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Mitigating network charging volatility arising from the price control settlement

Dear Joanna,

I write in response to the Ofgem consultation "Mitigating network charging volatility arising from the price control settlement"

Comments on the document's Overview and Executive Summary

The Overview to the consultation document contains the following statement: "Some suppliers have indicated that, when offering customers fixed price contracts, they include a risk premium to protect themselves against unforeseen changes to network charges. They have also stated that perceived volatility in network charges acts as a barrier to entry to the retail energy market, particularly for smaller suppliers who may be less able to absorb network charge fluctuations."

> We do not include such a premium because that would make us uncompetitive. There is clearly a limit to how much of a premium can be charged (largely set by the bigger players we are competing against who are more able to absorb the risks within their general business). No risk premium could cover us for the kinds of movements we have seen especially when CDCM was being introduced.

The Executive Summary states: "We agree that network charging volatility – particularly the ability to predict charges reasonably accurately - is an important issue for suppliers, and ultimately energy consumers."

Suppliers should not have to predict these charges at all. They should be fixed tariffs long in advance. The assumption of a requirement to predict continues to place all of the risk on suppliers and consumers.

The Executive Summary also states: “In this consultation paper, we identify a number of options that could help mitigate network charging volatility, or its effects, arising from the price control settlement (while maintaining the benefits of the RIIO framework including strong incentives for delivering efficiently). We do not, as part of this consultation, directly address volatility arising from the application of charging methodologies, that is, how the overall revenue constraint set at the price control is recovered from different customer groups. In this area, we will continue to work with the industry to develop the methodologies through the respective code governance arrangements.”

In our opinion it is difficult to separate the two issues.

The Executive Summary states “Our principal criterion for assessing the options is a consideration of which party is best placed to bear the cash-flow risk associated with changes to network allowed revenues. For example, limiting the number of changes or improving predictability of changes will reduce the risk to suppliers, and therefore potentially reduce the risk premium included in customers’ bills. However, limiting NWOs’ ability to recover costs may lead to increased variability in NWOs’ cash-flows, which increases their financing costs, and potential leads to higher overall network charges.”

Cash-flow risk is a red herring in this context. There needs to be an onus on NWO to minimise both cost rises and the associated volatility. They need to move their business cycles such that they can provide more certainty. Are they saying that their costs are so unpredictable and unmanageable that they need to be able to change them at will? This seems unlikely. The question to ask is who is best placed to do the forecasting and hence should take the risk of that forecasting being wrong?

Ofgem’s specific questions

We answer Ofgem’s specific questions below in the order in which they appear in the document.

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

We consider that it is important to make an overall consideration of the level of cost expected to be borne by customers over the coming years and not just the lack of predictability in the charges.

We recognise that Ofgem have attempted to increase transparency but ultimately this does not appear to address the volatility or the level of charges.

We are pleased that the proposals set out in this consultation are aimed at improving predictability (eg by providing advance notice of expected changes) but providing stability in network charges for individual customers is just as, if not more, important.

We note that Ofgem often quotes low average aggregate increases but the Half Hourly market has experienced increases of 20% and individual customers even more.

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

It is our perception that HH and non-domestic generally have been particularly disregarded in this matter.

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

The principal criterion Ofgem wish to use is which party is able to most efficiently manage cash-flow risk in relation to network charges.

The question we would ask is who is best placed to do the forecasting and hence should take the risk of that forecasting being wrong? Emphasis must be place on the ability of the NWO to assess the requirements on a forward basis. They must bear the costs of getting this wrong. This is the corrective incentive on them to improve their ability to manage the charges. Merely passing the buck on to suppliers and consumers provides an unacceptable buffer that removes any incentive for efficiency and improvement.

It is not a question of comparing DNOs' cash flow risk and cost of capital with the premium suppliers may or may not apply to tariffs to satisfy the risk they face. Smaller suppliers face real risk of being put out of business with the level of tariff change and this is not good for competition.

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 is a sixth option which is to create a lag such that tariffs are fixed two years ahead.

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

Whilst increased transparency is a good idea in an environment where forecasting must be done by participants and in the absence of any radical change we would be grateful for any extra information we could get. However, such forecasting is extremely difficult and it is not appropriate for responsibility for this to be left to the suppliers. Ofgem say that they have not identified any negative impacts associated with this option but the negative impact is that it reinforces the misconception that suppliers should be responsible for forecasting charges which are more easily forecast by the distribution operators themselves.

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

In the past it has been difficult to track which DNOs have made changes in October and which have not. Statements of no change would have been helpful. However, going forward we would prefer to see no mid-year changes.

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 on-going basis.

All of the information listed in para 3.16 would be useful, but it is likely that as a supplier we would purchase forecast information from a specialised third party analyst who would make use of this data. This kind of service would probably cost a five figure sum annually.

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?

No comment.

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

Several DNO's have habitually made changes in October as well as April.

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

Not for Suppliers. One change per year would seem to be easier.

The document states: "A penalty is applied if allowed revenues are over or under recovered from customers in any year. " This clearly needs to be removed as it introduces a perverse incentive to tinker with tariffs.

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?

To answer these three questions in order: No, no and no.

Whilst we accept that customers may face a shock if an error is not corrected as soon as it is discovered, it is more likely that the customer will not be exposed to the change, but the supplier. There also needs to be a clear incentive on the NWO to minimise charges through proper forecasting of requirements and system investments.

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

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?

This would certainly be an improvement but we would urge Ofgem to consider a longer period if possible.

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

No

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

Yes

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

Two years

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

No

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

There should be a lag applied to all of these on the grounds that the greater the number of lags built in the more stable the prices will be.

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 think there are merits in options i) and ii).
We are not inclined to favour iii) because it does not cause an overall limit should there be many small changes

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?

In theory we have no issue with asymmetric caps and collars.

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?

No comment

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

2015.

Should you wish to discuss any aspect of this matter, please do not hesitate to contact me.

Yours sincerely,

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