Consumer Focus
Campaigning for a fair deal

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Dear Lesley

Consumer Focus response to Ofgem "consultation on regulatory measures to address the effects of gross volume correction (GVC) and other settlements data adjustments on the distribution losses incentive mechanism."

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do. We have specific responsibilities for the energy and postal sectors.[1]

We welcome the opportunity to comment on this consultation that has potentially important material and sustainability implications for consumers.

The consumer impact of settlement data adjustments to the distribution losses incentive mechanism (DLIM) is focused around three key issues:

- whether adjustment to the DLIM is justified
- the materiality of any adjustment
- the effectiveness of DLIM at incentivising losses reduction and sustainability improvements.

Why this is important to consumers

Any proposed "windfall" to DNOs could result in payments from suppliers, which will ultimately be passed onto consumers. Ofgem have yet to make an assessment, but intend to do so further along the process with not fixed date so far. Some stakeholders have

[1] For further information on our role and duties, see http://consumerfocus.org.uk/g/4p4

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speculated that the total value of adjustments could equate to over £1bn, or over £38 per household.

The quantitative findings of Consumer First's research for DPCR5 ("Expectations of DNOs and Willingness to Pay for Improvements in Service – July 2008") suggest that carbon reduction initiatives are some of the most valued services that DNOs could provide for consumers. It is therefore relevant to assess whether the current loss incentive mechanism is "fit for purpose" and provides a working incentive for DNOs to reduce losses and hence carbon.

Justification for adjustment to distribution losses incentive mechanism

We remain unclear whether there is a need for an adjustment to the DLIM. Any GVC, or other adjustment mechanism, will be correcting for supplier volumes that will have been previously overstated. These earlier overstatements by suppliers will have resulted in lower apparent losses for distribution network operators (DNOs).

The average reported losses for CE YEDL for the 2000-2009 period are 4.9%; the losses for 2009/2010 are noticeably higher at 7%. However the losses for 2005/2006 and 2006/2007 (3.5% and 3.7% respectively) are much lower than the average. This suggests that in these years suppliers may have underestimated their withdrawals from the distribution network resulting in lower estimates of distribution losses for DNOs.

We have assumed that GVC corrections relate to the DPCR4 period because on page 12 of the Ofgem consultation it states:

"Whilst initial evidence suggested that these adjustments may have arisen from errors dating back ad significant period of time, we now understand that the 2009-10 adjustment, in the main, only reflected errors in recent years."

Under DLIM, DNOs would have received a performance bonus for this apparent performance improvement; it seems likely this will offset any penalty the DNO will receive for the apparent higher losses for the 2009/2010 year because of GVC. It is currently unclear whether the bonus and penalties resulting from data errors are of similar or differing scales, which makes it difficult to understand whether the consequences of simply leaving the adjustments in place would be a net windfall gain, a net windfall loss, or a broadly neutral outcome for networks. In the absence of evidence of significantly material loss there may be no justification for an adjustment to the 2009/2010 period.

From a consumer perspective, it is important that any corrections to network incentive regimes are balanced and not simply a 'one-way bet' where windfall losses are corrected but windfall gains are left unchanged. We therefore expect that the close out calculation will take full account of both the rewards and penalties that DNOs have been subject to to ensure there are no windfall payments. This seems consistent with 1.6: "The methodology we set out to close out the DPCR4 losses incentive should ensure that there are no windfall gains or penalties to the DNO arising from settlements date correction and provision accounting, the DPCR5 change to reporting methodologies, and the setting of new target for DPCR5."

Year	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09	average 00-09	09/10
%	6	4.7	5.6	5.3	4.8	3.5	3.7	5.5	5	4.9	7

Electricity Distribution Loss Percentage for CE YEDL Distribution Network Operator (source: Ofgem)

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Given the importance of 2009/10 data for calculating the rolling retention mechanism it seems reasonable for this to be adjusted for the purposes of the forthcoming mechanism so that it reflects an average of the losses experienced during a representative losses period.

Materiality

Ultimately suppliers will pass any costs resulting from this correction on to consumers.

Estimates vary on the materiality of the impact; Ofgem have yet to make an assessment, but intend to do so further along the process. Some assessments of materiality indicate upwards of £1bn in adjustments could be possible; this would equate to an average of about £38 per household (based on 26 million households in the UK).

There will be variations in the adjustments that individual DNOs will seek, depending on the nature of GVC or other corrections, which are likely to result in regional variation in the amount consumers will be asked to pay. Furthermore, this impact will felt more by consumers on standard tariffs – whose bills can be increased more easily by suppliers – than those on fixed rate deals. Vulnerable consumers tend to be over-represented in this segment due to poorer access to the internet and Direct Debit facility.

It is important to avoid sudden shocks in consumer bills; any adjustments should be smoothed to minimise their impact. The choice of methodology for calculating any adjustment could result in "gaming" opportunities for both DNOs and suppliers. Since this would result in consumer detriment, we would expect that the Authority is mindful of this possibility.

The effectiveness of DLIM at incentivising losses reduction and sustainability improvements

Ofgem estimate that 1.5% of the UK's total carbon emissions result from distribution losses. While out of the scope of the Ofgem consultation, there seems to be broad agreement that the current loss incentive on DNOs is not providing an effective mechanism to incentivise loss reductions. It is in consumers' interests that DNO losses are minimised, both to reduce distribution losses ie "wasted" electricity and to reduce carbon emissions.

