June 11th, 2012

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Mitigating Network Charging Volatility Arising From The Price Control Settlement

Dear Ms. Campbell,

Please find First Utility's response to the above consultation below.

Chapter 2 – Network Charging Volatility

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

We agree that the issue is a pressing one, particularly for areas which cannot easily be predicted ahead of the fact such as inflation and pass through costs. Over and under recovery of NWO costs and errors in charging calculations can also be significant drivers of charging volatility.

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

We believe that smaller players are disproportionately affected by high levels of volatility due to the fact that they are more sensitive to changes in gross margin, particularly if there is a disproportionate rise in charges for Profile Classes 1 and 2 (domestic) in relation to Profile Classes 3 to 8 and mandatory half hourly (non domestic) sites. In addition the limited access of smaller players to working capital and the higher financing costs that they generally face exacerbates the issue still further. It is therefore important that steps be taken to reduce volatility as far as possible in order to ensure a more level playing field for all market participants.

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

We agree that complexity in the new arrangements should be avoided as far as possible as this might then result in the creation of increased barriers to entry and further discourage participation in the market. We also agree that it is necessary for the new arrangements to accurately reflect risk and reward between different categories of market participants and thus allocate this risk in a more appropriate manner.

Chapter 3 – 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?

We believe that the proposed options 1 and 2 should be sufficient to make a significant difference.

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

We agree that improved information for both suppliers and customers would reduce risk to those parties and be relatively low in cost and simple in terms of implementation. Restricting the frequency of intra year changes in charging is also likely to be beneficial to suppliers. Although this may result in an increased cash flow risk for NWOs, we believe that this is a risk that they are able to bear as regulated natural monopolies with significant physical assets.

With reference to the other options including increasing the lag on incentive rewards and penalties for NWOs, as well as adjustments to allowed revenues from uncertainty mechanisms, we believe that these may weaken signals for investors and are unlikely to be as beneficial in the long run as the two options previously discussed. Although imposing caps and collars on changes to allowed revenues may be beneficial in terms of appropriately incentivising NWOs, the implementation of these is likely to be complex. We remain of the view that improved information provision to market participants and restriction of intra year charge changes will provide more overall benefit to suppliers with less increased risk for NWOs and are likely to be considerably less onerous to implement and enforce.

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

We do not believe this is a major issue as NWOs are required to give a certain minimum period of notice before this occurs.

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 agree with the proposed requirement for NWOs to set out the expected evolution of revenues and charges in their business plans. We also feel it would be useful for regular quarterly updates to be provided by each NWO in relation to revenue recovery performance against the price control so that provision can be made by suppliers for any under or over recoveries likely to result. We also support Ofgem's proposals to publish initial NWO requests for additional funding as well as the results of the annual iteration of the financial model. Making the RIIO financial model available to all parties will also greatly assist in predicting likely NWO revenue levels.

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

As stated in our answer above, we believe that provision of the RIIO financial model to all parties will provide significant benefit to the market.

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

To our knowledge, this has happened several times in the last five years and has generally been driven by either miscalculations by the relevant NWO or over or under recovery in terms of allowed revenue.

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

As a small supplier with relatively flexible internal systems, we feel that business processes could relatively easily be amended if this change were to be implemented and that the benefits of stability around charging levels would outweigh the costs resulting from this.

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 be potentially exempt?

We believe that allowing exemptions for specific events is likely to undermine the whole rationale for the proposed changes, particularly if the two proposed exemption categories are correcting for charge calculation errors and changes to the charging methodologies, as these categories have driven a number of intra year changes in recent years.

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 agree that it is appropriate to relax the penalty for over or under recoveries should the option to restrict intra year charge changes be implemented.

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?

Although we believe that this option is likely to be less effective than options 1 and 2, a 2 year lag would seem appropriate if Ofgem is minded to implement this change.

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; electricity distribution appears more prone to these errors than other areas.

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

Only in the case that an exemption is provided to allow intra year charge changes as a result of such errors should option 2 be implemented. If no such exemption is provided then an additional penalty would seem disproportionate.

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

We believe six months notice should be provided to the Authority and three months notice provided to users.

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

We do not believe so, however we remain of the view that implementation of this option is likely to weaken investment signals with possible negative results.

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

We agree that it would not necessarily be beneficial to apply a lag to indexation of allowed revenues for inflation and cost of debt as these are based on publicly available information.

b) pass through costs

The benefit of placing a lag on pass through costs is likely to be dependent on the size of the adjustment and market participants' ability to accurately forecast this. Perhaps this may be appropriate on a case by case basis.

c) revenue drivers

We believe that our comments in relation to potential lagging of pass through costs apply equally here.

d) within period determinations

We do not believe that this would be appropriate as we agree that introducing a lag between the Authority's decision to allow recovery of the costs of additional infrastructure investment and actual recovery of those costs would be likely to disincentivise such investment. Alternately, it might require NWOs to obtain bridging funds at a higher cost which would then be likely to be passed on to users through higher charges.

e) reopeners

We do not believe that this would be appropriate as it would only increase the already existing lag in this area thus increasing financing risks for NWOs and possibly resulting in higher charging costs for users.

f) innovation funding

This change would provide little additional benefit as costs around innovation funding make up a small proportion of the overall charges and are already capped in the transporter licence.

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?

Yes, as this will disincentivise NWOs from carrying out required investment and weaken signals suggesting that investment may be required. The cost impact on the NWOs which would result is also likely to be reflected through higher charges.

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?

We are unable to think of any and, in any case, do not believe that the results of implementation of this option are likely to be desirable.

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

Although we do not support this option, if implemented, the cap and collar should be symmetric as an asymmetric approach would be likely to result in the creation of perverse incentives.

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, as this will provide an increased level of certainty around charging levels in these sectors at as early a stage as possible.

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

These changes should also be applied on 1 April 2013 at the start of the next price control period for the reasons laid out in our answer above.

Please do not hesitate to contact me if you have any questions or would like any further information.

Yours sincerely,

Chris Hill

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