Joanna Campbell
Senior Analyst
Smarter Grid and Governance
Ofgem
9 Millbank
London
SW1P 3GE

Ecotricity Group Limited
Unicorn House
Russell Street
Stroud
Gloucestershire
GL5 3AX

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Ecotricity Reference No.: 301
emma.cook@ecotricity.co.uk
01453 769301

The Renewable Energy Company (Ecotricity) Consultation Response to Mitigating Network Charging Volatility Arising From the Price Control Settlement

Dear Joanna Campbell,

Ecotricity is an independent renewable energy generator and supplier with around 60,000 customer accounts.

Ecotricity welcomes the opportunity to respond on the issue of network charging volatility. As an independent supplier, this is a key issue for us; frequent and steep rises in network costs expose us to credit risk and greatly affect our ability to hedge. My colleague, Holly Tomlinson, attended the April Independent Suppliers' Forum where this issue was raised, like other small suppliers we are very pleased that Ofgem is addressing this issue.

Ecotricity's response is divided into two parts:

A) Answers to the questions outlined in the consultation; and
B) Our conclusion/summary views on the proposals outlined in the consultation.

A) Answers to questions outlined in the consultation paper

Question 2.1: *Have we correctly characterised the scope of the problem we are trying to address?*

We agree with Ofgem's characterisation that the primary problem with regard to network charging is a lack of predictability.

However, we believe that this problem cannot be fully resolved without a review of charging methodologies and a simplification of the entire process. This would enable suppliers to forecast future price changes and mitigate the risk of large increases that are not factored into priced contracts, which may cover two or three price control periods.

Unicorn House Russell Street Stroud Gloucestershire GL5 3AX
tel 01453 756111 fax 01453 756222 info@ecotricity.co.uk www.ecotricity.co.uk

We have some reservations about the term "volatility": it suggests that network costs go up and down, whilst the reality of the current situation is that prices are only going up. For ease of communication, however, we have used this term throughout our response.

Question 2.2: *Are there certain market segments or groups of customers that are particularly affected by charging volatility?*

Volatility in network costs is particularly problematic for small, independent suppliers. Our low margins and limited cash flow give us less scope for managing the risk that arises from unpredictable price increases. Network volatility creates a barrier to entry into the energy market, which reduces competition and is harmful to consumers.

Question 2.3: *Do you agree with the assessment criteria? Are there additional criteria that we should adopt for our final assessment?*

Yes, we agree with Ofgem's assessment criteria. We believe that particular importance should be placed on the question of which party is best placed to deal with the cash flow risk associated with changes to network allowed revenues. The current situation, in which NWOs can adjust their prices in response to uncertainty mechanisms, enables them to make investments almost risk free and hands all the risk to suppliers. As regulated monopolies, NWOs are in a better position with regard to risk than suppliers; who face competitive pressures on our prices and regulations requiring advanced notification of price rises.

Question 3.1: *Do you have any further suggestions of what could be done to mitigate network charging volatility arising from the price control settlement?*

We believe that a limit on the percentage change for year on year charges that distribution companies can make would be of great benefit.

Such legislation is justified because the lack of competitive pressure faced by distributors makes the DPCM the only downward pressure on prices. Given the above inflation rises of recent years it appears that this has not been effective and therefore legal limits on price rises are reasonable.

We believe that maintenance costs should be factored into NWOs' normal running costs or come out of their income and should not be treated as exceptional events requiring price rises.

Question 3.2: *Do you agree with our initial assessment of each option?*

We do not believe that option 1 would be of substantial benefit if implemented on its own. Although more information would be welcome, it will not be of much help if price rises remain unpredictable. Additional information is only useful if suppliers have the resources to interpret it. Independent suppliers do not generally have the staff and resources available to study all information and therefore its usefulness to us may be limited.

Of the options presented in the consultation, we believe that option 2 will be the easiest to implement and the most effective. We support Ofgem's proposal to limit the changes to one per year: even single intra year charges will make this measure ineffective.

