

Options for notifying use of system charges fifteen months in advance of price changes coming into effect – discussion paper

1. The purpose of this note is to outline a strawman for a potential distribution connection and use of system agreement (DCUSA) change proposal to provide energy suppliers with more certainty over the future use of system (UoS) charges that they will face, by notifying UoS charges a year in advance of current timescales, thereby providing 15 months’ notice, rather than the current 3 months, ahead of the date when the revised prices will take effect.

Issue definition

2. Feedback from recent stakeholder engagement events, including the sequence of bi-lateral meetings we have held with energy suppliers who responded to our invitations to hold meetings, is that suppliers would like to see more certainty in the path of future UoS charges. They have indicated that they typically offer 18 month to three year contracts (normally in October and [to some extent] April) and that they need to price some risk premiums into the products that they offer to end users to cover uncertainty. Taking the October round by example, one of the uncertainties is that suppliers only have firm UoS charges for the next six months (i.e. until the following April) as indicative charges are not published until the end of December. In some cases, for larger end users, they deal with this by including pass-through arrangements of UoS charges in their offering.

Potential Solution

3. We are actively giving consideration to the potential mechanisms for setting UoS charges a year in advance of the current timeline in RIIO-ED1 (i.e. providing 15 months’ notice rather than the current 3 months), and the transitional arrangements that would be required. The timeline in the table below is for illustrative purposes only. It could be changed for any year and best endeavours should be used to implement this as soon as practicable. In combination with the future revenue certainty provided by a favourable RIIO-ED1 fast-track decision in [October] 2013, if Ofgem agreement and industry mechanisms can be agreed and changed in time for the December 2013 charging publication Northern Powergrid would be happy to adopt an advanced timescale. Any transition timeline including the one illustrated below needs to allow for the appropriate governance/licence changes to be considered and put in place prior to implementation. The table example also ties in with the start of the new price control in April 2015.

Current Timeline – Example	Proposed timeline – Example
December 2014 – Set UoS charges for 2015/16	December 2014 – Set UoS charges for 2015/16 and 2016/17
December 2015 – Set UoS charges for 2016/17	December 2015 – Set UoS charges for 2017/18

Potential benefits

4. Detailed below are some of the potential benefits for key stakeholders of setting tariffs a year in advance:
 - **Suppliers** – will have between 15 and 27 months certainty of what UoS charges will be, rather than the current 3 to 15 months.
 - **End Users** – will potentially face lower charges from suppliers, as the supplier would not have to include such high risk premiums into their products as there will be more certainty on the UoS

element of their charge. Those end users who have pass-through contracts with their supplier will also benefit as they will know their tariffs for the same timescales. This will greatly assist in their business planning and provide economic benefit through cost certainty.

- **Northern Powergrid**—will be seen as a market leader, engaged in collaboration with leading energy suppliers on this opportunity, in terms of understanding how energy customers can benefit through innovative solutions to keep the overall cost of energy as low as possible.

Potential risks

5. A number of potential risks have been identified, these are detailed below and were considered when developing the options to be considered:
 - The timeline for the implementation of future DCUSA change proposals will need to be extended and the implication on charging methodologies should be considered.
 - A mechanism needs to be established for how any manifest errors in charging models or unintended consequences of the methodology are resolved in a timely way, particularly where parties, or end users, feel that they are disadvantaged in some way.
 - Ofgem might see this as a move away from cost reflectivity in favour of transparency and price stability (feedback suggests that suppliers favour predictability and stability and in an ideal world, from their point of view, would see a single fixed charge per customer).
 - Price movements between tariff publications could be larger as we are forecasting over a longer period and are more susceptible to environmental (weather) and economic changes that have not been incorporated, or foreseen, in our forecast. This would be mitigated by the notice period allowing suppliers and consumers to plan and adapt to any new charges.
 - The limits on over/under-recovery in the licence would need to be reviewed and the penalty interest calculations potentially removed or at least reduced.
 - There could be cashflow implication for Northern Powergrid, but if the over/under-recovery mechanism (including interest calculation) is adjusted this should mean that we get our money eventually. Suppliers have indicated that collection of appropriate revenues is desirable and therefore certainty is preferable to penalties levied on network operators for apparent over/under recovery.
 - Mechanisms for changes between indicative and final charges need to be established (i.e. are we allowed to change charges once they have been published?). Suppliers have indicated that they would prefer a single publication with no changes from this point.
 - There is no guarantee that suppliers will pass the increased certainty on to end users in the form of a lower price, though competition in the energy retail market should naturally drive the best value customer offers.

