Avonbank
Feeder Road
Bristol
BS2 0TB

Telephone 0117 9332175
Fax 0117 9332428
Email asleightholm@westernpower.co.uk

Tim Aldridge
Ofgem
9 Millbank
London
SW1P 3GE

Our ref -

Your ref

Date 27th November 2013

Dear Tim

Further consultation on restatement of 2009-10 data and closing out the DPCR4 losses incentive mechanism

I am writing on behalf of Western Power Distribution (South Wales) plc, Western Power Distribution (South West) plc, Western Power Distribution (East Midlands) plc and Western Power Distribution (West Midlands) plc in response to the above consultation of 21st October 2013.

Introduction

WPD has maintained throughout the DPCR4 close out process that it would be wrong for Ofgem to penalise DNOs over and above reclaiming the incentive received (by way of the increase to allowed revenue) at the outset of DPCR4. The large variance in the PPL values set out in Ofgem's Summary of Assessments for Close Out simply serves to highlight this further.

Where a reliable measure of each DNO's losses cannot be achieved, fairness requires that no DNO should face a net loss on the basis of data that all concerned accept is unreliable.

WPD has always maintained that the fairest way to protect both consumers and DNOs from unbalanced and unfair results, is to require all amounts received or paid to DNOs in DPCR4 relating to the DPCR4 losses incentive to be repaid or refunded.

If Ofgem is not minded to require all amounts received or paid to DNOs in DPCR4 relating to the DPCR4 losses incentive to be repaid or refunded, the only way to avoid inequitable results is to impose an appropriate reciprocal cap.

Chapter Two

Question 1: ***Do you have any views on whether any DNO should be able to use a different normal period based on strong evidence that 2006-07 and 2007-08 are inappropriate? What evidence should be considered?***

WPD Response:

WPD considers that DNOs should be able to use a different normal period where 2006/07 and 2007/08 are inappropriate.

Reasons for WPD's Position and Corresponding Evidence

The normal period set by Ofgem is based on aggregated data from all DNOs. This assumes that each individual DNO follows the same statistical pattern. The evidence provided by WPD demonstrates that this is not the case.

On 2 August 2013 WPD provided Ofgem with factual evidence to the effect that GVC adjustments were made by suppliers in the East and West Midlands areas over the 2006/07 and 2007/08 periods. This evidence not only demonstrated that GVC adjustments were made, but that GVC during those periods was abnormally high.

WPD also provided OFGEM with data showing the movement from R3 to DF. The data showed both a movement from a negative to positive discrepancy between R3 to DF settlement runs and a significant increase in magnitude.

In DPCR3, DF settlement runs produced marginally *larger* figures than the R3 settlement runs. Given that DF runs include additional sales such results were logical. The data provided to Ofgem, however, showed that in the East Midlands, West Midlands and South West licence areas, the DF runs in 2006/07 and 2007/08 were not only *lower* than the R3 runs, but were significantly lower. The only logical explanation for the significant increase in losses in the DF runs is an abnormally high level of GVC adjustments.

While the data showed that the 2006/07 and 2007/08 period was not normal for all three licensees, the East Midlands licence area was the most significantly affected area in those years. The incremental loss between R3 and DF increased by a magnitude of 5 in the East Midlands licence area. In the South West and West Midlands areas the incremental loss increased by a magnitude of 2.

The 2006/07 and 2007/08 period is therefore inappropriate for the East Midlands licence area and WPD should be able to use an alternative normal period.

WPD submitted further information in a supplementary data submission on 22 November. This detailed how the Ofgem normal period is in fact not normal for the East Midlands using report date data. East Midlands stands out as an outlier from the other 13 DNOs in this respect.

Impact of Ofgem's decision

Given that the data demonstrates that the stipulated normal period is not normal for the East Midlands licence area, if Ofgem is not minded to allow DNOs to use an alternative period, the only fair outcome is to either:

a) neutralise the DPCR4 losses incentive for DNOs that can show the set period is abnormal by setting the 5 x E value to zero (i.e. repaying any amounts awarded during DPCR4 relating to DPCR4 units); or

b) implement an appropriate reciprocal cap (see WPD's response to question 3 below).

