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Lesley Ferrando
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6 January 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 comment on this consultation. This response should be regarded as a consolidated response on behalf of UK Power Networks distribution licence companies: Eastern Power Networks plc; London Power Networks plc; South Eastern Power Networks plc and UK Power Networks (IDNO) Ltd. For convenience, the four licensees are collectively referred to as "UK Power Networks" throughout.

We have provided answers, where appropriate, to the consultation questions in the appendices to this letter, but we would like to bring out a number of key points:

- As Ofgem will be aware from our 2010 request for relief from penalty interest (and the subsequent granting of such relief) for one of our three network regions, supplier settlement data adjustments have not been significant in all DNO regions. Accordingly we believe that Ofgem's continued approach of considering regulatory measures based on individual DNO applications is appropriate and correct.

- We had particular concerns with Option 2 on the use of a common "normal" period but having participated in the Losses Working Group on 2 December we feel that all parties understand the need for appropriate "normal" periods to be applied for each DNO when considering if this option should be used.

- Finally, whilst UK Power Networks agrees with Ofgem that Option 1 is the better methodology because of its workability and transparency, we consider that either methodology is suitable for application.

There are two appendices that form the core of this response. Appendix 1 sets out our answers to the specific questions in your consultation. Appendix 2 provides some thoughts and observations on the matters raised at the Losses Working Group of 2 December that had not been included in the original consultation.

Thank you for meeting with UK Power Networks on the 22 December to discuss further the detailed mechanics of the two adjustment methodologies. We have included a further

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Appendix (number 3) and presentation with our response that answers the questions that you raised at this meeting. We would request that Appendix 3 and the presentation remain confidential to Ofgem at this stage of the process. We look forward to liaising with you further to understand how the weaknesses that we have identified with the two identified options can be addressed.

If you have any questions regarding this response please contact either myself or Jonathan Purdy on 07875 113017.

Yours sincerely

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Head of Regulation
UK Power Networks

Copy Paul Measday, Regulation Manager, UK Power Networks
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Jonathan Purdy, Income Reporting Manager, UK Power Networks

Appendix One – UK Power Networks' response to the questions set out in the consultation.

CHAPTER Two

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

UK Power Networks considers that the key techniques in use have been identified in Ofgem's consultation paper. Our own research and interaction with suppliers and other industry parties (including participation in the DCMF working groups in summer 2011) have not identified any other material and/or systematic methods of adjustment.

We also agree with Ofgem that whilst GVC was the first significant type of data adjustment used by suppliers to be identified (and consequently gave its name to the "GVC issue") there are other significant techniques used by suppliers (DMX, etc.) that have contributed to this issue.

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

There are a number of other factors that may have an impact on this issue including the increasing percentage of energy settled on actual meter readings at RF across recent years, and the impacts of significant changes in demand (caused by the recession) interacting with the workings of temperature profiles and coefficients. However, UK Power Networks considers that the impact of these is theoretical and believes neither to be practicably measurable.

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 believe that Ofgem has correctly identified the general principles with respect to the correction of data used for the losses incentive scheme. UK Power Networks agrees that it would be very impractical to attempt to un-pick all of the adjustments made. The nature of settlement (including aggregated supercustomer data) means that DNOs do not have all of the necessary records to conduct this process. Furthermore, it is our understanding that Elexon also does not have such data nor have suppliers/supplier agents maintained records over the period in a manner that would allow such an exercise.

This leaves the only realistic alternative as a top down approach.

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?

As noted above, Ofgem has correctly identified the general principles of a top down methodology and UK Power Networks does not consider that a bottom up methodology is possible. Given these principles, we consider that the components of the two methodologies identified by Ofgem are the only practical methodological application of the principle of normalisation.

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?

Both of the proposed methodologies are variations of a top down statistical approach that seek to re-construct the 2009/10 settlement position that would have occurred if suppliers' behaviours had been consistent with the target setting period. Both comprise of a number of components and it would theoretically be possible to create a hybrid of the two methodologies taking components from each but it is questionable as to whether it would produce a better answer.

CHAPTER Four

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

UK Power Networks agrees with Ofgem's analysis of the key issues with both methodologies. There are a number of other points that should also be considered.