Discussion of the options

6. Appendix 1 contains the decision tree that has been followed in terms of developing the options that are detailed below. All of the options are based on the assumption that the requirement of providing longer notice periods on UoS tariffs means that the limits on over/under-recovery in the licence would need to be reviewed and the penalty interest calculations potentially removed or at least reduced so that the level of risk exposure on DNOs does not increase.
7. The limits on over/under-recovery are set out in charge restriction condition 14 (CRC 14) which imposes certain supplementary restrictions, with respect to UoS charges levied by that licensee, which

amongst other things relate to the interest rate adjustments to be applied by the licensee to over/under-recoveries of revenue. These are currently set as:

- Where revenue exceeds 103% the PRt value is 3% (PRt means the rate of interest that is applicable in accordance with Part A of CRC 14 'Distribution Charges: supplementary restrictions').
- Where revenue is less than 97% the PRt value is 0%.
- In all other cases PRt has the value 1.5%.

This has the impact of rewarding DNO's for being between 0%-3% under-recovered and penalising them for any over-recovery of revenue allowances.

8. In the Ofgem decision document on charging volatility (October 2012) the decision to restrict the frequency of intra-year charges to once a year recognised the risk on the under/over-recovery adjustment and it was proposed to double the current bands that apply. A two year tariff offering inserts more risk to DNOs, so the above levels might need to more than double? Consideration also needs to be given to the penalty levels as well as increases in the range to which they apply. Because of the additional risk the penalty levels also need to reduce so that the level of risk exposure remains at least constant.
9. Four different options have been developed as part of the considerations. The first two carry additional risks due to a potential lack of consistency across the industry as they do not involve DCUSA changes, whereas the remaining two would have to be implemented by all parties.
 - **Option 1 - No DCUSA change to notice period and variable tariffs** – in this option indicative tariffs would be set a year in advance (i.e. giving 15 month notice) and the final notification would target the same amount of revenue but reflect any methodology changes that had been approved (i.e. the target revenue would be fixed but the allocation method could change).
 - **Option 2 – No DCUSA change to notice period and fixed tariffs** – in this option indicative tariffs would be set a year in advance (i.e. giving 15 month notice) and the final notification would target the same amount of revenue and use the same methodology as was used for indicative tariffs (i.e. the target revenue and the allocation method would be fixed).
 - **Option 3 – Revised DCUSA notice period for final charges** – the notice period in DCUSA for finalising tariffs would be changed from 40 days to 15 months (i.e. tariffs and target revenue would have to be locked down a year in advance).
 - **Option 4 –No DCUSA change to notice period but revised lead times for DCUSA change proposals**– the notice period in DCUSA would be unchanged but all change proposals that impacted charging methodologies would need to have a two year lead time.
10. The tables below consider the advantages and disadvantages of the proposed approaches.

Option 1 – No DCUSA change to notice period and variable tariffs

Advantages	Disadvantages/concerns
<ul style="list-style-type: none"> • Suppliers will have between 15 and 27 months of certainty regarding UoS charge target revenues, rather than the current 3 to 15 months. • Not all DNO's have to adopt this approach as there are no DCUSA changes. 	<ul style="list-style-type: none"> • Tariffs are not fixed as they could still change if there are changes to the charging methodology following initial publication (i.e. changes between indicative and final charges) • Final charges still need to be published at 40 day notice as currently defined by DCUSA. • It is a standalone option – not all DNO's would have to publish longer notice periods. • The DCUSA charging methodology needs to be

Advantages	Disadvantages/concerns
	<p>reviewed to make sure that any reference to using input data from certain time periods is tied in to the date of publication of charges not the implementation of the prices.</p> <ul style="list-style-type: none"> • A mechanism needs to be established to ensure that any manifest errors in the charging models or unintended consequences of the methodology are resolved in a timely way. • Price movements between years could be larger as DNOs are forecasting over a longer period and hence become more susceptible to external influencing factors. • Suppliers may not be able to reduce the risk premiums that are included in their charges to end users as there will still be uncertainty on the UoS element of their charge.

