British Gas

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Dear Paul

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

1. Thank you for giving us the opportunity to comment on Ofgem's minded-to position on the two issues raised in your letter of the 20th July. This is the British Gas response, and is not confidential.

2. Overall, while we are happy to accept Ofgem's minded-to positions on the two issues raised in the letter, we would strongly disagree with any substantive revenue adjustments under the losses incentive mechanism. We would be happy to meet with you to share our concerns over this more critical issue if that would be helpful.

3. In summary:

   - DNOs accepted the losses incentive when accepting the DPCR4 settlement in the round, recognising at the time inadequacies and volatility in the underlying measure;
   - taking the DPCR4 price control as a whole, the losses incentive has delivered poor value for money for consumers. Any additional adjustments to the benefit of networks would only serve to increase consumer detriment;
   - we would therefore have significant concerns if Ofgem was considering making an adjustment to incentive payments for unforeseen changes to measured losses, given clear asymmetries in the operation of incentives (i.e. had movements in measured losses resulted in a net benefit to the DNOs, the issue of reopening the incentive scheme would never have been raised);
   - DNOs have also been active in tabling adjustments to settlement data that have had a tangible impact on measured losses. Adjustments to allowed revenues for gross volume corrections would therefore amount to "cherry picking" of reasons for changes in measured losses, to the further detriment of consumers; however
   - so long as it can be shown that the networks could not reasonably have been expected to foresee the changes in losses in 2004/05, we accept Ofgem's minded-to positions to provide relief from the penal interest rate on over-recovery, and for the allowed revenue position to be reflected in charges by April 2011 (rather than October 2010).

Specification of the losses incentive

4. The electricity losses incentive was introduced as part of the DPCR4 settlement. At the time the losses incentive was set, Ofgem consulted numerous times on the way that

losses should be measured. Ultimately, Ofgem proposed using aggregate volume of units lost as a proportion of aggregate volume of units distributed as the way of measuring losses.

5. Although networks expressed concerns at the time that this would be a volatile way of measuring losses, the networks ultimately accepted the losses incentive (and the associated volatility in the underlying measure) as part of their overall price control package.

6. Part of the reason why networks accepted the incentive as part of the DPCR4 settlement was because their losses targets were set at the average level of losses on each network for the 10 year period from 1993/94 to 2002/03. This approach gave the networks more stable underlying targets (filtering out much of the volatility over the ten year period). However, as the trend in losses was falling ahead of the start of DPCR4, this approach also meant that the incentive targets calculated for the networks were very generous.

7. In our submissions to DPCR5, we pointed out that losses targets were so generous for some networks that they were able to earn positive incentive payments from the scheme when losses were actually increasing year-on-year. We do not believe that this represented good value for money to consumers.

8. This view was also supported by Ofgem's data on Return on Regulatory Equity (RORE) published as part of DPCR5. This showed that over-performance on incentives (and the losses incentive in particular) was largely responsible for networks receiving returns on equity significantly above that allowed at DPCR4.

9. Although the 20th July letter does not consult specifically on the issue of adjustments in allowances for losses measurement issues, we would be extremely concerned if this was being considered. Had changes in measured losses moved in a way that benefited networks, we think it highly unlikely that the networks would consider an adjustment to their revenues to compensate customers. Because of this fundamental asymmetry, and to preserve the integrity of the concept of the losses incentive, Ofgem should not consider any changes to allowed revenues in this instance.

Corrections to the reported losses

10. Ofgem has highlighted the issue of gross volume corrections as having a material impact on levels of measured losses in regulatory 2009-10. We are aware of this issue, and recognise that changes to industry data can indeed have an impact on losses (given the choice of measure selected in DPCR4).

11. However, while this is the case, we believe it would be grossly unfair on consumers were Ofgem considering making any adjustment to DNO allowed revenues to compensate for this. As noted above, DNOs were fully aware of the volatile nature of measured losses when deciding whether or not to accept the DPCR4 package. In addition, the generous targets set in the losses incentive mean that the DNOs have been more than compensated for such volatility.

12. Finally, we note that DNOs have also been active in proposing adjustments to industry data which would result in changes to measured losses advantageous to them. For example the "Energisation Status" project had an objective of including a significant volume of energy in settlements data from sites erroneously viewed as being de-energised (so reducing measured losses)[1]. Adjustments to allowed revenues for gross

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[1] The Energisation Status Project was initiated in September 2002 when two DNOs raised concerns with Elexon, that incorrect energisation status were causing them loss of income on Use of System billing (see Elexon's Energisation Status Project, Supplier Guidance, September 2004)

volume corrections would therefore amount to a DNO-driven "cherry picking" exercise, which would be grossly unfair on consumers.

Ofgem's minded-to positions

13. We recognise that measured losses in 2009-10 were more unpredictable than in other years in DPCR4. It seems reasonable to assume that the over-recovery of revenues by networks was not intentional, and on this occasion is not a result of a failure to set appropriate tariff levels.

14. We therefore agree with Ofgem's minded-to position that so long as it can be shown that networks could not foresee the changes in measured losses, then it is appropriate to give the DNOs relief from the application of a penal interest rate.

15. On the issue of the timing of the adjustment in tariffs to reflect the over-recovery, we recognise that a one-off adjustment in charges would merely need to be reversed in April 2011. This would result in more volatile network charges. Therefore so long as the over-recovery (and any accrued interest) is fully reflected in charges by April 2011, we also agree with Ofgem's minded-to position not to reduce use of system tariffs in October 2010.

16. I hope that you find this response helpful. Please do get in touch if you would like to discuss any aspect of this response in more detail.

Yours sincerely,

Tim Dewhurst

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