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Dear Tim,

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

This additional response to the above consultation follows Ofgem's recent publication of the data on supplier data cleansing activity between April 2005 and March 2013.

Taken at face value, the data would appear to suggest that all of the applications for restatement should be rejected. Only two regions exhibit negative data corrections during 2009/10 (Northern and Yorkshire) and even these two regions exhibit positive corrections in 2009/10 when we convert the data to the correct settlement date basis. Appendix 2 contains our observations on the data however overall we would point out that we do not consider that much, if anything, can be robustly concluded from it. More importantly, for the reasons provided below we do not consider the data to be relevant for the purposes of the close out of the DPCR4 losses incentive.

(1) DPCR5 Final Proposals were clear that the close out of the incentive would be performed using fully reconciled data and there is nothing abnormal with fully reconciled 2009/10 data

- Chapter 4 of the Final Proposals Financial Methodologies document is clear that the data to close out the incentive is 2009/10 reported data excluding corrections to **prior year**s and with **subsequent corrections** to the final year added in.
- The Elexon GVC clarifications in February 2010 meant that GVC corrections could then only be made at the RF run and correct for 'fluid' errors (i.e. those still having an effect on settlements). It is clear to us therefore that any abnormal corrections contained in 2009/10 reported data must relate to '**prior years**' which need to be removed for the close out and so cannot have any effect and any '**subsequent corrections**' to the final year cannot be affected by abnormal corrections due to the GVC rule changes.
- Not a single DNO passes Ofgem's statistical test for abnormality using unadjusted fully reconciled data.
- Fully reconciled 2009/10 data results in credible levels of losses when compared to the target. Ignoring SSE and SP (for different but obvious reasons) fully reconciled 2009/10 data results in aggregate losses which are only 0.19% higher than target (6.10% vs 5.91%) – much closer to the long term target than the equivalent proposed restated performance.

- We provided evidence in our main consultation response that demonstrates the primary driver for positive or negative levels of reconciliations is changes to the underlying level of demand and therefore continued negative reconciliations during a period of demand reduction is not abnormal.
- We are unclear why once the data specified for the close-out of the incentive had failed to demonstrate abnormality (as expected due to the Elexon GVC clarifications) this process has continued, with tests and data adjusted and further evidence permitted. We believe this may be because of a mistaken preconception that abnormality exists. This preconception may have its origins in the fact that there was a common misunderstanding of the DPCR5 Final Proposals in relation to the data that was to be used for the close out of the losses incentive (Ofgem's March 2012 consultation document indicated that reported data was to be used for the close out, and DNOs responses did not query). It is possible that this reported data may exhibit abnormality, but as the correct data to be used for close-out did not pass the statistical tests for abnormality, and would not be expected to, no further action was required.

(2) Settlement volatility is not new and DNOs accepted it with the DPCR4 price control

- We believe all parties (DNOs, Ofgem and suppliers) were well aware of the volatility of settlements data when the price control settlement was agreed.
- Appendix 1 contains a number of extracts from Ofgem documents and responses to those documents leading up to the acceptance of the DPCR4 price control. We believe these clearly show that DNOs, who received windfalls of over £400m from volatile settlement data relating to DCPR3, fully understood and accepted the risk associated with settlements data when they accepted the DPCR4 losses incentive.
- We do not accept that once all the data has been amended it is credible to suggest the original price control settlement is being honoured.
- We note that un-restated 2009/10 data would still result in DNOs receiving a reward of over £150m for the combined DPCR3 and DPCR4 period despite providing no evidence that their investment plans have been altered by the losses incentive in a way which would warrant any significant reward under the schemes.

(3) The DPCR4 losses incentive was designed as a symmetrical scheme to reflect performance in managing network losses over the long term. Reported performance in the period immediately prior to DPCR4 is not justification for any 'reasonable expectations'.

- All parties were fully aware of the volatility of settlement data and the risk associated with it when DNOs accepted the DPCR4 losses incentive.
- Ofgem made clear in their letter to Scottish Power in December 2007 that the losses incentive mechanism was **symmetrical** in nature and designed to reflect performance in managing network losses over the long term, adding that they considered that it was **well understood by all parties**, including SP, that the incentive was symmetrical (see appendix 1).
- Prior to setting the targets for DPCR4, Ofgem were well informed of the volatility of settlement data and had full visibility of the abnormally low levels of losses reported to them for some of the years prior to DPCR4. However they considered the issue to be primarily one of timing of the recording of units rather than affecting the aggregate volumes. We believe that Ofgem therefore considered the targets, based on a ten year average, to represent a sensible and symmetrical long term target.
- Therefore for any DNO, or Ofgem, to base expectations of incentive payments on the reported performance in a small number of years immediately prior to accepting the DPCR4

price control is neither reasonable, nor logical, nor supported by any of the consultations or responses leading up to the acceptance of the DPCR4 price control.

