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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 comment on this consultation. This response should be regarded as a consolidated response on behalf of UK Power Networks' three distribution licence holding companies: Eastern Power Networks plc, London Power Networks plc and South Eastern Power Networks plc. For convenience, the three licensees are collectively referred to as "UK Power Networks" throughout. Please note that our response is not confidential and can be published via the Ofgem website.

We have provided answers, where appropriate, to the consultation questions in the appendix to this letter but following on from your very useful workshop of 18 November there are a number of wider points that we would like to make.

UK Power Networks has made significant efforts to improve its losses performance in DPCR4. Ofgem has stated that the purpose of the losses incentive was to drive the DNOs to achieve an efficient level of losses on their distribution networks by taking positive action. We continue to believe that the DPCR4 mechanism was a very high powered incentive on DNOs to reduce losses and UK Power Networks responded to this incentive by:

- Establishing a dedicated in-house team to actively manage data quality.
- Employing an external contractor to conduct a field investigation programme inspecting sites that were physically energised but recorded as logically de-energised by the supplier, where no supplier meter readings had been received for extend periods or where the MPAN had not been registered by a supplier.
- Inspecting and performing technical checks on half hourly meters.
- Conducting audits of customers' Unmetered Supply Inventories
- Developing new IT to manage the programming of these activities and provide an analytical tool for desktop investigations of data anomalies.
- Continuing to provide a Revenue Protection service and subsidising that service to remove some of the disincentive on suppliers to actively manage theft.
- Actively engaging with Suppliers to improve data accuracy.

Between April 2005 and March 2012 our data management activities identified an estimated 2.5 TWh of non-technical losses (moving the loss percentage down across DPCR4 by at least half a percentage point) at a cost of over £30m. We achieved this despite reluctance from suppliers in more recent times to fully engage with our data management activities.

Our actions here were reinforced by Ofgem's observations to the workshop that the incentive was designed to have sufficient strength to motivate DNOs to take action and that they would have expected DNOs should have introduced measures to tackle losses in the early years of DPCR4 before they could see that there were problems with the data.

When the DPCR4 Losses Incentive was agreed the licence drafting<sup>1</sup> incorporated two options to address material changes (whether improvements or deteriorations) on the quality of information used to calculate losses. Either Ofgem could revise the targets or could change the reporting methodology. Ofgem and the DNOs are presently involved in this extended restatement and close out process on the basis of the latter precisely because the actions taken by suppliers towards the end of DPCR4 has created the situation whereby the reported losses are inconsistent with those on which the targets were set.

In closing out the DPCR4 losses incentive Ofgem must strike the correct balance between ensuring that those DNOs who took action are rewarded for their efforts to the long term benefit of customers, whilst protecting customers in the short term from unreasonable outcomes from the restatement process. This means that Ofgem must not give undue weight to any one aspect of the close out process that is not pragmatically supported by the evidence. A case in point here is the two legged credibility criteria process and the use of the lower of the two thresholds as the cap. We agree with Ofgem that the revised process for calculating the cap at 5% less than the overall losses percentage across the 2006/07 to 2007/08 normal period on a fully-reconciled basis is consistent with these aims and is the only credible cap for our three DNOs. We agree this irrespective that it results in UK Power Network's returning £26.5m to customers instead of earning a further £86.7m - a movement in customers favour from the restated position of £113.2m.

We would see any further capping/collaring, specifically at the higher of the two thresholds of a DNOs performance ( $\pm 5\%$  of DPCR4 targets as advocated by British Gas and WPD at the workshop) to be beyond what was agreed in the final DPCR4/DPCR5 settlement. We would see this as being a material reopening of these price reviews and a very significant movement into retrospective regulation. We also consider that capping at this level would require Ofgem to consult further as this would have to be applied to all DNOs and not just those that have applied for a restatement.

We would like to remind Ofgem that we have not accepted the decision in your 12 July 2013 document requesting that UK Power Networks reconcile the Units Distributed Not Accounted for in Settlement back into prior years. We continue to consider that to be inconsistent with Ofgem's DPCR5 Final Proposals of 7 December 2009. Nevertheless we made a submission on the basis requested by Ofgem reconciling the Data Management Units back into the relevant consumption year. This included a very reasonable and prudent calculation of units found post the DPCR4 period but relating to DPCR4 consumption years based upon the actual activities undertaken. We have further acceded to the essential asymmetry of Ofgem's approach by removing a category at Ofgem's request and curtailing assessment to the DPCR5 period.

