

**REQUEST FROM NORTHERN ELECTRIC DISTRIBUTION LTD AND  
YORKSHIRE ELECTRICITY DISTRIBUTION PLC FOR THE CONSENT OF THE  
GAS AND ELECTRICITY MARKETS AUTHORITY TO CALCULATE A  
COMPONENT OF ADJUSTED DISTRIBUTION LOSSES FOR THE RELEVANT  
YEAR 2009/10 ON A BASIS THAT DIFFERS FROM THAT USED WITHIN THE  
CALCULATION OF ADJUSTED DISTRIBUTION LOSSES IN RESPECT OF THE  
RELEVANT YEAR COMMENCING 1 APRIL 2002**

**12 November 2010**

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## SUMMARY

- 1 On behalf of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL), CE Electric UK Funding Company (CE) requests the consent of the Gas and Electricity Markets Authority (the Authority) to calculate one component of adjusted distribution losses in the relevant year 2009/10 on a basis that differs from that used in the relevant year commencing 1 April 2002.
- 2 Without a change to the basis of calculation, recent material changes to Supplier Volume Allocations (SVAs) under the settlement system (Settlements) will have the effect that the purpose of the DPCR4 losses incentive (as set out in the electricity distribution licence) cannot be achieved.
- 3 The changes in SVAs result principally, though not exclusively, from the application by suppliers of the technique known as Gross Volume Correction (GVC).
- 4 The observed changes in some suppliers' behaviour since June 2009 have the effect that, unless NEDL and YEDL make a change to the basis on which they calculate adjusted units distributed, electrical losses will be imputed to the relevant year 2009/10 that:
  - certainly did not occur in that year;
  - may not have occurred in the DPCR4 period; or
  - may not have occurred at all; and certainly
  - are not consistent with the measurements that were made at the time that the DPCR4 targets were set for both NEDL and YEDL.
- 5 During the course of our investigations it has also become clear that a material amount of error is introduced by a high proportion of implausible, negative estimated annual consumption (EAC) values within the settlements process also appear to have arisen as a result of the supplier behaviour. Negative EACs further distort the reporting of losses. In the case of this particular issue there is clear evidence that is grounded in actual settlement data that enables a relatively straightforward correction to be made.
- 6 Unless the Authority agrees to NEDL's and YEDL's using a different basis for the calculation of  $AUD_t$  in respect of the relevant year 2009/10 there will be an

inconsistency between the basis on which the targets for the DPCR4 period were set and the basis on which performance against those targets is reported in respect of 2009/10. In previous decisions the Authority has taken the view that there should not be such an inconsistency between targets and performance.

- 7 Without a change to the basis on which losses are calculated with respect to 2009/10:
- the reported losses performance and revenue driver of NEDL and YEDL will be adversely affected, giving rise to over-recoveries of £9.773m and £21.412m respectively in that relevant year;
  - the licensees will be unable to distinguish between losses that occurred in the DPCR3 and DPCR4 periods and will be unable to apply the correct incentive rate to the losses that are now being reported;
  - the targets for the DPCR5 period will be distorted by the abnormal data in respect of 2009/10;
  - the reported outturn in the DPCR5 period will continue to be distorted by the continuing use of the GVC facility; and
  - the purpose of the DPCR5 losses incentive cannot be met and would result in a perverse incentive on NEDL and YEDL to reduce the specification (and therefore the cost) of new plant and equipment being added to the system during the DPCR5 period (resulting in higher losses), since the losses incentive would be driven to its (penalty) collar.
- 8 CE's request is consistent with the decisions reached by the Authority in cases where the DPCR4 period target loss percentages have been reset by the Authority.
- 9 CE does not have access to MPAN by MPAN consumption data for the period concerned and suppliers have been unable or unwilling to share any detailed data set with us. The data that CE does have available to it is:
- settlement data received in its capacity as a distributor; and

- analysis provided by Elexon of the volume of adjustment that would be normally be expected at the DF settlement run compared to what has been seen.

This data has been used to inform this request.

10 CE requests that the Authority consents to NEDL and YEDL using a basis for the calculation of adjusted units distributed in 2009/10 that differs from that used in respect of the year commencing 1 April 2002 in the following respects:

- the settlement reconciliation runs R1-R3 received during 2009/10 to be normalised so as to take the arithmetic average of the reconciliation movements from the years 2005/06 through to 2008/09; and
- settlement reconciliation runs RF and DF received during 2009/10 to be disregarded and set to zero.

11 The restatement shall also incorporate two further adjustments; the first relates to negative EACs and the second relates to a data error reported by IMServ carrying out its role as Central Data Collection Agent (CDCA) in respect of the number of units entering the network at the Thurcroft grid supply point.

12 Changes consistent with these changes would also be made to calculate the growth term ( $GR_t$ ) under special condition B1 of the DPCR4 charge restriction.

13 These methodology changes (i.e. excluding the correction of the Thurcroft data error reported by IMServ referred to in paragraph 11 of this summary) would restate the losses incentive outcome for 2009/10 to be (-)£0.7m in respect of NEDL and £4.4m in respect of YEDL. This would represent a favourable movement of £12.490m and £25.875m in the value of the 2009/10 losses incentive for NEDL and YEDL respectively (compared to the position that would prevail if no changes were made to the basis of calculation). This includes adjustments of £1.5m for NEDL and £2.1m for YEDL in respect of negative EACs. As a result of adjusting the view of losses in 2009/10 the consequential effect on the growth term for that year would result in additional allowed income amounting to £1.1m in respect of NEDL and £2.0m in respect of YEDL. After taking into account changes in pass-through items and other incentives, the resulting change in use of system tariffs in 20011/12 that would result

from the giving of the consent that is being sought by CE would still be broadly in line with that envisaged by Ofgem at the time of the DPCR5 *Final proposals*.

- 14 However, the true economic effect of the totality of the DPCR4 losses incentive will not be known until the DPCR4 losses rolling retention mechanism (LRRM) is finalised after August 2011. The effect of the consent being requested by CE is therefore to stabilise allowed income entitlement, and therefore use of system charges, in the meantime. Accordingly, CE acknowledges that the interim position that would result from the granting of the consent will be revisited in the determination of the PPL term in Part D of CRC7 of the electricity distribution licence and in calculating the allowed loss percentages for the DPCR5 period.
- 15 The giving of the consent that is being requested is not a matter that is reserved for the Authority under the *Rules of Procedure of the Gas and Electricity Markets Authority* issued on 23 September 2010.
- 16 The replacement of the DPCR4 price controls by the DPCR5 price controls does not preclude the Authority from giving the consent sought in this request.
- 17 CE requests that the consent is confirmed by 18 December 2010 in order for it to be fully reflected in the indicative use of system charges that NEDL and YEDL must publish before 31 December 2010.
- 18 CE's auditor, Deloitte, has confirmed that, if CE secures the consent sought in this request, Deloitte would be prepared to issue the necessary certifications to allow the restated SLC47 price control returns to take the place of the provisional returns submitted by CE in July 2010.

## INTRODUCTION

- 1 CE Electric UK Funding Company (CE) is the UK-based parent company of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL).
- 2 On behalf of NEDL and YEDL, CE requests the consent of the Gas and Electricity Markets Authority (the Authority) to calculate one component of adjusted distribution losses in the relevant year 2009/10 on a basis that differs from that used within the calculation of adjusted distribution losses in the relevant year commencing 1 April 2002. The consent of the Authority to such a change is required in accordance with paragraph 9 of Special Condition C1 – Calculation of charge restriction adjustments arising from the distribution losses incentive scheme (the DPCR4 Losses Condition).<sup>1</sup>
- 3 In this request CE presents evidence to show that, without a change to the basis on which adjusted units distributed (which is a component part of adjusted distribution losses) is calculated for the year 2009/10, recent material changes to Supplier Volume Allocations (SVAs) under the settlement system (Settlements) operated in accordance with the Balancing and Settlement Code (BSC) will have the effect that the purpose of the DPCR4 Losses Condition cannot be achieved.

## THE DPCR4 LOSSES CONDITION

- 4 The DPCR4 Losses Condition sets out its purpose in paragraph 1 of the condition:

‘The purpose of this condition is to establish the amount of incentive that adjusts allowed demand revenue so as to reflect the performance of the licensee under the scheme set out below in respect of distribution losses.’
- 5 The DPCR4 Losses Condition rewards or penalises the licensee by reference to the difference between the targets, i.e. the allowed loss percentage (ALP) and the adjusted distribution losses ( $L_t$ ) achieved by the licensee in the relevant year  $t$ .
- 6 On occasions during the DPCR4 period, the Authority has varied the targets of licensees; in some cases using the power to issue a direction under paragraph 7 of the DPCR4 Losses Condition and in one case by modifying the licence using the procedure

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<sup>1</sup> Throughout this request we refer to the final paragraph of the DPCR4 Losses Condition as ‘paragraph 9’ although, as a result of a numbering error, the paragraph actually appears as a second paragraph 8.



set out in section 11 of the Electricity Act 1989 (the Act) so as to insert a revised ALP figure.

- 7 The request from CE relates not to the power to reset targets under paragraph 7 of the DPCR4 Losses Condition but to the giving of consent by the Authority to the licensee to allow it to change the basis of calculation of one component of adjusted distribution losses. The power to give such a consent is clearly present in the wording of paragraph 9 of the DPCR4 Losses Condition which provides that:

‘The licensee shall, unless otherwise agreed by the Authority, calculate each component of adjusted distribution losses for the relevant year t on the same basis as that used within the calculation of adjusted distributed losses in respect of the relevant year commencing 1 April 2002, pursuant to paragraph 7 of special condition D (Information to be provided to the Authority in connection with the charge restriction conditions), or in Scotland special condition E, of this licence in the form in which it was in force on 31 March 2005.’

- 8 During the currency of a price control period it would be possible to achieve the underlying purpose of CE’s request either by adjusting the targets in accordance with paragraph 7 of the condition or by varying the calculation methodology in accordance with paragraph 9 of the condition.
- 9 However, the DPCR4 period has now ended and it would be inappropriate to use the process for resetting the target (i.e. ALP term) for a year that has already closed under a price control that has now been superseded by the DPCR5 price controls.
- 10 Moreover, the effect of paragraph 8 of the DPCR4 Losses Condition is to prevent the resetting of the targets by a direction under paragraph 7 of the condition from taking effect until the next following regulatory year.<sup>2</sup> For these reasons CE considers that the better approach is to make use of the consent facility provided for in paragraph 9 of the DPCR4 Losses Condition.

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<sup>2</sup> Paragraph 8 provides that ‘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 relevant year commencing immediately after the date of the direction.’

**THE SUBSTANTIVE CASE FOR THE GIVING OF A CONSENT UNDER PARAGRAPH 9 OF THE DPCR4 LOSSES CONDITION**

- 11 Around March 2010 CE became aware of significant and unusual activity on the part of some electricity suppliers with respect to the data relating to settlement days under the trading arrangements operated in accordance with the BSC. Subsequent investigation has revealed a strong correlation between the actions of [\*] and the particularly pointed effect observed in the data received by the two CE-owned licensees.
- 12 The activity was significant enough to have a material impact on SVAs that are presently being treated under Settlements as occurring in the year 2009/10. The scale of the impact on the calculation of distribution losses was observed in the first quarter of 2010 and it was both unexpected and surprisingly large. Between December 2009 and March 2010, CE's assessment of its performance under the annual losses incentive moved by *ca.* £30m, resulting in the significant over-recovery that is present in the conditional SLC47 statement that was lodged in July 2010. To put that in context, the entire value of either the cap or the collar of the distribution losses incentive for DPCR5, which attaches a higher economic value to a lost unit than was the case in the DPCR4 scheme, is *ca.* £35m over five years.
- 13 CE has made extensive follow-up investigations and has discovered a great deal about the extent to which suppliers are able to make changes to settlement data, particularly in relation to the period that we previously thought had passed the point where adjustments could be made. The settlements process is complex and any analysis of the data contained therein is bound to be subject to uncertainty. That said, it has become clear to CE during its investigations that:
- The crux of the adjustments being made by suppliers relates largely (although not exclusively) to adjustments that have been made to correct what the suppliers have reason to believe are long-standing inaccuracies in their consumption data.
  - A typical example of the errors corrected would be where a so-called 'long term vacant property' had not been subjected to a meter reading for a number of years (the property might not even exist). In those cases, it is not unusual for Settlements to have been attributing an estimate of annual consumption to a property for many years.