Question 2: ***Do you have any views on the suitable normal period to be used should a DNO demonstrate, based on evidence, that the stipulated normal period is inappropriate for the restatement process?***

WPD Response:

Ofgem should allow DNOs to use periods in DPCR3. Alternatively, it should allow DNOs to use a continuous 24 month normal period containing part of 2005/06, all of 2006/07 and part of 2008/09.

Reasons for WPD's Position

At paragraph 2.50 of the consultation, Ofgem states that it has analysed 2005/06 as showing unusually low losses. Ofgem also states, in paragraph 2.22 of the consultation, that the normal years must fall within the DPCR4 period.

If this is truly Ofgem's position, it is difficult to see what alternative period is available to DNOs who can provide strong evidence that 2006/07 and 2007/08 are abnormal.

If a normal period cannot be found in DPCR4, it follows that DPCR3 should be used.

In the event that Ofgem is not minded to allow DNOs to use a period in DPCR3, where a DNO can show that 2006/07 and 2007/08 are abnormal (such as in the case of the Mid East licence area), the DNO should be able to use a continuous 24 month normal period containing part 2005/06, all of 2006/07 and part of 2008/09.

The abnormally high GVC in the stipulated normal period and the "unusually" low losses in the 05/06 period will be neutralised and the period can be used as a proxy to normal.

WPD have analysed the data and a suitable normal period using DPCR4 would either run from January 2006 to December 2007 or February 2006 to January 2008. These produce weighted average losses for the whole period of 5.61% and 5.72% respectively.

Question 3: ***Do you have any views on the application of the proposed credibility cap in relation to the restatement applications for both the annual incentive and the close out?***

WPD Response:

The credibility criteria for the cap should compare losses against the target only. Failing this, losses should be compared against either the target *or* the stipulated normal period. The credibility cap should also act as a true reciprocal cap and be capped at the target where a DNO exceeds target losses by more than 5%.

Credibility Criteria

Ofgem's proposed credibility cap is dependent on the normal period being normal.

As evident from our response to question 1 above, the stipulated normal period is not normal for WPD's East Midland’s area. If the stipulated normal period for a DNO includes abnormally high losses or abnormally low losses, the cap becomes ineffective because the DNOs "actual" losses are being compared to something that is itself abnormal.

For this reason, WPD considers that the credibility criteria should be set against DPCR4 targets rather than the stipulated normal period.

If Ofgem is not minded to compare losses against only the DPCR4 targets, losses should be compared against either the DPCR4 targets *OR* the stipulated normal period. On that basis, WPD submits that Ofgem should implement the following credibility criteria:

> The losses will be capped if the 2009/10 losses % is lower than 0.95 X the average of the normal period ***or*** 0.95 X the target swap.
>
> And
>
> The losses will be capped if the 2009/10 losses % is higher than 1.05 X the average of the normal period ***or*** 1.05 X the target.

True Reciprocal Cap

At paragraphs 2.45 and 2.46 of the consultation, Ofgem proposes that restated loss percentages should be capped at the lower of the following two thresholds:

a) 5% less than the target losses percentage; and (for consistency WPD submits the words "and" should be replaced with the words "or")

b) 5% less than the overall losses percentage over 2006/07 and 2007/08 on a fully reconciled basis.

Fairness dictates that the credibility caps need to be truly reciprocal. Where a DNO's losses do not meet the credibility criteria (either because the losses are 5% higher or 5% lower than the thresholds) the loss percentages should be capped. It is inconsistent to cap the losses for one of the credibility caps and not for the other.

On that basis, WPD submits that where a DNOs' losses are 5% higher than the DPCR4 targets (or the average losses of the normal period), the DNOs' losses should be capped at that threshold.

Question 4: *Do you have any views on the suitable normal period to be used in the credibility criteria should a DNO convince us that the stipulated normal period is inappropriate for the restatement process?*

WPD Response:

Please see our response to question 3. WPD considers that the normal period to be used in the credibility criteria should be the same as the normal period used for the GVC calculation.

