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By Email only

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Dear Tim,

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

Thank you for the opportunity to respond to the above consultation. We have some general observations to make, and also provide responses to your specific questions in the Attachment to this letter.

The issue of unusually high levels of data cleansing affecting DNOs' recorded losses has been the subject of extensive industry debate since 2010. In seeking to resolve the issue, Ofgem has published a number of consultations and decisions on the matter and has confirmed the policy decision that, on balance, it is in the interest of consumers for DNOs to restate their data where there is sufficient evidence that abnormal levels of settlement data corrections have occurred.

Our restatement submission of April 2011 recorded the attempts that we had made at that time to obtain information from suppliers and Elexon that would explain the extreme movements in settlement data. We received no satisfactory explanation as to the reasons behind such movements. The industry working group that we chaired during 2011 also sought to address the availability of data and methodologies that could support data correction. The group could not identify any "bottom-up" correction methodologies, ie using GVC and other correction data from suppliers, and identified the two "top-down" methodologies (the CE method and the SP method) that Ofgem took forward to consultation and further refinement. We believe that suppliers are now responding to Ofgem's request for losses data cleansing evidence, although we are surprised if they are now able to provide data which they have previously said was not available. We have little confidence that it will be possible to use any new supplier data for anything other than qualitative analysis, however if further reliance on this data is proposed we would expect full scrutiny by Ofgem's appointed auditors.

There has been a long and detailed consultation process, focused on the top-down methodologies and involving all industry participants in working group meetings and formal

consultations. We believe that this process has been robust, as demonstrated by the significant developments made to the correction methodology since the original restatement submission by Northern Powergrid in 2010.

Most recently, following responses to Ofgem's November 2012 consultation, there has been further detailed review of the data submitted by DNOs as well as the methodology more generally. This resulted in further methodology decisions being published in July 2013; together with a request for DNOs to submit fresh restatement applications and data.

Ofgem's data assurance report confirms that all data issues and policy decisions relevant to Electricity North West have been correctly reflected in our resubmitted close-out data. Our submission followed the process set out in Ofgem's July 2013 document, specifically in terms of the identification of abnormality in 2009-10, the approach to restatement and the application of the SP methodology for both close out and the annual incentive. We agree with the principle of equitable treatment across the DNOs, and therefore do not support any deviation from the very robust methodology decisions that were confirmed in the July 2013 document for any DNO.

The financial outcomes under our current submission are not significantly different from our position under the November 2012 consultation; however Ofgem's assessment applies a "credibility cap" which limits our overall reward by £4.1 million relative to our submission for close out. We comment on the proposed credibility thresholds in our detailed response.

We continue to believe that our submission (uncapped) represents an equitable resolution of a long-standing issue. We have formed this view on the basis of the expectations we had at the time of going into the final year of the DPCR4 period.

The overall effect of our submission is that we would retain £43.2m (2009-10 prices) under the DPCR4 incentive. This outcome is not unreasonable in the context that our incentive revenue for the first four years of the period (on the same basis) was £42.0m, coupled with the difficulty in establishing an accurate measure of performance for 2009-10. The significant change that we experienced in losses performance was not driven by any technical changes in the network, only became manifest towards the end of 2009-10 and there is sufficient data from the earlier years of the price control period to determine a reasonable expectation of the penalties or rewards that we and our customers might expect.

Our detailed responses to the questions raised in the consultation are attached. If you would like to discuss our responses in more detail please do not hesitate to contact me.

Yours sincerely,



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Attachment - Specific Questions

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?

Although we recognise that individual DNOs have had different experiences of the effects of abnormal data reconciliations during the DPCR4 period, we are concerned that the selection of different normal periods under the correction methodology could be perceived as “cherry-picking”. A response to the November 2012 consultation expressed particular concerns about this aspect of the process as it stood at that time and Ofgem has sought to establish a set of rules that can be applied in a consistent way in order to:

1. Establish abnormality in 2009-10 (and later years relevant to the closeout calculation);
2. Correct data where abnormality has been established; and
3. Apply a credibility check on the results of the restatement calculation.

Identification of the normal period is integral to each of these stages; however the principles at each stage are slightly different, as follows:

1. The identification of abnormality is based on assessment of the relative level of reconciliations in each period. This is the trigger for the restatement calculation.
2. The restatement correction is also based on assessment of the relative level of reconciliations.
3. The cap is put in place to prevent unintended consequences following restatement and is based on assessment of the absolute level of losses.

Previous consultations have discussed the specification of the normal period, and are summarised in Appendix 4 of the current consultation. The debate culminated in Ofgem’s July 2013 decision document which set out the reasons behind the choice of 2006-07 and 2007-08 as the normal period for all DNOs. In particular, paragraph 3.13 stated:

We have chosen this period on the basis of evidence from the aggregate data reconciliations that these two years best display ‘normality’ across the DNOs. That is, on aggregate, the reported data for these years does not appear to have been affected by unusual levels of data correction activity. We have excluded 2005-06 because, on aggregate, for reported data, this year displayed unusually positive reconciliations compared with other years of DPCR4¹. We have excluded 2008-09 as it is itself subject to the SF adjustment.

