FURTHER CONSULTATION ON RESTATEMENT OF 2009-10 DATA AND CLOSING OUT THE DPCR4 LOSSES INCENTIVE MECHANISM

RESPONSE FROM NORTHERN POWERGRID

02 December 2013

EXECUTIVE SUMMARY

1. It is matter of concern to us - and we think that it must also be to the Gas and Electricity Markets Authority (the Authority) - that the value of our restatement application varies by £70m under the different positions taken by Ofgem on how restatement of losses should be conducted from March 2012 to the present. The underlying data and method used to restate 2009-10 losses has been largely unchanged over this period, meaning that the swing is almost entirely the result of variations in Ofgem's proposed approach to the design and application of the statistical tests, and the cap being applied to restatement outcomes. Moreover, virtually all of the movement occurs in one of our licensees, Northern Powergrid Yorkshire, which was materially affected by the change in supplier settlements behaviour this process is intended to normalise out of the data being used to close-out the DPCR4 losses incentive. Finally, the application of indexation to the close-out values, to reflect the delay to recovery, has the scope to magnify all of these issues if it is undertaken inappropriately.

2. Whilst we appreciate that these vicissitudes are indicative of the scale of the challenge that confronts Ofgem in its efforts to restore continuity to such an impaired dataset, they are also a clear signal that Ofgem needs to be very careful about relying too heavily on any statistical technique where quite small changes in the rules by which the technique is applied result in such huge swings in the outturn values for licensees and customers. In the presence of such sensitivity to the precise specification of the statistical test it is necessary to admit as much evidence of different kinds as is available and to test any results by reference to a reasonable view of the outturn that could reasonably have been expected when the incentive was proposed and accepted. This is just as true of the post 2009-10 years as it is of 2009-10, since the settlements activity by suppliers in those post 2009-10 years will impact 2009-10 data on a fully reconciled basis.

3. Moreover, the cap that Ofgem is presently considering would also be discriminatory in its impact on Northern Powergrid. A small number of licensees saw a particularly extreme increase in fully reconciled losses in 2007-08 as a result of the change in supplier settlements reconciliations behaviour in subsequent years. These licensees are materially affected by a decision to impose a common cap which fails to recognise the timing of the impact of the change in supplier behaviour on fully reconciled losses.

Meanwhile, other licensees which did not see the same scale of increase in losses in 2007-08 as a result of the change in supplier behaviour do not face as tightly binding a cap, and so benefit from a more positive outcome to the restatement process.

4. It is also certainly not the case that the cap, for Northern Powergrid Yorkshire at least, reflects the level of performance that could reasonably have been expected at the time of the DPCR4 settlement. It was already quite apparent at the time of that settlement that performance on the incentive could well involve losses more than 5% below the targets. The fact, the average levels of performance across the industry in the two years before those targets were set was 8% below the targets, and the upper-quartile level (which is perhaps a better measure of what might have been credible) was 12% below the targets. The Authority has recognised in the case of SSE that the windfall its price control settlement in relation to losses entailed should not be revisited, as to do so would undermine regulatory certainty. It should also apply this position to considering how the cap should be established on the results of restatement outcomes, since at present this is set (in the case of some licensees) above levels that could reasonably have been expected had there been no change in supplier settlements behaviour.

5. We have looked at this issue in detail and believe that Ofgem can take two straightforward steps, acting entirely within the framework set by decisions taken to date, which would result in a significantly more balanced outcome than the latest position entails.

   a) The same hurdle should be applied for restatement of the post-2009-10 reported data as is being applied to 2009-10. This would allow the overwhelming evidence that abnormal activity continued beyond 2009-10 to be taken into account.

   b) The cap should be modified, with both legs being adjusted. The leg which uses fully reconciled data should use the average of losses in 2005-06 and 2006-07, with no need to subtract 5%. This would remove from the cap the impact of losses in 2007-08 which are affected by the abnormal supplier behaviour, and give an indication of the level of fully reconciled losses that would have been possible absent any change in supplier behaviour. The leg which uses target losses should be based on targets less 12%, to make allowance for the level of

performance that an upper-quartile distribution network operator (DNO) could credibly have been expected to achieve when those targets were set. With both these changes made, each leg of the cap would be significantly more robust, and Ofgem should seriously contemplate moving to an approach which sets the cap on the basis of the leg of the cap which features higher losses. This should help mitigate any residual stakeholder concern that the cap is being set at too loose a level for any specific DNOs.

6. Whatever the outcome of restatement, the restatement values relating to 2009-10 are going to be recovered from revenues with a delay of at least five years. Given the magnitude of some of those values, the approach to indexation used has scope to generate financially material windfall gains or penalties (depending on whether the licensee has a positive close-out value, or a negative value). The drafting of the DPCR5 final proposals and licence made no mention of indexation for the delay, and in the case of the monies already earned under the DPCR4 annual incentive the current licence drafting is quite clear that no indexation is to be applied.

7. But even if Ofgem believes that it would be inappropriate to apply no indexation of the close-out value from 2009-10 prices, the only possible alternative that could be justified based on regulatory precedent comes from other regulatory incentives during the DPCR4 and DPCR5 periods that involved a delay to the recovery of incentive values, relative to the year in which performance was measured. In all these cases, of which there are many, the incentive value is calculated in money of the day in the year in which performance was measured, and then the time value of money used to reflect the delay in recovery is the Bank of England base rate. Choosing any other approach, when this is clearly the only way any reasonable person could have expected indexation to take place (if it was going to be implemented) at the time of the DPCR5 settlements, would undermine regulatory certainty and be damaging to the overall price control framework.

INTRODUCTION

8. On 21 October 2013 Ofgem published a consultation entitled *Further Consultation on restatement of 2009-10 data and closing out the DPCR4 losses incentive mechanism* ('the Consultation').

9. This document sets out the response to the Consultation of Northern Powergrid Holdings Company ('Northern Powergrid'), Northern Powergrid (Northeast) Ltd ('Northeast') and Northern Powergrid (Yorkshire) plc ('Yorkshire').

10. We have organised it under the section headings set out in the Ofgem Consultation, responding to the questions in the order they appear in that document.

DEVELOPMENTS SINCE THE NOVEMBER 2012 CONSULTATION

Section 2, 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?

11. Since publishing the consultation, Ofgem has also published analysis by Western Power Distribution (WPD) purporting to demonstrate that 2006-07 and 2007-08 are inappropriate as a normal period for its East Midlands licensee. We have therefore broken down our answer into three parts:

    a) The principles we believe Ofgem should apply in assessing any request for an alternative normal period;

    b) Potential sources of relevant evidence; and

    c) An assessment of the data presented by WPD in its request.

Principles to apply in considering requests for alternative normal periods

12. Northern Powergrid believes that Ofgem should take into account electricity distribution company (DNO) specific evidence where it suggests a common approach to the normal period would be inappropriate for that specific DNO.

13. Different DNOs have been affected in different ways by the change to supplier settlement behaviour that took place in the DPCR4 period. Different energy supply businesses are likely to have changed their behaviour at different points in time. The extent and timing of the change individual suppliers made to their behaviour in different regions may also have been influenced by how their customer portfolio had evolved and been managed over time in each region. Since the supply business with the largest number of customers in each DNO's distribution services area varies across the country, the impact of supplier changes in behaviour on different DNOs will have varied in both scale and timing.

14. Finally, in order to avoid a potentially discriminatory outcome, if Ofgem judges that a particular DNO should be allowed to alter its normal period, it should also assess whether other DNOs may be able to make a similar case (or provide other DNOs with the opportunity to do so in light of Ofgem's decision).

Potential sources of relevant evidence

15. Evidence that could be considered in support of an alternative normal period, if it suggests abnormality of supplier behaviour during the common normal period, includes:

    a) Visual inspection of the pattern of reconciliations over time;

    b) Statistical testing of the reconciliations data; and

    c) Direct evidence from energy suppliers that they had changed their behaviour (e.g. on the number of GVC corrections).

The evidence presented by WPD

16. The evidence presented by WPD is worth considering but it has a number of shortcomings.

17. Firstly, WPD has not been able to present any direct evidence from suppliers that the pattern of reconciliations in its East Midlands area was related to abnormal supplier corrections activity. E.On is likely to be the supply business with the highest market share in that region (since it has the historical customer base), and abnormal corrections

activity is not apparent in the other areas where it also has the historical customer base (UKPN's Eastern area, and Electricity North West's area). Of course, E.On may have undertaken a trial of its settlements corrections activity in the East Midlands area that started before similar activity in other areas so we cannot rule out the possibility that the pattern in the data was genuinely related to abnormal activity.[1]

18. Secondly, WPD has undertaken no statistical testing of the data. This is a weakness of the approach.

19. Thirdly, while the WPD analysis focusses on the pattern of reconciliations over time, the analysis is flawed and reaches erroneous conclusions in relation to other DNOs and the status of East Midlands as an extreme outlier. There are a number of manifest weaknesses in the analysis, which include the following:

    a) The data on reconciliations is used in absolute terms which fails to control for the size of the licensees. East Midlands distributes larger amounts of electricity than average, and so would be expected to see higher than average levels of reconciliations (all else held constant).

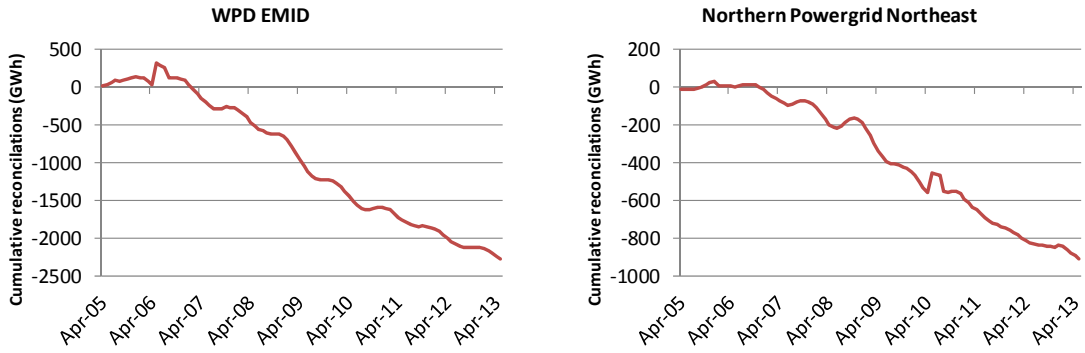
    b) No account is taken of the fact that different licensees may have had different normal patterns of reconciliations. For instance, one DNO might have normally received negative reconciliations (which were less negative than the subsequent abnormal behaviour) while others might have normally received positive reconciliations which then became negative.