Question 5: ***Should we allow additional evidence for demonstrating abnormality for post 2009-10 years where a DNO fails the statistical test for these years (i.e. treat post 2009-10 years in the same way as 2009-10)?***

WPD Response:

Where GVC adjustments were made in post 2009/10 years relating to 2009/10 data, evidence of those adjustments should be able to be included in the GVC adjustment calculations for DNOs who fail the statistical test.

Reasons for WPD's position

Where a DNO fails the statistical test, GVC related post 2009/10 data should be adjusted where:

1. There is factual evidence that GVC was applied in say 2010/11 which related to 2009/10. In these circumstances reconciliations for 2010/11 data which relates to the 2009/10 period should also be adjusted as if the DNO had passed the statistical test for both years.

2. A DNO's losses are so high that they exceed the credibility cap (as that cap is described in our response to Question 3 above). Exceeding the credibility cap is indicative of flawed settlement data. In such circumstances, post 2009/10 years should also be adjusted as these years contain reconciliations relating to 2009/10 which would have contributed to the cap being exceeded.

Question 6: ***Do you consider that permitting restatement, based on exceeding the reciprocal cap thresholds with fully-reconciled un-restated data for 2009-10, is a fair and appropriate means of protecting consumers and DNOs from unreasonable outcomes in the close out process?***

WPD Response

WPD considers that where a DNO exceeds the reciprocal cap thresholds, that DNO should:

a) be allowed to restate its losses; and

b) have its restated losses capped at the threshold.

WPD has maintained throughout the DPCR4 close out process that it would be wrong for Ofgem to penalise DNOs over and above reclaiming the incentive received (by way of the increase to allowed revenue) at the outset of DPCR4.

The incentive system relies on achieving a reliable measure of each DNO's losses, and if this cannot be achieved then fairness requires that no DNO should face a net loss on the basis of data that all concerned accept is unreliable. Without a reciprocal cap, some DNOs stand to repay millions of pounds over the amount received under the DPCR4 losses incentive. On an analysis of its substance such payments operate as a penalty. The imposition of penalties of such magnitude (particularly when compared to the amount of the incentive originally paid) on data acknowledged by Ofgem to be flawed would be unfair and unreasonable and out of all proportion to the objectives of the incentive scheme.

A fair outcome can, however, be achieved by way of the imposition of an appropriate reciprocal cap (as described in our response to question 3 above).

Question 7: ***Do you consider that 'reported-equivalent' data compared with the reciprocal cap should be applied to post-2009-10 years as evidence that contributes to a case for identifying abnormality in those years?***

WPD Response

Yes. The "reported equivalent" data used in comparison with the reciprocal cap should include post 2009/10 data where that data relates to the 2009/10 year. This is because if reconciliations in reported equivalent data for 2010/11, 2011/12 or 2012/13 show high levels of losses, such losses contribute 2009/10 settlement data on a reconciled basis and should be adjusted. This is consistent with approach C of the statistical test.

CHAPTER: Three

Question 1: ***Do you have any comments on the submissions from DNOs?***

WPD Response

The DNO submissions/Vanilla assessments show significant and material variations between DNO groups. Given that demand fell in all licence areas during DPCR4 and the difference between the actual losses and the target losses are not physically possible, it is concerning that some DNOs will receive large gains over the DNO period where some DNOs will suffer large penalties (even after the Vanilla assessment).

By way of example, on Ofgem's current approach, UKPN receives the greatest rewards with an average windfall of approximately £61.5m per DNO area (Vanilla assessment) and SP receives the largest penalty with an average of -£33.5m per DNO area.

While OFGEM state at paragraph 2.46 of the consultation that "DNOs do not directly compete with each other", this should not justify inequitable treatments of DNOs. Particularly where the settlement system was not designed to measure in year losses and the resulting data is "not fit for the purpose of measuring losses ".

In addition, the outcome of the incentive mechanism might well affect competition in the supplier market. Suppliers with a large market share in licence areas which are penalised under the incentive mechanism will receive significant gains and suppliers with a large market share in licence areas which are rewarded under the incentive mechanism will incur significant losses.

