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Dear Joanna

Mitigating Network Charging Volatility arising from the Price Control Settlement

RWE npower welcomes the opportunity to comment on these proposals. This response is provided on behalf of the RWE group of companies, including RWE Npower plc, RWE Supply and Trading GmbH and RWE Npower Renewables Limited, a fully owned subsidiary of RWE Innogy GmbH.

For clarity, we have split this consultation response into 2 parts:

- The letter will provide generic comments on the issues raised in the consultation.
- Appendix 1 provides answers to the specific questions.

We fully support the scope of this consultation, namely:

'...concerned with mitigating network charging volatility, and its effects, arising from the price control settlement, i.e. the setting of the allowed revenue constraint at the price control, and how this is updated year-on-year'.

We agree that such volatility in charges can act as a barrier to entry to the retail energy market, particularly for small suppliers who may be less able to absorb network charge fluctuations. Regulated charges should, by their very nature, be more predictable, particularly since the revenue that Network Operators can collect through tariffs is known for a 5 year period (soon to extend to 8-9 years). Yet Network Charges are probably the least predictable charges that suppliers and customers face. This therefore introduces considerable risk to market participants given the un-hedgeable nature of these tariffs.

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We believe the consultation correctly identifies Network Operator revenue changes as being a cause of volatility and this consultation goes some way to suggest how to improve this situation. It correctly identifies that predictability and transparency of information is the key to improving this process.

We will discuss these suggested improvements later. However, we believe one key process, which causes a major and unpredictable revenue change, is missing from the consultation - the implementation of a new price control itself.

Lack of Transparency and Predictability of RIIO-ED1 Revenues

We are concerned at the proposed timetable for RIIO-ED1. Suppliers will not have sight of final DNO revenues until November 2014 if DNOs are not fast tracked or March 2014 if DNOs are fast tracked. This will cause a huge issue for suppliers, and ultimately consumers, since the extent of the revenue step change between price controls will not be known until very late on in the process.

Suppliers contract with consumers on a 1, 2 and 3 year basis. Many of these contracts will be 'fixed price' where the DUoS charge is incorporated into the overall unit rate(s) and fixed charge that the customer sees on their invoice. Suppliers' ability to forecast DUoS tariffs accurately over that time horizon is the key to ensuring that the consumer is given the most cost reflective price. RIIO-ED1 will cause a step change in tariffs due to the potential change in revenue in April 2015. The extent of that step change will be completely unknown to suppliers when they are pricing in 2012-2014 for contracts which extend into 2015. Should suppliers assume 10% increase? 20% increase? 50% increase?

In short, suppliers will be forced to build in risk premium if they wish to sell fixed price contracts which span the new price control period. This is not good for consumer prices, UK plc as a whole - and may also lead to large windfall gains or losses by suppliers depending on how their risk premium varies with outturn prices. We will send a (confidential) estimate on the extent of such windfall gains or losses for npower – based on 5%-15% over or under forecast of revenue.

We have already discussed with Ofgem some possible options to overcome the late notice of revenues to suppliers:

1 The current timetable is revisited to publish all Distribution Network Operator (DNO) Allowed Revenues much earlier than intended;

2 Fix Allowed Revenue numbers for each DNO for 2015/16 and 2016/17 early (perhaps based on initial business plan information published in May 2013?). Changes to those initial numbers as a result of the review process by Ofgem will still be recovered by DNOs but spread across future years using the 'k factor' (a standard price control process);

3 Implement a narrow cap and collar (say +/-5%?) around an early published allowed revenue for each DNO for 2015/16 and 2016/17 and any further over or under recovery as per option 2.

The above proposals would also be extremely valuable to customers who are on pass through DUoS contracts with suppliers since it will provide better visibility of how their tariffs may change moving out. This would obviously assist them to manage budgets moving forward.

We would be keen to continue to discuss these – and other possible options – with Ofgem in order to make DUoS Allowed Reveues for the early years of the price control more transparent and predictable to suppliers at an early stage of the process.

We recognise the argument that the timescales for RIIO-ED1 are similar to previous price controls in terms of when the final details are known. This has caused major uncertainty in the past for suppliers since historical levels of Allowed Revenue changes due to a new price control may not be representative of future changes to Allowed Revenues. RIIO-ED1 provides the opportunity to change this fundamental flaw in the process, thereby reducing down the risk that suppliers face and providing consumers with a more definitive view of their tariffs moving forward.

RIIO-ED1 is very different from previous price controls in terms of the levels of investment that need to be made by DNOs to meet the new requirements of Smart Grid, low carbon technologies etc. RIIO-ED1, we would suggest, is an entirely new phase in the Distribution Price Control Review process and the extent of the step change could be of a very different magnitude compared to previous price control changes. Even if the low carbon initiatives are found to be less of an issue in ED1, the uncertainty around price control revenue step changes remain and need to be addressed.