- This estimated consumption will have been attributed to the supplier and will also have been included in the calculation of units distributed, as declared by the distributor. The number of units distributed to such a premises will therefore have been consistently overstated for as long as the error has existed. Also, the supplier's share of the energy purchased through the settlement period for every half-hour period in which the error has prevailed will be have been overstated.
- Under those circumstances, if the supplier corrects the reading, this results not only in a reduction in the number of units distributed but also the settlement system credits the supplier with the energy that the supplier now deems was not actually consumed but for which the supplier has paid. CE's understanding from dialogue with Elexon is that this 'credit note' is valued at today's wholesale price rather than at the price that prevailed when the energy was (inaccurately) previously assumed to have been consumed.
- The suppliers have developed the use of a technique known as gross volume correction (GVC), to enable them to make corrections to historical periods in Settlements that conventional wisdom has always supposed to have been closed, or 'crystallised' in the vocabulary of Settlements.
- These adjustments are made by suppliers or their agents and are not subject to challenge or scrutiny by any other party, either independent or interested. It is also relevant to note that the original design of Settlements did not envisage a 28-month process, rather full settlement over 14 months. The dispute process was introduced as a short-term measure that was intended to allow data cleansing of specific MPANs to be carried out for a short period of time, after which the process would revert to the originally envisaged 14-month process. A decade on, the dispute facility still exists and its use has been extended by some suppliers to make much more significant changes than were originally envisaged.
- Accordingly, to the extent that a supplier can carry out settlement data changes that 'disavow' units that have previously been allocated to it, it receives a credit at the expense of all other suppliers with a market share in that particular grid supply point (GSP) group. A knock-on impact of the correction is that units

distributed in the period when the data entries actually flow are depressed by the amount of the correction.

- A consequence of the way that the competitive market was set up is that the legacy supplier in a given region is likely to have a much higher proportion of these problematic data entries.[\*].
- The activity is not restricted to one supplier, but the impact does not appear to be uniform across the distributors. Data provided to CE by Elexon suggests that there is a strong correlation between the behaviour of some suppliers and the legacy region and the supplier's market share and the impact on the distributor.

14 CE's investigation has involved significant dialogue with suppliers, particularly with [\*]. We should stress that we have found no evidence of wrong-doing on the part of [\*] or of any other company. However, the fact that the activities might be within the rules on the supply and settlement side of the commercial arrangements operated by the electricity supply industry provides no comfort in relation to data being fit for purpose in relation to the proper operation of the incentives set out in the distribution licence. [\*] has told us [\*] that a significant exercise commenced in 2008 to find and execute a large volume of data corrections. The pattern of data subsequently received by CE through the settlement system is entirely consistent with the timing and scale of the project undertaken by [\*]. CE's data has been affected by other suppliers, but to a much lesser extent.

15 Although our understanding of the supplier management of Settlements has improved, we have been unable to reach a complete understanding of the reasons for the data changes that are being reflected in the changes to SVAs, but it is beyond any doubt that there has been significant use of facilities within the settlement process, particularly, but not exclusively, GVC facility, which has the effect that data from settlement periods that are crystallised is attributed to periods that are still open.

16 Neither Ofgem nor Elexon has complete visibility of the extent to which this facility is being used by suppliers and we have reached no conclusions at this stage as to whether the GVC facility is being used correctly or incorrectly with regard to the rules of the BSC. However, our view is that the correctness, or otherwise, of the application of facilities such as GVC under the BSC is not directly relevant to whether or not there is

a need to review our reported losses calculation. Although our own investigations have yielded some useful information, there is a limit to the level of detail that we are able to obtain from suppliers.

***The materiality of the issues raised in relation to the calculation of the distribution losses of NEDL and YEDL***

17 Throughout the DPCR4 period NEDL and YEDL used the unadjusted output from Settlements to determine ‘adjusted units distributed’ ( $AUD_t$ ) for the purposes of the calculation that has to be made in accordance with the DPCR4 Losses Condition. Under that method, any reconciliations that flow through Settlements during a given regulatory year are treated for the purposes of establishing the adjusted units distributed as having flowed in the year in which the settlement data entry is created. In calculating  $AUD_t$  we have not ‘reallocated’ those units of energy (whether positive or negative) back to the point in time at which the settlements data is suggesting that the flow took place. The basis of that method was that:

- there was a limited period in which adjustments could be made (i.e. the settlement period); and
- relatively consistent volumes of reconciled data in each year would be a reasonable proxy for the difference between what had been reported at initial settlement runs and the final answer that would flow through the settlements system by the end of the settlement period.

18 One of the main reasons for adopting that method was that it would be helpful for customers and suppliers if we were to declare a fixed outcome to the calculation in each year at the time of the revenue return, rather than to make a guess as to how the information would be amended by future settlement runs that would then require restatements as subsequent settlement system data was received after the point at which we declared our result for a given year. At the time that the method was set in 2002, it was generally expected that the volatility in settlement reconciliation initially seen after market start-up would decline. This expectation was explicitly shared by Ofgem and reiterated in the DPCR5 *Final proposals* in 2004.

- 19 The observed changes in some suppliers' behaviour since June 2009 have the effect that, unless NEDL and YEDL make a change to the basis on which they calculate AUD, electrical losses will be imputed to the relevant year 2009/10 that:
- certainly did not occur in that year;
  - may not have occurred in the DPCR4 period; or
  - may not have occurred at all; and certainly
  - are not consistent with the measurements that were made at the time that the DPCR4 targets were set for both NEDL and YEDL.
- 20 As part of our investigations into these wider issues, we have also discovered that the algorithms that the settlement system uses are susceptible to distortion if suppliers use the facility that is legitimately open to them to estimate consumption, without subsequently securing a proper meter reading. This can result in negative estimated annual consumption (EAC) values within the settlements process that may have arisen as a result of the supplier behaviour. A negative EAC suggests that a domestic property is generating units rather than consuming them. We have recently carried out a sampling exercise on 39% of the MPAN data that relates to our networks. We discovered a surprisingly large number of negative EACs in the data (which, it is worth noting, is data that has only very recently been made available to distributors and is required to be provided on a 'snapshot' once-per-quarter basis. We do not have continuous access to the consumption data at MPAN level).
- 21 We have extrapolated our findings across the entire non-half hourly metered population, from which we estimate that there are 59GWh of negative EACs across NEDL and YEDL. On an annual basis the negative EACs create losses of 59GWh with an adverse losses incentive effect of £3.6m in addition to the consequences of the change in supplier behaviour described above. Since we have only a snapshot of the data at a point in time we do not have any way of assessing the extent to which the current situation has prevailed throughout the DPCR4 period. Therefore the change in the incidence of negative EACs is not something we can precisely determine. In the absence of firm historical data, the approach we have adopted is based on the rationale that the number and size of negative EACs would increase as a consequence of the suppliers' increased use of GVC and as a result of the nature of the algorithm in the

national system that gives rise to the problem in the first place (the incorrect extrapolation of an apparent reduction in consumption to the point where the estimate continues to fall unless and until a new actual reading is introduced). We recognise that this does not take into account the value of any negative EACs which may have existed within the data set used to set the DPCR4 targets. However we have no reason to suppose that negative EACs were common at that date and we do not think it inappropriate to make the working assumption that all negative EACs have emerged during the DPCR4 period. Moreover, we have erred on the side of caution in making no adjustment for the adverse effect on reported losses of negative EACs in the years from 2005/06 to 2008/09, nor are we making any adjustment (because we simply cannot do so meaningfully) for EACs that have fallen to the point of being understated without being negative as a result of the automatic operation of the algorithm. If the creation of negative EACs has been a consistent consequence of suppliers' behaviour over the DPCR4 period we will have suffered significant adverse impacts during the earlier years of the DPCR4 period. If it has not been a consistent behaviour on the part of suppliers we are poised to be damaged by both the immediate effect under the DPCR4 losses incentive and by the effect of the DPCR4 Losses Rolling Retention Mechanism (LRRM) as it treats these implausible data entries as a component of deteriorating losses performance.

- 22 We note that Elexon has recently introduced a rule that will stop the algorithm producing new negative values, but the timing of that change will not recover any of the damage done to date and will not correct errors that are currently in the system.
- 23 These errors are much more clearly manifest and identifiable than the larger underlying movements caused by the change in SVAs. As such, CE is proposing that a straightforward adjustment for these errors be factored into the restatement of 2009/10 performance. Although we have no reason to believe that there were no similar errors in prior years, we can see no feasible route to correcting them.
- 24 We believe that even the correction of this straightforward error requires the consent of the Authority to the use of a different basis for the calculation of the losses performance of NEDL and YEDL for 2009/10, as it requires us to deviate from using *unadjusted* settlement data. We propose to replace the obviously incorrect negative consumptions with a more plausible value, i.e. the average for that profile class.

- 25 Taking all of these data issues together, CE believes that the resulting impact of these changes is material given the rapid movement in 2009/10 over-recovery seen between publication of 2010/11 final charges in February 2010 and the submission of our 2009/10 SLC47 audited price control return in July 2010 as detailed later in this request. CE believes that the majority of this movement is attributable to suppliers' actions that have introduced a material level of inconsistency between the reported actuals and the DPCR4 targets.
- 26 In its consideration of the issues raised by these changes to SVAs Ofgem may be guided by the materiality of the issue. The scale of the distortion is such that, unless a change to the method of calculation is agreed by the Authority or some other action is taken, NEDL and YEDL would be regarded as having over-recovered under their 2009/10 allowance by £9.773m and £21.412m respectively. We have already highlighted that the scale of this movement is broadly equivalent to the entire scope for penalty under the DPCR5 losses incentive. It is also worth noting that the 2009/10 over-recovery caused by this issue alone exceeds 5% of Combined Allowed Distribution Revenue, which is the regulatory long-stop that is designed to enable the Authority to take control of the licensee's tariff-setting when the licensee has over-recovered beyond any reasonable extent under normal circumstances. It is clear, therefore, that the consequence of this supplier activity is of an order that the licence assumes would justify serious regulatory intervention.

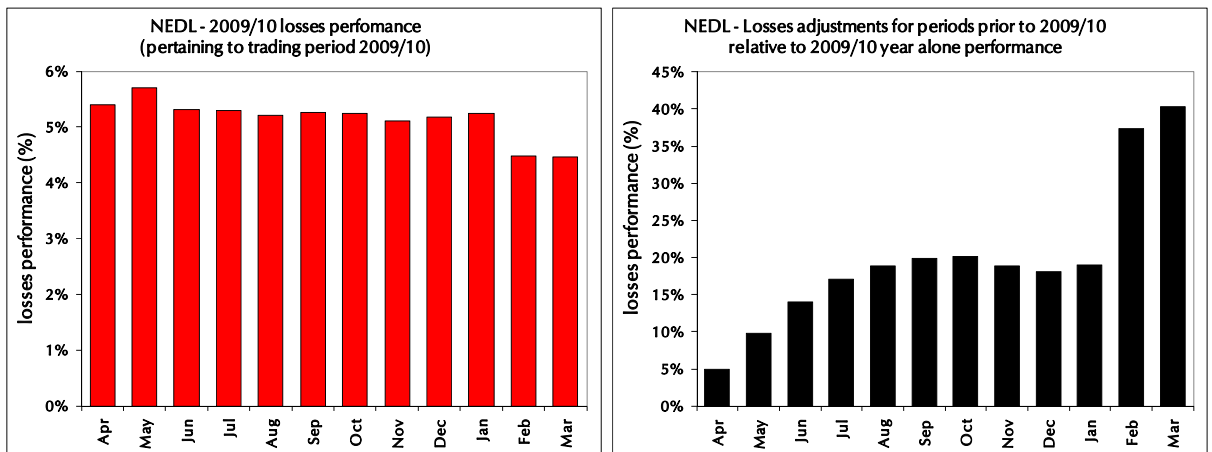
***Evidence of unusual supplier activity affecting the outputs from the settlements system***

- 27 Under the present market arrangements electricity distributors have almost no visibility of the data and processes that suppliers use to determine the data that is input into the settlements system. CE has consulted with Elexon, which has responsibility for delivering the BSC, other distributors, some of whom have witnessed similar late changes to data relating to their companies, and three electricity suppliers, namely [\*], [\*] and [\*].
- 28 The information set out below represents a summary of CE's view of the nature, extent and cause of the recent changes to SVAs, based on the best data and information that are available to CE in the circumstances.

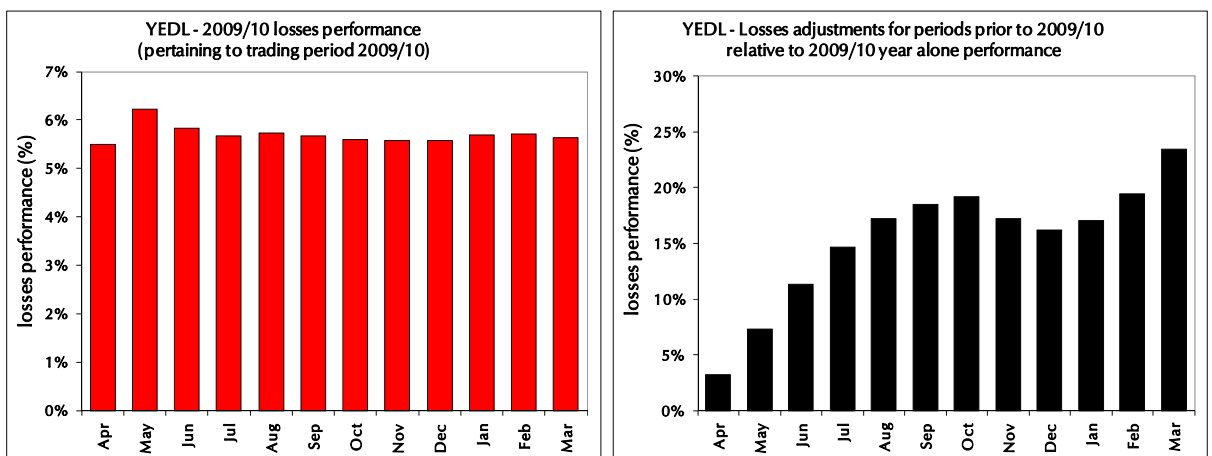


29 The Authority has the benefit of widely drawn information powers that will enable it to make more significant investigations should it so wish. CE was alerted to this issue because the reported losses derived from the data from the settlement system were not following the expected trend. This is illustrated in figures 1 and 2 below.