20. Addressing the first of these weaknesses is possible by normalising by the number of units entering the network. When this is done, Northern Powergrid Northeast and Scottish Power Distribution also become apparent as having been affected by higher than average levels of negative reconciliations over the course of 2006-07 and 2007-08 (combined). Moreover, Northern Powergrid Northeast and Northern Powergrid Yorkshire are both shown as having received negative reconciliations well over 100% greater than the average during 2007-08.

[1] During our initial 2010 discussions with Npower, which we have generally found to be open and helpful during this process, NPower stated that it began its programme of enhanced corrections activity around the summer of 2007, initially focussing on small and medium enterprise customers, before subsequently initiating a larger scale programme in 2009 covering residential customers. This is apparent in the reconciliations received during 2007 in our Northeast and Yorkshire distribution services areas.

21. Turning to the second weakness, the pattern of reconciliations over time can be visually inspected using cumulative sum (CUSUM) charts. The charts below illustrate the fact that other DNOs exhibit similar patterns in the reconciliations data to WPD East Midlands, with reconciliations that were broadly neutral during the course of 2005-06, which then became markedly more negative from April 2007 onwards.

Figure 1: CUSUM charts for WPD East Midlands compared to Northern Powergrid Northeast



22. Overall, the WPD analysis does highlight that the licensee may have been affected differently when compared to some DNOs. But the outlier status of the East Midlands licensee is overstated by the analysis. Other DNOs could also legitimately claim that similar analysis would show that an alternative normal period should also be applied to them. The lack of any statistical testing means that the WPD analysis provides no clear framework for determining where the line should be drawn between such DNOs.

Section 2, 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?

23. If the common normal period is demonstrated to be unsuitable for a specific DNO, then any alternative normal period must be demonstrated to be a better approximation to the behaviour of energy suppliers before they changed that behaviour.

24. The same evidence we have suggested in response to the previous question, which could be used to identify if the common normal period is unsuitable, could also be used in identifying a more suitable period.

25. We note that the WPD justification for a potential alternative normal period does not use any of these potential sources of evidence.

Section 2, 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?

26. Northern Powergrid has views on the proposed credibility cap for both the close-out and the annual incentive. In summary, these are as follows:

a) The evidence on industry wide (and DNO-specific) fully reconciled losses does not support Ofgem's choice of 2006-07 and 2007-08 data for use in the cap, instead supporting the use of 2005-06 and 2006-07 data.

b) Ofgem's appropriate decision to honour the decision at the DPCR5 price control review for SSE suggests lower levels of losses should be admitted for the purpose of restatement than Ofgem's current decision allows for.

c) Losses at levels more than 5% below the DPCR4 targets could credibly have been expected across the industry at the time the DPCR4 deal was struck.

d) Losses at levels more than 5% below the DPCR4 targets could also have credibly been expected for the Northern Powergrid licensees.

e) A different cap should be used for close-out, to reduce the impact of abnormal supplier settlements behaviour on the eventual outcome of the restatement process. The evidence suggests this should be based on average fully reconciled losses over 2005-06 and 2006-07 (with no need to subtract 5%) and the DPCR4 period targets less 12% (since this represented upper-quartile performance based on the basis on which losses were measured when those targets were established).

f) Each of the legs of this alternative cap would be far more robust and evidence based than the two legs of the current cap, and if Ofgem were to adopt these improvements, it could seriously contemplate moving to the British Gas proposal of taking the tougher of the two legs to set the cap.

g) There is no logical reason to apply the same cap to restatement for the annual incentive as is applied to restatement for the close-out, since the data generating processes are different.

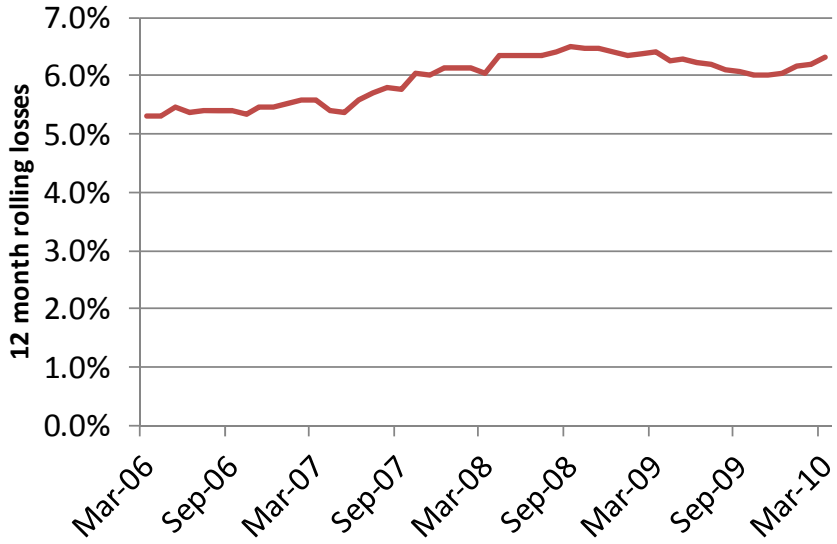
27. More details on each of these points are given below.

The evidence on industry wide fully reconciled losses does not support Ofgem's choice of 2006-07 and 2007-08 data for use in the cap

28. The credibility cap Ofgem has suggested for the close-out is inappropriate. This is because it incorporates losses data from 2007-08 which was affected by the change in supplier behaviour. The losses restatement process is intended to remove the effect of this change in behaviour from the dataset, so the cap as currently proposed means this objective is not achieved for all DNOs. Those DNOs where the impact of the change in supplier behaviour on measured losses was the most extreme are materially adversely affected by the inclusion of the 2007-08 data in the cap.

29. At paragraph 2.50 of the Consultation, Ofgem has justified its choice of 2006-07 and 2007-08 fully reconciled data, and the exclusion of 2005-06 (which formed part of the cap originally proposed by Ofgem in 2012), on the basis that DNOs have struggled to maintain unusually low losses seen in 2005-06, and that losses on a fully reconciled basis have displayed far more consistency over time. These statements do not accurately reflect the pattern seen in the data. The chart below shows fully reconciled losses on an aggregate basis for all those DNOs for which monthly data was published with the Consultation (12 in total).

Figure 2: Fully reconciled losses for DNOs applying for restatement



30. As can be seen from the chart, ***fully reconciled losses***, measured on a 12 month rolling basis, were indeed stable during the DPCR4 period up to June 2007, at between 5.3% and 5.6%. But they then stepped up to a new higher level, between 6.0% and 6.5%, at which they have remained. This step up was not related to the natural volatility of settlements. It was a direct result of the change in supplier settlement behaviour which took place in 2008 and 2009, since RF reconciliations received in 2008 and 2009, and DF reconciliations received in 2009 and 2010, will affect fully reconciled losses from mid-2007 onwards.

31. The charts for individual DNOs are reproduced at appendix 1. These again demonstrate that 2005-06 and 2006-07 show consistent, normal, levels of losses, before a step up from 2007-08 onwards as abnormal activity (which may have taken place in calendar years 2008 and 2009) begins to affect fully reconciled settlements data.[2]

32. The unusually low levels of losses during 2005-06 to which Ofgem referred are only seen in data which was reported as it was gathered, where reconciliation adjustments made by energy suppliers during the year 2005-06 (but which related to earlier settlements years) were reported against 2005-06. Since Ofgem is using fully

[2] We note that licensees operating in areas where E.On, Npower and Scottish Power are the legacy supply business exhibit fully reconciled losses in 2009-10 that are noticeably abnormal relative to levels seen in 2005-06 and 2006-07. Those licensees operating in areas where EDF are the legacy supply business show some signs of abnormality during the middle of the DPCR4 period, but this appears to have passed by 2009-10.

reconciled data to set the cap, these reconciliation adjustments have already been removed from the dataset. There is therefore no reason to exclude fully reconciled 2005-06 data from the cap.

Ofgem's appropriate decision to honour the decision at the DPCR5 price control review for SSE suggests lower levels of losses should be admitted for the purpose of restatement than Ofgem's current decision allows for

33. In considering the nature of the cap, it is important to consider the context set by the process which established the incentive and the targets at DPCR4. Ofgem has itself recently acknowledged that it would not be appropriate to revisit the benefit that will accrue to SSE as a result of honouring the final proposals made at a price control review, since it was already apparent when those proposals were made that losses measured on the basis being proposed were likely to be at levels well below the target. It is equally important to strive to honour that deal with respect to those companies that now need to restate their data to ensure that the outturn is measured on a basis that is consistent with the behaviour of suppliers when the deal was struck.

34. The DPCR4 licence conditions protected licensees and customers from the consequences of material changes in the way that losses data was reported. In activating this protective clause, and in its several decisions over the long period of time that commenced with our own application for restatement in 2010, Ofgem has repeatedly stressed the importance of ensuring consistency between the basis on which the DPCR4 targets were set and the basis on which performance against those targets would be measured. The purpose of the restatement exercise is not to arrive at an exact engineering level of electrical losses in 2009-10 but to arrive at the dataset that is most consistent with the dataset that would have resulted had suppliers not changed their behaviour.

