Electricity Distributors, Electricity
Suppliers and other interested parties

Promoting choice and value for all customers

Our Ref: 87/10
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20 July 2010

Dear Colleagues,

Requests for relief from the consequences of over-recovery on the basis that accelerated gross volume corrections may have distorted losses reporting

1. Two electricity distribution network operator groups ("the Requesting DNOs") have made representations to Ofgem in relation to atypically high levels of reportable electricity losses for the regulatory year 2009-10. The Requesting DNOs maintain that the higher reportable loss levels and the consequent over-recovery[1] may result from atypically high levels of gross volume corrections ("GVC") being made by suppliers.

2. The Requesting DNOs have asked Ofgem to consult on taking steps to provide exceptional relief from the consequences of over-recovery under the lossess incentive scheme[2]. The DNOs ask, in particular, that Ofgem address whether there should be, in the circumstances described, relief from:

   (i) the application of the penalty rate of interest where actual revenue in a regulatory year is over 103 per cent of allowed revenue for that year (in accordance with Special (Charge Restriction) Condition[3] 3.8-3.9 and 14.2)[4]; and

   (ii) the effect of over-recovery on future tariffs (in accordance with CRC 3).

3. We set out below our current minded-to position in relation to the above. This is limited to the particular facts put forward by the DNOs, and is without prejudice to any future consideration of (i) the substantive question of revenue adjustments under the losses incentive scheme and (ii) losses target setting in relation to GVC.

[1] An over-recover occurs where a DNO's actual revenue from use of system charges exceeds its price controlled allowed revenue for the year concerned.
[2] The losses mechanism for DPCR5 is at Special (Charge Restriction) Condition C7.
[3] Abbreviated to CRC for the purposes of this letter.
[4] The Special (Charge Restriction) Conditions can be viewed at the following link: http://epr.ofgem.gov.uk/index.php?pk=folder100985

Background

4. Information on the number of units of electricity entering distribution networks and being distributed has been used for two main purposes in relation to the price control for DNOs running from 1 April 2005 to 31 March 2010 ("DPCR4"):

   (i) The calculation of an allowed revenue adjustment under the losses incentive scheme.

   (ii) The calculation of a growth driver adjustment to allowed revenue (together with changes in the number of the DNO's customers).

5. The growth driver ceased to apply from 1 April 2010. The last regulatory reporting year in which it will have effect is 2009-10.

6. The losses incentive scheme is designed to incentivise DNOs to manage their networks in a way that reduces electrical losses. Its purpose is to benefit consumers and the environment. It works as follows:

   (i) Each DNO network is given a target level for distribution losses in each regulatory year, which is calculated by reference to the DNO's historical losses performance.

   (ii) Distribution losses in each regulatory year are calculated by deducting the number of units distributed from the number of units entering the network. The second of these two figures can be accurately determined; the first is ascertained from settlement data and is accepted to be less accurate.[5]

   (iii) Where a DNO exceeds its target level for losses, it is penalised; where its level of losses is below that target, it is rewarded.

7. Further detail of the losses incentive scheme can be found in CRC 7 of DNO licences. For the DPCR5 price control period commencing on 1 April 2010, additional information can be found in the Final Proposals, Financial Methodologies publication[6].

Gross volume correction

8. The Requesting DNOs argue that the reportable numbers of units distributed by the DNO networks concerned for 2009-10 (and, prospectively, for 2010-11) might have been depressed because suppliers with large market shares in those distribution areas appear to have fed large GVC adjustments into the settlement process. A supplier may make a GVC adjustment in order to correct electricity data errors: for example, a supplier may deduct aggregate *historic* meter over-readings from the *current* settlement figures.

9. Until March 2010, it was possible for suppliers to use GVC adjustments to undo electricity data errors dating back over many years. We understand that the majority of such adjustments lead to reductions in the reportable number of units distributed.

10. We consider it unlikely that GVC adjustments have, in general, caused material levels of volatility in the settlement data used by DNOs, especially when considered over the medium or long term.

[5] The primary use for settlement data is in the trading of electricity by generators and suppliers and the system balancing function carried out by National Grid. See the website of Elexon (the Balancing and Settlement Code Company) for further detail.
[6] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=372&refer=Networks/ElecDist/PriceCntrls/DPCR5

11. However, it seems likely that reportable losses for 2009-10 and 2010-11 may have been affected by an atypically high value of GVC adjustments. It appears that the following two factors may have contributed to this:

(i) Suppliers may have made increased use of proprietary computer software to identify suspect meter points.

(ii) Changes to the Balancing and Settlement Code, effective from March 2010, may have prompted suppliers to accelerate historic data adjustments, as they restrict suppliers' ability to make retrospective GVC adjustments.

12. At this stage, Ofgem has only carried out preliminary research into the possible effects of GVC on losses reporting for 2009-10 and 2010-11. However, review work carried out by Elexon supports the view that there may have been a material effect on the level of losses reportable by some DNOs for 2009-10 and 2010-11. Any such effect is likely to vary between different DNOs because some suppliers have very large market shares in particular DNO areas. In addition, the impact of a GVC adjustment might be affected by the losses reporting methodologies used by different DNOs in DPCR4[7].