- We consider that for Ofgem to now accept such arguments as acceptable grounds for reasonable expectations would suggest that in fact Ofgem never intended the scheme to be symmetrical and set lenient targets simply as a mechanism to provide additional return to DNOs, which we do not believe to be the case.

Data that would be potentially useful for the current process

Whilst we consider the data published by Ofgem not to be relevant for the reasons we highlight above, below we list some data items that would be useful for the close out of the DPCR4 losses incentive if Ofgem insisted on re-opening the price control to allow restatements:

a) Confirmation of the incentive payments made to DNOs to date since 2000 for the losses incentive schemes.
b) Evidence of the incremental investments made by DNOs (over and above those funding by base revenues) to reduce losses to achieve these rewards or penalties.
c) Evidence that where non-settlement adjustments have been made by networks that these adjustments were also performed in the regulatory year 2002/03 and so were a valid element of the reporting methodology used to set targets.
d) Alternatively, where adjustments have been made which were not part of the 2002/03 basis of reporting, the evidence that this was approved ahead of time by the Authority.

<u>Appendix 1: Evidence of parties' understanding of the impact of settlements volatility prior to acceptance of the DPCR4 price control</u>

Ofgem October 2003 Update Paper:
Ofgem: "Several DNOs have noted that measurement of losses are a particular problem that undermines the incentive arrangements, partly because small differences in consumption, as estimated through the settlement process, could have a significant impact on measured losses. However, this situation is improving and does not, in Ofgem's view, present an insurmountable obstacle to an effective output incentive."

EDF Response (representing EPN, LPN and SPN licensees): "If the incentive does not support the associated marginal investment, the effect of Ofgem's revised arrangements would be simply to introduce more risk (mainly associated with data quality, which is outside distributors' control).

Ofgem March 2004 Policy Paper:
Ofgem: "DNOs have expressed concern that measurement errors following the introduction of competition in electricity supply to domestic consumer may unduly distort the level of the benchmark. However, Ofgem considers that this issue is primarily one of timing of the recording of units over the initial period since 1998 rather than affecting the aggregate volumes. As discussed in previous documents, Ofgem expects settlements data volatility to reduce in future years."

CN response to March 2004 Policy Paper:
"We are concerned though with the way the fixed five-year target is calculated. Using settlement data for the 1998–2004 period produces very volatile results."

EDF response to March 2004 Policy Paper:
"In addition, we continue to be concerned that Ofgem has asserted that settlements data volatility will reduce. Under the proposed mechanism if a change in settlement data occurs in the next price control period, which results in an increase in the reported losses, then the use of a fixed average will result in the company losing revenue for a circumstance outside its control. This must increase the risk that DNOs face and hence increase the cost of capital."

United Utillites response to March 2004 Policy Paper:
"Your proposals, while helping to simplify the calculations to be done, are unlikely to achieve much in the way of reduced carbon emissions, and continue to have the potential to damage DNO finances.
Our concerns throughout the discussion on losses have been:

- additional investment in low loss equipment needs to earn more than the standard cost of capital, since it is discretionary expenditure, competing with other optional uses of scarce capital; and
- the volatile nature of past reported performance introduces additional risk, especially if the value of 'saved losses' is increased."

June 2004 Initial Proposals:

CN response to June 2004 Initial Proposals:

"If, however, Ofgem wants to adopt the same transitional arrangements for all DNOs, a possible way forward is to reduce the weight of actual losses performance over the 1998-2004 period from 100% to 70% to address the uncertainty regarding the settlement system in setting DPCR 4 losses targets."

UU response to June 2004 Initial Proposals:
"In principle, we agree with your desire to increase the incentive on DNOs to manage distribution losses by incorporating environmental cost in the overall value. However, such an incentive must offer the prospect of rewards for good performance as well as penalties for poor performance. This is currently not the case as:

- The targets are set based on a historical period, including artificially low levels of losses; and
- The prospect of new remote distributed generation biases the scheme towards penalties.

