



To distributors, customer groups,
distributed generators, suppliers,
connection providers and other
interested parties

*Promoting choice and
value for all customers*

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Dear colleague,

DPCR5 – looking ahead

1. It is now 2½ years since we issued the Final Proposals¹ for the current electricity distribution price control review (DPCR4). While we do not intend to commence the next review (DPCR5) until 2008, we are inviting views at this early stage on the general approach and key issues for the review. In the context of related work already undertaken, underway or planned, we also seek views on whether there are preparatory tasks we should commence this year.

Context

2. The broader energy policy context has developed significantly over the last few years. The Government's Energy White Paper, due to be published shortly, will undoubtedly be an important milestone, as were the EU agreement on a binding 20% renewable energy target and the Stern Review. These developments bring new challenges to the electricity distribution sector as the characteristics of users of the network change. Increased consumer participation, shifts in the pattern of use, energy efficiency and new sources of micro and local generation will all impact on distribution networks. Active network management is expected to become increasingly economic.
3. Ofgem's approach to network regulation has developed, and will continue to develop, to address these requirements. We introduced a number of new initiatives as part of the last price control back in 2004, in early response to changing priorities. We have since progressed changes to contractual, charging and connection issues. We have worked with DTI on a review of barriers to and incentives for distributed generation, which will be published shortly. We have begun work on long-term scenarios for the electricity sector, which will help identify a range of future challenges that the sector may face. We will take account of revisions to the cost of carbon we use in assessing policy. One of the advantages of the five year duration of the current price controls, compared to longer periods, is that we can now look to adapt the price controls to reflect these developments. We can also learn from our recent Transmission Price Control Review and our ongoing Gas Distribution Price Control Review.

¹ Electricity Distribution Price Control Review, Final Proposals, November 2004 – reference 265/04 available at <http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR4/Documents1/8944-26504.pdf>

Objectives for DPCR5

4. Our objectives for DPCR5 will flow from our statutory duties. Above all, we are looking to protect the interests of current and future customers by ensuring the electricity distribution network operators deliver the required outcomes while providing good value for money. The regulatory framework needs, inter alia, to facilitate sustainable development and investment where it is needed, to promote secure supplies and good customer service and to ensure the networks and the network operators change to meet the new challenges they will face.
5. In our view, in general, these objectives are best achieved through incentive regulation - leaving decisions with company management operating in a regulatory framework that enables better performing companies to earn higher returns. The track record of incentive regulation in the GB energy sector is excellent - as recognised internationally - and the sustained improvements that the distribution companies have made in quality, investment and efficiency position the sector well to meet future challenges. As noted in the recent Financing Networks study, it is important to build on the success achieved to date in gaining the confidence of investors and other stakeholders in the regulatory framework, to secure the increased investment that will be required. The changes we are considering for the overall approach to DPCR5 are evolutionary in nature but reflect the developments in the context described above.

Roles and responsibilities of electricity distribution businesses

6. In previous price controls, we have focused on the direct role of the electricity networks in serving current and future customers and the impacts of their actions on facilitating competition in generation and supply and on the environment. We have tended to use incentives to promote the behaviours we have sought (e.g. reducing losses and power cuts, improving efficiency and customer service, innovation) - changes to incentives are considered below.
7. We will need to consider whether we should, instead or in addition, define additional responsibilities or obligations. For example, requirements to develop economic and efficient networks may imply consideration of environmental costs associated with carbon emissions. As a first step, we could look to the distribution companies to assess their own carbon footprint. There have been suggestions that network companies should be a tool for intervening in other parts of the energy sector (such as smart metering). Some may question whether such approaches are appropriate or whether they would be effective. We would welcome views on whether and, if so, how the roles and responsibilities of the companies should change.
8. We also need to consider the implications of increased distributed generation for industry structures and relationships - such as the interface between transmission and distribution networks and the issue of ownership unbundling of distribution network operators from generators and suppliers. Other possibilities could include competitive tendering of some functions. We would welcome views on these issues.

Reducing emphasis on 5 year allowances set by the regulator

9. We expect to continue to use the traditional "building block" approach to assess revenue requirements. However, we recognise that there are concerns about the extent to which price control reviews are perceived to focus on 5 year expenditure assessments. In part this is a communication issue - the expenditure assessments do not determine what companies actually spend, which should be driven by business needs to meet licence and statutory obligations/responsibilities based on the long-lived nature of assets.
10. Some of the recent developments in our approach have already moved focus away from the allowances. For example, we have emphasised the importance of asset

management to embed consideration of whole life costs and benefits in ongoing decisions, we developed a sliding scale approach at DPCR4 to place more weight on company forecasts and we have announced plans for longer term scenarios. We will look to the companies to explain and quantify what they intend to deliver through their plans, in a way that is meaningful to a range of stakeholders. They will need to explain how they intend to resource delivery of the plans into the future, including how they will address the availability of skilled staff at all levels of their organisation, building on the welcome initiatives already underway.

11. We are reviewing our approaches to projecting expenditure requirements, to build on the better information available from the cost reporting work we have undertaken. We will seek better integration of opex and capex allowances and incentives, to reduce accounting distortions and encourage beneficial trade-offs. There may also be alternative ways of presenting our proposals that place less emphasis on allowances. These matters will be discussed in the first consultation document in early 2008.