In addition to the above concerns regarding RIIO-ED1, we wish also to highlight the following areas:

8 Year Price Control, Reopeners and Uncertainty Mechanisms

DNOs are being asked during to provide their plans for 8 years. There should be an overall commitment to the agreed numbers. Re-openers or uncertainty mechanisms should be minimised and appropriate delays built into the implementation in order to provide transparency and predictability of revenues for suppliers and consumers, as well as the avoidance of price shocks. <u>If such reopener / uncertainty mechanisms are the 'norm', it weakens the concept and effectiveness of a longer term price control.</u> Where such revenue adjustment mechanisms are essential, we believe that there should be a long lead time (minimum 2 years) between the notification of the change and the change in revenue.

Charging Methodologies

While accepting that Charging Methodologies have been excluded from the scope of this consultation, we welcome the fact that Ofgem recognises that these are another source of pricing volatility for Network Charges. Many of the changes going through the Industry at the moment will lead to significant changes to tariffs for consumers when implemented (e.g. 500MW model for distribution, nhh/hh changes etc). <u>Ofgem can play a major role in improving predictability in these areas by introducing a general rule that if a change affects tariffs, there should be at least a 2 year time delay between approval of the change and implementation.</u>

In Electricity Distribution, inputs into the charging models are very sensitive to even minor changes. The Industry is currently looking how to smooth / improve predictability of the inputs into the charging methodology, particularly CDCM. Ofgem again can play a major role in supporting this objective. EDCM is an additional concern since, due to confidentiality of site specific data, there is not the visibility of the input data. This therefore makes predictability of EDCM tariffs impossible for suppliers and consumers. EDCM, by its very nature, produces volatile tariffs. We believe it is an essential area for more transparency and predictability. Publication of tariffs which cover longer periods would be a solution to both these issue.

Publication of Tariffs for Longer Periods

NWOs are currently required through their licence to provide circa 3 months and 2 months notice of indicative and final charges. We would like to see this period extended to give more certainty for suppliers and consumers. The ideal situation would be that NWOs provide 2 years advance notice of tariffs. For example, for electricity distribution, this would mean that in February 2013 final tariffs for 2013/2014 and 2014/15. In February 2014, tariffs for 2015/16 would then be published (2014/15 would already be known for the last year). This would give suppliers and consumers alike 1-2 years notice of network charges. We would be comfortable to relax the penalties for over and under-recovery in order for this to happen. Any under or over recoveries would be carried over into the following years via the ‘k factor’. The transparency of this activity would be beneficial to the market as a whole.

Long Term Products

Npower are supporting the work being done in Electricity Distribution to provide Long Term Products. However, the option provided above – to provide 2 years final tariff notification in February would be a simpler solution to provide this under the normal price control process.

Appendix 2 (attached) provides detailed answers to the questions in the consultation.

We would like to meet with you to discuss these issues. Please feel free to contact me if you wish to discuss this response in more detail. This response is not confidential.

Many thanks,

By email so unsigned

Helen Inwood
Network Charging Manager

Enc: APPENDIX 1 (Consultation Questions)

APPENDIX 1

CONSULTATION QUESTIONS

CHAPTER: Two

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

This consultation correctly identifies that lack of predictability of tariffs is a major issue for suppliers, resulting in the need to apply risk margin to compensate for the uncertainty associated with unexpected changes in Network Charges. This is particularly relevant when providing fixed price contracts to consumers.

However, while welcoming this consultation, we believe that there are a number of issues which it does not address:

- The step change resulting from the start of a new price control (e.g. RIIO-ED1 /T1 / GD1). These are major sources of volatility but the consultation deals only with mid-price control changes.
- Changes to the Charging Methodologies: While these have been excluded from the consultation, we believe that Ofgem has a valuable role to play in the solution to smooth volatility caused through changes to the charging methodologies e.g. by ensuring at least a 2 year notice period is given between acceptance and implementation of the change.
- The issue of volatility affects both generation and demand users of Networks.
- The effect of volatility on customers with 'pass through' charging arrangements with their supplier. Many of these customers have seen large changes, at short notice, to their charges (particularly DUoS) during the last 2 years. In many cases, these customers would have seen little or no change to the networks around them, with the only justification to such large increases being a change in the charging methodology. Many such customers would value more stability in Network Tariffs.

