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17 December 2010

Dear John,

**Decision on request from Northern Electric Distribution Ltd ('NEDL') and Yorkshire Electricity Distribution plc ('YEDL') for consent to calculate distribution losses for 2009-10 on a basis that differs from that used for 2002-03**

1. We have carefully considered the request contained in your letter dated 12 November 2010 and the enclosures thereto which relate to the two electricity distribution network operators ('DNOs') in the CE Electric UK group ('CE'). We have also taken into account the responses to our supplementary queries contained in your letter dated 30 November 2010.
2. Your request refers to three issues which have affected provisionally reported numbers for units distributed (and, in the case of YEDL, units entering its distribution system) for relevant year 2009-10:
  - (i) Gross Volume Correction ('GVC') adjustments to settlements data by suppliers in the NEDL and YEDL distribution services areas (DSAs).
  - (ii) negative Estimated Annual Consumption ('EAC') values arising in settlements data for the NEDL and YEDL DSAs.
  - (iii) a period of over-reading at the meter for the Grid Supply Point ('GSP') at Thurcroft in Yorkshire.
3. We have separately considered your earlier request, together with that from two other DNOs, for relief from the penalty rate of interest associated with over-recoveries of revenue attributable to the GVC issue. This was the subject of our consultation letter (Ref 87/10) dated 20 July 2010 and decision letter dated 14 December 2010 which have been published on the Ofgem website<sup>1</sup>.

**Background to request**

GVC

4. GVC has been used by some electricity suppliers to obtain credit within the settlement system where they have identified meter points whose recorded supply has erroneously been billed to their account. This might relate, for example, to a long term vacant property which nonetheless had an estimated annual consumption level associated with it. Whilst the error concerned might have accrued over a prolonged period, the GVC adjustment would deduct the entire amount claimed by the supplier in a single period. This would have

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<sup>1</sup> <http://www.ofgem.gov.uk/NETWORKS/ELECDIST/POLICY/Pages/Policy.aspx>

the effect of distorting the apparent performance of the DNO for the area concerned, since the GVC adjustment would artificially depress the reportable number of units distributed for the period in which it was executed. The effects of GVC have varied between DSAs, reflecting the geographical market shares of the suppliers who have been most active in pursuing this type of billing rectification programme. Elexon, the Balancing and Settlement Code Company has since introduced a rule change to better regulate the use of the GVC mechanism in future<sup>2</sup>.

5. In your application you set out evidence to show that for relevant year 2009-10, a very high level of GVC adjustments affecting the NEDL and YEDL DSAs has led to a significant reduction in the number of units reportable as having been distributed through your networks under their normal reporting methodologies. This reduction, if not rectified, would result in significant penalties under the distribution losses incentive scheme.

#### Negative EAC values

6. Your review of settlement data in respect of GVC highlighted a significant number of instances where meter points had erroneously been ascribed a negative estimated annual consumption figure. The high incidence of GVC adjustments affecting data for 2009-10 is likely to have driven up the level of negative EACs because of a characteristic of the settlement calculation system (which has since been amended to address the effect).
7. The negative EACs have caused a further material reduction in the number of units reportable as having been distributed through your networks under their normal reporting methodologies.

#### Thurcroft GSP meter error

8. You have separately reported that there was a period of over-reading at one of the Grid Supply point meters at Thurcroft in Yorkshire which caused settlement data to show more units entering the YEDL distribution system in 2009-10 than was actually the case. Elexon have confirmed that a faulty pulse multiplier did result in an over-read at the Thurcroft GSP. However, they have also confirmed that, over time, the over-read is being reversed through the settlements reconciliation process.

### **CE's proposals to rectify the reporting position**

#### GVC

9. You have proposed an approach to correct for the undue impact of GVC on NEDL and YEDL in 2009-10 based on adjustments to reconciliation levels attributable to settlement runs after the initial (SF) settlement run as follows:
  - (i) Reconciliation levels for runs 1, 2 and 3 to be 'normalised' to the average reconciliation level for the period from 2005-06 to 2008-09.
  - (ii) Reconciliation levels for the Final (RF) and Dispute (DF) runs to be set to zero.
10. This approach is intended to neutralise the abnormal GVC effect in 2009-10 whilst recognising that a background level of volatility exists in settlement data in any case, to which a 'normal' level of GVC could be expected to be a contributory factor. We note that you have sense checked the results of your proposed changes to reconciliation levels to those which Elexon would have expected to see in 'normal' circumstances.