An appropriate reciprocal cap is the only way to limit unequal treatment between DNOs and the unfair results that arise from calculating the close out of DPCR4 on the basis of flawed data.

In addition, the table below shows the cost or the subsidy per customer by DNO. This illustrates an outcome in which customers face large discrepancies in the rewards received or payments enforced on data acknowledged to be flawed. WPD consider this to further demonstrate the defects in the incentive mechanism. It is for this reason that WPD considers that, the only fair outcome is to either:

a) neutralise the DPCR4 losses incentive for DNOs that can show the set period is abnormal by setting the 5 x E value to zero (i.e. repaying any amounts awarded relating to DPCR4 units); or

b) implement an appropriate reciprocal cap.
(Refer to our response to question 1 of chapter 2)

	5XE (£m)			Cost or Benefit Per Customer (£)	
	Vanilla	Post 09-10 abnormal	Customer No.s	Vanilla	Post 09-10 abnormal
ENWL	39.1	39.1	2368572	£17	£17
NPgN	3.5	11.7	1583627	£2	£7
NPgY	20.5	20.5	2272386	£9	£9
WMID	-42.6	-24.4	2446825	-£17	-£10
EMID	-24.3	-7.1	2603410	-£9	-£3
SWALES	-10.4	-10.4	1108168	-£9	-£9
SWEST	25.6	25.6	1561137	£16	£16
EPN	75.2	75.2	3556281	£21	£21
LPN	84.8	84.8	2279053	£37	£37
SPN	24.9	24.9	2257968	£11	£11
SPD	-32.6	-32.6	1996169	-£16	-£16
SPMW	-34.4	-34.4	1490883	-£23	-£23
SSEH	24.5	24.5	750446	£33	£33
SSES	66.7	66.7	2967585	£22	£22

The table shows that the largest cost per customer is £37 in LPN and the largest benefit per customer is £23 in SPMW. This represents a difference between the two DNOs of £60 per customer.

Question 2: ***Do you consider that DNOs have fulfilled the requirements set out in our July 2013 document?***

WPD Response

Yes

Question 3: ***Do you have any comments on our assessment of the submissions?***

WPD Response

Please see our response to question 1 of chapter three above.

Question 4: ***Do you have any comments on the steps we have taken to calculate values of the draft PPL terms?***

WPD Response

While the steps taken to calculate the draft PPL terms have improved, it remains that:

a) The statistical test has too few data points to be reliable. The unreliability of the test is further demonstrated by the fact that WPD's East and West Midland licensees do not pass this test despite clearly having been significantly affected by GVC adjustments in 2009-10.

b) If a DNO fails the statistical test, it is required to provide data evidence, which needs to be sourced from suppliers. DNOs do not possess this data and have no authority to demand it. We note that Ofgem issued a data request to suppliers on the 18th Nov 2013, asking them to provide details on GVC and other data adjustments. It may take a while for suppliers to produce and collate this data and the results may be too late to contribute to this consultation.

c) The requirement that all DNOs use the same normal period is unfair (see our response to question 1 of chapter two).

Question 5: ***Do you agree that the cap has been applied equitably to relevant parties? Please provide evidence to support your argument.***

WPD Response

The credibility cap as currently formulated compares losses against the stipulated normal period. This is unfair and inequitable to those DNOs for whom the normal period is not normal.

For this reason and as set out in WPD's response to question 3 of chapter two, the credibility criteria should be set against DPCR4 targets rather than the stipulated normal period. If Ofgem is not minded to compare losses against only the DPCR4 targets, losses should be compared against either the DPCR4 targets OR the stipulated normal period.

