November 2001

Information and incentives project

Developing the incentive scheme

Update

Executive summary

This document sets out further details on the Information and Incentives Project (IIP) incentive scheme which will apply to electricity distribution companies from April 2002 to March 2005. The scheme will strengthen the financial incentives on the electricity distribution companies with respect to key areas of quality of service – the number and duration of interruptions to supply and the speed and quality of telephone response.

This document builds on the initial proposals published in July 2001, in the light of responses to the document from distribution companies and other interested parties. In particular it sets out for consultation:

- an incentive framework which consists of:
    - an incentive scheme where companies are penalised annually up to 2 per cent of revenue (around £4 million per company per year), for failing to meet their quality of supply targets for the incentive scheme during this price control period;
    - a mechanism for rewarding companies who exceed their targets for 2004/05, based on their rate of improvement in performance up to this date; and
    - a process for rewarding frontier performance in the next price control period by specifying the way in which targets will be reset;
- the types of interruptions that will be included in the IIP incentive scheme which takes account of the level of control that distribution companies have over their impact;
- a method for creating a profile of targets for the number and duration of interruptions to supply; and
- a revised method for constructing the performance ranking for the quality of telephone response provided by distribution companies.

Ofgem has also sent each distribution company initial estimates of the changes that it is considering making to the existing targets for the number and duration of interruptions to supply, so they are consistent with the way in which companies collate information on network performance using new measurement systems and a common set of definitions. The changes are designed to make sure that the targets are neither more or less challenging than when they were set as part of the last price control review in 1999.

This update, together with the initial proposals published in July 2001, form a platform for incentivising quality of supply for the next three years. In addition to benefiting customers, it will help inform the assessment of quality of service at the next price control review. Once the incentive scheme is in place, Ofgem intends to start work on reviewing the framework of price regulation as applied to electricity distribution, as part of the build up to the next price control review.

Comments are invited by 3 December 2001.

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1. Introduction

Background and progress

Developing the Information and Incentives Project (IIP) incentive scheme

1.1 In July 2001, Ofgem set out its initial proposals on the IIP incentive scheme, which will apply to electricity distribution companies (which were formerly Public Electricity Suppliers) to strengthen the financial incentives on quality of service. Ofgem received responses from all the distribution companies as well as energywatch, British Gas Trading and Transco. In the light of these responses and further work undertaken since then, this document seeks views on key components of the incentive scheme as it is intended to operate from April 2002 to March 2005.

1.2 In developing these proposals further, Ofgem is mindful of:

- its duties and objectives as set out in the Electricity Act 1989 and Utilities Act 2000 and in particular its principal objective to protect the interests of consumers, wherever appropriate by promoting effective competition;
- the views that have been expressed by the distribution companies and other interested parties over the course of the project;
- the constraints placed on the incentive scheme by introducing it during the existing price control period and maintaining consistency with the approach taken in 1999; and
- the need for a workable incentive scheme for the rest of this price control period.

1.3 Since July 2001 a significant amount of work has been undertaken in developing the incentive scheme. Ofgem and its consultants have assessed, with information provided by the distribution companies, what adjustments need to be made to the existing targets for the number and duration of interruptions to supply to take account of changes in measurement systems and new definitions introduced last year to improve the accuracy and consistency with which this information is collected (Chapter 2). Further thought has been given to the framework and mechanics of the incentive scheme, including how outperformance could be rewarded; the calculation of incentive rates; and how telephone response performance will be assessed (Chapter 3 and Appendix 1). An initial outline draft of the licence modifications that will be required to implement the incentive scheme has also been produced (Chapter 4 and Appendix 2).

Developing the audit and reporting framework

1.4 Over the last few months work has continued developing the reporting and audit framework for the IIP. Ofgem and its consultants produced a draft audit framework and information template which was discussed with all of the distribution companies at a workshop on 5 September 2001. Ofgem's consultants have also visited each distribution business to review, and provide feedback on, the progress the distribution companies are making in implementing changes to their measurement systems. These visits are being used to test and develop the audit framework and information template. A report will be completed in advance of the IIP final proposals document in December.

1.5 Work has also begun on reviewing some of the existing reporting requirements on the distribution companies, with the intention of removing any unnecessary duplication, and improving consistency of definitions and reporting guidance. Ofgem is looking at the role of Standard Condition 5, which is about reporting on network performance, where there appears to be an overlap with some of the information that will be collected under the IIP. Ofgem is also in the process of reviewing the Regulatory Instructions and Guidance (RIGs) for the IIP with the aim of improving the structure and detail of the document. This may result in changes being proposed to the RIGs or relevant licence conditions. This work should be completed for the IIP final proposals in December.