<u>Interest rate adjustments to over recoveries</u>

13. Where the actual amount of revenue a DNO collects through use of system charges in any regulatory year is higher or lower than its price control allowed revenue for that year, the difference is carried forward as an adjustment to its allowed revenue for the following regulatory year.

14. Under CRC 3.2 of the Electricity Distribution Licence, DNOs are required to take all appropriate steps to ensure that actual revenue does not exceed allowed revenue. If, notwithstanding this condition, a DNO's actual revenue exceeds 103 per cent of allowed revenue, the over-recovery is subject to a penalty interest rate (see CRC 14.2)[8]. This increase in the amount which is to be deducted from the following year's allowed revenue is intended to penalise DNOs for failing to set appropriate tariff levels.

15. The Requesting DNOs have proposed that DNOs who have been affected by GVC adjustments should be given relief from the penalty interest rate adjustment. The rationale for this position is that the effect of GVC on reportable levels of losses may have lowered significantly their revenue allowances for 2009-10, and that they could not have known about such an effect when setting tariff levels for the year.

16. The effect of the penalty interest rate would not crystallise as a factor in a DNO's allowed revenue for 2010-11 until 31 March 2011. However, Ofgem understands that DNOs wish to know as soon as possible whether they will be subject to the penalty interest rate in respect of any over-recovery.

Minded-to position

17. For the reasons given below, we are minded to provide the relief from the penalty interest rate where a DNO can show to our satisfaction that:

(i) its reportable losses for 2009-10 are abnormally high as a result of settlement data adjustments;

(ii) those adjustments are unrelated to actual network performance and are outside its control; and

(iii) if those adjustments had not arisen, the DNO's recovery would have been less than 103 per cent of allowed revenue.

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[7] In DPCR5, DNOs are obliged to use a common reporting methodology.
[8] The penalty rate is the Bank of England base rate plus 3 percentage points.

If appropriate, we would expect to apply the same rationale for the penalty interest rate adjustment for the following regulatory year (2011-12).

18. We would give effect to this relief through a modification of CRC 14.2 of each affected DNO's distribution licence to specify that the value of PRt for relevant regulatory years be "1.5"[9] instead of "3".

19. We stress that any changes to the value of PRt made on this basis would be without prejudice to the outcome of any review of the actual level of losses from the DNO's network and/or substantive revenue adjustments under the losses incentive mechanism.

Adjustments to tariffs during 2010-11

20. Special Condition CRC 3.2 of each DNO's electricity distribution licence requires that the DNO, in setting its use of system charges, take all appropriate steps within its power to ensure that its actual revenue does not exceed its allowed revenue.

21. DNOs affected by the settlement data issue described are likely to have continued over-recovering revenue (against the allowed level suggested by their apparent losses performance) into regulatory year 2010-11; any brought forward over-recovery from 2009-2010 will also impact upon future charges. The affected DNOs concerned would normally be obliged to lower their charges in October 2010 to comply with the requirements of CRC 3.2 (i.e. to seek to prevent an over-recovery by the end of 2010-11).

22. Ofgem considers that such a reduction would not be in the interests of consumers because:

    (i) An imposed reduction in charges in October 2010 would be significant but short-lived, because the DNO would be able to raise its charges again once the over-recovery had been eliminated.

    (ii) Suppliers would be unlikely to pass on a temporary reduction in use of system charges (effected in October 2010) to consumers because of supply contract cycles; they would be more likely to pass on a subsequent increase.

Minded-to position

23. Therefore, we are minded to allow DNOs who have satisfied us of the matters set out in paragraph 17 to not reduce their use of system tariffs in October 2010, unless there is another regulatory reason for doing so. This would require a modification to CRC 3.2.

24. This would provide, however, only a limited exception, and DNOs would be required to take account of the allowed revenue position as of April 2011 in setting their charges at that time.

Possible implications for losses incentive adjustments/ DPCR4 revenue driver

25. This letter does not address the substantive question of how, if at all, to take into account the concerns raised when re-assessing the losses incentive scheme more generally. Ofgem should not be taken to be expressing here any view on that issue, and the minded-to positions set out herein are without prejudice to any such future assessment.

[9] This figure applies normally in respect of actual recovery between 100 and 103 per cent of allowed revenue.

26. As mentioned in paragraphs 4 and 5 above, the number of units distributed in 2009-10 is also used in the calculation of the growth driver adjustment to allowed revenues for that year. If it proved appropriate for a DNO to re-state information on units distributed in 2009-10, the growth driver adjustment would be updated at that time and would flow through to extant revenue allowances.

Responses and further information

27. We would welcome responses to the minded-to positions outlined in this letter. We would also welcome submissions and information on the settlement information issues discussed.

28. Responses should be sent to the above address for the attention of Paul Darby, Senior Manager, Regulatory Finance or emailed to regulatoryfinance@ofgem.gov.uk **by 31 August 2010**.

Yours sincerely,

Rachel Fletcher
Partner, Distribution