Electricity Distributors, Electricity Suppliers, Consumer Representatives and other interested parties

Promoting choice and value for all customers

Our Ref: SG&G/Distribution
Telephone: 020 7901 7194
Email: rachel.fletcher@ofgem.gov.uk

21 March 2011

Dear Colleague,

Consultation on the way forward in dealing with the interactions between the electricity distribution losses incentive scheme and Gross Volume Correction (GVC) activity

1. During 2010 we published three letters relating to the impact of unconventional GVC activity by major electricity suppliers on the losses incentive scheme for electricity distribution network operators (DNOs).

   (i) 20 July 2010 –
   "Requests for relief from the consequences of over-recovery on the basis that accelerated gross volume corrections may have distorted losses reporting"[1]

   (ii) 14 December 2010 –
   "The Authority's decision on requests for relief from the consequences of over-recovery of allowed revenue caused by gross volume corrections (GVC) in settlement data"[2]

   (iii) 17 December 2010 –
   Decision on request from Northern Electric Distribution Ltd ('NEDL') and Yorkshire Electricity Distribution plc ('YEDL') for consent to calculate distribution losses for 2009-10 on a basis that differs from that used for 2002-03[3]

2. In response, some suppliers have raised concerns about the likelihood of other DNOs requesting adjustments to losses reporting, and the timing and impact of any decision by Ofgem on use of system charges.

<u>Views invited</u>

1 http://www.ofgem.gov.uk/Networks/ElecDist/Policy/Documents1/Consultation%20on%20implications%20of%20gross%20volume%20corrections%20for%20DNO%20revenues.pdf

2 http://www.ofgem.gov.uk/Networks/ElecDist/Policy/Documents1/Decision%20on%20interest%20rate%20adjustments.pdf

3 http://www.ofgem.gov.uk/Networks/ElecDist/Policy/Documents1/Decision%20on%20request%20from%20CE%20Electric%20UK%20to%20restate%20losses%20for%202009-10.pdf

3. In this letter we set out our proposed way forward on any further adjustment applications related to GVC. Any objections to this proposal should reach us by the end of March 2011.

4. We also invite suggestions and comments regarding any improvements which could be made to the methodological approach set out in the 17 December 2010 letter. These should reach us before 2 May 2011.

Way forward

5. Our preference is to accommodate any further adjustments to DNO losses reporting to unwind for the impact of GVC as part of the DPCR4[4] losses rolling retention mechanism (LRRM) process. We will set out our decision on the amount of the DPCR4 LRRM incentive in a direction no later than 30 November 2012, which would then be reflected in the use of system charges effective from 1 April 2013.

6. Ahead of the LRRM process, we will review any DNO applications for an adjustment to losses reporting related to GVC which we receive by 15 April 2011 and which are supported by the necessary data.

7. Any effect on use of system charges arising from our decision on such applications would apply from 1 April 2012. We do not expect to make any decisions on losses reporting that would require a DNO to update its tariffs in October 2011.

8. In making any further adjustments to the losses reporting arrangements to account for GVC in this regulatory year, we will take appropriate account of comments we have received by 2 May 2011 on the methodology we set out in our 17 December 2010 letter. Ahead of the LRRM process we will consult again with interested parties on the methodology we will apply, including the treatment, at that time, and any updated evidence, of the effect GVC has had on settlement data.

Background

9. The losses incentive scheme adjusts DNO allowed annual revenues according to how they perform each year against their losses target. The DNOs calculate losses as the difference between the electrical units entering and exiting their distribution network, where settlements data is used to measure units exiting the network.[5]

10. The losses incentive scheme also has a rolling retention mechanism (LRRM) to encourage the DNOs to undertake loss reduction initiatives throughout the price control period by guaranteeing rewards (or penalties) for a subsequent five year period. As part of the DPCR5 Final Proposals we set out how we would calculate the revenue adjustments which should apply to each DNO as a result of the DPCR4 LRRM, which will, in part, be based on the final settlement data for 2009-10. Ofgem will publish the LRRM adjustments before 30 November 2012.

11. The settlements system is primarily designed for the purposes of the electricity trading and retailing system. Use of settlement data to evaluate DNO losses performance is an ancillary function. GVC has a conventional use within the settlements system to correct data held on meter annual advances and estimated annual consumption levels. However, some suppliers have used GVC in data cleansing exercises to make aggregate corrections to billing errors which may have accrued over lengthy periods. This can have the effect of distorting apparent losses performance by DNOs, and disrupt the associated allowed revenues if large numbers of backdated units are netted off distribution totals in single transactions. Evidence suggests that such an effect occurred in the 2009-10 regulatory year.

