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Dear Joanna

Response to Ofgem's Consultation on mitigating network charging volatility arising from the price control settlement (52/12)

Thank you for the opportunity to respond to this consultation. We recognise that the issue of charging volatility is of great importance to suppliers and customers and we have discussed our views with several stakeholders in recent meetings. It is important that the network companies recognise customers' and stakeholders' views on the appropriateness and acceptability of price control settlements and the RIIO price controls should facilitate this process. This consultation is a timely opportunity to establish the key principles to balance the needs of customers, suppliers and network companies.

We agree with Ofgem's distinction between predictability and volatility of revenues and it is important to recognise that there are different mechanisms to address each issue. Predictability and volatility of charges are driven by both the movement in revenues and the charging methodologies. We accept that these issues should be tackled separately, however Ofgem should recognise that any of the proposals introduced as part of this consultation could be ineffective due to volatility in the charging methodologies. Whilst removing some element of volatility in the charging methodologies may be desirable there is a danger in undermining the key principles behind them which have been the subject of numerous Ofgem consultations over many years. The principles have been to provide efficient cost signals to customers to promote the correct demand side response.

Ofgem's concern has been the additional risk premia that suppliers state they place on customers on long term tariffs as a result of uncertain network charges. These suggested premia for long term may be more open to scrutiny when supplier charges can be compared against standard evergreen supply tariffs as proposed in the retail market review. Whilst risk premia may, to some extent, be driven by the degree of unpredictability of revenues, it should be noted that similar statements were made by suppliers regarding different charging methodologies by DNOs.

The RIIO price controls are designed to ensure that networks deliver for their customers and stakeholders. Some of these mechanisms reflect the fact that networks will need to accommodate low carbon connections which have highly uncertain timescales. Other incentive mechanisms are included to improve the level of service for customers and penalise DNOs if they fail to meet the prescribed targets. In all of these cases, the use of uncertainty mechanisms, incentives and investment drivers are put in place ensure that customers do not pay for services they do not need or to introduce significant risk premiums. The mechanisms allow networks to finance the necessary investment in the most efficient manner but with an increase in revenue volatility.

Balancing the needs of both customers and networks must be carefully considered. We agree that some areas of volatility are predictable – indexation and cost of debt should be reasonably predictable but the incentives and uncertainty mechanisms are in place to protect customers' interests and improve the service they receive.

At a time when cash-flows may be reduced by the RIIO financeability principles, network companies have less flexibility to absorb revenue fluctuations. The RIIO financeability principles assume that shareholders will absorb some of the volatility created by the deferred cash from investments. It is therefore unlikely that networks will be in a position to absorb significant additional short term revenue shortfalls. Companies should be able to innovate and offer products to individual customers if they can agree a suitable risk premium.

Customers will only see a benefit from this consultation when the revenue volatility, charge volatility and the supplier risk premia are all reviewed. When Ofgem is assessing the appropriateness of its proposals, it should work with suppliers to understand the actual cost impact of the risk premium on customers and how this is determined. It is important that Ofgem correctly and efficiently balances the risk faced by networks and those faced by suppliers. It may be more efficient for customers for regulated companies to be compensated to carry more risk at prescribed market rates, rather than supply companies adding unregulated risk premia to customer bills.

We agree that Ofgem should look at solutions to improve the predictability of revenues. For charges overall, the charging methodologies are determined through open governance arrangements and it is these mechanisms which should determine any changes to reduce volatility, whilst recognizing the importance of cost reflectivity in delivering the most efficient network in the long term.. We have met with suppliers over this issue and we will continue to work with them to reduce unnecessary charging volatility.

Review of proposals

We agree that the five options discussed in the paper could reduce charge volatility, however we do not believe that they are all equally effective. We agree that options 1 and 2 (Improving information and restricting the frequency of intra-year charging) are likely to improve short term charge predictability at minimal cost to customers and networks. For Option 1, electricity suppliers already receive extensive information from DNOs and it is difficult to see what else could be provided which would have any meaningful effect. Option 2 is likely to increase the revenue risk for network companies at a time when revenues are significantly reduced. There are a number of reasons why companies may need to change charges mid-year including weather corrections and the implementation of charging methodology changes. One practical issue surrounding restricting the number of changes is that the change would incentivise suppliers to request April implementation dates and not October. We agree that Ofgem should widen the band for penalty rates for over and under-recovery; we suggest that the band should be increased to ±5%.

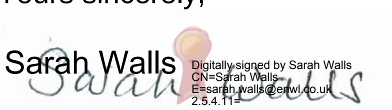
As mentioned earlier in this response, incentive mechanisms are an important part of the RIIO price controls and reward companies for delivering for customers. We are concerned that significant delays to incentive revenues will reduce the incentive properties of the mechanisms. If Ofgem chooses to adopt the proposed smoothing of revenue recoveries or introduce the proposed lag on incentive revenues (option 3), we would expect these adjustments to be uplifted by RPI and the cost of carry forward compensated at the cost of capital. It is important that Ofgem recognises that this change will have a cash flow impact which may change the business case for specific investments.

We do not believe that Ofgem should increase the lag on changes in revenue due to uncertainty mechanisms. These mechanisms were introduced to recognise that Ofgem, customers and companies do not fully understand the magnitude or timing of specific costs or companies have no influence on the level of the cost. In the future, we expect that these mechanisms will become more important and significantly more costs will be recovered through uncertainty measures. We therefore suggest that the carry costs associated with these revenues will be significant and the any benefit from cost predictability will be significantly outweighed by the risk and cost to customers and create additional financeability issues at a time when DNO revenues will already be stressed. Similarly, the proposed cap and collar mechanism (option 5) is a disproportionate solution which would significantly increase costs for DNOs and therefore increase charges for customers.

The introduction of any of the mechanisms must be carefully considered. We agree that options 1 and 2 could be introduced in DPCR5 but we do not believe this would be effective given the charge volatility created by the common charging methodology and that the suppliers' risk premia would still be in place for customers. The total revenue levels, charge methodologies and the supplier risk premia must be addressed to create any benefits for customers. It would not be appropriate to introduce option 3 before the end of DPCR5 as it would change the incentive dynamics of the current price control. On balance, we suggest that any mechanisms for electricity distribution should be incorporated in RIIO-ED1.

If you have any questions, please feel free to contact me or any of my team.

Yours sincerely,



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