Unicorn House Russell Street Stroud Gloucestershire GL5 3AX
tel 01453 756111 fax 01453 756222 info@ecotricity.co.uk www.ecotricity.co.uk
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We agree with Ofgem's assessment of option 3 and support its implementation.

We do not agree with Ofgem's assessment of option 4. We accept that lagging adjustments due to uncertainty mechanisms may reduce signals to investors, however we do not believe that this justifies abandoning this option. We would support the implementation of option 4 and believe that Network Operators (NWOs) should improve their planning and risk mitigation if they wish to avoid the effect of weaker investor signals.

We disagree with Ofgem's assessment of option 5. It is unclear why they believe that the reduced cash flow to NWOs would outweigh the reduced risk to suppliers.

Question 3.3: *Do code and licence charge notification differences in each network sector create problems in managing charge changes?*

In our experience unnecessary confusion is created from the differences between codes. We believe that these could be remedied through standardisation.

Question 3.4: *What information would you like the network operators to provide, that they currently do not, in order to help improve predictability of network charges for different customer groups? This should include:*

a) what information you would like to see in their business plan submissions, and
b) what information you would like to see provided on an ongoing basis.

We would like to see more opportunities for stakeholder feedback in business plans including an opportunity for stakeholders to state what outputs they wish to see delivered.

Question 3.5: *What information do you think we could provide that the network operators cannot, that would benefit you in terms of improving predictability of network charges?*

Ecotricity have no comments with regard to question 3.5.

Question 3.6: *In the last five years how frequently have networks introduced intra-year changes? What were the main reasons for these changes?*

Changes frequently occur in October. This is usually because the original price control estimates have been over or under predicted and costs need to be altered in order for Network Operators to avoid fines. We believe that this should not be permitted: suppliers and consumers should not suffer on account of poor judgement by distributers.

Question 3.7: *Are there any business processes that would mean only allowing one change per year on 1 April would not be feasible?*

No, we are not aware of any reason why this would present a business problem.

Question 3.8: *Do you think that there should be exemptions that would allow for changes due to specific events? Do you think these events should include the occurrence of errors*

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when calculating charges or changes to the charging methodologies? Are there any other events that should potentially be exempt?

No, we do not believe that there should be any exemptions. NWOs are responsible for their own calculation errors and it is appropriate that payment for this should come out of their profits and not be passed on.

Question 3.9: *Do you agree with our proposed change to the penalty for over or under recoveries were this option to be implemented?*

We do not believe that it would be appropriate to adjust the penalty, nor should this penalty be passed onto consumers.

It would be more appropriate to widen the limits for over or under prediction making the scheme more flexible.

Question 3.10: *Do you agree with our initial view that there should be a two year lag on adjustments due to the over or under recovery of revenue through the correction factor?*

Yes, we would support such a lag.

Question 3.11: *Are you aware of any errors that have been made when calculating network charges in sectors other than electricity distribution?*

Ecotricity have no comments with regard to question 3.11.

Question 3.12: *Do you think that introducing an additional licence condition to penalise NWOs when they make charge calculation errors is warranted?*

Yes, we believe that this would be warranted, however the same result could be achieved by simply forcing distributors to meet the cost of their own errors and preventing them from passing these on in future price control periods. This would be preferable as, unlike additional licence conditions, it would not increase complexity.

Question 3.13: *What do you consider to be an appropriate notice period for changes to allowed revenues?*

Suppliers should be notified of any change in allowed revenue at least eight weeks prior to it coming into effect. This will enable us to adjust our own prices accordingly so that we will not risk periods of increased costs that we are unable to pass on. This in turn will reduce the amount we need to hedge and therefore reduce prices.

Eight weeks will still give NWOs a month at the end of the third quarter to prepare their indicatives for the following six months and determine what, if anything, needs to be recovered from the next price set.

Question 3.14: *Do you consider there to be any potential exemptions to our proposal to lag all incentive adjustments?*

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We believe that the proposals to lag incentive mechanisms are reasonable and we do not believe that there need be any exceptions to this proposal.