Incentives – potential simplification and sustainability

12. At the last review, we introduced several new incentives and adjustment mechanisms, for example in relation to innovation, customer service and environmental matters. In general, these appear to have had a positive impact in focusing attention and effort in the areas specifically targeted. However, from better regulation and simplicity perspectives, we will want to consider whether all of the different mechanisms are needed. It may be possible to find an alternative approach, such as a package of commitments from each licensee with funding conditional on delivery.² Some other simplifications may also be possible, such as removing the complicated revenue drivers in the current control.
13. In 2006, we published our first annual sustainable development report.³ The incentives in the price control relate to several of the indicators in that report. The themes and indicators may provide a useful tool for reviewing and developing the package of incentives, as well as a mechanism for explaining how they address sustainable development issues.
14. One of the risks of incentive regulation is that management attention focuses on those activities that are quantified, measured and incentivised, to the possible detriment of other areas. We recognise that we cannot have mechanistic incentives for all of the important activities of distribution businesses. One approach to address this is to make one-off adjustments to revenue as part of a price control review. At the last review, we provided additional revenue to one group in recognition of their leadership on quality of service. We have already indicated that we will consider adjustments (positive or negative) at the coming review in respect of distribution business performance on connections, including particularly distributed generation and the issues set out in our proposals paper.⁴
15. At the last review, we took a small step to extend this concept to adjustments between reviews, with a customer service reward of up to £1 million a year, targeted to a significant extent at promoting best practice in meeting the needs of vulnerable customers. One option would be to extend this model substantially, both in scope and value. The benefits of this approach include its potential flexibility to respond to developing demands on distribution businesses and to encourage innovative practices. However, the decision making process would be important. We would welcome views on these issues.

² Except for the Innovation Funding Incentive (IFI), where we have committed to retain the existing mechanism.

³ Sustainable Development Report 2006, November 2006, reference 192/06, available at <http://www.ofgem.gov.uk/Sustainability/Documents1/15938-susdevbro06.pdf>

⁴ Review of Competition in Gas and Electricity Connections, Proposals Document, February 2007, reference 26/07, available at <http://www.ofgem.gov.uk/Networks/Connectns/CompinConn/Documents1/16982-2607.pdf>

Process – better engagement with consumers and stakeholders, fewer documents

16. As part of our *Consumer First* project and to inform the price review, we will commission research this year into consumers' views on electricity distribution. We are keen to engage the licensees in this work, as well as consumer representatives. We envisage that this research will involve a number of phases, intended to be open to capturing a range of issues of interest to consumers initially. For example, similar surveys prior to the last price review highlighted information provision and visual amenity as important issues, as well as interruptions to supply. We would expect to assess willingness to pay for improvements in the latter stages of the survey.
17. In addition, much of our work on developing the commercial regulatory framework over the past couple of years has involved encouraging the electricity distribution companies to engage more with their stakeholders. Some progress has been made and we are keen to take this forward into the price review process. We consider that there would be merit in the distribution companies consulting with stakeholders on choices within their business plans. This will require more transparency of business plans and could involve regional workshops, probably led by the distribution companies.
18. Drawing on lessons from DPCR4 and subsequent experience, we expect DPCR5 to involve fewer main consultation documents, but with longer response periods and more workshops. The cost reporting project has enabled us to streamline the data collection/normalisation process. A draft timetable for the review is set out in the annex to this letter.
19. We expect to continue several aspects of the process from DPCR4, including use of an Authority committee at key stages. The details will be developed later this year.

Plans for 2007

20. During 2007 (and indeed 2008), work continues on cost reporting, charging and connections issues. We still need further progress from the distribution companies in these areas – some are more advanced than others. We are progressing follow-up work from the Financing Networks project and have recently announced a review of the drafting and structure of the electricity distribution licence, both in preparation for DPCR5.
21. As noted above, we intend to commission a customer survey this year to inform our understanding of consumer interests going into DPCR5 (building on the surveys conducted in 2003-04).
22. We will also review the new initiatives introduced in DPCR4 in the light of the evidence and experience from the first two years of the current price control period.
23. Some companies have suggested that we should consider setting some aspects of the price control early to avoid them delaying or reducing initiatives due to uncertainty over arrangements to apply from April 2010. We recently extended the Innovation Funding Incentive on this basis. It has been suggested that a similar case applies for quality of service targets. We could potentially propose targets for customer interruptions and minutes lost for, say, 2010/11 and 2011/12 in the first DPCR5 consultation in early 2008 if a clear case is made that this would lead to benefits for consumers. We would welcome views on whether this is the case and, if so, how such an arrangement should be implemented.

Views invited

24. We would welcome views on any of the issues set out in this letter but in particular:

- Have we captured the key strategic issues?
- What changes should be considered to the role and responsibilities/obligations of distribution businesses?
- How can we build on or make best use of the range of developments and initiatives set out in paragraph 10 above?
- How can we simplify and refocus the incentive package to address future requirements?
- Do you agree with the suggested process and timetable set out, both for work in 2007 and for the review? What should we do differently?

25. We would welcome responses to this letter by **10 August 2007**, preferably submitted electronically by email to distributionpolicy@ofgem.gov.uk. Responses will be published on our website. As such, any confidential responses should be clearly marked as such and confidential issues set out in an appendix to any response.

26. If you have any questions on this letter please contact me on 0207 901 7255.

Yours faithfully,



Martin Crouch
Director, Electricity Distribution

Annex – draft timetable for DPCR5

Autumn <u>2008</u>	Customer survey first phase
February/March	Initial consultation and customer survey results (responses due May/June 2008)
April/May	Workshop on initial consultation Second phase customer survey results
June/July	Distributors submit 2007/08 data Distributors consult on draft forecasts
Autumn <u>2009</u>	Regional workshops on draft forecasts
January	Policy Paper (responses due April 2009)
March	Distributors submit revised forecasts
May	Distributors submit key 2008/09 data
End June/ July	Initial Proposals (responses due early September 2009)
July and Sept	Workshops on initial proposals
End November	Final Proposals Full draft licence modifications
<u>2010</u>	
February	Licence mod statutory notice