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

## RESPONSE FROM NORTHERN POWERGRID

**23 December 2011**

## INTRODUCTION

1. This is the response from Northern Powergrid Holdings Company (previously called CE Electric UK Funding Company) and its subsidiaries Northern Powergrid (Northeast) Ltd (previously called Northern Electric Distribution Ltd) and Northern Powergrid (Yorkshire) plc (previously called Yorkshire Electricity Distribution plc) to Ofgem's *Consultation on regulatory measures to address the effects of gross volume correction and other settlements data adjustment on the distribution losses incentive mechanism* (Ref 137/11) published on 24 October 2011 (the *Consultation*). We also give our views on the note circulated by Ofgem on 8 December 2011 entitled *Clarification of Para 5.9 of the settlement data adjustment consultation* (the *Supplementary note*).

2. Our views are set out below.

   - We first set out some clarifications regarding the terminology we adopt in this response, and regarding the approach we presume that the Gas and Electricity Markets Authority (the Authority) has taken to consistency with the DPCR5 settlement and those matters that may require a licence modification.

   - Part one gives an overview of our response to the issues raised in the *Consultation*.

   - Part two gives our answers to the specific questions raised by Ofgem in each chapter of the *Consultation.*

   - Annex 1 sets out our detailed response to the *Supplementary note*.

## TERMINOLOGY ADOPTED

3. Throughout this response we shall use the word 'correction' to describe a change to settlements data that has been instigated by a supplier using one of the facilities within the settlements system. We shall use the word 'adjustment' to describe any further changes made to that data for any purpose connected with the losses incentive in the electricity distribution licence. This is different from the usage frequently adopted by Ofgem in the *Consultation* but we think our language is preferable because suppliers maintain that they are indeed 'correcting' data and it is this 'corrected' dataset that must

be ‘adjusted’ to get to a dataset that is consistent with the basis on which the DPCR4 targets were set.

**CONSISTENCY WITH THE DPCR5 SETTLEMENT**

4. We note that the *Consultation* does not state in terms when something that is being contemplated by Ofgem is within the terms of the DPCR5 settlement and when it would be a departure from that settlement.

5. We consider this distinction to be an important one. There are areas where the DPCR5 settlement provides discretion for Ofgem to determine key parameters, in particular the estimate of losses in 2009-10 used to determine DNO rewards or penalties under the DPCR4 period incentive scheme. However, there are also areas where the Authority has already consulted upon the methodology to be used. In these areas the DPCR5 settlement places constraints on the way in which certain terms must be calculated. This is the case for how the residual distribution losses incentive (PPL) and DPCR5 allowed loss percentage (ALP) are set, and means that a licence modification would be required if the constraints placed on the Authority by the DPCR5 settlement were not to be respected.

6. We surmise that Ofgem would view any change to the DPCR5 settlement as requiring a *separate* consultation. This is based on the fact that a special consultation is merited for the possible change to the interaction mechanism, to deal with the asymmetry between the uncapped nature of the interaction mechanism and the capped nature of the annual incentive under the DPCR5 losses condition, which would require a licence modification. We are therefore working on the presumption that, *except where the* Consultation *states otherwise,* the discretion that the Authority must exercise will be exercised within the limits of the existing licence condition. This is consistent with statements made by Ofgem in its letter to the distribution charging methodology forum (DCMF) on the losses incentive on 9 November 2011 (the *DCMF letter*)[1] that undertaking a review of the losses incentive well into the DPCR5 price control period is likely to undermine the certainty that Ofgem wishes to provide for companies.

[1] Letter from Dora Guzeleva to Losses and Gross Volume Correction Working Group members, 7 November 2011.

7. There are, however, some points at which the *Consultation* invites comments on a question where the answer is in fact established by the DPCR5 settlement, and as a result some potential responses would require the DPCR5 settlement to be altered. In this response we shall highlight those areas where the approach of the Authority is constrained if the DPCR5 settlement is to be honoured without modification. The details of this are dealt with more fully below but, in summary, the relevant constraints of the DPCR5 settlement relate to the setting of the PPL and ALP terms, and removing these constraints would require the modification of special condition CRC 7.

8. For the avoidance of doubt, we do not dispute that the Authority could decide that, in the light of the new information that has emerged following the implementation of the DPCR5 settlement, it no longer wishes to honour the terms of that price control review.

9. If that is the case, it would be a very serious matter and one where it would be appropriate for the Authority to explain fully why it was proposing to vary the terms of the settlement reached at the last review, and the statements made since then that it did not intend to undertake a review of the DPCR5 losses mechanism. Moreover, where a change to the licence is necessary to release the Authority from the constraints imposed by paragraphs 7.8 and 7.12 of CRC 7, it is clear that such a change can be implemented only in accordance with the new procedure by which licence modifications may now be made. By contrast, where the Authority is acting within the terms of paragraphs 7.8 and 7.12 of CRC 7 it can issue the necessary directions without making any change to the licence. It is important therefore that Ofgem is clear about whether it is intending to honour or depart from the DPCR5 settlement.

## PART ONE – OVERVIEW

***To close out the DPCR4 incentive consistency with targets requires that GVC and other corrections made by suppliers must be adjusted for.***

10. The DPCR5 *Final proposals* (Ref 148/09, chapter 4, paragraphs 4.19 to 4.21) and the special conditions of the electricity distribution licence (CRC 7, Part D, paragraph 7.8) require the Authority to determine the reported losses experienced in 2009-10 for the purposes of closing out the DPCR4 incentive scheme. It is important that this determination is made in such a way that DNOs receive rewards or penalties based on their absolute performance within the DPCR4 period.

11. In determining the measure of losses that should be used in closing out the DPCR4 incentive scheme for the Northern Powergrid licensees, all the relevant considerations which apply remain those which the Authority took into account in its 17 December 2010 decision giving consent to calculate the distribution losses of our licensees for 2009-10 on a basis that differs from that used in 2002-03 (the *2010 consent*).

12. In particular, in closing out the DPCR4 period losses incentive, it is necessary to adjust the 2009-10 settlements data to address the effects of gross volume correction (GVC) and other correction to settlements data that have been made by suppliers using the various mechanisms within the settlements process.

13. These adjustments are necessary to ensure that the DPCR4 period incentive mechanism, taken as a whole (i.e. including the losses rolling retention mechanism (LRRM)), is applied on a basis that is as consistent as possible with the targets that were set at that price control review. This would allow the approach to meet the first and second of the key principles that the Authority set out at paragraph 14 of the *2010 consent*, namely like-for-like target setting and performance monitoring, and sufficiently accurate data.

14. Conversely, a failure to adjust the dataset for the purposes of the LRRM would lead to an inconsistency between the basis on which the DPCR4 targets were set and the reporting of performance against those targets.

***The CE method should be used for the Northern Powergrid licensees…***

15. For Northern Powergrid the method by which these adjustments should be made is the method described in the *Consultation* as the CE method.

16. The CE method has the merit that it proceeds from a dataset (i.e. the settlement final (SF) run) that has been determined by a process over which the distributor has no control and does not require any subjective judgement to be made by the distributor to establish the starting point.

