Regulation & Commercial

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(by e-mail)

Your ref
52/12

Our Ref
GB/52/12

Date
8 June 2012

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Dear Joanna

SPEN Response to "Mitigating network charging volatility arising from the price control settlement"

Our detailed response, on behalf of SP Distribution and SP Manweb, is attached.

Overall, we would like to see a more evidence based approach to Ofgem's consideration of these matters. In particular, we would like to see:

- Evidence of customers' preferences between more frequent but smaller changes in charges, as opposed to larger annual charges;
- Fuller consideration of the relation between individual charges, as determined by the common charging methodologies, and allowed revenue;
- A cost-benefit analysis which assesses the potential impact on energy bills (which we estimate to be less than 1%) against the potential disbenefits from delays in moving towards a low carbon economy and poorer performance resulting from weakened incentives; and
- An assessment of the degree of compliance of the proposed options with competition law and the risk of DNOs facing allegations of potential anti-competitive behaviour in the relevant markets.

We would urge Ofgem to publish a formal impact assessment before implementing this important proposal.

If you wish to discuss further any aspects of our response, please contact me.

Yours sincerely

Garth Blundell
Senior Analyst

SP Energy Networks Response to:

"Mitigating networking charging volatilitility arising from the price control settlement"

Network Charging Volatility

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

Our understanding is that individual customers are primarily concerned about their own individual charges. From that perspective, predictability of a network operator's allowed revenue is only the first stage in addressing customers' concerns.

Furthermore, we have seen no evidence that customers, as a whole, prefer larger infrequent changes to smaller albeit more frequent ones. In particular, customers are keen that the passing on of cost reductions are not delayed.

Many prices change regularly, including those of other utility services and essential items, such as mortgage payments. Casual empiricalism suggests that as markets become more competitive price changes become more frequent. Indeed, competition authorities usually regard simultaneous but infrequent price changes with suspicion, as they may indicate inappropriate or, at least, tacit collusion.

In our opinion, further consideration should be given to the difference between aggregate allowed revenue and individual charges, as the two are clearly not synonymous. Put simply: individual charges may change even when allowed revenue remains constant.

There is a risk that customers may form unrealistic expectations as regards individual charges from potentially misleading discussion of the predictability or otherwise of allowed revenue. We wish to avoid potentially misleading customers in such a manner.

In addition, a full cost-benefit analysis should take into account the potential disbenefits which may arise from delaying the transition to a low carbon economy, slowing reductions in carbon emissions and the impact on quality of supply and service levels. These may result from delayed investment by network operators and the effect of diluted incentives on their performance. In comparison with these potential disbenefits, the potential impact on energy bills, which we estimate to be less than 1%, seems very small.

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

Since the introduction of the Common Distribution Charging Methodology in April 2010, the main drivers behind volatility in tariffs are the allowed revenue, volume forecasts, load/coincidence factors and network peaking probabilities. All groups of customers can be affected by charging volatility.

