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4 November 2013

Dear Joanna

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

Thank you for the opportunity to respond to this consultation. Our RIIO-ED1 business plan was developed with our customers at the heart of the business and a key focus on reducing bills as much as possible and as soon as possible. In practice, this means that our business has significantly stretched itself in terms of financial ratio compliance in order to minimise our impact on customer bills. Despite this position, we welcome the opportunity to discuss additional mechanisms to reduce the total cost of electricity to customers.

Assuming that Ofgem will not fast track all fourteen licensees at the end of November, any decision to fix 2015-16 prices in advance could – on average - result in a delay to price reductions being passed through to GB customers (as the decision will use higher business plan revenues which will not include any Ofgem efficiency challenges). Ofgem could decide that this is appropriate if it would ensure that the expected reductions in charges proposed in DNOs Well Justified Business Plan submissions would be efficiently reflected in bills more quickly. If Ofgem is to enact a policy that may have this result it would need to be convinced that either suppliers could not act sufficiently quickly to allow charges determined at the end of the Ofgem price control review process to be passed on to customers and/ or that the risk premium included by suppliers in customer bills to reflect this uncertainty is more costly to customers than the benefit of earlier price reductions.

We understand from our engagement with suppliers that Distribution Use of System (DUoS) price predictability and volatility are factors that introduce risk and are priced into customer bills, but we do not have the information to advise on whether making the proposed changes would be of benefit to end customers. Ofgem must therefore seek to understand the drivers and scale of the risk premium included by suppliers, and the timescales within which suppliers are able to respond to price changes, to ensure that the changes proposed in the DNO plans are reflected in end prices for customers and that any risk premium is minimised. Ofgem must seek to understand whether the driver of any risk premium is DUoS price predictability or DUoS price volatility (and indeed whether this is consistent across the supply companies). If the driver of the risk premium is predictability, then increasing the notice period should reduce the risk, remove the premium and result in reduced customer bills. If the risk driver is based on the volatility of charges, then setting revenues early based on draft business plan submissions is likely to increase long term volatility and therefore increase risk (flowing through to customer bills).

The benefits of fixing the 2015-16 revenues will only occur if these risk premia are removed from customers' bills. If Ofgem receives evidence that convinces it that fixing prices early would be in customers' interests, Electricity North West would be able to enact any of options (a) to (c) outlined by Ofgem. The decision as to which is most appropriate will need to be driven by evidence as to how far in advance suppliers require notice in order to pass through savings to customer bills.

If Ofgem decides to fix the 2015-16 revenues earlier than it currently plans, any resulting revenue adjustments from the 2015-16 year must be smoothed over the remaining seven years of the price control. As we previously stated, our well justified business plan submission significantly stretched the financial ratios of the business and the proposal to adjust the revenues in 2016-17 would be unworkable.

We also note that the proposed NPV neutral adjustment (representing the time value of money) will not always adequately cover the increased risk in any individual year, where additional ratio pressure may necessitate an equity solution to resolve resulting financeability issues. The DNOs have submitted business plans with cost of equity assumptions which are unlikely to factor in this additional risk.

Additionally, any recovery of revenues in subsequent years should not be processed through the over- and under-recovery of revenues mechanism. This mechanism is designed to recognise that the collection of revenues is dependent upon the charging methodology assumptions and can be volatile. Any volatility above a prescribed limit could result in penalties for the DNOs. Including the revenue change within this mechanism could effectively reduce the allowed volatility cap and could result in additional penalties for companies. Any of the adjustments should be included in an additional term in the allowed revenue calculation.

We have included the responses to the specific questions raised in your consultation in Appendix 1. Please feel free to contact me or the team if you have any queries.

Yours sincerely,

Paul Bircham
2013.11.04
16:06:03 Z

Paul Bircham
Regulation Director

Appendix 1 – Responses to consultation questions

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.

These questions are better answered by suppliers. Supply companies have consistently reported that they include risk premia in contracts to protect themselves from uncertain network charges. They should therefore be in a position to identify the pricing mechanisms used. It is important that suppliers disclose the margins embedded within the contracts and their drivers to allow Ofgem to make its decision on the effectiveness of this proposal and the impact on risk pricing/allocation.

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?*

As stated in the main letter, Ofgem must recognise that the cost of changing the DNO revenue profiles could be higher than the proposed NPV adjustment. The networks' financial ratios are significantly squeezed in RIIO-ED1 and therefore the potential to breach these ratios has also increased. If the financial ratios are breached, the impact may include a higher future cost of debt which could ultimately increase customer bills. If this requires an equity injection to resolve, then the cost of deferral will be significantly higher.

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

Our preference would be to recover the revenue over the remaining years of the RIIO-ED1 period (Option 2). The reasons for this are described in the letter.

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

We do not believe that this is an appropriate mechanism as it could risk financeability in year 2.

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

We believe that your assessment of option C fails to recognise that the cost to the DNOs could be greater than the NPV adjustment if financeability is challenged.

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.*

This mechanism should only introduced if Ofgem can satisfy itself that the decision will remove the risk premium from the supplier element of the bill and that the removal of the premium would be more beneficial to customers than the price reductions expected from the RIIO-ED1 process.

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

In terms of complexity, price controls are already very complex. We do not believe that many customers will be able to effectively understand the detailed calculations underpinning the revenue calculation through the Price Control Financial Model and any subsequent adjustments based this mechanism. We therefore conclude that the proposed mechanisms will not significantly damage the ability of customers to understand the implications but recognise that we have a continuing role to play to ensure that we explain issues in a manner that is accessible, relevant and transparent for customers.