in this consultation document. They are:

i. Maintain SP's current ALPs (the 'base case' option), or
ii. Increase SP's ALPs for both its distribution networks (SPM and SPD).

The potential impacts of these options are outlined in more detail below.

Option (i) - Maintain SP's current ALPs - the 'base case'

6.2. This option would only have a direct impact on SP. That is, SP would be expected to continue to incur penalties under the losses incentive, assuming that its performance under the incentive did not improve. On the other hand, if performance did improve then the loss made under the incentive to date could reduce or become a net reward[18].

6.3. More generally, maintaining the current level of ALPs would ensure stability and certainty in relation to expectations of the losses incentive and use of system charges. It would uphold the decision made by Ofgem in 2006 in relation to SP's ALPs and keep the incentive properties of the incentive mechanism in place.

[18] As outlined in Chapter 3, SP estimate that a ±10% change in the number of units lost due to losses could result in a +/- £26m difference (SPD and SPM) in allowed revenue adjustments under the losses incentive.

Option (ii) - Increase the ALPs

6.4. As considered in Chapter 3, the effect of increasing SP's ALPs would be to increase the allowed revenues for each of their network areas by up to £63m (SPD) and £71m[19] (SPM) all other things being equal.

6.5. The following sub-sections consider how an increase in SP's ALPs would impact, inter alia, suppliers, consumers and the environment.

Impact on electricity suppliers

6.6. An increase in SP's ALPs will result in an increase in SP's allowed revenue for its two distribution areas. Consequently, use of system charges are likely to increase.

6.7. We understand that suppliers may not necessarily be able to pass through to customers the full value of any increases in use of system charges resulting from changes in the losses incentive target. This is because suppliers have a variety of different contractual or tariff arrangements with their domestic and non-domestic customers, and these different contractual and tariff arrangements confer different rights on the supplier to vary tariffs. Historically, most domestic customers have been on variable tariffs, with suppliers having the right to increase the tariff at any time, subject to certain notice requirements. However, increasingly domestic customers have been taking up various forms of price guarantee tariffs, such as fixed price deals or capped deals, which limit the ability of suppliers to pass on increases in costs for the duration of the fixed/capped price term[20]. These and other contract forms, such as indexed deals, are also a feature of the non-domestic sales market.

6.8. We are keen to understand the extent to which suppliers would be affected by an increase in use of system charges arising from an adjustment to SP's ALPs. Given the proliferation of different contractual and tariff arrangements, and the varying length of contract terms, we seek feedback on the following issues:

- What proportion of any increase in use of system charges would be borne by suppliers as opposed to end customers (taking into account footnote 20 below)?
- How would this vary over time, as fixed price/capped price terms expire and/or capped prices hit or move away from the capped levels?

[19] Depending on whether a limited or full adjustment of the ALPs is made – see also comments concerning possible deferral of revenue collection at paras 6.9 to 6.12.

[20] Suppliers might rely on clauses referring to actions by governmental or statutory bodies to adjust the terms of their fixed price deals which would result in costs being passed on to consumers

- How does this vary by customer class, such as between non-domestic and domestic customers, and between different categories of domestic customer. In particular, how will it affect fuel poor customers and those on higher tariffs such as pre-payment meter tariffs?
- How will the ability or inability of suppliers to pass on the increase in cost affect the profitability and solvency of suppliers, particularly the non "big-six" suppliers who are likely to be most at risk, and what impact might this have on competition in the supply market more generally?

Impact on consumers

6.9. An increase in SP's allowed revenue will result in an increase in use of system charges, which consumers will experience as a rise in their bills. Under SP's proposals there would be an initial 4% increment on use of system charges in 2009/10 equating to about a 0.7% increase on a domestic customer's final electricity bill - about £3.40 per annum (see Chapter 3).

6.10. Increases in final bills are likely to put pressure on consumers given the current economic climate, particularly those already in fuel poverty[21] and those on the margins of falling into fuel poverty.