35. It is important that this purpose continues to guide Ofgem in its treatment of the restatement applications that it has now received. We understand that Ofgem will wish to ensure that any restatement applications are subject to a sense check to ensure that they are reasonable. However, we regard it as axiomatic that Ofgem must do this in a way that recognises the context at the time the DPCR4 deal was agreed.

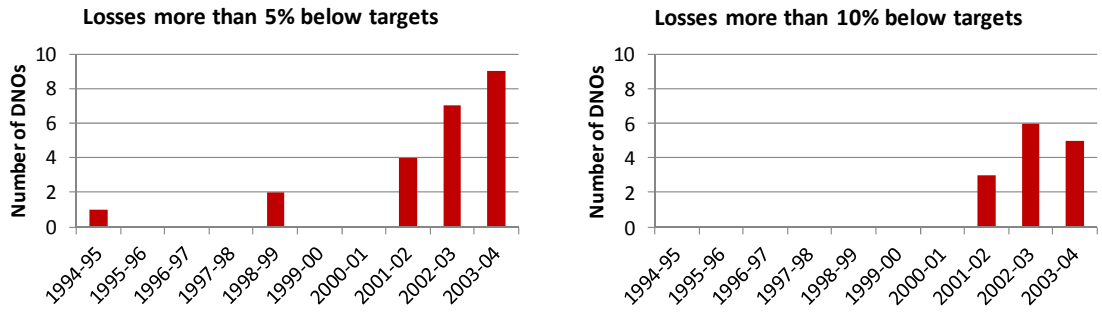
36. The parallel between Northern Powergrid's case and SSE's is strong even though SSE is not applying for restatement. In SSE's case Ofgem must allow the outcome to flow through because anything else would be detrimental to regulatory certainty. In our case restatement is necessary to restore losses to a level that is as close as possible to the level that would have been reported if there had been no change in supplier behaviour and the DPCR4 deal had outturned as both Ofgem and we could reasonably have expected. We note that, based on the figures in the November 2012 consultation, SSE will be allowed to recoup £91m in total from the DPCR4 period incentive which implies an outturn losses performance that is just under 12% better than its DPCR4 period targets. If the cap proposed by Ofgem is adopted, Northern Powergrid would be limited to £26m, which is much lower than the number we could reasonably have expected under the incentive (assuming consistent supplier behaviour) and such an outcome would necessitate a significant repayment of the revenue already recovered via the annual incentive.

Losses at levels more than 5% below the DPCR4 targets could reasonably have been expected across the sector at the time the DPCR4 deal was struck

37. Ofgem's justification for a figure of 5% less than the target loss percentage is based on the fact that losses were above this level 80% of the time in the data used to set targets. But it does not consider at what point in time losses were below the targets, which is also highly relevant to expectations at the point in time when the DPCR4 deal was struck.

38. The likelihood of considerable outperformance was apparent to all concerned at the point the deal was struck, because it was already evident in the data immediately running up to the setting of targets, and in the evolving performance data for 2004-05 which was already known when the final proposals were agreed. The charts below show the number of licensees reporting losses more than 5% and 10% below the DPCR4 targets in each of the years used to set those targets.

Figure 3: Number of DNOs reporting losses well below targets



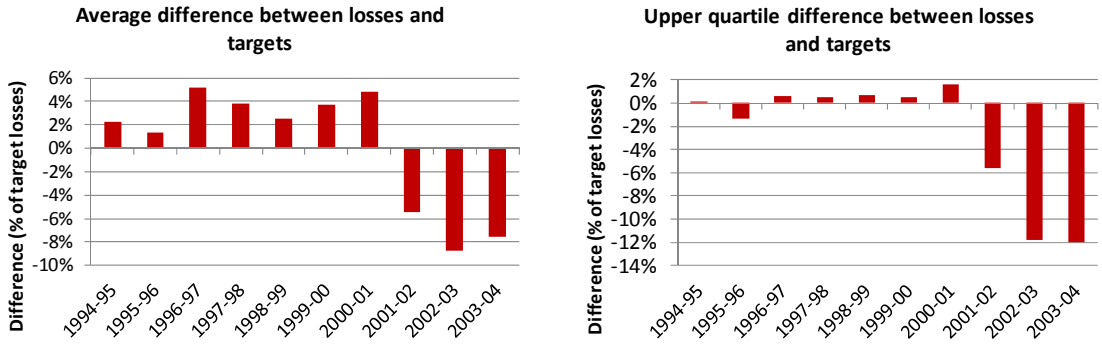
39. The years most relevant to credible expectations for performance on the losses incentive are those immediately before those targets were established (and the evolving performance during 2004-05, which DNOs would have had access to when they accepted the final proposals, but which is not included in the target setting database). This is because the DPCR4 price control required DNOs to retain the basis for measuring losses in the form that was in place in April 2002.

40. The first chart demonstrates that, in 2002-03 and 2003-04, seven and nine licensees reported losses more than 5% below the targets that were set at DPCR4. This means that, in 2003-04, almost three quarters of the industry reported losses more than 5% below the DPCR4 period targets, while in 2002-03 half of the industry did so. It is manifestly the case that losses more than 5% below the DPCR4 targets would have been credible, and within the reasonable expectations of all concerned, at the time those targets were set.

41. The second chart demonstrates that losses more than 10% below the targets would also have been credible. In 2002-03, six licensees reported losses below this level, representing almost half of the industry.

42. That leads to the question of what level of losses might have been credibly expected at the time the DPCR4 targets were set. The charts below show the difference between reported losses and the DPCR4 targets in each of the years used to set the DPCR4 targets, both taking the average of differences, and the upper-quartile level of difference.

Figure 4: Typical differences between reported losses and targets



43. The charts demonstrate that losses in the years immediately before targets were set were well below those targets. It is performance in these years which is most relevant to credible expectations of future levels of losses, provided there was no change in the basis on which targets were measured, a key requirement of the DPCR4 settlement.

44. The first chart shows that, on average, losses in 2002-03 and 2003-04 were around 8% below the targets that were set.[3] This means that, at the time the targets were set, it was credible that the *average* DNO would have achieved losses that were significantly lower than 5% below its targets.

45. The second chart shows the level of losses for a notional upper-quartile DNO (the average of the 3rd and 4th best performing DNOs). This gives a better measure of what might have been credible for some DNOs to have achieved on the losses incentive. As can be seen from the charts, upper-quartile DNOs reported losses 12% below the DPCR4 targets in both 2002-03 and 2003-04. Since Ofgem commonly uses upper quartile performance as a benchmark for achievability in its assessments, it follows that losses performance 12% below the DPCR4 period targets must have been credible at the time those targets were set – provided of course that no changes in supplier settlements behaviour brought about a change in the basis on which losses were measured.

46. Lastly, there are parallels with the treatment of SSE in Ofgem's (correct) decision that the DPCR5 deal must be respected. This decision will lead to losses that are more than

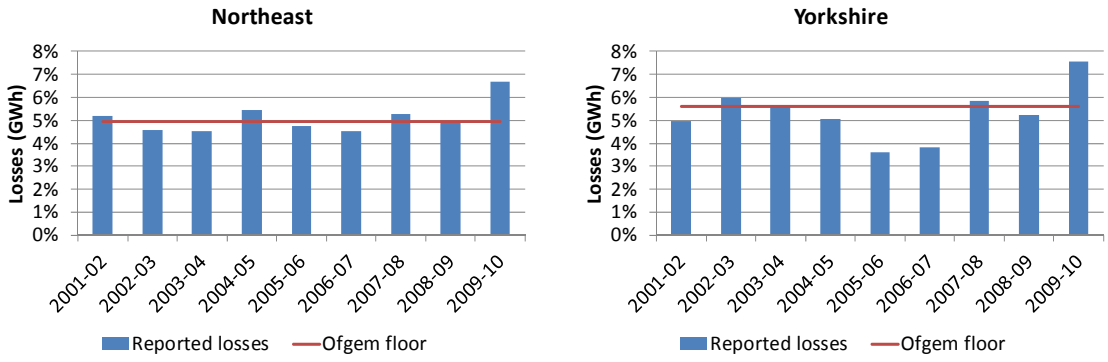
[3] The 8% figure is robust to calculating a weighted average figure, by taking industry wide losses in each year and calculating the difference to the targets those losses levels imply based on the DPCR4 target setting methodology

5% below the targets set for SSE. In fact, losses are almost 12% below the target. It illustrates that, while it is appropriate to protect customers from excessive gains due to restatement, defining that level at 5% below the level of the DPCR4 targets is not only overly restrictive but amounts to discriminatory treatment. The cap should not be designed to prevent a DNO from securing an outcome that another DNO (that was not subject to significant supplier data adjustments) has already secured. The DNO that has not been subject to these data adjustments has shown what was indeed 'credible' by reference to the deal that was struck. It would be discriminatory to set a manifestly less favourable limit on credibility in the design of the cap when the purpose of the exercise is to get back to the dataset that would have been used if there had not been any change in supplier behaviour. This over-riding purpose cannot be ignored in the design of the cap. And if it cannot be ignored, neither can it be given effect to in a way that discriminates against those distributors that have experienced the data changes.

Losses at levels more than 5% before the DPCR4 targets could also have credibly been expected for the Northern Powergrid licensees.

47. Northern Powergrid's experience of reported losses for 2001-02 to 2009-10 confirms this industry wide finding in its own specific case. It also confirms that Ofgem's proposed cap on restatement outcomes (which can alternatively be seen as a floor on losses) does not represent the level of performance that would have been credible at the time the DPCR4 targets were set. The figures are shown in the charts below.

