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Smarter Grids and Governance
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Dear Joanna

Mitigating network charging volatility arising from the price control settlement

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

We recognise the key policy challenges and the significant capital investments that Network Operators (NWOs) will be required to make over the price control period to ensure that low carbon technologies, such as electric vehicles and heat pumps, can connect at the appropriate time and cost. It is important that investments are efficient, are considered alongside market based alternatives, and that recovery of these costs is managed effectively, spread out over the long term. Given these policy challenges it is even more important that suppliers get greater visibility and predictability of charges, to ensure value for money, so that consumers are not unnecessarily exposed to risks around forecasting. Greater visibility of charges would also assist market entry for new suppliers.

To provide greater predictability of costs we would like NWOs to give us a minimum of 15 months notice of network tariff changes. In practice this would mean that fixed network tariffs are published for up to two years ahead, removing most of suppliers' exposure to volatility of these costs. At the end of year one, any under or over recovery, or incentive adjustments, would be used in setting the year three tariffs, ensuring that NWOs still recover their allowed revenues, but slightly later due to the time lag.

The end of a price control period is also an issue where we currently have a "cliff edge" change that is only known with any certainty three months before the start of the next period. We consider this issue requires more development to support a rolling view of potential changes to network charges and to achieve a similar notice period as for within period changes.

We also think that Ofgem could go further to help provide greater predictability of network charging. In our response to Ofgem's Retail Market Reform (RMR) proposals for domestic customers, we have made the case for a zero standing charge for all products, so that tariffs can be compared on the unit price, and for regional network charges to be consolidated nationally, ultimately leading to uniform charging. The benefit of this approach is that it will create a simple and more transparent structure to pricing for domestic customers, so that they can engage in the market and it will remove regional differences. We recognise that this may reduce, at some level, cost reflectivity of network charges, but we consider that the benefits to end consumers are likely to be more material.

We therefore support Ofgem's proposals to deliver more predictable charges over the price control period. Our detailed response is set out in the attachment to this letter, but in summary our position on the specific options considered is as follows:

- We agree that improved information provision in relation to the expected changes to NWOs' allowed revenue (option 1) is likely to reduce risk to suppliers by improving the predictability of changes, without causing any additional cash-flow risk to NWOs.
- We also agree that imposing restrictions on intra-year charge changes (option 2), to one change per year on 1 April, will improve the predictability of charge changes with minimal cash-flow risk to NWOs.
- We also agree that limited lagging adjustments (i.e. a two year lag on adjustments) to allowed revenues from incentive payments (option 3) would be beneficial.
- We do not consider that the automatic lagging of adjustments to allowed revenues from uncertainty mechanisms (option 4) would improve the allocation of risk. We agree with Ofgem's current policy of limiting the use of uncertainty mechanisms, and, where possible, limiting the number of adjustments.
- We are not convinced that suppliers would benefit from a cap and collar mechanism, and so do not consider that the benefits of introducing a cap and collar (option 5) will outweigh the costs.

The consultation document states that the predictability (or lack of predictability) of charge changes is the key issue identified by stakeholders. As a result, it focuses on options likely to improve predictability rather than stability in network charges. We note that one way of delivering predictable charges is to introduce arrangements that also provide more stable charges, which by their nature would be more predictable. We recognise that any move to stabilise charges will also need to consider the impact that this may have on developing cost reflective charges and ultimately revenue recovery. As an organisation with interests in both supply and generation, we would support further work to consider the options that could deliver stability in network charges.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact my colleague Mark Cox on 01452 658415, or myself.

Yours sincerely,

Denis Linford
Corporate Policy and Regulation Director

Attachment

Mitigating network charging volatility arising from the price control settlement

EDF Energy's response to your questions

CHAPTER: Two

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

The proposals set out in the consultation document are aimed at improving predictability rather than providing stability in network charges. We note that stable charges are also predictable and so one way of providing predictability would be to introduce stable charging arrangements. However, any move towards stable charges will need to consider the impact that this would have on developing charges that are cost reflective. We therefore believe that further work assessing these trade-offs should be undertaken to consider the options for delivering stable, cost reflective network charges.

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

No. All market segments and customers are affected by charging volatility to some degree. The trade-off referred to above may though be different.

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

We agree which party is able to most efficiently manage cash-flow in relation to network charges is an important criteria. However, a supplier is also exposed to under-recovering the network costs they are charged for. Suppliers have contracts with customers which include fixed network costs and so have to fund any discrepancy between the fixed costs in the contract and actual network charges. However, the price control mechanisms enable the network operators to eventually recover their allowed revenues.

