SPEN response to “Further consultation on restatement of 2009-10 data and closing out the DPCR4 losses incentive mechanism”

2. Developments since the November 2012 consultation

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?

We recognise that for some DNOs there may a case to be made that the common normal period is not appropriate. The onus should be on the DNO to make such a case and to present substantial supporting evidence. We agree that any such evidence would need to meet two overarching principles: that the normal period chosen

(a) falls within the DPCR4 period, and
(b) does not include historically low, one-off, losses levels.

Robust statistical analysis designed to detect structural change (e.g. CUSUM analysis) would have to be presented to demonstrate that the chosen normal period was indeed preferable, on objective grounds.

Such analysis and the data should be made available for review by third parties.

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?

In accordance with the overarching principles, the normal period chosen

(a) should falls within the DPCR4 period, and
(b) not include historically low, one-off, losses levels.

Furthermore, because of the seasonal pattern of demand for electricity, the normal period should comprise complete years of data i.e. the normal period should be a multiple of 12 consecutive months. This is because, in the UK, losses would generally be higher in the winter months than in the summer months.

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?

We recognise that the outcome of the restatement needs to be credible. The application of the proposed cap helps to protect consumers from unreasonable outcomes.

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?

We would expect the cap to be derived from the same normal period as that used in the restatement process.

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)?

Post 2009-10 years should be treated in a way that is consistent with the treatment of 2009-10.

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?

We consider that justified restatement of 2009-10 data is appropriate for closing out the DPCR4 losses mechanism.

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?

Post 2009-10 years should be treated in a way that is consistent with the treatment of 2009-10.

3. Close out of DPCR4: Draft PPL terms

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

In the time available, we have not reviewed other DNOs' submissions in detail.

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

SPEN's submission for SPD and SPMW has complied fully with Ofgem's requirements.

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

SPEN agrees with the assessment of its submission for SPD and SPMW.

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

SPEN agrees with the draft PPL terms for SPD and SPMW.

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

[No response]

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

We remain concerned that the spread of apparent gains and penalties does not reflect the underlying performance of the DNOs as regards their management of losses. We observe that the range of customer impacts[1] is from a reduction of £23 per customer for SP Manweb to an increase of £37 per customer for LPN.

If stakeholders are unable to agree on an equitable outcome, we suggest, even at this late stage, the DPCR4 losses incentive is turned off.

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[1] Calculated as 5XE, in 2009/10 prices, from Table 2 on page 28 of the consultation document, divided by the number of customers.

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

We consider that the PPL values should be recovered over a short a period as possible, subject to the appropriate application of RPI indexation and the time value of money, as measured by the weighted average cost of capital (WACC). The longer the time over which the recovery is spread, the greater is the gap between performance and financial consequences, which weakens the power of an incentive mechanism, and is increasingly likely to affect a different generation of customers.

In the case of SPD and SPM, we do not see why their PPL values should not be fully recovered in 2015/16. An early determination by Ofgem would provide sufficient notice to suppliers to take account of this when setting their prices.

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?

RPI indexation should be applied consistent with that applicable for each regulatory year, so as to maintain the purchasing power of the PPL values which are set in 2009-10 price levels.

In addition, the time value of money should be applied. This adjustment for the lag between an amount being earned by the DNO and it impacting allowed distribution network revenue and therefore being recovered through network charges.

Conversely, where a refund to customers is due, there would have been a reduction in network charges in that year had there not been a lag. In this case, the time value of money adjustment would compensate consumers for not receiving a reduction in their charges until a future year.

The pre-tax equivalent of the weighted average cost of capital (WACC), in real terms, as set for each regulatory year is required for this purpose as there will be a corresponding change in corporation tax liabilities, which results in the appropriate adjustment, after tax.

The WACC is the appropriate measure of the time value of money as the adjustment is clearly linked to an economic value i.e. the shadow price of a Megawatt-hour of electrical energy, including the associated carbon emissions.

4. Restatement of losses data for 2009-10 annual incentive

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?

Based on the decision in paragraph 4.11 of the consultation which states "that we do not consider it appropriate to recalculate the growth term for years prior to 2009-10", we agree with the values for the growth term set out in Table 4 of £0.28m and £0.70m for SPD and SPMW respectively.

However, in our view, we believe that abnormal adjustment volume corrections should also be applied to 2008-09, as there is clear evidence that the growth term for that year is also distorted.

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?

RPI indexation should be applied consistent with that applicable for each regulatory year, so as to maintain the purchasing power of the amounts involved.

In addition, the time value of money should be applied. This adjustment for the lag between an amount being earned by the DNO and it impacting allowed distribution network revenue and therefore being recovered through network charges.

Conversely, where a refund to customers is due, there would have been a reduction in network charges in that year had there not been a lag. In this case, the time value of money adjustment would compensate consumers for not receiving a reduction in their charges until a future year.

The pre-tax equivalent of the weighted average cost of capital (WACC), in real terms, as set for each regulatory year is required for this purpose as there will be a corresponding change in corporation tax liabilities, which results in the appropriate adjustment, after tax.

The WACC is the appropriate measure of the time value of money as the adjustment is clearly linked to the investment which is required to provide additional capacity to distribute the additional units.