17. That starting point has the merit that it is free of the influence of the variations made to raw settlements data by suppliers using GVC and other techniques in 2009-10.

***…and probably for other licensees as well.***

18. It is possible that for other distributors other adjustment techniques may be appropriate to close out the DPCR4 incentive. However, we have seen nothing yet that suggests that the CE method would be inappropriate in other cases.

***Unadjusted data should be used for ongoing reporting of losses during the DPCR5 period…***

19. We understand from suppliers that the data correction activity they have undertaken, and will continue to undertake subject to the new settlements rules, should lead to the more accurate measurement of losses. From a common sense regulatory perspective, more accurate data should be preferable as the starting point for the measurement of losses during the DPCR5 period to less accurate data.

20. We also have no reason to believe that the extent of supplier data correction activity will change during the DPCR5 period, and the extent of any potential change is currently impossible to pre-judge in advance of it taking place. Therefore, unadjusted losses represent the correct starting point for the measurement of losses on a consistent basis within the DPCR5 period.

21. The use of adjusted data within the DPCR5 period would also have drawbacks. For instance, any adjustment requires assumptions about the mechanism through which supplier data correction activity propagates into unadjusted losses. While one adjustment mechanism might be appropriate for the pattern of data observed in 2009-10, this same mechanism might not be appropriate in the future even if the extent of supplier data correction activity remains unchanged, for instance if the mechanism by which supplier corrections affect unadjusted losses changes.

***…and therefore the targets should be based on the average level of losses from the DPCR4 period using unadjusted data.***

22. The principle that targets should be set on the same basis as performance against these targets will be measured means that the targets for the DPCR5 period should be set using data that *includes* the corrections made by suppliers in the DPCR4 period (i.e. data that is unadjusted). This is because the dataset inclusive of the corrections made

by suppliers is more reflective of the data that may be expected to flow in the DPCR5 period with respect to any MPAN that has been subject to such a correction.

23. The DPCR5 *Final proposals* (Ref 148/9, chapter 4, paragraph 4.8 and chapter 6, paragraph 6.16) and the distribution licence (CRC 7, Part G, paragraph 7.12) also establish that the DPCR5 period target must be set by reference to the average level of losses during the DPCR4 period reported using the DPCR5 common methodology. If DPCR5 losses are to be measured on an unadjusted basis then it follows that the targets must be calculated using the average level of unadjusted losses experienced during the DPCR4 period.

24. To depart from this approach to setting the DPCR5 period target, for example by using adjusted losses in the calculation of the DPCR4 period average when unadjusted losses were to be used to monitor losses within the DPCR5 period, or using unadjusted data from only 2009-10 to set the target rather than the DPCR4 average, would not be consistent with the part of the *Final proposals* that is incorporated by reference in the licence and would therefore require a licence change. Such an outcome cannot be achieved through the direction that the Authority is required to make for the purposes of closing out the DPCR4 incentive under the terms of the DPCR5 *Final proposals* (Ref 148/09, chapter 4, paragraphs 4.19 to 4.21) and the distribution licence (CRC 7, Part D, paragraph 7.8).

25. Moreover, such a change to the licence would have a fundamental impact on its operation within the DPCR5 period, and would not appear to be consistent with statements made by Ofgem regarding the fact that such a review would not be undertaken in order to ensure certainty for the affected licensees with regard to the DPCR5 arrangements, as recognised by Ofgem in the *DCMF letter*.

***The differences between GVC and DMX do not justify a different approach to the DPCR4 LRRM or to the setting of DPCR5 targets.***

26. The type of settlement correction mechanism used by a supplier can have a different impact on the losses reported in the period. However, the two principal mechanisms of which we are aware, GVC and dummy meter exchange (DMX), have one important feature in common, namely that once the correction has been applied, whether GVC or DMX, the dataflows that will occur in future will be more reflective of the data that has

flowed after the supplier's correction than the position with respect to the dataflows relating to that MPAN prior to the supplier's correction.

27. We understand that it is not now possible to ascertain which MPANs were corrected by suppliers using GVC and which were corrected using DMX. However, Northern Powergrid's enquiries of suppliers using its distribution networks during the DPCR4 period indicate that the overwhelming majority of variations introduced by suppliers made use of the GVC facility rather than the DMX facility.

28. Accordingly, for Northern Powergrid it follows that;

- *for the purposes of determining the value of DPCR4 incentive* settlement data should be adjusted applying the CE method to all the dataflows that are required to determine the losses in the year 2009-10; and

- *for the purposes of setting the DPCR5 targets and the interaction mechanism that is an integral part of the DPCR5* Final proposals, the settlement data should not be adjusted by the application of the CE method (or by any other adjustments) but should be left as reported by the settlements system.

***The DPCR5 interaction component of the corrected net 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…***

29. The corrected net LRRM incentive mechanism, as defined in both the DPCR5 *Final proposals* (Ref 148/09, chapter 4, paragraph 4.24) and embedded in the distribution licence (CRC 7, Part D, paragraph 7.8), contain an interaction component that was specifically designed to ensure that there were no windfall gains or losses as a result of a change in reporting methodology at DPCR5, compared with that used for the purposes of the DPCR4 incentive.

30. At the time of the DPCR5 *Final proposals*, it was envisaged that this mechanism was required to deal with items such as the removal of substation energy from reported losses for some DNOs. However, the change in supplier settlements behaviour that has occurred during the later stages of the DPCR4 period, which necessitates an adjustment

to DPCR4 reported data to ensure it remains consistent with how DPCR4 targets were set, means that a significantly larger step change in reported losses will occur between adjusted DPCR4 data and unadjusted DPCR5 data. While such a large change in reporting methodology may not have been envisaged at the time of the DPCR5 settlement, the mechanism that was established has the necessary features to enable it to deal effectively with the situation that has now arisen.

31. While we have not yet received all the reconciliations due on 2010-11 losses data, our experience has already demonstrated that the impact of an increase in supplier data correction activity is continuing to be felt on our unadjusted losses data. This means that an effectively functioning interaction component of the DPCR4 LRRM is necessary to avoid an overall windfall penalty on our licensees.

***…although there is an inconsistency between the capped DPCR5 incentive and the uncapped interaction mechanism, which we believe would merit the revisiting of the DPCR5* Final proposals.**

32. Ofgem is to consult later on whether the DPCR5 settlement should be re-opened to ensure that there is an alignment between the interaction mechanism, which is uncapped, and the rewards and penalties under the DPCR5 period incentive, where caps and collars apply. Northern Powergrid acknowledges that, although there are disadvantages to any re-opening of a price control settlement, in the circumstances that have arisen with regard to the losses incentive a limited re-opener to correct a policy failure is appropriate.

33. Northern Powergrid has assumed that Ofgem does not intend to re-open any other aspects of the DPCR5 settlement. This understanding was reinforced by the *DCMF letter* which ruled out any more fundamental review of the losses mechanism during the DPCR5 period. We support this respect for the finality of the DPCR5 *Final proposals*. Moreover, inherent in the *Final proposals* was the deliberate and explicit protection for licensees and for customers from unanticipated and uncontrollable fluctuations in loss reporting. One aspect of this protection takes the form of caps and collars on the incentive mechanism. This limitation on the risks and rewards associated with the incentive was a material consideration for licensees in accepting the DPCR5 *Final proposals*.

