



Distribution Network Operators  
and other interested parties

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

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**Notice under section 11A(2) of the Electricity Act 1989 - Proposed modification to Special Condition CRC 7 of the Electricity Distribution Licence in accordance with the Authority's decision not to activate the Distribution Losses Incentive Mechanism contained in the fifth Distribution Price Control Review (DPCR5)**

The Authority<sup>1</sup> proposes to modify Special Licence Condition<sup>2</sup> CRC 7 ('CRC7') of the Electricity Distribution Licence (the Licence) to remove sections of the condition which relate to the losses incentive mechanism in the fifth electricity distribution price control period (DPCR5); and where necessary amend sections which pertain to the mechanism to recover the residual distribution losses incentive arising in the previous distribution price control period (DPCR4).

On 6 July 2012, we consulted on whether to activate the losses incentive mechanism in the DPCR5 period.<sup>3</sup> This was prompted by a range of issues that have emerged in recent years, raising concerns that the mechanism is not operating as intended, nor incentivising appropriate action by Distribution Network Operators (DNOs).

We issued a notice dated 1 October 2012 to modify CRC 7 of the 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. This date was changed from 30 November 2012 to 1 April 2013.

Having considered the responses to the July consultation, which are available on the Ofgem website alongside the consultation document, we have decided not to activate the DPCR5 distribution losses incentive mechanism. The implementation of this decision requires modifications of the terms in CRC7, particularly those which relate to the adjustment of a licensee's revenues to reflect losses performance during the DPCR5 period.

The reasons for the proposed modification are set out in the associated document: Decision not to activate the Losses Incentive Mechanism in the Fifth Distribution Price Control (Ref 149/12).<sup>4</sup> Readers are directed to Chapter 3 in particular.

We are now conducting a formal (statutory) consultation on the further proposed modification to CRC7 which are set out in Appendix 1 to this Notice.

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<sup>2</sup> Special Licence Conditions are not generic but specific to each licensee, however CRC7 contains the same standard information for each licensee

<sup>3</sup> [www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/Consultation%20-%20whether%20to%20activate%20the%20DPCR5%20losses%20mechanism.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/Consultation%20-%20whether%20to%20activate%20the%20DPCR5%20losses%20mechanism.pdf)

<sup>4</sup> [http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/1A\\_Decision\\_Losses\\_DPCR5\\_161112.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/1A_Decision_Losses_DPCR5_161112.pdf)

The effect of the modification would be to remove any clauses pertaining specifically to the DPCR5 losses incentive mechanism. The modification retains and, where necessary, revises the mechanism for calculating the distribution losses incentive term based on the residual distribution losses incentive arising in the previous DPCR4 charge restriction period (known as the 'PPL' term).

Interested parties may make representations with respect to the proposed modification and we will take those representations into account in coming to our decision. Any such representations should be made in writing and sent to us by 14 December 2012, by e-mail to [dora.guzeleva@ofgem.gov.uk](mailto:dora.guzeleva@ofgem.gov.uk) or by post to Dora Guzeleva at Ofgem, 9 Millbank, London, SW1P 3GE.

Should our decision be to proceed with the modification, the modification will come into effect 56 days after the publication of that decision.

Hannah Nixon  
[Produced electronically]

**Senior Partner**  
**Smarter Grids and Governance (Distribution)**

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

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

#### Introduction

- 7.1 The purpose of this condition is to establish the mechanism for calculating the amount of the term IL (the distribution losses incentive term) that applies in CRC 5 (Restriction of Distribution Charges: non-generation incentive revenue adjustment).
- 7.2 The effect of the application of the distribution losses incentive term in CRC 5 is to adjust the calculation of the licensee's Combined Allowed Distribution Network Revenue under CRC 3 (Restriction of Distribution Charges: Use of System Charges) (whether upwards or downwards) in order to reflect the licensee's final performance under the Distribution Losses Incentive Scheme in the previous charge restriction period (1 April 2005 to 31 March 2010).
- ~~7.3 The mechanism mentioned in paragraph 7.1 includes distribution losses targets and incentive amounts, to be determined by the Authority within Regulatory Year 2011/12 by reference to methodologies set out in Chapter 4 of the Authority's decision document published on 7 December 2009 under reference number 148/09, that will have effect in relation to the licensee for a period of five Regulatory Years commencing on 1 April 2010.~~

#### Part A: Calculation of the losses incentive adjustment (IL)

- 7.34 For the purposes of Part B of CRC 5, which adjusts the calculation of the licensee's Combined Allowed Distribution Network Demand Revenue under CRC 3, the IL adjustment in Regulatory Year  $t$  is derived in accordance with the following formula (in this condition, the Principal Formula):

$$IL_t = PPL_t \text{ ~~[} UILt + PCOLt - COLt \text{]} \text{ have been removed from the original equation}~~$$

where:

$IL_t$  is the distribution losses incentive adjustment term, and has the value of zero for each of the Regulatory Years beginning on 1 April 2010 and 1 April 2011.

