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Electricity distribution networks, electricity suppliers, electricity consumers and other interested parties

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Date: 4 October 2013

Dear Stakeholder,

Consultation on the timing of a decision on electricity distribution networks' revenue for 2015-16

We are seeking your views on whether there is benefit in making an earlier than proposed decision on the revenue that will be recovered by electricity distribution network operators (DNOs) in 2015-16. This is the first year of the new electricity distribution price control (RIIO-ED1) and it starts on 1 April 2015. The current timeline for the RIIO-ED1 price control review means that 2015-16 revenue will be decided in November 2014.

The outcome of this consultation may only affect the timing of our decision on revenue for 2015-16 and not any other aspect of the RIIO-ED1 timetable. The outcome of the RIIO-ED1 review will be a decision on the outputs that DNOs will need to deliver and related revenue for the eight year RIIO-ED1 price control period. If we decide to make an early decision on 2015-16 revenue there will be a true-up in future years to ensure that agreed outputs are delivered and the costs of doing so are recoverable.

Suppliers have told us that they would prefer an earlier decision on 2015-16 revenue to help them accurately price network charges into the energy contracts they offer consumers. DNOs recover their revenue from suppliers who in turn recover from electricity consumers as part of the electricity bill.[1]

This consultation has been informed by stakeholders' views provided through the RIIO-ED1 engagement programme to date. We outline and seek views on three options for when we could make a decision on DNOs' revenue for 2015-16. We also seek views on how any revenue not recoverable in 2015-16 could be deferred to future years.

The deadline for response is 4 November 2013 and it should be sent to Joanna Campbell (joanna.campbell@ofgem.gov.uk). We invite your views by posing a number of questions throughout this letter which are summarised in appendix 1.

Our previous work on revenue volatility

Suppliers have indicated that volatility in network charges, the way each DNO recovers the cost of operating its system, is a key concern. Some suppliers have indicated that in order to manage the risk of unexpected changes in revenue they include a risk premium in consumers' energy bills to compensate them for bearing this risk. We agree that the ability

[1] Electricity distribution network charges account for c. 16% of the typical electricity bill. For further details see: https://www.ofgem.gov.uk/ofgem-publications/64006/householdenergybillsexplainedudjuly2013web.pdf

to predict charges with a degree of accuracy is important for suppliers and ultimately energy consumers.

We have previously worked with our stakeholders to identify improvements to the price control framework to increase the predictability of revenue changes. This work resulted in our decision to implement measures to improve the predictability of revenue changes during a price control period.[2] These measures will be implemented in RIIO-ED1. Our previous work did not specifically address changes in revenue as a result of moving from one price control period to another.

Listening to current concerns

We noted earlier this year in our Strategy Decision[3] that suppliers are concerned that the price control review process means they do not have enough notice of revenue changes at the start of a new price control period. We outlined the current RIIO-ED1 review timetable for making our decision on revenue as the following:

- for slow-tracked DNOs it will be decided at Final Determination (FD) in November 2014; and
- for fast-tracked DNOs it will be decided at fast-track FD in February 2014, with the exception of an update of some allowances related to financial parameters[4] which will happen at slow-track FD in November 2014.

The DNOs published their RIIO-ED1 business plans in July this year.[5] The business plans outline each DNO's view of the costs of delivering proposed outputs over the eight years of RIIO-ED1. Most DNOs are forecasting a fall in charges in 2015-16 when compared to 2014-15. However, suppliers have indicated that their key concern in relation to volatility is not mitigated by the direction of the expected change as there will still be uncertainty when they are pricing contracts to consumers.

Since we published our Strategy Decision we have had further discussions with some of our stakeholders on the materiality of this issue. The options in this consultation have been informed by the views already expressed. We now provide a further opportunity for parties to formally comment. We are particularly interested in better understanding the materiality of the issue and assessing the costs and benefits of the options available.