6.11. The impact on consumers will depend on how SP would recover an increase in their allowed revenue, including any arrangement concerning interest on outstanding sums. That is, as considered in Chapter 3 above, SP could seek to recover the increase in allowed revenue immediately (or at least in the short term) or over a longer period of time, spreading the impact on suppliers/consumers in any given year. SP have said:

> *"Apart from collecting part of any increase in allowed revenue through a 4% price change in 2009/10 (which equates to about £3.40 for a typical LV consumer), SP will forego any additional allowed revenue entitlement as they propose that this could be absorbed by a reduction of an equivalent amount in SP's DPCR5 revenue allowance which would mean very reduced impacts on consumers in years beyond 2009/10. This is SP's preferred option"*

6.12. However, we feel it is important to make clear that they would not actually be giving up any of the increased revenue under this approach – they would obtain a compensating extension of depreciation allowances against their Regulatory Asset Value (RAV).

[21] A household is said to be in fuel poverty if it needs to spend more than 10% of its income on fuel to maintain a satisfactory heating regime (usually 21 degrees for the main living area, and 18 degrees for other occupied rooms).

6.13. If SP choose to recover the increase in allowed revenue immediately or in the short term then current users of their networks will be affected by an increase in their use of system charges. However, this impact may not be felt by all categories of customers (see 'Impact on suppliers' above).

6.14. Should SP recover their increased allowed revenue over a more protracted period of time, then future consumers will also bear the costs of current use. Spreading additional use of system charges over a longer period will reduce the size of any increase to use of system charges and is also likely to ensure that consumers on variable and fixed supply terms are more equitably treated – because in the long term, suppliers are more likely to be able to amend the terms of consumers on fixed deals, as opposed to only variable deals in the short term. However, spreading costs out over a longer period would mean that future consumers would pay for costs they are not necessarily responsible for. That said, there are existing 'roller' mechanisms within the current price control (including the 'losses roller') which have the effect of extending incentive earnings into the subsequent price control period.

6.15. Bearing in mind the relative impacts, we welcome views on the alternative approaches to recovering any increase in allowed revenue.

Impact on competition

6.16. DNOs do not actively compete with one another in their provision of electricity networks.

6.17. An increase in ALPs is likely to have a more significant effect on competition in the supply market. That is, suppliers inability to pass on use of system costs may directly affect their profit margins. Diminishing profit margins may discourage market entry.

6.18. In addition, market participants, suppliers in particular, rely on a certain level of stability and certainty to ensure they are able to effectively plan ahead and attract/maintain appropriate levels of investment. Actions that undermine regulatory and financial certainty are likely to hinder current and potential participants' ability to plan ahead and therefore increase barriers to entry and expansion.

Impact on the environment

6.19. An increase in SP's ALPs may have the effect of weakening the incentive properties as SP or others may consider that there is scope for targets to be adjusted if they appear to be doing badly. This would reduce the incentive on SP to improve the physical efficiency of its network and therefore reduce losses. Because losses represent an actual amount of energy generated and therefore potentially the emission of greenhouse gasses, loosening the incentive to contain losses means that, other things being equal, reductions in greenhouse gas emissions may not be as substantial or as forthcoming as they might otherwise be.

6.20. It is difficult to calculate to what extent the incentive would be weakened and consequently how emissions of greenhouse gasses would be affected. However, just a 1 percent increase in the current level of total distribution losses would equate to roughly 97,000 tonnes of CO2 per annum[22] or 7,000 tonnes per DNO.

Impacts on health and safety

6.21. We do not consider there to be an impact on health and safety.

Risks and unintended consequences

6.22. The issues considered as part of this consultation and impact assessment are of considerable materiality – that is, SP are at present incurring large financial penalties under the incentive scheme and if their ALPs are increased, customers and suppliers stand to bear the costs of a rise in SP's allowed revenue.