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<sup>1</sup> Special Condition C1 of the DPCR4 Licence

We are concerned that the absence of data from suppliers and the very late plea from Ofgem for information concerning the adjustments that have made to settlement may result in some limited or incomplete submissions. We consider that Ofgem should exercise great caution in using any of this information as definitive evidence of data adjustments that suppliers have made in settlement. Ofgem will need to allow DNOs sufficient and appropriate time to review any data submissions including the opportunity to obtain from Elexon any available information about unauthorised post RF settlement adjustments made by suppliers.

Overall we consider that Ofgem's proposals in this consultation represent a pragmatic way to finally close out the DPCR4 losses incentive despite Ofgem's significant rewriting of the intent of the agreed close out mechanism. We look forward to finally closing out the DPCR4 losses incentive.

If you have any questions regarding this submission then please do not hesitate to contact me in the first instance. In addition we would be more than happy to come and see you again to discuss any points requiring clarity and to answer any questions that you may have.

Yours sincerely

A handwritten signature in black ink, appearing to read 'K Hutton', with a stylized flourish at the end.

Keith Hutton  
Head of Regulation, UK Power Networks

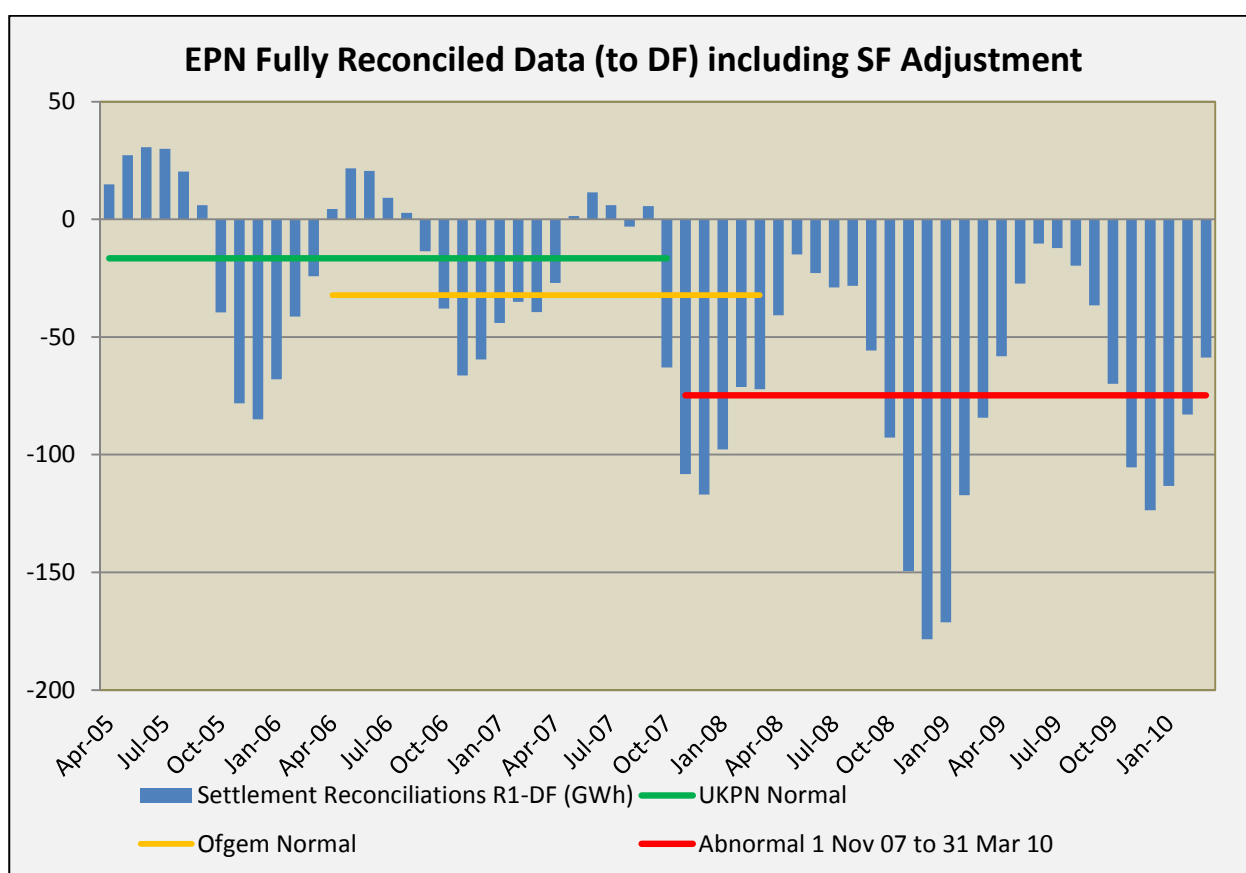
## Appendix – UK Power Networks’ response to the questions set out in the consultation