We have reviewed the latest data available from all DNOs applying for restatement and they show the 2005-06 reconciliation level in the aggregate data to be close to the fixed upper bound in the standard statistical test; however we also note that our own data does not follow this pattern and is well within the bounds of normality in all three years from 2005-06 to 2007-08. We have however followed the common methodology as defined by Ofgem in the interests of achieving, in Ofgem’s words, “the fairest approach to ensuring equitable treatment across the DNOs”.

¹ On aggregate, the level of positive reconciliations in 2005-06 was far lower than that of negative reconciliations in 2009-10 (Ofgem footnote).

The development of the correction methodology has involved extensive debate and consultation over the past three years, and our submissions at each stage have complied with the various Ofgem decisions taken during this period. We agree with the principle of equitable treatment across the DNOs, and therefore do not support any deviation from the methodology decisions that were confirmed in the July 2013 document.

If Ofgem were to be convinced of the need for a departure from the common methodology by an individual DNO, we suggest that the justification would need to include strong evidence that the level of reconciliations in 2005-06 was not abnormally positive, ie reconciliations did not fall into the same pattern as the aggregate DNO data.

We consider that the key issue in defining abnormality due to data cleansing is the relative level of reconciliations in each period rather than the absolute level of losses that result. Our own data demonstrates that relatively low losses in one year may not be due to abnormally positive reconciliations. Similarly, a high level of absolute losses is not necessarily the result of an abnormally negative level of reconciliations. We do not support the use of the reciprocal cap as a measure of abnormality for this reason.

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?

We do not agree with the use of a different normal period; however we would expect that any other justified period would be a continuous period of at least two years and should not contain an abnormally positive level of reconciliations.

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?

Ofgem has proposed that a restated loss percentage would be capped if it is below the thresholds of both the criteria:

- 5% less than the target losses percentage.
- 5% less than the overall (weighted) loss percentage over 2006-07 and 2007-08 on a fully-reconciled basis.

The cap would be applied at the lower of the two loss percentage thresholds.

We have a number of comments on this proposal.

Firstly, we believe that our 2009-10 restated losses performance of 4.94% is credible and technically feasible, a lower loss percentage being evidenced in 2005-06. Furthermore, the result of the restatement calculation is virtually the same as was obtained under the same methodology but using different normal periods, following the July 2012 data request, which provides further evidence of the robustness of the outcome.

Secondly although we accept the principle of a cap as a means of protecting customers and DNOs from any unintended consequences of the methodology, we believe that this should be based on losses performance in the normal period only, as originally proposed in principle in Ofgem's July 2012 data request. The objective of the cap is to apply a reasonableness

check on the calculated 2009-10 performance and it is appropriate to use a period relatively close to 2009-10 to set the threshold. It is difficult to understand the relevance of a threshold based on the target, which is itself based on performance in a period going back to 1994-95. We do not believe that the introduction of a cap based on the target is justified, particularly with a margin of only 5% applied. Our review of the latest DNO submissions show that the 2009-10 performance of the SSE companies (that have not restated data) are 11% less than target (SSES) and 12% less than target (SSEH) respectively. Since these levels are derived from unrestated data, we believe that the lower of these should form the basis of the target threshold applied to all DNOs, should the target threshold be retained.

The principle of having two credibility thresholds is problematic more generally. We understand that the intention is to draw on more than one consideration of credibility in the context of significant uncertainty, the principle being that the thresholds would serve in the round to inform on the credibility of calculated results and should not be considered as absolute individual caps. This suggests that the cap should be applied at the lower of the two thresholds, as Ofgem has proposed, but possibly gives the false impression that DNOs are “cherry-picking” to suit their data. Equally, if the tighter of the two thresholds is chosen, this could be argued to unfairly tilt the result against the DNOs. Our preferred solution is to remove the target threshold as a measure of credibility altogether.

In the current consultation, our submission is capped at the normal period threshold. As stated elsewhere in this response, we have followed the common methodology as defined by Ofgem in the interests of achieving an equitable treatment across the DNOs. If, however, departures from the common methodology are allowed, in particular in respect of the normal period, we would suggest that this credibility threshold should be widened to allow for the additional uncertainty attaching to the exact definition of the normal period.

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?

There is not necessarily a direct linkage between the two normal periods used for these different purposes. The normal period for restatement is based on the level of abnormal reconciliations; whereas the credibility test of the final result is based on the absolute level of losses. We do not agree with the use of a different normal period; however if this is to be considered we suggest that separate justification should be required for the use of a different normal period for the credibility threshold.

