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Dear Rachel

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

Ofgem's open letter issued on 21 March 2011 invited comments on possible improvements to the methodological approach that CE proposed to Ofgem for dealing with the distortions that would arise as a result of suppliers' use of the gross volume correction (GVC) and other facilities within the Settlements system.

The foundation of our position is that, with respect to both the 2009/10 annual incentive and the close out of the DPCR4 rolling incentive, *all* licensees should use a dataset that does not give rise to windfall gains or losses for customers or licensees when the reported outturn is compared with the targets. The general principle that should apply in all cases is that any adjustment that is made to Settlements data should try to unpick what has been done to the underlying data so that the basis on which the revised dataset is computed corresponds as closely as possible with the basis on which the targets were set. This will ensure that the declared purpose of the losses condition in the DPCR4 charge restriction conditions is met, namely 'to reflect the performance of the licensee… in respect of distribution losses'. In an ideal world this exercise would be carried out MPAN-by-MPAN. In the circumstances in which we find ourselves this exact replication is not possible so some broader judgement has to be made. We believe that with respect to Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL), the adjustments to the data from the Settlements system that we proposed, and that the Authority endorsed, for the purposes of the 2009/10 annual incentive are also appropriate for the close out of the DPCR4 rolling incentive. Accordingly, we propose no further changes to the recently approved methodology in this letter.

We have already established to Ofgem's satisfaction that, in our case, unless an adjustment were to be made, there would be a misalignment between the basis on which the DPCR4 period losses targets had been set and the way in which performance against those targets would be measured. Hence the fundamental requirement is satisfied in our case and we believe that Ofgem has set a helpful precedent by testing our application against this important principle. The adjustment now needs to be made in the close out of the DPCR4 incentive for NEDL and YEDL for this principle to be maintained.

Although we consider that the approach that we proposed, and that Ofgem approved, is likely to have merit in many, if not all, DNOs' cases, we acknowledge that the mismatch between targets and reported outturn that we demonstrated was particular to our circumstances and, indeed, it was predominantly driven by the behaviour of one particular supplier. If other distribution licensees have been similarly affected by similar behaviour on the part of the suppliers that use their respective networks, we believe that there would be a very strong case for applying the CE adjustment method throughout the sector.

However, we recognise that it is also possible that the behaviours that we experienced may have occurred at different points in the Settlements cycle, or perhaps may not have occurred at all, in the case of other distribution licensees. If the behaviour that drove the distortion in Settlements data is different in a given case then a slightly different approach may be needed that takes into account the different circumstances of that case.

Accordingly, we suggest that Ofgem will first need to confirm that it is satisfied that there is a mismatch between targets and reported losses that needs to be addressed for a particular licensee and then Ofgem must determine whether the method of adjustment that we proposed is also apt for that licensee's circumstances.

We appreciate that it would be simpler if the application of the same adjustment method would give a sensible result across the board, but we suspect that such an approach has the potential to give rise to windfall gains and losses that would be undesirable and inconsistent with Ofgem's statutory duties.

In these circumstances, Ofgem may wish to proceed by inviting distribution licensees to make their own case for the application of the approved CE methodology or for the application of a different methodology if their own circumstances would merit this. It would be reasonable for Ofgem to expect a licensee to demonstrate that any adjustments meet the following criteria:

- improved consistency between the basis on which the DPCR4 targets were set and reported performance;
- erring on the side of customers where there is doubt about the adjustments that may be appropriate in the particular circumstances of that licensee;
- the application of the adjustments should be auditable and based on data that has not been manipulated by the licensee or any other party; and
- the result should be plausible when compared with the losses performance of the licensee prior to the point at which the anomalies in the data began to manifest themselves.

We believe that the approved CE methodology meets these criteria *in our case*. Nevertheless, if it can be shown that variations to that methodology would better meet these criteria with respect to NEDL or YEDL, we would expect Ofgem to apply such variations in the DPCR4 rolling incentive close out. If no one can suggest improvements that would better meet these criteria we would expect the methodology approved by Ofgem in its decision of 17 December 2010 to be applied to the DPCR4 rolling incentive close out calculation for NEDL and YEDL in the same way as it has been applied to the reporting for the purposes of the 2009/10 annual incentive.

