Electricity North West
304 Bridgewater Place, Birchwood Park,
Warrington, Cheshire WA3 6XG

Telephone: +44 (0) 1925 846999
Fax: +44 (0) 1925 846991
Email: enquiries@enwl.co.uk
Web: www.enwl.co.uk

Andy Cormie
Distribution Policy
Ofgem
9 Millbank
London
SW1P 3GE

By Email only

16 August 2012

Dear Andy,

Consultation on whether to activate the Distribution Losses Incentive Mechanism in the Fifth Distribution Price Control

Thank you for the opportunity to respond to the above consultation.

We agree that minimising losses of electricity is an important regulatory objective in the context of the overall drive to a low carbon future. However, we do not believe that the DPCR5 Distribution Losses Incentive Mechanism will meet 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. The experience of the final year of DPCR4 has demonstrated that the potential volatility in settlement data is of sufficient magnitude to render it unfit for the purpose of measuring losses, and is not addressed by the measures put in place at DPCR5 (eg the two year lag and the caps and collars).

We are fully supportive of Ofgem's preference for Option 3, to close out the DPCR4 losses mechanism but stop short of setting targets for DPCR5. We have seen that the issues around 2009/10 data, the closeout of DPCR4 and the interaction with DPCR5 have diverted management attention away from driving activity to reduce real losses of electricity, and believe that similar data issues will persist throughout DPCR5.

We also support moving the date by which a direction is to be provided on the PPL term and DPCR5 targets from 30 November 2012 to 1 April 2013. The outcome of the current consultation regarding the deactivation of DPCR5 needs to be known before a decision on the DPCR4 closeout (and possibly the means of implementing it) can be made. Although deactivating DPCR5 would remove a number of issues that currently require consideration in the DPCR4 closeout, the sensitivity of the closeout payment to the detailed mechanism, which is yet to be agreed, suggests that it would be sensible to allow more time for final decisions to be made.

Our detailed responses to the questions raised in the consultation are attached. If you would like to discuss our consultation responses in more detail please do not hesitate to contact me.

Yours sincerely,

Tony McEntee

Tony McEntee

Head of Commercial Policy
Direct line 01925 846854
Tony.McEntee@enwl.co.uk

Specific Questions

CHAPTER 2

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

Electricity North West chaired the Distribution Charging Methodologies Forum (DCMF) Working Group on the Losses Incentive and Gross Volume Correction, and supported the letter from that group to Rachel Fletcher (copy attached) which set out the concerns of both suppliers and DNOs regarding the use of settlement data for losses measurement. The group concluded that:

- The Distribution Losses Incentive Mechanism (DLIM), 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.

The work of this industry group took place alongside a number of other significant activities, notably two rounds of submissions for the restatement of 2009/10 data, and two major consultations on issues relating to data restatement and the DPCR4 closeout, followed by the current consultation. We are also currently engaged on a further data request designed to inform the choice between four options for applying restated data in the DPCR4 closeout calculation. These activities have required a significant level of management attention, which inevitably has been diverted away from tackling technical losses which reduce carbon emissions.

This effect has been compounded by the uncertainty of the data itself, driving forecasts of DPCR5 performance which go outside the limits set by the cap/collar arrangement. Under these circumstances it is extremely difficult to make a business case for any further loss-saving investment to be made.

Question 2: Do you have views on whether or not the DPCR5 losses mechanism should be activated?

We believe that the DPCR5 losses mechanism should not be activated. It has become clear that the recent level of volatility associated with settlement data is significant, and sufficient to make the measurement of losses by this method inappropriate. We have seen that the issues around 2009/10 data, the closeout of DPCR4 and the interaction with DPCR5 have diverted management attention away from driving activity to reduce real losses of electricity, and believe that similar data issues will persist throughout DPCR5.

CHAPTER 3

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

Yes, whilst we agree there should be no retrospective changes to the mechanism itself, this is on the basis that approved data adjustments are allowed to correct for the abnormal data adjustments made by suppliers. Although the DPCR4 mechanism has suffered from similar issues as the prospective DPCR5 mechanism, these have mostly become manifest in the final year of the period. There is sufficient data from the early years of the scheme on which to set a reasonable expectation of the penalties or rewards that DNOs or their customers might expect by virtue of performance against the DPCR4 losses target.