**Figure 1 - NEDL losses performance**



**Figure 2 - YEDL losses performance**

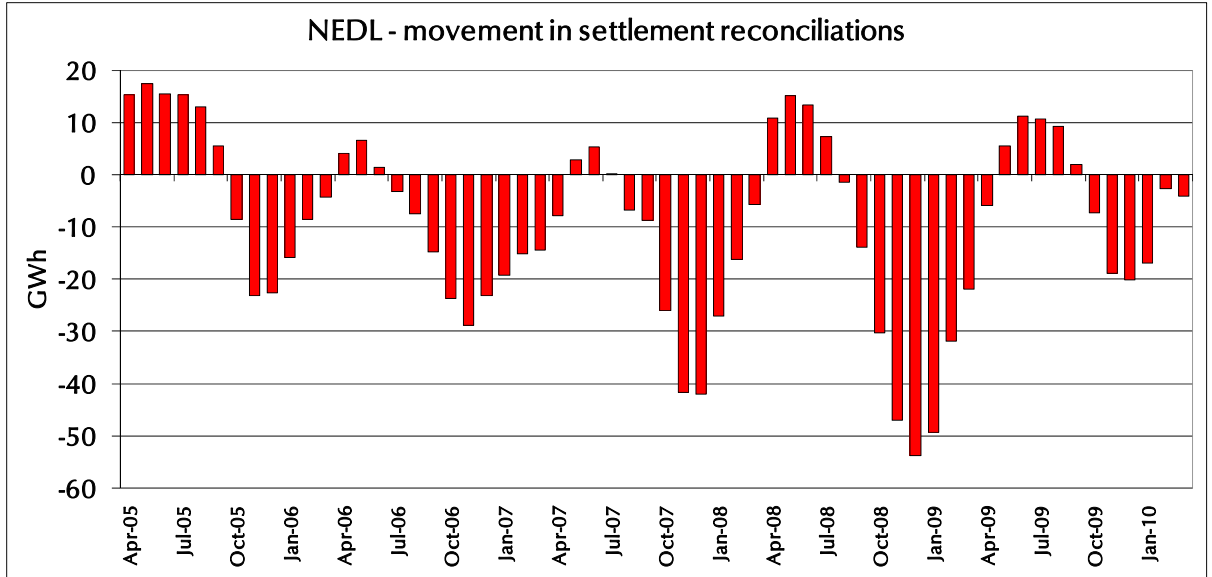


30 It is clear from figures 1 and 2 that, while the losses relating to 2009/10 were remaining stable, significant adjustments were being made for the period prior to 2009/10, particularly those received during February and March 2010.

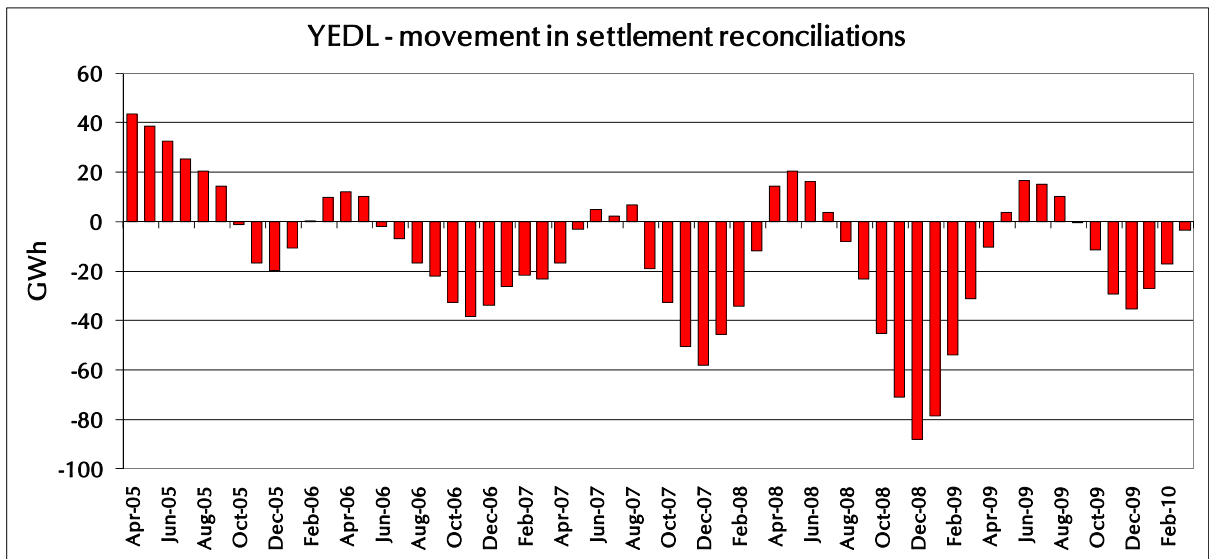
31 We have established with the help of Elexon that the changes are not explained by any change in the volume of settlements data that is based on actual meter readings by final reconciliation (RF).

32 It is also clear that settlement reconciliations are becoming increasingly volatile. This is illustrated by figures 3 and 4 below:

**Figure 3 – NEDL reconciliation movements**



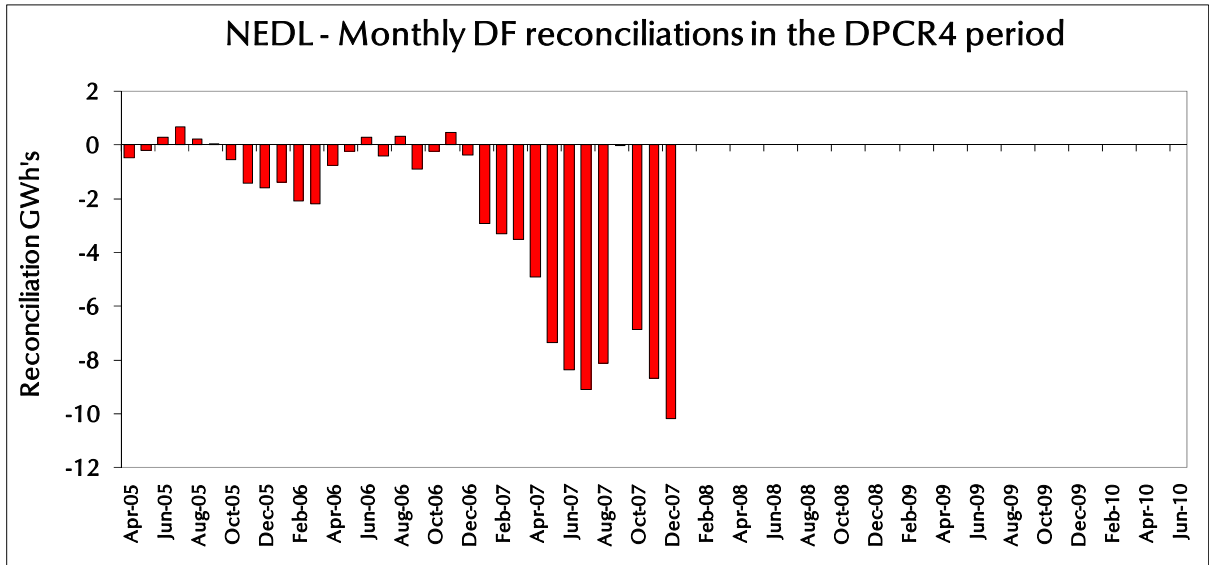
**Figure 4 – YEDL reconciliation movements**



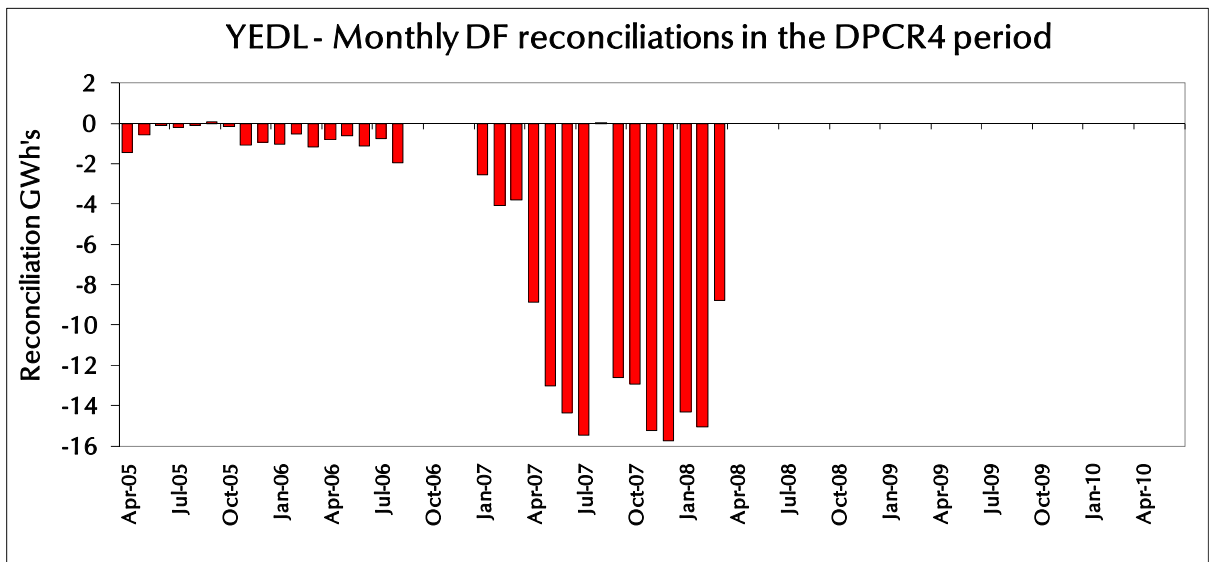
33 Figures 3 and 4 show a consistent seasonal pattern to the reconciliation movements but the magnitude of the reconciliation movements has steadily increased throughout the DPCR4 period. The more recent reconciliation movements appear lower because not all of the reconciliation runs have been completed for those months.

34 Furthermore, CE has identified a surge in dispute final (DF) movements driven by supplier data management activity that is highly unusual. This is shown in figures 5 and 6 below.

**Figure 5 – NEDL DF reconciliation movements**



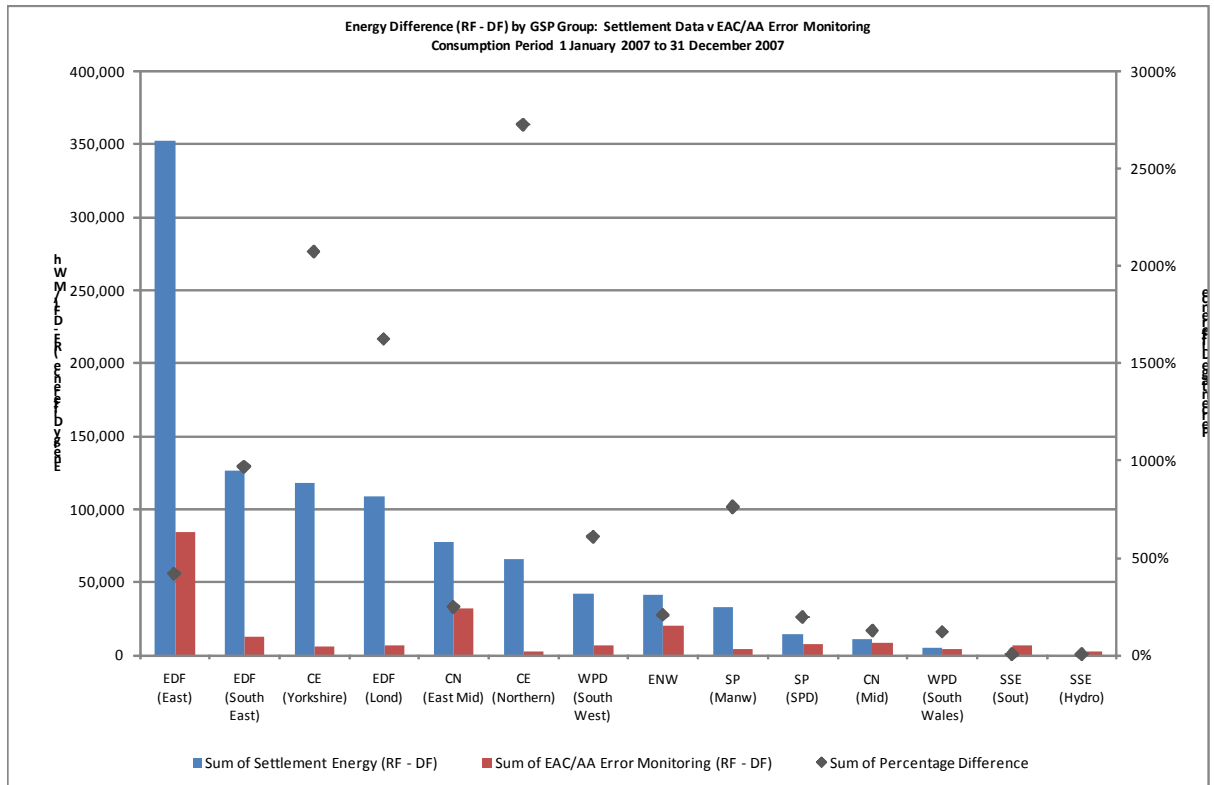
**Figure 6 – YEDL DF reconciliation movements**



35 Figures 5 and 6 show that the level of DF reconciliation movement remained stable and relatively low throughout most of the DPCR4 period until May 2009 when we received the DF reconciliations for January 2007 and the level of movement significantly increased. Coincidentally in May 2009 there was a meeting between Elexon and suppliers where the use of GVC was discussed.