Figure 5: Reported losses over 2001-02 to 2009-10



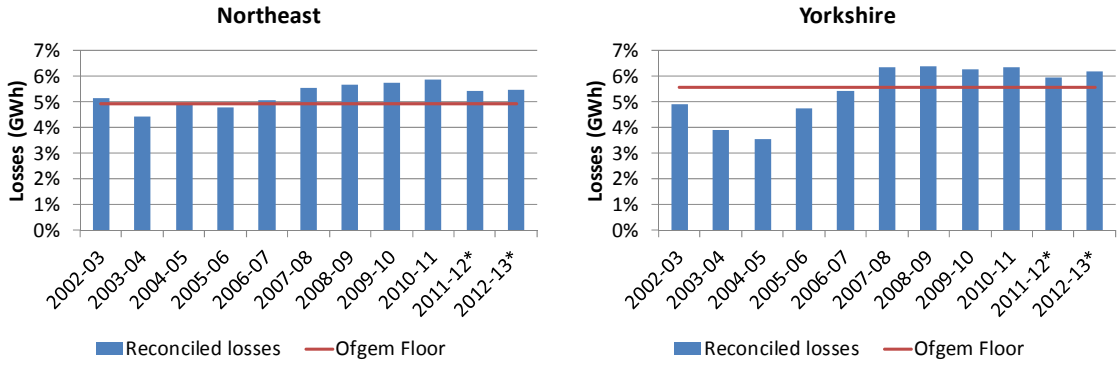
Note: Figures are based on original revenue returns, so do not include the updates which are necessary to arrive at an appropriate dataset for restatement, such as correcting the relatively minor issues identified during the audit of our data

48. Based on the data from the period immediately before the targets were set, and the emerging performance in 2004-05 to which distributors had access, a performance that was 7%-8% below the floor that Ofgem now proposes could reasonably have been foreseen in Northeast. Reported losses at this level were in fact seen in 2002-03 and 2003-04. In Yorkshire the unreasonableness of the proposed floor on restated losses is even more apparent, as a performance that was 10%-11% below the proposed floor could reasonably have been foreseen in Yorkshire at the time the deal was struck. Reported losses at these levels were seen in 2001-02 and 2004-05.[4]

49. The losses reported in these years also do not appear unreasonably low in the context of reported losses during the DPCR5 period. Although our reporting methodology includes no adjustments to settlements data, only 2009-10 in Northeast, and 2005-06, 2006-07 and 2009-10 in Yorkshire appear markedly out of step. These years aside, the data appears entirely consistent with that from the years running up to the start of the DPCR4 period.

50. Of course, the fifth distribution price control review moved the basis of measurement of losses for the purposes of close-out to reconciled data. The level of losses on a fully reconciled basis from 2002-03 onwards are shown below.

Figure 6: Fully reconciled losses over 2002-03 to 2012-13



** Data for 2011-12 and 2012-13 is not yet fully reconciled*

51. As can be seen from the charts, the floor on losses performance certainly does not appear to define the lowest level of losses that could have reasonably been foreseen,

[4] The principle that the best level of expected future performance under an incentive is the current level of performance has long been recognised by Ofgem. It was recognised, for example, in how the targets and interaction component of the DPCR5 losses incentive were developed.

even if years with historically low fully reconciled levels of losses such as 2003-04 in Northeast, and 2004-05 in Yorkshire, are excluded.

a) For Northeast, the floor on losses happens to be almost equal to the average of fully reconciled losses performance in the first two years of the DPCR4 period (i.e. the floor proposed in the November 2012 consultation on PPL), but it is still above the data for three of the five years prior to 2007-08 (i.e. the most recent 5 years' worth of data from a time before the abnormal behaviour of suppliers started to affect the dataset).

b) For Yorkshire the perversity of the proposed cap is even more apparent. It is above the level of fully reconciled losses seen in all of the years for which fully reconciled data is available prior to 2007-08 (when abnormal activity increases the level of losses significantly).

52. Moreover, fully reconciled losses illustrate another inconsistency inherent in Ofgem's proposed floor on restatement outcomes. The cap draws in data from 2007-08, which was manifestly and materially affected by abnormal supplier settlement behaviour which took place during the regulatory year 2009-10. Even though only 95% of the level of 2007-08 losses affects the floor, this figure is still well above the level of losses that could reasonably have been expected prior to the change in behaviour. The effect is most severe in Yorkshire, due to the scale of the step-up in losses that occurred as a result of the change in suppliers' behaviour. This means that the impact of the change in behaviour on the cap in Yorkshire is especially pronounced, because of the pattern of behaviour exhibited by suppliers in the Yorkshire area.

A different cap should be used for close-out, to reduce the impact of abnormal supplier settlements behaviour on the eventual outcome of the restatement process

53. The cap should be modified, either across the industry or for those specific DNOs where fully reconciled 2007-08 data is significantly affected by the abnormal supplier activity which took place in 2009-10.

54. The evidence set out above strongly suggests that an industry-wide cap could be implemented using the following approach for each of the two legs.

    a) The fully reconciled losses leg of the cap should use the weighted average level of fully reconciled losses seen in 2005-06 and 2006-07, since these years represent normal levels of fully reconciled losses before the change in supplier settlement behaviour. Since the cap would no longer feature 2007-08 fully reconciled data (which is affected by the change in supplier settlement behaviour), it would no longer be necessary to subtract 5% from the level of losses calculated based on the data.

    b) The target losses leg of the cap should use the targets less 12%, since this represents the level of losses that would have been credible at the time the DPCR4 deal was struck, based on upper quartile performance in the two most recent years for which complete data was available.

55. These two legs have considerable advantages. The first reflects the level of fully reconciled losses that could have credibly been expected based on the normal levels that were seen before the impact of the change in supplier settlements behaviour. This level needs no adjustment, and takes into account the fact that the DPCR5 settlement requires that the DPCR4 period be closed out on the basis of fully reconciled data. The second reflects the levels of losses relative to targets that could credibly have been expected at the time the DPCR4 deal was struck, assuming no change in supplier settlement behaviour. It also ensures that DNOs which were subject to abnormal supplier settlements behaviour do not suffer a discriminatory outcome relative to SSE, which was not affected by abnormal behaviour, and is closing out the DPCR4 period incentive at levels of losses almost 12% below its DPCR4 period targets.[5]

56. With these two changes, each leg of the cap would be significantly more robust. In light of this, we believe that if it were to adopt this alternative cap, Ofgem could seriously contemplate setting the cap at the level of the tougher of the two legs, as proposed by British Gas in the workshop on 18 November 2013.

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[5] The levels of fully reconciled losses in SSE's distribution service areas are largely stable over the DPCR4 period, showing no evidence of abnormal supplier behaviour. This is also the case in the South Wales area, where SSE is also the legacy supply business, adding weight to our view that losses in SSE's distribution services areas have not been affected by abnormal activity.

57. We note that, if this cap were to be applied to SSE, both legs would approximate to the levels of losses being used to close out its DPCR4 period settlement. This indicates that the cap proposed above does indeed define a credible level of losses that could have resulted for all DNOs in the absence of a change in supplier settlement behaviour.

58. We also note that using this alternative cap would have implications for how the proposed reciprocal cap would need to be calculated. A reciprocal could still be calculated by taking the percentage difference between the binding leg of the cap and the targets, and then using this to calculate the reciprocal level of losses.

There is no logical reason to apply the same cap to restatement for the annual incentive as is applied to restatement for the close-out

59. Since the data generating process can differ significantly between reported and fully reconciled data, there is no logical reason why it should feature the same level of losses. This is the case for DNOs that made 'non-settlements' adjustments to reported losses data. These might mean that their reported losses would be expected to run at a different level to fully reconciled losses (absent any changes in supplier behaviour), and so a different cap might be appropriate.

60. Such adjustments did not feature in Northern Powergrid's reporting methodology. The company reported losses in a way that means the timing of the impact of abnormal supplier settlements behaviour differed between fully reconciled and reported data. But that factor aside, there is no reason to expect a cap for annually reported data to differ from a cap for fully reconciled data. The current cap, that draws on fully reconciled losses in 2007-08, would be inappropriate since it is affected by abnormal supplier behaviour. But the alternative cap we suggest above would be appropriate for Northern Powergrid (and also some other DNOs which did not include adjustments in their annually reported data, such as the Scottish Power licensees).

61. Recognising, however, that some DNOs reported on a basis that would be expected to deliver a different level of losses compared with the fully reconciled measure of losses which must be used for the purposes of close-out, it may be appropriate in such cases for the annual incentive to be capped using a different cap to the one used for close-out. This alternative cap should still feature the same leg based on the targets. But the leg of the cap which depends on actual losses should depend on reported losses. This would

allow the 2009-10 annual incentive result to reflect the reporting methodologies of DNOs which made non-settlements adjustments to their annually reported data. The years chosen for the reported losses leg of this 'annual reporting' cap might need to differ from the years used in the cap for close out, reflecting the markedly different patterns of abnormality seen in reported data compared to fully reconciled data.

Section 2, 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?

62. Our views on the normal period to be used in the credibility criteria are set out in full in our answer to the previous question, from paragraphs 59 to 61.

63. Given that the 'as reported' dataset being used for restatement purposes is in most cases different from the fully reconciled dataset being used for the cap, there is no reason why the chosen normal period for the credibility criteria should be the same as the normal period stipulated for the restatement process.

64. There is also no reason that the same credibility criteria must be used for all DNOs, since the pattern of data seen over time varies between DNOs, reflecting differences in timing and extent of changes in energy supplier settlement behaviour.

65. The same principles should however be used in selecting a suitable normal period, regardless of whether this is for the restatement or for the credibility criteria. In each case, the normal period chosen should be selected in order to allow restatement of losses on a basis that is consistent with the behaviour of suppliers when the DPCR4 deal was struck, before the change in that behaviour.

Section 2, 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)?

66. It would be entirely logical for Ofgem to treat the post-2009-10 years in the same way as 2009-10. This is because data reported in the post-2009-10 years will, in the case of most DNOs, affect 2009-10 on a fully reconciled basis.

67. We are firmly of the view that the same standard must be applied to restatement of the post-2009-10 years as is applied to 2009-10, and that it is appropriate to take into account other evidence and not merely the results of the statistical tests. We hope that Ofgem will agree that, faced with this evidence, any other approach would lack consistency, it being hard to see how a rational judgement could include evidence for one year but disregard it in respect of another.