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

We have not identified any other options.

Question 5: Do you agree with Ofgem's preference for Option 3?

Yes. We support the reasoning in the consultation document, ie

- The activation of the DPCR5 mechanism would introduce a level of volatility in DNO charges that would be inappropriate for DNOs, suppliers and customers. This option turns off the mechanism before any incentive payments or penalties are made.
- The option removes the need for calculation of DPCR5 targets and also the requirement to consider further the issues raised in the consultation paper of March 2012 "Consultation on conflicts in the Distribution Losses Incentive Mechanism and data to be used in calculating its components"
- The proposed reporting requirements (see Questions 6 & 7) mean that there is a low risk of actual losses increasing significantly in the remaining years of the DPCR5 period.

Both options 1 and 2 (full or partial activation of the DPCR5 mechanism) would require resolution of all the issues relating to the interaction between DPCR4 and DPCR5, and still leave the industry with a sub-optimal incentive, which suffers from all the negative aspects outlined in our answer to Question 1, above. We do not believe that the DPCR5 mechanism provides any incentive for DNOs to invest in losses reduction as the outcome is largely outside their control.

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?

We support this as a sensible alternative to developing a replacement incentive. The proposal is consistent with the ideas being put forward currently for RIIO–ED1 and the details of the reporting requirement could be developed by the working group set up by Ofgem for this purpose.

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

Although we support the principle of this approach for RIIO–ED1 it must be remembered that without an explicit incentive there is no funding for these activities within DPCR5. The reporting in the final two years of DPCR5 is best aimed at serving two purposes:

- To develop a common understanding and a common approach to reporting.
- To set the baseline for losses performance on which to measure RIIO-ED1 performance.

Against this background, it would be inappropriate to publish league tables of activity at the beginning of the 2013/14 regulatory year.

CHAPTER 4

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?

We support the proposal to move back the date by which a direction is required on the value of the PPL term. We believe that the current consultation and its potential effect on the interaction adjustment, together with the various options still on the table for handling the DPCR4 closeout, mean that there is considerable uncertainty regarding the value of PPL for each of the DNOs. We believe that the process has already effectively "timed out" with regard to setting a PPL value for 2013/14 that is anything other than broadly in line with DCUSA forecasts (see Question 9 below) and it would therefore be appropriate to allow more time for proper analysis of the data before setting PPL values for 2014/15 and beyond.

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?

We have already responded to this question in our letter of 23 July 2012. Our stated preference in that response was for the forecasts for 2013/14 to be set to zero, supported by a statement from Ofgem that any direction on the value of PPL, whether made before 30 November 2012 or at a later date, will not include an adjustment to allowed revenue in 2013/14. Ofgem have subsequently stated in their decision letter that DNOs should use the estimations they made in the May DCP066 reports for the value of PPL in their forthcoming DCUSA forecasts, with the implication that the PPL direction will be based on these forecasts in respect of 2013/14. This has a bearing on our answer to question 8, above.

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?

This depends on the outcome of the calculation in terms of the magnitude of the PPL term to be recovered. We believe that the recovery/payment of PPL in any single year should be limited to the annual cap/collar envisaged under the DPCR5 mechanism. However, it may be appropriate for an initial "holding" number to be set for 2013/14 in line with DCUSA forecasts, followed by balancing figures across future years. An alternative approach might be for the final number to be incorporated within the baseline settlement of the RIIO-ED1 Final Proposals.

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?

It is entirely appropriate to move this date back, in line with the PPL direction (Question 8).

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.

We have already responded to this question in our letter of 23 July 2012. In the decision letter on this question, Ofgem have left the decision to individual DNOs so as not to prejudice the outcome of the current consultation. Our current forecast is that we expect the proposals in the consultation document to be implemented and that we will need to set prices to recover the annual penalty estimated in our 2012-13 DUoS charges. We will also set the 2013-14 DUoS forecasts for annual incentive to zero in order limit the amount of this under-recovery to its current single-year effect.