Consultation: Whether to activate the Distribution Losses Incentive Mechanism in the Fifth Distribution Price Control

Response by SP Energy Networks

SP Distribution Ltd and SP Manweb Plc

CHAPTER: One

Chapter one is an introduction. We have no comments.

CHAPTER: Two

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

1.1 We do not believe that the existing losses mechanism is effectively incentivising DNOs to reduce losses.

1.2 It is clear that even in the normal course of settlement, reported losses vary much more as a result of settlement effects than would be possible through the influence of DNOs' loss reduction measures.

1.3 Further, it is now understood that an abnormal level of data cleansing activity by suppliers has materially affected reported losses across a number of DNOs in 2008-09 and 2009-10. This activity clearly cannot be either controlled or predicted by DNOs.

1.4 In the absence of any action by DNOs, losses may also vary as a result of changes to the level or type of demand on the network. Even with perfect settlement data this could result in unearned reward or penalty.

1.5 Typically, around 75% of network losses are variable, and increase with demand. DNOs may therefore be rewarded or penalised simply because demand decreases or increases.

1.6 DNOs may also be rewarded or penalised simply as a result of shifting demand patterns. If total demand remained constant but the share of LV units decreased, losses would decrease. Similarly, energy increasingly supplied through embedded generation rather than via the GSP may result in either increasing or decreasing losses.

1.7 For all of these reasons, a DNO who invests in loss reduction cannot be sure that the investment will result in a reward (or even a reduced penalty for slowing an upward trend).

1.8 There is no possibility of identifying cost-effective losses reduction measures and sharing best practice across DNOs.

1.9 There is therefore very limited incentive on DNOs to spend to reduce losses.

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

2.1 We firmly believe that the DPCR5 losses incentive mechanism in its current form should not be activated. We are not aware of any stakeholder who disagrees with this view.

2.2 When it became clear that the DPCR4 Losses Incentive was introducing significant volatility in Distribution Charges, a DCMF Losses and Gross Volume Correction Working Group was set up at the request of suppliers. Working group meetings were attended by a wide range of stakeholders: Elexon, suppliers, distributors and a number of consultants.

2.3 This working group concluded that as settlement data is not within the control of DNOs, any losses incentive mechanism based on settlement data has at best limited incentive properties, and offers the potential for large windfall gains and losses for DNOs.

2.4 A letter summarising the conclusions of this working group was sent to Ofgem on 26th August 2011, recommending a fundamental review of the Distribution Losses Incentive Mechanism. This letter was signed by all large suppliers, and by all of the DNOs with the exception of UKPN.

2.5 There are further practical issues which are likely to undermine the reliability of the DPCR5 Losses Incentive Mechanism:

> 2.5.1 Given the abnormal settlement data patterns in 08-09 and 09-10 there is no consistent period sufficiently long to set a robust target for DPCR5.
>
> 2.5.2 The future impact of smart metering on settlement cannot be predicted. This may well have an impact similar in magnitude to suppliers' recent concentrated data cleansing activities.

2.6 As there is neither a consistent basis for a target, nor a clear expectation of the future path of settlement losses, DNO performance under the intended DPCR5 mechanism cannot be predicted.

2.7 There is therefore very limited incentive benefit, but a considerable risk that either DNOs or customers will be undeservedly penalised.

2.8 SP therefore support Ofgem's preference not to activate the DPCR5 losses mechanism (Option 3 response to Question 5).

CHAPTER: Three

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.

3.1 SP hold the view that as a general principle retrospective changes to any part of any price control settlement are undesirable.

3.2 The option not to activate the DPCR5 mechanism is such a change. Exceptionally, SP accept that this is justified by the unacceptable increase in risk to DNOs and customers beyond what was understood at the time that DPCR5 was finalised. Such a change is in the interest of both DNOs and customers.

3.3 We do not believe that this justifies any retrospective changes to the DPCR4 mechanism.

3.4 Unfortunately, the DPCR5 Final Proposals blur the distinction between the DPCR4 and DPCR5 mechanisms.

3.5 The PPL Term is described as containing components related to both the residual penalty for DPCR4 (part of the DPCR4 mechanism) and an adjustment for the target change on transition to DPCR5 (part of the DPCR5 mechanism).

3.6 We therefore believe that adjustments **to the DPCR5 component of PPL only** which are necessary to meet the objective of not activating the DPCR5 mechanism cannot be considered retrospective changes to the DPCR4 mechanism. They are prospective changes to a mechanism which is not yet active, intended to forestall a previously unforeseen increase in risk to both customers and licensees. Such changes are therefore acceptable.

3.7 Unlike the DPCR5 mechanism, which has not yet been activated, the DPCR4 mechanism has been active for a number of years. Retrospective changes to the operation of the DPCR4 mechanism (recalculation under a new mechanism, of either the DPCR4 Losses penalty/reward already realised or the residual penalty/reward which forms the DPCR4 component of PPL) during its active period are not justifiable.

