



Distribution Network Operators
and other interested parties

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

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Dear colleague

Notice under section 11A(2) of the Electricity Act 1989 – proposed modifications to Special Condition CRC 7 of the Electricity Distribution Licence

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 Residual Distribution Losses Incentive (PPL) term for the Distribution Losses Incentive Mechanism (DLIM).

Background

Electrical losses are an inevitable consequence of transferring electricity across the distribution network and they have a significant financial and environmental impact on consumers. Losses contribute to approximately 1.5 per cent of GB's greenhouse gas emissions.

To encourage Distribution Network Operators (DNOs) to manage an efficient level of losses on their networks, we introduced a losses incentive mechanism as part of our electricity distribution price control.

Special Condition CRC 7 was devised to calculate the adjustment to DNOs' revenues to reflect distribution losses performance. In particular, Part B of the licence sets out the process for directing the PPL term (or 'close out') from the Fourth Distribution Price Control Review (DPCR4) period.

During 2010, some DNOs noted high levels of data corrections arising from abnormal levels of data cleansing activity by suppliers. The data corrections that suppliers applied increased the notional losses for affected DNOs for 2009-10. This not only affected the losses incentive (reward or penalty) DNOs earned in that year, but also the final close out amounts for each DNO associated with the DPCR4 DLIM. This impact is compounded because 2009-10, the final year of DPCR4, is particularly important for the close out calculation as it determines the ultimate DPCR4 incentive amount received/incurred by each DNO.

Since 2010 we have been extensively involved with industry in seeking to resolve this issue. We decided that restatement of 2009-10 losses positions (affecting the DPCR4 DLIM) would be permitted if DNOs could demonstrate that they had been affected by abnormally high levels of data cleansing.

On 1 October 2012, we modified CRC 7 to move the dates by which the Authority was required to direct the value of the PPL and Allowed Losses Percentage (ALP) terms from 30 November 2012 to 1 April 2013.¹

We further modified CRC 7 as a result of our decision of 16 November 2012 not to activate the DLIM for the Fifth Distribution Price Control Review (DPCR5).² We modified CRC 7 to remove all references to the DLIM for DPCR5, which included removing the requirement for the Authority to direct the ALP value.³ These modifications, due to come into effect on 1 March 2013, did not affect the requirement for the Authority to direct the PPL term by 1 April 2013.

Our work on the restatement of 2009-10 data and the closing out of the DLIM in DPCR4 is taking longer than expected, for the reasons set out below. As a consequence we believe we will be unable to direct the PPL term by 1 April 2013. We are therefore proposing changes to CRC 7 in relation to the timing of the Authority's direction of both the PPL term and the period over which it should be recovered.

Proposed modifications

The details of the proposed modifications are set out in Appendix 1 to this Notice. The text reflects the changes to the licence that will come into effect on 1 March 2013, to provide clarity on what the text of the licence condition will be if the modifications that we now propose are made.

The effect of the proposed modifications will be to give the Authority flexibility in determining the timing of the direction of the PPL term and the timing for recovery of this term, which will be determined in light of the date on which the PPL term is directed.

Reasons for the proposed modifications

Since 2010 we have been extensively involved with industry in seeking to resolve the data cleansing issue affecting 2009-10 data. More recently, we published two letters, on 9 March 2012 and 30 July 2012, to bring this issue to a satisfactory conclusion. They reinforced the principle that restatement of 2009-10 losses positions would be permitted if DNOs could demonstrate that they had been affected by abnormally high levels of data cleansing.

On 16 November 2012, we issued a consultation on the assessment of applications from ten DNOs to have their losses positions restated to remove the effects of the abnormal data cleansing in 2009-10.⁴ In it we presented our assessment of the restatement applications. The consultation also included the close out values for those four DNOs not applying for restatement. We invited responses to our consultation by 14 January 2013.

Due to the complexity of the subject matter, some stakeholders requested an extension to allow them the opportunity to fully analyse the evidence presented. This included additional evidence that we published on 7 December 2012. Following these requests, we extended the deadline for responses to our consultation to 28 January 2013. We received 12 responses to our consultation.

¹ The modification direction can be found at:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=752&refer=Networks/ElecDist/Policy/losses-incentive-mechanism>

² Our decision can be found at:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=755&refer=Networks/ElecDist/Policy/losses-incentive-mechanism>

³ The modification direction can be found at:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=779&refer=Networks/ElecDist/Policy/losses-incentive-mechanism>

⁴ Our consultation and its responses can be found at:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=762&refer=Networks/ElecDist/Policy/losses-incentive-mechanism>

One respondent identified some potential discrepancies between the data required for the DPCR4 close out process and that provided by DNOs. We have been pursuing explanations for these potential discrepancies with each of the DNO groups.

In the course of pursuing this issue with the DNOs, it has become clear to us that there is considerable further work required on data assurance before we can direct the PPL terms with confidence. We have scheduled a meeting with respondents to the 16 November 2012 consultation on 6 March 2013 to discuss the potential data discrepancies and the way forward.

We recognise that DNOs and other interested parties are looking to us to direct the PPL term as soon as practicable to provide greater clarity as to their respective financial positions and to inform the setting of distribution charges. However, given the magnitude of the potential value of the incentive mechanism it is important that the final PPL terms are calculated on the basis of accurate and robust data. Because we do not consider this is feasible by 1 April 2013, the proposed modifications will give the Authority flexibility in determining the timing of the direction of the PPL term.

We acknowledge that we may need to reconsider our previous decision to recover the close out values over 2014-15 and 2015-16⁵ depending on the actual timing of the Authority's direction of the PPL term. We consider that any prejudice to parties who would prefer earlier certainty regarding the value of the PPL term can be removed if the regulatory years for recovery of the PPL value are set by reference to the date on which the PPL is directed. We will communicate further on this issue once we have more clarity of the likely time that we will be directing the PPL term.

Next steps

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 15 March 2013, preferably by email to dora.guzeleva@ofgem.gov.uk or alternatively by post to Dora Guzeleva at Ofgem, 9 Millbank, London, SW1P 3GE.

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

Hannah Nixon

[Produced electronically]

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

⁵ Our decision can be found at:
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=781&refer=Networks/ElecDist/Policy/losses-incentive-mechanism>

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

Part B: Residual distribution losses incentive (PPL)

7.4 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 paragraphs 7.5 to 7.7, that is to be recovered by the licensee.

7.5 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.

7.6 In subsequent Regulatory Years, the value of PPL_t shall be calculated by reference to the methodology set out in the Authority's decision document published on 3 January 2013 under reference number 01/13.

7.7 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.~~ The Authority will direct the period over which the value of PPL_t is to be recovered taking account of the date on which the PPL_t direction is made.