Question 6: ***Do you consider that, more generally, the approach and calculations have been applied equitably in all circumstances?***

WPD Response

WPD does not consider that the approach has been applied in an equitable manner. In particular:

a) Ofgem has allowed some DNOs to adjust settlement data to correct inaccuracies, but not allowed other DNOs to make such adjustments. While Ofgem claims that this approach is necessary to maintain consistency with the way the targets were set, some of the errors developed during the DPCR4 period (i.e. before the targets were set). This unfairly penalises DNOs whose targets were set before such errors occurred and whose methodologies, consequently, did not adjust for those errors. In addition, no suggestion was ever made that the selection of a particular reporting methodology could stand to preclude a DNO in future from seeking to rely on data outside of that methodology when seeking a restatement of losses.

b) Ofgem has allowed one DNO to close out on the basis of RF data, whereas it has required all other DNOs to close out on the basis of DF data. While Ofgem claims that this approach is necessary to maintain consistency with annual reporting, it remains that closing out on RF data provides the DNO with an unfair advantage. As a result of GVC adjustments, the DF data for DPCR4 is more unreliable than RF data and shows abnormally high losses. When the targets were set, DF data was not so affected by GVC and was more consistent with RF data. The discrepancy between RF targets and RF settlement data is therefore smaller than the discrepancy between DF targets and DF settlement data. This means that closing out on the basis of RF data gives that DNO a significant advantage.

c) Ofgem has allowed one DNO to close out on a basis that is completely different to its methodology. While Ofgem claims that this DNO is not applying for restatement, it remains that the DNO receives an advantage because its losses are measured against targets which were set on a completely different basis.

d) The disparity between the rewards or penalties received by DNOs under the losses incentive mechanism are as a result of the different methodologies as well as the settlement data. As a result, requiring DNOs to only use settlement data consistent with their methodologies is in fact creating inequitable and unjustifiable disparities.

Question 7: ***Do you have any views on the appropriate period for recovery of the PPL based on the draft PPL terms?***

WPD Response

The recovery period should depend on the size of the PPL. If the PPL is significant, recovery should take place over a number of years. If, however, the PPL is small, recovery could take place over a year or two years.

Question 8: ***Do you have any views on the way that indexation and the weighted-average cost of capital (WACC) should be applied when the close out values are recovered*?**

WPD Response

The DPCR4 loss closeout amounts are effectively restatements of K-factor and should be treated accordingly – i.e. interest should be applied. As the close out values are not an investment, WACC shouldn't apply. Interest and not WACC was applied to the rewards or penalties given in the Quality of Service Incentive. There is no reason why the Losses Incentive should not be consistent with that incentive program.

This argument is supported by a memorandum issued by OFGEM on the 26th July 2013 entitled "Inflation and the time value of money in the ED1 license" which stated:

For adjustments to allowed distribution network revenue set out in chapter 2 of the current draft of the proposed ED1 licence, the use of a time value of money adjustments will vary depending on the following guidance:

- Where there is a direct link to incurred costs, a time value of money adjustment which uses WACC will be applied. This follows the same principles as those that apply to adjustments through the financial model.

- Where an incentive is linked to an economic value, a time value of money adjustment which uses WACC will be applied.

- No time value of money adjustment will be applied to discretionary payments or incentives which are not linked to an economic value. The reason is that such payments/penalties are not directly linked to costs incurred and therefore there is no reason to compensate the licensee/consumers.

- For the correction factor for over/under recovery we propose maintaining the current treatment. A time value of money adjustment which uses the risk free rate (Bank of England base rate) plus a margin will be applied.

On this basis, as the losses incentive is not linked to costs, a time value of money adjustment which uses the risk free rate (Bank of England base rate) plus a margin should be applied.

CHAPTER: Four

Question 1: *Do you have any comment on our assessment of the restatement applications for the purpose of the 2009-10 annual incentive and the proposed changes to the growth term figures?*

WPD Response

WPD is not requesting any changes to the growth term.

Question 2: *Do you have any views on the way that indexation and the WACC should be applied when the changes to revenue as a result of changes to the growth term are recovered?*

WPD Response

The DPCR4 loss closeout amounts are effectively restatements of K-factor and should be treated accordingly – i.e. interest should be applied. As the close out values are not an investment, WACC shouldn't apply. Interest and not WACC was applied to the rewards or penalties given in the Quality of Service Incentive. There is no reason why the Losses Incentive should not be consistent with that incentive program.

Should you wish to discuss any aspects of our response please contact (dwornell@westernpower.co.uk).

Yours sincerely

ALISON SLEIGHTHOLM
Regulatory & Government Affairs Manager