



Network companies
Electricity suppliers
Consumer representatives and
other interested Parties

*Promoting choice and
value for all customers*

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31 July 2009

Dear Colleague,

Decision of the Gas and Electricity Markets Authority on the representation made by ScottishPower EnergyNetworks for higher allowed loss percentages

1. At its meeting on 16 July 2009 the Gas and Electricity Markets Authority ('the Authority') considered a representation from ScottishPower EnergyNetworks ('SP') for a re-opening of the allowed loss percentages levels ('ALP') for its two licenced electricity distribution network operators ('DNO'), SP Distribution Ltd ('SPD') and SP Manweb plc ('SPM').
2. The Authority also considered a separate representation for an increase in SPD's ALP in relation to an issue affecting the treatment of units distributed to transmission-connected EHV sites.
3. On 3 March 2009 Ofgem¹ published an impact assessment and consultation document (Ref 26/09)² which addressed the arguments and circumstances relevant to SP's representations. This letter sets out the Authority's decision and the reasons for the Authority's decision. In reaching its decision the Authority carefully considered the information before it, including the representations made by SP together with the points made in the responses which we received. Having done so the Authority made the following decisions in respect of SP's representations:
 - (i). that the ALPs for SPD and SPM should not be changed on the basis of SP's representation in respect of the main ALP issue³;
 - (ii). that the effective ALP for SPD in respect of the EHV units issue⁴ should be changed such that its overall performance under the losses incentive scheme will be as if its ALP had been set at a value of 5.64 for regulatory year 2005-06 and 5.34 for regulatory years 2006-07 to 2009-10 inclusive⁵;
 - (iii). the losses roller mechanism⁶ is to remain in effect for SPD and SPM except to the extent necessary to achieve the financial adjustment intended under (ii) above.

Background summary

4. The current electricity distribution price control ('DPCR4') includes a scheme designed to incentivise DNOs to reduce electrical losses from their networks. Lower electrical losses help to reduce the carbon footprint of electricity distribution activity and should bring

¹ Ofgem is the office of the Authority which assists it in discharging its functions

² <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=345&refer=Networks/ElecDist/PriceCtrls/DPCR4>

³ The main ALP issue is explained at paragraph 7 below

⁴ The EHV units issue is explained at paragraph 8 below

⁵ This amounts to revenues of about £12m over DPCR4 for SP in nominal prices

⁶ See paragraph 1.10 of Ofgem's impact assessment dated 3 March 2009, and paragraphs 20 & 25 below

financial savings for consumers in the medium to long term. Under the scheme the total amount DNOs can charge for use of their distribution systems is increased or decreased depending on their performance against their allowed loss percentages and suppliers pass on those adjustments to consumers through their bills.