Option 2 – No DCUSA change to notice period and fixed tariffs

Advantages	Disadvantages/concerns
<ul style="list-style-type: none"> • Longer notice period is provided of target revenues. • Tariffs are locked down 15 months in advance. • Not all DNO's have to adopt this approach as there are no DCUSA changes. • End users – will potentially face lower charges from suppliers, as the supplier would not have to include such high risk premiums into their products as there will be more certainty on the UoS element of their charge. 	<ul style="list-style-type: none"> • Final charges still need to be published at 40 day notice? • It is a standalone option – not all DNO's would have to publish longer notice periods • It would need to be written into any new methodology change proposals that they would not impact on charges that have already been set. • It could (and is likely to....) lead to potential inconsistencies in the charging models used by DNOs if some companies lock down tariffs early – lack of consistency is unlikely to be well received. • Ofgem might see this as a move away from cost reflectivity in favour of transparency and price stability. • The DCUSA charging methodology needs to be reviewed to make sure that any reference to using input data from certain time periods is tied in to the date of publication of charges not the implementation of the prices. • A mechanism needs to be established to ensure that any manifest errors in the charging models or unintended consequences of the methodology are resolved in a timely way. • Price movements between years could be larger as DNOs are forecasting over a longer period and hence become more susceptible to external influencing factors. • Because of the potential for different approaches

Advantages	Disadvantages/concerns
	by DNO's, suppliers may not be able to reduce the risk premiums that are included in their charges to end users as there will still be uncertainty on the UoS element of their charge.

Option 3 – Revised DCUSA notice period for final charges

Advantages	Disadvantages/concerns
<ul style="list-style-type: none"> • Longer notice period is provided of target revenues. • Tariffs are locked down 15 months in advance. • All DNO's have to adopt this approach as there is a DCUSA change. • Clean and easy to implement • End users – will potentially face lower charges from suppliers, as the supplier would not have to include such high risk premiums into their products as there will be more certainty on the UoS element of their charge. • End users on pass through contracts will have increased certainty of costs. 	<ul style="list-style-type: none"> • There is a potential inconsistency with the licence which says that we must give at least three months' notice of changes to charges – although there is an inconsistency this is not considered to be a significant issue. • Ofgem might see this as a move away from cost reflectivity in favour of transparency and price stability. • The DCUSA charging methodology needs to be reviewed to make sure that any reference to using input data from certain time periods is tied in to the date of publication of charges not the implementation of the prices. • A mechanism needs to be established to ensure that any manifest errors in the charging models or unintended consequences of the methodology are resolved in a timely way. • Price movements between years could be larger as DNOs are forecasting over a longer period and hence become more susceptible to external influencing factors.

Option 4 – No DCUSA change to notice period but revised lead times for DCUSA change proposals

Advantages	Disadvantages/concerns
<ul style="list-style-type: none"> • Longer notice period is provided of target revenues. • Tariffs are locked down 15 months in advance. • Not all DNO's have to adopt this approach as there are no DCUSA changes to the notice period. • End users – will potentially face lower charges from suppliers, as the supplier would not have to include such high risk premiums into their products as there will be more certainty on the UoS element of their charge. 	<ul style="list-style-type: none"> • Final charges still need to be published at 40 day notice? • It is a standalone option – not all DNO's would have to publish longer notice periods. • It would need to be written into any new methodology change proposals that they must have a 24 month implementation lead time • Ofgem might see this as a move away from cost reflectivity in favour of transparency and price stability. • The DCUSA charging methodology needs to be reviewed to make sure that any reference to using input data from certain time periods is tied in to the date of publication of charges not the

Advantages	Disadvantages/concerns
	<p>implementation of the prices.</p> <ul style="list-style-type: none"> • A mechanism needs to be established to ensure that any manifest errors in the charging models or unintended consequences of the methodology are resolved in a timely way. • Price movements between years could be larger as DNOs are forecasting over a longer period and hence become more susceptible to external influencing factors.

Recommendations

11. On balance it is felt that option 3 'Revised DCUSA notice period for final charges' is the best solution as it maintains consistency amongst all DNOs and introduces clear set of rules within DCUSA. In addition there have already been a number of changes to the DCUSA that require DNOs to provide 15 month notice period for changes to certain methodology inputs (i.e. DNO time bands) so there are precedents for longer notice periods.

