



Distribution Network Operators
and other interested parties

*Promoting choice and value for
all gas and electricity customers*

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Date: 24 August 2012

Dear colleague,

Notice under section 11A(2) of the Electricity Act 1989 - Proposed modifications to Special Condition CRC 7 of the Electricity Distribution Licence in relation to the date by which the Authority is to direct the value of the PPL and the Allowed Losses Percentage (ALP) terms for the Distribution Losses Incentive Mechanism

The Authority proposes to modify Special Condition CRC 7 of the Electricity Distribution Licence in relation to the date by which the Authority is to direct the value of the PPL and the Allowed Losses Percentage (ALP) terms for the Distribution Losses Incentive Mechanism.

On 6 July 2012, we initially consulted on whether to activate the losses incentive mechanism in the fifth electricity distribution price control period (DPCR5).¹ This was because a range of issues that have arisen in recent years have raised concerns that the mechanism is not operating as intended or incentivising appropriate action by Distribution Network Operators (DNOs).

Questions 8 and 11 of that initial consultation sought views on proposals to change two dates in Charge Restriction Condition 7 (Adjustment of licensee's revenues to reflect distribution losses performance) of the Electricity Distribution Licence. Having considered the responses to the initial consultation, which are available on the Ofgem website alongside the 6 July 2012 consultation document, we are now conducting a formal (statutory) consultation on the proposed modifications.

The proposed modifications are set out in Appendices 1 and 2 to this Notice.

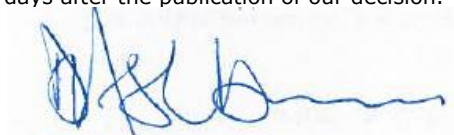
The effect of the modifications would be to change the date by which the Authority is to direct the value of the PPL and the Allowed Losses Percentage (ALP) terms from 30 November 2012 to 1 April 2013.

The reasons for the proposed modifications are set out in Appendix 3 to this Notice.

Interested parties may make representations with respect to the proposed modifications and the Authority will take those representations into account in coming to its decisions about the proposed modifications. Any such representations should be made in writing and sent to the Authority by 21 September 2012, preferably by e-mail to dora.guzeleva@ofgem.gov.uk or alternatively by post to Dora Guzeleva at Ofgem, 9 Millbank, London, SW1P 3GE.

¹ www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/Consultation%20-%20whether%20to%20activate%20the%20DPCR5%20losses%20mechanism.pdf

We will take account of any further representations made in response to this statutory consultation and come to a final decision on the proposed modifications. Should our decision be to proceed with the modifications, the modifications will come into effect 56 days after the publication of our decision.

A handwritten signature in blue ink, appearing to read 'D. Ashbourne', with a long horizontal flourish extending to the right.

David Ashbourne

Partner
Smarter Grids and Governance (Legal)

Appendix 1 – Proposed modification with respect to directing the PPL term

CRC 7. Adjustment of licensee's revenues to reflect distribution losses performance

Part D: Residual distribution losses incentive (PPL)

7.7 For the purposes of the Principal Formula:

PPL_t is the amount of the residual distribution losses incentive arising in the previous charge restriction period (1 April 2005 to 31 March 2010), set in accordance with the provisions of paragraph 7.8, that is to be recovered by the licensee.

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7.8 The value of PPL_t in each of the two Regulatory Years beginning on 1 April 2010 and 1 April 2011 is set at zero.

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7.8A In subsequent Regulatory Years, the value of PPL_t shall be calculated by reference to the methodology set out in Chapter 4 of the Authority's decision document published on 7 December 2009 under reference number 148/09.

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7.8B The amount of PPL_t assigned for recovery in respect of subsequent Regulatory Years will be set in a direction given by the Authority no later than 1 April 2013 following consultation with the licensee and all other Distribution Services Providers. That direction will set out the period over which the value of PPL_t is to be recovered, and such period shall not commence before the Regulatory year beginning 1 April 2012 and shall not extend beyond the end of the Regulatory Year beginning 1 April 2016.

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Appendix 2 –Proposed modification with respect to directing the ALP term

CRC 7. Adjustment of licensee’s revenues to reflect distribution losses performance

Part G: Setting the allowed loss percentage (ALP)

- 7.12 The value of ALP, calculated by reference to the methodology set out in Chapter 4 of the Authority’s decision document published on 7 December 2009 under reference number 148/09, will be set out in a direction given by the Authority not later than 1 April 2013 that will apply (subject to paragraph 7.13) for as long as this condition continues in force.
- 7.13 The Authority may, at the licensee’s request, or with the licensee’s consent (which must not be unreasonably withheld), direct the licensee to change the value of ALP, to which paragraph 7.12 refers, to a different value specified by the Authority, provided that the following conditions have been met.
- 7.14 The conditions referred to in paragraph 7.13 are that the Authority must:
- (a) have had due regard to the purposes of this condition; and
 - (b) be satisfied, following consultation with the licensee, that there has been a material change (whether an improvement or deterioration) in the quality of the information used to derive the System Entry Volumes or Units Distributed.
- 7.15 A change to the value of ALP in accordance with paragraph 7.13 may be directed by the Authority at any time but may not take effect before the beginning of the next Regulatory Year following the date of the direction.