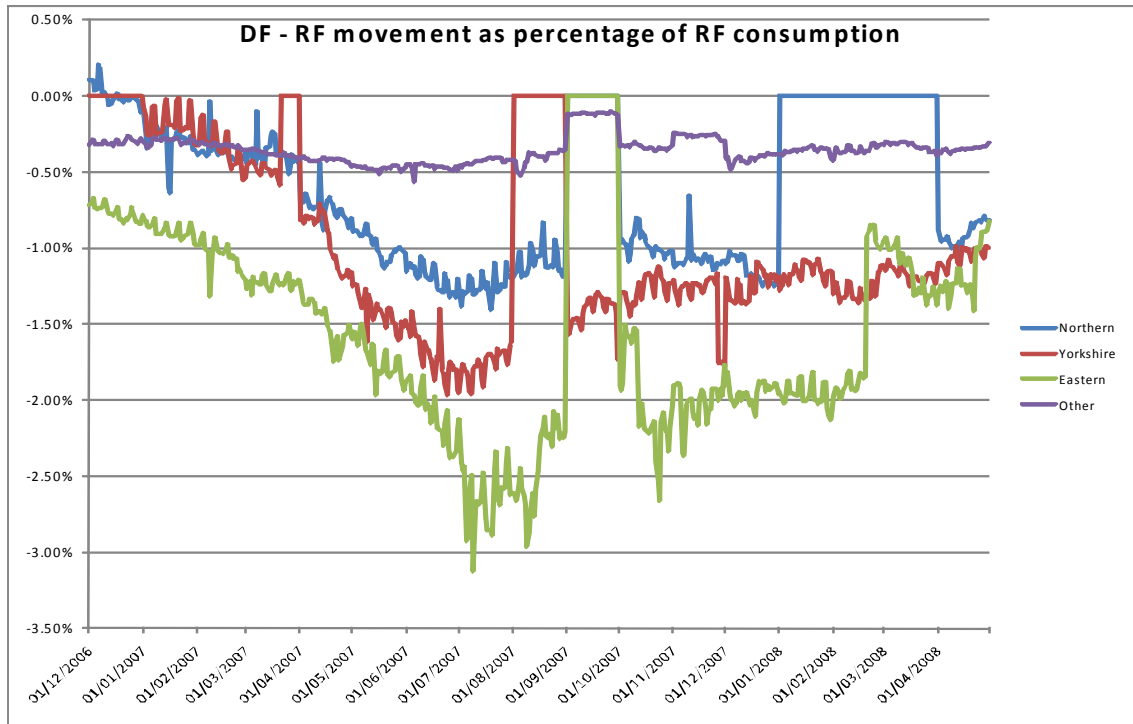
36 Very early in our discussions Exelon confirmed that the reconciliation movements between RF and DF have been much higher than it had expected. This is shown in figure 7 below, which has been provided by Exelon, where the red bars indicate the level of movement Exelon expected to happen between RF and DF based on its monitoring of large supplier volume allocations and the blue bars show the level of actual movement occurring between RF and DF. The diamonds indicate the percentage difference; as the blue bars exceed the red bars the level of movement is above Exelon's expectations.

**Figure 7 – Exelon comparison of expected and actual reconciliation movements between RF and DF**



37 The chart in figure 8 below clearly shows that three distribution areas have been more significantly affected by movements in the DF reconciliation run, particularly covering the consumption period 1 December 2006 to 31 November 2007 which was processed during 2009/10.

**Figure 8 DF reconciliation movement relative to the RF position for the consumption period**



38 Our understanding, which has been built up during our investigations and our discussions with suppliers, is that most of these changes reflect longstanding data integrity issues that date back to before DPCR4. Suppliers have informed us that they have made corrections for errors that occurred prior to the start of the DPCR4 period. In the case of [\*], we have been told by [\*] managers that tracking back to the source of the errors is impossible, since the supplier changed its billing systems towards the end of the DPCR3 period and the historical records are no longer retained.

39 Suppliers' initial responses when we raised these matters in discussion were sometimes to say that the distributor had benefited from lower reported losses before the error was corrected and therefore the correction was neutral over a period of time. However, in reality, because the errors existed in many cases prior to the start of the DPCR4 period the error was included in the data from which our DPCR4 targets were calculated.

Therefore, as the error would have been in both the target and the reported actual numbers, the distributor gained no additional losses benefit from the error.

*The use of the GVC facility*

40 Elexon became concerned about the use of a facility within the settlements system known as GVC. Although Elexon does not hold disaggregated data on GVC, it believes that the recent exceptional movements in settlement reconciliations may arise from the increased use of this facility by some suppliers.

41 Although distributors have no visibility of the underlying data, our discussions with the three suppliers referred to above confirm Elexon's hypothesis that the use of the GVC facility largely explains the significant changes in settlement reconciliations. We have been unable to find any other facility within the settlements processes that has the potential to be used on such a scale as to produce the changes that we have observed. However, one supplier has told us that GVC is only one of many mechanisms that can be used to change settlements data relating to SVAs.

42 Elexon has described GVC as follows:

'GVC is a technique used to correct errors relating to Meter Advance Periods during which some Settlement Dates have already been subject to a last reconciliation run (whether a Final Reconciliation or Post Final Settlement Run) - i.e. where part of the error has "crystallised" in Settlement. It applies the principle that the total gross volume of energy for a given Metering System should be correct. Where energy has been misallocated to a range of Settlement Dates within a Meter Advance Period which have passed through the last reconciliation run, GVC can be applied to reallocate the lost or gained energy volume to a range of Settlement Dates which have not yet been subject to a last reconciliation run – termed the "fluid" period. This process ensures that the total gross volume of energy is correct, although allocated to the wrong Settlement Dates/Settlement Periods.

GVC was introduced in March 2000 as a technique to address errors due to erroneous Large EACs and AAs<sup>3</sup> in Settlement. Its use was later described in BSCP504 Section 4.14. Today GVC use is much broader. Under the current arrangements it can be used to address almost any NHH consumption error, *no matter how old*, and as such is a very powerful technique. GVC was introduced at a time when electricity prices were fairly constant, and the financial impact of settling energy in an incorrect Settlement Period was relatively low. Electricity prices since have not only become far more volatile but have also risen dramatically. As a result the impact is far greater, particularly (for example) energy taken in Settlements Periods in excess of 5 years ago is settled at today's market prices.' (Emphasis added.)<sup>4</sup>

- 43 In August 2009 Elexon took steps to apply controls to the use of GVC and as a result a change was made to the BSC that applied some restrictions to its use. The decision to apply new constraints to the use of GVC was confirmed in October 2009 but the effective date of the application of the new rules was 1 March 2010. The rule change appears to have provided an impetus to those suppliers that were making extensive use of GVC to increase their use of the technique in those circumstances where it would soon cease to be applicable. However, it should be noted that the facility has not been withdrawn and its continued availability has implications for the close-out of the distribution losses incentive in the DPCR4 period, the setting of the losses targets for the DPCR5 period and the calculation of losses in the DPCR5 period.
- 44 For the purposes of this request the key points to note about the increased use of GVC are:
- under the arrangements that prevailed until 1 March 2010 GVC could be used to address almost any non-half hourly consumption error, *no matter how old*;
  - GVC results in adjustments to the energy attributed to suppliers appearing in a settlement period that is still open in order to compensate for a historical period,

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<sup>3</sup> Annualised Advances.

<sup>4</sup> Elexon, Draft Change Proposals – BSCP40/01.

after DF, where readings are now crystallised (i.e. a period in respect of which the readings cannot be changed);

- at least one large supplier [\*] believes that the rule change relating to GVC does not restrict a supplier's ability to make retrospective GVC adjustments, but merely removes the opportunity for suppliers to request GVC at DF; and
- large-scale corrections, spanning many years, may be compressed into the 2009/10 settlement runs, thus concentrating the effect into a single regulatory year.

45 As a result, unless the Authority agrees to NEDL's and YEDL's using a different basis for the calculation of  $AUD_t$  in respect of the relevant year 2009/10:

- the reported losses performance and revenue driver of NEDL and YEDL will be adversely affected, giving rise to over-recoveries of £9.773m and £21.412m respectively in that relevant year;
- the licensees will be unable to distinguish between losses that occurred in the DPCR3 and DPCR4 periods and will be unable to apply the correct incentive rate to the losses that are now being reported;
- the targets for the DPCR5 period will be distorted by the abnormal data in respect of 2009/10;
- the reported outturn in the DPCR5 period will continue to be distorted by the continuing use of the GVC facility; and
- the purpose of the DPCR5 losses incentive cannot be met and would result in a perverse incentive on NEDL and YEDL to reduce the specification (and therefore the cost) of new plant and equipment being added to the system during the DPCR5 period (resulting in higher losses), since the losses incentive would be driven to its (penalty) collar.



**PRECEDENTS RELEVANT TO THIS REQUEST**

- 46 We are not aware of any previous occasions on which a licensee has asked the Authority for its consent to allow the licensee to change the basis on which it calculates any component of adjusted distribution losses. There are therefore no direct precedents that we are aware of that relate to the giving of a consent under paragraph 9 of the DPCR4 Losses Condition.
- 47 We have, however, looked at all of the cases of which we are aware in which the Authority has considered the resetting of the ALP term either by direction under paragraph 7 of the DPCR4 Losses Condition or by a modification of the ALP term by the licence modification process set out in section 11 of the Act. Our review confirms that this request is consistent with the previous decisions of the Authority.
- 48 The decisions in these cases make clear that the Authority has considered and determined a number of points that raise issues that are relevant to this request, notwithstanding the fact that this request relates to the exercise of the power to give consent to a change in the basis of the calculation of one component of adjusted distribution losses rather than the express power to reset targets. These precedents are considered below.
- 49 We have considered the following cases in which Ofgem had to consider whether it was appropriate to reset the ALP term of the DPCR4 Losses Condition:
- in July 2006 Ofgem used its power of direction under paragraph 7 of the DPCR4 Losses Condition to reduce the ALP of United Utilities Electricity plc (the UU decision);
  - in June 2007 Ofgem used its power of direction under paragraph 7 of the DPCR4 Losses Condition to reduce the ALP of Southern Electric Power Distribution plc (the SEPD decision);
  - in February 2006 modifications were made to the DPCR4 Losses Condition of SP Distribution Ltd (SPD) and SP Manweb plc (SPM) using the procedure set out in Section 11 of the Act. The effect of these modifications was to reduce the ALP of each licensee (the SP 2006 decision);

- in July 2009 the Authority rejected a request made by ScottishPower EnergyNetworks for the ALPs that had been set in the SP 2006 decision to be revised upwards to take account of reported and projected performance since the SP 2006 decision (the SP 2009 main ALP decision);
- also in July 2009 the Authority agreed to the request made by ScottishPower EnergyNetworks for the ALPs set in the SP 2006 decision to be adjusted to correct an error in respect of EHV units (the SP 2009 EHV units decision); and
- also in July 2009 the Authority rejected a request made by ScottishPower EnergyNetworks for the DPCR4 LRRM to be disapplied with respect to SPD and SPM (the SP 2009 LRRM decision).

50 The salient points from each of these cases that have relevance to CE's request are considered in paragraphs 51 to 81 below.