#### Negative EAC values

11. You have proposed that the negative EAC values in 2009-10 settlements data for NEDL and YEDL should be replaced with profile average values for the MPAN class concerned and we note that this is broadly consistent with the approach which will be used in the settlements

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<sup>2</sup> [http://www.elexon.com/changeimplementation/findachange/proposal\\_details.aspx?proposalid=849](http://www.elexon.com/changeimplementation/findachange/proposal_details.aspx?proposalid=849)

system itself going forward. Your analysis of the total effect of the negative MPANs is based on an extrapolation of information from settlement data aggregators.

12. In response to a query we raised you have confirmed that you would monitor ongoing settlements data and discount in your future reporting any units relating to advances of the subject meters until the benefit of the methodological adjustments referred to above had been 'used up'. This will address the risk that units might be double counted, as valid meter readings enter the settlement system going forward.

#### Thurcroft GSP meter error

13. You have proposed that the reportable number of units entering the YEDL network for 2009-10 should be reduced to compensate for the meter over-read at the Thurcroft GSP. In response to a query we raised you have confirmed that you would monitor and add back in your future reporting, units deducted from settlements totals through the reconciliation process. This will address the risk that units might be deducted twice, giving YEDL an undue benefit.

#### **Factors considered by the Authority**

14. In considering the proposals made by CE we have been cognisant of the purpose of the losses incentive scheme in DPCR4<sup>3</sup> which was to apply an incentive adjustment to DNOs (reward or penalty) to reflect their performance in respect of distribution losses. We have also considered three key principles relevant to the operation of the losses incentive scheme. Those are that there should be:

- (i) Like for like target setting and performance monitoring - the basis used to set the benchmark level of losses for a DNO should be sufficiently equivalent to the basis used to calculate the out-turn loss levels which are compared to that benchmark.
- (ii) Sufficiently accurate data - the data used to set the target and measure out-turn performance should be sufficiently accurate.
- (iii) Even handed treatment as between licensees - the approach to setting benchmark losses and measuring performance should be 'even handed' as between different DNOs with any differences in treatment being objectively justified.

15. Losses reporting for relevant year 2009-10 is governed by Special Condition C1 of the electricity distribution licence which was in effect at the time<sup>4</sup> ('the condition'). The condition incorporated two provisions which are pertinent to CE's application. Firstly, under paragraph 7 of the condition, in specified circumstances the Authority could direct a change to the DNO's allowed loss percentage ('ALP') where there had been a material change in the quality of the information used to derive system entry volumes or the numbers of units distributed. Secondly, whereas paragraph 9 of the condition stipulates that the DNO must normally stick to the losses reporting methodology it used in a reference year (2002-03), it also provides for the Authority to agree to a different basis for calculating the level of losses from the DNO's network.

#### The distribution losses incentive scheme in DPCR5

16. Each DNO's reported losses information for 2009-10 is used to ascertain its losses incentive adjustment for that year but it is also important for two reasons relating to the losses incentive scheme for the DPCR5 price control period<sup>5</sup>:

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<sup>3</sup> The DPCR4 price control period ran from 1 April 2005 to 31 March 2010

<sup>4</sup> <http://epr.ofgem.gov.uk/index.php?pk=doc188957>

<sup>5</sup> The current price control for DNOs (DPCR5) runs from 1 April 2010 to 31 March 2015

- (i) Performance in 2009-10 is pivotal to the calculation of the adjustment which will be made under the losses rolling retention mechanism ('LRRM') which is explained in chapter 4 of the DPCR5 Final Proposals – Financial methodologies document<sup>6</sup>.
- (ii) The reported loss rate for 2009-10 will be included in the calculation of ALPs for DPCR5.

17. Each DNO will be required to provide updated losses information for the DPCR4 period in due course to facilitate the calculation of LRRM and ALP values. This will provide an opportunity to make any further adjustments to the 2009-10 losses data for NEDL and YEDL which might be warranted by further or better information on the issues covered in this letter.