Next steps

1.6 This document provides further detailed information on how the incentive scheme could work for the period between April 2002 and March 2005. Ofgem has arranged to meet with each of the distribution companies at the end of November to discuss this document and the initial proposals published in July

2001. Following these meetings, and in the light of any written responses received, it is Ofgem's intention to publish its final proposals in December. The final proposals will address all the issues raised by the initial proposals and this update including the targets for the number and duration of interruptions to supply, incentive rates, a revised draft of the licence modifications, and a summary of responses to this document and the July 2001 initial proposals.

1.7 Following publication of the final proposals document, each distribution company will have to decide whether it will accept the proposals. If companies do accept the proposals Ofgem intends to publish revised licence modifications during February 2002. Subject to agreement the appropriate distribution licences will then be modified and the incentive scheme will become operational from 1 April 2002 to 31 March 2005.

1.8 Once the incentive scheme is in place, Ofgem intends to start work on the third strand of work associated with the IIP by reviewing the other incentives created by the framework of price regulation as applied to distribution. This will include, for example, the treatment of efficiency in setting the next price control review. A general discussion of the scope of this work was set out in an IIP update document in May 2001.

Responding to this document

1.9 If interested parties would like to respond to this document they should do so by 3 December. Comments should be sent to:

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1.10 Unless marked as confidential all responses will be published by placing them in Ofgem's library. This document is available on Ofgem's website (www.ofgem.gov.uk). Any questions on this document or the IIP more generally should, in the first instance, be directed to Cemil Altin.

2. Revising targets for the number and duration of interruptions to supply

Introduction

2.1 This Chapter outlines the work that has been undertaken on revising the existing targets for the number and duration of interruptions to supply. This work has two main elements:

- revising targets for changes to definitions that were introduced last year to improve the consistency of reporting; and

- revising targets for changes to measurement systems that companies are introducing to improve the accuracy of their reporting.

2.2 Some of the one-off adjustments that will be made to the existing targets for introducing standard definitions and changes in measurement systems could lead to a relaxation in the targets that companies are expected to meet. This is not designed to make the targets numbers easier or more difficult to achieve but to make them consistent with how network performance will be measured by companies in the future. Ofgem is writing to each of the distribution companies separately setting out its thoughts on the information that they have submitted in these areas and an initial estimate of changes to the existing targets. Subject to the comments made by the companies and further discussion with the technical consultants, revised targets will be included in the December final proposals document. The purpose of this Chapter is to outline in general terms the main areas where changes are likely.

Adjusting targets for new definitions

2.3 As part of the work that Ofgem undertook last year on improving the information it collects from distribution companies on quality of service, standard (and consistent) regulatory definitions for reporting were introduced for the first time. These definitions (and associated guidance notes) are set out in the Regulatory Instructions and Guidance (RIGs) document, published in February 2001.[1] It is

[1] Information and incentives project “Regulatory instuctions and guidance” February 2001

important that the existing targets for the number and duration of interruptions, which were agreed as part of the last price control review, are consistent with the new definitions.

2.4 EA Technology (EATL), who are assisting Ofgem with this work, sent each of the distribution companies an information request which required them to quantify (and provide explanatory narrative on) the impact of the new definitions and changes in measurement systems on their existing targets for the number and duration of interruptions to supply.

2.5 The impact of the standard definitions on the number and duration of interruptions will, to some extent, overlap. Some companies have provided information on an aggregate level while others have attributed the impact to individual definitions. Most companies have estimated that the impact of many of the new definitions on the number and duration of interruptions will not be significant. Generally there appears to be a reasonable degree of consistency in the estimates provided by companies. Differences could exist for a number of reasons depending on the definitions previously used. As a general principle, Ofgem considers that where it can be demonstrated that a change in performance can be attributed to a standard definition, then this should be taken into account in setting targets for the IIP incentive scheme.

2.6 It is important that the process that Ofgem and EATL have used for assessing the information that has been submitted by the distribution companies is consistent across the companies. The general approach that has been taken has included looking at - the expected (or likely) impact of the change; whether the company estimate is consistent with, and justified by, the narrative it has provided; and the estimates and narrative submitted by other companies.

Adjusting targets for changes to measurement systems

2.7 Most of the distribution companies are in the process of making changes to their measurement systems to improve the accuracy of reporting on quality of supply, and in particular on the impact of network performance on customers.

2.8 A number of distribution companies have already made changes to their measurement systems which, they have argued, led to an increase in reported figures for the number and duration of interruptions to supply. These distribution companies have suggested that this is indicative of their improved ability to measure the impact of network performance on customers rather than poorer performance. It is important that companies are not provided with a disincentive to improve the level of accuracy in their reporting. Ofgem considers that where it can be demonstrated that changes in reported performance are due to improvements in the way companies measure the impact of network performance on customers, and where this has not already been taken into account in the way targets were set during the last price control review, then this should be reflected in the targets for the IIP incentive scheme. Where adjustments have been made previously it will be important to ensure that there is no double counting.