As Ofgem recognises in its consultation document, the Settlements system is primarily designed for the purposes of the electricity trading and retailing system. The use of Settlements data to evaluate distributors' losses performance is an ancillary function. If, given the new information that came to light as a result of CE's application last year, Ofgem concludes that data from the Settlements system is not currently capable of being used to fulfil the requirements of the losses incentive as Ofgem envisaged (the declared purpose of which is set out in the DPCR5 licence conditions) then consideration needs to be given to:

- how the Settlements system can be changed, prior to the DPCR5 losses incentive mechanism becoming fully operative, in order to facilitate the accurate and timely reporting of a licensees' losses performance; or

- alternative measures (outside Settlements), such as post-processing of the data, that will allow the losses incentive to operate as envisaged but would mitigate the known vagaries of the Settlements system.

It is clear to us that the data difficulties that were highlighted in Ofgem's decision in CE's case are an enduring feature of the way that the Settlements system currently works and were not merely a one-off event. The fundamental shortcomings of a lack of any basic controls, a lack of transparency and a lack of auditability remain. The wide-ranging freedom enjoyed by suppliers in relation to being able to make unilateral, unvalidated modifications to Settlement dataflows may have wider implications for the future governance of Settlements generally, but they certainly need to be addressed as a priority if Settlements data is to be regarded as fit for the purpose of rewarding or penalising distributors for their losses performance. To bring the dataset to a standard where it is fit for the purposes of the DPCR5 losses incentive, we think that Ofgem will need to call upon the participants in the Settlements system to introduce some quite significant changes to the way that the dataset is assembled within the rules of Settlements. If such changes can be introduced before the DPCR5 losses incentive becomes fully operative that would be ideal. If it cannot be done within that timescale, distributors will need to work together and with Ofgem to develop an alternative methodology for measuring losses in the DPCR5 period. In this connection it is perhaps worth noting that the introduction of smart meters is certain to introduce a discontinuity into the DPCR5 losses incentive, so further work on the measurement of losses in the DPCR5 period is going to be necessary in any event. Ofgem may consider it appropriate to initiate a project that covers all these aspects to ensure that the DPCR5 losses incentive meets the declared purpose of the condition.

We suggest that if an alternative losses methodology is to be successful in the DPCR5 period then such a methodology must better demonstrate compliance against a set of robust principles. We believe that any methodology used in the DPCR5 period would have to:

- be in the interests of customers;

- reward or penalise the distributor for the results of its behaviour (rather than the behaviour of others over whom it has little or no influence);

- be based on data that is auditable and cannot be manipulated by the licensee or a third party; and

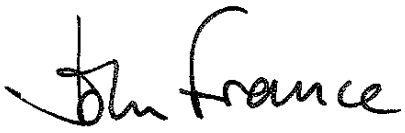
- be as consistent as possible with the arrangements for incentivising losses performance in the DPCR5 period as set out in the DPCR5 *Final proposals.*

We must also comment upon some of the implementation issues to which Ofgem referred in the open letter. In terms of the timing of the implementation of any change to use of system charges, there are already constraints within the distribution licence that mean that a licensee must give three months indicative notice of a change to its charges. Following the Ofgem decision on 17 December 2010, CE gave the requisite period of notice of a change to its charges, albeit that this was a departure from the forecast allowed revenue included in CE's distribution use of system and connection agreement (DCUSA) notifications provided during 2010. In these published statements we specifically referred to the uncertainty caused by the Settlements data issues. When we discussed our proposals with Ofgem we did not know that some suppliers had decided to take the commercial risk of going out to the market with a service offering prior to the publication of indicative charges that are subject to the formal three month notice period.

We do not think that there is anything more that we could or should have done to alert suppliers to the possibility that this matter was under review. Moreover, we do not believe that Ofgem has done anything for which it should reproach itself. CE and Ofgem worked conscientiously to ensure that a decision was made in time for it to be reflected in our charging statements and published within the timescales set out in the licence. Moreover, we took pains to ensure that all suppliers were treated the same in terms of notification. However, we wish to place on record that we had no knowledge that some suppliers were already taking a position in the market that was based on a judgement that the reported over-recovery position would not change materially. Moreover, other suppliers, having read our public statements as part of their due diligence, might have been less inclined to lock themselves into a set of contract prices that disregarded the caveats that we had placed on our published over-recovery forecasts. Our actions and Ofgem's process were fair and consistent with respect to all suppliers.

Finally, Ofgem will no doubt appreciate that we have given considerable thought to the issues associated with the measurement of losses and we would hope to be involved in any exploration of any further proposals or developments.

Yours sincerely



John France
Regulation Director

cc Lesley Ferrando