We believe both can be remedied through suitable modification of targets and more considered treatment of future distributed generation.

Target for losses: It is essential that targets are set at a level that allows companies the prospect of rewards for improvements in performance, as well as penalties for poor performance. We have had detailed discussions with your staff around the target setting process, and have suggested specific adjustments to take account of the inconsistencies in the historical pattern of reported losses."

WPD response to June 2004 Initial Proposals:
"Ofgem have proposed an increase in the incentive rate for reducing losses. The increase may encourage changes to network plant and design. However such changes would only be achieved very gradually and would not affect the network for decades.

In contrast the apparent level of losses is subject to the smooth running of the settlements system and the settlements system that has experienced significant poor performance. In addition the inclusion of EHV sales and their associated losses means that the level of losses will be influenced by the activity in this market sector over which DNOs have no influence or control.

Overall the increase in the incentive rate adds to the short-term risks of the company."

CN response to September 2004 Update Paper:
"We thank Ofgem for meeting our request for a worked example of the losses targets before the deadline for this response. We are now comfortable with the calculation of the targets, which we accept as stretching but sensible benchmarks."

WPD response to September 2004 Update Paper:
"WPD confirms the views expressed in our response to the June consultation paper. These can be summarised as:

1. The increase in the incentive rate adds significantly to the short term risk of the company because of the increased impact of factors such as changes to EHV sales and further deterioration in the operation of the settlements system, both of which are outside the control of DNO's.
2. The target level of losses is weighted too heavily towards recent history, thus producing a target that is not a true 10-year average. The estimated cost of this difference is £5m to WPD during the course of a 5-year price control."

Ofgem letter to SP December 2007:
"Once the ALPs had been re-set it was always possible for there to be a range of financial outcomes, including reductions in allowed revenues, because the losses incentive mechanism is symmetrical in nature (i.e. it provides for both rewards and penalties) and designed to reflect performance in managing network losses over the long term.

We also note your argument that it is reasonable for SP to expect to be able to "meet if not in fact outperform the losses incentive target set by Ofgem at any point in time". This suggests that SP considers the incentive to be asymmetric and reward only – whereas we consider that it was well understood by all parties, including SP, that the incentive is symmetrical."

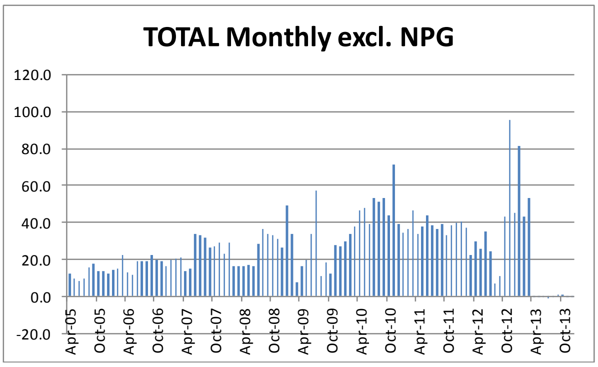
Appendix 2: Observations on supplier data cleansing activity data

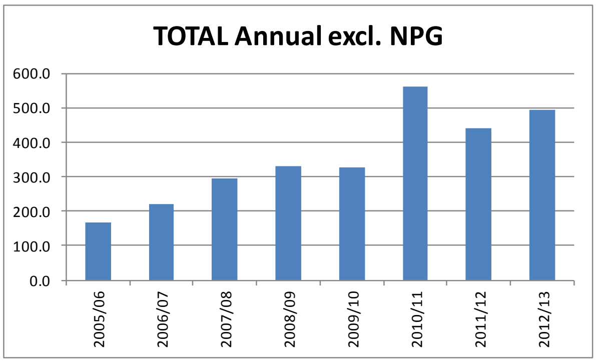
Whilst we do not believe that any robust conclusions can be drawn from the data published by Ofgem we would make the following observations:

- The data appears to show that there have generally been net **additions** to settlements via data cleansing activity during the period.
- The data for the WPD East Midlands region provides no evidence that would support their application for the use of a different normal period.
- The only significant exception to the additions to settlements is the 2009/10 **reporting year** data for the two Northern Powergrid regions – although we note with interest that the **reporting year** data for these regions in years subsequent to 2009/10 return to showing net **additions** to settlements.
- Even for the two Northern Powergrid regions the 2009/10 data on a **settlement year** basis also exhibits net **additions** to settlements – consistent with our view that **fully reconciled** data for 2009/10 is not affected by abnormal levels of settlement corrections.