6.23. Consequently, any decision made by Ofgem is likely to be scrutinised by industry participants. Also, if we were to make a change other licensees may see this as a precedent that they could rely on in the event that they are doing badly under the same or another mechanism applicable to network regulation.

Post-implementation review

6.24. Following the revision of SP's ALPs, Ofgem would monitor SP's performance against the losses incentive as part of its usual monitoring processes.

6.25. In addition, as part of our preparations for DPCR5, we intend to review all aspects of the current price control, including the losses incentive, to ensure it is fit for purpose.

Related Issues

Impact of adjusting allowed revenue for transmission connected EHV units

6.26. Chapter 4 considers SP's request that the ALP for their SPD network area should be further increased to take account of distributed units that should have been excluded from the calculation of ALPs. In particular, SP consider that distributed units relating to EHV sites connected to the transmission system should not have been included in the calculation of SPD's ALP.

[22] Based on DEFRA's grid rolling average (0.537kgCO2/kWh) and annual distribution losses of 18,000 GWh.

6.27. We agree that these units should have been excluded from the calculation of SPD's ALP. However, given that SP could have made us aware of this issue when DPCR4 was set, we welcome views as to whether the impact of these units on losses since the beginning of DPCR4 should be incorporated fully retrospectively into any adjustment or whether the adjustment should only affect the calculation of prospective revenues/charges under the losses incentive.

Conclusion

6.28. The impacts of maintaining current ALPs or increasing them are considerable. On the one hand SP are already incurring large penalties based on the current configuration of the losses incentive and unless performance improves substantially, will continue to incur penalties. However, if their ALPs are increased then suppliers and ultimately consumers will pay the price through higher use of system charges. On the other hand, SP assert that an increase in their ALPs would only be restoring the position to what it should rightly have been from the outset.

6.29. The impacts of an increase in SP's ALPs may not be shared equally across consumers depending on the period of time over which the increased allowed revenue is recovered and the relative split of fixed and variable term consumers.

6.30. In order assist our decision making process, we are keen for market participants to explain to what extent they may be impacted by the options considered in this consultation and impact assessment document.

7. Next steps

Chapter Summary: This chapter sets out the next steps and timetable that we propose to follow.

Consultation on impact assessment (this document)

7.1. This document explains the background to this issue and the work undertaken to date in considering SP's request. This consultation and impact assessment will form a key part of our decision making process. **This consultation closes on Wednesday 15 April 2009**, and responses should be addressed to Paul Darby, preferably by email to paul.darby@ofgem.gov.uk, or by post to Ofgem, 9 Millbank, London, SW1P 3GE.

7.2. We will consider responses received by this date and propose then to take the matter to the Authority in May 2009 for a decision.

7.3. Following this we will publish our decision which is expected to be in May 2009. If the decision requires changes to the ALPs for SPD and SPM we would expect to make these either through directions made under the existing licence or modifying the relevant licence condition.

Appendices

Index

Appendix 1 - Consultation Responses and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from electricity suppliers and consumers. Please give reasons for your views with reference to this impact assessment document, or other material which you would like us to consider.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 15 April 2009 and should be sent to:

Paul Darby
Regulatory Finance Team
Ofgem, 9 Millbank, London, SW1P 3GE.

020 7901 7072

paul.darby@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Any questions on this document should, in the first instance, be directed to:

Paul Darby
Regulatory Finance Team
Ofgem, 9 Millbank, London, SW1P 3GE.

020 7901 7072

paul.darby@ofgem.gov.uk

Summary of Questions

CHAPTER: One

CHAPTER: Two

CHAPTER: Three

Question 1: Do you think that the ALPs agreed to by SPM and SPD in 2006 should be revisited in light of information now available from SP?

Question 2: What are your views on the recalculated ALPs proposed by SP?

Question 3: Do you think a change to SP's ALPs, if made, should be backdated?

