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19 September 2014

Dear Andy

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

Thank you for the opportunity to respond to the above consultation. We agree that DCP 178 would be a significant change and welcome the opportunity to express our concerns directly. We also provide responses to your specific questions.

General

We consider that the proposal is not consistent with Ofgem's stated policies in this area. These policies are designed to improve the predictability of network charge changes without increasing risk for network operators, with the aim of lowering overall customer bills. In particular, we consider that implementation of DCP178 would reverse an Ofgem RIIO policy decision[1] which has been the basis for the submission of the DNO Well Justified Business Plans. In that decision Ofgem assessed and rejected an option to impose a cap and collar on allowed revenues, recognising the effect on financing costs in the decision document:

Para 2.83 We considered that there would be a cost involved both in terms of financing costs of delayed revenue collection for a NWO and the potential for investors to view NWOs as more risky investments.

Para 2.92 We consider these arguments are equally valid in our decision not to implement caps and collars. These arguments focus on the concern that the potential mismatch between a NWO's costs and revenue recovery may lead to higher financing costs for NWOs.

We note that Ofgem did not explicitly consider caps and collars on network charges, since changes to the charging methodologies were not within the scope of the decision. However, we consider that DCP178 would effectively apply a zero cap and collar on charges, which is a more extreme version of a cap on allowed revenue and therefore inconsistent with Ofgem's policy decision.

We consider that DCP178 is addressing the symptom of a problem rather than the cause. We support measures to reduce volatility and improve the predictability of the calculation of individual charges within the charging models. A number of proposals in this area are currently being implemented and we have not yet had the opportunity to see the benefits of these in practice.

[1] Ofgem Decision in relation to measures to mitigate network charging volatility arising from the price control settlement: https://www.ofgem.gov.uk/ofgem-publications/50572/cvdecision.pdf

Specific Questions

1. Do you agree with the working group's view that DCP178 would result in these benefits and costs?

No. We do not believe that this proposal is in the best interests of customers. The principle of transferring risk from suppliers to DNOs in order to reduce the associated premium is fundamentally flawed. The additional risk on DNOs would translate into an increased marginal cost of debt, and possibly lead to a tendency to set prices at a level more likely to over-recover, to the detriment of end customers. It is the business of suppliers to manage a portfolio of risks, and gain competitive advantage through their ability to minimise the associated risk premium. Placing the risk premium with DNOs is not efficient and removes this competitive pressure.

On a point of detail, your letter appears to misinterpret the nature of supplier pass-through contracts. Our understanding is that such contracts pass through DUoS charges to end customers without the addition of a risk premium. It is also our understanding that most contracts for customers connected at extra-high voltages are currently of this type.

2. Are there any other benefits and costs that you think would result from DCP178?

It is worth clarifying the cost of capital point made at the foot of page 2 in your letter. The introduction of DCP178 will substantially increase the risk of large under and over recoveries. The table below outlines the change in risk under the current position and how it changes under RIIO and then under DCP178.

This table highlights the amount of volume risk associated with each winter period. Under DPCR5, we have been able to adjust prices to allow for the outturn in the previous winter and therefore the maximum exposure is simply the outturn volume in the upcoming winter period.

Under RIIO the ability to make mid-year price changes has been removed and consequently when prices are set, the DNO has limited knowledge of the outturn for the current winter and needs to forecast the upcoming winter. Consequently the risk is extended to two winters. Under DCP 178, the forecast needs to include the winter in the following year and consequently the exposure is three winters.

The further out the DNO needs to forecast the volume the greater the uncertainty. Where a DNO is forecasting growth for 3 winters and the outturn is a continual reduction in consumption (eg such a case happened in 2008 with the onset of the recession), the outturn could be significantly lower than the volume forecast for the 3rd winter and therefore lead to a substantial under-recovery. Under DCP178, the cumulative under-recovery at any point in time could be extremely large which would affect the risk associated with a DNOs cashflow and therefore their cost of capital.

	DPCR5	**RIIO ED1**	**DCP178**
Notice Period	3 months + Option of mid-year price change	3 months.	15 months
Volume risk (number of winters included in forecasts)	One	Two	Three
Application of under/over recovery	Following year	One year lag	One year lag
Penalty interest band	+/- 3%	+/- 6%	+/- 6%

To highlight the additional risk that DNOs will face under this change proposal we have modelled the impact of this change using the following assumptions:

- Ongoing under/over recovery risk = +/-£2.5m (this is the intrinsic risk that DNOs always face due to the 40 days notice between setting and implementing prices; and also takes account of the approximate 1 month lag on the availability of outturn volume data at the time of setting prices)
- Under/over recovery risk relating to the summer period = +/-£5m
- Under/over recovery risk relating to the Winter period = +/-£10m

These assumptions are reasonable based on our experience of forecasting volumes and they are also consistent with the penalty interest band of +/- 3% for a six month period moving to +/- 6% under RIIO.