Scope of this consultation

We note that this consultation only considers changes in revenue and not changes in final network charges. Revenue is only one of the inputs to the methodology used to derive network charges. This consultation does not consider volatility in network charges because existing open governance arrangements provide a mechanism for the industry to consider volatility in this context.

We are aware that there are currently two Distribution Connection and Use of System (DCUSA)[6] modifications being progressed which consider improving the predictability of network charges.[7] We are supportive of the industry considering the costs and benefits of

[2] Decision in relation to measures to mitigate network charging volatility arising from the price control settlement (Oct 2012): https://www.ofgem.gov.uk/publications-and-updates/decision-measures-mitigate-network-charging-volatility-arising-price-control-settlement
[3] Strategy decision for the RIIO-ED1 electricity distribution price control (Mar 2013), para.s 4.13 – 4.17: https://www.ofgem.gov.uk/ofgem-publications/47067/riioed1decoverview.pdf
[4] The relevant financial parameters are the allowed return on debt (which is based on an index), opening Regulatory Asset Value (RAV), tax and pension liabilities.
[5] For a link to the DNOs' business plans see, Open letter consultation on RIIO-ED1 Business Plans (Jul 2013): https://www.ofgem.gov.uk/ofgem-publications/75338/riioed1bppublicationseekingviews.pdf
[6] The DCUSA is a multi-party contracted between DNOs, suppliers and generators concerned with the use of the electricity distribution system and connections to or from it. See: http://www.dcusa.co.uk/Public/Default.aspx
[7] Change proposal DCP178 proposes to make it mandatory for DNOs to provide 15 months notice of charges. Change proposal DCP180 proposes fixing the model used to create charges up to five years in advance so only changes in revenue would impact charges over the fixed period.

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approaches that consider the volatility of network charges and will continue to monitor the progress of these modifications.

The purpose of this consultation is to consider when we can make our decision on the opening base revenue allowance for the first year of RIIO-ED1. Therefore we are not proposing to provide further notice of other adjustments that may impact revenue in 2015-16. For example, some incentives earned in the current price control will impact revenue in 2015-16 because they operate with a lag. This includes the incentives related to quality of service[8] and the Low Carbon Networks (LCN) Fund Second Tier competition[9] which will be run in 2014. Suppliers should continue to seek information on the expected materiality of these adjustments from DNOs.

Options we are considering

We consider there to be three available options for when we could make a decision on the opening base revenue allowance for 2015-16. These three options are summarised below.

Option (a): This reflects the current RIIO-ED1 review process and results in revenue for all DNOs being finalised at FD scheduled for November 2014.

Option (b): For slow-tracked DNOs' 2015-16 revenue would be finalised at the slow-tracked Draft Determination (DD) scheduled for July 2014. For fast-tracked DNOs 2015-16 revenue would be finalised at the fast-track FD scheduled for February 2014.

Option (c): All 14 DNOs' 2015-16 revenue would be notified as part of our decision to this consultation. This is the earliest opportunity at which we could make a decision on 2015-16 revenue. Each DNOs' revenue would therefore be based on its business plan submission rather than our assessment of the efficiency of the plan.

Assessment of the options

Assessment criteria

We consider the principal criterion for assessment to be the achievement of the most efficient allocation of risk. In this consultation the risk to different parties (DNOs, suppliers and electricity consumers) relates to the uncertainty in the value of revenue the DNOs will be allowed to recover in 2015-16. In evaluating each option we must reach a view on the relative cost to each party of managing this risk.

In addition to this is a consideration of the additional complexity each option could introduce. Additional complexity may make the price control framework more difficult to understand for our stakeholders. If this were the case then any benefit gained from greater predictability of revenue may be undone.

Option (a) represents the base case against which we have initially assessed option (b) and (c).