### 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?

We remain of the opinion that normal periods should ideally be selected on a licensee specific basis to reflect the differing mix of activities, timings and market shares of suppliers across the DNOs.

Comparing the DNO specific Normal Period identified for EPN in 2012 with the new standard Normal Period results in 12 months of what we would consider to be normal reconciliations being excluded and five months of abnormally negative reconciliations being drawn into the into the Normal Period. This is illustrated in the chart below.



However, we can understand and concur with Ofgem’s pragmatic decision (as with the introduction of a single more robust test to identify abnormality) to define a standard normal period for all DNOs removing their discretion over the choice. We consider that Ofgem should either allow all DNOs to select their own normal period or enforce a common period for all restatements. Given the length of the consultation process to date we do not see that there would be any compelling evidence for an individual DNO group to select their own normal period and we observe the clear risk to customers of ‘cherry picking’ were this permitted.

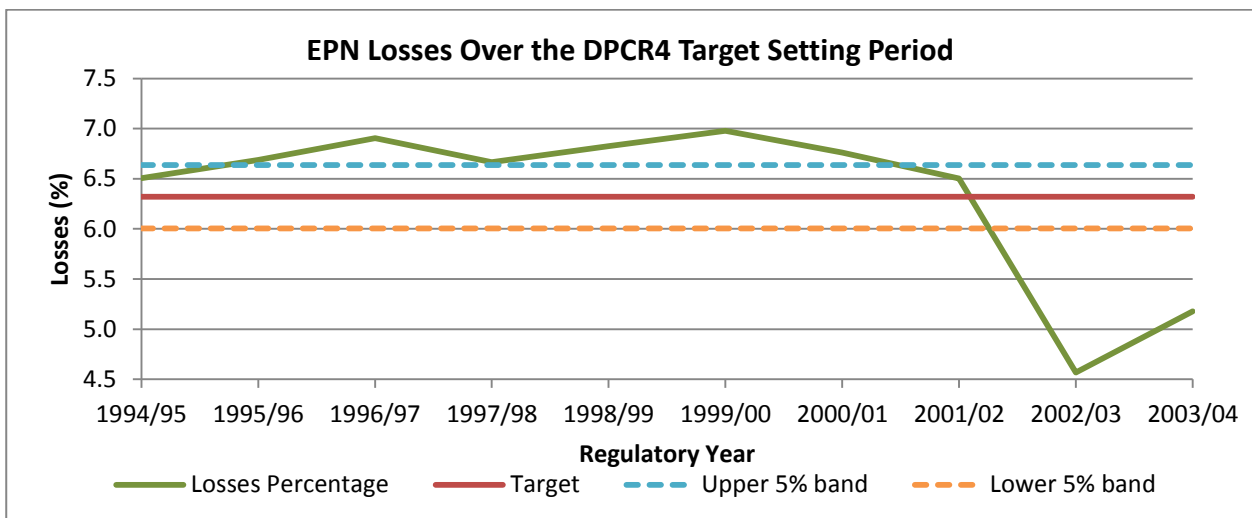
**Question 2:** Do you have any views on the suitable normal period to be used should a DNO demonstrate, based on evidence, that the stipulated normal period is inappropriate for the restatement process?