2.9 In addition to the principles outlined above Ofgem considers that any adjustments which are made to the existing targets should only cover changes which have already been made by companies, or those that are in the process of being implemented this year to meet the required levels of accuracy from April 2002.

2.10 Some companies have found it difficult to estimate the impact of implementing new systems. The information that companies have submitted shows that there are significant differences in the estimated impact of changes in measurement systems on the existing targets. These difference could arise for a number of reasons including the existing quality of companies' measurements systems. For example, some companies have estimated that the impact of changes in measurement systems will be less than 10 per cent of the existing targets, while others have estimated that the impact will be much more – including estimates of up 50 per cent.

2.11 In assessing the reasonableness of these estimates Ofgem and EATL will consider – the detailed disaggregated information that companies have provided on the impact of changes to the measurement systems at different voltage levels; whether the estimate is consistent with, and justified by, the supporting narrative that the company has provided; the experience of other companies that have made similar changes to their measurement systems; and the work that PB

Power undertook last year on reviewing the measurement systems of each company.

A possible further review of targets in 2002

2.12 A number of companies have argued that it will be necessary to have a further review of targets next year, as they are not able to forecast with sufficient accuracy, what the impact will be on targets of changes in measurement systems and the new definitions. The need for a further review of targets needs to be balanced against two criteria:

- the risk to customers and companies that the adjustments to targets do not accurately reflect the actual impact of introducing standard definitions and measurement systems on the existing targets; and
- the possibility of creating additional uncertainty for companies about the targets they are expected to meet by reviewing them again.

2.13 Ofgem considers that it will be appropriate to have a further review of targets next year but that it should be limited in scope to ensure that an appropriate balance is reached between the two criteria identified above. Given that the majority of changes to measurement systems will have been made by the end of this year and that the new definitions introduced in April 2001 will have bedded down, it should be possible to carry out a limited one-off review next summer. It will be important that the review is able to take account of over and under adjustments to the targets. The process for any review would also need to be reflected in the relevant licence condition for the IIP incentive scheme.

3. Developing the framework and mechanics of the IIP incentive scheme

Introduction

3.1 The July 2001 document set out Ofgem's initial proposals on the framework and mechanics of the IIP incentive scheme. Some of the key issues raised by the document included:

- the way in which companies should be rewarded for outperformance under the incentive scheme;
- the types of interruptions to supply it might be appropriate to exclude from the incentive scheme;
- the amount of revenue that should be exposed to the scheme as a whole and to each output measure;
- possible ways of dealing with annual variability in performance; and
- the use of performance rankings for the speed and quality of telephone response provided by companies.

3.2 This Chapter sets out Ofgem's further thinking in these areas in the light of the views that have been expressed by distribution companies and other interested parties and further work by Ofgem. The framework and mechanics of the IIP incentive scheme outlined in this Chapter relate to the operation of the scheme over the period April 2002 to March 2005. At the time of the next price control review it will be necessary to consider the most appropriate arrangements relating to the incentivisation of quality of service.

How targets were set in 1999

3.3 The existing targets for 2004/05 for the number and duration of interruptions to supply were set as part of the last distribution price control review in 1999. They were set by applying a required percentage improvement over the period of the price control (2000/01 to 2004/05) to the forecast performance for 1999/00, which was derived from a 10-year linear trend in actual performance.

The required percentage improvement differed across companies depending on two criteria – a ranking of:

- ♦ (the better of) absolute performance in 1997/98 and 1998/99; and
- ♦ the improvement in own performance over time, measured as the (better of) performance in 1997/98 and 1998/99 compared to average performance over the period 1990/91 to 1994/95.

3.4 Companies were ranked separately on the basis of each of these criteria and an average was taken to derive the final overall ranking. In deriving the rankings, data for any year where performance was more than 2-standard deviations away from the average for the preceding years, was excluded, i.e. the performance figure for the whole year was excluded. There were no adjustments made to the data for specific events.

3.5 Based on the final overall ranking, companies were required to make a percentage improvement on the forecast performance figure for 1999/00, by the end of the price control period. This produced a figure for the final target for 2004/05. Where the targets put forward by the distribution companies were lower than those derived from the method explained above, these were used instead.

An incentive framework

3.6 This section sets out Ofgem's thoughts on an incentive framework for quality of service including the issues associated with rewarding outperformance.

Rewarding outperformance

3.7 The July 2001 document outlined an incentive framework but recognised that one disadvantage of the proposal was that companies would have little incentive to carry on trying to make improvements in quality of service once they had reached their agreed targets. In the light of this, it sought views on an appropriate method for rewarding outperformance. In response, all of the distribution companies disagreed with the initial proposal to introduce an incentive scheme which allowed no opportunity for earning an additional reward if they exceeded their targets. A number of companies put forward possible ways for rewarding outperformance under the IIP incentive scheme. Most of these proposals suggested there should be an automatic reward for beating the existing targets equal in size to the penalty for not meeting the target i.e. a symmetric scheme.