Evaluating the benefits

Option (b) and (c) respectively provide 4 and 11 months additional notice when compared to the base case. In theory this additional notice will allow suppliers to better price the contracts which they offer consumers. This reduction in risk to suppliers should result in a reduction in any risk premium in a consumer's electricity bill, and hence be beneficial for consumers.

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[8] See Charge Restriction Condition 8 of the electricity distribution licence: https://epr.ofgem.gov.uk/Document
[9] For further information on the competition see: https://www.ofgem.gov.uk/electricity/distribution-networks/network-innovation/low-carbon-networks-fund

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We are unable to conduct a robust quantitative assessment of this benefit. This is because we do not have sight of the risk premium, if any, that suppliers include in the contracts which they offer consumers. In addition we do not have visibility of the relationship between the risk premium and the amount of notice of revenue changes provided.

In order to inform our decision we request that respondents, in particular suppliers, provide evidence of how an additional period of notice may benefit consumers. In particular, the impact on the accuracy of pricing contracts of an additional 4 or 11 months notice.

Question 1: *Please provide any relevant information to improve our analysis of the benefit of each option including (if available):*
(i) information on the risk premium included in contracts offered to consumers; and
(ii) the expected reduction in the risk premium an additional 4 months (option (b)) and an additional 11 months (option (c)) would provide.
Please specify if you wish any data provided to remain confidential.

Evaluating the cost

The options we are consulting on do not result in an overall reduction in risk but a movement of risk from one party to another. Therefore the benefit to suppliers, and consequential benefit to consumers, identified above may be outweighed by the cost to other parties of managing additional risk. We consider that the primary factor influencing costs is the magnitude of the difference between the revenue that would be provided under option (b) or (c) when compared to under option (a).

The agreed 2015-16 revenue under option (b) or (c) could be higher than the revenue that we would have decided under option (a). Consumers would therefore be paying more in 2015-16 than they would have done under the base case (assuming all else held equal). We recognise that this impact would be temporary as consumers will only pay for the outputs that DNOs are required to deliver, which will be set out in FD.

Alternatively, agreed 2015-16 revenue under option (b) or (c) could be lower than the revenue that we would have decided under option (a). DNOs would still be expected to deliver agreed outputs in 2015-16 so in this scenario they would have to fund output delivery from sources other than through charges to consumers. Again, this impact would be temporary as DNOs will still be allowed to recover the full revenue required to deliver outputs agreed for RIIO-ED1.

There is however a cost to parties of deferring revenue to future years. We propose that any deferred revenue is uplifted by the Weighted Average Cost of Capital (WACC)[10], ie the deferral would be net present value (NPV) neutral. This uplift is intended to compensate consumers for the short-term risk they will be taking on by over-paying for services in 2015-16. It also compensates DNOs for the time value of money of funding service delivery through means other than charges to consumers. Applying a WACC adjustment is consistent with the treatment of similar revenue deferrals in the price control framework.

In our previous work on mitigating network charging volatility[11] we also stated that improving the predictability of revenue changes could result in higher financing costs for DNOs over the longer term as they may face more short-term cash-flow risk. Given this consultation considers a one-off event (changing from the current price control to RIIO-ED1) we do not consider any option to have an impact on the longer term cash-flow risk of DNOs. Therefore, implementing either of these options would not require granting the DNOs additional allowances, beyond the NPV neutral adjustment for deferred revenue.

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[10] WACC used would be the vanilla WACC and represents the rate of return allowed on each DNO's Regulatory Asset Value.
[11] See footnote 2.

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Question 2*: Do you have any views on the potential costs we have identified? Do you consider there to be other costs we have not identified?*

How to recover deferred revenue

As noted above, option (b) or (c) could result in revenue being deferred from 2015-16 to future years. The amount of deferred revenue would be known at FD and could be either positive or negative. It would be included in the opening base revenue allowance for years after 2015-16 at FD. There are a number of options for how any deferred revenue could be recovered, these are:

1) all deferred revenue could be recovered in 2016-17;
2) deferred revenue could be spread over the remaining 7 years of RIIO-ED1; or
3) deferred revenue could be recovered in 2016-17 unless it breached a specified threshold in which case the remainder would be spread over future years.