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

All customers are affected by charging volatility:

- Those on fixed price contracts, or tariffs, with their supplier, may be paying more if the supplier feels it necessary to add in risk margin to manage volatility of prices. In addition, they may see large unexpected increases in charges at the time of contract renewal.
- Those on 'pass through' contracts with their supplier may receive large increases in Network Charges at short notice. This has been particularly significant for DUoS where many customers have seen increases in excess of 100%. This volatility has been caused not only by the price control, but also changes to the charging methodology (CDCM and EDCM). It is difficult to explain such increases to customers when they may see no apparent change to the immediate network around them. A recent publication by National Grid suggests that TNUoS charges in 2015/16 will increase by an average of 25%. This clearly has significant financial and budgetary implications for customers and may also impact the viability of their business.

- Volatility also affects the risk of generation companies as well as consumers. It is becoming increasingly difficult for such companies to estimate Network Charges. For example, Renewables Companies are making financial investment decisions for 20 years or longer. As Network Charges increase in cost and volatility, it is difficult to effectively evaluate projects upfront. If one cost component changes significantly, it can affect the viability of the whole project.

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

We agree with the criteria listed.

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?

A number of further suggestions are listed below:

<u>(a)</u> <u>RIIO ED1</u>

As already identified in the above letter, we have concerns that a major source of network volatility is the implementation of a new price control itself. The timescales of publication of final Allowed Revenues under the RIIO processes is too late for suppliers who need certainty of revenues 2-3 years in advance. RIIO-ED1 is an immediate problem that this consultation could address. Our suggestions to mitigate this charging volatility risk arising from the RIIO-ED1 timetable is:

1 The current timetable is revisited to publish all Distribution Network Operator (DNO) Allowed Revenues much earlier than intended;

2 Fix Allowed Revenue numbers for each DNO for 2015/16 and 2016/17 early (perhaps based on initial business plan information published in May 2013?). Changes to those initial numbers as a result of the review process by Ofgem will still be recovered by DNOs but spread across future years using the 'k factor' (a standard price control process);

3 Implement a cap and collar (say +/-5%?) around an early published allowed revenue for each DNO for 2015/16 and 2016/17 and any further over or under recovery as per option 2.

<u>(b)</u> <u>Tariff Notice Period</u>

NWOs are currently required through their licence to provide circa 3 months and 2 months notice of indicative and final charges. We would like to see this period extended to give more certainty for suppliers and consumers. The ideal situation would be that NWOs provide 2 years advance notice of tariffs. For example, for electricity distribution, this would mean that in February 2013 final tariffs for 2013/2014 and 2014/15. In February 2014, tariffs for 2015/16 would be published (2014/15 would already be known for the last year). This would give suppliers and consumers alike 1-2 years notice of network charges. We would be comfortable to relax the penalties for over and under-recovery in order for this to happen. Any under or over recoveries would be carried over into the following years via the ‘k factor’. The transparency of this activity would be beneficial to the market as a whole.

(c) Reporting Arrangements

While the provision of DCP066A and MOD186 data has been useful to suppliers, we would like to see a more detailed breakdown of the numbers feeding into Allowed Revenues. We support the suggestions made in the consultation regarding the provision of a publically available financial model. We would also like to see quarterly reporting by the NWOs regarding changes to these inputs. Suggestions on further reporting are provided in our response to Question 3.4.

(d) Notification of Requests to Ofgem which may result in Changes to Revenue

This issue has not been addressed in the consultation. We have already raised in DCP106 a request which would require DNOs to provide advanced information to DCUSA Parties of their application to Ofgem for extraordinary changes to revenue and the implementation dates that have been requested. This would provide more transparency of potential future revenue changes.

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

Option 1: Yes we agree with Ofgem's assessment

Option 2: Yes, we agree with Ofgem's assessment that only one change per year would be beneficial

Option 3: Yes, we agree with Ofgem's assessment that a 2 year lag would be beneficial

Option 4: No, we do not agree with Ofgem's assessment. We believe that a 2 year lag would be beneficial for all uncertainty mechanisms

Option 5: Generally, we believe that if we have more transparency and predictability of the price control revenues, as covered in our discussions above, this should be sufficient. We would like to see more detail behind caps and collars before providing a view on Ofgem's assessment.

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 do not believe that this will be an issue. We believe that best practice should be taken from each market sector.

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

We would like to see:

- A common published financial model and items suggested in 3.16 of the consultation would be very beneficial to suppliers at the business plan submission stage.

- The summary breakdown of 'Best View' Business Plan Future Revenues clearly shown for each year in current year prices. (This will reduce the confusion surrounding RPI and what values have been used). These should be updated on a regular basis (e.g. quarterly?), based on latest information available. It should show a full summary of all assumptions behind the revenues in a tabular format specifying what the assumption refers to and the high / low percentage range on the revenue value shown.

