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By Email only

21 December 2011

Dear Lesley,

Consultation on regulatory measures to address the effects of gross volume correction and other settlements data adjustments on the distribution losses incentive mechanism

Thank you for the opportunity to respond to the above consultation.

As you are aware, we have already corrected our 2009/10 reported data using Option 1 (the CE methodology) based on evidence of abnormal data received in that year. We believe that the same methodology is appropriate for correcting the DPCR4 methodology data that is to be used in the DPCR4 close out calculation; however we have reduced our view of the effect of negative EACs. We have also applied the correction methodology to the later settlement data that feeds into the unwinding of March Accruals and Prior Period Adjustments, as required by our DPCR4 losses reporting methodology.

We have separately provided analysis that shows that the Engage methodology gives similar results to CE when applied on a consistent basis.

We do not believe that the data for DPCR5 target setting should be adjusted, as otherwise it would be necessary to continue to apply similar adjustments throughout DPCR5. We support the principle that the LRRM should be settled on a self-contained basis, minimising ongoing interaction with DPCR5 and reducing uncertainty going forward. Furthermore we believe it should be a fundamental principle that that the ACL2 term is calculated on a consistent basis with the DPCR5 target rather than with data used during DPCR4. We therefore consider that unadjusted data should also be used in the ACL2 term in the LRRM.

Our detailed responses to the questions raised in the consultation are attached. The Appendix gives more detail on our approach to applying correction methodologies to the data required for the calculation of the LRRM, for which the backing spreadsheets have been provided to you separately. If you would like to discuss these or our consultation responses in more detail please do not hesitate to contact me.

Yours sincerely,

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Specific Questions

CHAPTER: Two

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

It is difficult to say. We have no visibility of these activities in settlements – for instance, it appears that some suppliers use mechanisms similar (or even identical) to GVC that are known by a different name. It is for this reason that "top down" approaches to identifying and correcting abnormal data are the most appropriate.

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

The reason for identifying the abnormal level of corrections is not to question their validity, but to recognise the extent to which they exceed the level of correction that was occurring during the period that the losses incentive target was set. An issue for the design of the incentive is that an increased level of corrections may materialise at any time due to external factors, such as a supplier revenue assurance exercise or a significant meter change programme. This means that the issue of data corrections can emerge at any time.

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 with the general principles and constraints that have been identified, namely;

- Like for like target setting and performance monitoring.
- Sufficiently accurate data for DPCR5 target setting.
- An 'even handed' treatment of licences.
- A top-down approach to correcting performance, to a reasonable degree of accuracy, based on either the CE or the Engage generic methodology.

Further principles have emerged during our consideration of the issues, which we believe should also be taken into account:

- Even handed treatment of licences does not mean that there has to be a single "right" answer for all DNOs; in particular, it may be that different periods of abnormal settlement data are appropriate in different DNO areas, provided that the DNO has sufficient justification.

- A reasonable degree of accuracy is an appropriate objective in a situation where there is no single "right" answer. In this context, the two methodologies can provide a useful reasonableness check on each other.

- Where changes or clarifications are required in the rules concerning the interaction between DPCR4 and DPCR5, the preferred solution should sit within the package of actions to close DPCR4, rather than changing the DPCR5 rules going forward.

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?

We spent considerable time as an industry during 2011 trying to identify alternative methods for data correction; however no better methodologies emerged due to the limited amount of data available to DNOs. Even if such data were made available we do not believe that it would be cost-effective, or an appropriate use of resources, to try to replicate the settlement arrangements in order to carry out this exercise.

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?

We believe that whilst both methods have similarities they should be considered as distinct with no attempt to produce a hybrid approach. From our perspective both approaches give comparable results when applied to the data that obviously requires correction.

CHAPTER: Four

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

We believe that you have captured the key strengths and weaknesses of the options, but we have specific comments on some of these below:-

<u>Option 1 – CE methodology</u>

Weaknesses

- *it sets all RF and DF settlement data to zero which could result in valid adjustments to settlement data being discarded.*

  DF does not form part of ENWL's DPCR4 reporting methodology. We have modelled the effect of applying a normal RF adjustment in the same way as R1-R3 (which would align more closely to Option 2) and consider that this would have minimal effect. The within-year adjustment to 2009/10 data in respect of RF would be reduced from 106GWh to 102GWh, based on a four year average; if the normal period were based on a three year average, which appears more appropriate in the case of RF, then the revised adjustment is 107GWh.

- *there is an assumption within the methodology that the data from 2005-06 to 2008-09 is "normal" and that reconciliation data for 2009-10 is corrupt.*

  Our submission to Ofgem of 14 April 2011 gave evidence of anomalies in 2009/10 reporting data (ie relating to settlement periods arising up to 14 months before 1 April

2009)[1]. Although we received some abnormally large (negative) reconciliation runs in the early part of 2009 calendar year, we recognise that focus on the 2009/10 reporting year is a conservative approach and probably appropriate for our DNO area.