### **The Authority's decision on CE's proposals**

18. We consider that your submission, together with information we have received from Elexon and electricity suppliers shows that there has been a material change in the quality of the information used to derive distribution losses information for NEDL and YEDL in 2009-10. We consider that the proposed adjustments are necessary to restore their allowed revenue position to the proper level and will not therefore be detrimental to the interests of consumers. The Authority therefore agrees to the restatement of losses information for 2009-10 by NEDL and YEDL on a revised basis in accordance with paragraphs 20 to 24 below, and subject to the stipulations and caveats set out.

19. We note that the independent auditor for NEDL and YEDL has indicated that if CE's proposals are accepted by the Authority, it will be appropriate for their 2009-10 revenue reporting returns to be restated accordingly.

### GVC

20. The Authority's decision on this matter is that you should adjust the reported number of units distributed by NEDL and YEDL in 2009-10 in accordance with the proposed approach summarised in paragraph 9 above. This will result in the reported numbers of units distributed in 2009-10 being increased by 183 GWh for NEDL and 395 GWh for YEDL.

21. You must report any factor which comes to your attention after implementation of this decision which impinges on the basis for the decision or suggests that further adjustments in respect of the GVC issue might be necessary or appropriate.

### Negative EAC values

22. The Authority's decision on this matter is that you should adjust the reported number of units distributed by NEDL and YEDL in 2009-10 in accordance with the proposed approach summarised in paragraph 11 above. This will result in the reported numbers of units distributed in 2009-10 being increased by 25 GWh for NEDL and 34 GWh for YEDL.

23. You must also carry out the monitoring/unit discounting action referred to in paragraph 12, keeping appropriate records and advising Ofgem of any difficulty in achieving the requirement. In addition you must report any factor which comes to your attention after implementation of this decision which impinges on the basis for the decision or suggests that further adjustments in respect of the negative EAC issue might be necessary or appropriate.

### Thurcroft GSP meter error

24. Whilst Elexon have advised that the Thurcroft over-read is being rectified through the reconciliation process, we agree that it is appropriate to adjust YEDL's 2009-10 figure for units entering the network. Therefore the Authority's decision on this matter is that:

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<sup>6</sup> <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=372&refer=Networks/ElecDist/PriceCtrls/DPCR5>

- (i) The reported number of units entering the YEDL network for 2009-10 should be reduced by 36.3 GWh.
- (ii) YEDL is to add units back to future totals for units entering its network to reflect settlement adjustments addressing the original over-read, keeping a record of these adjustments and reporting any difficulties in achieving them to Ofgem.

Effects on losses incentive earnings and allowed revenue for 2009-10

25. The approximate affect on NEDL and YEDL's revenue reporting for 2009-10 is expected to be as set out below, subject to the exact allocation of units between distribution unit categories, which affects the revenue driver calculation:

£m	NEDL before restatement	NEDL after restatement	YEDL before restatement	YEDL after restatement
Losses incentive adjustment	-13.2	-0.7	-21.5	6.48
Allowed demand revenue	181.9	195.6	226.3	256.5

26. It is important to note that the 'before restatement' figures shown above have not yet been reflected (as a dip) in use of system charge levels. Although the absolute value of the adjustments authorised in this letter is significant, their effect will be to ensure that CE's allowed revenues stand at their proper levels. Therefore, we do not expect the adjustments to cause CE's use of system charges to increase by more than would have been anticipated under the DPCR5 price control settlement.

**Next steps**

27. You should submit restated revenue reporting returns for NEDL and YEDL for 2009-10 as soon as possible, and in any case by 31 January 2011, reflecting the decisions set out above, together with an opinion from the independent auditor concerning the appropriateness of the restated returns.

28. We refer in paragraph 17 to the fact that all DNOs will be required to provide updated losses information for the DPCR4 period on a common basis during 2011 to facilitate the calculation of LRRM and ALP values. In determining these values for NEDL and YEDL we will take into account any further or better information arising in relation to the matters covered in this letter and our decisions on these matters are therefore explicitly subject to further adjustments in that regard should they prove necessary or appropriate.

29. Any queries regarding the content of this letter should be sent for the attention of Paul Darby, Senior Manager, Regulatory Finance or emailed to: [regulatoryfinance@ofgem.gov.uk](mailto:regulatoryfinance@ofgem.gov.uk).

Yours sincerely,



**Rachel Fletcher**  
**Partner, Distribution**  
**Signed on behalf of the Authority and authorised for that purpose**