3.8 Energywatch said that companies should not be permitted to increase distribution charges if they exceeded their targets in this price control period. It said that the suggestion put forward by Ofgem, to establish how the process for resetting the targets for the next price control period, has the most likely potential for incentivising outperformance in the existing price control period.

3.9 In July Ofgem said it did not consider it appropriate during this price control period for incentives for outperformance to be delivered through a symmetric scheme where companies would be rewarded automatically for exceeding their targets. This was because in addition to uncertainty over customers' willingness to pay for improvements in quality of service, the performance of some of the companies in the last year of the previous price control (1999/00) had already exceeded the targets for the end of this price control period (2004/05). This would mean some customers paying more for a level of service that had already been achieved before the price control period had begun.

3.10 Ofgem is not opposed in principle, given the appropriate circumstances, to a symmetric incentive scheme. As part of the next price control review, it will be necessary to consider whether changes should be made to the incentive scheme. This will depend on a number of factors including experience of how the IIP incentive scheme has worked.

3.11 Taking the above views and arguments into account, Ofgem considers that there is a case for providing an additional financial incentive for companies who exceed their targets and without this incentive might not seek to deliver further improvements in quality of service over the remainder of this price control period.

Rewarding improvements in performance

3.12 One option for rewarding outperformance would be to reset the quality of supply targets across all companies and introduce a symmetric incentive scheme. The existing targets are indirectly linked to capital expenditure allowances determined at the price control review in 1999. Any decision to make quality of supply targets tougher may require review of the related capital expenditure requirements. Reviewing capital expenditure allowances in the middle of a price control period would significantly weaken the incentive effect on costs, be perceived as creating significant regulatory uncertainty and is a disproportionate mechanism for achieving the objective of introducing a quality of service incentive scheme.

3.13 Instead, Ofgem is considering introducing a modification to the IIP incentive scheme, as proposed in July 2001, to reward all companies that exceed their quality of supply targets for 2004/05. For companies who do not exceed their targets for 2004/05 there will be no reward. It is proposed that companies will be rewarded on the basis of their improvement over the duration of the incentive scheme in the current control period. Basing the reward on the rate of improvement in performance overcomes the difficulty of automatically rewarding a company for exceeding targets, which may have already been met.

3.14 The following issues need to be addressed if such a modification is to be made:

- the IIP incentive scheme covers the following areas – the number and duration of interruptions to supply and the speed and quality of telephone response. It is for consideration whether the scheme should apply to all of the output measures that are included in the IIP incentive scheme;

- the maximum amount of revenue that should be made available for outperformance. Ofgem's initial thoughts are that this should be limited to a one-off adjustment of 2 per cent of price control revenue for one year. This is the same amount of revenue which is at risk in the final year of the scheme to underperformance. Putting a greater amount of revenue at risk would not be consistent with the approach being proposed for setting interim targets where no improvement in performance is sought for 2002/03 and 2003/04 (discussed later in this chapter);

- the base year for measuring the rate of improvement. There seem to be two options – either 2001/02 or 2002/03. Both years' data will have been audited. There is a risk that by nominating 2002/03 as the base year companies may have a perverse incentive to perform badly and hence make a larger percentage improvement easier to achieve in the last two years of the control; and

- the way in which the rate of improvement in performance is linked to the reward. There are two alternative approaches. Companies that improve over the period by a predetermined percentage could receive a reward of 2 per cent. Companies achieving less than the predetermined percentage but still exceeding their targets for 2004/05 could receive a prorated reward. Alternatively, all companies who exceed their 2004/05 targets could be banded on their rate of improvement so that those in, for example, the top third were able to charge an additional 2 per cent, the middle third, 1.3 per cent and the bottom third 0.67 percent.

Rewarding frontier performance

3.15 Ofgem also wants to incentivise frontier behaviour (i.e. to incentivise companies to be the best) in an appropriate way. Ofgem has recognised that there is a cost (or price) quality trade-off, and that companies should be free (subject to minimum quality and maximum cost constraints) to choose what combination of cost and quality they offer their consumers. It is not possible to take account of this issue when introducing an incentive scheme during a price control period. Incentivising absolute quality performance without taking account of price or cost could disadvantage those companies that have chosen to deliver a package of relatively lower costs and quality.

3.16 One approach for rewarding frontier performance is through the way in which targets for quality of supply are reset at the time of the next price control review when costs can also be considered. The July 2001 document indicated that companies that were at the frontier could be rewarded with less demanding targets in terms of future improvement than those further from the frontier. This represents a financial reward to the extent that it reduces the risk associated with meeting these targets and so earning the allowed rate of return (subject to also meeting the underlying cost assumptions).