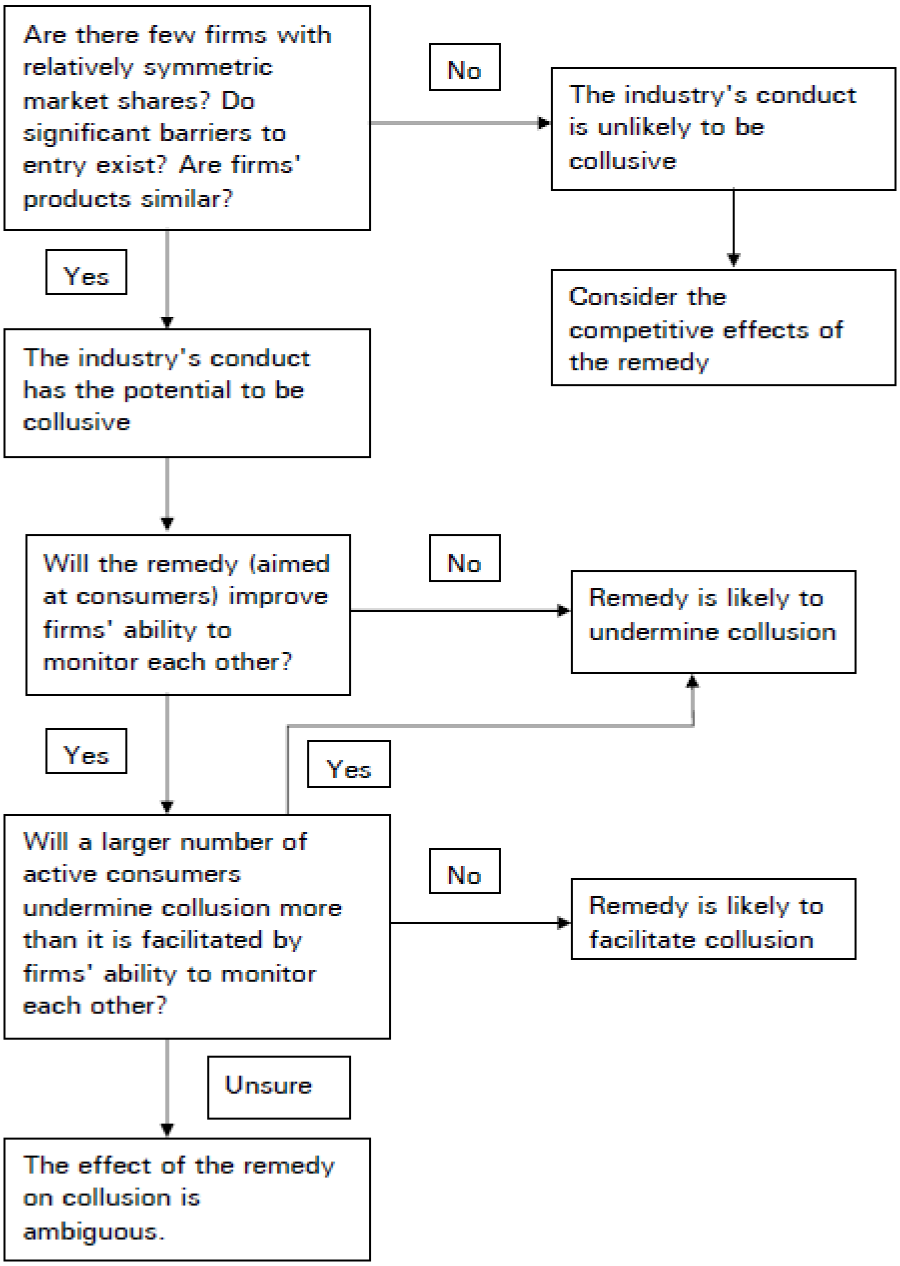
Question 2.3: Do you agree with the assessment criteria? Are there additional criteria that we should adopt for our final assessment?

It is essential that Ofgem assesses the potential impact of the options on the competitive process, in the same way that other competition authorities would. This requires an evidence based assessment.

The OFT has published guidance to policymakers on assessing the effectiveness of potential remedies in consumer markets[1], which advises:

> "When considering whether to implement a remedy in a consumer market, a policymaker should consider whether the market structure after implementation is likely to sustain collusion. If the conduct of the market is not likely to be collusive, the specific effects of the remedy should be considered (see relevant sections in the main text). If it is likely that the market structure could sustain collusion, the policymaker should next consider whether the remedy has the potential to improve the firms' ability to monitor their rivals"

FIGURE 1: IS THE INTERVENTION LIKELY TO FACILITATE COLLUSION?



Source: OFT (2008), "Assessing the effectiveness of potential remedies in consumer markets", Appendix A, Figure A.1, OFT994, April

[1] OFT (2008), "Assessing the effectiveness of potential remedies in consumer markets", OFT994, April

Of particular relevance is the conclusion that where a remedy improves firms' ability to monitor each other then it is likely to facilitate collusion. In view of this risk, a full assessment of the supply-side reaction seems appropriate. We seek Ofgem's reassurance that any measures proposed would be compliant with competition law and that that they would not put DNOs at risk of allegations of potential anti-competitive behaviour in the relevant markets, including the market for the supply of electricity to consumers and the markets for the supply of goods and services to DNOs.

We would urge Ofgem to publish a formal impact assessment[2] before implementing this important proposal. If Ofgem decides not to do so, we request that it explains why it is not necessary.

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?

