

DNOs, consumers and their  
representatives, and other  
interested parties

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Dear Colleagues

**Open letter consultation on the applications from Western Power Distribution (WPD), SP Energy Networks (SPEN) and UK Power Networks (UKPN) for relief from the penalty interest, as a consequence of under recovery relating to the close out of the DPCR4 losses incentive mechanism**

1. In our<sup>1</sup> recent decision on closing out the DPCR4 losses incentive mechanism (published 21 March 2014)<sup>2</sup>, we indicated that we would consider applications from Distribution Network Operators (DNOs) in relation to any adverse impact or penalty as a result of the effect of the restatement of losses data or the anticipation of the residual losses incentive (PPL values) on allowed revenue under/over recovery positions.<sup>3</sup> This is to prevent DNOs being unfairly penalised for the under/over recovery of revenue related to the Authority's decisions not to activate the Distribution Losses Incentive Mechanism (published 16 November 2012)<sup>4</sup> and the decision on closing out the DPCR4 losses incentive mechanism.

*Background and DNOs' applications*

2. Where the actual amount of revenue a DNO collects through use of system charges in any Regulatory Year is higher or lower than its price control allowed revenue for that year, the difference is carried forward as an adjustment to its allowed revenue for the following Regulatory Year.
3. Under special licence condition CRC 14 (Distribution Charges: supplementary restrictions), if a DNO's actual revenue is less than 97 per cent of allowed revenue, the under recovery is uplifted by the Bank of England Base rate when brought forward, and the supplementary penalty interest rate adjustment (the  $PR_t$  term) is set to zero. Conversely, if a DNO's actual revenue is greater than 103 per cent of allowed revenue,  $PR_t$  is set to 3 per cent. This represents a penalty for the DNO, because a smaller under or over recovery would attract a  $PR_t$  value of 1.5 per cent.<sup>5</sup>
4. WPD, SPEN and UKPN have submitted applications to us requesting relief from the  $PR_t$  value of zero for affected Regulatory Year(s)<sup>6</sup>. The applications are a result of the effect of the restatement of losses data or the anticipation of PPL values leading to their actual revenues collected being less than 97 per cent of their allowed revenue for affected Regulatory Year(s). These applications are published as subsidiary documents to this consultation.<sup>7</sup>

<sup>1</sup> The terms "Ofgem", "the Authority", "we" and "us" are used interchangeably in this document.

<sup>2</sup> <https://www.ofgem.gov.uk/ofgem-publications/86757/decisiononclosingoutdpcr4lossesmechanism-mar-14.pdf>

<sup>3</sup> Paragraph 2.183

<sup>4</sup> <https://www.ofgem.gov.uk/ofgem-publications/45566/1adecisionlossesdpcr5161112.pdf>

<sup>5</sup> Under CRC 14, if a DNO's actual revenue collected is not more than 103 per cent of allowed revenue and not less than 97 per cent of allowed revenue,  $PR_t$  equals 1.5 percent.

<sup>6</sup> The affected Regulatory Year is the Regulatory Year that the actual under/over recovery took place.

<sup>7</sup> <https://www.ofgem.gov.uk/publications-and-updates/consultation-applications-western-power-distribution-sp-energy-networks-and-uk-power-networks-relief-penalty-interest-consequence-under-recovery-relating-close-out-dpcr4-losses-incentive-mechanism>

5. In order for us to be able to direct a different value of  $PR_t$  it is necessary to modify CRC 14 for WPD, SPEN and UKPN. On 24 July we consulted on proposals to modify CRC 14 for those licensees<sup>8</sup> and we recently issued our licence modification decision to modify CRC 14.<sup>9</sup> This is expected to come into effect on 24 October 2014 and will allow us to direct a change to  $PR_t$  values for WPD, SPEN and UKPN.
6. Before issuing a direction under the modified CRC 14, we seek views on our minded-to position on the necessary  $PR_t$  value(s) for the affected Regulatory Year(s).

*Our minded-to position*

7. Based on the applications from WPD, SPEN and UKPN we are satisfied that, in relation to the losses incentive values, their decisions to under recover allowed revenue were justified. We are also satisfied that their treatment of the anticipated PPL value(s) caused the  $PR_t$  value with respect to the affected Regulatory Year(s) to be zero and that without the PPL value(s) they would have incurred a different  $PR_t$  value. Therefore, in relation to the losses incentive values, we are minded-to provide WPD, SPEN and UKPN with relief from the penalty interest rate ( $PR_t$ ) of zero with respect to the affected Regulatory Year(s).
8. The table below sets out the affected Regulatory Year(s) covered by this consultation, the required change to  $PR_t$  with respect to the affected Regulatory Year(s), and the expected impact on allowed revenue. Additional detail on how these figures are calculated can be found in the subsidiary documents published alongside this consultation.

