Consumer Focus response to Ofgem consultation on whether to activate the Distribution Losses Incentive Mechanism in Fifth Distribution Price Control

17 August 2012

Contents

About Consumer Focus

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy-makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

General commentary

Losses from the electricity distribution network are of real and tangible importance for UK consumers. Recent figures quoted[1] suggest that around 5-8% of the electricity flowing through the distribution network is lost and losses are responsible for around 1.5% of total UK greenhouse gas emissions. Consumers pay for this economic inefficiency and environmental damage, so an effective incentive on distribution network operators (DNOs) to reduce losses from their networks is vital if these impacts are to be minimised.

It is disappointing to note Ofgem is minded not to activate the Distribution Losses Incentive Mechanism in the Fifth Distribution Price Control (DPCR5).[2] This will mean for the period from April 2010 to March 2015 there will have been no financial incentive on DNOs to reduce their losses. A considerable amount of regulatory and industry time has been expended on seeking an acceptable solution to this problem, the cost of which is ultimately borne by consumers. More worryingly, it appears to us highly likely that networks will have received a windfall gain of £250m[3], already paid for by consumers, that bears little relation to their effectiveness in tackling losses and that there is currently no proposal on the table to claw back.

Since the DPCR5 period commenced in April 2010 – and the losses mechanism was an integral part of this price control – it is difficult to understand why April 2010 is not considered the commencement of the losses mechanism and hence the mechanism has already been activated. Is Ofgem really saying that the intention of the DCPR5 price control was only to incentivise DNOs to deliver losses reductions in the final half of the price control period and not the full 5 year period? A decision at this stage to remove the financial incentive for DNOs to reduce losses will penalise DNOs who have taken early action to reduce them. This is a perverse outcome, as it is in the interests of consumers that DNOs take early action to reduce losses.

We do agree with Ofgem that the losses data for the DPCR5 period lack robustness and are not suitable for the calculation of incentives with a high degree of materiality. As noted, the poor data quality is principally due to the legitimate action taken by suppliers to address data quality issues through the application of Gross Volume Corrections (GVCs), which had a significant impact on the reported losses by DNOs for the 2009-10 period.

However, we feel GVCs provide only a partial explanation for the current undesirable situation. Since the option to use GVC has always been available to suppliers during the DPCR5 period – with no limits on how it can be applied – the potential for disruption to the losses incentive mechanism has existed since its inception. It appears to us that the underlying deficiencies in the losses mechanism have been in existence for a considerable period of time and are only now being tackled because they are creating windfall losses for networks rather than consumers.

---

[1] http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/Consultation%20-%20whether%20to%20activate%20the%20DPCR5%20losses%20mechanism.pdf
[2] Ibid.
[3] We note that the first four years of the DPCR4 losses incentive resulted in a net reward to the DNOs of ~£250m. Given the lack of robustness in the incentive mechanism identified by Ofgem, we find it hard to have confidence that this represented a legitimate reward for the networks rather than a windfall.

We accept there is no merit in developing a new losses incentive mechanism for the remainder of the DPCR5 period: the focus should be on developing an effective mechanism for RIIO-ED1. However, we remain deeply sceptical the proposal to publish a league table of actual measures DNOs are taking to reduce losses will provide any tangible motivation to DNOs to reduce their losses. While reputational regulation can play a useful role in competitive areas of the market, it is less clear that it is viable tool for application to monopoly networks – consumers and network users cannot choose which network they use and therefore cannot easily reward or punish good or bad behaviours.

The wide scale deployment of advanced metering systems ("smart" meters) will provide the means for more accurate measurement of losses during the ED1 period. It will not be necessary for the roll out of smart meters to be complete (currently anticipated for 2019) before they are able to yield valuable data on losses. It is estimated that between 4 and 6 million smart meters will already be on walls by the end of the foundation stage of roll-out. ED1 includes a formal review part way through the 8 year price control period; we would strongly suggest a comprehensive analysis of the role smart metering can play in delivering an improved losses incentive mechanism is an integral part of this review, as well as in the ongoing RIIO discussions on losses.

Consumer Focus is currently evaluating the merits of an international comparison of mechanisms for incentivising reductions in distribution losses. We hope this study will provide valuable insights for the UK and we would welcome your input in this endeavour.

Response to Consultation Questions

Questions 1: Do you have views on whether the existing losses mechanism is effectively incentivising DNOs to reduce losses? Please explain your answer.

The consultation document does not provide any means of assessing the effectiveness of the losses programme for the DPCR4 period at reducing losses and greenhouse gas emissions since each DNO was permitted to report losses based on their own methodology and no details of the methodologies used are provided.