DCUSA changes required

12. In terms of changing the notice period in DCUSA it is section 19.1 that needs to be amended. A red lined version of the proposed changes is shown below - the original text is an extract from version 5.8 of DCUSA which was published on 1 April 2013.

19.1 The User shall pay to the Company in respect of services provided under this Agreement (and under the agreements referred to in Clause 19.2) the charges set out in the Relevant Charging Statement (save where the Company is the Payor, in which case the Company shall pay such charges to the User). The Company may vary such charges at any time by giving the requisite period of written notice to the User (where the requisite period of notice is the period specified in the Company's Relevant Charging Statement or, where no such period is specified, ~~40 days~~ 15 months). Notwithstanding that the Company may vary such charges at any time the Company shall use reasonable endeavours to: (1) vary such charges no more than two times per year; and (2) vary such charges with effect from 1st April or 1st October. Such charges and any variations are and will be calculated in accordance with the provisions of the Relevant Charging Statement.

The final sentence of the extract above will also need to be removed when Ofgem write into the licence that DNOs are limited to one tariff change per year.

13. In addition to the above the following paragraphs in schedule 16 of DCUSA also need to have changes considered in order to provide additional clarity.

*43. In determining the load characteristics of each category of demand user the DNO Party will use reasonable endeavours to analyse meter and profiling data received for the most recent 3 year period, **at the time of setting charges for the relevant charging year, for which data are available in time for use in the calculation of charges.** The three*

elements of load characteristics – Load Factors, Coincidence Factors, and the estimated proportion of units recorded in each relevant time pattern regime that fall within each distribution time band – will be calculated individually for each of the 3 years and a simple arithmetic average will be calculated to be used in tariff setting.

49. *The peaking probability represents the probability that an asset at that network level would experience maximum load during that distribution time band. In deriving peaking probabilities the DNO Party will use reasonable endeavours to use the most recent 3 year period, at the time of setting charges for the relevant charging year, for which information is available in time for use in the calculation of charges. Peaking probabilities will be derived individually for each of the 3 years and a simple arithmetic average will be calculated to be used in tariff setting.*

DNO Risk evaluation

14. The limits on over/under-recovery are set out in charge restriction condition 14 (CRC 14) which imposes certain supplementary restrictions, with respect to UoS charges levied by that licensee, which amongst other things relate to the interest rate adjustments to be applied by the licensee to over/under-recoveries of revenue. These are currently set as:

- Where revenue exceeds 103% the PRt value is 3% (PRt means the rate of interest that is applicable in accordance with Part A of CRC 14 'Distribution Charges: supplementary restrictions').
- Where revenue is less than 97% the PRt value is 0%.
- In all other cases PRt has the value 1.5%.

This has the impact of rewarding DNO's for being between 0%-3% under-recovered and penalising them for any over-recovery of revenue allowances. In addition if the DNO is over-recovered by more than 5% then they must provide an explanation as to why they are over-recovered and intend to increase their charges in the following year, except and to the extent that the Authority has consented to such an increase.

15. The risk to the DNO is primarily a cashflow one rather than an actual revenue risk apart from the impact of the PRt penalty amounts. This is because an under/over-recovery is corrected plus interest.
16. The tables below are based on the May 2013 combined allowed distribution revenues (ARt) for 2013/14 published in DCUSA Schedule 15. The tables consider the follow scenarios:
- Current over-recovery limits in CRC14.
 - Doubling the current over-recovery limits in CRC14 but maintaining the PRt values.
 - Doubling the current over-recovery limits in CRC14 but halving the PRt values.
 - Doubling the current over-recovery limits in CRC14 but removing the PRt values.

The results show that at a Northern Powergrid level we currently face a maximum penalty of circa £0.3m (£.01m in the Northeast and £0.2m in Yorkshire) if we remain with the 3% over-recovered limit and the exposure increases to nearer £1.0m if we exceed the 3% limit and assume a 5% over-recovery position (£0.4m in the Northeast and £0.6m in Yorkshire).

Doubling the over/under-recovery limits also doubles the exposure on the DNOs, so to maintain parity the PRt values should be halved. In fact consideration should be given to removing them completely as this would eliminate the risks to DNO's of setting tariffs further in advance.