Question 4: What are your views on the approach suggested by SP to mitigate the effects of changes on suppliers and consumers?

CHAPTER: Four

Question 1: Do you think an increase in the ALP for SPD in respect of transmission-connected EHV units should be backdated? And if so should this be partial or full backdating?

CHAPTER: Five

Question 1: What are your views on Ofgem's 'minded to' position in respect of the main ALP issue?

Question 2: What are your views on whether an adjustment to the ALP for SPD in respect of transmission-connected EHV units should be partially or fully backdated?

Question 3: Which option do you think Ofgem should pursue in responding to SP's representation for higher ALPs?

Question 4: Do you think there are any additional options/factors Ofgem should consider?

Question 5: Do you think Ofgem is right in drawing a distinction between this case and other cases where a DNO's ALPs have been changed by direction?

Question 6: Do you think there are any wider implications for the losses incentive scheme in the current or future price control periods?

CHAPTER: Six

Question 1: How would you be impacted by an incremental change in SP's allowed revenues if ALPs were increased?

Question 2: Would any particular customer groups be affected?

Question 3: If SP's ALPs were to be increased, do you think that a cap on loss incentive earnings should be imposed?

Question 4: If SP's ALPs were to be increased, how quickly do you think SP should be allowed to recoup incremental revenues?

CHAPTER: Seven

Appendix 2 – Illustrative Material

ESQCR re-opener changes to forecast RORE - background information

1.1. The following factors have been taken into account in the calculation of the forecast incremental change in RORE shown on page 27.

- SP recently submitted claims for ESQCR costs on behalf of SPD and SPM. These claims were reduced to take account of relevant allowances already provided for in DPCR4 price control allowed revenues.
- The reduced amounts were input to the ESQCR re-opener model developed with the assistance of DNOs participating in an earlier round of ESQCR re-openers.
- The resulting additional revenue, RAV, and quality of service incentive allowances were added to the original DPCR4 values and the resulting RORE for the combined project (DPCR4 + ESQCR) calculated. The re-opener model computes additional revenue allowances based on the DPCR4 cost of equity (7.5 per cent real post-tax). As SPD's RORE (as published in the DPCR5 policy paper) was close to the original 7.5% value the impact is small but, because SPM's RORE (as published in the DPCR5 policy paper) was significantly below the original 7.5% value the impact is greater.
- Prior to submission of their ESQCR claim SP had been unable to separate ESQCR costs out from their main cost totals. When they submitted their ESQCR costs claim we used this information to strip the ESQCR element out of their costs totals for the three elapsed years of DPCR4 and the forecast costs for the remaining two years for the purpose of calculating the incremental change to RORE figures given in this paper.
- Because ESQCR works are disruptive to network operation (i.e. they cause interruptions to customer supplies) they will have depressed DNOs' performance under the quality of service (QoS) incentive scheme. We have therefore given DNOs an appropriate level of relief in this regard but, owing to the way the scheme works, some of the associated income will not be received until 2010-11 and 2011-12. We have included this income in the calculation of RORE values for DPCR4 on a present value neutral basis.