68. Our application sets out the relevant evidence to support our case for restatement under method C. Restatement itself is never in doubt for either of the Northern Powergrid licensees, due to the spike in abnormal activity which took place during the regulatory year 2009-10 (but which partly affects fully reconciled data for earlier years). Given that the effect of the change in supplier behaviour will continue to flow into settlements data unless suppliers make another subsequent behavioural change, there should be a presumption that subsequent years will require restatement to ensure consistency with the behavioural standard that prevailed when the price control was set.

69. Moreover, our application provides compelling evidence, both quantitative and qualitative, that the change in behaviour by suppliers has continued to affect post-2009-10 data. For instance, we asked suppliers once again for more information about their use of gross volume (GVC) after 2009-10. Although only two suppliers provided us with any more evidence in time for our application, the two suppliers that did both confirmed that the use of GVC continued after 2009-10. One of these suppliers is the largest supplier of premises in our region.

Section 2, 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?

70. Northern Powergrid supports the use of the reciprocal cap thresholds as a justification for permitting restatement.

71. Since the cap limits the extent of rewards that DNOs can receive under the DPCR4 period scheme, it is entirely logical and even-handed that a reciprocal cap should be used to identify cases where DNOs should be allowed to restate their 2009-10 losses.

72. We note that, if Ofgem were to move to the alternative cap we propose in response to section 2 question 3, this would also require a change to the reciprocal cap (on the basis described above at paragraph 58).

Section 2, 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?

73. Northern Powergrid agrees that reported equivalent data compared to the reciprocal cap in the post-2009-10 years should contribute to a case for identifying abnormality in those years.

74. As stated in response on section 2 question 5, the assessment of abnormality of reported equivalent data for post-2009-10 years should admit all the same sources of evidence as are allowed for 2009-10 data.

75. As set out in response to the previous question, Northern Powergrid believes the use of the reciprocal cap in identification of abnormality represents a logical and even-handed approach to the identification of abnormality. This is also the case for the post-2009-10 data.

CLOSE OUT OF DPCR4: DRAFT PPL TERMS

Section 3, Question 1: Do you have any comments on the submissions from DNOs?

76. We continue to believe that the additional evidence presented by Northern Powergrid in its restatement application, based on sources other than the reciprocal threshold, continues to justify restatement of the reported equivalent data for all of the post-2009-10 years.

77. We note that if Ofgem were to adopt a reciprocal threshold test for abnormality, based on the cap proposed in the Consultation, this would provide further evidence of abnormal supplier behaviour having affected losses in every relevant year for both our licensees, with the exception of 2011-12 in Yorkshire. If Ofgem were to adopt the

alternative version of the cap proposed by Northern Powergrid in response to section 2 question 3, along with the alternative reciprocal cap (described above at paragraph 58), this would provide additional evidence of abnormal supplier behaviour in every relevant year except 2011-12 and 2012-13 in Yorkshire.

Section 3, Question 2: Do you consider that DNOs have fulfilled the requirements set out in our July 2013 document?

78. Northern Powergrid considers that its submissions have fulfilled all of Ofgem's requirements in the July 2013 document, provided that Ofgem takes the logical step of admitting additional evidence, beyond the statistical test, to the assessment of abnormality in post-2009-10 years.

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

79. Ofgem has correctly evaluated the financial impact on Northern Powergrid of the various scenarios presented in the Consultation.

80. Ofgem has also appropriately treated all of the data issues identified in relation to Northern Powergrid since the audit of DNO data was initiated. The materiality threshold for any remaining data discrepancies strikes a proportionate balance between ensuring accurate data, the costs of further data audit work, and the fact that there are legitimate reasons for differences between different datasets, the scale of which can never be known with certainty, and which mean it will never be possible to reconcile exactly between various datasets.

Section 3, Question 4: Do you have any comments on the steps we have taken to calculate values of the draft PPL terms?

81. Northern Powergrid believes that the cap on 2009-10 fully reconciled losses used in calculating the draft PPL terms is inappropriate, since it incorporates fully reconciled

data from 2007-08 that is manifestly affected by the abnormal supplier behaviour which created reconciliations that were put through the settlements system in 2008 and 2009 (but which affected previous years), and since levels of losses more than 5% below the DPCR4 targets could credibly have been expected at the time those targets were set. Further details are set out in response to question section 2 question 3, including our proposal for an alternative cap (which is set out at paragraphs 53 to 58).

82. We also note that at paragraph 3.18 Ofgem has re-confirmed its decision to index the annual incentive amounts received during the DPCR4 period to 2009-10 prices. We previously stated, and continue to recognise, that the use of un-indexed annual incentive amounts would be inconsistent with the logic of the 5E calculation.

83. However, we now believe that the decision to index the annual incentive amounts before calculation of PPL should be reconsidered, and that no indexation should be applied to those amounts. Our rationale for this view is as follows.

    a) During the RIIO-ED1 licence drafting working group, Ofgem expressed a view (in relation to the Network Innovation Competition values) that if the proposals do not expressly mention indexation none should be applied, even if an alternative approach would appear more appropriate. If Ofgem were to implement such a principle in a blanket fashion then no RPI indexation should be applied to the DPCR4 period annual incentive amounts, since the DPCR5 final proposals make no mention of indexation.

    b) The use of DPCR4 period annual incentive values in nominal terms, rather than inflation indexed terms, will confer a benefit on those DNOs that recouped positive amounts on the annual incentive, since that value will be ascribed a lower value when it is netted off the gross close-out value ('5E'). Similarly, it will confer a cost on those DNOs that were in penalty on the annual incentive, since the value to be added to PPL will be smaller than if indexation was applied (on account of the fact the *negative* value to be netted off from '5E' will be smaller). This property of the DPCR5 final proposals should have been obvious to anyone inspecting them, as they were written quite clearly to use unindexed amounts from the annual revenue returns in the calculation of PPL. Since Ofgem has decided to ensure regulatory certainty by not revisiting the terms of the DPCR5

deal which conferred a windfall gain on SSE (the move to fully reconciled data, rather than its own engineering measure of losses), it should also not revisit the windfall gains and losses conferred on DNOs by the use in the calculation of PPL of DPCR4 period annual incentive amounts in nominal, un-indexed, terms.

84. We note that the DPCR5 licence still states that PPL will be calculated in nominal terms, since the content from the DPCR5 final proposals (as subsequently modified by Ofgem) which is referenced by the licence states:

> close out = corrected net LRRM incentive - ∑incentive over DPCR4
>
> where
>
> ∑incentive over DPCR4 is the sum of 'Incentive for Units distributed after 1.4.2005' from 2005-06 to 2009-10 as reported in the DPCR4 revenue returns.

85. The implication of these words, that the annual incentive values used should be those actually reported in the DPCR4 period revenue returns, is extremely clear. Since no indexation is referenced in the formula, the licence still admits no indexation to these values.

86. Ofgem has therefore still neither made the formal licence modification nor taken the formal licence modification decision that would be required to effect a calculation of PPL which provided for the application of RPI indexation to the DPCR4 period annual incentive amounts. As things stand we wonder whether Ofgem has the vires to implement a PPL that applies any indexation to those annual incentive amounts. No doubt this is something that Ofgem will consider before it proceeds to determine a close-out value that includes any indexation.

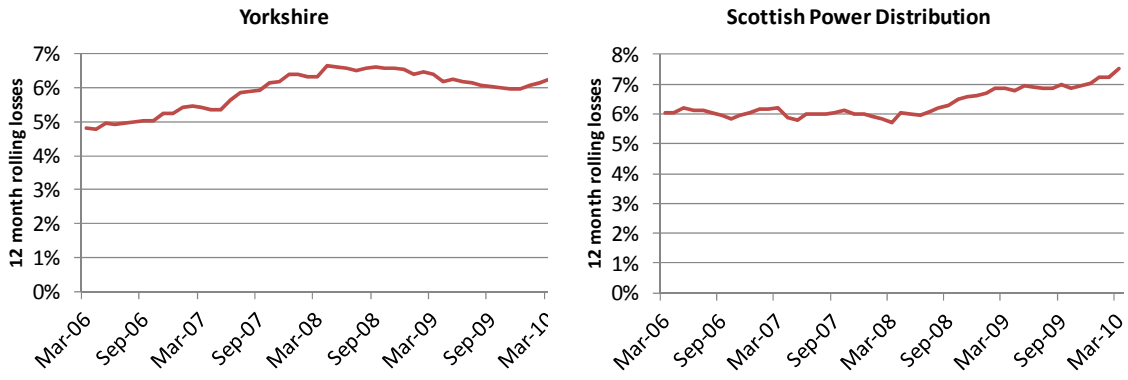
Section 3, Question 5: Do you agree that the cap has been applied equitably to relevant parties? Please provide evidence to support your argument.

87. We do not agree that the cap has been applied equitably to relevant parties.

88. Although the data has been calculated using the same formula, the different patterns of data seen by DNOs leads to the cap on some DNOs incorporating data that has been

more extremely affected by abnormal supplier settlements behaviour than others. The charts below illustrate these different patterns for two DNOs, Yorkshire and Scottish Power Distribution.

Figure 7: Fully reconciled losses in the DPCR4 period



89. The charts demonstrate that the cap for Northern Powergrid Yorkshire in particular incorporates fully reconciled losses from 2007-08 that reflects the changed supplier behaviour that the restatement process is intended to remove. Meanwhile, the cap for Scottish Power Distribution does not incorporate data affected by the abnormal supplier behaviour, since fully reconciled losses for that DNO started to rise in 2008-09, rather than 2007-08.[6]

90. Moreover, the cap will result in different outcomes for DNOs depending on the basis on which they reported, even if the pattern of supplier behaviour was identical. For example, Electricity North West reported data excluding reconciliations received in the dispute final (DF) round. The fully reconciled data used to define the cap also excludes DF reconciliations. Since these affect data at a lag of 28 months, the cap for Electricity North West will be less affected by abnormal supplier behaviour in 2009-10 than a DNO which experienced exactly the same pattern of supplier behaviour but which reported on a basis which included DF reconciliations. This would be discriminatory treatment, since the cap can reasonably be expected to be looser on those companies

6 An Elexon determination removed the South Scotland settlements area from the dispute final run process, for settlements dates (i.e. fully reconciled dates) from July 2007 onwards. This significantly limited the extent to which abnormal supplier activity in 2009 could impact fully reconciled losses in 2007-08. Northern Powergrid did not enjoy this same protection, and so the outcome of a cap which uses fully reconciled data from 2007-08 is discriminatory.

that reported on a basis that excluded DF reconciliations than those which included them.