DNO	Licensee	Affected Regulatory Year(s)	$PR_t$ value to direct with respect to the affected Regulatory Year(s)	Expected change to allowed revenue (£m)	DNO application	Ofgem comments with respect to the affected Regulatory Year(s)
WPD	EMID	2013/14	0.66134	+0.19	See Subsidiary document 1A and WPD's response to the statutory consultation on CRC 14 <sup>10</sup>	See Subsidiary document 1B which uses the latest information from WPD to show how we have calculated a $PR_t$ value of 0.66.
UKPN	EPN	2013/14	1.5	+0.58	See Subsidiary document 2	We have verified the numbers in the UKPN's application for Regulatory Year 2013/14 and agree with the proposed change to $PR_t$ .
SPEN	SPD	2011/12	1.5	+0.22	See Subsidiary document 3	We have verified the numbers in SPEN's application and agree with the proposed change to $PR_t$ .
	SPMW	2011/12 & 2012/13	1.5	+0.55		

<sup>8</sup> <https://www.ofgem.gov.uk/ofgem-publications/88929/statconcrc14losses.pdf>

<sup>9</sup> <https://www.ofgem.gov.uk/publications-and-updates/decision-changes-licence-condition-crc-14-relation-dpcr4-losses-incentive-mechanism>

<sup>10</sup> WPD's response to the statutory consultation provides additional information on the under recovery - <https://www.ofgem.gov.uk/ofgem-publications/89479/wpdresponsetocr14changes.pdf>

9. For UKPN and SPEN, a  $PR_t$  value of 1.5 per cent is proposed to be directed with respect to the affected Regulatory Year(s). Excluding the impact of the anticipated PPL in the affected Regulatory Year(s), UKPN and SPEN would have received a  $PR_t$  value of 1.5 per cent.
10. For WPD, a  $PR_t$  value of 0.66 per cent is proposed to be directed with respect to the affected Regulatory Year. See Subsidiary document 1B for further information on this calculation. Excluding the impact of the anticipated PPL in Regulatory Year 2013/14, WPD's East Midlands licensee (EMID) would have been in an over recovery position of greater than 103 per cent, attracting a  $PR_t$  value of 3 per cent under the provisions of CRC 14. A  $PR_t$  value of 0.66 per cent with respect to the affected Regulatory Year ensures that the additional allowed revenue EMID can recover is a value that:
- means it does not suffer any penalty interest adjustment caused by the anticipated PPL (ie it receives interest of 1.5 per cent on this value) but,
  - it incurs a  $PR_t$  value of 3 per cent on the over recovery that would have occurred had the under recovery in relation to PPL not taken place.

*Applications for relief from  $PR_t$  for revenues recovered in Regulatory Year 2014/15*

11. In their applications, WPD and UKPN have also requested relief from an anticipated  $PR_t$  value of zero for revenues recovered in Regulatory Year 2014/15. This request will be considered under the new CRC 2A (Restriction of Allowed Distribution Network Revenue) for RIIO-ED1, which is expected to come into effect on 1 April 2015. We expect any applications for relief from  $PR_t$  with respect to revenues recovered in Regulatory Year 2014/15 to be made in 2015, once the regulatory returns have been submitted. This will provide us with the complete information on actual and allowed revenues to determine whether there is a need to direct an alternative  $PR_t$  value.<sup>11</sup>

*Responding to this consultation and further information*

12. We are seeking stakeholders' views on our minded-to position outlined in this letter. Responses should be sent to the above address for the attention of Tom Mackenzie, Distribution Policy or emailed to [thomas.mackenzie@ofgem.gov.uk](mailto:thomas.mackenzie@ofgem.gov.uk) by 15 October 2014. We consider that a four week consultation period is sufficient because of the limited scope of this consultation.
13. Subject to the modifications to CRC 14 coming into effect and responses to this consultation, we propose to issue a Direction to adjust  $PR_t$  by November 2014.
14. This consultation is limited to the particular facts put forward by WPD, SPEN and UKPN, and is without prejudice to any future consideration of revenue adjustments resulting from the close-out of the DPCR4 losses incentive.

Yours faithfully,



**Dora Guzeleva**  
**Head of Networks Policy: Local Grids**

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<sup>11</sup> Evidence for Regulatory Year 2014/15 has been redacted from UKPN's application because we are not considering it as part of this consultation.