Under the current system, DNOs are rewarded for nominal rather than actual losses. This is because coarseness and lag resulting from the settlement data reconciliation process result in a disconnect between the stated losses for individual years compared to actual. GVC and other adjustments serve to exaggerate further this disconnect. The table on the previous page suggests that there appears to be little stability or predictability in the level of distribution losses being delivered by the scheme and no noticeable long term reduction in their level. This may suggest problems with either or both of the scheme design and the data being used within it.

It is not appropriate to change the incentive mechanism for the current DPCR5 period as this will create sector uncertainty and undermine DNO investment in reporting tools. However, in a "smart" world, with universal deployment of smart meters, there should be the tools available to reduce this discrepancy. This should lead to improved capability to measure losses; the first step to their improved management and reduction.

A system that is fit for purpose for effectively incentivising losses should:

- promote year on year improvement in distribution losses

- only expose networks to bonuses or penalties where these are clearly linked to events or behaviours within their reasonable control

- strike the right balance between investment costs to existing consumers that will benefit both existing and future consumers

- provide confidence and predictability in distribution charges for stakeholders; suppliers will price in risk if there is uncertainty, which will result in consumer detriment.

This submission is entirely non-confidential and may be published on your website. If you have any questions regarding its content, please do not hesitate to contact me on 020 7799 8041.

Yours sincerely

[Unsigned as sent via email]

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Consultation questions

CHAPTER: Two

Question 1: Do you think we have identified the main data/billing adjustment techniques used by electricity suppliers and their impacts?

No response.

Question 2: Are there any other factors you think we should take into consideration in assessing the impact of settlement data volatility?

No response.

CHAPTER: Three

Question 1: Do you agree with the general principles and constraints we have identified with respect to the correction of data used for the losses incentive scheme?

We agree a top-down approach is the only practicable option given the difficulties in unpicking supplier settlement adjustments data.

Question 2: Do you think we have identified the only two practical methodologies for normalising losses incentive data for 2009-10? If not, what other approaches do you think we should consider?

It does seem that a third option – do nothing – should be included so that stakeholders can fully understand the reasons and necessity for the proposed adjustments.

Question 3: Do you agree that Options 1 and 2 are distinct approaches such that a hybrid incorporating the best points of each is unachievable?

No comment.

CHAPTER: Four

Question 1: Have we identified the important strengths and weaknesses of each option? If not, what additional points should be considered?

No comment.

Question 2: Do you think that the impact of particular factors on SF data can be clearly identified? Can a recessionary impact be separated from other factors such as extreme weather? How important is it for the purposes of the adjustments methodology to also take account of other variables affecting SF data such as extreme weather conditions?

No comment.

Question 3: Do you consider that both methodologies can deal equally well with all types of settlements data correction?

No comment.

Question 4: Should Option 2 allow DNOs to select different "normal" periods or is there a case for setting a standard period? What would the benefits or drawbacks be of selecting a standard "normal period" across all DNOs? Would the selection of different "normal" periods substantially affect the outcome?

We would urge caution in delegating full autonomy to DNOs to select their own "normal periods." This could allow for gaming and the desire to maximise revenue by DNOs determining normal periods, rather than an equitable assessment of any adjustments that may be due.

Question 5: Do you support our preferred approach to have a single methodology that would be used across all DNOs that have adequate evidence of abnormally high settlement data corrections?

As acknowledged in the consultation document (4.16) a one size fits all approach may not be appropriate for the different types of data correction and different levels of volatility occurring in each DNO area. We would strongly urge that the materiality of the impact upon consumers is fully considered, because vulnerable consumers will tend to be more heavily impacted and we are likely to see more consumers fall into fuel poverty.

Question 6: Do you consider that Option 1 should be that single methodology? If not please give reasons for your response.

No comment.

Question 7: Are suppliers still undertaking significant levels of settlement data adjustments? What has been the impact of the changes to the BSC to limit the use of GVC, and what will be the impact of P274? Are ongoing settlement data adjustments likely to be on the same scale as those observed for 2009-10?

No comment.

CHAPTER: Five

Question 1: Do you agree that in calculating the LRRM, the selected adjustment methodology should be applied to the 2009-10 losses reported under both the DPCR4 and DPCR5 methodologies?

We support the statement in 5.6 that there "are not windfall gains or losses to the DNO...". This should ensure penalties and rewards received by DNOs due to GVC and other adjustments are netted across the DPCR4 period to ensure an equitable outcome. For example, this should take account of years when DNO losses appear to be below average, such as 2005/2006 and 2006/2007, in calculating likely windfalls.

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Question 2: Do you believe that either Option 1 or Option 2 could be applied to the 2009-10 losses re-reported under the DPCR5 common reporting methodology?

No comment.

Question 3: Do you agree that in setting the DPCR5 ALP we should not include any settlements data adjustment?

The ALP should be based on an average figure for the period, which includes both periods with atypically low and high reported losses. This is based on Ofgem's assumption that most adjustments took place within the DPCR4 period.

Question 4: Do you believe that the type of adjustment (GVC, DMX or other) impacts how the targets should be calculated? If so, how should this be done?

The type of adjustment may impact upon the timing of the application of the adjustment. If the adjustment took place within the DPCR4 period, then this will be taken account of when averaging reported losses. However, if the adjustment took place outside of this period then it would not be taken into account in the LRRM calculation. In these cases, an assessment must be made on the difficulty of obtaining this data and its likely material impact.

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