



To distribution network
operators, suppliers and other
interested parties

*Promoting choice and value for
all gas and electricity customers*

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Dear colleague

Decision Letter

Regulatory measures to address the effects of gross volume correction and other settlements data adjustments on the distribution losses incentive mechanism: decision on methodology and process for restatement applications

This letter contains the Authority's decisions in relation to the consultation referred to above.

Background

The distribution losses incentive mechanism is designed to drive the distribution network operators (DNOs) towards achieving an efficient level of losses on their distribution networks. The targets for the fourth distribution price control (DPCR4) for each licensee were based on the historic average ten-year losses performance of each DNO¹.

During 2010, some DNOs noted high levels of data reconciliation corrections arising from abnormal levels of Gross Volume Corrections (GVCs) and other "data cleansing" activity by suppliers. These corrections increased the notional losses for those DNOs for 2009-10. This not only affects the losses incentive (reward or penalty) they earn in that year, but also affects the calculation of the close out position for DPCR4 and the setting of losses targets for the current price control, DPCR5.

In November 2010, two licensees from the CE Group² (Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL)) applied for consent to calculate their distribution losses for 2009-10 on a basis that differs from that used for 2002-03. CE proposed a methodology (the CE methodology) for restatement of 2009-10 data to address the abnormal levels of data corrections. On 17 December 2010, we made our interim decision agreeing to the restatement of losses information for 2009-10 by NEDL and YEDL (the CE interim decision).

In March 2011 we published an open letter consultation on the way forward in dealing with the interactions between the distribution losses incentive scheme and GVC activity. This letter stated that our preference was to consider any further adjustments to licensee losses

¹ DPCR4 ran from 2005-06 to 2009-10.

² The two CE Electric licensees (NEDL and YEDL) have for convenience in the past been referred to collectively simply as "CE". CE has, since the original applications, changed its name to Northern Powergrid Holdings Company and operates through the two licensees Northern Powergrid (Northeast) Ltd and Northern Powergrid (Yorkshire) Plc. For continuing convenience Northern Powergrid Holdings, Northern Powergrid (Northeast) Ltd and Northern Powergrid (Yorkshire) Plc may be referred to collectively as "CE" at points in this letter, in order to avoid confusion with past decisions. In addition, reference may be made in this letter to NEDL and YEDL. Those companies clearly no longer exist and any such references are for convenience only and such references should be read as references to the entitled successors of those companies to the rights and obligations under the losses incentive mechanism.

reporting with respect to GVC adjustments as part of the LRRM process to be undertaken in 2012. However we agreed to review any licensee applications received by 15 April 2011 (supported by the necessary data) in advance of the LRRM. We also stated that ahead of the LRRM process we would consult on the methodology we would apply, if there was sufficient (or updated) evidence of unconventional GVC (or other similar sales data adjustments by electricity suppliers) which impact on a licensee's settlement data.

In April 2011, Electricity North West Limited (ENWL) also applied to revise the way they reported losses in order to adjust for abnormal levels of data corrections and proposed to use a similar methodology to the CE methodology. In the same month, two licensees from the SP group (SP Manweb (SPM) and SP Distribution (SPD)) made similar applications, although they proposed to use a different methodology (the SP methodology) to the CE methodology.

On 24 May 2011, we set out information on the way forward for dealing with the interactions between the losses incentive scheme and GVC activity. In that letter, we advised that we would be running a consultation process on the SP methodology in due course.

On 29 July 2011, we made our interim decision agreeing to the restatement of losses information for 2009-10 by ENWL (the ENWL interim decision).

On 24 October 2011, the Authority then published a consultation document (ref 137/11)³. The consultation closed in January 2012 and, having considered the responses and other relevant factors, this letter sets out our decisions on the issues on which we consulted.

The October 2011 consultation

In the October 2011 consultation document we sought views on the following issues:

1. The relative strengths and weaknesses of the two methodologies
2. The appropriateness of using a single methodology for all DNOs
3. How to close out the last price control (DPCR4), taking account of any abnormal settlement data corrections in the calculation of the losses rolling retention mechanism (LRRM)
4. Whether or not abnormal settlement corrections should be removed from the data used to calculate the targets for the current price control (DPCR5).