34. While we do not contend that we expected the cap or collar to bite from the start of the DPCR5 period, as now appears to be likely, this outcome is not inconsistent with the *Final proposals* and is something we have expected since the decision of the Authority on our methodology change application that was granted in December 2010. Given this, we do not believe that there is any reason to revisit other issues relating to the operation of the DPCR5 losses incentive which were consulted upon during DPCR5, and have already been established as part of the *Final proposals* and the licence, except insofar as is necessary to correct the policy failure we have noted above which could cause licensees to experience a windfall gain or loss.

***Further requests for methodology changes in the DPCR5 period cannot be ruled out…***

35. The principle of consistency is as important to the DPCR5 settlement as it was to the DPCR4 deal. However, one important distinction that differentiates the two is the presence of a limitation on the materiality of the losses incentive in the DPCR5 settlement. It is already clear that the losses measurement systems will be far from perfect during the DPCR5 period. The transition to DPCR5 has placed limits on the extent of large windfall gains or losses that can be created, while at the same time the changes to supplier behaviour during 2009-10 leads us to believe that the likelihood of such large financial swings (if left uncorrected) is greater than most observers would have believed when DPCR5 was settled.

36. The approach we have recommended in this response is one that we believe should help to minimise the prospect that there will be a need to re-visit the issue of a mismatch between the basis on which targets have been set and the reported performance against those targets in the DPCR5 period. However, further requests for methodology changes in the DPCR5 period cannot be ruled out. Firstly, there are still uncertainties about the extent to which dataflows in the DPCR5 period may be affected by future changes in the behaviour of suppliers with regard to settlements corrections. Secondly, while the target setting process and interaction mechanism set out in the licence anticipate a certain relationship between targets set on the basis of DPCR4 data and the 'standing still' level of DPCR5 period losses, the change in supplier corrections behaviour during the DPCR4 period could still have an unanticipated impact on DPCR5 period data flows even without further changes in supplier corrections behaviour. The response by Ofgem to any such request for a methodology change

during the DPCR5 period could take the form of a variation to the losses target (subject to the constraints on such re-setting that are set out in CRC 7) or the method of calculating reported losses.

37. We wish to be clear that, in the same way that we believe it is correct to adjust DPCR4 reported losses in the current circumstances to avoid an inconsistency with the DPCR4 targets that would cause us to suffer a windfall loss, we believe it would be correct to undertake similar measures in the future if this situation, or indeed a reverse situation where we experienced a windfall gain, were to arise.

***…and it may be appropriate to set materiality thresholds for future methodology change requests.***

38. Accordingly, Northern Powergrid recommends that Ofgem should consider whether it is necessary to make arrangements now that will establish a materiality test for the consideration of any application made by a distributor to vary its targets or its method of calculation during the DPCR5 period.

**PART TWO – RESPONSES TO SPECIFIC QUESTIONS RAISED IN THE CONSULTATION**

**CHAPTER Two:**

**Chapter two, question 1:** Do you think we (Ofgem) have identified the main data/billing adjustment techniques used by electricity suppliers and their impacts?

39. **Answer:** Yes. From the information available to us, we understand that during 2009-10 the dominant correction activity which affected settlements reconciliation runs in our distribution licence areas was GVC.

**Chapter two, question 2**: Are there any other factors you think we should take into consideration in assessing the impact of settlement data volatility?

40. **Answer.** Techniques such as GVC and DMX are regarded by suppliers as a legitimate method to ensure the data in settlements is corrected and is therefore made more accurate. Our concern is that the targets set for distributors with respect to electrical losses have been set on an inconsistent basis with the reported losses from the settlements system within the DPCR4 period due to a sharp rise in the use of techniques such as GVC, particularly in the final year of the review period. Given the nature of the losses incentive which is valued at five times the outperformance in the final year, the corrections made by suppliers that greatly exceed the incidence of correction during the prior years from which the targets for the DPCR4 period were derived, would have a significant distorting effect on the incentive unless some action were taken to restore consistency between the targets and the outturn.

41. The *Consultation* makes a reference in chapter two to the impact of negative EACs on settlements data. Negative EACs appear to have become more common in 2009-10 than during the period on which targets were based. We understand that these negative EACs would have affected SF data, and also various reconciliation rounds, as the data was reported. They should therefore be taken into account in some way in assessing the impact of settlement data volatility.

42. For the future, the likely impact of the rollout of Smart Metering should also be considered. Smart Meters should ultimately provide for more accurate settlement data and therefore fewer errors. However, experience from rollouts elsewhere in the world suggests that the introduction of Smart Meters will lead to the identification of errors that have previously gone undetected and may introduce new errors as a result of the implementation. There is therefore likely to be a material discontinuity between the dataset prior to Smart Meters being introduced and the dataset following the rollout.

43. Ongoing monitoring of the impact on the settlements process of the Smart Meter roll out would therefore be required to identify whether this should, in future, be taken into account when assessing the impact of settlement data volatility.

**CHAPTER Three:**

**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?

44. **Answer:** Yes. We do not believe it is practical to reconstruct settlements data from the bottom-up to exclude supplier data corrections to the extent that they match the underlying extent of corrections that prevailed when the targets were set. Firstly, we are told by suppliers that the data is not available for such a reconstruction exercise and, secondly, it would not be feasible to seek to match the underlying extent of data corrections on a bottom up basis. We note that this was also the conclusion of the joint supplier/DNO DCMF losses workshops.

**Chapter three, 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?

45. **Answer:** Yes. Our view is based upon the findings taken from the industry working group under the DCMF. At the end of these meetings no other methodology was put forward as a further alternative.

**Chapter three, 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?

46. **Answer:** Yes. A fundamental distinction between the two methodologies is that the SP/Engage method limits the relative *proportion* of units that change as a result of reconciliation, as opposed to the absolute value of energy that was 'disavowed' (which is the characteristic of the CE method). These are fundamentally different approaches - i.e. one relative the other absolute - and there does not seem to be any benefit from combining these two methods. A hybrid of the two methods would not be superior to the CE method or indeed to the SP/Engage method applied in isolation.

**CHAPTER Four:**

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

47. **Answer:** In the main yes, but we feel that the CE method is to be preferred for the following additional reasons:

- the CE method is firmly grounded in a dataset (i.e. the SF run) over which the distributor has no influence and does not require any subjective judgement to be made by the distributor or Ofgem about the starting dataset;

- the SP/Engage correction comes from different reconciliation runs and is less reflective of actual supplier activity;

- while some commentators feel the need to monitor data to avoid 'double counting' is a drawback of the CE method, our view is that the monitoring requirements are straightforward and easily demonstrated. Moreover, the need to undertake this monitoring flows from a feature of the CE methodology which we believe is in fact a strength, namely the fact that the negative EACs component of the adjustment is supported by detailed data on the settlements characteristics of individual MPANs.

