Registered Office:
Newington House
237 Southwark Bridge Road
London SE1 6NP

Registered in England and Wales No: 3870728

Company:
UK Power Networks
(Operations) Limited

Joanna Campbell
Smarter Grids and Governance
Ofgem
9 Millbank
London
SW1P 3GE

By email to: joanna.campbell@ofgem.gov.uk

13 June 2012

Dear Joanna

Consultation on 'Mitigation of network charging volatility arising from the price control settlement'

Thank you for the opportunity to provide views on Ofgem's consultation paper: 'Mitigating network charging volatility arising from the price control settlement' and for confirmation to Paul Measday for allowing us to submit our response two days late. This response should be regarded as a consolidated response on behalf of UK Power Networks' three electricity distribution licence holding companies – Eastern Power Networks plc, London Power Networks plc and South Eastern Power Networks plc. I can confirm that this response is non-confidential and can be published via the Ofgem website.

We understand that suppliers are looking for a greater degree of certainty in the level of DUoS prices that are charged by DNOs. Since the start of DPCR5, DNOs have made significant improvements in the visibility to suppliers of potential future prices changes. Although we recognise that further improvements can be made we believe that the benefits of this process are yet to be fully realised. The new RIIO-ED1 price control framework will also provide greater certainty of DUoS prices through the lengthening of the price review to eight years and the increased emphasis and requirement for DNOs to engage with all stakeholders. UK Power Networks takes the latter point very seriously and has agreed through the Distribution Charging Methodology Forum (under licence Standard Licence condition 22a, which UKPN chairs) to engage with suppliers to allow them further visibility of future price changes. .

We also note that the overall level of volatility caused by a change in DUoS to the overall supply bill is relatively small. A 10% change in the level of DUoS prices will disturb customer bills by less than 2%. We have considered carefully the potential options presented, together with Ofgem's initial assessment, as laid out in the consultation document. Our opinion is that none of the options proposed will offer more than limited benefits to suppliers and will impose a disproportionate level of bureaucracy. Taking each option in turn, our view is as follows:

Option 1 (Improving information provision) is already addressed adequately through the forecasts of upcoming tariff revisions provided by DNOs to all parties. Work is continuing through the DCMF

Return Address:
Newington House
237 Southwark Bridge Road
London
SE1 6NP

MIG and its sub-groups to review and further improve these forecasts, amongst other changes from Suppliers that have recently been submitted to DCUSA.

Option 2 (Restricting intra-year charge changes) could cause a DNO to find themselves significantly under or over recovered as a result of events outside of their control, such as a particularly mild or severe winter. We believe that this risk could be mitigated, if the banding on recovery levels, where a penalty could be applied, is increased to reflect such circumstances.

Option 3 (Increasing the lag on changes due to incentive performance) appears of limited merit, as changes to reflect incentive rewards/penalties already lag by two years. We believe it is important that companies are exposed to the costs/benefits of their business performance, in a timely manner. This would be further weakened if this lag were to be extended.

Option 4 (Increasing the lag on changes due to uncertainty mechanisms) looks at a number of different uncertainty mechanisms. We share Ofgem's view that addressing volatility through limiting the number of adjustments (as seen in the use of reopener windows and materiality thresholds) is more appropriate than increasing lags.

Option 5 (Imposing a cap and collar on changes) considers placing limitations on the scope of changes to Allowed Revenue. Ofgem is correct to conclude that this is a complex option with numerous issues to overcome and significant risk to be managed. We agree that this is not an option which should be taken forward.

To summarise, it is our opinion that, subject to modification of the banding arrangements, only option 2 is likely to be of benefit to the suppliers.

In the attached appendix, we have provided answers to the specific questions laid out in the consultation, which add further detail to the views expressed above.

I hope that you will find our response helpful. If any aspect requires further explanation or clarification, please do not hesitate to contact me.

Yours sincerely

K Hutt

Keith Hutton
Head of Regulation
UK Power Networks

cc Paul Measday, Regulatory Reporting and Compliance Manager, UK Power Networks

Appendix 1

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

We believe that the main issue that suppliers have isn't so much the overall volatility of allowed revenue but more so the actual movement between tariffs. However in part this is an outcome of the Common Distribution Charging Methodology (CDCM) which was designed to be cost reflective. In our view the industry is working to address these concerns through industry workgroups and subsequent DCUSA change proposals.