In the consultation document, we further explained that once we came to a decision on the methodology, we would make a decision on the application by SP, and if necessary review the CE and ENWL interim decisions.

Responses

A summary of the consultation responses received and the individual consultation responses are published on our website⁴. In addition to inviting formal consultation responses to inform our decisions, we have sought extensive input from industry stakeholders and have collected and analysed other relevant evidence during the consultation period, including through running an industry workshop.

During the course of the consultation, licensees provided us with information on the potential impact of the choice of restatement methodology on their units distributed and we have published the summaries of those data collection exercises⁵.

All of this information has been taken into account in reaching our decisions.

Framework for consideration

In making our decisions, we have sought to comply with our principal objective under s3A of the Electricity Act 1989 which, in summary, is to protect the interests of existing and

³ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=607&refer=Networks/ElecDist/PriceCtrls/DPCR5>

⁴ *Ibid.*

⁵ *Ibid.*

future consumers in relation to electricity and to carry out our functions in a manner which we consider will best promote effective competition in the generation, transmission, distribution or supply of electricity. We do not set out here the detail of the statutory provisions, but have applied the requirements set out in that section.

In the context of this decision, we consider that we should carry out our functions in a manner that we consider is best calculated to promote efficiency and economy on the part of DNOs and the efficient use of electricity conveyed by distribution systems.

In seeking to discharge our statutory duties, we have had regard to the following:

- The purpose of the distribution losses incentive mechanism, which is to drive the DNOs towards achieving lower levels of losses on their distribution networks.
- The principle that restatement in any given instance, will only be appropriate where the Authority is satisfied that there is a defect in the way in which the mechanism would operate in the event that restatement were not to be allowed, for instance by creating an inconsistency between target setting and performance monitoring.
- The need to ensure equality of treatment of licensees, with any difference in treatment as between licensees being objectively justified.
- The desirability of promoting regulatory certainty, for the benefit of industry and the public.
- Our assessment of the merits of addressing any particular defect and the qualities of the methodologies proposed to achieve this, for instance, the relative accuracy of the data that result from the adjustments.

In assessing the relative merits of the CE and SP methodologies, we have also considered the degree of transparency they each bring, fairness to customers, the appropriateness of assumptions made within them, the ease of audit and the potential for replication by other DNOs.

The case for the opportunity to apply for restatement

We consider that sufficient evidence exists that abnormal levels of settlement data corrections have occurred in some distribution areas, such that reported 2009-10 data are deficient in reflecting the performance of some licensees for the purposes of adjusting allowed revenue.

Despite extensive engagement, stakeholders have not been able to provide detailed evidence of the levels of correction activity that have been undertaken.

We continue to consider that allowing restatement applications is necessary to give the opportunity to restore allowed revenue positions to the proper level and will not therefore be detrimental to the interests of customers. **It is, however, the responsibility of each licensee to demonstrate the extent of any abnormal activity affecting 2009-10 data in order to justify restatement within their own distribution area.**

The two methodologies compared

Both methodologies have merits and drawbacks in dealing with abnormal data activity. However, on balance, and taking into account the framework for making our decision, the views of respondents and other evidence we have collected, we consider that the SP methodology is statistically more robust and results in more accurate data than the CE methodology for addressing abnormal reconciliation activity.

Crucially, the CE methodology relies on P222 reports for dealing with negative EACs (estimated annual consumption). These reports are not available retrospectively, meaning that not all DNOs have access to the relevant reports covering the 2009-10 period. This issue significantly compromises the accuracy of data that some DNOs would have access to for the purpose of restatement applications under the CE methodology.

We expressed in the consultation letter concern over the ability of DNOs to select their own “normal period” under the SP methodology. We consider that the safeguards outlined below

mitigate that concern to a large extent, such that we no longer consider this factor to weigh substantially against the SP methodology. **The Authority has decided that the SP methodology is preferable to the CE methodology.**

A single methodology for all

Responses to the consultation broadly supported a single methodology being applied to all licensees. We agree, and consider this to be consistent with an even handed treatment of licensees. Such an approach is also in the interests of greater regulatory certainty.