3.8 We note that the part of the DPCR5 Final Proposals which relates to the DPCR4 Losses Incentive does not seek to make such changes, but simply to provide detail which clarifies rather than contradicts DPCR4 Final Proposals

3.8 We consider the possible restatement of 2009-10 losses under the DPCR4 mechanism (intended to correct for abnormal date cleansing) to be a justifiable adjustment of a clearly distorted input, rather than a change to the DPCR4 mechanism itself.

3.9 SP have had well-documented concerns over the consistency of settlement data extending further back than simply the closing years of DPCR4. So while we would oppose any move to retrospectively change the DPCR4 losses mechanism, if Ofgem was to propose to simply turn that mechanism off then it is unlikely that SP would object (this could be achieved simply by directing the restatement of 09-10 to the target).

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

4.1 We are unaware of any other practical options regarding the activation (or not) of the DPCR5 losses mechanism.

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

5.1 We firmly believe that the DPCR5 losses incentive mechanism in its current form should not be activated (Option 3). We are not aware of any stakeholder who disagrees with this view.

5.2 As noted under Question 2, all large suppliers and all DNOs with the exception of UKPN supported the conclusion of the DCMF Working Group that settlement data was an unsuitable basis for a stable and effective losses incentive mechanism, and signed a letter to Ofgem to that effect in August 2011.

5.3 Options 1 and 2 require Ofgem to issue a direction on the DPCR5 (target adjustment) part of PPL and the DPCR5 Target itself.

5.4 The DPCR4 data (whether reported on a DPCR4 or a DPCR5 methodology) is demonstrably inconsistent (both across the 5 years and with the target years), as the latter years are affected by abnormal levels of supplier data cleansing activity.

5.5 There is therefore no self-consistent set of historic data long enough to be used to calculate a target for DPCR5.

5.6 It is still unclear whether the present abnormal settlement losses will persist or change during DPCR5. The introduction of smart metering introduces further uncertainty to any forecast.

5.7 There is therefore no certainty that losses within DPCR5 will be self-consistent, never mind consistent with the basis on which the target was set.

5.8 We therefore do not believe that it is possible to calculate a robust target for DPCR5.

5.9 Given that a robust target cannot be calculated, a robust direction cannot be issued on the appropriate adjustment for the target change (the DPCR5 part of PPL).

5.10 Consequently, Options 1 and 2 expose both customers and DNOs to the full risk of the DPCR5 losses penalty/reward, although the outcome is neither controllable nor foreseeable by DNOs. This also exposes suppliers to volatility in charges.

5.11 We believe that for these reasons, both Options 1 and 2 are not feasible.

5.12 SP therefore support Ofgem’s preference for Option 3 (not to activate the DPCR5 losses mechanism).

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.

6.1 We believe that it is unrealistic to devise an alternative losses incentive for the remainder of DPCR5.

6.2 In the absence of a formal incentive, there may be some merit to a reporting requirement for DNOs.

6.3 However, this needs to be seen in the context of the marginal impact of changes in losses arising from the installation of lower loss equipment, against the potentially larger effects on losses of changes in power flows resulting from changing patterns in and levels of demand.

6.4 Some DNOs may already have let contracts for the provision of equipment which will run to or near to the end of the DPCR5 price control period and may not be able to change their plans, at least not without incurring additional costs. Such plans would have been formed at a time when the theoretical benefits of investment in lower loss equipment may not have been observed in the volatile settlement data and, so, DNOs could not rely on sufficient funding.

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.

7.1 Any reporting requirement should be proportionate and avoid excessive detail.

7.2 It would not be appropriate to report costs in a way which could be used to identify the unit costs of particular items of equipment, as this would be potentially detrimental to competition in equipment supply.

7.3 In our view, it would be premature to publish a league table, as this would require a high degree of comparability across DNOs' figures. There have been difficulties in establishing comparable reporting for business carbon footprint, even though there are published guidelines. In the absence of an agreed methodology for estimating the impact of measures on losses, it seems highly unlikely that figures would be comparable across the DNOs.

7.4 The relation between this reporting and that of the wider carbon footprint is unclear, as estimated emissions from losses are already included in the table for Business Carbon Footprint.

CHAPTER: Four

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.

8.1 We agree that given the timing of a decision on whether to implement Options 1, 2 or 3, it is unlikely that there would be sufficient time to determine the PPL term, or potentially make licence changes conditional upon that decision by 30 November 2012.

8.2 We note that the value of the PPL term may also be affected by the outcome of the separate consultation into conflicts between the interaction adjustment and cap and collar.

8.3 The DPCR5 component of PPL (interaction adjustment) cannot be calculated before the DPCR5 Target value is set. Therefore, if direction of the DPCR5 Target is delayed for any reason, direction of PPL must be delayed.