***Procedural issues***

51 In each of the cases referred to above it was possible for the ALP term to be reset to better achieve the stated purpose of the condition. It is no longer possible to modify the DPCR4 period ALP term, whether by direction or by licence modification under section 11 of the Act, because the DPCR4 Losses Condition no longer operates as a forward-looking incentive mechanism. Although it would be possible to achieve the same effect by an alteration to the DPCR5 losses incentive condition, for the reasons set out in paragraphs 9 and 10 above, it is in our view more appropriate to use the consent facility in paragraph 9 of the DPCR4 Losses Condition.

52 We note that, with the exception of the cases involving SPD and SPM, the powers were exercised by the appropriate senior member of staff at Ofgem rather than by the Authority.

***The correction of errors in the data set on which the DPCR4 targets were based in the UU decision, the SEPD decision and the SP 2009 EHV decision***

53 Both the UU decision and the SEPD decision were relatively straightforward. In both cases the ALPs were reduced because the licensee concerned had informed Ofgem that

it had identified specific data issues which showed that the original ALPs had been incorrectly calculated. In this respect the SP 2009 EHV decision was also similar.

- 54 In each of these cases changes were made to the ALP to ensure that it was set at the level that it would have been set at had the errors in the data not been present when the original targets were set.<sup>5</sup>
- 55 To the extent that the recent changes in SVAs that CE has witnessed represent the correction of longstanding data errors that were present in the data set on which the DPCR4 period targets were derived, there is a clear parallel between CE's request and the UU decision, the SEPD decision and SP2009 EHV decision. If the data changes that have featured in SVAs since May 2009 have the effect of correcting errors that were present in the data set used to set the DPCR4 targets, the reported losses would have been higher and the ALPs for NEDL and YEDL for the DPCR4 period would also have been higher. The giving of the consent sought in this request, therefore, would be entirely consistent with the principles that guided Ofgem's behaviour in the UU decision, the SEPD decision and the SP 2009 EHV decision.

### *The SP2009 main ALP decision*

- 56 The circumstances that gave rise to the cases involving SPD and SPM were such that Ofgem has set out more fully the reasoning behind the judgements that it reached in those cases. Although the circumstances giving rise to CE's request are very different we have nevertheless formulated our request having regard to the principles delineated by Ofgem in its publications relating to the SPD and SPM cases. CE's request is entirely consistent with the principles set out by Ofgem in its decision in those cases.
- 57 Ofgem's thinking is most clearly set out in the impact assessment and consultation issued on 3 March 2009 entitled *Electricity Distribution Allowed Loss Percentage – Representation by ScottishPower EnergyNetworks* (the *SP Impact Assessment*).
- 58 Paragraph 5.3 of that publication summarises the key considerations behind the decision that the Authority was minded to take:

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<sup>5</sup> There was a complication in the SEPD decision where the constraint on the date from which the target could be varied meant that to achieve the correct economic impact the effect of the change had to be concentrated into tougher targets for the remaining period of the price control rather than specifying the targets that would have applied throughout the period had the information been available when the targets were set.

- i. There should be comparison of “like with like”. The basis used to set the benchmark level of losses for a DNO should be sufficiently equivalent to the basis used to calculate the out-turn loss levels which are compared to that benchmark
- ii. The data used to set the benchmark and measure out-turn performance should be sufficiently accurate
- iii. The approach to setting benchmark losses and measuring performance should be “even handed” as between different DNOs with any differences in treatment being objectively justified’.

59 We address each of these considerations below.

*Targets and methods on a like-for-like basis*

60 CE’s case is based on the Ofgem guiding principle that the basis on which the targets were set should be consistent with the basis on which performance against the target is subsequently reported. Ofgem has expressly, or implicitly, been guided by this consideration in all of the cases in which ALPs have been reset. The purpose of the resetting has in each case been to re-establish consistency between the targets and the reported performance of the licensee. This consideration is reflected in the criteria set out in paragraph 7 of the DPCR4 Losses Condition which introduces the test of whether there has been a material change (whether an improvement or deterioration) in the quality of the information used to derive adjusted system entry volumes or adjusted units distributed. Note that this guiding principle is directed not at ensuring that the most accurate data is used for the purposes of operating the losses incentive under the condition, but at ensuring that there is consistency between the methods in use when the targets were set and the reported performance: otherwise there would be windfall gains or losses that would arise simply because of an inconsistency between these two components of the incentive mechanism. This principle was reinforced in the consideration given to the DPCR4 LRRM at DCPR5. Ofgem was mindful that:

‘DNOs should only be rewarded based on actual changes in performance’<sup>6</sup>

and

‘We do not want to reward or penalise DNOs for changes in losses that arise from the change in reporting methodology. We therefore need to adjust the net LRRM incentive accordingly.’<sup>7</sup>

- 61 CE has shown that the changes in the SVAs that have been introduced since May 2009 are on a scale that makes it quite clear that, irrespective of whether the adjusted data is more or less accurate than the data prior to its adjustment, the adjusted data set now incorporates adjustments that were not present in the data set that was used to set the DPCR4 targets.
- 62 Since it is not now appropriate to reset the *targets* to take account of this change, CE contends that it is appropriate to change the basis on which adjusted distribution losses are calculated so as to remove the adjustments and to restore the consistency with the behaviour of suppliers when the DPCR4 targets were set. Failure to do so would give rise to a windfall loss that would be as unjustifiable as the windfall gain that Ofgem believed would accrue to ScottishPower EnergyNetworks had it not adjusted the ALPs in the SP 2006 decision. In relation to that decision Ofgem did not contend that ScottishPower EnergyNetworks’ new method of calculating adjusted distribution losses was *inaccurate*; it contended that the targets had been set on a basis that was inconsistent with the new method of calculation and, therefore, consistency required that the targets be reset.
- 63 CE finds itself in an analogous position, except that the inconsistency, if left uncorrected, will have a material adverse effect on the CE-owned licensees, whereas in the ScottishPower EnergyNetworks case the inconsistency would have benefited the licensee.
- 64 It should be noted that CE is seeking the consent of the Authority prior to the making of a change to the basis on which adjusted distribution losses are calculated. The *SP Impact Assessment* suggests that Ofgem supposed that ScottishPower EnergyNetworks did not seek this consent before changing its methodology.

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<sup>6</sup> DPCR5 *Final proposals – incentives and obligations*, paragraph 7.16.

<sup>7</sup> DPCR5 *Final proposals – financial methodologies*, paragraph 4.23.

*Accuracy of data*

- 65 The second consideration that guided the Authority in the ScottishPower EnergyNetworks cases was that the data used to set the benchmark and measure out-turn should be sufficiently accurate.
- 66 We are not at this stage able to state categorically whether the data that reflected the behaviour of suppliers at the time when DPCR4 targets were set or the data that includes the recent material adjustments that is now being reported under the settlement system is the more accurate data set to use in determining rewards and penalties under the DPCR4 Losses Condition.
- 67 Perhaps this will become clear as Ofgem's own investigation proceeds. For the purposes of this request it does not matter which data set is the more accurate because the key consideration is that the performance should be measured using a method that is consistent with the behaviour of suppliers when the DPCR4 targets were derived.
- 68 However, it is important that we address the issue of whether the adjustments to the data that we have shown above represent merely short-run volatility within settlements data or whether it is indicative of a systematic change that is likely to impose undeserved penalties on NEDL and YEDL on an enduring basis.
- 69 It may be suggested that the adverse movement in losses seen in the reported data for 2009/10, whilst unrepresentative of the performance in that year, should be allowed to stand because it represents the correction of windfall gains that arise from an understatement of losses in earlier years. This would not be a correct view. In evaluating this aspect of the situation it is important to bear in mind that many of these changes relate to longstanding errors, such as long-term vacant properties. The losses targets for the DPCR4 period were set on the basis of reported losses that had not been disturbed by the recent supplier activity. What matters in terms of distributor performance and obligations is that the reported performance is measured on a basis that is as close as possible to the methods in place when the targets were set. Even if it can be established that the 2009/10 data includes losses from prior years, the discontinuity between the methods in use when the targets were set and the way that suppliers have adjusted prior years' data would justify a change to the method of calculation of the 2009/10 losses performance. We have also modelled the effect of

changes such as this and have confirmed that the combined operation of the DPCR4 losses incentive, the DPCR4 LRRM, the DPCR5 targets and the DPCR5 reported performance will (all other things being equal) result in the CE-owned distributors suffering a financial penalty in both nominal and NPV terms. In short:

- the DPCR4 targets did not allow for the changes in suppliers' behaviour; therefore
- the DPCR4 reported losses will move adversely (relative to the DPCR4 targets); and
- the DPCR4 LRRM will interpret the profile of performance as one of deterioration since losses that would have been reported early in the DPCR4 period are concentrated in the later years.

As far as DPCR5 is concerned:

- the DPCR5 target will be based on an average of the DPCR4 actuals; so
- the negative impact of the changes is diluted in the target to the extent that the adjustment does not cover the whole of the DPCR4 period; whereas
- the negative impact of the change will be reflected in every year's reported losses in DPCR5.

***Evenhanded approach as between licensees***

70 The circumstances that led to the SP 2009 main ALP decision and SP 2009 LRRM decision were such that the Authority had to consider whether, in rejecting the ScottishPower EnergyNetworks requests, it was meeting its obligation to be even-handed between licensees.

71 The circumstances in which ScottishPower EnergyNetworks' ALPs had been reset in 2006 were very particular to ScottishPower EnergyNetworks and appear to have weighed heavily in the Authority's consideration of the request from ScottishPower EnergyNetworks.

72 Nevertheless the consideration of evenhandedness between licensees is relevant to CE's request.

73 In this respect it must be remembered that during the DPCR4 period (and prior to that) there was no common methodology for the measurement of electrical losses by the distribution network operators (DNOs). Consenting to a change in the methodology used by NEDL and YEDL would therefore not have the effect of allowing those two licensees to depart from a method of measurement that otherwise would be common to all the DNOs in the DPCR4 period; it would not therefore offend against the principle of evenhandedness.

74 Furthermore, it is clear from the analysis presented (particularly in the charts that appear at figures 7 and 8 above that the changes in SVAs that NEDL and YEDL have witnessed are on a scale that is not generally occurring in the sector. This appears to derive from the fact the changes in SVAs that are giving rise to the spike in losses witnessed by CE are the result of supplier behaviour and not all suppliers have the opportunity, or perhaps the intention, to embark upon the kind of programme that [\*] has embarked upon. [\*].

75 [\*].

76 The consideration that Ofgem should be evenhanded between distribution licensees means that the desirability of there being consistency between the methods in use when the targets were set and the methods in use when measuring performance against those targets requires that special steps must be taken where one DNO group is more likely to be disadvantaged than others by the introduction of any inconsistency. On the other hand, the circumstances of NEDL and YEDL appear to be different from those of most - possibly all - DNOs. CE's request does not, therefore, introduce a significant risk that the giving of a consent to NEDL and YEDL would introduce 'regulatory uncertainty' of the kind that Ofgem identified as undesirable in the *SP Impact Assessment*.

***Ofgem's observation on the circumstances in which price controls, or their components, may be reopened or adjusted***

77 Ofgem has set out its view that allowing reopeners of price control settlements is generally undesirable because to do so may 'reduce the onus on DNOs to manage their



costs and forecasts accurately’ and it is therefore not something that Ofgem would do lightly. With this consideration in mind Ofgem states that:

‘Generally speaking, we believe that there would have to be clear, evidence based reasons to reopen elements of a price control, even where a specific mechanism is provided within the charge restriction conditions of a licence. This is important in the context of providing “regulatory certainty”.’<sup>8</sup>

- 78 We agree that the tests that must be satisfied before a price control is reopened should be onerous. However, CE considers that this request advances the ‘clear, evidence based reasons’ to which Ofgem refers in its statement about reopening elements of a price control. Moreover, this request does not relate to the resetting of the price control or even to the targets set out in that price control. It relates to the basis on which the performance against those targets should be measured so that performance and targets are consistently based. In the respect it is more accurate to regard the consent as being necessary to fulfil the purpose of the DPCR4 price control settlement than to regard it as a reopener of the price controls or the resetting of the losses target established by that settlement.
- 79 In this connection it should be noted that the consent facility is expressed in the DPCR4 Losses Condition as a (potential) relief from a constraint. The constraint is the obligation to calculate each component of adjusted distribution losses on a basis that does not differ from the basis that was used by the licensee in 2002/03. The purpose of the wording of the constraint is to ensure that performance is reported on a basis that is consistent with the basis of calculation that applied when the targets were set. The assumption behind the drafting is that the freezing of the methodology at the year 2002/03 – the last year in the series from which the average used for the purpose of setting the DPCR4 targets was derived - is sufficient to secure this policy intent. CE’s request for a consent to vary its methodology is entirely consistent with the underlying purpose of the constraint in paragraph 9 of the DPCR4 Losses Condition because it is now necessary to vary that methodology to secure consistency between the methods in place when the targets were set and the reported performance of the licensee. The giving of the consent being sought by CE therefore better serves the underlying purpose of the constraint.

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<sup>8</sup> *SP impact assessment* paragraph 5.36.