- some commentators have observed that the CE method adjusts for negative EACs but does not adjust for large positive EACs that may also have affected settlements data. This observation misses an important point about the purpose of the CE method. The objective of the method is to arrive at the dataset that most closely resembles the dataset that would have been received had suppliers continued to behave as they had behaved in the period from which the DPCR4 targets were derived. At the Ofgem workshop held on 2 December 2011 the Elexon representative confirmed that an increased use of GVC would give rise to an increase in the incidence of negative EACs and it is with this increase that the CE method seeks to deal. By contrast implausibly large positive EACs may reasonably be presumed to have featured in both the data from which the targets were derived and the reported performance. Consistency between reported outturn and the basis on which targets were set requires that adjustment is made for negative EACs but not for large positive EACs;

- one supplier has questioned whether the negative EACs were corrected before being used in settlements. We have provided suppliers with the list of negative EACs attributable to them and asked them to confirm where this was the case. The CE method enables an adjustment to be made where the settlements data that is used in the CE method already incorporates the actual reading that removes the negative EAC; and

- some suppliers have observed that the SP/Engage method was presented as a method that could be applied more generally. This is a purely presentational observation as the CE method can be described in a similar manner.

**Chapter four, 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?

48. **Answer:** The answer to the first two sub-questions is no. In general it is only possible to infer what may be causing general variations in SF data. Whilst it may appear that the recession has had a significant effect on units distributed this may also be said of

the effects of seasonal temperature variations (which may be in the opposite direction) and it is not possible to say with any confidence what effect each element has had.

49. In terms of the third sub-question, the *Consultation* could perhaps have given more emphasis to the fact that the CE method does not need to make a *separate* estimate of the effects of the recession or the extreme weather of 2009-10 because the timing of the these issues mean that their effects are largely reflected in the SF run from which the CE method proceeds (due to the large number of meter readings taken in this period). The method also has the advantage that, to the extent both of these effects were not fully captured through the increase in meter readings, their residual effects would have tended to offset each other. It is therefore not correct to cite the absence of any specific recession adjustment, or adjustment for extreme weather, as being a disadvantage of the CE method. In fact the converse is true: the CE method has the merit that it does not require anyone to guess what the effect of the recession has been.

50. The purpose of adjusting settlements data in the reported outturn is to achieve reasonable consistency with the data that was used to set the targets. Clearly supplier data correction activity such as GVC has had a significant influence on this consistency (between targets and actuals) and therefore the challenge is to adjust the settlement data that has been altered by GVC and other techniques so that it is reasonably consistent with the dataset that was used to set the targets.

51. It is important to understand that the CE method does not contend that the alterations to the data made by suppliers using techniques such as GVC have made that data less accurate than it would otherwise have been. Indeed, we readily accept that GVC may have improved the underlying accuracy of the data. In this respect we wish to correct Ofgem's summary on page 24 of the *Consultation* which states that in the CE method there is an assumption that the data from 2005-06 to 2008-09 is 'normal' and the reconciliation data from 2009-10 is 'corrupt'. The word 'normal' is not in doubt since it conveys the impression that this was the normal behaviour of suppliers at this time. The word 'corrupt', however, conveys the wrong impression. We do not contend that the data from this period is corrupt, only that it is the result of a changed behaviour that is inconsistent with the behaviour of suppliers during the period from which the DPCR4

targets were derived.[2] The CE method is justified because it is an effective way to restore a reasonable consistency between targets and actuals, rather than because it results in a dataset that aligns better with reality. We believe this correction to be important because it goes to the heart of the exercise with respect to the close out of the DPCR4 incentive and the setting of targets for the DPCR5 period.

**Chapter four, question 3:** Do you consider that both methodologies can deal equally well with all types of settlements data correction?

52. **Answer:** In general yes. Both methods are relatively simple 'top down' quantification methods that rely on normalising the data having regard to a dataset that preceded the behavioural change on the part of suppliers. They are both applicable to settlement date, run date or accounting date regulatory reporting methods and use readily available data (though some DNOs may not have the full P222 negative EACs data). However we would note that:

- the outcome under the CE method is not influenced by the subjective selection of the 'stable period' and adjustment to SF based on historical data that is itself subject to some inconsistency;
- adjustments made using the CE method have the stronger technical basis as the method is based on the evaluation and adjustment of absolute values of energy, i.e. it sets out to reverse the effect of the actual adjustments made by suppliers. Correction is applied at those points in the cycle where supplier activity is known to have been most influential and objectively verifiable (i.e. it is not skewed towards SF); and
- when applied to 2009-10, the CE methodology incorporates the impact of both the recession and temperature variations without needing to estimate these effects.

[2] Ofgem appears to recognise this position correctly at paragraph 3.7 on page 19 of the *Consultation*

**Chapter four, 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?

53. **Answer:** The requirement to select a 'normal' period is a significant drawback in the SP/Engage method because the selection of this 'normal' period is subjective and can have a significant influence on the output. However, if that method is to be used by any DNO it makes sense for the DNO to be permitted to select the 'normal' period having regard to the behaviour of the suppliers that used their network. Ofgem would have to satisfy itself that the period chosen by the distributor was reasonable.

54. In any case, whatever method of adjustment is used, the onus should be on each licensee to demonstrate that supplier behaviour has given rise to a mismatch between the basis on which targets have been set and the basis on which outturn performance has been reported. The SP/Engage method requires a judgement to be made about the normal period. In this method this assumption is fundamental to how much adjustment can be made by the DNO. Although Ofgem has stated that the SP/Engage method uses a 'statistically modelled approach' (Paragraph 4.6 on page 17 of the *Consultation)*, what this amounts to is looking at a graph and identifying a period where the graph looks relatively flat. The classification of the normal period therefore remains highly subjective and could differ between DNOs. This could mean that each DNO's assumptions around the choice of the 'normal' settlement period would be based on each DNO's observed patterns, and in doing so, it could lead to a DNO choosing a period which gives it the most favourable result. The impact in the calculation that would result from selecting a different normal period would mean the requirement of a like-for-like comparison may be put at risk. It would place a significant burden on Ofgem to determine whether each distributor had chosen an appropriate 'normal' period, leading to the prospect of windfall gains or losses for customers or distributors that might result from such discussions. The CE method also requires that a normal period is identified, but since the CE method proceeds from unadjusted SF data, it is less sensitive to this subjective selection of a normal period.

**Chapter four, 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?

55. **Answer:** The approved Northern Powergrid methodology is suitable for use with respect to our two networks. It may also be appropriate for others to use this method without any amendment where suppliers have made use of similar facilities at the same points in the settlement cycle over broadly the same period of time. However, Ofgem may wish to satisfy itself that the imposition of a single methodology regardless of the circumstances does not carry the risk that an exercise that is designed to restore consistency between targets and outturn may in some cases give rise to greater inconsistencies than are present in the unadjusted data. Looking at the implications in the settling of the close out of the DPCR4 LRRM, we feel that Ofgem should be wary of the potential for unjustifiable outcomes that might arise from imposing a single method irrespective of the circumstances. We recommend that Ofgem should preserve its flexibility to deal with the different circumstances of different licensees, always having regard to the purpose of the losses incentive as set out in the DPCR4 licence condition.