The criteria set out by Ofgem in their guidelines of 30 July 2012 for the selection of a normal period remain appropriate. A normal period must occur within the DPCR4 period and be at least two years in length. It must identify a period “where reconciliation corrections are at a more stable level”. This is the critical test for a normal period because the primary function of the SP Methodology is to normalise the R1 to DF reconciliations. Having identified a period where the reconciliation corrections are stable then under the guiding principles it must pass the second test that “reported losses performance during the normal period must be credible”.

**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 agree with Ofgem’s 2012 decision that credibility criteria are essential for the assessment of reasonableness of any restatement calculation. Ofgem set out its logic and reasoning for a credibility test in its November 2012 consultation. However, Ofgem’s July 2013 document proposed a significantly different credibility capping process, incorporating a hard mathematical calculation. The revised cap has two thresholds, five per cent less than the target losses percentage and five per cent less than the normal period losses where failure of these tests results in losses being capped at the lower of the two losses percentage thresholds.

We agree that the target losses percentage can provide a measure of credibility. However, we do not agree that 5% less than target represents the practical limit that a DNO could reduce losses particularly when targeting non-technical losses over time between the losses setting period and 2009/10. The target setting period starts in 1994/95 and if we look at the losses in EPN over the target setting period (shown in the chart below) then in only two of the 10 years are losses within the  $\pm 5\%$  range. Between April 2005 and March 2012 our data management activities identified an estimated 2.5 TWh of non-technical losses (moving the loss percentage down by at least half a percentage point). We consider that in the 11 years from the mid-point of the target setting period to 2009/10 and our data management activities during DPCR3 and DPCR4 a 10% reduction in losses is perfectly achievable.



We agree that the second and more important leg of the credibility cap needs to be refined to performance in the DPCR4 period. We also agree that fully-reconciled data displays far more consistency year-on-year than reported data and that the cap should, therefore, be on this basis.

Ofgem has elected to specify the same time period for both the normal period for restatement and the normal period for the credibility cap. It must be noted, however, that these two are not seeking to assess the same criteria. A normal period for restatement needs to identify a period where settlement reconciliations are normal. The credibility cap however needs to take a wider view and requires a period where the overall losses are normal. These do not need to be, and will not necessarily be coincident. We can however, see the pragmatic logic that where a hard mathematical capping process is applied that it should operate using the defined Normal period that has already been used to re-state the 2009/10 performance.

In the absence of abnormal data cleansing the underlying level of losses for our DNOs would be lower in 2009/10 than in the normal period (2006/07 and 2007/08). Given the time remaining in the DPCR4 period of we therefore agree with Ofgem that a threshold of 5% per cent below the normal losses performance is both appropriate and reasonable. This places the UK Power Networks capping values at the very top end of the range for a credible cap but we nevertheless feel that this is a reasonable way to limit consumers exposure whilst retaining the effect of the mechanism (and the regulatory settlement that it reflects).

The effect of the cap on the PPL values across our three DNOs is very significant as can be seen from the table below.

<b>Impact of Capping on PPL Values (£m, 2009/10 prices)</b>			
DNO	Restated Value	Capped Value	Variance
EPN	19.5	-34.1	-53.6
LPN	52.7	16.0	-36.7
SPN	14.5	-8.4	-22.9
<b>Total</b>	<b>86.7</b>	<b>-26.5</b>	<b>-113.2</b>

The difference between the capped and uncapped PPL values across UK Power Networks' three DNOs is £113.2m this is a significantly material value for us to forgo as a result of Ofgem's capping criterion.

**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?*

Given the decision to base the normal period for the credibility cap on the same normal period that is used for the reconciliation run re-statement then logically, should a DNO convince Ofgem that a different normal period is appropriate for the restatement process, then that same normal period should apply to the credibility cap calculation. Allowing differing normal periods would undermine the appropriateness of either period being considered as "normal".

**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)?*

We consider that post 2009/10 years should be treated in the same ways as 2009/10. If alternative evidence such as the reciprocal cap is permitted for 2009/10 then that same evidence should also be permitted for post 2009/10 years.