~~$UILt$  is an amount calculated in accordance with Part B below.~~

~~$PCOLt$  is an amount calculated in accordance with Part C below.~~

~~$COLt$  is an amount calculated in accordance with Part C below.~~

$PPL_t$  is an amount calculated in accordance with Part ~~D~~B below.

## Part B: Calculation of losses incentive prior to annual smoothing (UIL)

7.5 For the purposes of the Principal Formula:

UIL<sub>t</sub> is the amount of distribution losses incentive before the annual smoothing is applied and is calculated as follows:

$$UIL_t = LR \times PIAL_{t-2} \times \left( \frac{L_{t-2}}{L_{t-2}} \right) \times \left[ \left( 1 + \frac{I_t}{100} \right) \times \left( 1 + \frac{I_{t-1}}{100} \right) \right]$$

where:

LR is the distribution losses incentive rate, and has the value of £60 per MWh for units physically distributed on or after 1 April 2010.

PIAL<sub>t</sub> is the price index adjustment relating to distribution losses, and is determined as set out in Part E below.

L<sub>t</sub> is the Adjusted Distribution Losses in Regulatory Year t, as calculated in accordance with the methodological basis set out in Part F below.

AL<sub>t</sub> means an amount representing the benchmark level of distribution losses in the Regulatory Year t calculated, subject to the provisions of Part G below, in accordance with the following formula:

$$AL_t = ALP \times UD_t$$

where:

ALP is the allowed loss percentage as set by a direction given by the Authority (see Part G below).

UD<sub>t</sub> is the Units Distributed, expressed in MWh, in Regulatory Year t as calculated according to Part F below.

I<sub>t</sub> means the Average Specified Rate, as defined in CRC 2 (Definitions for the Charge Restriction Conditions), in Regulatory Year t.

## Part C: Calculation of amount of losses carried over between years

7.6 For the purposes of the Principal Formula:

COL<sub>t</sub> is the amount of distribution losses incentive in excess of the annual upper or lower threshold to be carried over from Regulatory Year t to Regulatory Year t+1 and is zero for each of the two Regulatory Years beginning on 1 April 2010 and 1 April 2011, and thereafter is to be calculated from one of the following formulas:

(a) If  $UIL_t + PCOL_t \geq 0$  then

$$COL_t = \left( UIL_t + PCOL_t \right) \min \left( PIAL_{t-2} \times UT, \left( UIL_t + PCOL_t \right) \right)$$

or

~~(b) If  $UIL_t + PCOL_t < 0$  then~~

$$~~COL_t = \max \left( \left( \frac{PIAL_{t-2} \times LT}{UIL_t + PCOL_t} \right) \right)~~$$

~~where:~~

~~UT is the annual upper threshold and has the value set out in Appendix 1.~~

~~LT is the annual lower threshold and has the value set out in Appendix 1.~~

~~PIAL<sub>t</sub> is the price index adjustment relating to distribution losses, and is determined as set out in Part E below.~~

~~PCOL<sub>t</sub> is the amount of distribution losses incentive in excess of the annual upper or lower threshold carried over from Regulatory Year t-1 updated by the Average Specified Rate, and is calculated in accordance with the following formula:~~

$$~~PCOL_t = COL_{t-1} \times \left[ 1 + \frac{I_t}{100} \right]~~$$

#### **Part D: Residual distribution losses incentive (PPL)**

~~7.74~~ For the purposes of the Principal Formula:

PPL<sub>t</sub> 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 paragraphs ~~7.5 to 7.78~~, that is to be recovered by the licensee.

~~7.85~~ The value of PPL<sub>t</sub> in each of the two Regulatory Years beginning on 1 April 2010 and 1 April 2011 is set at zero.

~~7.8A6~~ In subsequent Regulatory Years, the value of PPL<sub>t</sub> shall be calculated by reference to the methodology set out in ~~Chapter 4 of~~ the Authority's decision document published on ~~XX 7 December 2009~~ under reference number ~~148/09 YY~~. [This will reference the final version of the updated methodology for calculating the close out value of DPCR4, currently under consultation as Document B.<sup>5</sup><sup>6</sup>

~~7.8B7~~ The amount of PPL<sub>t</sub> 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<sub>t</sub> 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.