**Chapter four, question 6:** Do you consider that Option 1 should be that single methodology? If not please give reasons for your response.

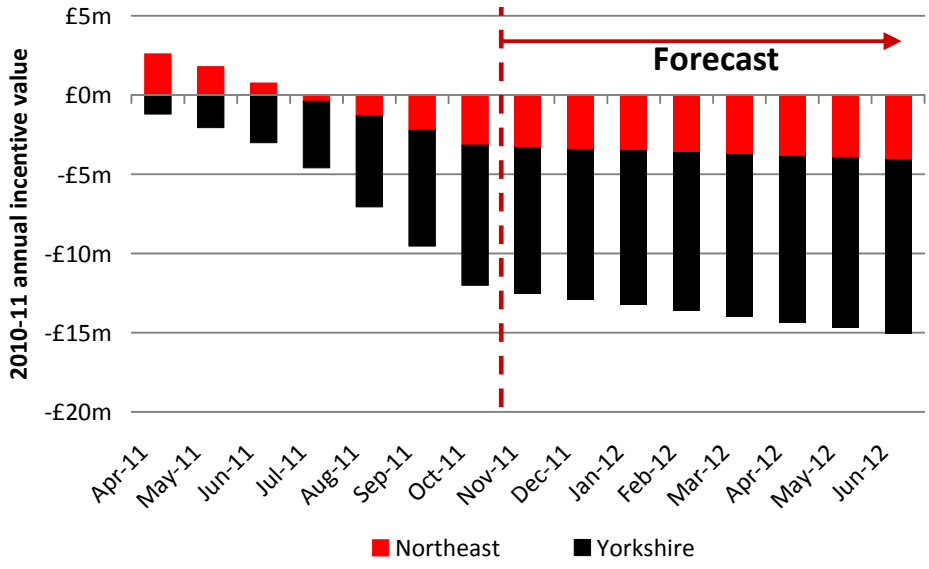
56. **Answer:** Yes. If there is to be one methodology, we believe that Option 1 has more to recommend it than Option 2. We agree that the selection of the appropriate 'stable' period in Option 2 is subjective and this has a more significant impact on the result under this method than the determination of the period from which the amount of adjustment is determined under the CE method. This drawback is not compensated for by any material advantages that have been claimed for the SP/Engage method. In particular, the claim that the SP/Engage method deals with the recession whereas the CE method does not is spurious for the reasons given above in the answer to chapter four, question 2 at paragraph 49 above.

**Chapter four, 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 on-going settlement data adjustments likely to be on the same scale as those observed for 2009-10?

57. **Answer:** Suppliers have clearly stated that they intend to continue to use GVC and other correction techniques. Unless there is some intervention that prevents or limits this they will continue to use these tools. Even where the use of individual tools is limited within the settlements process, we expect that suppliers would, legitimately, continue to make corrections by any other tools which remain available to them.

58. We have seen evidence of continued settlements corrections in the data we have received from the period after 2009-10. The pattern of continuing deterioration in reported losses for 2010-11 is shown in Figure 1 below. The chart shows how the financial performance of our two licensees on the 2010-11 losses annual incentive has evolved between April and October 2011, as we have continued to receive reconciliations through the settlements process. It also shows our forecast for ongoing reconciliations to the 2010-11 data.

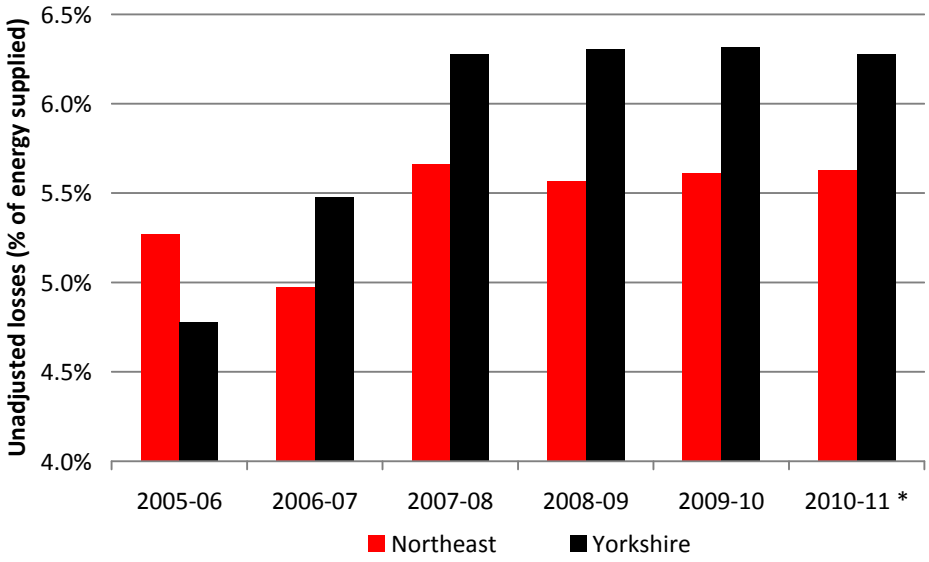
Figure 1: The ongoing deterioration of 2010-11 losses incentive financial performance for the Northern Powergrid licensees (£m, 2010-11 prices)




59. In any case the impact of GVC activity carried out so far means that any MPAN that has been adjusted by GVC (or similar) will now have that change locked in. Therefore

even if the practice were to be banned altogether the impact would continue to be felt throughout the DPCR5 period. The continuation into 2010-11 of the higher level of losses experienced by Northern Powergrid during the later stages of DPCR4, measured on a reconciled basis, is shown in Figure 2 below. The figure suggests that the effect of the settlements correction activity experienced during 2009-10 has not diminished.

Figure 2: Reconciled losses for Northern Powergrid's licensees




* Note: includes RF reconciliations for months up to and including October 2010

**CHAPTER Five:**

**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?

60. **Answer:** It is important to be careful about the datasets that should and should not be adjusted.

61. In summary, where the purpose of the calculation ensures that the DPCR4 period incentive delivers the correct outcome, an adjusted dataset must be used. Otherwise there will be an inconsistency between the basis on which the targets were set and the reporting against those targets. By contrast, where the purpose of the exercise is to look ahead, either to set the targets for the DPCR5 period or to calculate the 2009-10 losses on the basis of the DPCR5 common methodology for the purpose of the interaction

component that forms part of the corrected net LRRM incentive, it is essential that unadjusted data is used.

62. On 8 December Ofgem issued the *Supplementary note* that touches on this subject and we have set out a detailed response to that note in Annex 1 below.

**Chapter five, 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?

63. **Answer:** Whatever method of adjustment is used it is appropriate to adjust the dataset used to calculate actual losses in 2009-10 for the purposes of calculating rewards and penalties under the DPCR4 incentive.

64. It is inappropriate to adjust the dataset used to calculate actual losses in 2009-10 for the purposes of calculating both the interaction component (that forms part of the corrected net LLRM incentive) and the DPCR5 period targets. Our reasoning is as follows.