5. In 2005 Ofgem conducted an investigation into SPM's regulatory submissions under the losses incentive scheme relating to the period from 2001-02 to 2003-04 which fell within the previous price control period ('DPCR3'⁷). The investigation was closed in January 2006, without any finding of a licence breach, on the basis of a compromise agreement⁸ under which:
 - SP formally restated their losses for regulatory years 2001/02 – 2004/05;
 - SP retained their loss incentive earnings under DPCR3⁹ for both SPD and SPM relating to the low loss levels reported for 2001/02 – 2003/04;
 - and the ALPs for SPD and SPM were reduced by a number of percentage points for DPCR4.
6. The ALPs in SP's licence were amended using the powers available to the Authority under section 11 of the Electricity Act 1989 which deal with the 'modification of licences'. By letters of 6 February 2006, SP consented to the proposed modification of its ALPs under Special Condition C1 for both SPD and SPM¹⁰.
7. In late 2007 SP wrote to Ofgem asking for the ALPs for SPD and SPM to be increased using the mechanism available to the Authority under paragraph 7 of Special Condition C1¹¹ (or the powers contained in section 11 of the Electricity Act 1989) because they have been subject to significant penalty adjustments at the present levels whereas some other DNOs are benefitting from reward adjustments. They considered that their ALPs had been re-set at too low a level following the investigation because of the way data from the three years from 2001-02 to 2003-04 had been used in the calculations. This part of their representation is referred to below as 'the main ALP issue'.
8. In December 2007 we replied to SP saying that we were minded not to recommend increases to the Authority in respect of the main ALP issue. We did, however, agree in principle that an increase in the ALP for SPD appeared appropriate with respect to the treatment of units distributed to transmission-connected EHV sites in the original ALP calculations. This part of their representation is referred to below as 'the EHV units issue'.
9. At the start of 2008 we agreed to have a fresh look at SP's representation, and as part of this we carried out a review of settlements data with SP and Elexon¹². However, at the conclusion of this process, we considered that the work carried out to reconcile SP's loss reporting to settlement data supported the 'minded to' position and was consistent with the data available to the Authority at the time SP's ALP was adjusted at the conclusion of the 2005 investigation. As set out in Ofgem's consultation document (see further below), we remained of the opinion that SP's ALPs should not be increased in respect of the main ALP issue.
10. In July 2008 SP formally responded to our 'minded to' position setting out arguments in support of their position. They subsequently made specific proposals for increased ALPs including measures to mitigate the impact of increased revenue allowances on electricity suppliers and consumers. We considered the issues raised by SP's representation to be sufficiently important to carry out the impact assessment¹³ referred to in paragraph 3

⁷ The DPCR3 price control ran from 1 April 2000 – 31 March 2005

⁸ 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

⁹ SP earned rewards under the losses incentive totalling £91m over DPCR3

¹⁰ Copies of the statutory consultation of 10 January 2006 and SP's response of 6 February 2006 can be viewed at the following link:

<http://www.ofgem.gov.uk/Licensing/Archive/0806%20-%20Notice%20under%20section%2011%20of%20the%20Electricity%20Act%201989p.pdf>

¹¹ Special Condition C1 can be viewed at the following link: http://epr.ofgem.gov.uk/document_fetch.php?documentid=14040

¹² The settlement system is administered by Elexon (www.elexon.co.uk), who are the Balancing and Settlement Code Company for Great Britain

¹³ The Authority has a statutory duty, subject to certain exceptions, to carry out an impact assessment under section 5A of the Utilities Act 2000 where it believes that a proposal is important. We considered SP's representation met the criteria under section 5A given the financial materiality of making a decision and the potential impact on SP, suppliers, and consumers. We also considered

above and readers of this decision letter are referred to that document for more comprehensive information. We received several responses to the impact assessment¹⁴ including one from SP which reiterated their arguments for higher ALPs, which in summary were:

- that they had disagreed with the approach used by Ofgem to re-set their ALPs but accepted the compromise agreement having regard to the time/resource implications of the matter continuing¹⁵ and the possibility that their ALPs could be re-adjusted at a later time;
- that there has been material improvement in the quality of relevant data indicating that their ALPs were re-set at too low a level;
- that the loss incentive rewards they received in DPCR3 (see paragraph 5 and footnote 7 above) should be disregarded for the purposes of their representation;
- that they have been treated unfairly in comparison to other DNOs which is contrary to the non-discrimination requirements of the IMED¹⁶;
- that the financeability of their network operations has been compromised;
- that the losses incentive scheme as it applies to SPD and SPM has been undermined.