Generally the data suggests that have been net additions to settlements:

Overall, with the exception of Northern Powergrid the effect of data cleansing from the data published by Ofgem is to **add** units to settlement.

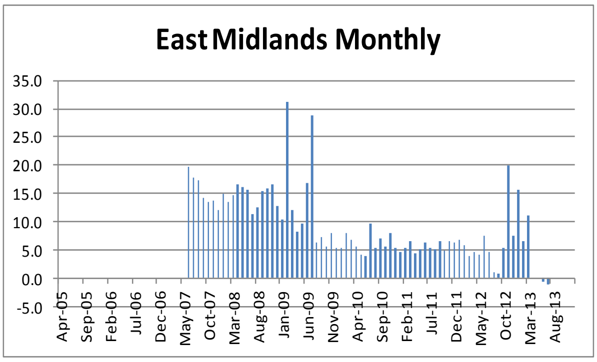


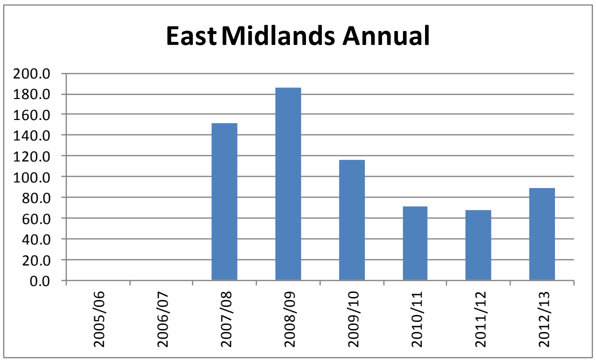


Whilst we do not believe that too much can be drawn from the data published, it clearly does not provide supporting evidence of abnormal settlement corrections for the majority of DNOs.

Data for the WPD East Midlands region:

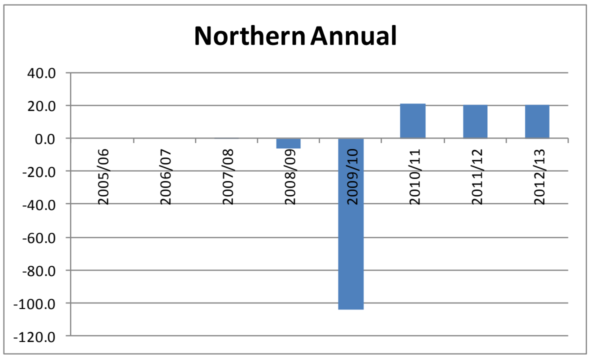
WPD have applied to use a different normal period for the East Midlands region and in our previous response we expressed our view that WPD had failed to demonstrate why 2006/07 and 2007/08 was inappropriate for the East Midlands. Certainly there is nothing in the further data published by Ofgem which would qualify as **strong evidence** which could support the application from WPD.

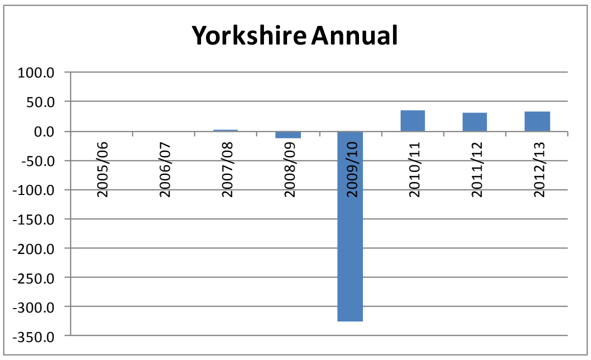




Data for the Northern Powergrid regions:

The two Northern Powergrid regions are the only two regions which exhibit reductions to settlements from the data published by Ofgem.





We would note however that if Ofgem accept the supplier corrections applied by reporting year as evidence for abnormality for Northern Powergrid in 2009/10 then the fact that the same corrections data turns positive from 2010/11 onwards would not support the case for allowing Northern Powergrid to restate the reconciliations received post 2009/10.

We would also note that when we look at data for the Northern Powergrid regions on a settlement year basis rather than on a reporting year basis i.e. the basis on which Northern Powergrid accepted that the close out the of the DPCR4 losses incentive would be performed, then 2009/10 also exhibits net additions to settlements.