SP ENERGY NETWORKS

Regulation & Commercial

By E-mail

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Date:
19th September 2014

Contact / Extn:
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Dear Andy,

Re: Consultation on a proposal to increase significantly the notification period for changes to distribution use of system charges

Further to your letter dated 8th August regarding the above which relates to the DCUSA change proposal DCP 178, please find below the response from SP Distribution plc and SP Manweb plc.

We are very supportive of the principle of introducing price certainty and understand the importance of this to both Suppliers and Customers. However we believe this would be better met by addressing areas of volatility with the current methodologies rather than the approach proposed by DCP 178 which only focuses on predictability. In addition, we believe that DCP 178 conflicts with recent Ofgem ED1 licence updates designed to improve the link between costs and prices. Our comments on the specific questions raised are provided below.

1. Do you agree with the working group's view that DCP 178 would result in these benefits and costs

Regarding the benefits and costs, we make the following points:

- DCP 178 will make charges predictable for a specific period of time it will not necessarily make them any more transparent than they already can be under the current arrangements.
- The Change Report includes reference to Suppliers offering longer term contracts – 15 months' notice may not assist contracts of longer than 2 years and may in fact make it more difficult to predict tariffs if the impact on DNO's allowed revenues are more volatile and material over/under recoveries result. The likely step change in charges is an issue which could not be quantified by the working group therefore the impact remains unknown. Addressing areas of

volatility within the current charging methodologies would be a far better approach for DNOs, Suppliers and Customers.

- The Change Report aims to show that historically DNOs have rarely breached the new licence threshold of +/-6% for under/over recoveries. However, the Change Report did not report on how many times mid-year prices changes had been required to meet licence obligations and therefore this analysis is incomplete. Both SPD and SPM have implemented mid-year price changes.

- In its comparison with DCP 164 the working group noted that Ofgem can direct an earlier implementation of any changes if deemed appropriate. Therefore the uncertainty of tariffs may not be removed if they can change within the notice period.

- For EDCM customers, charges are based on actual network usage to which a time lag already applies, DCP 178 will further lag the impact of a customers' behaviour and could further reduce the cost reflectivity of their charge, and delay the effect of pricing signals.

2. Are there any other benefits and costs that you think would result from DCP 178?

As per our responses to both consultations, the following key costs should be considered in detail:

ED1 Base Allowed Revenues

Whilst ex-ante revenues (in real prices) will be set in advance at the conclusion of the ED1 price control process these will be subject to change every year to reflect:

a. RPI inflation to current year prices (there will be rules in the new Licence that provides for the determination of RPI in November of year t-1). This will clearly not be known 15 months in advance.

b. Annual iteration process – this is a new process under ED1 (which will be set out in the Financial Handbook) to correct ex-ante revenues for:

   i. Adjustments to reflect actual expenditure compared with forecast expenditure
   ii. Legacy adjustments in respect of the outturn of the DPCR5 price control
   iii. Changes to the cost of debt element of the allowed return
   iv. The annual iteration process impact is not known until the end of November in year t-1. For example base revenues (over 90% of allowed revenues) for 2016/17 tariff setting will not be known until November 2015

Moving tariff setting back to 15 months before the start of a year e.g. December 2014 for 2016/17 would mean that the impact of the annual iteration process would be two years out of date; and fall foul of Ofgem's intention to ensure that charges to customers reflect actual costs. DCP 178 clearly conflicts with this new process.

c. ED1 other allowed revenue items (Incentive mechanisms/pass through items etc.) and the claw-back term (in respect of prior year over/under recovery) - the majority of the Licence conditions in respect of these items will have rules in place for determination with a two year delay to reflect actual revenue entitlements e.g. actual incentive revenues in respect of performance in 2015/16 under the quality of supply incentive would be reflected in allowed revenues in 2017/18; 15 months' notice would mean that we would be estimating the outturn for these items by December 2015 i.e. before the end of 2015/16.

Not only will allowed revenues be unknown 15 months in advance, but this uncertainty combined with the current unpredictability in the volumes element of charges could lead to much larger over/under recoveries and, hence, a resulting volatility in charges which Ofgem have tried to mitigate by implementing revised charge restriction conditions (2 year delays for incentives/pass through/over and under recovery aspects of allowed revenues) as part of the ED1 licence drafting process. Ofgem have deliberately implemented this 2 year delay so DNOs would have this information to assess and inform prices being set three months before the next regulatory year. This is nullified by setting prices 15 months in advance.