- *the treatment of negative EACs could also be considered a weakness as it is based on a 'snap-shot' in time. Suppliers have also noted concerns about the availability of negative EAC data and the risk of negative EACs that have already turned positive being taken into account before they have in fact been included in the settlement total. In addition, while Elexon reports identify 'high' negative EACs there may be many others which are smaller and therefore not included.*

  We propose basing our final determination of negative EACs on November 2011 P222 data. We also propose excluding any new negative EACs that appear in this data compared with previous runs. This approach provides a conservative estimate of the impact that negative EACs have had in 2009/10.

- *DNOs need to monitor negative EACs which were included in the calculation of the adjustment to ensure that there is no 'double counting' of units.*

  We believe that by basing the adjustment on November 2011 P222 data then no further adjustments are necessary as all reconciliation runs in respect of 2009/10 have been completed.

Option 2 – SP methodology

Weaknesses

- *The assumptions around the choice of the "normal" settlement period based on observed patterns. While Option 1 also includes an assumption that the data for the years from 2005-06 to 2008-09 is normal, the difference is that for Option 2 the assumed normal period is a vital aspect of the methodology. The classification of a normal period is highly subjective and could differ between DNOs. The impact in the calculation resulting from selecting a different normal period has not been tested, but there are concerns as to whether DNOs using different "normal' periods would meet the requirement of like-for-like comparison. DNOs might choose a period which gives them the most favourable result.*

  In our commentary on the CE methodology we have indicated that we believe the choice of 2009/10 reporting year as the period to be corrected to be conservative but probably appropriate. As we have stated previously, it may be that different periods of normal/ abnormal settlement data are appropriate in different DNO areas, provided that the DNO has sufficient justification.

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

[1] The stated period is based on RF reconciliations; the ENWL reporting methodology for DPCR4 was based on exit volumes being attributed to the year in which they are invoiced to customers, and did not include DF reconciliations.

methodology to also take account of other variables affecting SF data such as extreme weather conditions?

We do not believe that the individual factors on SF data can be separately identified.

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

We believe that both methodologies are valid for determining the appropriate level of correction, and we have separately supplied spreadsheets that show the calculations under both methodologies as defined in the consultation, and also for the SP/Engage methodology based on a "normal" period ending in January 2008 in order to capture all the data that requires correction. For ENWL, Option1 calculates the correction at 283GWh. When we apply Option 2 to the data that requires correction, the correction is 297GWh. This difference of 14GWh needs to be considered against the total NHH units distributed of approximately 12,000 GWh, ie around 0.1%.

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?

It would be legitimate to specify a different normal period if identified by objective means and justified by the DNO to Ofgem's satisfaction.

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?

This would seem appropriate due to the high level nature of the adjustments. This would assist in the transparency of the approach and to an extent remove suggestions that DNOs are choosing the most beneficial periods for correction.

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

We believe that Option 1 provides the most transparent and replicable methodology, and is the more readily applicable whatever the DNO DPCR4 reporting methodology.

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?

Only suppliers are in a position to answer this question as DNOs do not have the data. Our expectation is that P274 should improve settlement data from both a losses perspective and

from the perspective of competition in electricity supply; however we cannot predict the extent to which it will change supplier behaviour during the DPCR5 period.

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?

No. Although we agree that the correction methodology needs to be applied to the DPCR4 data within the LRRM, we do not agree that correction is necessary or appropriate in respect of DPCR5 data. The key issue is that each of the DPCR4 and DPCR5 regimes is internally consistent in terms of target-setting and performance measurement. For DPCR4 this is achieved by ensuring that the data reported for 2009/10 reflects, as far as reasonably practicable, the level of reconciliation activity that was taking place when the targets were set (ie the ten year period prior to DPCR4). Equally, the baseline for DPCR5 should be set on a basis that anticipates the circumstances of the forthcoming period, as far as this can be achieved. It is legitimate for a "new normal" to be set for the new period, based on average uncorrected performance during DPCR4.

If the DPCR5 target is based on corrected data, then this implies that data should continue to be corrected throughout DPCR5. Although it may, in the event, be necessary to consider the issue of data corrections in DPCR5 it would be better to do this once sufficient evidence has emerged rather than to do so at the outset.

We are also concerned by the apparent disconnect suggested by paragraphs 5.9 and 5.12 of the consultation document, and the subsequent clarification of 5.9 issued on 7 December. The purpose of the ACL2 term in the LRRM calculation is to calculate the Interaction Adjustment, ie the amount of any windfall gain or loss that would accrue to the DNO based on its 2009/10 performance against target under the DPCR5 methodology. The important principle, therefore, is that ACL2 is calculated on a consistent basis with the DPCR5 target rather than with data used during DPCR4. Application of corrections to both ACL1 and ACL2 would also potentially dilute the effect of the DPCR4 corrections in the LRRM to a significant extent, reducing the effectiveness of the processes being envisaged.

In summary, we believe that there appears to be good evidence for a clear distinction between data used for DPCR4 or DPCR5 purposes, so that the former can be corrected whilst the latter is not. If the DPCR5 target is based on uncorrected data then ACL2 should also be calculated on this basis.

