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4 November 2013

Dear Anna

Timing on a decision on electricity distribution networks' revenue for 2015-16

SSE understands the concerns that exist for suppliers and customers around uncertainty over DNO revenue allowances and, hence, the setting of tariffs for 2015/16. We therefore welcome the consultation and the consideration of different options that could help to alleviate these concerns.

<u>Volatility and predictability of charges</u>

We support the significant steps that have already been taken by Ofgem and the industry to reduce the volatility of charges. Specifically, the smoothing of base revenue in DPCR5 has minimised the level of volatility throughout DPCR5; the introduction of a 2 year lag on incentives and the RPI true-up has increased the predictability of charges for suppliers; and there is much greater transparency around the setting of distribution charges, with the charging models all being available in the public domain and modifiable by all industry parties.

These changes build on CRC 3.2, under which all DNOs have a licence obligation to take all appropriate steps within their power to ensure that in any regulatory year their actual revenue does not exceed their allowed revenue. In practice this means that DNOs must set tariffs as accurately as possible to ensure that any over- or under-recovery is minimised.

During RIIO-ED1, given all of the steps that have already been taken, the remaining material uncertainty in terms of distribution charges will lie in areas that are effectively outwith the DNOs' control: such as customer consumption; regulatory decisions; and code changes including modifications to the charging models.

Uncertainty over 2015/16 tariffs

As well as the improvements detailed above, we also note that the RIIO process has represented a considerable step change in transparency of future revenue allowances from DPCR5. During the RIIO-ED1 process there has been involvement of stakeholders at every stage since February 2013, the publication of DNO Business Plans in July 2013 and consultation on Ofgem's initial assessment in November 2013, and the Price Control Review Forum. Nevertheless, the commencement of RIIO-ED1 on 1 April does bring a higher degree of uncertainty around the tariffs for 2015/16 than normal, as the base revenue is still subject to significant regulatory decision.

We agree with the analysis set out in the consultation document and, in particular, the focus of this work being on achieving the most efficient allocation of risk between DNOs and suppliers. As set out in Appendix I in our answers to the questions in the consultation, we consider that there is merit in Option (b) as this would effectively result in the uncertainty around setting the tariffs for 2015/16 being consistent with every other charging year. However there are certain conditions that we would require to ensure the appropriate allocation of risk between DNOs and suppliers should Option (b) be adopted:

(i) A sensitivity analysis should be carried out by Ofgem as part of the draft determination for RIIO-ED1 to look at the impact of the potential over- and under-recovery resulting from Option (b) on the financeability of DNOs' businesses;

(ii) DNOs must be able to recover the deferred revenue (whether positive or negative) in full in 2016/17; and

(iii) Rather than adjusting for the deferred revenue via the K-factor, a term should be added to the final determination to adjust for the difference between the base revenue set in draft determination and at final determination.

I hope that the above information is helpful. Please do not hesitate to get in touch if you would like to discuss any of this further.

Yours sincerely,

Aileen McLeod
Head of Regulation, Networks

Appendix I

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 risk premium an additional 4 months (option (b)) and an additional 11 months (option (c)) would provide.

Not answered.

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?

Not answered.

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

Our preferred treatment of deferred revenue is Option (a), i.e. DNOs would need to recover all deferred revenue in 2016/17. Deferring over a longer period, i.e. Options (b) and (c) would increase the cash flow risk for DNOs and therefore increase financing costs. Options (b) and (c) would also result in increased inter-generational transfers, which is not consistent with best regulatory principles.

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

N/A

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

Option (a) would result in tariffs being set as normal in December 2014 prior to implementation on 1 April 2015. Whilst this has been the historic approach, we note that this does require a fast turnaround of tariffs once the base revenue has been determined and allows little time for discussions with suppliers.

Option (b) alleviates the timing issue associated with Option (a) however there is clearly some resulting impact on the accuracy of the tariffs.

Option (c) introduces the potential for highly inaccurate tariffs and hence significant risk for DNOs in terms of cash flow and hence financeability.

Overall, we consider Option (b) to have merit, although certain conditions would need to be met in order to ensure the appropriate allocation of risk between DNOs and suppliers:

(i) A sensitivity analysis should be carried out by Ofgem as part of the draft determination for RIIO-ED1 to look at the impact of the potential over and under-recovery resulting from Option (b) on the financeability of DNOs' businesses;

(ii) As detailed in our answer to Question 3, DNOs would need to be able to recover the deferred revenue in 2016/17; and

(iii) Rather than adjusting for the deferred revenue via the K-factor, a term should be added to the final determination to adjust for the difference between the base revenue set in draft determination and at final determination.

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.

Option (a) or (b) will drive the greatest benefit to customers as they are likely to provided the most accurate tariffs and reduce the risk of a swing in distribution charges 2016/17 to allow DNOs to recover any deferred revenue.

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

Option (c) risks under- or over-charging customers, possibly significantly, and could introduce a serious cash flow risk for DNOs. This would increase the costs of financing DNOs' businesses and hence could have a detrimental impact on customers in the longer term.