SP ENERGY NETWORKS

Regulation & Commercial

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Your ref

Our Ref AH290311

Date 31st March 2011

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Dear Lesley

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

I am writing in response to Rachel Fletcher's open letter of 21 March 2010.

In general we support the approach set out in the letter. We strongly agree that there should be a window of opportunity for DNOs to submit proposed adjustments to distribution losses now, but we acknowledge the preference to revisit these adjustments within the DPCR4 loss rolling retention mechanism (LRRM) process in 2012. We have collected a great deal of evidence over recent months regarding the material distortions of the losses incentive in DPCR4 as a result of GVC and other settlement adjustments. We believe that your proposed approach – if applied also to relevant non-GVC settlement issues, represents a proportionate response to the issues raised by the impact of these revisions on the losses incentive mechanism.

Our detailed comments on the proposed approach in the Way Forward section of the letter are set out below.

1. Inclusion in the LRRM process

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

Subject to your commitment outlined in Paragraph 6, we understand the argument that this approach allows additional time to carry out a process that is integrated into the overall DPCR4 losses 'close out' determination. It will allow further opportunity to ensure -

- *appropriate consideration of what are a wide number of causes and effects which can be complex and difficult to quantify accurately,*

- *development of a solution, or set of solutions which are similar in principle, and*
- *even-handed treatment between licensees.*

We cannot see any case for denying DNOs that can provide satisfactory evidence an opportunity for appropriate adjustments to be determined prior to 2012 as you suggest in Paragraph 6.

We are concerned however at the apparent assumption that the abnormal impacts upon the losses incentive are limited to 'GVC'. We have consulted with Suppliers, DNOs and Elexon and we conclude that GVC is only one of several means which Suppliers use to systematically adjust settlements data and distort the purpose of the losses incentive mechanism. Further, we do not think that Suppliers use the GVC mechanism in a consistent manner and believe that there is no clear obligation upon Suppliers to maintain accurate records of these particular adjustments. However, gross volume correction may be a useful shorthand for all settlement corrections (including negative EACs) provided it is not limited to the process definition appearing in the BSC.

We are committed to working with Ofgem on these issues to find a solution, or set of solutions which are consistent in principle, to remedy the distortions to the losses mechanism.

2. Applications by DNOs in advance of the LRRM process

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

We strongly support this position.

SP intend to submit an application by 15th April with the necessary supporting data.

We believe that the commitment by Ofgem to review any applications received by 15th April, followed, we trust, by a decision shortly thereafter, will reduce the current very material uncertainty surrounding future revenues and as a consequence, prices to end customers. Without such an opportunity, SP will be forced to continue to forecast very high volatility of revenues within our DCUSA 'provision of cost information' (DCP066) returns.   We know this to be a major concern to Suppliers in their tariff setting process and we believe this proposed way forward addresses this. ***We note Ofgem's view that clarity in terms of forecast costs facilitates competition between suppliers and enables them to compete more effectively. (See, for example, the Authority Direction regarding DCP050, published 21 January 2010)***

We believe that without this opportunity to submit applications, Ofgem's ongoing commitment to the investor community surrounding regulatory certainty and financial stability for network operators could be undermined.   The financial impacts arising from distortions to the DPCR4 LRRM mechanism were not foreseen when DPCR5 base revenues were set.

We fully understand and support Ofgem's rationale for its decision to grant consent to one other DNO Group's request to calculate distribution losses for 2009/10 on a basis that differs from that used for 2002/03, as published in your letter dated 17th December 2010. This decision and its timing allowed that DNO to mitigate potential uncertainty surrounding pricing in 2011/12. We accept that adequate notice of changes in distribution charges leads to improvements in the accuracy of Suppliers' forecasts and their assessment of future tariffs and that the timely provision of this information allows Suppliers to compete more effectively .

3. Impacts on tariffs in 2011/12

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

We fully accept this position.

SP will not reflect any decision into its pricing until 1 April 2012. We accept that adequate notice is required for Suppliers to set tariffs in an informed manner. We believe that this proposal and our agreement fully addresses Supplier's concerns as stated in your letter as they relate to the timing and impact of any decision.

4. Methodology for adjustments

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

We support this position, so long as "GVC" is interpreted to include other adjustments to settlements data by suppliers or their agents and, where relevant, correction of other settlement anomalies such as negative AAs/EACs where these distort the purpose of the losses mechanism.

Given the complexity involved it is possible that refinements to methodologies approved under the 15th April deadline may be appropriate. We think that the LRRM process is an opportunity to take full account of refinements to the methodology and the most up to date data available on the adjustments concerned. However, it is also appropriate that in the meantime DNOs have an opportunity to submit adjustments to allowed revenue to take account of at least a proportion of the distortions to the losses incentive as a result of these settlement issues. This will also allow greater certainty for suppliers over prospective tariff movements from 2012/13.

I hope that this is helpful. As you know we are happy to discuss at any time and are willing to use our various resources to assist with your deliberations.

Please contact myself if you have any queries.

Yours sincerely

Allan Hendry

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