8.4 We therefore agree that the date by which a direction is required on the value of PPL should be moved from 30 November 2012 to 1 April 2013

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.

SP have responded to this question separately as requested. Our preference is that current estimates should be left in place.

Our full response is repeated below:

"It is very clear from stakeholder feedback that predictability of DNO charges is seen to be of great importance and worthy of maintaining where possible. To this end ***we believe that current estimates should be left in place*** *where a reliable estimate can be made.*

In recent years, at Suppliers' request and formalised via DCUSA arrangements, DNOs have provided five-year forecasts of their charges on a quarterly basis alongside regular *teleconference calls to provide further explanation. In response to requests from Suppliers, SP held an additional call in June 2011 to address uncertainty surrounding the impact of the DPCR4 Losses close out. At this time we explained our pricing strategy to smoothly recognise the difference between our expected net LRRM penalty and that which had been recognised to date. Suppliers (and Ofgem) were comfortable with this approach since it offered predictability and minimised the risk of a 'spike' when a final decision on the net LRRM became available.*

Note that we had elected to recognise the estimated net LRRM by the end of the DPCR5 period rather than go beyond that timeframe.

It is also worth noting the SP context specifically. We now believe that we are close to approval of our losses correction in line with our estimates. Prior to our correction submission we had prudently used a pessimistic estimate of our close out penalty in setting our 2011/12 prices. By the time we came to set prices for 2012/13 however we had a reasonable expectation that this estimate would be reduced and priced in positive values, i.e. with hindsight we had previously over accrued penalty to date. The values in question are £8million and £6million for SP Distribution and SP Manweb respectively. These values have remained unchanged since June 2011 and been set out in DCP066 return at four subsequent quarter ends. We note from recent published forecasts that two DNOs have each forecast impacts of some £45million in 13/14 and presume that Suppliers would not welcome these being reset to zero at this point.

Continuing with our current pricing strategy gives the greatest possible predictability for Suppliers and the minimal 'spike' when a final decision is available. Setting the value of PPL to zero for 2013-14 necessarily compromises this and concentrates, or at least moves, the close out impact to later years.

Our preference is also consistent with the stakeholder consensus view for 2012/13 DNO pricing reflected in Ofgem's letter on the matter dated 13 December 2011, "Losses Incentive Mechanism – PPL term"."

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.

10.1 As noted in our response to Question 9, SP projections recognise the estimated net LRRM by the end of the DPCR5 period rather than going beyond the current price control.

10.2 If current estimates of PPL are left in place (as we believe they should be), then recovering the rest of the final value of PPL within DPCR5 is reasonable.

10.3 We believe that this should be the default presumption, and that only where this would introduce an extreme spike in charges should there be a possibility of extending the recovery of PPL beyond the end of DPCR5.

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.

11.1 We agree that given the timing of a decision on whether to implement Options 1, 2 or 3, it is unlikely that there would be sufficient time to determine the Target value, or potentially make licence changes conditional upon that decision by 30 November 2012.

11.2 We note that calculation of the DPCR5 target may also be affected by the outcome of the separate consultation into conflicts between the interaction adjustment and cap and collar.

11.3 We therefore agree that the date by which a direction is required on the value of the DPCR5 Target should be moved from 30 November 2012 to 1 April 2013

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.

SP have responded to this question separately as requested. Our view is that Ofgem may reasonably direct DNOs to forecast zero penalty.

Our response is repeated in full below:

"As stated above [in our response to Qu. 9] it is clear that stakeholders value predictability in DNO charges. Our view is generally that current estimates should be left in place where a reliable estimate can be made.

In our forecasts we have repeatedly estimate that the DPCR5 incentive impact is zero, i.e. simply the mid-point of the cap and collar precisely because we do not consider that a reliable estimate can be made for this incentive. We note from inspection of recent published forecasts that another three DNOs have adopted this approach.

We are surprised that other DNOs are forecasting values at either the cap or collar given the various complexities and uncertainties correctly identified in the consultation, not least of all the current absence of a target. We note that only one DNO is forecasting to the full cap and that others are forecasting more moderate reward or penalty. In summary across all DNOs forecasts for DPCR5 impacts are zero or relatively immaterial.

*As we do not believe a reliable estimate can be made **we think it would be reasonable for Ofgem to direct DNOs to forecast zero** penalty/ reward in respect of the DPCR5 incentive. In any case SP would not have envisaged changing its zero forecast for 2013/14 or beyond.*

Separately we firmly believe that the DPCR5 losses incentive mechanism in its current form should not be activated. We are not aware of any stakeholder who disagrees with this view. Whilst that decision is itself the subject of this consultation, this apparent consensus may separately and alternatively lead DNOs to the view that a reasonable estimate of the impact in 2013/14 is zero."