As stated above, the absence of key datasets available to all licensees for applying the CE methodology is a severe impediment to consistent application of that approach. A further consideration is that, while the CE methodology was designed to address the correction activity for the DPCR4 losses reporting methodology applied to Northern Powergrid licensees, the SP methodology was expressly developed to be applicable to DNOs with different DPCR4 reporting methodologies. **The Authority has decided that a single methodology should be applied to all applications for restatement of settlement data for the 2009-10 year.**

Method for assessing individual restatement applications – strengthening the application of the SP methodology

The SP methodology allows licensees to select their own 'normal' period to reflect the specific activity to be addressed in their area, and then to 'normalise' 2009-10 data based on a common methodology.

In order to make the SP methodology more robust, to ensure even handed treatment between licensees, and to address some of the concerns raised during the October 2011 consultation, **the Authority has decided that the application of the SP methodology to any particular licensee should be conditional upon the satisfaction of certain statistical tests and guiding principles.** These include a statistical means to identify abnormal activity affecting 2009-10 data.

The Authority considers that such an approach will better uphold the objective of the distribution losses incentive mechanism and should limit potential volatility in losses mechanism revenues – and hence limit the impact on consumers. The tests and principles need to be flexible enough to recognise that different licensees will have experienced different levels of supplier activity at different times and consequently could have different normal and abnormal periods. As such, the tests and principles, which are set out in the Annex to this letter, seek to ensure that the selection of normal and abnormal periods can be objectively justified in each case.

Review of interim decisions and inviting re-submissions from past applicants

Our decision letter of 17 December 2010 (the CE interim decision) explained that further adjustments to the 2009-10 losses data for NEDL and YEDL might be warranted should further or better information on the issues covered in that letter come to light. Our decision letter of 29 July 2011 (the ENWL interim decision) explained that we would be consulting on the most appropriate methodological approach to use and that the decision on this methodology would allow us to reach decisions on any remaining restatement applications by DNOs. We explained that the outcome of this consultation could also lead to a review of the interim decisions already taken on NEDL, YEDL and ENWL.

It follows from what we have said elsewhere in this letter that in light of the outcome of the consultation and our decision on the methodology, the interim decisions reached on past applications for restatement by NEDL, YEDL and ENWL now need to be reviewed. Accordingly, NEDL, YEDL and ENWL should now resubmit their restatement applications using the SP methodology and the tests and principles set out in the Annex to this letter in order that their interim decisions can be reviewed and so that final decisions can be made on their applications using this new data.

It further follows from what we have said elsewhere in this letter that for the same reasons SPM and SPD should also resubmit their restatement applications using the SP

methodology and the tests and principles set out in the Annex to this letter in order that decisions can be made on their applications using this new analysis.

Decisions on the October 2011 Consultation

Having taken into account the framework described above, the responses received, and other evidence, the Authority has accordingly made the following decisions:

1. All licensees are to be given the opportunity to apply for an adjustment to their 2009-10 reported losses data and the Authority will consider any such applications which we receive by 13 April 2012 and which are supported by the necessary data.
2. Licensees need to demonstrate to the Authority that abnormal data correction activity affected their 2009-10 reported losses in their applications.
3. Where the licensee can satisfy 2, above, the SP methodology, rather than the CE methodology, is to be used in the submission of all applications for restatement of 2009-10 losses data.
4. The application of the statistical tests and guiding principles set out in the Annex to this letter is necessary to ensure that the SP methodology is applied appropriately. The Authority will apply these tests and principles to all applications for restatement of 2009-10 losses data.
5. NEDL, YEDL and ENWL are required to now resubmit their restatement applications using the SP methodology and the tests and principles set out in the Annex to this letter in order that their interim decisions can be reviewed and so that final decisions can be made on their applications.
6. SPM and SPD are required to now resubmit their restatement applications using the SP methodology and the tests and principles set out in the Annex to this letter in order that decisions can be made on their applications.