Summary

3.17 In summary, Ofgem proposes an incentive framework which has three main elements:

- an incentive scheme that penalises companies annually, up to 2 per cent of revenue, for not meeting their quality of supply targets during this price control period[2];
- a mechanism for rewarding companies who exceed their targets for 2004/05, based on their rate of improvement in performance up to that date; and
- a process for rewarding frontier performance in the next price control period by specifying the way in which targets will be reset.

Mechanics of the incentive scheme

Exposure of revenue to the scheme

3.18 The July 2001 document outlined a possible profile of revenue to expose to the IIP incentive scheme as a whole over the period 2002/03 to 2004/05. Some respondents argued that the full amount of revenue (2 per cent) should be exposed immediately. Others suggested that given uncertainty regarding the data it would be appropriate to expose a lower level of revenue at least for this price control period. One respondent suggested that no revenue should be exposed to the incentive scheme and that a 'wooden dollar' scheme should operate for the remainder of this price control period.

3.19 Ofgem is concerned that exposing no revenue during this price control period could create perverse incentives if, in the future, there was the expectation that companies were to be provided with explicit financial incentives with respect to quality of service.

[2] The way in which Ofgem intends to assess telephone response performance under the IIP incentive scheme is discussed below.

3.20 Ofgem's auditors for IIP information are presently undertaking a review of the progress that companies have made in implementing changes to their measurement systems. The auditors report is expected to identify:

- any significant problems with the progress that companies are making; and
- any areas where companies are not collating IIP information in accordance with the RIGs.

3.21 Their initial view is that the companies that are implementing changes to their measurement systems are making good progress. A number of inconsistencies in reporting against the RIGs have been identified but these are not considered significant.

3.22 Ofgem recognises that a balance needs to be struck between the amount of revenue that is exposed against the robustness of the data and targets that underpin the IIP incentive scheme. In the light of the views expressed by companies and any possible uncertainty caused by the re-opener of targets, Ofgem considers that it is prudent to reduce the amount of revenue that is exposed to the incentive scheme in the first year of its operation.

Table 1: A profile of revenue to expose to the incentive scheme

	2002/03	2003/04	2004/05
Percentage of regulated revenue exposed to the incentive scheme (%)	1	2	2
Average amount of revenue per company (£m)[1]	2	4	4

Note (1): This is based on forecast regulated revenue taken from the final proposals document for the distribution price control review (December 1999)

Exposure of revenue within the scheme

3.23 The July 2001 document set out a possible profile of revenue to be exposed to each of the output measures. Most of the distribution companies agreed with the relative weighting attributed to each of the output measures. Some companies suggested that no revenue should be exposed to the telephone response measure as performance figures may not be robust. The initial report that has been produced by Accent suggests that the results from the customer survey will be robust. Ofgem has also refined the way in which the performance ranking will be derived to help ensure that adequate steps are taken with regards to the statistical robustness of the ranking.

3.24 Given these considerations, and the figures outlined in Table 1, the profile for the amount of revenue to expose to each individual output measure is shown in Table 2.

Table 2: A possible profile of revenue to expose to each output measure

	2002/03	2003/04	2004/05
Total amount of revenue exposed (%)	1	2	2
Amount exposed to each output measure (%):			
Duration of interruptions	0.5	1.25	1.25
Number of interruptions	0.25	0.5	0.5
Telephone response	0.25	0.25	0.25

3.25 Ofgem needs to consider how the amount of revenue that is exposed to telephone response is split between the speed and quality of response. Initial thoughts are that they should be weighted equally, (i.e. 0.125 per cent of revenue exposed to each). Ofgem will want to review this, in the light of the further information that it will receive before final proposals on performance in the customer survey.

Interruptions included in the incentive scheme

3.26 The July 2001 document sought views on whether interruptions sourced from outages of embedded generators or faults on transmission (or other connected) networks should be included in the incentive scheme. Ofgem's further thoughts in these areas are outlined below.

Interruptions on transmission (and other connected) networks

3.27 Distribution companies have argued that there is little, if anything, they can do to avoid being affected by a fault on a transmission network. Ofgem considers that different considerations apply for the number and duration of interruptions to supply and whether the transmission fault affects a local part of the transmission system or a wider area.