We are somewhat uncomfortable with DNOs using their own methodology to measure losses, given the material and environmental importance of reducing losses. Heterogeneity of methodologies means comparisons and benchmarking between DNOs is very difficult. We are concerned whether the Regulator has a sufficient understanding of the detail of DNOs' businesses or the appropriate skills to be able to effectively assess "good" performance on losses provided on this basis. This makes comparability and the ability to benchmark an important regulatory tool for the effective monitoring and validation of stated losses performance. The comparability of data produced by a flawed methodology is of little value.

We note the first four years of DPCR4 resulted in a net reward to DNOs of circa £250m. We are not assured this reward is justified by measures taken by DNOs to reduce their losses. We are disappointed that fully reconciled data for this period has not been provided as part of the consultation so that we may assess whether the level of claimed losses are reasonable. This raises the possibility that under reporting of losses during the DPCR4 period – due to settlement errors, corrected by Gross Volume Corrections in the DPCR5 period – may have resulted in DNOs receiving financial reward for reducing losses, without robust evidence to support this claim. We would seek further assurances from Ofgem that it is confident the financial payments made to DNOs have resulted in DNOs taking tangible steps to deliver genuine reduction in losses. In the absence of this reassurance, there remains high level of concern the losses incentive mechanism for the DCPR4 period has not delivered value for money to consumers.

Question 2: Do you have views on whether or not the DPCR5 losses mechanism should be activated? Please explain your answer.

Since the DPCR5 period commenced in April 2010 – and the losses mechanism was an integral part of this price control – it is difficult to understand why April 2010 is not considered the commencement of the losses mechanism and hence the mechanism has already been activated. Is Ofgem really saying that the intention of the DCPR5 price control was only to incentivise DNOs to deliver losses reductions in the final half of the price control period and not the full 5 year period? This position seems incompatible with Ofgem's overriding objective to protect consumers.

A decision at this stage to remove the financial incentive for DNOs to reduce losses will penalise DNOs who have taken early action to reduce them. This is a perverse outcome, as it is in the interests of consumers that DNOs take early action to reduce losses. It will be interesting to note the reaction of DNOs to the proposals. If there is little objection to the removal of financial incentives over by certain DNOs, this may strongly suggest they have made very little investment to reduce their losses even though almost half of the price control period has elapsed.

Question 3: Do you agree with our position that we should not allow retrospective changes to be made to the DPCR4 mechanism? Please explain your answer.

As a general principle, we would not support retrospective changes. Retrospective changes undermine regulatory certainty. This is undesirable as can lead increased risk premia being borne by DNOs and suppliers, which is a cost ultimately borne by consumers.

However, we note this issue appears to have become manifest following networks expressing concern that they may face windfall losses in the fifth year of DPCR4, having received significant gains from the incentive in its first four years. We consider that it would set an undesirable precedent – in addition to being entirely immoral – if windfall losses faced by networks were corrected while windfall gains were not. This would leave consumers facing downside-only risk from the mechanism. We expect to see Ofgem bring forward options to claw back unjustified windfall gains that networks have already received.

Question 4: Are there other options we should have considered?

While it is clear that the existing methodology is not fit-for-purpose for DPCR5 we consider that there is still time left to develop an effective methodology for RIIO-ED1, We would encourage Ofgem to continue considering whether alternative approaches are possible before it finalises the forthcoming price controls.

Question 5: Do you agree with Ofgem's preference for Option 3? Please explain your answer.

We agree the mechanism should not be activated as the data lacks robustness subject the there being complete confidence that DNOs have not been rewarded for any underreporting of losses in the DPCR4 period (see answer to question 1). There must be a high degree of confidence in the data to justify the apportionment of incentives with a potential materiality of several hundred million pounds.

A decision to proceed with option 3 means DNOs will have been without any financial incentive whatsoever for the 5 year DPCR5 period. We also have some concerns that the rewards DNOs received for the DPCR4 period may not have been fully justified. This almost certainly means consumers will and have faced the added expense (due to the additional generation required to make up for losses) and environmental harm (due to increased resource extraction, burning of fossil fuels) resulting from avoidable distribution losses, because DNOs will have invested less to minimise losses in the absence of an effective financial incentive.

Question 6: Do you have views on our proposal to introduce a reporting requirement for DNOs to inform us of actual measures they are taking to reduce losses? Please explain your answer.

We are deeply sceptical the proposal to publish a league table of actual measures DNOs are taking to reduce losses will provide any tangible motivation to DNOs to reduce their losses. It is unclear who the audience for the league table would be and how the opinion of this audience would act as a driver for DNOs to make financial investments to reduce losses. It appears a rather feeble attempt to appear to be doing something, the impact of which is likely to be the same as doing nothing.