Option 1

- The simplicity and ease of application of Option 1 is an important strength if all DNOs are to use a single methodology.
- In DPCR4 DNOs had an obligation to report as they reported in 2002/03; this means that there will be differences in the reporting methodologies across DNOs. Option 1 uses reported data such that it could be applied consistently across all of the different DNO reporting methodologies. It also has the advantage that being based upon reported data. All of the information is therefore already available and would have been audited as a part of DNOs regulatory returns.
- However, there are possible issues with Option 1 over the availability of data for the negative EAC calculation at a common historic point. The dataset used is one that is discretionary, being requested by DNOs on a supplier specific basis and is a snapshot of the situation at the time of request. It is our understanding that not all DNOs have the dataset available from the same date nor necessarily for all suppliers and its snapshot nature means that it cannot be re-created. However, we consider that this could be overcome by revising the methodology such that all negative EAC impacts are recalculated from a later common dataset retrieved by all DNOs (such as the February 2012 refresh). The discussions at the Losses Working Group on 2 December indicated that other DNOs were thinking in a similar vein.

Option 2

- Whilst Option 2 attempts to address adjustments in a less simplistic manner than Option 1 the resulting methodology is more complex to apply and less transparent than Option 1. We see transparency as one of the critical issues for suppliers and customers and hence in this respect Option 2 is the poorer option.
- The definition of the "normal" period is a critical component of Option 2 – different definitions can give very different outcomes, as is discussed further below in response to question three.
- Option 2 benefits from having a more logical adjustment to the underlying SF data (which is not adjusted in Option 1 other then for Negative EACs).

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?

UK Power Networks considers that it is not possible to quantify the impact of external factors on the SF data using information available to the DNOs. We consider that where in the time between meter reading dates the settlement process places reconciliation adjustments for non-systematic factors such as the recession or extreme weather can not be accurately quantified and therefore, we do not believe we can separate, or analyse the effects.

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

UK Power Networks consider that since both methodologies are based upon the same principles they both deal effectively with settlement data correction.

However, we are concerned that under Option 2 no suitable common "normal" period could be identified that deals adequately with the RF, and more particularly with the DF reconciliations for all DNOs. We are also concerned that what could be defined as a "normal" period may vary not just between run types but also by supplier, depending upon when individual suppliers commenced or ceased data cleansing activities. Setting a range for the normal periods under Option 2 would therefore be necessary to enable it to deal effectively with all types of data correction. In this context Option 1 provides a materially better fit because it does not require the setting of a "normal" period for the RF and DF runs.

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?

If Option 2 is chosen DNOs must be allowed to set an appropriate "normal" period. Setting a standard "normal" period would advantage some DNOs and disadvantage others depending upon when supplier data cleansing activities started and stopped within their GSP groups and what settlement runs were being impacted.

As requested by Ofgem at the Losses Working Group on 2 December, we have prepared a revised Option 2 questionnaire response based on the selection of regionally appropriate normal periods. This is included within Appendix Three but, as stated in our covering letter, is confidential to Ofgem.

We do not support the use of Option 2 without allowing the DNOs to set DNO specific normal periods based on the available evidence.

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?

UK Power Networks can see practical benefits for Ofgem and suppliers in limiting DNOs to a single methodology, as long as one can be found that will not unfairly disadvantage/ advantage any single DNO. This may however be problematic as, although many DNOs face the same broad issue, the timing and magnitude of adjustments vary between them.

When added to the volatile nature of the LRRM calculation this could cause problems in achieving this aim. It must also be borne in mind that the application of any methodology is only applicable on a licensee by licensee basis in accordance with the terms of the Charge Restriction Conditions, and then only following an application from an individual DNO accompanied by appropriate evidence.

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

UK Power Networks considers that Option 1 should be the single methodology for the following reasons:

- Option 1 is the more workable and transparent of the two methodologies.
- There are issues in defining the "normal" period for the RF and DF under Option 2 as well as issues for some with data availability.
- Option 1 should work with all DNO reporting methodologies whereas for Option 2 there remains a number of issues of interpretation that will require detailed clarification.

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?

As a general rule suppliers do not inform DNOs as to the level of settlement data adjustments that they are undertaking. However, from our analysis of current settlement data and from the statements made by some suppliers in the DCMF Working Group there is still a very significant level of adjustment being undertaken. When comparing against our experience in 2009/10 we believe that many suppliers are now correcting data much earlier in the process such that the results are seen in earlier settlement runs.