*Ofgem's observations on the responsibility of a licensee to notify Ofgem promptly where discontinuities arise*

- 80 Finally, we note from the *SP Impact Assessment* that Ofgem has attached importance to whether or not the matter should have been visible to the licensee when the relevant decision was made (i.e. when the targets were set).<sup>9</sup> In CE's case, we were unable to see the potential for discontinuity between behaviour of suppliers when the targets were set and the behaviour of suppliers as it affected reported performance for the simple reason that the discontinuity arose from changes in supplier behaviour that were not apparent until March 2010. Once it became clear that something unusual was occurring CE made enquiries of the relevant suppliers and raised the matter promptly with Ofgem.
- 81 This request does not propose to vary any of the terms of the DPCR4 Losses Condition, neither does it propose that the target allowed loss percentage set out on the face of the condition should be varied. Instead, this request proposes that the Authority makes use of a facility included as part of the DPCR4 settlement and which appears within the licence condition that was implemented to give effect to that settlement with specific reference to losses. The giving of a consent under paragraph 9 of the DPCR4 Losses Condition is therefore perfectly consistent with the DPCR4 settlement. The exercise of such a power was anticipated when that settlement was reached and CE contends that the use of this facility will ensure that the reporting of the losses performance of NEDL and YEDL will be consistent with the assumptions that were made when the targets were set as part of the DPCR4 settlement.

**DERIVING AN ALTERNATIVE METHOD OF CALCULATING ADJUSTED UNITS DISTRIBUTED IN 2009/10**

- 82 Having established that there has been significant supplier activity that has the effect of introducing a systematic discontinuity between the basis on which the NEDL and YEDL DPCR4 losses targets were set and the basis on which losses in 2009/10 are now being reported, we turn our attention to the changes that should be made to CE's method of determining adjusted units distributed in 2009/10.

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<sup>9</sup> *Ibid* paragraph 4.7.

- 83 The issue here is that routine changes to settlement data by suppliers are a perfectly legitimate part of the settlement process and of the behavioural norm of suppliers that prevailed when the DPCR4 targets were set. If the intensity of those programmes had remained unchanged, there would be no material inconsistency. It is the significant step change in the volume of activity and, in particular, the adjustment to long-standing data problems that creates the distortion, since the underlying assumption that the effect of supplier changes would be a constant within a price control period is invalidated.
- 84 The purpose of the change to the basis of calculation should be to restore consistency between the behaviour of suppliers when the targets were set and the reported performance of the licensee against those targets. To do this it is necessary to quantify the amount by which the changes in suppliers' behaviour that have been seen since the targets were set have affected (and will continue to affect) the data as reported in the settlements process.

***The prospect of achieving MPAN by MPAN correction and the need for (at least) an interim position for 2011/12 charge setting***

- 85 The ideal adjustment to the data reported so far would be one that would analytically identify the impact of the *change* due to supplier data management programmes and the use of GVC and isolate its effect on the entire set of historical data, leaving the data set that would have been the result of no change in behaviour – i.e. the result that is measured in a manner consistent with the way that the targets were set.
- 86 We understand that Ofgem has issued an information request to suppliers asking for data that may help it to reach a view that would enable, MPAN by MPAN, the impact of the change in suppliers' behaviour to be quantified. CE acknowledges that, if a complete data set can be provided by suppliers to Ofgem, it may be possible to quantify precisely how the change in suppliers' behaviour has affected reported performance since the targets were set. However, to do so would also require all corrections triggered (some by CE) during DPCR3 and DPCR4 to be rolled back to their inception in order to ensure a proper balance between upward and downward adjustments to units distributed.
- 87 The best that can be hoped for is that some meaningful assessment of these quantities can be achieved. CE's own inquiries of suppliers give strong reason to doubt that

suppliers will be able to provide sufficient data to enable this calculation to be carried out with any sort of precision. If it can be done at all, it will certainly take a long time to carry out the necessary analysis of the data that Ofgem has requested. We should proceed on the assumption that the results of Ofgem's inquiries may enable it to reach an exact and decided view on this by the time the close-out of the DPCR4 LRRM (and the target setting for DPCR5) has to be determined after the end of August 2011.

88 However, it is certain that, whatever opportunity there may be to carry out a precise calculation of the impact of the changes in suppliers' behaviour within that timescale, there is no prospect that such a calculation could be made within the timescales necessary to incorporate the consequences of that judgement within the assumption that must be made for the setting of use of system charges to take effect in April 2011.

89 It follows that, at least for the time being, something other than an MPAN by MPAN approach must be used to determine the adjustments that should be made to the data being received from the settlements system for the purposes of preparing a (revised) SLC47 return in respect of 2009/10 on which the 2010/11 use of system charges can be based.

*Adjustment based on the best data available to CE*

90 CE does not have access to MPAN by MPAN consumption data for the period concerned and suppliers have been unable or unwilling to share any detailed data set with us. The data that CE does have available to it is:

- settlement data received in its capacity as a distributor; and
- analysis provided by Elexon of the volume of adjustment that would normally be expected at the DF settlement run compared to what has been seen.

91 The fact that there has been such a marked increase in the adjustments being made by suppliers becomes an important feature in the adjustment that we are proposing. The charts included at figures 5 and 6 show quite clearly that a step increase occurred. The dates upon which these increases are observed tie very closely to what we have been told by [\*]. This is helpful in that it gives us confidence to view the settlement data that preceded the inception of those changes as being much more consistent with suppliers'

behaviour when the targets were set for the DPCR4 period. In other words, we have strong data-driven and corroborated evidence that:

- there has been only one step change in the data;
- it occurred in early 2009;
- the change has persisted up to the present day; but
- data flows for four years of the DPCR4 period are representative of the normal pattern of supplier data corrections with which we are seeking to be consistent.

92 Therefore, we have broken our data sets down to allow us to use the pre-2009/10 data as a reference data set, to which we can compare the 2009/10 data and make proposals to adjust the raw data in order to achieve a level of consistency that is properly reflective of the requirement. We will explain the various options that we have considered and the logic that has led us to our proposed method.

93 In making this proposal, CE has used the best information that it has at its disposal. We have consulted with Elexon and with other industry experts and, although it is not reasonable to suggest that anyone else is in a position to validate all of our work, it is certainly true to say that the response that we have received has consistently confirmed that it is hard to envisage a better alternative to using established settlement data norms as the reference point.

94 Furthermore, CE believes that the adjustments that Ofgem may now consider appropriate to enable CE to prepare a revised SLC47 return for 2009/10 on a basis that is consistent with the behaviour of suppliers at the time when the DPCR4 targets were set, would also be appropriate in the final calculation of entitlement under the DPCR4 LRRM (and in the determination of targets for, and reported performance in, the DPCR5 period) in the absence of a better alternative. However, it is not necessary to prejudge that decision at this point. This request, therefore, relates only to the basis on which adjusted units distributed are calculated in 2009/10 for the purposes of the annual losses incentive under the DPCR4 Losses Condition and for the purposes of the unit-driver component of the growth term.

*The baseline from which we start - July 2010 (SLC47) annual losses incentive position*

95 Table 1 shows the losses incentive values reported in the SLC47 returns made in July 2010 and the forecast of 2010/11 over-recovery submitted on 31 October 2010 in Template B (as required by paragraph A6(b) of SLC47. Assuming that no SLC47 return restatement is made and assuming no other revenue profiling changes, the impact on allowed income for the year 2011/12 arising from the carried forward correction factor ( $K_t$ ) would be a reduction of £12.6m (plus interest) in respect of NEDL and £22.7m (plus interest) in respect of YEDL.

**Table 1 – Current reported position (based on July 2010 SLC47 return)**

<b>£m</b>	<b>NEDL</b>	<b>YEDL</b>	<b>CE</b>
<b>2009/10 losses annual incentive – <math>IL_t</math></b>	<b>(-)13.196</b>	<b>(-)21.470</b>	<b>(-)34.666</b>
Sum of DPCR4 annual losses incentives	(-)2.099	14.180	12.081
2009/10 over-recovery (a)	9.773	21.412	31.185
Base interest on 2009/10 over-recovery (0.563% $I_t$ ) (b)	0.055	0.121	0.176
Penalty interest on 2009/10 over-recovery if applicable (1.500% $PR_t$ ) (c)	0.147	0.321	0.468
Correction included in 2010/11 allowed income – $K_t$ (a + b + c)	9.974	21.853	31.828
<b>2010/11 over-recovery forecast</b>	<b>12.626</b>	<b>22.725</b>	<b>35.351</b>

*Validating the historical data set (pre-2009/10) as being a reliable reference set*

96 As part of our assessment of this issue, we have run a large number of different permutations of adjustments. In order to get some level of comfort that our own historical data set produces reasonable results when used as the reference point, we consulted Elexon and asked it what it could offer by way of an alternative reference point.

97 Elexon helpfully shared with us the results of its own calculation that establishes what it would expect as a credible level of change in the late stages of the settlement process. The Elexon large EAC/AA monitoring data used to produce the chart in figure 7 above provides an assessment of the level of movement Elexon expects to see in the DF reconciliation run. Therefore, it could be presumed that any movement above that level of movement has been caused by supplier data corrections. Although the type of

supplier behaviour that we are observing will affect the consistency of settlement data at every stage, it has proved useful to be able to gain an alternative reference point for the reconciliation series that we strongly expect has been most significantly distorted by the suppliers' changes.

- 98 We have compared the results of:
- a. normalising the 2009/10 DF data to the norms set by our own historical settlement data; and
  - b. simply constraining the DF data flows received in 2009/10 to the maximum that Elexon told us it would view as reasonable.
- 99 We found the outcome of the two processes to be broadly consistent. The reduction in the 2010/11 over-recovery forecast compared to the baseline position established in our SLC47 statement as a result of applying method (a) was £13.8m and as a result of applying method (b) it was £10.9m. In evaluating this result, we noted that the normalisation method created a more favourable outcome for CE and we also could not ignore the reality that in the Elexon projections we have access to (what may be the only) third party, independent assessment of what would be regarded as 'normal'. The conclusion that we drew from the differential between the two methods is that our historical data contains a small, but nevertheless greater than 'normal', amount of positive reconciliations. So we examined the effect of simply disregarding the DF data flow for the reporting period 2009/10. This resulted in an outcome of £11.4m that was within £0.5m of the Elexon-based projections of £10.9m. Ideally, we would have been able to apply an Elexon-based expectation to all of the other settlement runs, since all of those runs have also been affected by the supplier behaviour. However, Elexon does not have the data necessary to do this. Nevertheless, these tests provide us with a significant amount of comfort that there is scope to make straightforward and auditable adjustments to the actual data that has been received and, in so doing, to create a movement in the outcome that is very consistent with a verifiable external point of reference.

***Establishing the scope of the adjustments to be made***

- 100 From what we see in the Elexon data and what we have learned from Elexon and our discussions with [\*], we can be confident that the DF data set is the most significantly affected (on its own it accounts for around one third of the sharp movement that we have seen in the 2009/10 data). Early in our considerations we contemplated making an adjustment to DF only. However, we quickly became certain that merely adjusting the DF data would not cover all of the movements that result from supplier data activities. In particular, [\*]'s supply business told us during the course of our investigation that its data correction activities have resulted in changes in the RF reconciliation rather than the DF reconciliations.
- 101 Although the late stages of the reconciliation data have seen the most marked changes, if we were to normalise only these data flows this would not take into account any of the knock-on changes in the R3, R2 and R1 reconciliation runs that would also result from the same situation where a supplier corrects a long-standing error in settlement. The GVC adjustment at RF or DF might be used to make a correction for the crystallised period but the act of carrying out the adjustment will also create reconciliations in the uncrystallised period that also contribute to the quantum of inconsistency that exists relative to the baseline that was set by the DPCR4 targets.
- 102 Having validated our understanding (in discussion with suppliers, Elexon and other industry experts) that the impact of corrections to long standing errors such as long-term vacant properties would affect *all* stages of settlement reconciliation, we proceeded to evaluate the impact of carrying out a more comprehensive set of normalisation adjustments.

***The options for normalisation***

- 103 For any given series of settlement data, we considered the options of:
- leaving it untouched;
  - normalising it to the average amount seen in the reference data set;
  - constraining the magnitude of the change applied by reference to the reference data set; or
  - disregarding the data flow altogether.



104 We ran many permutations of the possible options and considered the underlying implications of applying each of the different treatments to establish what might be regarded as a best-fit solution. Our conclusions are set out below.

*The treatment of SF data*

105 We quickly established that the appropriate thing to do with the SF data was to leave it untouched. Although the supplier behaviour could be argued to create a distortion in that data set that would be removed if a ‘perfect’ solution could be found, the implications of adjusting SF seemed to us to have significant disadvantages – most notably that the restated method would tend to override any fundamental change in overall consumption levels.

*The treatment of DF data*

106 At the other end of the settlement period is the DF data set, which we know to have been the most significantly affected. In our discussion with Elexon, Elexon was quite clear that it did not consider our DF data set to be fit for the purpose of calculating losses. Historical levels of DF have been very low and sometimes positive; as such, we are proposing to disregard the DF data set altogether for the purposes of this adjustment.

