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Dear Rachel,

<u>Distribution Charging Methodologies Forum (DCMF) Working Group</u>
<u>On the Losses Incentive and Gross Volume Correction</u>

We are writing collectively to you as members of the Losses and Gross
Volume Correction (GVC) Working Group with an update on our discussions
in relation to Settlement data and the Distribution Losses Incentive
Mechanism (DLIM).

This Group was set up at the request of suppliers under the auspices of the
Distribution Charging Methodologies Forum (DCMF) to provide a greater
awareness of the operation of the DLIM (CRC 7 in the DNO Licence). The
DNOs, the six major suppliers, one small supplier and ELEXON have all been
represented in the Group. We have also kept your own team up to date with
our discussions.

The Group has met on five occasions. Areas covered include:

•   Overview of the losses incentive and the two 'top down' methodologies
         currently proposed for data correction

•   The extent that DNOs can influence the data used for the losses
         calculation

- Review of why data can change during the Settlement process (e.g. new meter readings, change of metering standing data, data correction activities)
- Areas where losses reporting could be improved (e.g. potential changes to some areas of the Balancing & Settlement Code (BSC))

Although the Group spent considerable time looking at how the current losses reporting process could be improved, there is an underlying concern that the DLIM, due to the use of Settlement data, is unable to deliver on its objectives of encouraging DNOs to achieve an efficient level of losses on their distribution networks.   The reasons behind these concerns are outlined below.

Use of Settlement Data to calculate Distribution Losses

Under the Distribution Losses Incentive Mechanism:

Calculated Distribution Losses = Units Entering – Units Distributed

Units Distributed are determined using Settlement data.

Calculated Distribution Losses are made up of:

1 Technical losses (mainly under direct influence of the DNOs)

2 Non Technical losses (mainly out of the DNOs' influence)

Examples of the factors affecting technical and non-technical losses are shown in Appendix 1.

Illustrative impacts of some of these factors on the percentage Units Distributed for one DNO are shown in Appendix 2. This clearly shows that the largest movements in Settlement data being used in the losses calculation are **outside** of the influence of the DNO. This can result in windfall gains or losses for DNOs which may be unrelated to losses improvement work carried out on the network. This means that the DLIM is not meeting its objectives of encouraging DNOs to achieve an efficient level of losses on their distribution networks since the outcome is largely outside of their influence.

Volatility of Settlement Data

Historically, the DLIM has relied on data errors and data movements being at a consistent level across price controls. Therefore, any change in calculated losses could be assumed to be an improvement or degradation of losses that were under the DNOs' influence.

However, the effectiveness of the DLIM is reduced when Settlement data becomes more volatile due to major data correction activities by suppliers, as demonstrated for 2009/10 data. The reason for this has been shown to be partly due to the application of Gross Volume Correction (GVC). However, the Group has shown that an increase in many other areas of data cleansing carried out by suppliers (e.g. improvements at RF performance, data issues caused by long term no access sites, metering data error correction etc) were also a major contributory factor. Suppliers anticipate that this increased volume of data correction will continue. This is a result of meter change programmes, initially covering Profile Class 5 - 8 and later, more significantly, the rollout of SMART metering. It is therefore likely that future losses reporting will be subject to large fluctuations in excess of the caps/ collars for the duration of DPCR5 and that this will not be within the influence of the DNOs. This therefore significantly impacts on the effectiveness of the DLIM, and will likely result in ongoing issues similar to those we have seen for 2009/10.

The Potential for Improved Reporting of Losses

In looking at possible approaches for identifying and adjusting the losses data to address the issue of abnormal Settlement adjustments, it was confirmed that there is no additional data available to DNOs other than that currently used in the data adjustment approaches developed by CE and Engage Consulting on behalf of SP. To date no new methodologies have emerged.

The Group have looked at a number of potential BSC changes with the view to mitigating the weaknesses in the DLIM by seeking to improve losses reporting. However, there is concern in the Group about making major

changes to Settlement that do not address the root cause of the problem. The real issue is that the DLIM is using data that is not suited for the purpose of measuring Distribution Losses. The solution should not be to change the established principles of Settlement (annual Gross Cashflow approximately £1.5bn) in order to make a marginal improvement to the DLIM (annual value at cap £60m). The correct approach should be to address the source of the problem i.e. the DLIM itself should be reviewed.

Impact of the DLIM

Whilst the principle of a losses incentive is accepted as a valid means of encouraging DNOs to achieve an efficient level of losses on their distribution networks, the Group are concerned at the effectiveness of the DLIM against its stated objectives based on the points raised above.

Suppliers and consumers are exposed to total DNO revenue adjustments of +/- £60m per annum and an overall exposure of five times this level. These changes result in unpredictable and volatile DUoS tariffs.

In Summary

The Group are concerned that:
- The Distribution Losses Incentive Mechanism, by using Settlement data that is both volatile and outside the DNOs' control, no longer meets its objective of encouraging DNOs to achieve an efficient level of losses on their distribution networks.
- The DLIM results in windfall gains or losses for DNOs and exposes suppliers and customers to potentially large and unpredictable DUoS tariff movements.
- There is concern that any BSC changes, discussed as part of this Group to mitigate the weaknesses in the DLIM by seeking to improve losses reporting, make significant changes to Settlement and do not address the root cause of the problem. The correct approach is to address the source of the problem i.e. the DLIM itself should be reviewed.

This letter has been prepared to capture the sentiment of the Group and may also assist you in developing your forthcoming consultation on the way ahead.

We hope you find these comments helpful.

Yours sincerely

Andy Manning
On behalf of British Gas

Harvey Jones
On behalf of CE-Electric

Julia Haughey
On behalf of EDF Energy

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On behalf IPM Energy Retail Ltd

APPENDIX 1

<u>LOSSES</u>

Technical losses (under DNO control)
• Fixed (mainly transformers)
• Variable (cables and lines)   Increase with square law as network utilisation increases
• Can be reduced over time by investment and operational practice

Non-technical losses (partly DNO / partly supplier control)	
• Unregistered/ illegal connections	DNOs' responsibility
• Theft	Suppliers' / DNOs' responsibility
• Metering errors	Suppliers' responsibility
• Meter Reading Data	Suppliers' responsibility
• Standing data issues	Suppliers' responsibility
• Data cleansing activity	Suppliers' responsibility
• Profiling allocation errors	Profile Administrator responsibility

APPENDIX 2

Example DNO Data

	Volume	% units distributed	Responsibility
Transformer Change Programme	1–2 GWh	<0.01%	DNO
VAR compensation project	2–4 GWh	0.01-0.02%	DNO
Unregistered MPANs	4 GWh	0.02%	DNO
Theft	50 GWh	0.2%	DNO/Supplier
Data Cleansing / other data changes	300 GWh	1.2%	Supplier

Units distributed	~ 25,000GWh (Roughly 50/50 HH/NHH)
Losses	~ 1250GWh (5% Units Distributed)
Cap/collar	~75GWh