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

We believe that a customer who is on a tariff that is either site specific or not used by many others would be most impacted by charging volatility. This is normally a consequence of the individual change and the smaller number of parties over which to spread the associated change. Similarly if a supplier had a number of these types of customers they would also see a greater proportion of any movement.

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 you have selected to make the assessment, namely cash-flow and financing risk, the complexity of the revenue and price setting arrangements and the links to other Ofgem policies and objectives.

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?*

As we have stated previously in the response to Q2.1, there is a need to understand whether the driver for volatility concern is driven by the price control settlement or whether it is driven by inter tariff disturbance. We agree that the areas identified seem to be the most suitable areas for consideration to reduce charging volatility caused by the level of price control settlement.

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

Option 1 is largely covered by obligations already placed on DNOs as laid out in the Distribution Connection and Use of System Agreement (DCUSA) clause 35a 'Provision of Cost Information'. This sets out a requirement on DNOs to provide a quarterly forecast of Use of System Revenue.

Volatility in tariffs isn't necessarily a component of the changes in the revenue recovered. It is often the volatility in the movement between the different tariffs, which is, at least in part, a consequence of the need for the CDCM to be as cost reflective as possible, in the calculation of charges.

There is work underway with the CDCM 'Super Group' to review and revise some parts of the Methodology to resolve these issues. This has resulted in DCUSA change proposals that are now being progressed. In addition two change proposals have also been submitted from Haven Power and these are also progressing at the current time.

In light of the work being progressed in the industry groups, it is our view that the current arrangements should not be revised at this time. Industry stakeholders already have sufficient advance notification of movement in revenues. The effect on charges can be modelled using the publicly available charging models and industry stakeholders are progressing changes to mitigate volatility between charges in the charging model.

Option 2 – we broadly agree with this option as the most likely to benefit suppliers as well as being relatively easy to implement. However, this option would remove the DNOs ability to undertake a mid year tariff change. If we are not able to change prices we could exceed or fail to meet our over or under recovery thresholds and this could potentially place us in breach of the licence, which increases the risk on the business to not be able to recover our Allowed Revenue. We would also need to consider the possibility of the introduction of a material error, which we would want to be corrected as soon as possible in order to ensure that the error wasn't made more significant by delaying the introduction of the correction. This option is only viable if the thresholds in the licence were sufficiently revised.

Option 3 – we currently have a two year lag on most of our incentives and any further delay in this would seem to be unreasonable, as performance in year t is finalised in year 1 and used in the calculation of prices in year 2. We believe that any other approach could significantly impact upon cash flow. Furthermore, we believe that it is very important that incentive penalties or rewards should be received in a timely manner, otherwise the incentive loses its purpose. Hence for both these reasons, we do not support this option.

Option 4 could impact upon our ability to recover enough of our allowed revenue to cover the costs of running the business. This would have the potential to increase financing costs, which would be detrimental to both customers and investors. Please also see our response to Q3.15

Option 5 would place a cap and collar on the amount of Allowed Revenue we were able to earn for a given year, which in the most extreme case could see a DNO be continually under recovered if the cap was too restrictive for each year. A further concern would be whether a restriction on what revenue can be earned might lessen the drive to deliver outstanding performance or desire to innovate. This could in turn weaken the price signal provided to the customer. Undoubtedly this would be complex to administer and would have significant risk for the DNO.

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

From a DNO perspective we do not believe that code and licence charge notification differences create problems, although suppliers are better placed to provide feedback on this.

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 is a question for other industry stakeholders to respond to.

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?*

This is a question for other industry stakeholders to respond to.

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

As UK Power Networks (or EDF Energy Networks respectively) we have detailed the primary reasons for a change of tariff over the last five years, which shows we have always changed prices during the year in all regions since April 2009, although the changes in October 2011 were solely as a result of a DCUSA DCP (DCP071A) being implemented.