Figure A2.1 DNO loss incentive earnings so far in DPCR4

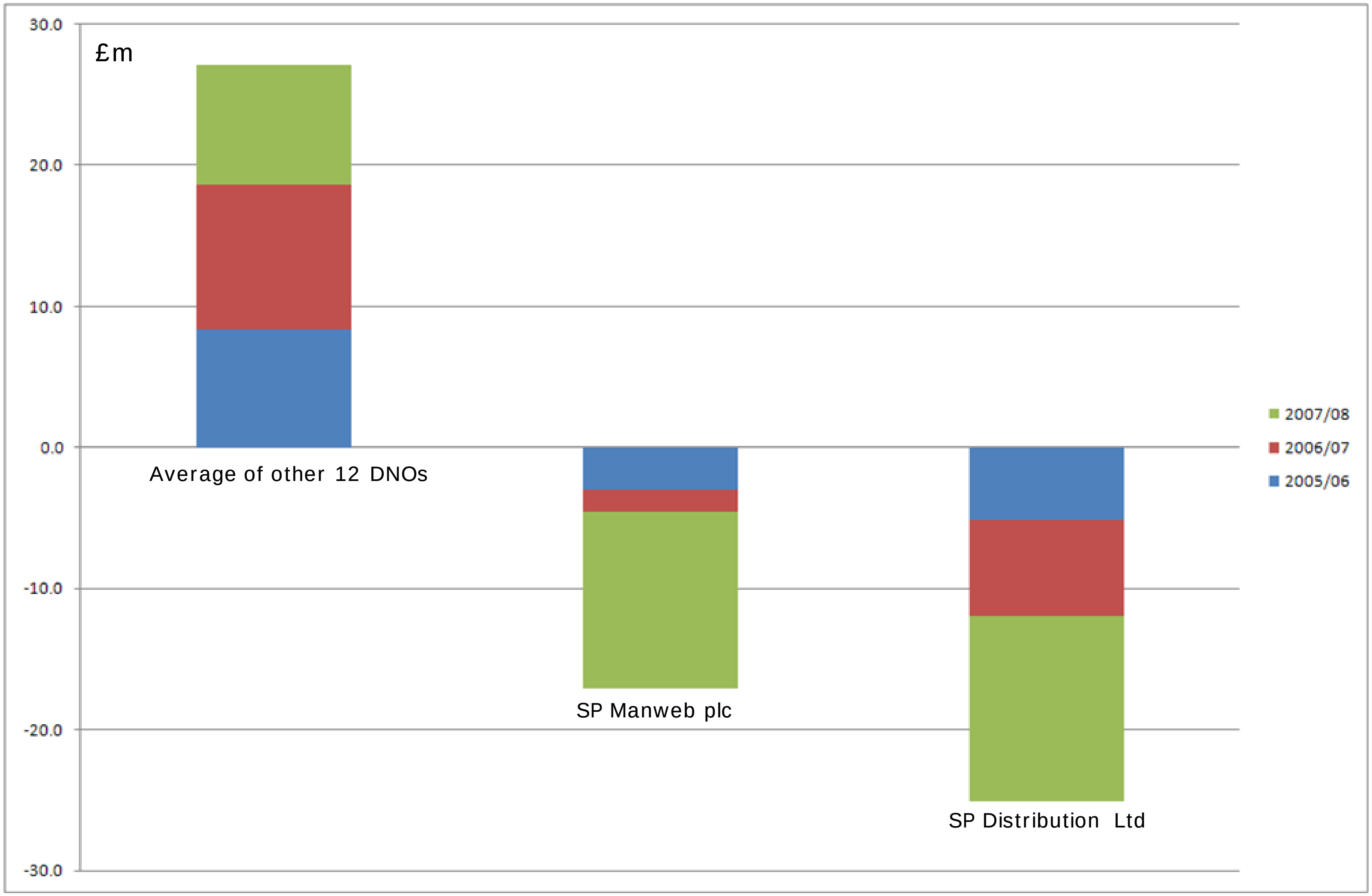


Figure A2.2 SP Loss percentages and loss incentive earnings

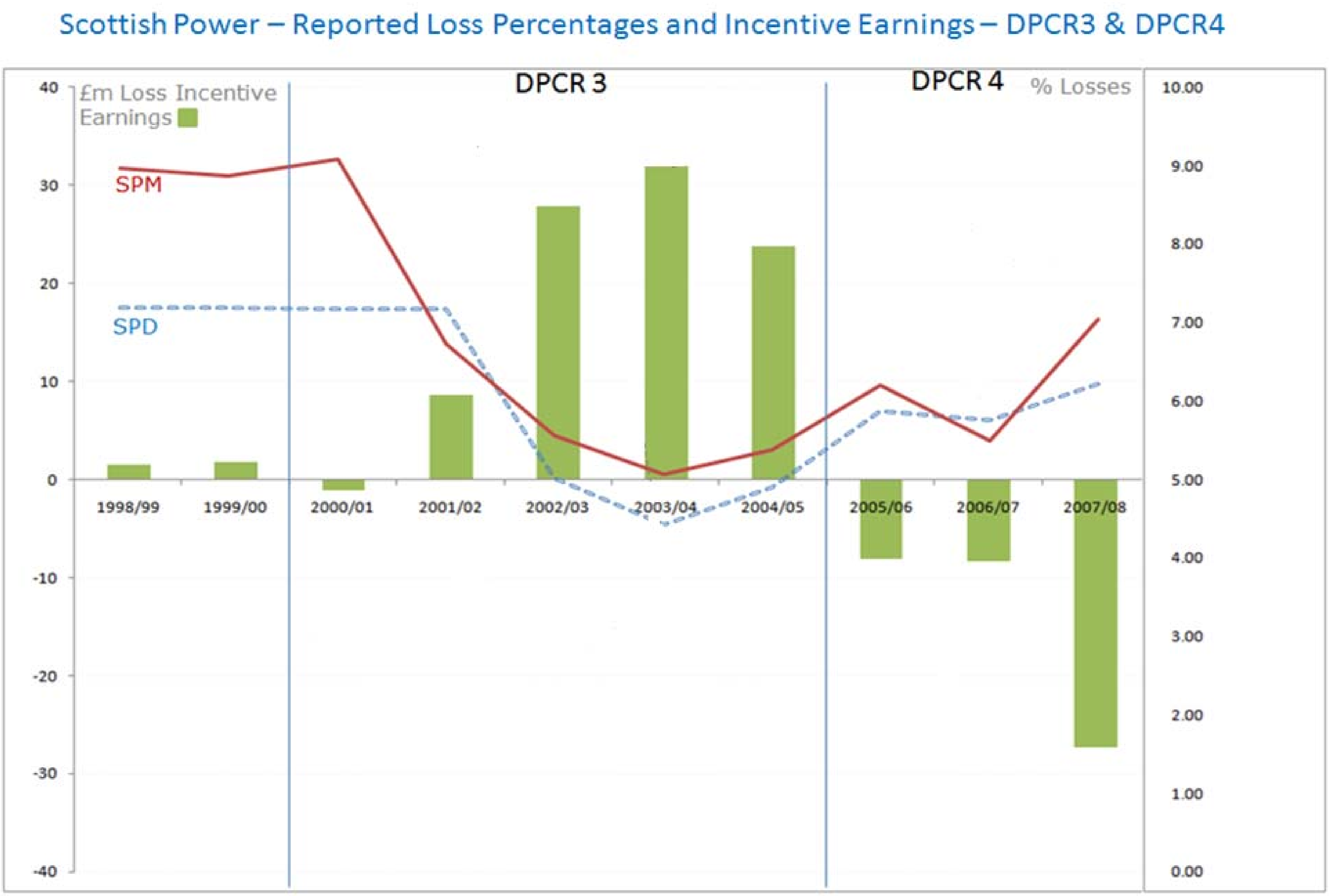


Figure A2.3 Other possible approaches to recalculation of ALP values for SPD and SPM

Basis of recalculation	SPD ALP	SPM ALP
1. Average loss percentage for the ten years to 2003/04 (using fully restated values)	6.32	7.00
2. Average loss percentage for the ten years to 2005/06	6.03	6.39
3. Average loss percentage for the ten years to 2006/07	5.97	6.30
4. Average loss percentage for the ten years to 2006/07	5.88	6.22
5. Ten year rolling average	variable	variable
6. Average loss percentage for the three years to 2007/08	6.00	6.00
7. Allowed losses = actual losses	variable	variable
8. Average loss percentage for the ten years from 1994/95 to 2006/07 (excluding the years 2001/02 to 2003/04)[23]	6.42	7.15