**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 the statistical test remains the most appropriate proof of abnormality. Permitting restatement based upon exceeding the reciprocal cap is a reasonable proposition when the DNO has failed to demonstrate abnormality through the statistical test.

**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?*

Once again the statistical test is the most appropriate proof of abnormality. However, as noted above, if other forms of proof are acceptable for 2009/10 then logically they should also be acceptable for the post 2009/10 years.

The reciprocal cap is the case in point here. Ofgem proposed in its July 2013 document that if the un-restated losses for 2009/10 were above both of the reciprocal cap thresholds, then a DNO may be permitted to apply for restatement even if it had failed the statistical test. Given that Ofgem has already determined that this is a secondary proof of abnormality in 2009/10 then it should be accepted as proof of abnormality in post 2009/10 years.

### **CHAPTER: Three**

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

We do not have any specific comments on the original submissions from the DNOs.

Since their original submission WPD have made a further submission proposing an alternative normal period that was published by Ofgem on 23 November. Having asserted at the workshop of 18 November that 2006/07 to 2007/08 was not suitable as a normal period for their East Midland region, it was asked of WPD whether they could identify a 24 month period within the 36 months from April 2005 to March 2008 where the reconciliations could be considered as normal. Their reply was "no".

The alternative normal period that has now been proposed by WPD does not appear to be based upon reconciliation levels which is the key requirement in the selection of a normal period. Rather it is based upon a two year period where the reported losses happen to be very similar to the target. Given that WPD have stated publicly on a number of occasions during the close out process that Ofgem should set their to set their losses performance to target this approach looks

like an outrageous example of 'cherry picking' a normal period to suite their desired outcome. Ofgem's guidelines of 30 July state that "all restatement applications must ... identify a normal period where reconciliation corrections are at a more stable level". Under the guiding principles "...in addition to stable reconciliation levels, reported losses performance during the normal period must be credible". On this basis WPD's proposed normal period does not comply with the guidelines for the selection of a normal period and should be rejected.

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

We consider that our DNOs' applications have fulfilled the requirements set out in the July 2013 document.

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

We do not have any specific comments on the assessment of the applications.

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

We do not have any specific comments on the calculations of the steps Ofgem have taken to calculate values of the draft PPL terms.

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

Notwithstanding our views on the principle of the cap (see above), the calculations performed by Ofgem are an equitable application of the cap.

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

We consider that our licensees have been treated equitably in this approach and in the calculations.

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

In its 25 April 2013 letter Ofgem indicated that the first year of PPL recovery would be 2015/16. However, when making the final PPL direction Ofgem will need to take into account the interim PPL values that DNOs have been directed to use for 2012/13 and 2013/14.

In its decision of 13 December 2011 Ofgem directed that the value of PPL for 2012/13 would be set consistent with the estimations that DNOs made in their November 2011 DCUSA forecasts. In the case of the three UK Power Networks DNOs these values were zero.



In its decision of 25 July 2012 Ofgem directed that DNOs should carry forward the estimations they made in their May 2012 DCUSA forecasts reports for the 2013/14 value of PPL to later forecasts. This was clarified further in Andy Cormie's email of 24 August 2012 that "we would also expect DNOs to be using the estimations they made in May of the value of PPL in their indicative and final tariffs for 2013/14". UK Power Networks along with other DNOs set its 2013/14 DUoS prices on this basis. Ofgem will need to direct that these values as used by DNOs are set as PPL values for 2013/14 in time for inclusion in the audited revenue returns in 2014.

In the case of the three UK Power Networks' DNOs these values are -£45m for EPN, £12m for LPN and £1m for SPN.

The requirement to direct PPL values for 2012/13 and 2013/14 in line with those used by the DNOs will mean that the final PPL values applicable from 2015/16 will be different to those published in this consultation (before allowing for the indexation up from 2009/10 money). This will need to be clearly explained in the final decision document.

As a matter of principle PPL values should be recovered in the shortest practical timescale that neither creates a significant one off distortion in DUoS nor is outside of a timescale that suppliers can reasonably plan for. We suggest that PPL adjusted for 2012/13 and 2013/14 revenue elements with indexation, should be recovered on the basis of 3% of allowed revenue per year from 2015/16 for as many years as are necessary.