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Appendix 3 – Reasons for the Proposed Modifications

Background

The Distribution Losses Incentive Mechanism aims to incentivise Distribution Network Operators to reduce losses of electricity on their networks. In response to requests from a range of stakeholders, we published an initial consultation document on 6 July 2012 on whether problems with data and issues affecting the mechanism have reduced the incentive on DNOs to such an extent that it is no longer effective. The consultation document asked whether it might be better not to activate the DPCR5 losses incentive. The consultation put forward three options:

- Option 1: Activate the mechanism as intended
- Option 2: Activate the mechanism and turn it off part way through the period
- Option 3: Do not activate the DPCR5 losses incentive

In the initial consultation document, we explained that Option 3 was our preferred approach.

The initial consultation document went on to consider whether delays experienced so far meant that it would be appropriate to move the date, from 30 November 2012 to 1 April 2013, by which the Authority is required to give two directions:

- i) on the value of the “PPL term” and,
- ii) on the losses targets that each licence would be required to meet during DPCR5.

This statutory consultation focuses only on proposals to move these dates. While the arguments for moving both dates are similar, there are key differences which make it more straightforward to consider each issue in turn.

In addition to changing the date by which a direction is required on the value of PPL, a number of additional amendments are being proposed. They are explained below, but are to remove known ambiguities in CRC 7.8 of the licence that would otherwise be exacerbated by the date change and to allow the period over which the value of PPL is recovered to be spread over different years than is currently permitted.

Proposal to move the date by which a direction is required on the value of PPL

As set out in detail in Chapter 4 of the 6 July consultation, closing out the losses incentive applying to the fourth distribution price control (DPCR4) results in a value known as the PPL term. It is made up of a number of elements:

- the sum of the incentive paid or penalised over the DPCR4 period,
- the Losses Rolling Retention Mechanism (LRRM),²
- the interaction adjustment.³

Charge Restriction Condition 7.8 of the Licence requires the Authority to set the value of PPL in a direction by 30 November 2012. As set out at paragraph 4.4 of the initial consultation document, work on setting the value of PPL has already been delayed by a range of issues, including abnormal supplier activity aimed at cleansing settlement data and the volatility of settlement data more generally. However, as also made clear, to proceed with that work while the 6 July consultation was still active would be likely to prejudice its outcome.

² The LRRM is designed to encourage loss reduction initiatives to be undertaken at any time over the price control.

³ The “interaction adjustment” aims to protect against a situation where a DNO benefits financially in the first years of DPCR5 without having to take action to reduce losses. This might happen where a DNO’s closing position in DPCR4 (which becomes their starting position in DPCR5) is lower than the DPCR5 target.

This is because, were respondents to agree with the preference for Option 3, there would be no need for the Interaction Adjustment element of the PPL calculation. Implementing a change such as this would require a separate licence change before the value could be finalised. The consultation therefore proposed that because of delays caused by problems with data and because of the additional delay created by the consultation itself, it would be appropriate to move the 30 November 2012 date in the licence back to 1 April 2013.

Responses to proposal to move the PPL direction date

There were 11 responses to this question, though only 7 of these were explicit about whether the date should be changed (four DNOs and three suppliers). Of these, all were in favour of moving the date back to 1 April 2013. The vast majority of respondents felt that it was right to ensure the PPL was calculated correctly, but that it should be done as soon as possible.

A number of suppliers commented that, were the date to be moved back, sufficient time would be needed before the PPL term that was eventually directed could be recovered in charges. This was in order to protect consumers from any additional uncertainty which would be likely to follow through an increase in risk premiums. The need to understand the impact of proposals on consumers was also noted.

Our view

Having considered responses we remain of the view that it is necessary to change the date in the licence by which a direction on the value of PPL is required. There were no direct objections to our proposals and those who did not explicitly agree, in general, only requested that the direction be given as soon as possible – this is something we are working towards achieving.

We also recognise the need to be clear on the impact on consumers. We believe this is best considered in the context of decision on what the length period for recovery of PPL should be which, as discussed below, can only be done when more is known about the value of the PPL term itself.

We are therefore now consulting formally on the proposed licence modification to give effect to this (drafting to be found at Appendix 1).

Additional amendments required to CRC 7.8

CRC 7.8 sets the value of PPL to zero for the first two Years of the DPCR5 price control period (i.e. 1 April 2010 to 31 March 2011 and 1 April 2011 to 31 March 2012).

A direction on the value of PPL for the remaining three Years is required to be made by the Authority by 30 November 2012 (i.e. during the third Regulatory Year). However, because PPL is recovered through DUoS charges that are set in advance of each Regulatory Year, DNOs would have had no notice of the value of PPL in advance of the commencement of Year 3 because, even if the Authority's direction were made in November 2012, it will have been given part way through the Year. This has led to confusion, with some DNOs estimating the value of PPL for recovery in Year 3 and others setting the value to be recovered at zero.