Using the definitions from the Ofgem clarification paper:

2009-10 reported figures (ie including all data adjustments) at RF	A
Revised 2009-10 reported figures (after correction / normalisation by the agreed methodology)	B
Initial 2009-10 figures ('A'), including all data adjustments and re-reported using the DPCR5 common methodology	C
Revised 2009-10 figures ('B') (ie corrected according to agreed methodology) and re-reported using the DPCR5 common methodology	D

Term	Reporting Methodology	Initial data to use as per Final Proposals	Data to use in the event that a methodology is applied to correct 2009-10 figures	
		LRRM AND TARGETS	**LRRM**	**TARGETS**
$LUD_{2009/10}$	DPCR4 restated	A	B	
$UD_{2009/10}$	DPCR5	C	C	C
$ACL_{2009/10}$	DPCR4 restated	A	B	
$ACL2_{2009/10}$	DPCR5	C	C	

It may be noted that this approach minimises the changes required to the calculations set out in the DPCR5 Final Proposals.

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?

Yes, both approaches can be used for re-reporting under the DPCR5 common reporting methodology, although we do not believe that this is necessary or appropriate.

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

We agree that no settlements data adjustment is required to the data used for setting the DPCR5 ALP. See answer to Question 1, Chapter 5.

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?

No, and we do not believe there is data available that would support such a distinction even if it was right in principle.

APPENDIX Application of Correction Methodologies

Introduction

In order to provide the context for the subsequent calculations, the principles applied to our DPCR4 Reporting methodology are set out below:

- We do not use provision accounting for calculating and attributing actual revenue values or units distributed to a particular regulatory year.
- We attribute system exit volumes to the regulatory year in which they are invoiced to customers; there is no subsequent revision to system exit volumes after the end of the regulatory year.
- There is a defined process in place to estimate unbilled consumption for the days of consumption not included on the final invoice produced prior to yearend up to the yearend date.

Approach

For either methodology, consideration needs to be given to how (or whether) the methodology should be applied to each of three DPCR4 data sets:

- DPCR4 Revenue Return data (including any approved resubmissions)
- Restatement of 2009-10 to take account of settlement reconciliation runs
- Restatement of DPCR4 under DPCR5 rules for purposes of calculating DPCR5 ALP

CE Methodology

<u>DPCR4 Revenue Return</u>

Our resubmission of the 2009/10 losses calculation, approved by the Ofgem letter of 29 July 2011, comprised adjustments to Distributed Units as follows:

- Reporting Correction of 36.1GWh (in respect of DF data); plus
- GVC Adjustment of 228.2GWh; plus
- Negative EAC Adjustment of 52.3GWh.
- A total of 316.6GWh

<u>2009-10 adjusted for prior/post settlement</u>

The adjustments to be made in respect of prior periods and later settlement runs (in accordance with DPCR5 Final Proposals Financial Methodologies paragraphs 4.19 and 4.20) are calculated on the following basis:

Units Entering

- No adjustment

Units Exiting

- Replace the adjustment for Negative EACs with a (reduced) adjustment based on the latest (November 2011) P222 data.

for each of Supercustomer (NHH), DADS (HV, LV HH) and EHV data:

- move Prior Period Adjustment back into 2008/09;
- substitute actual SF 2009/10 data for (reported plus Year End Accrual).

for Supercustomer (NHH) data:

- No further adjustment is required in respect of R1, R2 or R3 data since these have already been set to an annual average figure in the DPCR4 Revenue Return data.
- No further adjustment is required in respect of RF or DF data since these have already been set to zero in the DPCR4 Revenue Return data.

Restatement under DPCR5 rules (for target setting)

Note that we do not believe that adjustment is appropriate for this data set; however if an adjustment is required:

The corrections identified in the previous section need to be allocated to the settlement year to which they apply, using the settlement calendar. These corrections can then be applied to settlement date data.

The correction methodology would need to continue to be applied throughout DPCR5 for consistency with the target setting.

SP Methodology

DPCR4 Revenue Return

This data has already been corrected and no further corrections are applicable under the SP methodology.

2009-10 adjusted for prior/post settlement

Units Entering

- No adjustment

Units Exiting

- Unwind the corrections made under the CE methodology
- Identify corrections by applying the SP methodology to the data set under the DPCR5 rules (below) and then allocate the corrections to DPCR4 reporting years using the settlement calendar

for each of Supercustomer (NHH), DADS (HV, LV HH) and EHV data:

- move Prior Period Adjustment back into 2008/09;
- substitute actual SF 2009/10 data for (reported plus Year End Accrual).

for Supercustomer (NHH) data:

- Apply adjustments to later R1, R2, R3 and RF data on the same basis as data reported in 2009/10.
- Set DF to zero, consistent with the ENWL DPCR4 reporting methodology.

Restatement under DPCR5 rules

Note that we do not believe that adjustment is appropriate for this data set; however if an adjustment is required the SP methodology can be applied directly to this data.

The correction methodology would need to continue to be applied throughout DPCR5 for consistency with the target setting.