<sup>5</sup> [http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/2B\\_Con\\_Losses\\_Methodology\\_DPCR4\\_161112.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Documents1/2B_Con_Losses_Methodology_DPCR4_161112.pdf)

<sup>6</sup> Note: This text will not be part of the amended CRC7 if we proceed to make the modification.

## ~~Part E: Determination of the price index adjustment (PIAL)~~

### ~~7.9 For the purposes of the formula set out in Parts B and C above:~~

~~PIAL<sub>t</sub> is the price index adjustment, which, in the Regulatory Year beginning on 1 April 2010, has the value of 1, and in each subsequent Regulatory Year is derived from the following formula:~~

$$~~PIAL_t = \left[ 1 + \frac{RPI_t}{100} \right] \times PIAL_{t-1}~~$$

~~where:~~

~~RPI<sub>t</sub> is as defined in Part A of CRC 2, and is determined in accordance with the method set out there.~~

## ~~Part F: Basis of calculation of Adjusted Distribution Losses (L)~~

~~7.10 For the purpose of the calculation of the formula set out in Part B above, the amount of L is calculated as the sum of:~~

~~(a) the difference (in MWh) between System Entry Volumes and Units Distributed, as measured and reported under the Distribution Losses Reporting RIGs issued by the Authority under standard condition 44B (Distribution Losses Reporting Regime); and~~

~~(b) an amount (in MWh) representing the DG Losses Adjustment (DGA<sub>t</sub>) of Units entering the system at Entry Points (other than Entry Points which are connected to an onshore Transmission System) where the loss adjustment factor applied for settlement purposes is less than 0.997, as calculated by the following formula:~~

$$~~DGA_t = \sum (LAF_{it} - 0.997) \times DGV_{it}~~$$

~~7.11 In the formula for the DGA term above:~~

~~DGV<sub>it</sub> is the total number of units, in respect of the Regulatory Year t, entering the licensee's Distribution System at Entry Point i, and~~

$$~~LAF_{it} = \min (LAG_{it}, 0.997)~~$$

~~where:~~

~~LAG<sub>it</sub> is the value, in the Regulatory Year t, of the annual loss adjustment factor applicable to Entry Point i, and is derived by applying the loss adjustment factors used in the relevant settlement procedure of the Balancing and Settlement Code in respect of Entry Point i to the units for that Entry Point for each half hour of the Regulatory Year t, and then dividing the sum of those loss adjusted units by DGV<sub>it</sub>.~~

## ~~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 30 November 2012 (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.~~

**~~Part H: Continuity of the basis of calculation~~**

~~7.16 — The licensee must, unless otherwise agreed by the Authority, calculate distribution losses in accordance with the Statement of Compliance approved by the Authority under standard condition 44B.~~

~~7.17 — Appendix 1 follows immediately below.~~

**~~APPENDIX 1~~**

**~~Values for the annual upper and lower thresholds by licensee~~**

**~~(see paragraph 7.6 of this condition)~~**

<del>Licensee</del>	<del>UT</del>	<del>LT</del>
	<del>€</del>	<del>€</del>
	<del>a</del>	<del>a</del>
	<del>n</del>	<del>n</del>
	<del>n</del>	<del>n</del>
<del>Central Networks West plc</del>	<del>5.2</del>	<del>-5.2</del>
<del>Central Networks East plc</del>	<del>5.1</del>	<del>-5.1</del>
<del>Electricity North West Ltd</del>	<del>4.5</del>	<del>-4.5</del>
<del>Northern Electric Distribution Ltd</del>	<del>3.1</del>	<del>-3.1</del>
<del>Yorkshire Electricity Distribution plc</del>	<del>4.0</del>	<del>-4.0</del>
<del>Western Power Distribution (South West) Ltd</del>	<del>2.3</del>	<del>-2.3</del>

<del>Western Power Distribution (South</del>	<del>3.4</del>	<del>-3.4</del>
<del>EDF Energy Networks (LPN) plc</del>	<del>4.4</del>	<del>-4.4</del>
<del>EDF Energy Networks (SPN) plc</del>	<del>4.0</del>	<del>-4.0</del>
<del>EDF Energy Networks (EPN) plc</del>	<del>6.3</del>	<del>-6.3</del>
<del>SP Distribution Ltd</del>	<del>4.5</del>	<del>-4.5</del>
<del>SP Manweb plc</del>	<del>4.2</del>	<del>-4.2</del>
<del>Scottish Hydro Electric Power</del> <del>Distribution plc</del>	<del>2.9</del>	<del>-2.9</del>
<del>Southern Electric Power Distribution</del>	<del>6.0</del>	<del>-6.0</del>