The secondary criteria include the potential complexity of any changes, as well as consistency with other Ofgem policy objectives. In this regard, we are unsure how option 5 sits with Ofgem's policy on cost reflectivity.

CHAPTER: Three

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?

Yes, we have a number of suggestions as set out below.

- **Minimum notice period.** To provide greater predictability of costs we would like NWOs to give us a minimum of 15 months notice of network tariff changes. This

would mean fixed network tariffs are published for up to two years ahead, removing most of the volatility and exposure suppliers have to these costs. At the end of year one, any under or over recovery, or incentive adjustments, would be used in setting the year three tariffs, ensuring that NWOs still recover their allowed revenues, but slightly later due to the time lag.
The end of a price control period is also an issue, where we currently have a "cliff edge" change that is only known with any certainty three months before the start of the next period. Again this should be addressed to get a better "rolling" view of potential changes to networks charges to ensure similar notice periods are retained.

- **Introduction of reporting arrangements that covered the entire price control process.** The new RIIO arrangements have introduced uncertainty mechanisms, which can have a significant impact on the revenues that the NWOs can collect, these uncertainty mechanisms generally relate to significant, capital intensive investments. Due to their long term nature, it would appear unlikely that these investments will suddenly appear, and so it would seem reasonable that the NWOs are able to forecast their allowed revenue with a degree of accuracy up to 12 months ahead. We would therefore support the introduction of reporting arrangements that covered the entire price control process that included a base case (based on submitted business plans/latest view) and high/low scenarios so that the impact of uncertainty mechanisms are known. We would expect the divergence between the base case and high/low scenarios to be minimal for the next 12 to 24 months, but expanding further into the future. Publication of this information would enable suppliers and generators to build these into their business plans, stress test these against different scenarios and take judgement calls on likely paths for revenue and network charges.

- **Timely communication of potential impacts of price controls.** We are equally keen to ensure that step changes at the start of the price control periods are clearly communicated to the industry in a timely manner. In particular we note that the impact of the TPCR4 rollover for 2012/13 had a significant impact on charges faced by the industry which only became clear in December 2011 for effect in April 2012. This had a material impact on the costs faced by generators and suppliers that they were not able to build into their business plans. We therefore believe that there is a role for NWOs to communicate the potential impacts of new price controls to stakeholders in a timely and transparent manner so that these can be built into business plans. At the same time there is also a role for Ofgem to consider the timing of their decisions with regards to price controls and how these decisions can be reached in a timely manner to inform NWOs and the industry. We would suggest for changes as significant as the start of a price control period, five months notice is not sufficient and would welcome engagement with Ofgem and the NWOs to consider what can be done to address this.

- **A new single charge at national level.** Consumers face regional variations under the current process for charging for transmission and distribution costs, due to varying elements depending on the network they are connected to, the price controls and charging methodologies. Regional differences in the transmission and distribution costs for consumers, particularly at a domestic level, add significant complexity to the retail market, leading to inconsistent regional pricing strategies and corruption of tariff comparisons through national averages. As per our response to the RMR for domestic customers, national unit rates could be achieved by Ofgem setting a national domestic transmission and distribution charge, while retaining cost reflective charges in transport and distribution revenue for network providers and business consumers. This type of arrangement would make network charges more stable and predictable.

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

We agree with most of Ofgem's initial assessment with options 1, 2 and 3 appearing to be the most beneficial. However, we are not convinced that option 5 will lead to any benefit for suppliers.

Specific questions in relation to option 1:

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

We understand the code and licence charge notification differences in each network sector and manage the charge changes accordingly. However, we would welcome learning from best practice to reduce differences and make improvements.

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.

Clarity on incentives that reward/penalise NWOs and a range of realistic high-low scenarios are important to improve suppliers' understanding of possible changes. We would also like to see an obligation on NWOs to publish information on their requests to Ofgem to consider additional allowed revenues in a timely manner. This has been proposed under DCUSA open governance for DNOs but it is yet to be approved and should be extended to other NWOs. Insight into DNO and Ofgem views will also be welcome.

One of the biggest causes in volatility is the price controls and the lack of lead time in publishing charges for the first period of the new price control. Greater visibility of network charges through this process is needed.