There remains the possibility of substantial discontinuities in allowed revenue between price control periods. For example, at price control reviews, the cost of equity and depreciation lives have been changed, which are major components of allowed revenue.

Depending on the magnitude of the change, it may be possible to smooth a step change in allowed revenues over several years, subject to financeability requirements.

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

Subject to our detailed comments below, we are in broad agreement with Ofgem's initial assessment of each option.

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?

Electricity DNOs may be obliged by changes to the DCUSA to change prices in October.

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.

This question appears to relate to individual charges rather than allowed revenues, and would therefore primarily relate to the relevant charging methodologies.

As regards allowed revenues, electricity DNOs already publish, quarterly, projections of the main components of allowed revenue.

We propose to develop well-justified business plans for SP Manweb and SP Distribution building on the fast-tracking of SP Transmission for RIIO-T1. These will include projections of annual allowed revenues and the impact on the average bill. We are also developing a programme of stakeholder engagement.

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[2] Section 5A of the Utilities Act 2000 requires that, before implementing an important proposal, Ofgem either carry out and publish an assessment of the likely impact of implementing the proposal, or publishes a statement setting out its reasons for thinking that it is unnecessary for it to carry out such an assessment.

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?

Ofgem already publish annual reports on the performance of electricity distribution and transmission. We suggest that these are developed to set out more clearly the impact on allowed revenues and the date of publication brought forward.

The annual iteration of the RIIO-T1, GD1 and ED1 financial models will be an essential stage in determining allowed revenue for the next year.

Ofgem already undertakes a comprehensive consultation process which allows interested stakeholders to become informed on a wide range of regulatory issues. Nevertheless, there may be scope for increasing the number of impact assessments which Ofgem publishes.

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?

Within the last five years we have changed prices in October 2009, 2010 and 2011 in both SP Distribution and SP Manweb. There was also a price change in August 2007 in SPD.

Apart from 2011, the main reasons for the 1st October price changes are:

1. Revised allowed revenues – we have an obligation to price to cap; and
2. Revised view on volumes – there has been significant volatility in volumes as a result of the credit crunch, recession and unpredictable movements in settlement data

The price change in October 2011 was due to a DCUSA change proposal that changed the IDNO discounts, the implementation date was 1 October 2011, hence the price change. However, this had a very minimal impact on all the way tariffs.

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

The current licence obligations to take all appropriate steps / use best endeavours to ensure that the revenue collected in each regulatory year does not exceed allowed revenue may be in conflict with restricting the change in charges to 1 April. We accept that a number of incentives in price controls (such as losses and quality of service in the case of electricity distribution) operate with a two year lag. However, there are a number of reasons why licensees may need to adjust charges intra-year, including:

- Forecasting variances of demand or customer numbers by tariff category;
- Unexpected increases in business rates or licence fees;
- Changes to charging methodology mid-year resulting from the DCUSA governance process (in the case of electricity distribution)

The price cap obligation and the associated penalty rate of interest for over-recovery would have to be removed if Ofgem decide changes in use of system charges should be restricted to 1 April. Our initial estimate is that a deadband of 5% of allowed revenue would need to be applied. Similarly, the existing multi-year restrictions on over- and under-recovery would also need to be revisited, as indicated in paragraph 3.42.

There also needs to be some flexibility to deal with manifest errors. Additionally, if proposals for licence breach penalties to be accompanied by required compensation to customers through the charging mechanism are implemented, this may also mean that intra-year charge adjustments are needed.

The provision, in SLC38, of the electricity distribution licence for an increase in use of system charges to compensate any electricity supplier which makes a valid claim for losses that it has incurred in complying with a last resort direction may conflict with a restriction to only changing charges on 1 April each year.

It should be noted that the requirement on Transmission Owners not to amend charges mid-year without the Authorities consent should be seen in the context of a relatively simple price control and charging framework compared with electricity distribution.

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?

Unless the current licence obligations are removed or amended it is essential that appropriate exemptions remain, as indicated in our response to 3.7 above.

It seems desirable that material errors are corrected within year. Otherwise, charges will fail to appropriately reflect costs for extended periods.

Pass through costs, including business rates, should still be passed through in the year to which they relate.

Changes in the applicable rate of VAT will have to be applied in accordance with legislation.