- *number of interruptions to supply* – distribution companies are able, in many cases, to provide a degree of interconnection between transmission connection points. This can be used to reduce the impact of a single, localised transmission point loss. Not many distribution companies have automated these arrangements at present, which would enable them to achieve alternative supply arrangements before an interruption is counted under the IIP incentive scheme.[3] In the medium term, it may be possible for a distribution company to have more influence over the extent of the impact of the fault, for example by extending interconnection and automating the supply transfer switching. In the light of these considerations, Ofgem intends to exclude the impact of faults on transmission (or other connected) networks on the number of interruptions to supply in the IIP incentive scheme. This will need to be looked at again when the incentive scheme is reviewed as part of the next price control review;

- *duration of interruptions to supply* – once a fault on the transmission network has occurred there are certain things that the distribution companies can do to mitigate, to some extent, the duration of the interruption. There are direct actions (such as the effectiveness of the operational interface with the National Grid Company – NGC) and indirect actions (such as encouraging NGC to optimise their outage planning and emergency return to service arrangements). It seems appropriate that some incentive is retained on distribution companies in this area. Ofgem intends to limit the impact of faults on transmission (and other connected) networks on the duration of interruptions to supply. This will be done by including a fixed proportion of the actual duration of interruptions to supply sourced from a fault on transmission (and other connected) networks within the measure of the duration of interruptions in the IIP incentive scheme, e.g. 10 per cent.

[3] The Regulatory Instructions and Guidance (RIGs) document February 2001, sets out the definition of an interruption as the loss of supply of electricity to one or more customers due to an incident, which lasts 3 minutes or longer.

Interruptions from outages on embedded generators

3.28 It is not clear at this stage what impact any increase in the amount of embedded generation connected to the distribution network will have on a company's performance under the IIP. While an outage at an embedded generator may lead to customers being interrupted on the connected distribution network, the presence of an embedded generator may in time bring positive benefits for quality of supply. At present the number of outages caused by failures of embedded generation is relatively small. If the amount of embedded generation increases this may change. In the light of this, the impact of outages from embedded generators will be included in the IIP incentive scheme. This will be reviewed as work progresses on the embedded generation project and if there is evidence that any company is being affected disproportionately by faults from embedded generators.

Table 3: Interruptions included in the incentive scheme

Interruptions sourced from	**Treatment**
Pre-arranged outages	Included in the incentive scheme
Outages of embedded generators	Included in the incentive scheme
Faults on transmission (and other connected) networks	Excluded from the number of interruptions, for example, 10 per cent included in the duration of interruptions
Other factors including third party damage	Included in the incentive scheme

Calculating incentive rates for the number and duration of interruptions to supply

3.29 The July 2001 document indicated that the most appropriate form for the incentive scheme for the number and duration of interruptions is to use a mechanism where companies forego a specified amount of revenue for each 'unit' by which they fail to meet their own target, i.e. companies are set an incentive rate. Companies were broadly supportive of the use of an incentive rate although there were some concerns with the detail of how it would be constructed.

3.30 These included views that:

- a company specific performance band should be used;
- a common incentive rate should be used; and
- any common performance band should be based on absolute numbers not a percentage.

3.31 There is no definitive way of calculating the incentive rate. The adjustments suggested by respondents would be beneficial to some companies but detrimental to others. Without common performance bands some companies could fail their targets by more 50 per cent, while others by less than 5 per cent, before they lost the maximum amount of revenue exposed to the output measure. Using common incentive rates would mean that all companies would lose the same amount of revenue for each 'unit' that they deviated from their target. This would lead to significantly different performance bands and would not reflect the absolute amount of revenue exposed to the scheme for each company. Using a common performance band based on absolute performance numbers would mean that those companies that have lower targets for 2004/05 would be able to deviate from their targets by much more on a percentage basis than companies with higher targets.

3.32 Ofgem considers that the method outlined in the July 2001 document is the most appropriate approach. This will ensure that all companies can deviate from their targets by the same percentage before they lose the maximum amount of revenue exposed to that output measure.