*The treatment of RF data*

107 It is clear from our discussions with suppliers that the RF data set has also been significantly affected by the adjustments that have been described in this request. Accordingly we propose to disregard the RF data set altogether for the purposes of this adjustment.

108 In between the SF data and DF and RF runs are the primary reconciliation runs, R1, R2, and R3. It is clear that there is no case for removing any of these runs in their entirety as they are the product of the mainstream settlement processes in which all suppliers are supposed to secure the final accurate reading (noting that DF data flows were originally meant to be used as part of a properly formulated settlements dispute, a practice that is now being circumvented by the use of GVC at DF).

109 Accordingly, the options considered for these data flows were either normalising them to the average of the years 2005/06 to 2008/09 or applying some kind of constraint to

the extent to which that normalisation could be taken. We opted for normalising based on the average, rather than constraining the change because using an average derived from past behaviour has more objective merit than the selection of an arbitrary constraint.

***The proposed adjustment***

110 A method that normalises all the data after SF appears, at face value, to have some obvious merits, not least its coherence and its simplicity. However given the relatively wide range of plausible outcomes and the unusual nature of the circumstances we think that it would be reasonable for Ofgem to expect us to propose a method that includes a reasonable amount of prudence in favour of customers.

111 On balance, we are proposing a method that incorporates that degree of prudence and uses the best information available to us. It amounts to a hybrid of these approaches, where:

- SF remains unchanged to ensure that overall levels of consumption are reflected through into the final outcome;
- R1-R3 are all normalised by taking the arithmetic average of the reconciliation movements from the years 2005/06 through to 2008/09 to reflect the fact that the effects of the unusual supplier activity would have a knock on effect on the more recent consumption values (either estimated or actual) which are used the earlier reconciliation runs;
- RF and DF are disregarded and set to zero to reflect the obvious dominance of the unusual supplier activity on these historically low volume settlement runs.

112 These changes would restate the losses incentive outcome for 2009/10 to be £0.1m for the CE licensees ((-)£2.2m in NEDL and £2.3m in YEDL). The overall impact on allowed income for the year 2011/12 arising from the recalculated carried forward correction factor ( $K_t$ ) would be a reduction of £1.4m (plus interest) in NEDL and an increase of £1.6m (plus interest) in YEDL. After taking into account charges in pass-through items and other incentives, the impact on use of system tariffs in 2011/12 would be broadly in line with Ofgem's expectations at the time of *Final proposals*.

**Table 2 – Impact of approach excluding DF and RF reconciliation movement then replacing the R1, R2 and R3 reconciliation movements with normalised values**

<b>£m</b>	<b>NEDL</b>	<b>YEDL</b>	<b>CE</b>
<b>2009/10 losses annual incentive – <math>IL_t</math></b>	<b>(-)2.238</b>	<b>2.340</b>	<b>0.102</b>
Sum of DPCR4 annual losses incentives	8.858	37.990	46.848
2009/10 over-recovery (a)	(-)1.185	(-)2.398	(-)3.583
Base interest on 2009/10 over-recovery (0.563% $I_t$ ) (b)	(-)0.007	(-)0.014	(-)0.020
Penalty interest on 2009/10 over-recovery if applicable (1.500% $PR_t$ ) (c)	(-)0.018	(-)0.036	(-)0.054
Correction included in 2010/11 allowed income – $K_t$ (a + b + c)	(-)1.209	(-)2.448	(-)3.657
<b>2010/11 over-recovery forecast</b>	<b>1.442</b>	<b>(-)1.576</b>	<b>(-)0.134</b>
<i>Change in 2009/10 annual losses incentive from Baseline case – <math>IL_t</math></i>	<i>10.958</i>	<i>23.810</i>	<i>34.768</i>
<i>Change in 2010/11 over-recovery forecast from Baseline case</i>	<i>(-)11.184</i>	<i>(-)24.301</i>	<i>(-)35.485</i>

***Confirming that the corrections do not amount to a windfall for CE***

- 113 A legitimate concern in making these adjustments might be that the changes could be supposed to have the undesirable effect of reversing the impact of negative reconciliations that flowed in 2009/10 where these reconciliations were correcting positive reconciliations that had benefited the CE licensees earlier in the DPCR4 period. The nature of the problem prohibits an analytical check to confirm that this is not the case, but we have examined the overall effect on the outcome of the losses incentive on the CE licensees for the DPCR4 period and from it have gained significant comfort that the adjustments proposed do not result in a windfall of the type described.
- 114 The basis of our check is to note that if the performance in 2009/10 had remained the same as the average performance between 2002/03 and 2004/05, the annual incentive earned in 2009/10 would have resulted in rewards of £4.3m in NEDL and £8.4m in YEDL (amounting to about £63m at CE level over the DPCR4 period). When the same calculation is performed using the average of the losses performance seen in 2003/04 and 2004/05, the annual incentives earned in 2009/10 would have been rewards of £3.7m in NEDL and £13.0m in YEDL (amounting to about £83m at CE level over the DPCR4 period). This indicates a range of annual losses incentive ( $IL_t$ ) value between

£12.7m and £16.7m. Our proposal results in annual values for 2009/10 that are well below the figures indicated in this range.

- 115 This check confirms that the overall benefit that would accrue to the CE licensees from the annual losses incentive throughout DPCR4 would still be at least £20m less than the total amount that would have accrued had the results from Settlements throughout DPCR4 reflected the performance that was reported between 2002/03 and 2004/05. In other words, the ultimate outcome of the annual incentives would be substantially lower than the outcome where performance simply remained constant for the DPCR4 period. From an engineering perspective, the assumption that losses would not have changed during the DPCR4 period from the level seen in the three years immediately preceding that period seems reasonable. CE's proposal produces an outcome that is considerably less favourable than would result from that assumption.
- 116 All other things being equal, if CE were receiving a double benefit, with 'false' positive reconciliations having flowed early in the period (to its benefit) followed by the corresponding corrections being reversed through these proposed adjustments, the outcome for the CE licensees would exceed the amount that would have accrued had performance for each year of the DPCR4 period matched the average that prevailed from the point at which the measurement method for the DPCR4 period was entrenched under the terms of the DPCR4 licence. This not being the case, we can draw some comfort (although we acknowledge it is not a precise check) that this process is not creating a significant double benefit.

**THE BASIS PROPOSED BY CE ON WHICH NEDL AND YEDL SHOULD CALCULATE ADJUSTED DISTRIBUTION LOSSES IN 2009/10**

- 117 CE requests that the Authority consents to NEDL and YEDL using a basis for the calculation of adjusted units distributed in 2009/10 that differs from that used in respect of the year commencing 1 April 2002 in the following respects:
- R1-R3 reconciliation runs received during 2009/10 to be normalised so as to take the arithmetic average of the reconciliation movements from the years 2005/06 through to 2008/09.

- RF and DF reconciliation runs received during 2009/10 to be disregarded and set to zero.
- The restatement shall also incorporate two other evidentially supported errors that were not factored into the provisional SLC47 return pending resolution of the more significant inconsistencies discussed in the rest of this request:
  - a. adjustments in relation to the assessment of negative EACs to reflect that population of implausible data entries being replaced with the annual average for the relevant profile class (estimated at a total adjustment of 59GWh (25GWh in NEDL and 34GWh in YEDL) which equates to £3.6m of losses benefit; and
  - b. the data error reported by IMServ carrying out its role as Central Data Collection Agent (CDCA). In August 2010 IMServ identified that the meter multiplier for one of the new channels installed at the Thurcroft GSP in the YEDL region was incorrectly set up. The multiplier was set to 0.025 when it should have been 0.020 representing an overstatement of 25%. The 294 days between 28 October 2009 to 17 August 2010 the data has been overstated by between 220MWh and 250MWh per day overstating the 2009/10 units entering the network by 36.3GWh which equates to £2.068m of losses benefit.<sup>10</sup>

Changes consistent with this would also be made to calculate the growth term (GR<sub>t</sub>) under special condition B1 of the DPCR4 charge restriction.

### **THE LIMITED NATURE OF CE'S REQUEST CONSIDERED IN RELATION TO THE DPCR4 ROLLING INCENTIVE AND THE DPCR5 LOSSES INCENTIVE MECHANISM**

118 This request relates to the calculation of adjusted units distributed in the year 2009/10 for the purposes of calculating the annual losses incentive adjustment under the DPCR4 Losses Condition. In and of itself it is not a request to vary the basis on which distribution losses will be measured for the purposes of the DPCR4 LRRM (although

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<sup>10</sup> This is not a methodology change, but a data correction that should be made in any case.

we believe that the steps proposed in this request are also likely to be necessary in the light of the ongoing investigation that Ofgem is conducting). However, this request does not seek to anticipate the adjustments that might be necessary to ensure that the data used to close out the LRRM is fit for purpose.

- 119 Similarly, since the *Final proposals* for DPCR5 made clear that the losses figure that would be used in respect of 2009/10 for the purposes of the close-out of the LRRM would be the average losses over the DPCR4 period as a whole and this number would be used to set the target loss percentage for the DPCR5 period, CE's request for consent to change the basis on which NEDL and YEDL calculate adjusted units distributed in 2009/10 has no limiting effect upon the determination of the targets for losses for the DPCR5 period.
- 120 Therefore, were the Authority to give its consent to the request made by CE, this would not prejudice the determination of the losses figure in respect of 2009/10 to be used for the DPCR4 LRRM or for the DPCR5 targets. Although the considerations that have led CE to make this request are also likely to be relevant to the close-out of the LRRM and the setting of the DPCR5 targets, the giving of a consent under paragraph 9 of the DPCR4 Losses Condition does not constrain the Authority with respect to the data set that must be used to complete the close-out of the DPCR4 LRRM and the setting of targets for DPCR5.
- 121 In the *Final proposals* for DPCR5 Ofgem set out its understanding of the way that it was interpreting the DPCR4 LRRM commitment. This commitment was made in the DPCR4 *Final proposals* and was not reflected in the DPCR4 Losses Condition. However, at DPCR5 Ofgem made clear that its interpretation of the DPCR4 LRRM commitment was such that the totality of the annual losses incentive (as provided for under the DPCR4 Losses Condition) and the LRRM equated to five times the value of the outperformance (or underperformance) against the target in the fifth year of the DPCR4 period. It follows that amounts that result from the annual incentive mechanism for each year of DPCR4 are merely payments on account where the final value of the totality of DPCR4 losses incentives will be determined when the LRRM value is calculated once the necessary data becomes available at the end of August

2011, in accordance with the DPCR5 *Final proposals*.<sup>11</sup> Since this request relates only to the calculation of a component within the annual losses incentive its true economic effect is provisional. The full economic effect will not be seen until a decision is made on the data to be used to close out the DPCR4 LRRM.

- 122 That is not to say that the consent being sought by CE is irrelevant. It is an important matter because the path of prices (if not the final economic value) is determined by the annual entitlement to revenue that results from the application of the price control formula in each year of its application. Specifically, unless the Authority gives its consent to CE's request, the over-recovery (reflected in the  $K_t$  factor) of NEDL and YEDL in respect of 2009/10, as reflected in the price control returns that were submitted under SLC47 in July 2010, will remain at £9.773m and £21.412m respectively.
- 123 The nature of the obligation in CRC3 - Restriction of Distribution Charges: Use of System Charges is that the licensee has an obligation in setting demand use of system charges to 'take all appropriate steps within its power to ensure that, in Regulatory Year t, Regulated Combined Distribution Network Revenue does not exceed Combined Allowed Distribution Network Revenue'. The amount of Combined Allowed Distribution Network Revenue is partly determined by the carried-forward correction factor from the year 2009/10. Therefore, even if the ultimate economic value of the totality of the DPCR4 losses package would be unaffected by giving the consent to CE's request, the path of prices will be materially affected by whether or not the Authority gives the consent that is being sought.
- 124 For the reasons set out in this request CE believes that there is sufficient evidence to indicate that some change is likely to be necessary to the data that is used to close out the DPCR4 LRRM when the final data necessary to complete the calculation becomes available at the end of August 2011. Having regard to the benefits of stability in pricing CE requests the consent of the Authority to make an adjustment to the basis of calculation used in respect of the 2009/10 annual losses incentive that will facilitate a stable path of prices in the meantime.

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<sup>11</sup> The timetable for the receipt of the data needed to perform the calculations envisaged in the DPCR5 *Final proposals* indicates that this should be received by the end of the April 2011. However, under the DPCR5 special conditions, the Authority has until 30 November 2012 to issue the necessary directions.

125 [\*].

### **THE RULES OF THE AUTHORITY WITH RESPECT TO THE GIVING OF A CONSENT UNDER PARAGRAPH 9 OF THE DPCR4 LOSSES INCENTIVE**

126 Since the giving of a consent in accordance with paragraph 9 of the DPCR4 Losses Condition does not amount to the modification of the licence or the insertion or modification of any incentive regime in relation to any activities of the licensee, CE considers that the giving of such a consent is not a matter that is reserved for the Authority under the *Rules of Procedure of the Gas and Electricity Markets Authority* issued on 23 September 2010.