- For example, 2015/16 would could be

Revenue Type	£m	High Case	Low Case	Assumptions
Known Costs – x	X m	+2%	-2%	Text
Known Costs – y	Y m	+3%	-5%	Text
Known Costs – z	Z m	+8%	-6%	Text
Incentive 1	a m	+20%	0%	Text
Incentive 2	b m	+50%	-10%	Text
Smart Grid	c m	+200%	-100%	Text

- As we get closer to 2015, the percentage range around each cost should tend closer to zero for the earlier years of the price control.

- We would also like to see a <u>High / Low figure on the Total Allowed Revenue</u> for each year i.e. the total Allowed Revenue for the year should not fall above or below these values.

The above information should be presented in a consistent format across all 14 DNO areas for RIIO-ED1.

b) what information you would like to see provided on an ongoing basis.

The information listed in 3.16 of the consultation would be very helpful to suppliers. The implementation of common financial models would also be extremely useful. These should be regularly updated by the NWOs who should ensure that the information is as up to date as possible.

We would like to see NWOs providing regular tariff forecasts to suppliers. This would take account of new revenue information and quarterly updated charging model inputs (including demand forecasts). These models should be released to suppliers on a quarterly basis. Ofgem may wish to consider linking the accuracy of these tariff forecasts to an incentive scheme, particularly for RIIO-ED1. This would reward NWOs for providing good forecasts to the market.

We have already raised in DCP106 a request which would require DNOs to provide advanced information to DCUSA Parties of their application to Ofgem for extraordinary changes to revenue and the implementation dates that have been requested. This would provide more transparency of potential future revenue changes. This information could equally be provided by Ofgem.

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?

We believe that Ofgem should be promoting a culture within the Industry which improves predictability of Network Charges. This is essential to obtaining an overall improvement to the current situation. For example, any Industry Changes to be implemented (e.g. Changes to Revenues through the Price Control Mechanism or Charging Methodology Changes) should be analysed to establish the effect on tariffs. If the change is found to affect tariffs significantly, it should be the norm to delay implementation of the change at least 2 years. There are a number of Industry Changes being progressed at the moment, which, if implemented, will cause large changes in tariffs (e.g. in DUoS, 500MW model, new non-half hourly/ half hourly working group changes; in TNUoS Project TransmiT; in BSUoS, CMP201/202 and the corresponding BSC modifications etc).

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?

Over the last five years there have been mid year changes in all charge types. However, this is of particular concern in electricity distribution since 2010 and the introduction of the CDCM. The main reasons for these changes have been to correct for allowed revenue position within year and/or implementation of a charging methodology change. In electricity distribution, there have also been occasions where changes have been made to correct for DNO errors (one of which resulted in a July change).

In electricity transmission, National Grid implemented a mid-year price change in 2010. This resulted in changes to supplier customer billing and also required considerable communication with customers on why their rates had changed mid-year.

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 do not believe this to be the case. We support restricting changes to one price change per year. April is the main change date for electricity charges and October for gas. We would therefore support these implementation dates if it is easier. However, we would also be happy to accept changes on 1 April only if Ofgem believes this to be more efficient.

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 do not support any exemptions that will allow for changes due to specific events since any such mechanism devalues the intention of this change. Once tariff prices have been set, they should remain for the whole period. Errors in particular should not be regarded as exempt from this. The consultation correctly identifies that consumers will often not see the impact of the correction since it is dependent on their contractual agreement with the supplier. Implementing at the next set price change (up to one year later) will allow fairer treatment of consumers as well as?

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

Yes. We believe widening the penalty band for over/under recoveries is appropriate given that the NWOs will not have the opportunity to correct mid-year. We also support penalties for systematic over or under recovery.

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. This gives more predictability of Network Charges to suppliers.

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

There have been 2 confirmed errors at final tariff publication (and a possible error at indicative tariff publication – we have contacted Ofgem separately regarding the details around this) for electricity distribution. We are not aware of errors made in other sectors.

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

Yes. It is unacceptable that these errors are occurring. Suppliers are consumers are forced to bear the risk associated with these errors while the NWO is completely neutral to the financial impacts that they have caused. A penalty mechanism should be applied if errors are made. This should be applicable to <u>both indicative and final tariff publication</u>, since both are equally important to suppliers for pricing purposes. These penalties should be applied to all market sectors.

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?

Our preference would be at least a 2 years notice period for changes to the allowed revenue change.

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

No. All incentive adjustments should be lagged for at least a 2 year period after notification.

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

As a general point, we would prefer a standard lag of 2 years for everything. This increases transparency and predictability.

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?

Generally, we believe that if we have more transparency and predictability of the price control revenues, as covered in our discussions above, this should be sufficient.

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?

Not without further analysis.

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. Any changes to improve predictability should be implemented at the start of the next price control – or prior to that date, if practically possible.

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

Any changes to improve predictability should be implemented as soon as is practically possible.