Question 3.15: *Do you agree or disagree with our initial assessment of whether a lag should be applied to the following uncertainty mechanisms? a) indexation b) pass through costs c) revenue drivers d) within period determinations e) reopeners f) innovation funding. Please explain your reasoning.*

We would support the implementation of lags on all of the above. The position of NWOs as regulated monopolies makes them a good investment so we do not believe that a small weakening of signals to investors would be costly. Furthermore, lagging effectively amounts to increased risk mitigation making such an investment more secure.

Question 3.16: *Do you agree or disagree with our initial assessment that the benefits of introducing one of the three options for a cap and collar do not outweigh the drawbacks?*

We do not agree with Ofgem's assessment. We would strongly support a cap and collar approach as a means of reducing inter year variability for suppliers. High increases in network costs for suppliers are ultimately passed on to consumers. In the current economic climate steep rises in energy bills are particularly difficult for households to manage and increase public mistrust in energy companies; were it possible for energy suppliers to phase in rises more gradually, we believe it would not be so problematic.

We believe that Ofgem has overstated the negatives of this option. With regard to the effect on incentive schemes; this will not be a problem provided that penalties for bad performance are properly applied. As stated above, we do not believe that any diminishing of signals to investors would have a major negative effect as this will simply smooth profitability.

Question 3.17: *Do you consider there are any other options for the design of a cap and collar mechanism that we have not considered?*

Please see our response to Question 3.1.

Question 3.18: *Do you have any views on whether a cap and collar, if implemented, should be symmetric or asymmetric?*

A maximum increase or cap, is the most important feature, however we appreciate that a minimum or collar would smooth price changes in the long run and therefore may be preferable.

Question 3.19: *Do you agree that if changes are needed in the gas distribution or transmission sectors that they should be implemented on 1 April 2013, the start of the next price control period?*

Yes. We believe that the 1st of April 2013 would be an appropriate time to implement these changes.

Question 3.20: *When should we apply any changes to the electricity distribution sector?*

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We would like to see changes as soon as possible in both networks. Whichever time is chosen, it must be the start of a new price control period. We would support Ofgem finishing an old price control period early and starting a new one if necessary.

B) Our conclusion/summary views on the proposals outlined in the consultation

Overall Ecotricity is very pleased that the issue of volatility is being addressed. We believe that NWO's have a disproportionate level of protection from financial risk, particularly that which arises from their own errors. The lack of competitive pressure combined with their ability to alter prices within price control periods and thus avoid fines, creates a situation in which their ability to profit is combined with artificially low costs and risks. The knock on effect of this is to increase risk for suppliers and increase costs for consumers. This justifies substantial intervention to improve predictability and consistency of network charges. We would support the implementation of all five proposed strategies to achieve this.

We agree with Ofgem's proposals to implement options 1, 2, and 3. Although improving information, as proposed by option 1, would be of some benefit, this benefit will be limited to the extent that our resources enable us to study it and it would not be sufficient on its own. We believe that the single most important change would be limiting changes to once a year as suggested under option 2.

We would like to stress the importance of coordinating policy on this point. If, as proposed under the Retail Market Review, Ofgem sets a national standing charge; this single annual price rise could be timed so as to coincide with any change in the standing charge. If, in addition to this, DNOs were required to give eight weeks' notice prior to any change, suppliers could incorporate both changes in our input costs into our own retail prices. We could reduce the number of times we raise our prices and reduce our exposure to risk. As well as making prices less volatile for consumers, this lower risk would enable us to reduce the amount we charge.

We disagree with Ofgem's position on options 4 and 5. We would support lagging of adjustments as well as a cap on annual increases. As stated above, too much priority is given to the financial position of NWO's over the risk faced by suppliers.

Ecotricity welcomes the opportunity to respond and hope you take our comments on board. We also welcome any further contact in response to this letter. Please contact Emma Cook on 01453 769301 or emma.cook@ecotricity.co.uk.

Yours sincerely,

Emma Cook
Head of Regulation, Compliance & Projects

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