Using these assumptions we have created a fan chart which shows the impact of this change proposal on our expected range of over/under recovery. This chart is over the page and an explanation is set out below:

DPCR5

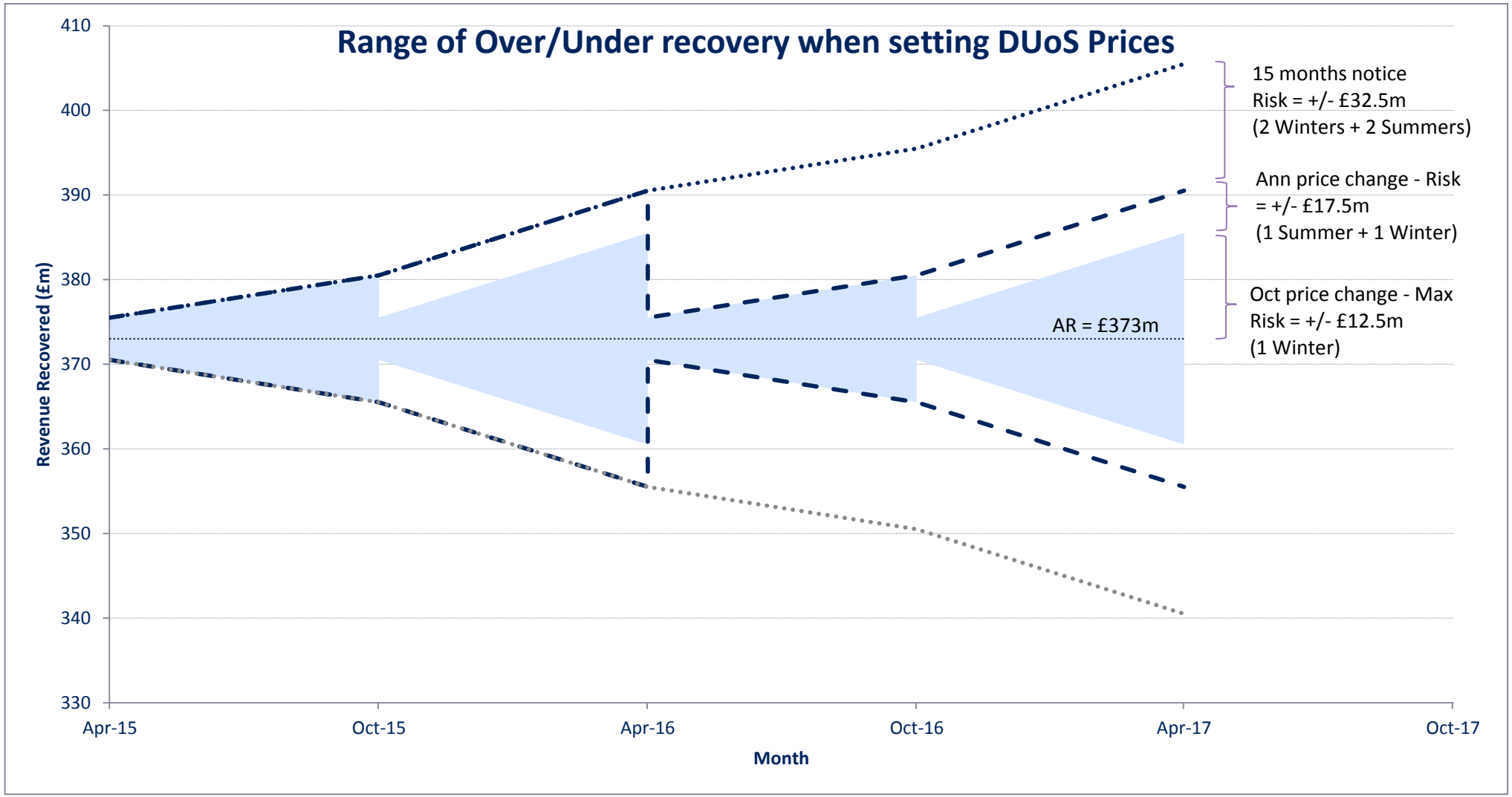
- The grey shaded area represents the range of expected under/over recovery at any point in time under DPCR5 when prices can be set in April and October. The recovery position increases to +/- £7.5m across the summer and the prices are reset in October. The recovery position increase to +/- £12.5m across the winter and prices are reset again in April.
- The maximum expected over/under recovery position relating to any one year is £12.5m.