We consider that option 1 has the benefit of being the simplest approach to implement. However, we are seeking views from parties on whether the materiality of the adjustment would impact their view of the appropriate treatment. We note that previous engagement has suggested that the materiality of adjustments is a secondary concern to the predictability of adjustments.

We also ask parties to propose what an acceptable threshold may be for use in option 3 if they consider that option 1 is not appropriate.

Question 3*: What is your preferred treatment of deferred revenue? Please explain your reasoning.*

Question 4*: If you prefer option 3 for deferring revenue, what do you consider an appropriate threshold? Please explain your reasoning.*

Our initial assessment

The price control review process must strike the right balance between providing information to stakeholders as early as possible while allowing for appropriate time to consider DNOs' business plan proposals to ensure that they provide value for money for consumers.

As noted above we are seeking information from respondents to improve our analysis of the benefits of the options we have put forward. Currently our initial view is based on our initial qualitative assessment of the relative merits of each option.

Based on previous price controls, it is likely that option (c) would result in consumers paying more in 2015-16 than under the base case. It may result in consumers materially overpaying for services in 2015-16 because revenue will be based on business plan assumptions prior to our assessment of their efficiency. While the impact is temporary, ie consumers will see a reduction in charges in future years (including a compensatory uplift of WACC), there is still likely to be a cost to consumers for managing the temporary impact on their cash-flow. Our initial view is that the magnitude of the additional revenue that could be recovered in 2015-16 makes this an unattractive option and is unlikely to benefit consumers.

The outcome is less certain under option (b). Our decision on revenue under this option will have been informed by our assessment of the efficiency of each DNO's business plan. We therefore expect revenue to be closer to that which we would have set under the base case. Therefore the cost to consumers of managing the impact on their cash-flow is also likely to be lower than under option (c).

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The realisation of a net benefit from implementing option (b) relies on suppliers being able to reduce any risk premium due to the additional 4 months notice of revenue. We are seeking input from stakeholders in order to better quantify this benefit.

In relation to the secondary criteria of additional complexity, option (b) and (c) both create some additional complexity. We do not currently consider that one is more complex than the other. Implementing either option would require additional steps in the setting of final revenue as we have discussed above.

Question 5*: Do you have any views on our initial assessment of each option?*

Question 6*: Which option do you consider will drive the greatest benefit to consumers? Please support this view with analysis of the costs and benefits.*

Question 7*: Do you have any views on the relative complexity of option (b) and (c)?*

Next steps

We have summarised the questions for stakeholders in appendix 1. We request that you send your response to Joanna Campbell (joanna.campbell@ofgem.gov.uk) by 4 November 2013. Please note that, unless clearly marked confidential, your response will be placed on our website.

Following this consultation process we aim to publish our decision before the end of the year.

Yours sincerely,

Anna Rossington
Head of RIIO-ED1

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Appendix 1 – Questions for consultation

1. Please provide any relevant information to improve our analysis of the benefit of each option including (if available):
   (i) information on the risk premium included in contracts offered to consumers; and
   (ii) the expected reduction in the risk premium an additional 4 months (option (b)) and an additional 11 months (option (c)) would provide.
   Please specify if you wish any data provided to remain confidential.

2. Do you have any views on the potential costs we have identified? Do you consider there to be other costs we have not identified?

3. What is your preferred treatment of deferred revenue? Please explain your reasoning.

4. If you prefer option 3 for deferring revenue, what do you consider an appropriate threshold? Please explain your reasoning.

5. Do you have any views on our initial assessment of each option?

6. Which option do you consider will drive the greatest benefit to consumers? Please support this view with analysis of the costs and benefits.

7. Do you have any views on the relative complexity of option (b) and (c)?

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