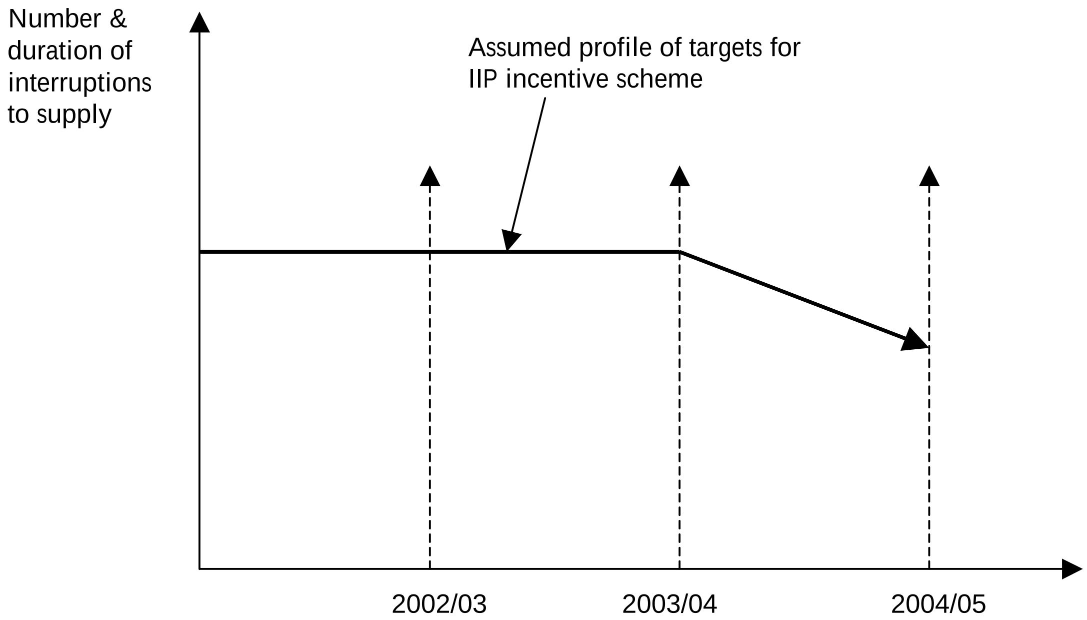
3.33 Appendix 1 sets out the incentive rate for each distribution company for both the number and duration of interruptions to supply, including an explanation of how they have been derived. These have been calculated using the profile of revenue exposed to the scheme and each output measure that is set out in this Chapter.

Setting a profile of targets

3.34 The July 2001 document indicated that Ofgem intends to set annual targets for the number and duration of interruptions to supply. This provides strong ongoing incentives on companies with respect to quality of supply and ensures that the incentive scheme can operate each year in line with the price control. In response to the July 2001 document companies have expressed concerns that they had not agreed to interim targets as part of the price controls and that there could be a number of reasons why their actual performance may deviate from an assumed profile. These include changes in the capital expenditure plans from when the price control was agreed; uncertainty over the time taken for capital expenditure projects to impact on performance; and other events, (such as foot and mouth) which have had an impact on their ability to undertake planned work on the network.

3.35 One way of dealing with these issues is by sculpting the profile of targets for the number and duration of interruptions in supply. Annual targets could be created so that for the first two years of the incentive scheme (2002/03 and 2003/04) companies would not be required to make any further improvements in performance beyond the level achieved in 2001/02, i.e. the profile would be flat. There would then be a downward step change to the target in the final year of the incentive scheme (2004/05). Companies would have the option (and an incentive under the reward scheme) to take an ‘alternative route’ to meet (and exceed) their final target, i.e. adopt a steeper profile. Using this approach companies are incentivised to make sure that quality of supply does not deteriorate while at the same time deliver improvements by the end of the price control in March 2005 consistent with the targets which were agreed in 1999. This is shown in Figure 1 below.

Figure 1: Profiling targets



Consistency with the price control

3.36 A number of companies have argued that exceptional events, particularly those that are weather related, should be excluded from the IIP incentive scheme. This is because performance on the number and duration of interruptions to supply could deteriorate significantly following exceptional weather, which would make it harder for a company to meet its targets and avoid losing revenue under the incentive scheme.

3.37 Some companies have argued that to maintain consistency with the price control it is necessary to exclude certain events (or a whole year) from the IIP incentive scheme that is more than 2-standard deviations from the historic average performance level. It is argued that this will protect companies against exceptional events. The July 2001 document outlined alternative approaches to dealing with exceptional events that did not rely on excluding specific events from the incentive scheme in order to maintain the incentives on companies to restore supply as soon as possible. In developing its thoughts in this area Ofgem has reviewed the approach that was used during the last price control to set the existing targets, which is outlined in paragraph 3.3.

3.38 The way in which the existing targets were set did not exclude specific events from the calculations. Excluding specific events from the IIP would not be consistent with the price control. The financial risk that a company faces under the IIP is limited to a maximum of 2 per cent of revenue in each year that the scheme operates, i.e. there is a limit to the downside over the whole year. Ofgem's analysis shows that on the basis of historic performance, for almost all companies, they will hit the financial cap before performance on both the number and duration of interruptions to supply for the year gets as bad as 2-standard deviations from the historic average. This means that the cap on the financial risk associated with the IIP incentive scheme as a whole provides adequate protection to companies with respect to exceptional events. For the small number of instances where this is not the case, this is because past performance has not varied significantly from year to year, i.e. it has not previously been volatile. In the light of these considerations, Ofgem does not intend to exclude any specific events or performance for the whole year from the incentive scheme.

Force majeure

3.39 As a general rule there will be no exclusions from the incentive scheme for exceptional circumstances such as severe weather. Ofgem does recognise that there may be other unforeseen circumstances (such as terrorist action etc.) which may have a significant impact on the ability of companies to act effectively in delivering an appropriate quality of service to its customers. These are often called 'force majeure' conditions or circumstances. It may be appropriate, under such circumstances, for Ofgem to retain the possibility of reviewing how the incentive scheme operates once the scale of such an event becomes apparent. If there is any mechanism for force majeure it will need to be reflected in the licence condition for the incentive scheme.