Reasons for the Authority's decision – Main ALP issue

No material change

11. On the basis of SP's representation in respect of the main ALP issue, the Authority does not believe it has been presented with information which it considers amounts to a material change in the quality of the relevant information for the purposes of exercising its discretion to direct a change to SP's ALP under paragraph 7 of Special Condition C1¹⁷ or under section 11 of the Electricity Act 1989. The Authority has taken the view that similar considerations apply to an exercise by the Authority of its discretionary powers under section 11 of the Electricity Act 1989 as they do the exercise of the power under paragraph 7 of Special Condition C1.
12. In reaching its decision the Authority has carefully considered the representations made by SP. However, in light of the submissions made and taking account of the matters set out in Ofgem's consultation, the responses received and all the information before it, the Authority did not in the circumstances consider it appropriate to direct a change to SP's ALP on the main ALP issue.
13. In reaching this view, the Authority noted that the work Ofgem carried out with SP and Elexon supported the view that the data used to re-set SP's ALPs in 2006 was the best available and did not consider that there had been a material change in the quality of information used to derive adjusted system entry volumes or adjusted units distributed. The Authority also had regard to the other factors which it considered went to the issue of whether there had been a material change – the Authority did not consider that either SP's poor out-turn performance, volatility factors in settlement data or the change in Elexon's audit status amounted to evidence of such a change.

The 2005 Investigation & the IMED

14. The Authority also considered that a reduction of the ALPs for SPD and SPM was at the heart of the agreement under which the investigation into SP's losses reporting was

that conducting an impact assessment was consistent with best regulatory practice. A copy of the Impact Assessment 'Electricity Distribution Allowed Loss Percentages – Representation by ScottishPower Energy Networks' can be viewed at the following link: <http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR4/Documents1/IA%20-%20SP%20ALP%20Representation.pdf>

¹⁴ The responses can be viewed at the link at footnote 2 above

¹⁵ This point was raised in SP's response to the 'minded to' of 28 July 2008, and referred to in the Ofgem consultation document at paragraph 2.5

¹⁶ Directive 2003/54 concerning common rules for the internal market in electricity

¹⁷ One of the responses to the impact assessment suggested that a change to SP's ALP by way of Special Condition C1 was not now legally possible because under paragraph 8 of Special Condition 7 a change to the value of ALP in accordance with paragraph 7 may be directed by the Authority at any time during the year but shall not take effect before the beginning of the next relevant year commencing immediately after the date of direction and by that time a new price control period with new ALPs would have commenced. However, in any event the power to change ALPs under section 11 of the Electricity Act 1989 remains available.

closed in early 2006. Although there was no finding of a licence breach when the investigation into SPM was concluded under the compromise SP agreed to, the Authority considered it appropriate to take account of the circumstances of that compromise in considering SP's present representation.

15. The Authority noted the representations made by SP in relation to the non-discrimination provisions in the IMED. The Authority acknowledged that SP was treated differently to other DNOs in that the methodology that was used to set the new ALPs for SP in the wake of the 2005 investigation differed from that used to set the original ALPs for the current price control which is currently being applied to other DNOs. The Authority believes that the approach taken to reset SP's ALPs at the time was a valid approach that was justified in the circumstances – in the context of a compromise outcome to the investigation into SPM which was applied to SPM and SPD, and agreed to by SP on 6 February 2006 (see paragraph 5 above). The Authority considered that the basis on which SP's ALPs were re-set under the investigation closure agreement (i.e. making use of the three years data) was and remains objectively justified following consideration of SP's representations. The Authority has considered and does not accept SP's representation that there has been a material improvement in the quality of relevant data which would warrant a change to SP's ALPs.
16. Although some other DNOs have earned reward adjustments under the losses incentive so far during DPCR4, SP's application has been reviewed in the context of the GB wide scheme and the Authority does not consider that they have been treated unfairly in all the circumstances.

Regulatory certainty / certitude re enforcement decisions

17. More broadly, the Authority also considered it important for regulatory certainty that price control schemes are not re-opened except where there are clear evidence based reasons for doing so. The Authority also considered it important for certitude concerning the Authority's enforcement decisions that such decisions (or aspects thereof) are not re-opened save where there are clear evidence based reasons for doing so.

Wider impacts

18. The Authority also considered the wider impacts of directing a change on the main ALP issue, namely a significant adverse impact on suppliers and consumers in the SPD and SPM areas, notwithstanding any mechanism as suggested by SP to spread the effect over time. The Authority considered Centrica's response and noted that the potential effect on fuel poor customers and smaller suppliers might be particularly acute if SP's ALPs were amended. This was so even taking into account SP's proposed measures to mitigate the impact of increased revenue allowances on electricity suppliers and consumers. The Authority also considered that increasing SP's ALPs could weaken the effect of the losses incentive for SPD and SPM with associated harm to consumers and potential implications for carbon emission reductions. It could also, to some extent, undermine the scheme generally.