	Eastern Power Networks plc/EDF Energy Networks (EPN) plc	London Power Networks plc/EDF Energy Networks (LPN) plc	South Eastern Power Networks plc/EDF Energy Networks (SPN) plc
October 2008	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.	No price change	No price change
April 2009	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.
October 2009	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.
April 2010	Implementation of the CDCM. KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.	Implementation of the CDCM. KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.	Implementation of the CDCM. KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.
October 2010	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates.
April 2011	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates, LCN2t funding direction.	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates, LCN2t funding direction.	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates, LCN2t funding direction.

	Eastern Power Networks plc/EDF Energy Networks (EPN) plc	London Power Networks plc/EDF Energy Networks (LPN) plc	South Eastern Power Networks plc/EDF Energy Networks (SPN) plc
October 2011	Impact of DCP071A – Increased Discounts for LDNOs	Impact of DCP071A – Increased Discounts for LDNOs	Impact of DCP071A – Increased Discounts for LDNOs
April 2012	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates, LCN2, PPL and DPCR5 Losses Incentive forecasts.	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates, LCN2, PPL and DPCR5 Losses Incentive forecasts.	KD recovery position, unit mix and volumes, network performance incentives, NG Exit Charges, Business Rates, LCN2, PPL and DPCR5 Losses Incentive forecasts.

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 licence conditions which require the recovery of allowed revenue (including CRC3) specify that the DNO needs to not over or under recover within a defined threshold. We believe that circumstances beyond our control could prevent us from being able to ensure that we continue to comply with these licence conditions as they are currently written if only one price change per year was allowed.

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 are of the view that DCUSA change proposals which impact upon charging or the calculation of charges, are a routine feature of the charging system, and hence they should be implemented on a regular timescale, (each April), so as to not disturb charges unnecessarily.

Where a material error has occurred which will impact on the calculation of charges, the implications could be significant either for the DNO or the supplier. As such, we believe that on balance this should be exempt and thus be corrected at the next available opportunity.

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

The proposal to keep the penalty rate for over or under recoveries but widening the band before any penalty is applied would ensure that based upon an accurate forecast the DNO should not find themselves in the position where they face a penalty charge for issues outside of their control. We consider that doubling the band width would be an appropriate change.

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 believe that as long as the banding for where a penalty is applied was sufficiently increased then applying a two year lag on the recovery of revenue through the correction factor would be of benefit in reducing the volatility seen in the level of Allowed Revenue recovered.

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 experience from 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?*

We believe that an additional licence condition is inappropriate and in our view each error should be reviewed by Ofgem on its own merits.

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

Currently the lag is set to two years which we consider to be appropriate.

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

We do not believe that there are any exemptions.

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

We have reviewed each of the above mechanisms and reached a view on the benefits of whether a lag should be applied, and detail those below;

- Indexation Mechanisms – We agree with Ofgem that this is not an appropriate mechanism to lag.
- Cost pass through – We would have a concern if this mechanism was lagged, as these costs are outside our control and can be significant, for example, Exit Charges or Business Rates.
- Revenue Drivers – We do not believe that it is appropriate to conclude a review of this mechanism without a clear understanding of what it would look to take account of, however it may be appropriate to review again further following the introduction of RIIO-ED1.
- Within period determinations – As stated by Ofgem we believe that these will have already been subject to extensive discussions and a failure once agreed to allow the DNO to recover the costs could cause a DNO to seek intermediary funding from investors at a higher cost than those of Suppliers funding the volatility risk.

- <u>Reopeners</u> – As with the 'within period determinations' we would agree with the view of Ofgem on this, in that due to the restrictions which are already in place to only allow a reopener where a materiality threshold has been reached, a suitable period of time will have elapsed and thus a further lag is not appropriate.
- <u>Innovation Costs</u> – These costs will be relatively small and as such will have only a small impact upon volatility, also the maximum adjustments allowed are set out in the licenses, therefore we agree with Ofgem that there is no benefit

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 believe the increase in any cash flow risk materially out weighs all benefits of these options to apply a cap and collar, because as an extreme these options could leave a DNO in a constant under recovery position.

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 do not consider that there are any other options for the design of a cap and collar mechanism.

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

We do not believe that this option warrants further exploration.

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?*

This is a question for other industry stakeholders to respond to.

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

At the earliest, any changes should be introduced with effect from 1 April 2015, in line with the commencement of RIIO-ED1, thereby allowing the revised Allowed Revenue numbers to take account of any increased risk brought about by any revisions.