We would like NWOs to provide regular models that are used to create network charges for a two year duration incorporating assumptions from their latest Business Plans. Suppliers do not have the transparency of network dynamics to re-produce forecast tariffs from historic models. A commentary on what changes have been made to each model and the reason behind this will allow suppliers to start understanding the risks and improving future forecasts.

NWOs have clearly done a considerable amount of work in the finalisation of their business plans. To help users understand the key information quickly, we would welcome the inclusion of an executive summary in future versions. We would also welcome consistency in reporting. As an end-user of the business plans and other information provided by NWOs, we have 14 areas to consider. A consistent reporting format, perhaps following the distribution approach, will be useful.

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?

Whilst we recognise that significantly more information is now available, the end of a price control period is still an issue where we currently have a "cliff edge" change that is only known with any certainty three months before the start of the next period. We consider this issue requires more development to support a rolling view forward of changes to network charges and to achieve a similar notice period as for within period changes. Any information Ofgem could provide that could alleviate the "cliff edge" change would be welcome.

We also understand that Ofgem has visibility of NWOs' business plans ahead of its publication. If Ofgem is able to share some of the information in advance, even with caveats, this would be useful to stakeholders.

Specific questions in relation to option 2:

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

In each of the last five years we have had intra-year DUoS changes, and intra-year changes to Gas Distribution Network (GDN) charges and just one TNUoS change. The NWOs are best placed to provide details of the changes and the reasons for them.

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.

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

We think it is unfair that suppliers are penalised with short notice changes to charges due to errors the NWOs have made when calculating charges. This occurred in 2011, when SSE changed DUoS rates in July. Although we do not believe that specific penalties should apply, we believe that the NWOs should be exposed, in the short term, to the impacts of their errors as they are best placed to manage and control these. Therefore, NWOs should be required to provide 15 months notice before making any changes to charges.

Similarly, any changes to the charging methodologies should have a sufficient period of notice to enable suppliers to adjust their cost forecasts accordingly.

We are not aware of any other events that should potentially be exempt.

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

Changes will need to be made to the tolerances for the application of penalties if NWOs are restricted in the dates that charges can be changed. In particular we are aware that the majority of the GDN within year changes have been driven by the incentives to not over or under recover revenue, and so there is a clear interaction between incentives and price setting processes. It is important to retain a mechanism to encourage overall revenue recovery but there should be more flexibility to support greater predictability of network charges.

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?

A two year lag would make changes more predictable but careful thought will need to be given about how this mechanism would work across price control periods.

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

We are not aware of any but the electricity distribution charging methodologies and information provided by the DNOs give us much greater transparency than we have for other network charges.

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

We do not believe a penalty for charge calculation is warranted. We recognise that it is not possible to remove all human error so mistakes will be made. From a supplier perspective, if we have sufficient notice of the error correction then our business will not be impacted. We would also like NWOs to be open and honest about charge calculation errors and a penalty may discourage this.

Specific questions in relation to option 3:

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

An appropriate notice period is no less than 12 months.

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

No.

Specific questions in relation to option 4:

Question 3.15: Do you agree or disagree with our initial assessment of whether a lag should be applied to the following uncertainty mechanisms? Please explain your reasoning.

a) indexation
b) pass through costs
c) revenue drivers
d) within period determinations
e) reopeners
f) innovation funding

We agree with Ofgem's initial assessment that, on balance, it will not be beneficial to automatically lag all adjustments to allowed revenues due to uncertainty in mechanisms. However, we are concerned with the suggestion that decisions ought to be made on a case by case basis as this will introduce uncertainty and may not achieve the objective of enhancing predictability (and stability).

Specific questions in relation to option 5:

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 agree that the benefits do not outweigh the drawbacks.

In addition, cap and collar will make it harder for suppliers to forecast costs and we are also concerned that it is not cost reflective. For example, if a customer charge is capped at 20% then the shortfall in revenue recovery will either be reallocated to others, seeing a lower than 20% increase in the same year, or it will be carried over to the next year. Neither is cost reflective and there is a risk that one customer is being cross subsidised by others. It would also mean increasing the complexity of our forecasting to consider many different permutations of possible caps and collars.

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?

No.

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

For the avoidance of doubt, we do not support a cap and collar. However, if implemented, we believe it should be symmetric.

Timing of implementation:

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.

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

As suggested in the consultation document, Options 1 & 2 could be introduced prior to the next price control, so 1st April 2013 seems reasonable.

EDF Energy
June 2012