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

If Ofgem decide changes in use of system charges should be restricted to 1 April the associated penalty rate of interest for over-recovery would have to be removed. Our initial estimate is that a deadband of 5%? of allowed revenue would need to be applied. We envisage that the major causes of unanticipated over or under recoveries will result from unexpected changes in the volume and/or mix of units arising from extreme temperatures, changes in energy prices and macroeconomic, regional or sectoral economic developments and unpredictable movements in settlement data.

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?

We agree that an adjustment for over or under recovery in year t should impact network charges in year t+2. This would remove the need to estimate the adjustment when setting charges and for the subsequent true-up.

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

Although we do not have detailed knowledge of other licensees' behaviour, we are not aware of any errors being made when calculating network charges in sectors other than electricity distribution.

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

A penalty mechanism for charge calculation errors would increase the risk that they were not admitted to and would remain undetected.

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?

A key determinant of allowed revenue in RIIO will be the annual iteration of the financial model, which will determine the MOD_t component of allowed revenue. Ofgem propose to issue this determination in November of each year. Consequently, this will be the earliest opportunity for allowed revenue to be notified for the following regulatory year.

However, notification of individual charges would not be available until the end of December.

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

Although not referred to in the consultation document, we presume that Ofgem do not intend to lag the payment of enforcement penalties and guaranteed standards failures.

Also, the cost of debt indexation for RIIO operates without a lag but is calculated from a proprietary third-party index of sterling non-financial corporate bond yields.

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

We agree that it is not appropriate to lag inflation indexation. Ofgem have recently consulted on the RPI indexation methodology to be applied for RIIO. The allowed cost of capital is expressed in real terms and must be appropriately adjusted by the corresponding change in the RPI.

b) pass through costs

Pass through costs, including business rates, should still be passed through in the year to which they relate.

c) revenue drivers

Revenue drivers for RIIO-T1 have already been set for SP Transmission and SHETL and operate without a lag.

Although the revenue drivers for RIIO-ED1 are yet to be developed, we do not anticipate proposing lagged mechanisms.

Typically, revenue drivers are linked to volumes and so do not necessarily change charges per unit of measure (e.g. per MW of distributed generation), although total allowed revenue would change.

d) within period determinations

It is not appropriate to lag revenue arising from within period determinations, as this would have an adverse impact on financeability and would potentially delay desirable projects.

Furthermore, these adjustments would follow a consultation process, which informs interested stakeholders.

e) re-openers

Re-openers already result in lagged recovery of costs. A further lag in revenue recovery would amount to a delayed re-opener.

Furthermore, again these adjustments would follow a consultation process, which informs interested stakeholders.

f) innovation funding

A lag in revenue recovery would deter innovation by network operators, which would result in disbenefits to customers and wider society.

RIIO-ED1 will see the roll-out of smart meters and the development of the first stages of the "Smart Grid", so it is important that potential benefits are not discouraged.

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?

Imposing a cap and collar on changes to allowed revenues would weaken the effect of incentive mechanisms. The design and implementation of uncertainty and incentive mechanisms themselves should take account of the extent to which they would affect the predictability of network charges, for example, by appropriate lags in the adjustments to allowed revenue.

Financeability is a critical part of the overall price control settlement and should not be put at risk by inappropriate restrictions on adjustments to allowed revenue.

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?

Although more complicated designs are conceivable, we do not believe that they would be desirable.

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

We see no basis for imposing an asymmetric cap and collar.

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?

Implementation at the start of the next price control period seems appropriate, subject to necessary licence modifications.

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

Again, implementation at the start of the next price control period seems appropriate. Nevertheless, if Ofgem decide to proceed with Option 1 (improved information for suppliers and customers) this could be introduced at an earlier date, subject to any necessary changes in industry codes.

Option 2 would require a licence modification to remove the current obligation on the licensee, in CRC3, to take all appropriate steps within its power to ensure that the revenue collected in each regulatory year does not exceed allowed revenue, as these are inconsistent with restricting the change in charges to 1 April. In addition, the penalty interest rate applied to over recoveries would need to be relaxed and provision made for a deadband, if proposed. These would require statutory consultation on the proposed licence modifications and the relevant timescales would then apply.