91. The only way Northern Powergrid can see to avoid such a discriminatory outcome is to adjust the cap in the way suggested in response to section 2 question 3, at paragraphs 53 to 58. We also note that the cap we suggest would be almost exactly in line with the level of losses SSE is using to close out the DPCR4 period incentive. By moving to this cap, a discriminatory outcome for some DNOs relative to SSE could be avoided, without allowing any DNOs to restate to levels of fully reconciled losses that are below those they actually recorded during the DPCR4 period before the change in supplier settlements behaviour.

Section 3, Question 6: Do you consider that, more generally, the approach and calculations have been applied equitably in all circumstances?

92. As set out in response to the previous question, Northern Powergrid believes the use of the cap Ofgem has proposed leads to a manifestly inequitable approach being applied, since different DNOs have been affected by abnormal settlements behaviour to different extents and at different times, which the current cap fails to cater for.

93. It is also possible that the use of a common normal period for all DNOs could have a similar discriminatory effect on certain DNOs. Northern Powergrid has commented on this issue and the strength of the evidence presented by WPD in support of an alternative normal period in response to section 2 question 1, above.

Section 3, Question 7: Do you have any views on the appropriate period for recovery of the PPL based on the draft PPL terms?

94. The original DPCR5 settlement anticipated the recovery of PPL over up to three years but set no rules for how PPL would be split between those years, and no rules for whether it would be recovered more quickly than three years in the case of small amounts.

95. In light of this flexibility in recovering PPL within a timeframe of up to three years, and given the significant delays to the close-out in light of the issues with settlements data, Northern Powergrid proposes that the period over which PPL should be recovered should reflect the scale of the sum to be recovered.

96. As a practical way of balancing both the interests of companies and customers, reasonableness could be evaluated with reference to a fixed limit on the amount by which revenues can be affected in any given year. We suggest that a cap of £20m (in 2009-10 prices) should be used for this purpose, to avoid disproportionate cashflow impacts, but ensure cash is returned to (or recouped from) customers within a timeframe that is reasonable in the circumstances.

97. In practice, this would mean that DNOs with PPL exposure of less than £20m would see the whole of this amount enter allowed revenues in the first year of recovery. DNOs with £20m to £40m of PPL exposure would see £20m enter allowed revenues in the first year, with the remainder in the next. DNOs with over £40m of PPL exposure would see £20m enter allowed revenues in the first two years, with the remainder in the third year. The third year amount may be over £20m in light of some of the draft PPL terms being consulted on, but energy suppliers would have been given significant advance notice in order to factor this into their charges to end users and pass on the PPL amounts, so this does not appear inappropriate.

Section 3, 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?

98. We welcome Ofgem's decision to consult on how indexation should be applied to the close-out values to reflect the delay from 2009-10 in their recovery, and note that this issue has not previously been consulted on. There are two points we believe are relevant to the way in which indexation and the time value of money should be applied to close-out values.

99. Firstly, we note that the DPCR5 final proposals and licence are silent on the indexation of PPL, which was to be based on 5E calculated in 2009-10 values less the sum of annual incentive amounts included in the revenue returns. We noted in response to section 3 question 4 that**,** during the RIIO-ED1 licence drafting working group, Ofgem expressed a view (in relation to the Network Innovation Competition values) that indexation can only be applied in the manner written down in its proposals, even if an alternative approach would appear to be more appropriate. If Ofgem were to implement such a principle in a blanket fashion then no indexation of any form (for inflation or the time value of money) should be applied to the PPL terms to reflect the delay in their recovery.

100. Secondly, even if Ofgem does not believe that the approach described in the licence drafting working group would be appropriate in this case, there is an established framework in the DPCR5 and DPCR4 licences for reflecting delays in the recovery of incentive amounts. Even if some form of indexation to PPL had been intended when the DPCR5 final proposals were struck, the only possible option that could have been contemplated by any reasonable individual evaluating those proposals would have been the precedent established under other incentives. The table below summarises this precedent.

Table 1: summary of regulatory precedent on incentive indexation

Incentive	Delay to recovery	Indexation used
DPCR3 period		
Quality of service	2 years	Barclays Bank base rate
Losses	No delay	None specified
DPCR4 period		
Quality of service	2 years	Bank of England base rate
Losses	No delay	None specified
DPCR5 period		
Losses	2 years	Bank of England base rate
Interruptions	2 years	Bank of England base rate
Customer service	2 years	Bank of England base rate
Connections guaranteed standards	4 years	Bank of England base rate

101. In both the DPCR4 and DPCR5 period settlements, the only time that subsequent adjustments used the weighted average cost of capital was for *cost* items where an allowance would have been granted at a price control review if the relevant information had been available at the time of the review (for example, vegetation management costs). The close-out amounts are not a cost item, but instead the result of an incentive which has been unexpectedly delayed. It should therefore be treated in the same way as all the other incentives were treated in that price control period, through indexation using the Bank of England base rate.

102. In face of this strong precedent, it would be damaging to regulatory certainty if Ofgem were to choose an approach to indexation that deviated from both the exact drafting of the DPCR5 final proposals (which admits no indexation) and the precedent established by other similar situations in the licence (which admits indexation using the Bank of England base rate). Therefore, even if Ofgem does decide that some form of indexation would be warranted, the only reasonable approach would be to use the form of indexation adopted for delays to recovery of other incentive amounts under the DPCR4 and DPCR5 licence conditions i.e. to adopt the Bank of England base rate as the relevant time value of money with which to index the losses incentive close-out value from 2009-10 to the year in which it is eventually recovered.

RESTATEMENT OF LOSSES DATA FOR THE 2009-10 ANNUAL INCENTIVE

Section 4, 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?

103. The figures calculated by Ofgem in its assessment of Northern Powergrid's restatement for the purpose of the 2009-10 annual incentive correctly reflect Ofgem's stated intention in calculating those figures.

104. We also support the correction of manifest errors in previous years, as well as 2009-10, when calculating the restated growth term for 2009-10. If this were not done, then the growth term for 2009-10 would not be calculated on a 'like-for-like' basis.

105. We note that the losses figures for the annual incentive have been capped on the same basis as the fully reconciled figures for the close-out. All our comments on the cap, set out in response to section 2 question 3 above, apply to Ofgem's assessment of the restatement applications for the 2009-10 annual incentive. Moreover, as set out in response to section 2, question 3 at paragraph's 59 to 61, there is no logical reason why the cap used for the annual incentive should be equal to the cap used for close-out, since the latter uses fully reconciled data while the annual incentive uses reported data.

Section 4, 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?

106. There is no clear reason why any indexation or WACC should be applied to changes in the growth term, other than the normal treatment that was already established in the DPCR4 period licence to handle unanticipated fluctuations in that growth term.

107. Even in the absence of abnormal supplier settlements behaviour, licensees would not have known their 2009-10 growth term and allowed revenues until the year had finished. Any under- or over-recovery which resulted from a mis-estimation of the likely growth term would have been added to other under- or over-recoveries and indexed in the same way, using the Bank of England base rate plus 1.5 percentage points (or an alternative rate of penalty interest if under- or over-recoveries move

outside set bands). In certain special circumstances, where it was entirely beyond the control of licensees to avoid the extent of under- or over-recovery actually experienced, Ofgem has granted relief from the impact of penalty interest.

108. There is therefore no reason why the changes in the growth term being made now to correct for the effects of abnormal supplier behaviour should be treated in a different way. They should enter into 2009-10 under- or over-recoveries as stipulated by the terms of the DPCR4 period licence. Indeed, since the change to the growth term is to be effected through a resubmission of the 2009-10 revenue return (which will also necessitate resubmissions of more recent revenue returns), this treatment will follow automatically. It would be perverse for Ofgem to make further adjustments, either to the growth terms or to other price control parameters, in order to apply inflation and the weighted average cost of capital to the amounts.

109. If under- or over-recoveries exceed a set percentage, penalty interest would be imposed unless Ofgem exercises its ability to give relief from these different rates of interest. We note that paragraph 5.9 of the Consultation states that any application for such relief will be considered on its merits. We support Ofgem in its taking of this position, as it continues the established precedent from the relevant price controls for how under- or over-recoveries are treated.

Appendix 1 – levels of fully reconciled losses across DNOs

110. The tables below show the level of fully reconciled losses for all DNOs across the DPCR4 period.

111. The charts show losses measured on a 12 month rolling basis, i.e. in the 12 months to the month on the x axis of the chart. For example, losses at the left hand end of the line relate to the 12 months to March 2006, or equivalently the 2005-06 regulatory year.

112. We have organised them in two ways – firstly, by DNO group, to show the patterns each experienced, and secondly according to legacy electricity supplier in the DNO's distribution services area.