The revenue effects of this decision will not be calculated until the Authority takes a decision on any revised restatement applications and concludes the consultation on associated policy issues, at a date no later than 30 November 2012. As with all other licensees, any resubmission of a restatement application by NEDL, YEDL and ENWL will be dealt with in the DPCR4 close out process and will therefore affect charges from April 2013.

Abnormal levels of data correction activity and closing out DPCR4 and target setting for DPCR5

We will be seeking further views on how to deal with abnormal levels of data correction activity for the purpose of closing out DPCR4 (ie calculating the LRRM) and target setting for DPCR5 in a consultation to be published shortly.

Next steps

We will be publishing details on the statistical tests referred to in the Annex to this letter within the coming days. At that time we will provide further guidance on the process for restatement applications. In order to achieve regulatory certainty at the earliest point practicable, we have set a deadline for submission of 13 April 2012.

We will be hosting a stakeholder workshop on 23 March 2012, during which DNOs will have the opportunity to ask questions about the application process. In the mean time, if you have any queries on this matter, please contact Tim Aldridge on 020 7901 7350 or at tim.aldridge@ofgem.gov.uk.

Yours faithfully,



Rachel Fletcher
Acting Senior Partner, Distribution

Annex: Method for the assessment of restatement applications

Statistical tests

To address one of the key concerns with the SP methodology identified in the consultation, we are requesting that licensees use statistical tests to assess normal and abnormal data correction activity, on an objective basis:

- The first test is for establishing abnormality affecting 2009-10– the degree to which volumes of corrections in reconciliation runs have changed over time.
- Following identification of abnormal activity, the second test is for identifying an appropriate 'normal' period – where reconciliation corrections are at a more stable level.

We have devised statistical tests for this purpose and will be separately publishing details on these tests, and the process for applying them, in the coming days. Alternatively, DNOs may provide us with details of their own statistical tests for identifying normal and abnormal activity which we are prepared to consider. The final say on whether to allow an alternative to what we have set out will rest with the Authority and we may require that a licensee works within the framework set out, failing which the application may be rejected.

Guiding principles

In addition, we will be assessing any restatement applications according to guiding principles designed to help maintain the integrity and credibility of the losses mechanism, and to help limit revenue volatility. Licensees should use these guiding principles in combination with the statistical tests in providing evidence for restatement applications:

- Due to the calculation for closing out DPCR4, applications can only apply for restatement to 2009-10 data⁶
- The normal period must occur within the DPCR4 period due to the unreliability of some data for prior years (particularly over short time periods)
- The normal period should cover a continuous period of at least two years and be longer in duration than the abnormal period
- In addition to relatively stable reconciliation levels, reported losses performance during the normal period must be credible e.g. the normal period should not include historically low, one-off, losses levels⁷
- The restatement must result in credible, technically feasible losses performance in 2009-10, that the licensee can justify would have been achievable.

Finally, there are two circumstances where we may apply a cap to restatement applications:

- if a licensee can identify abnormal activity affecting 2009-10, but is unable to establish a normal period using the tests and principles set out in this Annex, or
- if a licensee's restatement application accords with the tests and principles set out in this Annex but the restated performance is not credible (ie it does not meet the final guiding principle, above).

In such circumstances any restatement application will be capped such that the restated gross close out of DPCR4⁸ may not be greater than if the average performance for the first three years of DPCR4 was maintained during 2008-09 and 2009-10⁹.

We will publish all restatement applications to ensure transparency of the process.

⁶ The algebra for calculating the LRRM means that the close out position is equivalent to five times the incentive in 2009-10 less rewards/penalties already received/incurred over DPCR4 (exclusive of the interaction adjustment).

⁷ This is to ensure that a DNO is not unduly rewarded or penalised by a year where there is a known reason for abnormal losses.

⁸ Five times the incentive in 2009-10 less total incentives over DPCR4.

⁹ Evidence presented to us suggests that, on aggregate, abnormal activity began in 2008-09.