Furthermore, without any commentary on how this will be verified, it is difficult to have confidence that the information provided on actual measures taken can correspond to claimed losses reductions.

In practice the question may be summarised as: “does the reporting requirement on DNOs provide a greater incentive to reduce losses than no incentive at all?” To which the answer is: “barely”.

Question 7: Do you have views on the detail of what DNOs would be required to report and the approach to publishing details? Please explain your answer.

DNOs should be obliged to differentiate between:

- the replacement of assets that have reached the end of their operational life; and
- the replacement or upgrading of assets specifically to reduce losses before the end of their planned operational life; and
- where a decision to replace an asset with a more expensive, but more efficient one, is made.

Our key interest is that DNOs should not receive credit for replacing equipment which they would have replaced anyway, or where that asset replacement is already being rewarded under a separate incentive.

It would be useful for DNOs to provide a list of investment activity they undertook during the DPCR4 period to help ascertain both whether the rewards DNOs have received under the losses incentive are justifiable and to improve the benchmarking data available to Ofgem.

Question 8: Do you have views on our proposal to move the date by which a direction is required on the value of PPL from 30 November 2012 to 1 April 2013? Please explain your answer.

As you aware such a move will impact upon suppliers’ ability to forecast their DCUSA charges. This increase in uncertainty will be lead to increased risk premia which will be passed onto consumers. The proposed licence change will also add to regulatory uncertainty and undermine Ofgem’s credibility with DNOs and suppliers.

We are disappointed to note that the materiality of this impact on consumers has not been quantified, or indeed explicitly acknowledged. It has been presented as an issue that impacts suppliers – which it does – but ultimately, it will be felt by consumers both in pass through and any negative impacts upon competition in the supply market.

We note Ofgem’s recent decision to direct DNOs to use their May 2012 forecasts of PPL for 2013/14 and feel that this is a positive step to improve forecasting accuracy for supplier, which should ultimately benefit consumers.

Question 9: Do you think that DNOs should set the value of PPL to zero in their July 2012 DCUSA forecasts for 2013-14 or leave current estimates in place? Please explain your answer and respond on this point by 24 July 2012.

We were not able to answer this question with the information provided. We would base our assessment on an appreciation of the materiality of the options and the impact on consumer bills. The consultation document does not provide an assessment of the material impacts that changes from the forecast DCUSA charges will have on individual suppliers and DNOs so we are unable to assess the impacts on consumers, both directly and by the impact on competition as the impact will not be felt evenly by suppliers.

Question 10: Do you have views about whether the PPL term, when set, should be recovered over the single remaining year of DPCR5, over two years running into RIIO-ED1 or in the first two years of RIIO-ED1? Please explain your answer.

We do not have sufficient information at this time to provide a detailed response. We await an assessment of the materiality of the options, both the direct pass through to consumers, and any distortion of competition in the supply market.

We see a clear advantage in terms of reducing regulatory complexity if the PPL term is recovered prior to the commencement of ED1. However, we may be inclined to accept an incursion into ED1 should the consequent level of volatility on DUoS risk significant impacts on consumers' bill, or have a negative impact on the supply market.

Question 11: Do you have views on whether we should move the date by which a direction is required on the DPCR5 targets from 30 November 2012 to 1 April 2013? Please explain your answer.

We agree that setting a target at this stage for a target that may not be activated is inappropriate.

Question 12: Do you have views on whether DNOs should set to zero, their forecasts for recovery of annual incentive in 2013-14? Please explain your answer and respond on this point by 24 July 2012.

Again we do not have sufficient information on the material impact of the options to provide an opinion, but we suggest it is premature to make such announcement prior to the conclusion of the consultation.

Consumer Focus response to Ofgem's consultation on whether to activate the Distribution Losses Incentive Mechanism in the fifth Distribution Price Control

For more information please contact Duncan Carter on 020 7799 8041 or email duncan.carter@consumerfocus.org.uk

www.consumerfocus.org.uk

Published: August 2012

If you require this publication in Braille, large print or on audio CD please contact us.

For the deaf, hard of hearing or speech impaired, contact Consumer Focus via Text Relay:
From a textphone, call 18001 020 7799 7900
From a telephone, call 18002 020 7799 7900

Consumer Focus

Fleetbank House
Salisbury Square
London EC4Y 8JX

Tel: 020 7799 7900

Fax: 020 7799 7901

Media Team: 020 7799 8004 / 8006

For regular updates from Consumer Focus sign up to our monthly e-newsletter by emailing **enews@consumerfocus.org.uk**