Figure 8: DPCR4 period fully reconciled losses for Northern Powergrid's licensees

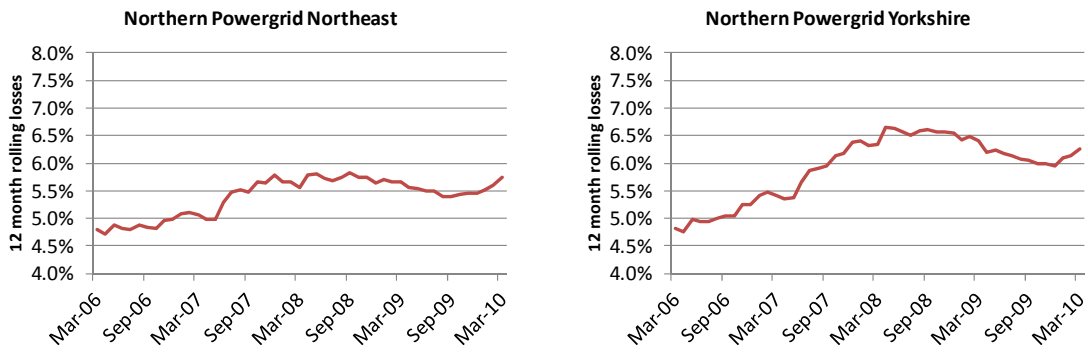


Figure 9: DPCR4 period fully reconciled losses for Scottish Power's licensees

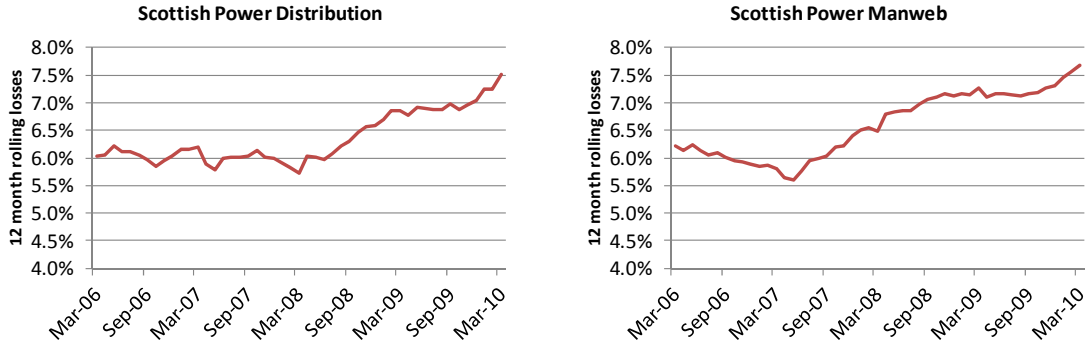


Figure 10: DPCR4 period fully reconciled losses for Electricity North West

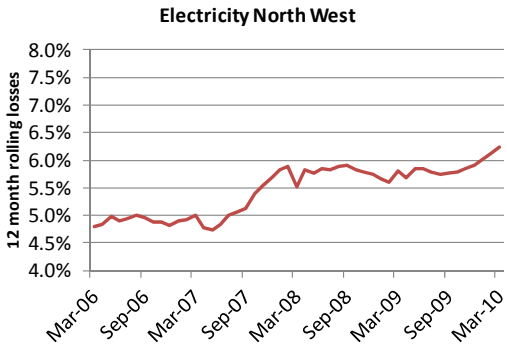


Figure 11: DPCR4 period fully reconciled losses for UKPN's licensees

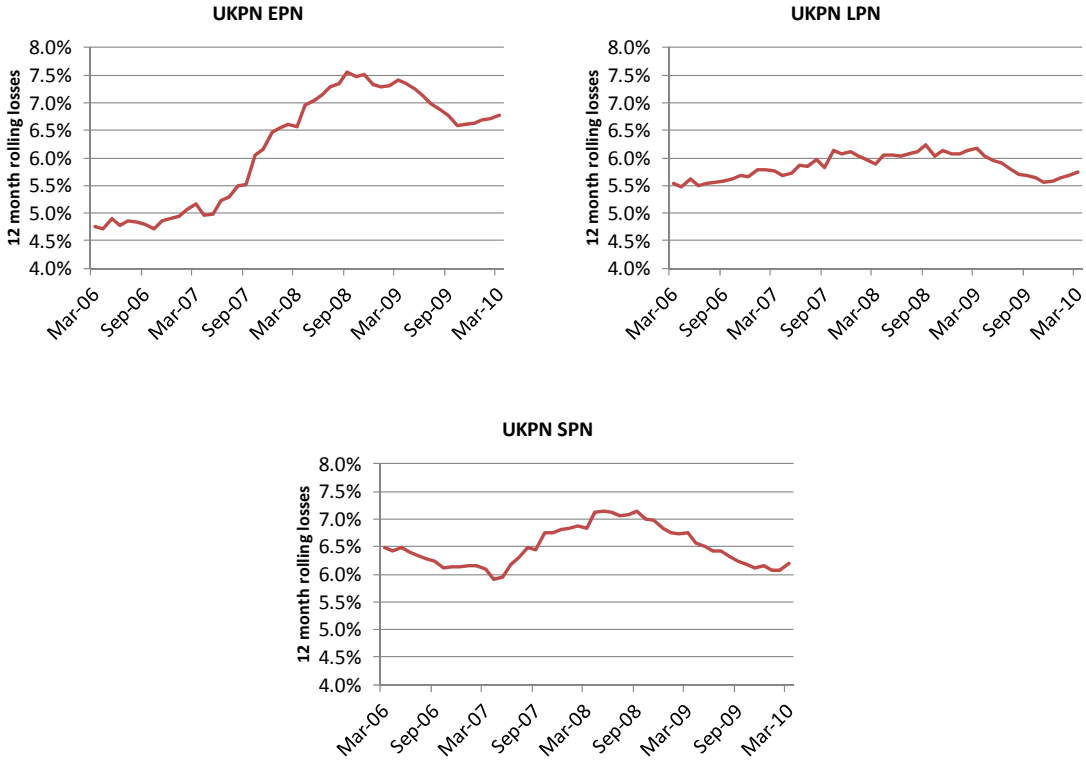


Figure 12: DPCR4 period fully reconciled losses for SSE's licensees

Note: monthly data has not been published for SSE Hydro and SSE Southern

Figure 13: DPCR4 period fully reconciled losses for WPD's licensees

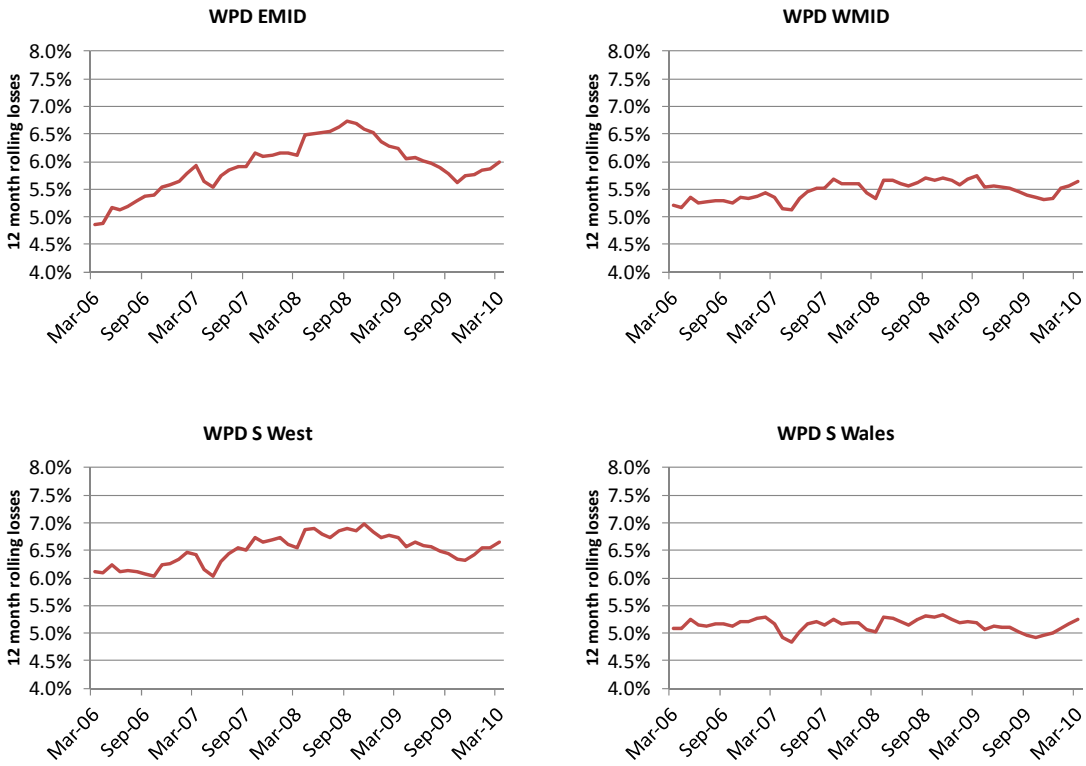


Figure 14: DPCR4 period fully reconciled losses for licensees where Npower is the legacy supplier