Northeast (2013/14 ART = £299.2)	Over-recovery limits (%)	Over-recovery value (£m)	PRT	Risk exposure (£m)
Current over-recovery limits in CRC14	0% - 3%	£0.0m - £9.0m	1.50%	£0.0m - £0.1m
	3% - 5%	£9.0m - £15.0m	3.00%	£0.3m - £0.5m
Doubling the current over-recovery limits in CRC14 but maintaining the PRT values	0% - 6%	£0.0m - £18.0m	1.50%	£0.0m - £0.3m
	6% - 10%	£18.0m - £29.9m	3.00%	£0.5m - £0.9m
Doubling the current over-recovery limits in CRC14 but halving the PRT values	0% - 6%	£0.0m - £18.0m	0.75%	£0.0m - £0.1m
	6% - 10%	£18.0m - £29.9m	1.50%	£0.3m - £0.5m
Doubling the current over-recovery limits in CRC14 but removing the PRT values	0% - 6%	£0.0m - £18.0m	0.00%	£0.0m
	6% - 10%	£18.0m - £29.9m	0.00%	£0.0m
Yorkshire (2013/14 ART = £381.5)	Over-recovery limits (%)	Over-recovery value (£m)	PRT	Risk exposure (£m)
Current over-recovery limits in CR14	0% - 3%	£0.0m - £11.4m	1.50%	£0.2m
	3% - 5%	£11.4m - £19.1m	3.00%	£0.3m - £0.6m
Doubling the current over-recovery limits in CRC14 but maintaining the PRT values	0% - 6%	£0.0m - £22.9m	1.50%	£0.0m - £0.3m
	6% - 10%	£22.9m - £38.2m	3.00%	£0.7m - £1.1m
Doubling the current over-recovery limits in CRC14 but halving the PRT values	0% - 6%	£0.0m - £22.9m	0.75%	£0.0m - £0.2m
	6% - 10%	£22.9m - £38.2m	1.50%	£0.3m - £0.6m
Doubling the current over-recovery limits in CRC14 but removing the PRT values	0% - 6%	£0.0m - £22.9m	0.00%	£0.0m
	6% - 10%	£0.0m - £38.2m	0.00%	£0.0m

Supplier risk evaluation

17. Suppliers include a risk premium in their tariffs to cover potential uncertainties in the charges that they face. Setting UoS charges a year in advance will significantly reduce those uncertainties and allow suppliers to reduce the level of the risk premiums that they include on the products that they offer, which in turn should reduce the charges that can be offered to the end user.
18. The level of risk premium included in supplier charges is commercially confidential so could not be included in this paper, but they may be able to provide this information confidentially to Ofgem to support this proposal.

Conclusions

19. Feedback from recent stakeholder engagement events, including the sequence of bi-lateral meetings have held with energy suppliers who responded to our invitations to hold meetings, is that Suppliers would like to see more certainty in the path of future UoS charges. Northern Powergrid is keen to work with Ofgem and energy suppliers to facilitate the setting of tariffs a year in advance. Taking such a step will certainly increase the risk exposure on us, so Ofgem would need to consider increasing the limits on over/under-recovery and reduce the PRT values by a compensating amount to maintain the exposure limits. Ideally the PRT values will be set to zero hence removing the risk on DNO's of setting tariffs a year in advance.

20. End users will potentially face lower charges from suppliers, as the supplier would not have to include such high risk premiums into their products as there will be more certainty on the UoS element of their charge.
21. Having considered a number of options the proposed solution is to change the notice period in section 19.1 of DCUSA from the current 40 days to 15 months. This is by far the easiest and cleanest way of achieving the objective and introducing a clear set of rules within DCUSA has the added advantage over the other options, considering that it would also maintain consistency across the industry. In addition there have already been a number of changes to the DCUSA that require DNOs to provide 15 month notice period for changes to certain methodology inputs (i.e. DNO time bands) so there are precedents for longer notice periods.

Next steps

22. The following deliverables have been identified as the next steps for progressing this proposal:
 - Obtain supplier input on the proposal.
 - Lobby Ofgem on the over/under-recovery levels and associated.
 - Draft a methodologies issues group (MIG) paper, if appropriate.
 - Draft and submit a DCUSA change proposal.

Appendix 1 – Options decision tree