- We understand from suppliers that the data correction activity they have undertaken, and will continue to undertake subject to the new settlements rules, should lead to the more accurate measurement of losses. From a common sense regulatory perspective, more accurate data should be preferable as the starting point for the measurement of losses during the DPCR5 period to less accurate data.

- We also have no reason to believe that the extent of supplier data correction activity will change during the DPCR5 period, and the extent of any potential change is currently impossible to pre-judge in advance of it taking place. Therefore, unadjusted losses represent the correct starting point for the measurement of losses on a consistent basis within the DPCR5 period.

- The use of adjusted data within the DPCR5 period would also have drawbacks. For instance, any adjustment requires assumptions about the mechanism through which supplier data correction activity propagates into unadjusted losses. While one adjustment mechanism might be appropriate for the pattern of data observed in 2009-10, this same mechanism might not be appropriate in the future even if

the extent of supplier data correction activity remains unchanged, for instance if the mechanism by which supplier corrections affect unadjusted losses changes.

**Chapter five, question 3:** Do you agree that in setting the DPCR5 ALP we should not include any settlements data adjustment?

65. **Answer:** Based on the presumption that, in this question, Ofgem is using the term 'adjustment' in the same way that we do, yes.

66. Our view is based on an assumption that unadjusted data will be used to measure losses on an ongoing basis during DPCR5. This seems appropriate from a common sense regulatory perspective. We understand from suppliers that the data correction activity they have undertaken, and will continue to undertake, should lead to the more accurate measurement of losses. This more accurate data should be preferable as the starting point for the measurement of losses during the DPCR5 period to less accurate data.

67. It follows that the adjustments necessary to close out the DPCR4 incentive (to ensure consistency with the DPCR4 target) must be backed out in setting the DPCR5 targets because the DPCR5 outturn with respect to these MPANs will continue to reflect the new information that led to the GVC and other adjustments in the first place. This means that the unadjusted data will be more reflective of the data that is likely to flow during the DPCR5 period than the adjusted data would be.

68. This approach to setting the DPCR5 ALP was also established within the DPCR5 *Final proposals* (Ref 148/9, chapter 4, paragraph 4.8) and is now embedded in the distribution licence (CRC 7, Part G, paragraph 7.12), which require that the DPCR5 period target must be set by reference to the average level of losses during the DPCR4 period reported using the DPCR5 common methodology. If DPCR5 losses are to be measured on an unadjusted basis then it follows that the targets must be calculated using the average level of unadjusted losses experienced during the DPCR4 period.

69. Any change to our licence in terms of how targets are set would have a fundamental impact on the operation of the losses incentive within the DPCR5 period, and would not appear to be consistent with statements made by Ofgem regarding the fact that such a review would not be undertaken in order to ensure certainty for the affected licensees with regard to the DPCR5 arrangements, as recognised by Ofgem in the *DCMF letter*.

**Chapter five, 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?

70. **Answer:** With respect to the distinction between DMX and GVC, the supplier whose behaviour has been the decisive influence on settlements corrections affecting our own losses performance has always given us to understand that these corrections have been dominated, if not exclusively caused by, GVC rather than DMX activity. It is not now possible to determine precisely the relative contributions of each facility to the very significant effect on our losses that we have observed.

71. However, although there would be a rather different effect from the impact of each correction method, in both cases unadjusted data from the DPCR4 period is a *better* basis for setting the DPCR5 targets. Given that a perfect correspondence between the data used to set the DPCR5 targets and the basis on which performance will be reported in the DPCR5 period is not feasible, all that can now be done is to use the dataset to set the DPCR5 targets that best approximates to the likely impact of the activity carried out by suppliers up to now. That dataset must include suppliers' corrections (whether GVC or DMX).

72. GVC and DMX have one important feature in common namely that once the correction has been applied, whether GVC or DMX, the dataflows that will occur in future will be more reflective of the data that has flowed after the supplier's correction than the position with respect to the dataflows relating to that MPAN prior to the supplier's correction. As a result, our response to question 3 in chapter five applies regardless of whether supplier corrections have made use of the GVC or DMX facilities. We have not examined the appropriate approach in the case of any other supplier settlement correction mechanisms as we understand GVC to have been the most common mechanism used by the dominant supplier with respect to our two networks.

73. Although GVC and DMX have different impacts in both cases the corrections made by the supplier at a particular MPAN are *more* reflective of the dataflows that may be expected in respect of that MPAN in future than the uncorrected data would be. For this reason *unadjusted* data (i.e. data that incorporates the suppliers' corrections) is the better basis for setting the DPCR5 period targets (having regard to the need for

consistency). It also follows that the interaction component should use the same unadjusted dataset to fulfil its purpose.

74. However, even if Ofgem were to set the DPCR5 period targets using unadjusted DPCR4 period data (as we propose), this would be a stable basis for setting the DPCR5 period targets only if it is assumed that the suppliers' correction activity will drop to the average extent experienced during the DPCR4 period or that it will decline in the DPCR5 period at the same rate as it grew in the DPCR4 period. Yet we know that, so far, there is no evidence of this. It follows that even if unadjusted DPCR4 period data is used to set the DPCR5 period targets this is likely to result in an unattainably low losses target for a distributor that has been materially affected by the data correction activity of suppliers. The pattern of continuing deterioration in reported losses for 2010-11 is shown in our response to chapter four, question 7 above. This suggests that suppliers are continuing to make corrections to MPANs at levels that are at least commensurate with the effect seen in the later years of the DPCR4 period, or that the change in supplier behaviour during the DPCR4 period has had a persistent effect on unadjusted losses.

75. Therefore, although unadjusted data is preferable to adjusted data for the purpose of setting the DPCR5 targets, using this dataset will not guarantee material consistency between the DPCR5 targets and the reported outturn in the DPCR5 period because:

- the unadjusted data is still likely to understate the average level of losses in the DPCR4 period because the GVC/DMX activity that has occurred so far has not corrected all of the electrical losses that were mistaken for units distributed in the earlier years of the DPCR4 period;

- it is unknown how much more, or less, activity there will be on the part of suppliers in the DPCR5 period that will affect MPANs that have not yet been the subject of GVC or similar techniques. Assuming suppliers are not creating any new data errors, a steady state as between targets based on the average of unadjusted data and outturn in the DPCR5 period would be achieved only if the suppliers' behaviour satisfies the conditions described in the previous paragraph. We know that this is not the case, but we do not know if the increase in reported

losses in the DPCR5 period that will result from the actions already taken and the continuation of these activities will be material; and

- new discontinuities between the targets and reported outturn are likely to be created by the introduction of Smart Meters during the DPCR5 period.

76. Despite these qualifications it remains the case that there will be more consistency between targets and reported losses in the DPCR5 period if unadjusted data from the DPCR4 period is used to set the targets for the DPCR5 period. If this unadjusted data were to be used Ofgem could define materiality thresholds that would apply to any application in the DPCR5 period that was made on similar grounds to our own application with respect to the year 2009-10.