### **THE CONTINUED EFFECTIVENESS OF PARAGRAPH 9 OF THE DPCR4 LOSSES CONDITION**

127 The DPCR4 Losses Condition was removed from the licence by the modification of the special conditions that gave effect to the DPCR5 *Final proposals*.

128 The continued effectiveness of the DPCR4 Losses Condition for the purposes of determining the amount of the correction factor ( $K_t$ ) to be carried forward from the final year of the DPCR4 period to the first year of the DPCR5 period is ensured by the provisions of Part D of CRC3 – Restriction of Distribution Charges: Use of System Charges. Specifically, paragraph 9 of CRC3 determines the components of the calculation of  $K_t$  in the year commencing 1 April 2010 by reference to the provisions of the price control conditions of licence that applied during the DPCR4 period.

129 The saving provision for the carried-forward  $K_t$  factor depends for its effectiveness not only on the continued application of the algebra of the DPCR4 price controls but also upon the regulatory mechanisms and definitions that are essential to the effective operation of that algebra. Without the definitions and mechanisms within the DPCR4 price control conditions, the algebra has no content. Those mechanisms include the consent facility in paragraph 9 of the DPCR4 Losses Condition.

130 Another way to look at this is to consider the position that would now prevail if the ability to give a consent under paragraph 9 of the DPCR4 Losses Condition had expired with the replacement of the DPCR4 price control conditions with the DPCR5 special



conditions. If the consent facility is no longer present, then it follows that neither is the restriction on changing the calculation methodology without the consent of the Authority. It cannot therefore be inferred that the removal of the DPCR4 Losses Condition has the effect of removing the ability of the Authority to give a consent under paragraph 9 of that condition.

**THE TIMESCALE WITHIN WHICH THE AUTHORITY IS REQUESTED TO GIVE ITS CONSENT**

- 131 CE respectfully asks that the Authority reach a decision on whether to give its consent to this request in time for NEDL and YEDL to reflect that decision in the setting of use of system charges to apply from 1 April 2011.
- 132 In accordance with the requirements of paragraph 11 of SLC14: Charges for Use of System and connection, NEDL and YEDL must publish indicative charges three months before the date on which it proposes to amend use of system charges. The Distribution Connection and Use of System Agreement (DCUSA) requires that the licensee shall use reasonable endeavours to vary use of system charges no more than twice each year and to vary the charges with effect from 1 April or 1 October.
- 133 If we are to take into account any consent that may be given by the Authority the timetable is such that we shall need that consent to have been confirmed to us by 18 December 2010 in order for it to be fully reflected in the indicative use of system charges that we must publish before 31 December 2010.
- 134 If the Authority needs more time to consider whether or not to give the consent being sought, NEDL and YEDL could publish indicative use of system charges by 31 December 2010 that had been formulated on the assumption that the consent would be forthcoming before the date on which formal notice under DCUSA has to be given of a change of use of system charges. The date by which formal notice has to be given under DCUSA is 20 February 2010. Paragraph 11(a) of SLC14 requires the licensee to include a statement of any assumptions on which the indicative charges have been based. The assumption that the Authority will give the consent being sought could be included in the NEDL and YEDL statements.

135 Although CE does not think that the giving of a consent under paragraph 9 of the DPCR4 Losses Condition is something that is reserved for the Authority,<sup>12</sup> if Ofgem takes the view that the matter must be decided by the Authority, the timetable is such that the appropriate Authority meeting to consider our request would be the meeting on 18 November and CE would expect to have the opportunity to make its case to the Authority directly at that meeting.

#### **THE RESTATEMENT OF THE SLC47 RETURNS OF NEDL AND YEDL**

136 On 20 July 2010 Ofgem placed on its website an open letter to electricity distributors, suppliers and other interested parties headed: ‘Requests for relief from the consequences of over-recovery on the basis that accelerated gross volume corrections may have distorted losses reporting’ (the Open letter).

137 In that letter Ofgem set out its ‘minded to’ position about the application of interest-rate penalties in the years 2010/11 and 2011/12 and its position with respect to the benefits of avoiding a mid-year tariff change in October 2010. The minded-to position adopted by Ofgem did not bear directly on the revenue return required to be submitted by licensees under SLC47 (the SLC47 return) in respect of the year 2009/10. However, in that consultation Ofgem also made it clear that it had not yet addressed the substantive question of the impact of the use of GVC facility on the losses incentive scheme more generally and the number of units distributed in the growth driver term of the DPCR4 price control. NEDL and YEDL made clear that, until Ofgem had completed its consideration of the substantive issues and reached a view on whether adjustments should be made to the reported losses in 2009/10, the SLC47 return should be regarded as provisional.

138 When NEDL and YEDL submitted the SLC47 price control returns for 2009/10 they each reserved the right to submit a further SLC47 return covering the year 2009/10 (and, potentially, other years) when more reliable information about the calculation of units distributed became available.

139 Paragraph 15 of SLC47 requires that the licensee must take all appropriate steps within its power to ensure that the information provided to the Authority for the purposes of

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<sup>12</sup> See above paragraph 126.

the condition in the SLC47 return ‘is not restated after the date on which that information has been provided except where restatement is necessary in the opinion of the Appropriate Auditor’.

140 Paragraph 3 of SLC47 requires that the licensee shall act in accordance with any Regulatory Instructions and Guidance (the Revenue Reporting RIGs) issued by the Authority for the purposes of that condition. By virtue of paragraph 8 of SLC47 the licensee must ensure that the SLC47 return is accompanied by a report addressed to the Authority from an ‘Appropriate Auditor’ which states that the auditor has completed the ‘Agreed Upon Procedures’ (AUPs) issued by the Authority. The AUPs issued by Ofgem under SLC47 require the Appropriate Auditor to:

- ‘(ii) Obtain an explanation of the methodology used by the licensee as at financial year 2002/03 to adjust settlement date to give total units distributed. Check that the current method used by the licensee to adjust the settlement data to give total units distributed is the same methodology it used for that purpose in financial year 2002/03
- (iii) If the methodology mentioned in (ii) above is not the same as the one used for 2002/03, check that there is written approval from the Authority for the use of a revised methodology.’

141 When preparing the SLC47 return, the regulatory accounts of NEDL and YEDL and the statutory accounts of CE, CE discussed the issues relating to settlement data with Deloitte and we explained our concerns over the effect of supplier activity on reported data and upon the losses incentive. Deloitte, in its role as the group’s auditors and as the Appropriate Auditor for the SLC47 returns, has examined the background to this issue and has been involved in detailed discussions with us in relation to:

- need for a post-balance sheet event disclosure in the 2009 accounts for our UK-registered entities;
- the accounting treatment of the data that has already been received in relation to accounting charges taken in the accounts for our USA-registered parent entities; and

- the conditionality that the directors attached to the SLC47 return in July.

142 Deloitte recognises the problems in using reported settlement data to assess system losses. In the light of this we can confirm that, if CE secures the consent sought in this request, Deloitte, in its role as the group’s auditors and as the Appropriate Auditor for the SLC47 returns, considers that it would be necessary to restate the SLC47 return using revised data for the number of units distributed by NEDL and YEDL in 2009/10. We can further confirm that, were the Authority to grant the consent requested by CE, Deloitte has told us that it would be prepared to issue the necessary certifications to allow the restated SLC47 returns to take the place of the provisional returns submitted in July 2010. Draft revised SLC47 returns prepared in respect of NEDL and YEDL on the assumption that the request for consent is granted by the Authority are attached at Annex 1 to this request

**POTENTIAL IMPACTS OF A DECISION TO GIVE NEDL AND YEDL CONSENT TO VARY THE BASIS ON WHICH ADJUSTED UNITS DISTRIBUTED IS CALCULATED**

143 In the *SP Impact Assessment* Ofgem made the observation that, if the data flows relating to ScottishPower EnergyNetworks had been found to be inherently unreliable, Ofgem would ‘be bound to consider whether the ALPs set for other DNOs should be reviewed’. CE acknowledges that the same principle applies to this request; if the behaviour that CE has witnessed has been occurring on a material scale with respect to other DNOs’ networks, Ofgem may have to allow other DNOs to make changes to the basis on which they calculate adjusted units distributed. However, our own experience suggests that the material effects that CE has witnessed have been driven by the behaviour of one particular supplier (i.e. [\*]). Other DNOs may therefore not have experienced this effect at all or they may not have experienced it to any material extent. [\*].

144 To assist Ofgem’s consideration of this request we have assessed the consequences of granting the request using the same criteria as Ofgem set out the *SP Impact Assessment*.

***Impact on electricity suppliers***

145 Granting the request from CE would have the effect that use of system charges in 2011/12 take the same path that was envisaged by Ofgem when the *DPCR5 Final*

*proposals* were determined. In this respect suppliers would be denied the benefit of the application of over-recovery to the setting of the prices that would occur in 2011/12 if the consent were to be withheld. Whether such a benefit would be retained by suppliers or passed on to end-customers would depend on the characteristics of the electricity supply market, about which we make no comment in this request.<sup>13</sup>

146 However, since Ofgem has indicated that it is investigating the consequences of suppliers' use of the GVC facility and that it may need to take action to ensure that the change in supplier behaviour does not have undesirable consequences for the losses incentives placed on DNOs, there must be a distinct possibility that the full Ofgem investigation will lead, in due course, to some adjustment to the 2009/10 data.

147 Until that investigation is completed Ofgem may conclude that the path of prices expected when the DPCR5 *Final proposals* were determined, is to be preferred to what would be likely to be a temporary reduction in 2011/12 followed by a steep rise in 2012/13. Essentially this is the same argument that Ofgem used when it concluded that it would be inappropriate to require a reduction in charges in October 2010.<sup>14</sup>

### ***Impact on consumers***

148 To determine the impact on consumers it is necessary to make assumptions about how changes to use of system charges will be reflected in suppliers' prices to end-customers.

149 If we assume that price changes that have effect from 1 April in any year are fully priced into the offerings made by suppliers, the consideration set out in paragraphs 145 to 147 above apply to consumers rather than suppliers.

150 To the extent that suppliers would not pass on the pricing benefit that would follow from the withholding of the consent, the effect on consumers would be dampened.

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<sup>13</sup> We note Ofgem's observation in the Open letter that suppliers would be 'unlikely to pass on a temporary reduction in use of system charges' but 'they could be more likely to pass on a subsequent increase.'

<sup>14</sup> See the Open letter where, at paragraph 22, Ofgem concluded that '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....'

***Impact on competition***

151 There would be no impact on competition in the distribution of electricity. As far as the supply market is concerned, giving the consent being sought by CE would lead to a more stable path of prices. In this regard the *SP Impact Assessment* stated:

‘market participants, suppliers in particular, rely on a certain level of stability and certainty to ensure they are able to effectively plan ahead and attract/maintain appropriate levels of investment. Actions that undermine regulatory and financial certainty are likely to hinder current and potential participants’ ability to plan ahead and therefore increase barriers to entry and expansion.’

In this respect the giving of the consent would contribute to pricing stability and would have a beneficial impact on competition.

***Impact on the environment***

152 In the *SP Impact Assessment* Ofgem observed that, in that case, an increase in the ALPs might have had the effect of weakening the incentive properties of the losses incentive and, therefore, ‘reductions in greenhouse gas emissions may not be as substantial or forthcoming as they might otherwise be’.<sup>15</sup>

153 In this case, the DPCR4 period having closed, the decision to consent to CE’s request could not alter the incentive properties of the DPCR4 losses incentive. With respect to the DPCR5 losses incentive, CE contends that the information that it has brought to Ofgem’s attention shows that steps must be taken to ensure that the data that is used to reward or penalise performance under the DPCR5 losses incentive must not be susceptible to manipulation or variation by suppliers in such a way that the probability of the outcome is skewed towards penalty, particularly given the presence of caps and collars in the DPCR5 losses. Failure to address CE’s concerns could undermine the DPCR5 losses incentive mechanism because there would be no point in investing in the means to reduce losses if the behaviour of suppliers were likely to take the DNO to the limit of the penalty under the incentive in any case.

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<sup>15</sup> Paragraph 6.19

*Impacts on health and safety*

154 There are no impacts on health and safety.

*Risks and unintended consequences*

155 The risks and possibility of unintended consequences associated with consenting to this request are negligible because this decision does not pre-empt the significant decision to be made after August 2011 regarding the adjustments to be made to the data for the close-out of the DPCR4 LRRM and the DPCR5 losses targets.

*Post-implementation review*

156 Following the granting of the consent sought by CE, Ofgem would be able to continue its own investigation with the benefit of information provided by suppliers and by Elexon. It would be able to reach its final decision after August 2011 with the benefit of the remaining settlement reconciliation runs and the information that it receives following its information request to suppliers.