Cost Reflectivity
This proposal requires all model inputs to be set in advance; resulting in the tariffs being calculated on aged customer/network data thus reducing cost reflectivity. Incorporating the impact of changes in customer behaviour as a result of pricing signals will be delayed.

Cost of Capital
There is a greater possibility of significant under- or over-recoveries occurring as a result of the proposed notice period, and due to the asymmetry in the treatment of interest there is a potential impact on the cost of capital.

3. **For Suppliers and Customers, can you provide supporting evidence for the benefits identified by respondents to the working group's consultations?**

Not applicable.

4. **Do you think the proposed notice period would cause any issues with implementing any changes to charges which may be required due to developments in the operation of the network?**

Any changes in network/operational technology that will require a methodology change may not be reflected in a timely manner. This is evidenced by the extended development time needed for the new tariffs required under DCP 179 (and associated P300 and P272). The charging methodologies may not be able to quickly capture any changes needed to ensure that customers receive cost reflective charges thereby reducing the methodologies' compliance with the DCUSA Objectives

This could result in directions from Ofgem and/or derogations being sought to set charges outside of the methodology for particular groups of customers.

5. **Do the benefits of certainty outweigh any costs or effects of delay?**

No, the costs could be significant in relation to DNOs under/over recoveries; we do not believe the DCP 178 working group sufficiently addressed this issue.

Under the draft RIIO EDI Licence, DNOs will have an obligation to use its reasonable endeavours to ensure that regulated revenues do not exceed their allowed revenues. Under the current approach to setting tariffs we are forecasting allowed revenues 40 days in advance – with a 40 day notice period there will be certainty regarding the majority of the components of allowed revenue under ED1. However, tariffs are not only based on forecasts of allowed revenues; there are forecasts of a number of variables including units distributed, MPAN counts and agreed capacities. The likelihood is that the actual outturn for these variables will be different (e.g. a very cold winter (compared with normal) could cause units distributed to increase above the estimates at the time of tariff setting – this will lead to an over recovery).

A mid-year price change was previously used to correct prices if an over/under recovery was forecast. From April 2015 mid-year price changes are no longer permitted and to support this the over/under recovery penalty rate threshold has been increased to +/- 6%. We have yet to see if this is sufficient given the variables that affect revenues recovered that are outside the DNOs direct control.

DCP 178 is likely to further impact the level of revenue recovered in any one year but only limited consideration has been given to addressing a further increase or adjustment to the over/under recovery thresholds. The working group has suggested a "wait and see" approach which we consider inappropriate.

Again, a potential result of this could be requests for derogations in order to update tariffs should it be forecast that the thresholds will be breached. This is not in customers or suppliers interests and will not remove the uncertainty of more frequent price changes.

6. **Can you give examples over the next five years of likely changes to distribution charges that are critical to deriving benefits but which would be delayed unduly if DCP 178 was approved?**

It should be noted and considered that all changes raised through the open governance process seek to improve the current charging methodologies and aim to ensure they better meet the DCUSA objectives. Any change that is identified and progressed to approval (i.e. is a proven improvement) will have a delayed implementation under this proposal. This can only be detrimental to Customers.

Specific examples include the EHV Distribution Charging Methodology (EDCM) review currently underway. A number of key principles are being debated in view of issues raised in relation to cost reflectivity and volatility. If DCP 178 is approved, any resulting improvements may not be implemented until April 2017 at the earliest.

In addition, DCP 178 is an enduring change and, if approved, will likely be in place when the next price control revenues are set. DNOs will therefore be required to set tariffs for the first year of the next price control without knowing what the revenues will be.

In summary, we very much support the principle of reducing DUoS tariff volatility rather than increasing the predictability in the way DCP 178 proposes. The current revenue recovery mechanism does not support such a long notice period and DNO licence conditions would have to be amended as indicated above.

Although there may be some shorter term predictability in the charges, these are likely to become increasingly volatile over the longer term, as significant over/under recoveries would have to be corrected in following years.

We would be happy to discuss further our concerns regarding DCP 178 and please do not hesitate to contact Wendy Mantle on 0151 609 2335 if you have any queries on the responses provided above.

Yours sincerely

Jim Sutherland
Acting Regulation and Commercial Director