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 (ie treat post 2009-10 years in the same way as 2009-10)?

We agree that the same principles for assessing abnormality should be applied to post 2009-10 years, where these are relevant to the closeout calculation. However, the defined statistical tests remain the clearest way of identifying any such abnormality.

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?

No – we do not believe that a simple measure of the absolute level of losses is a sufficient indicator of an abnormal level of data cleansing.

We consider that the key issue in defining abnormality due to data cleansing is the relative level of reconciliations in each period rather than the absolute level of losses that result. Our own data demonstrates that relatively low losses in one year may not be due to abnormally positive reconciliations. Similarly, a high level of absolute losses is not necessarily the result of an abnormally negative level of reconciliations. We do not support the use of the reciprocal cap as a measure of abnormality for this reason.

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?

We agree with the principle that relevant post-2009-10 years should be assessed in the same way as 2009-10. However we do not agree with sole reliance on the Reciprocal Cap for this purpose.

CHAPTER: Three

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

We have no comments on the detail of the applications made by other DNOs, although we were surprised by the magnitude of some of the changes in outcomes since the November 2012 consultation.

We believe that our own submissions have been consistent and made in a transparent way from the start, and have led to broadly consistent results as the assessment and restatement methodologies have developed.

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

Ofgem’s data assurance report confirms that all data issues and Ofgem policy decisions relevant to Electricity North West have been correctly reflected in our resubmitted close-out data. Our submission followed the process set out in Ofgem’s July 2013 document, specifically in terms of the identification of abnormality in 2009-10, the approach to restatement and the application of the SP methodology for both close out and the annual incentive.

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

We have not commented on the detail of other DNO applications, but consider that Ofgem's vanilla assessments appear to have been applied in a consistent way to those DNOs who have submitted applications. We have commented elsewhere in this response on the application of the credibility cap.

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

Ofgem's calculation of the closeout payment under the various restated and un-restated scenarios is consistent with our own calculation, which followed the steps set out in the DPCR5 Final Proposals document (as amended by Ofgem's decision document of 3 January 2013).

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

The application of the cap appears to follow the methodology set out in the July 2013 decision document. We have commented elsewhere in this response on the overall level of the cap.

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

More generally, the approach and calculations are consistent with the July 2013 decision. Although we recognise that individual DNOs have had different experiences of the effects of abnormal data reconciliations during the DPCR4 period, we are concerned that departures from this established process could be perceived as "cherry-picking".

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

Our current expectation is that the PPL term would be recovered over the two years 2015-16 and 2016-17.

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?

Ofgem suggests that the final values could be adjusted for RPI-indexation and the time value of money, using the appropriate rate of WACC, due to the delay in recovery from 2009-10.

We do not agree that it is appropriate to apply RPI or WACC adjustments to reflect the delay in settling these payments. We believe that 2009-10 is the appropriate year in which the close-out should take effect and RPI-indexation has already been applied to bring the relevant data to this common 2009-10 basis.

The original intention was that the PPL term would be recovered within the DPCR5 incentive mechanism. We suggest that the adjustments for this term should be calculated in the same way as for other lagged incentives in the DPCR5 licence and be based on applying the Average Specified Rate.

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?

We note that Ofgem's vanilla assessment is to allow our restatement application for the 2009-10 annual incentive.

We agree with Ofgem's calculation of the effect on the growth term (+£0.57m against the interim restatement position). We agree that it is not appropriate to cap the restatement since the recalculated losses (5.21%) are above the credibility cap based on reconciled data, and are greater than the reported data in any of the four previous years of DPCR4.

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?

The consultation suggests that any updates to 2009-10 data should be applied by means of updating the annual revenue return for 2009-10. We do not believe that this would be efficient as it would require the resubmission of all revenue returns from 2009-10 to the date of the decision in order to calculate the successive over/under recoveries. It would also be inappropriate for companies to be penalised for any new under or over recovery beyond penal interest thresholds that results from this restatement as they could not reasonably have foreseen the change at the time of setting prices for the year in question.

Ofgem also suggests that the final values could be adjusted for RPI-indexation and the time value of money, using the appropriate rate of WACC, due to the delay in recovery from 2009-10. We do not agree that RPI or WACC adjustments are appropriate in this case.

We suggest that the basis of the adjustment should reflect the position that would have arisen if the 2009-10 revenue return been calculated with the corrected data at the time. Any increase in the calculated growth term would appear as an under-recovery at year end, and simply attract (assumed non-penal) interest as it rolled through subsequent years until the DNO was in a position to feed it into prices.

The net effect of resubmitting the complete series of relevant revenue returns can be replicated by applying the appropriate interest rate adjustments to the figures calculated in Ofgem's decision document. The adjusted figure can then be applied in the then-current revenue calculation.