## ANNEX 1: COMMENTS ON THE OFGEM SUPPLEMENTARY NOTE

1. In this Annex we comment on Ofgem's *Supplementary note*.

2. Paragraph 5.9 of the *Consultation* states

> 'As stated above $ACL2_{2009/10}$ is the 2009-10 losses re-reported using the DPCR5 methodology. This means that any adjustment approved by Ofgem to normalise abnormal settlement corrections in 2009-10 will need to be included in this figure. We therefore propose that the selected correction methodology is re-run using 2009-10 data reported according to the DPCR5 common methodology in order to give a revised $ACL2_{2009/10}$ for the purposes of the LRRM calculation. This will also give a revised figure for the units distributed in 2009-10 re-reported using the DPCR5 methodology - $UD_{2009/10}$.'

3. This passage can be read in at least two ways. It could be read to mean that the $ACL2_{2009\text{-}10}$ term should include the 'losses' that have been removed from the 2009-10 dataset in accordance with an Ofgem approved methodology change (i.e. these 'losses' would be reflected in the calculation), i.e. losses would be calculated on an adjusted basis under our terminology. Alternatively, it could be read to mean that the 'adjustment' itself should be reflected in the calculation (which would *remove* these 'losses' from the dataset), i.e. loses would be calculated on an adjusted basis under our terminology. We had interpreted the *Consultation* as meaning the first of these interpretations and we were surprised that Ofgem's *Supplementary note* indicates that it had meant to convey the second of these meanings. We note that this clarification is without prejudice to any decision over the correct approach to this issue.

4. It is clear that the second of these meanings would give rise to an outcome that would be inconsistent with the purpose of the interaction mechanism of which the term $ACL2_{2009\text{-}10}$ is a component.

5. This can easily be demonstrated. The interaction mechanism is that part of the calculation that ensures that the licensee receives neither a windfall benefit nor a disbenefit from the move from the DPCR4 period incentive arrangements to the DPCR5 incentive arrangements. More specifically, its purpose is to ensure that (a) the

DPCR4 incentive closes out to generate the economic value that was intended under that incentive; and (b) that the DPCR5 incentive will generate the economic value that was intended under that incentive. In order to secure these two outcomes the interaction mechanism looks at the benefits or penalties that the licensee will receive under the DPCR5 incentive if its performance stands still relative to its performance in the final year of the DPCR4 period. The adjustment is based on the premise that since the DPCR5 target is derived from the average of the DPCR4 years there will be rewards or penalties in the DPCR5 period that would arise even if the licensee's performance remained stable at the level it realised in the year 2009-10. These rewards or penalties that arise from 'standing still' must be removed so that the net result is that the *change* in the losses performance achieved in the DPCR5 period is rewarded or penalised at the DPCR5 incentive rate.

6. Since Ofgem is minded (correctly) to set the *targets* in the DPCR5 period on the basis of unadjusted data, because that is the dataset that is most consistent with the data that will flow in the DPCR5 period, it follows that the interaction mechanism which is determined by the following equation:

$$5*\text{Incentive Rate}*(TL_{DPCR5} - ACL2_{2009\text{-}10})$$

would be inconsistent with this approach if the $TL_{DPCR5}$ term (i.e. the targets for DPCR5) were to be derived from unadjusted data but the $ACL2_{2009\text{-}10}$ term were to be derived from adjusted data. Subtracting one from the other as part of this calculation makes sense only if these two datasets are consistently derived.

7. It may be worth reiterating why the term $ACL_{2009\text{-}10}$ that is used in the close out of the DPCR4 incentive (sometimes colloquially referred to as the 5 times E calculation) is different from the term $ACL2_{2009\text{-}10.}$

8. Ofgem's *Supplementary note* recognises that it was always intended that $ACL_{2009\text{-}10}$ would differ from $ACL2_{2009\text{-}10}$. This is because in the DPCR5 *Final proposals* the method by which actual losses are calculated to close out the DPCR4 incentive differs from the method that Ofgem requires licensees to use in the DPCR5 period. At the time the DPCR5 *Final proposals* were written this was expected to be limited to items such as removing substation electricity from measured losses. If the nature of these differences had not been recognised in the definitions of $ACL_{2009\text{-}10}$ and $ACL2_{2009\text{-}10}$

licensees would have received a windfall benefit or loss under the interaction mechanism merely because the prescribed method of calculating actual losses was changing.[3]

9. After the DPCR5 *Final proposals* were published it became clear that there is another (and much larger) difference between the way that actual losses will be measured for the two purposes of closing out the DPCR4 incentive and the operation of the DPCR5 incentive. That new difference is represented by the adjustments that must be made by a distributor in order to ensure that DPCR4 performance is measured on a basis that is consistent with the setting of the DPCR4 targets. These differences must also be reflected in the definitions of $ACL_{2009\text{-}10}$ and $ACL2_{2009\text{-}10}$.

10. This was explained unambiguously in the *Final proposals*. Ofgem recognised that there were three policy intents that the close out, and interaction mechanism, needed to achieve:

> '7.10. In closing out the DPCR4 losses incentive we intend to apply the LRRM (as described above) and to take steps to ensure that there are no windfall gains or losses to the DNOs arising from:
>
> - settlement data corrections and provision accounting,
> - changes in reporting methodology, and
> - adjustments to the DPCR5 targets.'[4]

11. The first of these policy intents was effected through the way in which losses were measured for the purpose of the DPCR4 incentive scheme close out, to increase the degree of consistency across all DNOs.

12. The second and third of these policy intents were effected through the interaction mechanism. On this, Ofgem specifically stated that:

> '7.17 This means that where a DNO's losses calculated according to the new reporting methodology at the start of DPCR5 are lower than when reported

[3] Or, alternatively, licensees would have closed out the DPCR4 incentive with a reward or penalty that resulted from an unintended consequence of a definitional change to measurement of losses for the purposes of the DPCR4 incentive.

[4] DPCR5 *Final proposals*, *Incentives and Obligations*, page 40. Note that the use of the term 'corrections' here is likely to relate to DNO corrections to settlements data that prevailed with the DPCR4 period, as opposed to supplier GVC activity.

according to the reporting methods used in DPCR4, the roller amount will be reduced to avoid a windfall gain to the DNO, and vice versa.'[5]

In other words, where there is a legitimate reason that losses for the purpose of the DPCR4 incentive should be calculated on a different basis from reported losses during the DPCR5 period, windfall gains and losses should be avoided by accounting for the change in methodology through the interaction mechanism. If the change to reporting methodology between the DPCR4 LRRM and the DPCR5 period incentive scheme has the effect of *reducing* measured losses at the start of DPCR5 (i.e. 2009-10), then the roller amount should be reduced to avoid a windfall gain to the DNO. Likewise, if the change to reporting methodology *increases* measured losses when moving from the DPCR4 close out methodology to the DPCR5 reporting methodology, there should be a compensating increase to the roller amount to avoid a windfall loss to the DNO. This windfall amount would be equal to the 'standing still' advantage (or disadvantage) which the DNO experiences as a result of the change in reporting methodology decreasing (or increasing) its measured losses starting point for 2009-10.