Other matters

19. The Authority acknowledged that SP have been subject to significant penalty adjustments under the losses incentive scheme in DPCR4, and noted SP's representation with regard to the financing of its distribution activities. The Authority, whilst mindful of its duty to have regard to the ability of licensees to finance their activities, did not consider it would be appropriate to increase SP's ALPs merely to allow particular credit rating criteria to be met¹⁸.

¹⁸ In the event that SPM or SPD considered that there were factors impacting on their ability to finance their businesses, they could approach the Authority with a price control disapplication request under Special Condition A4 of their distribution licence. The Authority recently published and consulted on draft guidance on arrangements for responding in the event that an energy network company experiences deteriorating financial health. Chapter 4 of that document sets out the indicative criteria the Authority would consider in deciding whether to re-open a price control settlement. The final draft of the guidance will shortly be published by Ofgem, but the draft document can be viewed at the following link:
<http://www.ofgem.gov.uk/Networks/Policy/Documents1/Arrangements%20for%20responding%20to%20financial%20distress%20-%20Guidance%20Doc%20FINAL.pdf>

The losses roller

20. In light of its decision not to direct a change to SP's ALP on the main issue, the Authority considered it appropriate for the losses roller to remain in place for its original purposes within the losses incentive scheme (but see comments below in respect of the EHV units issue).

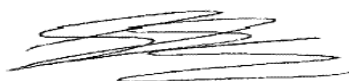
Reasons for the Authority's decision – EHV units issue

21. In reaching its decision on the EHV units issue, the Authority has carefully considered the representations made by SP. In light of the submissions made and taking account of the matters set out in Ofgem's consultation, the responses received and all the information before it, the Authority agreed that there has been a material change in the quality of relevant information in relation to SPD's ALP. In this case a material improvement in the quality of relevant information has demonstrated that SPD's ALP should have been higher so that target setting and performance measurement would be on a like with like basis.
22. The Authority carefully considered the extent to which it should backdate the adjustment to SPD's ALP. On the one hand, the Authority considered that SP may be partly responsible for the present position in that they should have provided the relevant information to Ofgem when their ALPs were first set at the beginning of DPCR4. The Authority also noted the view of Centrica, who opposed full backdating to the beginning of DPCR4.
23. The Authority considered that although SP bore some responsibility for not highlighting the issue when their ALPs were originally set, this did not outweigh the rationale for full backdating on the EHV units issue. The Authority also considered that backdating of the increased ALP was consistent with the approach taken by the Authority in previous, similar cases. In reaching its decision to grant full backdating to SPD, the Authority considered that the impact on suppliers and consumers (including fuel poor customers) of increasing SPD's ALP would be limited.
24. The Authority decided that the effective ALP for SPD should be changed such that its overall performance under the losses incentive scheme will be as if its ALP had been set at a value of 5.64 for regulatory year 2005-06 and 5.34 for regulatory years 2006-07 to 2009-10 inclusive. This treatment is consistent with the approach taken in previous cases where particular factors affecting the quality of relevant data have been identified. We will liaise with SP regarding the implementation of the decision. It is likely that the financial adjustment will be made as part of the financial settlement for SPD in the next price control period (DPCR5) which will run from 1 April 2010 to 31 March 2015.

The losses roller

25. In light of its decision to direct a change to SPD's ALP on the EHV units issue, the Authority has recommended that an appropriate adjustment be made to the effect of the roller for SPD only so that the effect of backdating the increase in ALP relating to the EHV units issue is not defeated.
26. Queries relating to the content of this letter should be sent to the above address for the attention of Paul Darby, Senior Financial Manager, Regulatory Finance or emailed to paul.darby@ofgem.gov.uk.

Yours faithfully,



Steve Smith
Managing Director, Networks