The BSC changes to limit the use of GVC appear to have caused a reduction in the level of DF adjustment but has simply resulted in a more significant level of adjustment going through at RF.

BSC Modification Proposal 274 will have no impact on the data for the DPCR4 period and if implemented, would not have an impact on settlement until more than half way through the DPCR5 period.

Looking forward we believe that P271 mandating the half hourly trading for profile class 5-8 customers and the roll our of smart metering may create anomalous disturbances in Settlement in the coming years.

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?

The logic of applying an adjustment to the 2009/10 DPCR4 reported numbers is to create a consistency with the target setting period given that it has been established that supplier behaviour has altered. To then adjust the DPCR5 interaction term in the same manner is inappropriate, it cannot be correct to normalise the 2009/10 position for the expected DPCR5 performance by reference back to the DPCR4 target setting period. If these were consistent then there would be no reason to consider adjustment methodologies in the first place. It this therefore inappropriate to adjust the 2009/10 losses reported under the DPCR5 methodology for the interaction adjustment.

It is also worth noting that in Ofgem's DPCR5 decision document[1] paragraphs 4.22 to 4.24 state the aim of exposing the LRRM outcome to the DPCR5 data is to prevent any benefit or loss arising from the change to the DPCR5 methodology. As the adjustment forms no part of the DPCR5 methodology it should not be applied to the DPCR5 element of the LRRM calculation.

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?

As stated in our answer to the above question we believe that adjusting the losses re-reported under the DPCR5 methodology would be incorrect. Therefore, a choice of options is erroneous.

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

Yes, we agree that in setting the DPCR6 ALP we should not include any settlements data adjustment. From what we have learned whilst looking at this problem we believe that going forward there will be a much higher level of correction to settlement data than in previous years. We believe that this will be increased in the medium term by the introduction of smart meters. This will at least double the rate of meter changes across the UK during the roll out period which when combined with the subsequent non-half hourly to half hourly trading migration creates potential for a step increase in metering technical detail issues to affect settlement. Additionally, it is our understanding that much of the anomalous data correctly sits in the DPCR4 period, although not in the correct month or year. These two factors suggest that leaving the corrections in the DPCR5 targets is the most appropriate course of action as it better represents the new "normal" level of settlement correction.

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

The data currently held by Elexon and the records that suppliers are required to keep does not allow any meaningful analysis of these adjustments that could be applied to any target setting or measuring methodology. Only if mandatory detailed records had been and continued to be kept could these adjustments be incorporated. Any change to require such records to be kept is too late to be fully incorporated in DPCR5.

[1] Financial Methodologies 148/09, 7 December 2009

Appendix Two

There are a number of other points that we would like to bring to Ofgem's attention and/or comment upon including some the actions arising from the Losses Working Group on 2 December.

At the Losses Working Group Ofgem proposed a timetable for DNOs to submit data for DPCR4 close out and DPCR5 target setting in May/June 2012 followed by Ofgem giving notice of their intended direction in summer 2012. This timetable is effective for DPCR5 target setting which requires only RF data for 2009/10. However, it is not effective for DNOs whose DPCR4 reporting methodologies include DF data as this will not be complete for 2009/10 until August 2012. It should be noted that our Option 2 questionnaire responses are based upon a forecast of the missing DF data (Option 2 requires the calculation of an adjustment between actual DF and Normal DF). Clearly this lack of DF data is not problematic under Option 1 because this methodology sets DF to zero.

On 30 November Ofgem issued a draft policy paper on the "unintended interaction between the DPCR4 Losses Rolling Retention Mechanism (LRRM) and the DPCR5 cap and collar". This was followed up at the Losses Working Group by the presentation of four options for potential implementation. Should one of the capping options be implemented UK Power Networks consider that Capping Option 2 to be the most appropriate. The major advantage of Capping Option 2 is that finalisation of DPCR4 incentive performance is achieved in 2012 – all other methods extend finalisation through to the end of the DPCR5 incentive period. This also delivers certainty of DPCR4 incentive values to DNOs, suppliers and other relevant industry parties.

It should, however, be considered that to implement any of the Ofgem options would be a change to the DPCR5 final proposals, would require a licence change (because the licence explicitly refers to the final proposal in this area) and would need to be agreed individually with all DNOs.