Energy UK Comments on Mitigating Network Charging Volatility Arising from the Price Control Settlement

11 June 2012

Energy UK represents a wide spectrum of interests across the sector. This includes small, medium and large companies working in electricity generation, energy networks and gas and electricity supply, as well as a number of businesses that provide equipment and services to the industry.

Energy UK welcomes the opportunity to provide comments on this Ofgem consultation. We have an interest in this issue as our members are suppliers to domestic and industrial customers both gas and electricity and also as large consumers of gas at gas fired power stations.

CHAPTER: Two – Network Charging Volatility

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

Yes, but the issues of charging volatility extend beyond supply to the domestic sector. There are issues in setting tariffs for industrial customers and for gas-fired generators as consumers of gas. Gas-fired generators usually face direct pass-through of network charges and will face uncertainties in their cost base due to fluctuations in these charges.

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

Energy UK believes all market segments and customers are affected to some extent and that there would be overall benefits if charges and changes to charges were more predictable for the following year and for the years beyond that.

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

Yes

CHAPTER: Three – Options to mitigate volatility in network charges

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?

A number of suggestions are set out below.

- **Minimum notice period.** To provide greater predictability of costs we would like NWOs to provide a minimum of 12 months notice of network charges. This would mean fixed network charges are published for up to two years ahead. At the end of year one, any under or over recovery, or incentive adjustments, would be used in setting the year three charges, ensuring that NWOs still recover their allowed revenues, but slightly later due to the time lag. How this is managed in the transition between price control periods and rollover years to avoid large step changes in charges with little notice needs further consideration.

- **Reporting arrangements across the entire price control period**. 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. NWOs will have information about these projects well in advance so will be able to forecast their allowed revenue with some degree of accuracy for at least the next 1-2 years. We would therefore support the introduction of increased transparency and reporting of revenues and charges flowing from the base case, latest forecast (NG view on likely commitments) and high / low case scenarios, so that the full impact of uncertainty mechanisms is understood. Clearly we would expect to see only minimal divergence between the various scenarios in early years, with a wider spread in later years. Publication of this information would enable suppliers and generators to build these into their business plans, and make their own judgments on future revenues and charges.

- **Timely communication of potential impacts of price controls**. We are 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. We also believe there is likely to be a significant step change in TNUoS charges at the start of the RIIO-T1 period in April 2013. Such changes with little notice have 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 NWOs should 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. Ofgem should also consider the timing of its decisions with regards to price controls and how these decisions can be reached in a timely manner to inform NWOs and the industry. Five months notice of changes in charges, that can be very significant at the start of a price control period, is not sufficient. We would welcome engagement with Ofgem and the NWOs to consider what can be done to address this.

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

Yes, we agree with most of Ofgem's initial assessment with options 1, 2 and 3 appearing to be the most beneficial. With respect to option 5 our members have a range of views, some agreeing with Ofgem's assessment whilst others consider it could be useful to narrow the range of possible outcomes for the following year.

Specific questions in relation to option 1: Improved information provision
Question 3.3: Do code and licence charge notification differences in each network sector create problems in managing charge changes?

Our Members 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. This could be applied to the DCUSA 40 day final price notification and extending this to the two month notice required by the UNC would be helpful, particularly in the April tender round.

With respect to gas transmission and distribution we are not clear how the requirement to provide 150 days notice of indicative charges (if this is retained) will work when the financial model under the RIIO framework runs in November to set allowed revenue from the following April. Will indicative charges be based on old information?

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.

Energy UK believes that business plans already contain indications of allowed revenue across the price control period which will be subject to various adjustments as the price control period progresses. For Gas Transmission, indicative charges have been provided at selected points on the network to demonstrate the effect of anticipated investment, but only following a request. These charges show substantial variation across the price control period, in some cases more than doubling from projected 2013 values before falling back to current levels at the end of the period. There would be merits in providing some indicative charges at each iteration of the business plan, this would then provide earlier indications of the magnitude of the step change in charges at the start of a new price control period.

We believe it would be helpful for Ofgem to publish all the items listed in 3.16 in a timely manner once it is available. It would also be helpful if the charging models and indicative charges that derive from the allowed revenue setting processes were published for a number of years ahead or potentially the remainder of the price control period with a commentary to explain the year on year changes. The provision of scenarios leading to a range of possible charges would also be helpful. In addition to this further scrutiny of deviations between indicative and actual charges could be a useful process as would a better understanding of the range of possible outcomes under incentive mechanisms. We also consider that the existing reports UNC0186 and DCP066 are helpful in providing transparency and should be extended to electricity transmission. However the forecasts can sometimes show step changes and care needs to be taken in the preparation of these forecasts to ensure they represent the NWOs best view of future revenues.