[23] The approaches were calculated by SP/Ofgem but approach 8 was mooted by Ofgem

Appendix 3 – Information on Electricity Distribution in Great Britain

Background

1.1. At privatisation, the Public Electricity Suppliers (PES) were responsible for both the distribution and supply of electricity, taking the place of the former regional electricity boards. With the introduction of competition in supply, it was important to ensure that all supply businesses, both new and old, had fair access to the distribution networks.

1.2. The Utilities Act 2000 introduced separate licences for distribution and supply, and required that these be held by separate legal entities.

Distribution

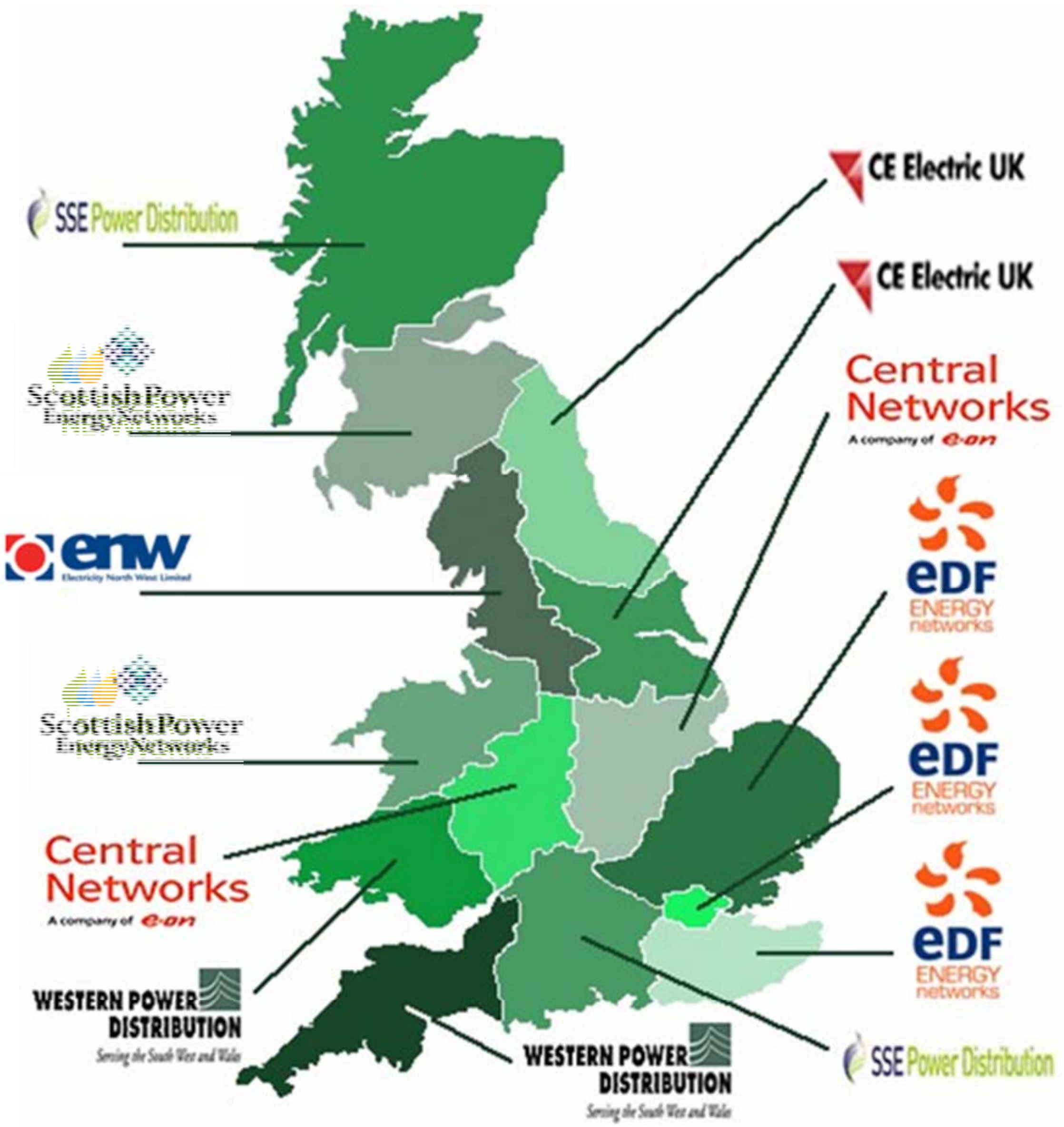
1.3. DNOs are responsible for local distribution of electricity along overhead wires and through underground cables in their respective distribution services areas. This includes responsibility for ensuring that customers have a reliable electricity supply. Following a number of corporate acquisitions, the 14 distribution licensees are now owned by seven groups (see Map below).