RIIO

- The bold dashed line represents the range of expected under/over recovery at any point in time under RIIO when prices can only be set in April. The recovery position builds across the summer and increases to +/- £17.5m before prices are reset in April.
- The £17.5m consists of the ongoing risk (£2.5m) plus one Summer (£5m) plus one Winter (£10m)
- The maximum expected over/under recovery position relating to any one year is £17.5m

DCP 178

- The dotted line represents the range of expected under/over recovery at any point in time under DCP178 when prices can only be set in April with 15 months notice. The recovery position builds across the 15 months notice period and then the 12 month period over which the prices apply. Consequently the recovery position increases to +/- £32.5m before prices are reset in the following April.
- The £32.5m consists of the ongoing risk (£2.5m) plus two summers (£10m) plus two winters (£20m)
- The maximum expected over/under recovery position relating to any one year is £32.5m.
- This modelling understates the potential recovery position for the following reasons:
    - We would expect the uncertainty on the volume forecast to be far greater for the second winter than the first.
    - The modelling is based on an underlying risk of 40 days notice of prices. DCP 178 increases the notice period to 15 months which increases the underlying risk to 3 months. Effectively this means that when setting prices in December for the following year +1, the DNO will have limited visibility of the outturn for the existing winter.


Range of Over/Under recovery when setting DUoS Prices
410
400
390
380
370
360
350
340
330
Revenue Recovered (£m)
Apr-15
Oct-15
Apr-16
Oct-16
Apr-17
Oct-17
Month
AR = £373m
15 months notice
Risk = +/- £32.5m
(2 Winters + 2 Summers)
Ann price change - Risk
= +/- £17.5m
(1 Summer + 1 Winter)
Oct price change - Max
Risk = +/- £12.5m
(1 Winter)

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

No response.

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?

We consider that the proposal reduces the cost reflectivity of the price signal in charges (particularly if any shortfall or surplus triggers penal interest rates relating to over or under recoveries).

The proposal would also delay the implementation of modifications to the charging methodology which had been accepted as meeting the DCUSA objectives. More generally, by deferring charges the proposals would weaken the cost reflective signal relative to the baseline (for example the effectiveness of the "super red" price signal in EDCM charges).

The proposal will make it more difficult for DNOs to take account of any changes to their business. Where a reopener has been identified or a within-period determination has been made, the DNO may be entitled to recover the cost within year (in line with paragraph 2.79 of the Ofgem charging volatility decision). This change proposal will mean that DNOs would not be able to amend charges to reflect these changes for an additional year.

We believe there are a number of existing change proposals that are important in assisting DNOs in the development of their networks. The most important of these is DCP179 which implements new time of use distribution tariffs for all customers. This will introduce a price signal that will encourage customers to move their consumption away from peak, whereas at present the majority of customers pay the same distribution tariff regardless of when they consume. We anticipate that the introduction of these tariffs will result in a change in consumer consumption patterns and result in significant cost savings in future reinforcement for DNOs and therefore customers. This change proposal needs to be in place ready for the SMART metering roll out that begins in 2015 and to ensure the full benefits of SMART metering are realised.

In addition to DCP179, we believe the following change proposals need to be implemented as soon as possible:

- DCP 161 (exceeded capacity charges) – This change will impose cost reflective exceeded capacity charges on customers and incentivise them to reduce peak consumption.

- DCP137 (generation dominated areas) – This change will remove credits to generators where they are driving costs on a DNOs network

- DCP138 (Network Use Factors) – Ofgem identified in the EDCM decision document that the calculation of Network Use Factors needs amending. This change will make the EDCM charge more cost reflective and should not be delayed.

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

We believe that this balance has already been addressed by Ofgem in making the decision on charging volatility.

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 DCP178 was approved?

There are a large number of change proposals that will be submitted to the Authority in 2014, and these need to be progressed as a matter of urgency. The proposal to implement this change in November 2014 will delay these changes to the detriment of our customers.

There are a number of substantial areas of work that need to be progressed over the next five years and it is important that these are not unnecessarily delayed by the imposition of a requirement to provide 15 months notice of charges. We have summarised below a few of the important changes that we expect to be brought forward over the next few years. However, we recognise that this is not an exhaustive list and that DNOs have a licence obligation to review the methodology each year and bring forward changes where necessary:

- The implementation and standardisation of Demand Side Management Agreements
- Changes relating to the implementation of SMART metering
- The treatment of asset replacement within the CDCM
- Review of the calculation of LDNO discounts
- Any changes that may arise from the fundamental review of the EDCM by the MIG EDCM sub-group.

Conclusion

We recognise that the introduction of new charging methodologies may have increased volatility in recent years, but there are a number of change proposals that have been implemented and some that are still under consideration that should reduce this effect in the future. In addition, the initiatives in Ofgem's decision document on volatility have not all yet been implemented and will further reduce volatility. We do not believe that an inefficient market structure should be put in place to address what is a temporary issue. We believe that the enduring solution is not to implement this change proposal.

Yours sincerely

Paul Bircham
Regulation Director