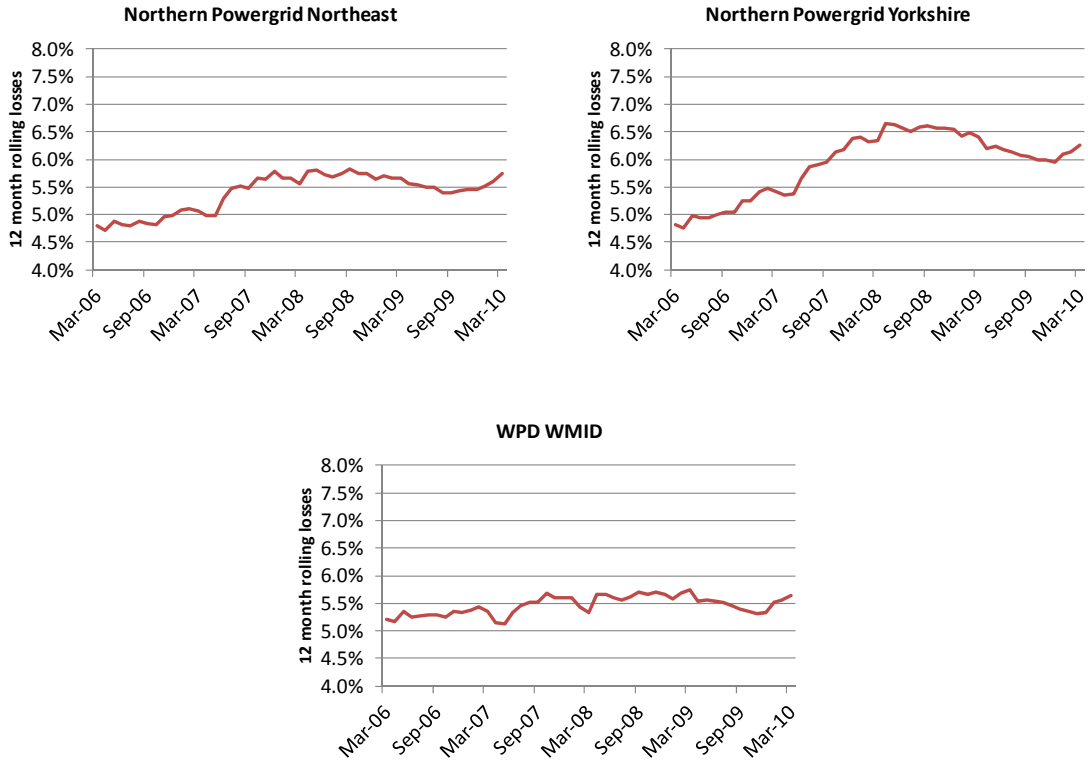


Figure 15: DPCR4 period fully reconciled losses for licensees where E.On is the legacy supplier

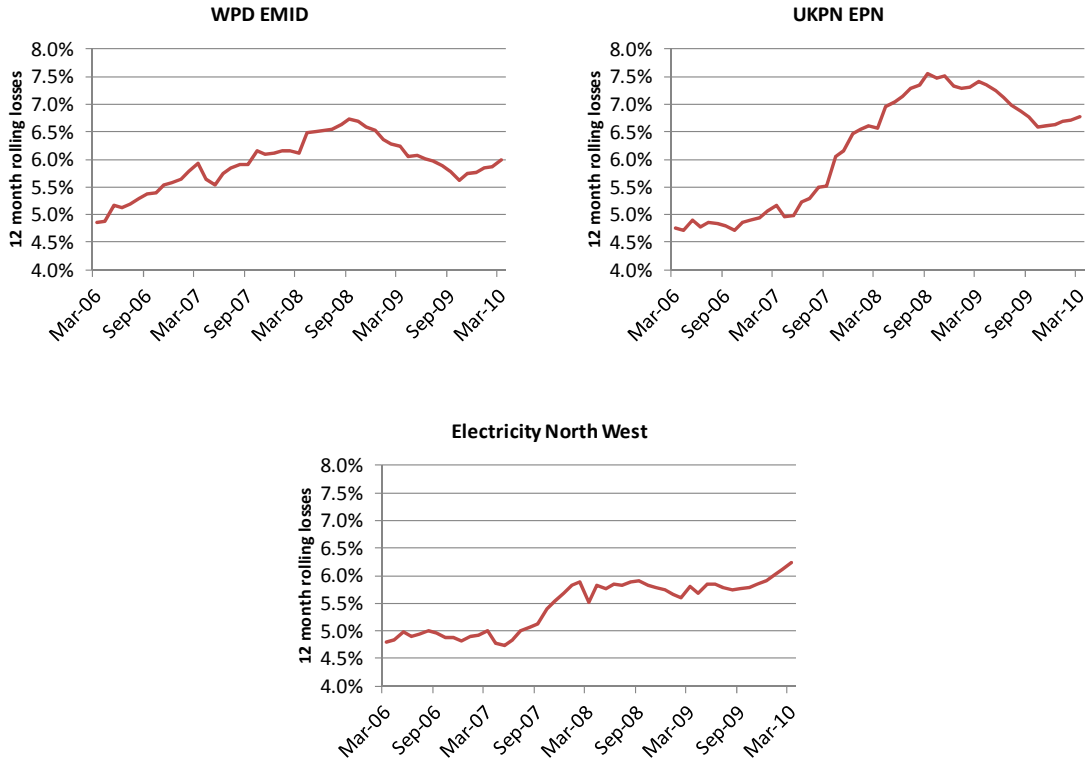
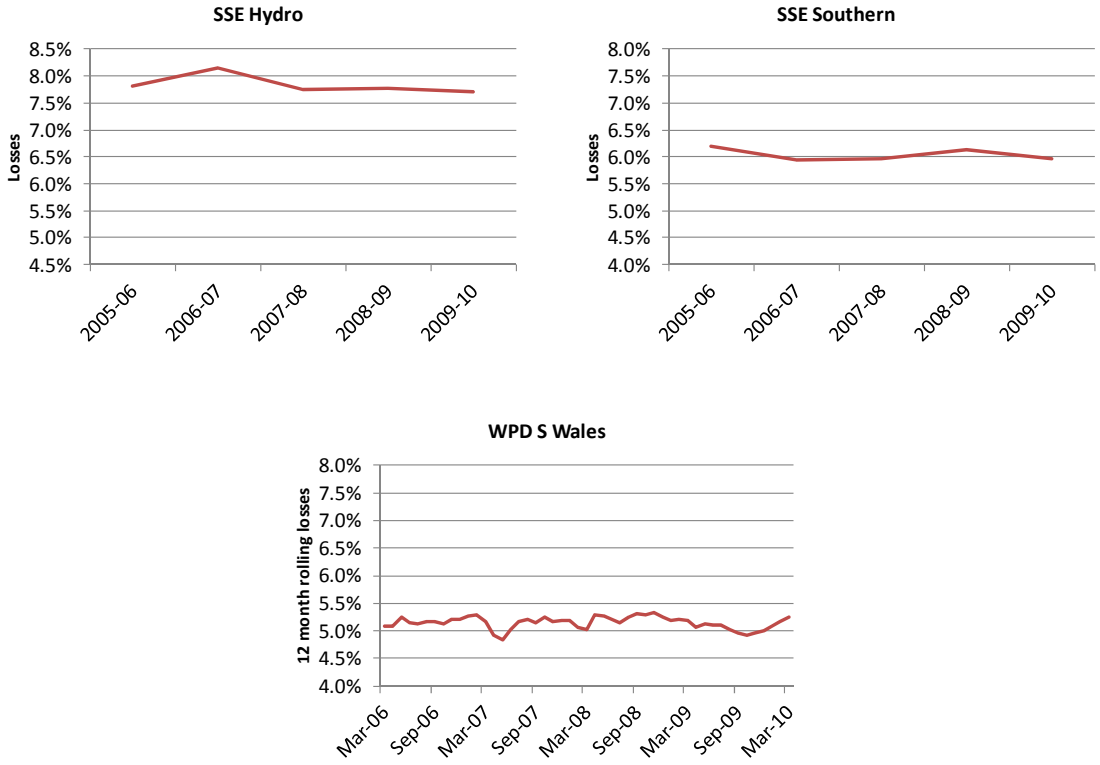


Figure 16: DPCR4 period fully reconciled losses for licensees where SSE is the legacy supplier



Note: monthly data has not been published for SSE Hydro and SSE Southern

Figure 17: DPCR4 period fully reconciled losses for licensees where EDF is the legacy supplier

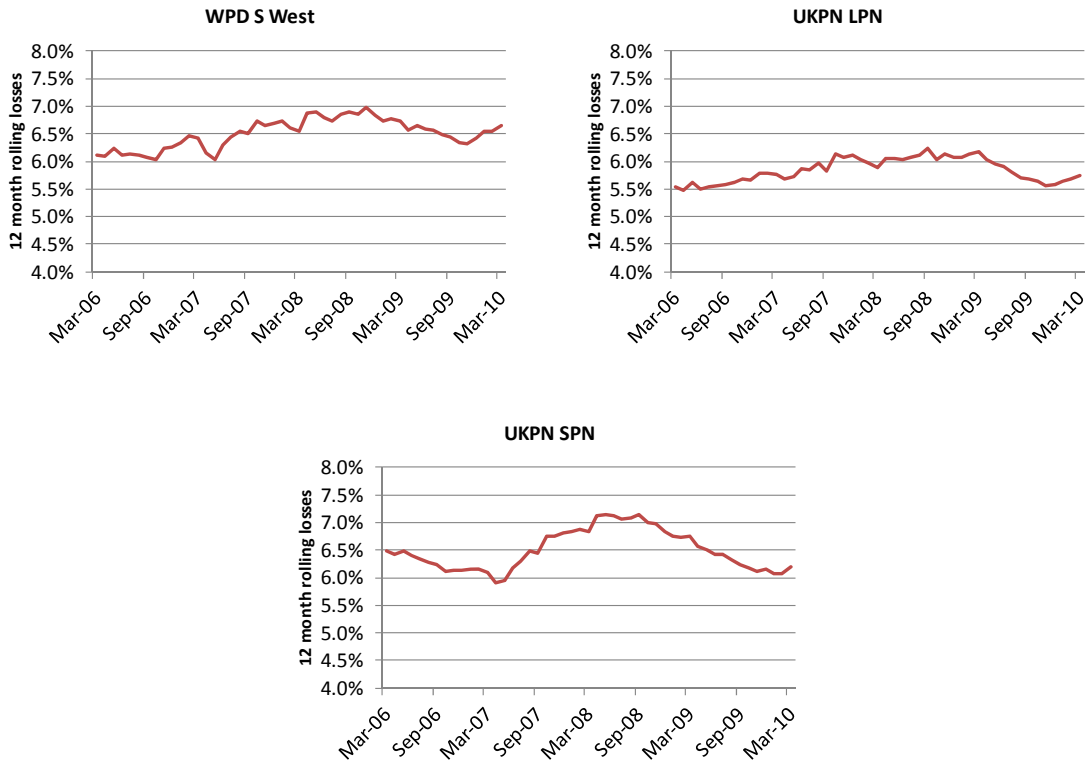


Figure 18: DPCR4 period fully reconciled losses where Scottish Power is the legacy supplier