How much does distribution cost the customer?

1.4. Electricity distribution charges account for around £3.7 billion annually and make up around 14 per cent of customers' electricity bills.

1.5. For a typical domestic electricity customer, based on consumption of 3300 kWh of electricity a year, the distribution element of their bill is approximately £65 per year.

Map Showing DNO Distribution Services Areas



Appendix 4 – The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.[24]

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly[25].

1.4. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them[26]
- the need to contribute to the achievement of sustainable development; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas[27].

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[24] entitled "Gas Supply" and "Electricity Supply" respectively.

[25] However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

[26] under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- promote efficiency and economy on the part of those licensed[28] under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
- secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- the effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation[29] and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

[27] The Authority may have regard to other descriptions of consumers.

[28] or persons authorised by exemptions to carry on any activity.

[29] Council Regulation (EC) 1/2003

Appendix 5 - Glossary

A

ALP

Allowed Loss Percentage - the value set down in special condition C1 of the special conditions of each DNO's distribution licence. The ALP is multiplied by the number of units distributed by that DNO in a given regulatory year to produce the allowed/benchmark level of losses for that year.

D

DNO

Distribution Network Operator - one of the 14 ex-public electricity suppliers which holds an electricity distribution licence and which has a geographically defined distribution services area.

DPCR

Distribution Price Control Review - the regulatory price control that applies to DNOs. The current price control (DPCR4) runs from 1 April 2005 to 31 March 2010.

E

EHV

Extra High Voltage – Customers supplied at this voltage are usually large industrial sites.

Elexon

Elexon is the Balancing and Settlement Code Company for electricity distribution in Great Britain.

F

Fuel Poverty

A household is said to be in fuel poverty if it needs to spend more than 10% of its income on fuel to maintain a satisfactory heating regime (usually 21 degrees for the main living area, and 18 degrees for other occupied rooms).

M

MWh

Megawatt hour – one megawatt of electrical energy flowing for one hour. The unit of electricity used in loss incentive calculations.

R

RAV

A measure of the value of the capital employed in the regulated business, based on historical investment costs, on which licensees earn a return and receive regulatory depreciation.

Regulatory year

The period from 1 April to 31 March.

S

SPD

SP Distribution Ltd – the company within the ScottishPower group which holds the electricity distribution licence for the south of Scotland (see map at Appendix 4).

SPM

SP Manweb plc – the company within the ScottishPower group which holds the electricity distribution licence for the Merseyside and North Wales area (see map at Appendix 4).

Supplier (Electricity)

A company holding an electricity supply licence which buys electricity from the wholesale market for resale to commercial and domestic customers. There is a competitive market for electricity supply.

Appendix 6 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

7.4. Please send your comments to:

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Ofgem
9 Millbank
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SW1P 3GE
andrew.macfaul@ofgem.gov.uk