13. If the term $ACL2_{2009\text{-}10}$ in the interaction mechanism is modified so that it is also adjusted according to the approved methodology for $ACL_{2009\text{-}10}$, then this would prevent the interaction mechanism mitigating for any windfall gains or losses that would arise from any Ofgem approval for a revision to the methodology used in calculating losses in 2009-10 for the purposes of the DPCR4 LRRM, given the (correct) proposal to use unadjusted losses for the DPCR5 incentive scheme. If Ofgem were instead to leave the definition of $ACL2_{2009\text{-}10}$ unchanged this would allow it to fulfil its original policy intent, of correcting for windfall gains and losses arising from changes to reporting methodologies.

14. This point can also be illustrated further by a statement in the DPCR5 *Final proposals* regarding how the algebra of the DPCR4 corrected LRRM had been established:

> 'If $ACL2_{2009\text{-}10}$ is the losses for 2009-10 re-reported using the DPCR5 common reporting methodology [Ofgem footnote], then the corrected net incentive under the LRRM ('corrected net LRRM incentive') is calculated as follows…

[5] DPCR5 *Final proposals, Incentives and Obligations*, page 42.

[Ofgem footnote] i.e. the same as RLt used in the DPCR5 target setting calculation'[6]

It follows from Ofgem's 'if' statement, and the associated footnote, that if $ACL2_{2009\text{-}10}$ is not measured on the same basis by which the DPCR5 targets are set (and, consequently, the basis on which losses are reported for the purposes of the DPCR5 incentive scheme), then the corrected net LRRM mechanism would need to be defined differently in order to fulfil its policy intention. Given the discussion above, maintaining the definition of $ACL2_{2009\text{-}10}$ as that set out in the *Final proposals* would allow it to continue operating as per its original policy intent.

15. We conclude that whatever Ofgem originally meant by the words used in paragraph 5.9 of the *Consultation*, it would not be appropriate to apply as policy the meaning that Ofgem sets out in the *Supplementary note*. The only approach that would ensure that the interaction mechanism achieves its purpose is to use *unadjusted* data both to set the targets for DPCR5 and to calculate the value of $ACL2_{2009\text{-}10}$. That approach would ensure that there is consistency between the interaction mechanism and the targets with which it interacts. The differences between $ACL_{2009\text{-}10}$ and $ACL2_{2009\text{-}10}$ are fully justified because of the different circumstances that govern the close out of the DPCR4 incentives (i.e. the 5 times E calculation) and the interaction mechanism that relates to the rewards and penalties that will flow in the DPCR5 period.

16. Our own case illustrates this point very clearly.

17. If $TL_{DPCR5}$ (i.e. the term that sets the target losses for the DPCR5 period) is set using unadjusted data (as proposed in Ofgem's *Supplementary note*) we expect that the following targets would apply to Northern Powergrid in the DPCR5 period:

| | |
|---|---|
| Northeast | 5.32% |
| Yorkshire | 5.76% |

18. Using the methodology set out in the regulatory instructions and guidance (RIGs) for calculating losses for the purposes of the DPCR5 incentive, the current losses

[6] DPCR5 *Final proposals, Financial Methodologies,* page 25

performance of Northern Powergrid at the close of the DPCR4 period (i.e. in 2009-10) was as set out below:

| | |
|---|---|
| Northeast | 5.75% |
| Yorkshire | 6.24% |

19. If these two licensees stood still with respect to losses for five years this would give rise to *penalties* under the annual incentive for the DPCR5 period as below:

| Annual penalty, 2010-11 prices | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 |
|---|---|---|---|---|---|
| Northeast | £3.1m | £3.1m | £3.1m | £3.1m | £3.1m |
| Yorkshire | £4.0m | £4.0m | £4.0m | £4.0m | £4.0m |

(These penalties have been constrained by the application of the cap and collar mechanism.)

20. In summary, over the DPCR5 period if Northern Powergrid were to stand still relative to its 2009-10 position it will be penalised by the maximum amount under the caps and collars of the DPCR5 incentive.

21. Turning back to the interaction mechanism, if we use adjusted data to derive the $ACL2_{2009\text{-}10}$ term, we would see our DPCR4 net LLRM close out result being *negatively impacted* as a result of the interaction mechanism by the following amounts:

| | |
|---|---|
| Northeast | £11.4m |
| Yorkshire | £37.7m |

22. This would mean that the interaction would have the opposite effect from its true purpose. In addition to the annual penalties of £7.1m p.a. we would see our DPCR4 net LLRM close out result being *negatively impacted* by £49.1m.

23. However, if unadjusted data is used to determine the $ACL2_{2009\text{-}10}$ term, the result would see our DPCR4 net LLRM close out result being *positively impacted* by the interaction mechanism by the following amounts:

| | |
|---|---|
| Northeast | £16.7m |
| Yorkshire | £27.0m |

24. This would mean an *increase* to our DPCR4 net LRRM close out of £43.7m. An increase as a result of the interaction mechanism intuitively makes sense, as the interaction mechanism is intended to compensate DNOs that start DPCR5 in a position where a penalty will be incurred in every year if they do nothing other than 'stand still' at 2009-10 losses performance levels. We do acknowledge that the payments our licensees would receive under the interaction mechanism would exceed the detriment that they would suffer under the annual incentive. However, this difference arises from the fact that the interaction mechanism is uncapped whereas the DPCR5 annual incentive is capped, rather than a failure of the interaction mechanism in isolation.[7]

25. If the change to the definition of the $ACL2_{2009\text{-}10}$ term that Ofgem proposes in its *Supplementary note* were made, the swing in the total DPCR4 net LLRM close out result for Northern Powergrid licensees would total £93m, as a result of moving from a £43.7m *increase* in the DPCR4 net LRRM close out on account of the interaction mechanism using an unchanged definition of $ACL2_{2009\text{-}10}$, to a £49.1m *reduction* if the definition of $ACL2_{2009\text{-}10}$ is changed.

26. Finally, the spreadsheet Ofgem issued at the same time as the *Consultation*, *DPCR5_ALP_PPL_calculator_tool*, is consistent with Northern Powergrid's original interpretation of paragraph 5.9 of the *Consultation*, in that it does not involve a revised definition of $ACL2_{2009\text{-}10}$. In particular:

- in the spreadsheet there is only provision to supply two datasets on losses, while the table under paragraph 4.1 in Ofgem's *Supplementary note* shows the need for two datasets for the calculation of LRRM (B&D) and a third (C) to calculate the targets; and

[7] We have stated above that we would support Ofgem if it wished to promote a change to the *Final proposals* to bring the interaction mechanism into line with the caps and collars.

- the spreadsheet is designed so that the calculation of DPCR5 targets and the calculation of $ACL2_{2009\text{-}10}$ use the same dataset.

27. Paragraph 5.16 of the *Consultation* states that Ofgem has constructed the spreadsheet so as to be consistent with the DPCR5 *Final proposals*. We confirm that we agree that the spreadsheet as published is consistent with the *Final proposals*. It is inconsistent with the interpretation given in the *Supplementary note* to the meaning of paragraph 5.9 of the *Consultation*.