---

[4] The fourth price control period (DPCR4; 2005-2010)
[5] In DPCR4 DNOs were using three different losses reporting methods, which used settlement data in different ways. In DPCR5 (2010 – 2015) we have required all DNOs to report losses in the same way - based on the settlement data received in that year.

12. We have already approved one application from a DNO group (CE Electric UK) to restate losses information for 2009-10 on a revised basis of calculation in order to unwind the effect of GVC on their losses performance and allowed revenues. Our decision on that application was set out in our letter referenced at paragraph 1(iii) above. Although we consider the terms of our decision to have been reasonable in all the circumstances, some electricity suppliers expressed concerns on three aspects of our decision:

(i) the fact that our decision, published on 17 December 2010, affected CE's indicative charges published later that month (and effective from 1 April 2011) which were consequently significantly higher than they would have been if we had not taken the decision when we did,

(ii) the absence of a consultation on CE's application before we made our decision, and

(iii) the approval of an approximating methodology to remove the GVC distortions in CE's losses data for 2009-10 and the assumptions embodied in that approach.

13. This letter does not seek to deal with the detail of the representations received which have been the subject of separate meetings and correspondence. However, we appreciate that they have highlighted issues of general concern to suppliers and DNOs, in particular because of the prospect of further applications by other DNOs.

Timing of use of system tariff changes resulting from further restatement applications

14. DNOs publish early forecasts of their allowed revenue positions on the DCUSA website[6] and electricity suppliers refer to this information in their own retail tariff planning. The DCUSA forecasts come with health warnings about assumptions and estimates used by DNOs in their preparation and they do not have the same status as indicative charge publications which are stipulated in the electricity distribution licence. However, in normal circumstances, the forecasts are intended to be a useful tool for suppliers and to be positive for competition in the retail market.

15. Our decision on CE's losses restatement application led to a significant change in their allowed revenue from the numbers included in their DCUSA forecasts published during 2010. It should be noted that CE had specifically referred to uncertainty caused by settlement data issues in the statement accompanying their DCUSA forecast.

16. In dealing with any future applications from DNOs we want to allow suppliers and their customers to have as much notice as possible of use of system charge impacts whilst ensuring that our treatment of DNOs is fair. We therefore think it useful to set out our views on how these matters could be taken forward.

17. For any further applications fully supported by the necessary data received before 15 April 2011, we would consider a decision separate to the LRRM process and the decision on any such adjustment would be framed such that the effect on use of system charges would not apply before 1 April 2012 (the next annual charging revision).

18. We will need to consider any further applications from DNOs on their merits but, given the time which has elapsed since DNOs submitted revenue returns for 2009-10 and the representations from suppliers referred to above, our preferred position is to defer any further adjustments to allowed revenues until the DPCR4 close out (LRRM) calculations referred to in paragraph9. This would reflect in the use of system charges effective from 1 April 2013. This will allow us the maximum amount of time to refine corrections to DPCR4 losses data for the purposes of that adjustment and also for setting DPCR5 losses targets which will be done at the same time. Details of this process are given at

[6] http://www.dcusa.co.uk/Public/Documents.aspx?t=10

Part D of special condition CRC 7 of the electricity distribution licence[7] and in chapter 4 of the financial methodologies document in the final proposals for DPCR5[8].

19. Any adjustment we make for GVC-related losses restatements as part of the LRRM calculations will include a time-value adjustment to recognise the delay to the DNO receiving its corrected revenues.

20. We consider that the preferred position set out above is consistent with the decision we have already taken and the factors of which we are aware at this stage. We also expect any affected DNOs to update the information in their DCUSA forecast statements to reflect their present view on the extent to which they think the GVC issue may affect them, and in particular to update their DCUSA statements should they send any formal application based on the GVC issue to us.

Approach to correcting for GVC distortions in DNOs' losses reporting

21. Although our enquiries to date indicate that the complete data sets needed to fully correct for the GVC issue are not available, the representations we have received from suppliers have suggested that there may be some improvements which could be made to the methodological approach we used in CE's case (set out in our decision letter of 17 December - see 1 (iii) above). We are already liaising with some suppliers in this regard but we would welcome suggestions and comments from any other knowledgeable parties, to reach us before 2 May 2011.

22. In the interest of arriving at a robust and timely conclusion of this work, we encourage suppliers to provide the relevant information to any DNO who is seeking to understand GVC activity by suppliers operating in its area.

23. We would further welcome any suggestions or comments on the preferred approach set out in paragraphs 5 - 10 above. These should be sent for the attention of Lesley Ferrando at the above address or emailed to Lesley.Ferrando@ofgem.gov.uk before the end of March 2011.

Yours faithfully,

Rachel Fletcher
Director, Distribution

7 http://epr.ofgem.gov.uk/index.php?pk=doc610092

8 http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=372&refer=Networks/ElecDist/PriceCntrls/DPCR5