We do not believe this situation is appropriate or was intended when condition CRC 7.8 was drafted. So regardless of whether or not the DPCR5 losses incentive is activated, this point needs to be addressed. However, moving the date for the direction back from 30 November 2012 to 1 April 2013 would clearly worsen the problem.

In addition to the date change, Appendix 1 therefore sets out a number of proposed modifications designed to remove this ambiguity and to provide clarity for DNOs about the content of the direction on the value of PPL when it is given.

In particular, the proposed modifications at paragraph CRC 7.8B seek to ensure that when the direction on the value of PPLt is given, it is able to set out the period over which the term is recovered. This issue was the subject of Question 10 of the initial consultation. The concern raised in the consultation is that delays in calculating and giving the direction on PPLt are reducing the number of Years of DPCR5 that DNOs would have left to recover it, increasing the impact on suppliers and consumers, in some case significantly.

To guard against such an impact, the consultation proposed allowing the recovery of the PPL term to be spread over a number of years, including over years that fall into the next price control period. Responses to this proposal were mixed, however there were two clear messages:

- the decision over what period to spread recovery could only be made when the value of PPLt was known; and
- the need to protect consumers from sharp increases in charges.

Only one respondent did not consider it appropriate for DPCR4 issues to be played out in what will be RIIO-ED1 (i.e. across more than one price control period). We understand the impact that such a decision may have. However, in line with the vast majority of responses to this question, we are also concerned about the potentially significant impact that restricting recovery of the value of PPLt to one year might have on consumers. It should also be stressed that whilst part of the recovery would be taking place in Regulatory Years that fall in to the next price control period, recovery would not be under the terms of the forthcoming price control.

So because it is not yet possible to be explicit about the period over which PPLt will be recovered, we are proposing a number of modifications at paragraph CRC 7.8B which will allow us to make the decision on the relevant recovery period later, in view of all the facts. In line with the existing provisions of CRC7.8B we are required to consult on the value of PPLt before making a direction. We will make clear what period we intend to set for recovery of PPLt in that consultation and seek views.

Proposal to move the date by which a direction is required on the DPCR5 losses targets

The delays referred to earlier also affect our ability to set targets (the ALP term) for the DPCR5 losses incentive which are required by CRC 7.12 to be set in a direction which is also required to be given by the Authority by 30 November 2012.

In particular, as explained in the initial consultation document, the data needed for setting the targets will not be ready and useable until the conclusion of an extensive piece of work, removing the effects of abnormal data cleansing from DNOs 2009-10 losses performance.

The initial consultation therefore also proposed moving the date by which a direction is required on the DPCR5 targets back to 1 April 2013. We are now consulting formally on the proposed licence modification to give effect to this (drafting to be found at Appendix 2).

Responses to Proposal to move the ALP direction date

Of the ten responses received to this question of the consultation only seven were explicit about whether the date should be changed (four DNOs and three suppliers). Of those, 5 were in favour and two were against. Of the two responses against, one supplier said they would prefer the decision to be made in November as part of removing the current

uncertainty that is created by DNOs not knowing how to forecast their tariffs. The one DNO that was against said they would not support a change unless absolutely necessary.

As with the date by which a value of PPLt should be directed, many of the respondents felt more generally, that it would be preferable to provide the direction on the DPCR5 targets as soon as possible, recognising that this would first require a decision on whether to activate the DPCR5 losses incentive.

Our view

Having considered responses, we remain of the view that it is necessary to move the ALP direction date from 30 November 2012 to 1 April 2013.

If a decision is taken to activate the DPCR5 losses incentive, we would need to proceed with setting the DPCR5 targets. The process for setting these targets gives rise to a number of outstanding complex policy questions. In particular, these questions relate to a potential conflict between the cap and collar⁴ and the interaction adjustment, but also to problems (discussed in detail in the consultation document) regarding a period of abnormal data cleansing activity that affected some DNOs' 2009-10 losses positions. The impact of these questions is potentially significant and we would want to ensure that, were we to decide that the DPCR5 targets are required, the process for setting them was robust. We do not believe that there is sufficient time between now and the 30 November 2012 to meet such an objective.

If a decision is taken not to activate the DPCR5 mechanism we would need to remove the DPCR5 target setting process altogether. Given the complexity and difficulty of the issues, it is unlikely we will have come to a decision on whether or not to activate DPCR5 losses incentive in time to remove the DPCR5 target setting process before 30 November 2012.

We are therefore now consulting formally on the proposed licence modification to move the ALP direction date from 30 November 2012 to 1 April 2013 (drafting to be found at Appendix 2).

⁴ The DPCR5 losses incentive includes a 'cap and collar' on the amount a DNO can receive or be penalised by each year which was introduced in response to concerns that the size and volatility of the rewards and penalties seen under the DPCR3 and DPCR4 losses incentives were difficult to predict or manage.