Some standardisation of reporting formats across the NWOs would also be helpful and facilitate industry interpretation and understanding.

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?

More frequent updates of incentive performance would be welcomed.

Specific questions in relation to option 2: Restricting the frequency of intra-year change
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 believe there have been intra-year changes to network charges for each sector. 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?

We are not aware of any business processes that would prevent a move to one change per year on 1 April. Over time processes and contracts will adapt to the prevailing arrangements. If there was price certainty over a two year time period then this may mitigate against all contract renewals migrating to April

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?

In general, intra year changes should be avoided, but there could be exceptional circumstances in which this is necessary. Any such changes should be subject to approval by Ofgem.

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

In order to inform our view it would have been helpful to see some analysis of historic under and over recoveries that may have occurred in the absence of a within year price change.

In the absence of this, based on principles alone, we agree it would seem reasonable to relax the penalty rate by widening the band before any penalty rate is applied. However it is important to retain an incentive on NWOs to forecast accurately and some of the proposed measures, such as lagging of incentives payments, if implemented, should contribute to improved NWO forecasts.

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 support a two year lag to give more predictability of charges over a longer timeframe but have some concerns over how much this might cost.

Careful thought about how this mechanism would work across price control periods is needed.

It will be necessary to consider European tariff developments on this issue for gas transmission.

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

No

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

We expect NWOs to take due care when calculating charges and acknowledge that whilst errors can happen they are rare. Currently the NWO faces no consequences of errors - the consequences are faced by suppliers and customers - so it would seem reasonable for the consequences to be shared in some way and a penalty on the NWO would seem appropriate.

Specific questions in relation to option 3: Increasing the lag on changes due to incentive rewards or penalties

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

Customers and suppliers are interested in charges rather than allowed revenues, whilst these are directly related having greater certainty in allowed revenues would not necessarily give greater certainty in charges unless and until the charges are published. A year would seem reasonable.

Greater certainty in charges further out would be welcome but we recognise this is not cost free and we do have some concerns that this delay may diminish the incentive for enhanced performance. This would particularly be the case where longer duration incentives are set such that incentive rewards towards the end of the period are expected to recoup costs incurred early in the period in order to deliver the enhanced performance. However on balance we support lagging of incentive rewards as this would then allow for actual incentive performance to be reflected in charges rather than forecast incentive performance.

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: Increasing the lag on changes due to uncertainty mechanisms

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 broadly agree with Ofgem's initial assessment; generally that these uncertainty mechanisms relate to actual costs and in some cases there are restrictions on when they can be used within the price control period.

With respect to revenue drivers, NGG has argued that in order to finance its business it needs to recover more revenue in the year of spend rather than after the year of delivery. It also considers that it needs additional SO revenue to deliver capacity on start dates other than October or capacity which is not signalled at a particular time of year, to meet customers' requirements. Whilst it is Ofgem's role to determine the appropriateness of such arrangements, it is difficult to see how lagging the application of revenue drivers would help to ensure delivery of capacity to support new gas fired generation. However if NGG's proposals stand we would hope to see enhanced information provision with respect to indicative charges beyond the next year taking due account of all uncertainty mechanisms.

Specific questions in relation to option 5: Imposing a cap and collar on allowed revenue changes
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 with Ofgem's initial assessment, the complexity is not warranted. In general, step changes in charges will be manageable for suppliers if they are predictable some time ahead such that the range of possible charges narrows over time. Ensuring good forecasting performance and information provision will be important.

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?

If implemented 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, but gas transmission charges have already been published with effect from October 2012 so a further change in April 2013 may not be desirable.

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

Options 1 & 2 could be introduced prior to the next price control, so 1st April 2013 seems reasonable. However other options are very much linked to the price control settlement so should not be implemented before April 2015. Good progress needs to be made on establishing the policy aims and principles for the RIIO-ED1 price control and for distribution charges to fit within that context.

We would be happy to discuss these issues further, to do so please call Julie Cox on 01782 615397.

Notes

This response represents a broad consensus of members' views. Some member companies may hold different views on particular issues and we would point out that National Grid was not a contributor to this response.

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