**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?*

An indexation mechanism for PPL was not defined in the DPCR5 Final Proposals. It is therefore appropriate for consistency to take the same approach as that used for other incentive schemes that do have indexation defined in the DPCR5 Final proposals. There were two incentive schemes described in the DPCR5 Final Proposals where there was a lag between the year of performance and the year of payment. These were the Quality of Service incentive<sup>2</sup> and the (now defunct) DPCR5 Losses Incentive<sup>3</sup>. In both of these schemes values were calculated in the money of the year of record indexed up from any base value by RPI and then indexed up by Bank of England Base Rates into the year of payment. It is an established regulatory position that all deferred revenue incentives (non-investment) attract indexation of Bank of England Base Rate. We can see no logical reason why there should be any different approach to the setting of the out turn values in this case.

Ofgem has already in this consultation expressed all of the values in 2009/10 money which leaves only the base rate interest indexation to apply, taking account of any interim payments made by DNOs in 2012/13 and 2013/14 (as noted above).

The Bank of England Base Rate has been 0.5% since 2009 and the forward guidance from the Bank of England suggests that they will hold this rate until "late 2016". Given this we suggest that the pragmatic solution would be to set the annual indexation value at 0.5% and calculate PPL terms in a one off exercise, proving finalisation and clarity to the market.

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<sup>2</sup> CRC8 in the current Distribution Licence.

<sup>3</sup> The old CRC7

## **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?*

Units Distributed in 2009/10 were depressed by supplier's abnormal settlement adjustments. Re-stating 2009/10 using the SP/Engage/Ofgem methodology results in a more realistic level of units distributed and consequently a higher annual incentive value through the growth term. However, the application of Ofgem's proposed capping rule reduces the values of the growth term across UK Power Networks' three DNOs by over £7m, turning the values for LPN and SPN negative resulting in a reduction to the allowed revenue.

UK Power Networks applied for restatement of the 2009/10 annual incentive submission for all three of our licensees even though we expected that under Ofgem's proposed capping rules it would result in a reduction to the allowed revenue for LPN and SPN. We did this because we considered it to be unreasonable (and unfair to consumers) not to apply for restatement where Ofgem's revised single statistical test showed that abnormality had occurred even if this gave an adverse result for us.

**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 restatement applications for the 2009/10 growth terms are just that, restatements. Any policy for indexation must therefore be both consistent with the indexation methodology used for the interim restatements approved by Ofgem and with what would happen if a DNO were to restate its 2009/10 regulatory return for any other reason. Restatement will create a revised under/over recovery for 2009/10 which would be carried forward to 2010/11 and subject to indexation under CRC 14.2. In this case because the year being restated is several years back technically any restatement of 2009/10 should also be followed by consequential restatements of 2010/11, 2011/12 and 2012/13 (and possibly future years depending upon when the restatement was made). This is clearly not a sensible mechanism and we concur with Ofgem's proposal to address the restatement variance as a one off adjustment to a future year's allowed revenue subject to a time cost of money adjustment.

This time cost of money adjustment should follow the principles of CRC 14.2 with one important criterion. It should not cause a DNO to be placed into either of the penalty interest rate bands ( $PR_t = 0$  or  $PR_t = 3$ ) for either 2009/10 or any subsequent year given that a restatement on this basis was not even being contemplated within the time window that DNOs could have set charges to affect the 2009/10 revenue. This means that the restated 2009/10 growth terms variances should be indexed up from 2009/10 using a  $PR_t$  value of 1.5.

The Bank of England Base Rate has been 0.5% since before the start of the 2010/11 regulatory year and the forward guidance from the Bank of England suggests that they will hold this rate until "late 2016". Given this we suggest that the pragmatic solution would be to index the allowed revenue by 2% (0.5% Base rate plus 1.5%  $PR_t$ ) for each regulatory year from 2009/10 until the year in which Ofgem directs an adjustment be added into the allowed revenue.

Given their low values Ofgem should direct that annual restatement adjustments be applied to the 2015/16 allowed revenue in addition to any PPL value.