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Dear Lesley

CONSULTATION ON REGULATORY MEASURES TO ADDRESS THE EFFECTS OF GROSS VOLUME CORRECTION AND OTHER SETTLEMENTS DATA ADJUSTMENTS ON THE DISTRIBUTION LOSSES MECHANISM

I attach the response from Northern Powergrid to the Ofgem *Consultation on regulatory measures to address the effects of gross volume correction and other settlements data adjustments on the distribution losses mechanism* (the *Consultation*).

In this letter and in our response we use the term 'correction' to describe a change to settlements data instigated by a supplier using one of the facilities within the settlements system. We use the term 'adjustment' to describe any further changes that a distributor may be allowed to make to that data for any purpose connected with the losses incentive in the electricity distribution licence.

In summary, we contend that:

- to close out the DPCR4 incentive, consistency with the DPCR4 targets requires that gross volume correction (GVC) and other corrections made by suppliers must be adjusted for;
- the adjustment method described in the *Consultation* as 'the CE method' should be used for the Northern Powergrid licensees. It is probably appropriate to use the same method for other licensees as well but this will be dependent upon their circumstances and the behaviour of the suppliers that have used their networks;
- settlement reconciliations received since 31 March 2010 indicate that suppliers are still correcting settlement data to the extent that featured in the reconciliations that flowed in 2009-10. This means that unadjusted data from 2009-10 remains the best guide to the level of losses that would be reported under the new methodology in the DPCR5 period if the licensee's system performed at the same level in the DPCR5 period as it did in the final year of the DPCR4 period;
- unadjusted data should be used for ongoing reporting of losses during the DPCR5 period and therefore the targets for that period should be based on the average level of losses from the DPCR4 period that is also derived from unadjusted data;
- the DPCR5 interaction component of the corrected net losses rolling retention mechanism (LRRM) incentive, as defined in the DPCR5 *Final proposals* and embedded in the distribution licence, is necessary to ensure that no windfall gains or losses occur as a direct result of the step change to unadjusted losses that has already occurred;

- the interaction mechanism was created as part of the DPCR5 settlement to ensure that licensees neither gained nor lost from changes in reporting methodology and adjustments to the DPCR5 targets; this was an important and explicit part of the DPCR5 settlement that provided protection for customers and companies;

- if adjusted data is used as the figure for actual losses in 2009-10 (the $ACL2_{2009\text{-}10}$ term in the interaction mechanism) this would have the opposite effect from the policy intent as set out in the *Final proposals* and would be contrary to the licence. It would represent an adverse swing of £93m for Northern Powergrid that would be unacceptable to our shareholder;

- Ofgem's published spreadsheet uses the correct dataset for the $ACL2_{2009\text{-}10}$ term, whereas the supplementary note published by Ofgem on 8 December 2011 is inconsistent with Ofgem's spreadsheet. The spreadsheet correctly reflects the DPCR5 *Final proposals*; the supplementary note does not and is incorrect;

- there is an inconsistency between the capped DPCR5 incentive and the uncapped interaction mechanism, which gives rise to a situation where a licensee could receive an interaction payment that is larger than outcome of the losses incentive could ever be. Since that interaction payment was intended to balance the effect of moving from one basis to another, it is clear that a defect has inadvertently been introduced to the design of the mechanism. Therefore, we believe there is merit in revisiting the DPCR5 *Final proposals* to correct this technical error; and

- although we believe that our proposed approach gives a good chance that the losses incentive could be allowed to continue without further intervention during the DPCR5 period, further requests for methodology changes cannot be ruled out because it is not known how supplier behaviour will continue to affect the data flows in the DPCR5 period and whether this will render the reported outturn inconsistent with the way that the DPCR5 targets have been set.

I should add that our response makes the presumption that, except where the *Consultation* states otherwise, Ofgem intends to continue to honour the DPCR5 settlement. If this assumption is correct, it follows that Ofgem is constrained in ways that are not explicitly recognised in the *Consultation*. Alternatively, if Ofgem wishes to be released from these constraints, licence modifications will be necessary. In our response we explain where the DPCR5 *Final proposals* and the licence act to limit Ofgem's discretion in the present circumstances.

You will appreciate that this matter is very important to us and it is vital to us that Ofgem does not proceed to make a decision on the various matters that are now before it without having fully understood the points that we have made in our submission. We therefore request the opportunity to take you and your colleagues through our submission as soon as you are able to fit us into your schedule.

Yours sincerely

John France
Regulation Director