Assessing telephone response performance

3.40 The July 2001 document outlined one option for incentivising companies on the basis of their telephone performance. Companies that were poor performers (e.g. bottom third of companies) would have their revenue reduced by the maximum amount exposed to the output measure. Companies that were good performers (e.g. top third of companies) would be able to retain the revenue exposed to the output measure.

3.41 Companies have expressed a number of concerns with the use of a performance ranking for assessing telephone performance.[4] These include issues such as statistical robustness and the 'fairness' of the ranking mechanism. Some companies have also suggested that we should use targets for the speed of telephone response, for example by benchmarking against other industries. Other companies were content with the broad approach.

3.42 It is not possible to set targets for telephone speed of response at this stage. Historical data is not available and benchmarking against other industries would not be appropriate as they do not have the same call trends or profiles. Ofgem considers that one way to deal with the other concerns that have been raised is by refining the way in which the performance ranking works.

3.43 Ofgem considers that it is appropriate to incentivise companies on separate performance rankings for the speed of telephone response and the quality of telephone response. This will make it easier to interpret performance and create the rankings and provide clearer incentives to the distribution companies.

3.44 Ofgem intends to put in place a performance ranking that will penalise companies that have a level of performance that is below the average of all companies. Companies that are further away from the average will lose more revenue. This will be achieved by using an incentive rate, which will specify the amount of revenue that a company will lose for each 'unit' they are away from the average. It is also important that the ranking of the companies is statistically robust, i.e. that differences in performance are 'true'. In ranking companies Ofgem will undertake a statistical test to ensure that this is the case. Where it is not possible to determine, with an appropriate level of confidence, whether a difference in performance is statistically robust Ofgem will assume that, for the company concerned, it has the same ranking (or performance) as the company directly above it.[5]

[4] Telephone performance is being assessed by two measures – the speed of response and the quality of telephone response as measured by a survey of customers' views being carried out on behalf of Ofgem by Accent.
[5] In undertaking the statistical test for company A, the standard error around the observed level of performance may overlap with the standard error around the level of performance of company B (which is ranked one place higher). In such a case, it may not be possible to say with certainty that company A has a worse performance than company B.

3.45 Ofgem has received an initial report from Accent, which sets out companies' performance under the survey so far, and data on the speed of response from the distribution companies. This information will be used as one of the inputs in deciding on the size of the incentive rate for each element of telephone response performance.

Issues for consideration

3.46 Ofgem welcomes views on any of the issues raised by this Chapter and in particular on:

- the incentive framework and the approach to rewarding outperformance;
- the interruptions to be included in the incentive scheme;
- the setting of a profile of targets;
- the treatment of exceptional events; and
- the approach to assessing telephone response performance.

4. Implementing the incentive scheme

Introduction

4.1 This Chapter sets out Ofgem's further thinking on how the IIP incentive scheme will be implemented and in particular on the changes to the licence conditions that will be required to introduce the scheme. An initial draft of the relevant licence conditions for the incentive scheme are set out in Appendix 2.

The incentive scheme licence conditions

Legislative background

4.2 The Utilities Act 2000 established new licensing arrangements for gas and electricity companies, which included the creation of standard licence conditions for distribution. These standard licence conditions became effective on 1 October 2001 when they were determined by the Secretary of State.

4.3 Ofgem considers that it may be necessary to make a number of separate, but related, modifications to the distribution licence. These could take the form of either standard licence conditions or special licence conditions.[6] The key difference between a standard licence condition and a special licence condition is the modification process that must be followed. A standard distribution licence condition (or modification) can be introduced if, following statutory consultation, the majority of standard distribution licence holders in whose licence the condition is (or will be) 'switched on' when the modification is made agree to the modification. The majority voting thresholds have yet to be defined by the Department for Trade and Industry (DTI). A special licence condition is specific to the relevant licence holder. If the individual licence holder does not agree to the modification it cannot be implemented. In either case, where a modification has not been accepted by licence holder(s) the matter can be referred to the Competition Commission.

[6] It is Ofgem's intention that any standard licence modifications will only apply to Part C of the standard licence conditions, i.e. those that presently relate only to the ex-Public Electricity Supply (PES) distribution businesses.

4.4 Ofgem's initial thoughts on the appropriate location for the licence conditions that will be required to introduce the incentive scheme are outlined in Table 5.

Table 5: The IIP incentive scheme licence condition

Area	Type of licence condition
RPI-X + Q + R	It will be necessary to introduce a modification to the existing charge restriction licence condition to adjust price control revenue depending on performance under the IIP incentive scheme (i.e. Q) and for outperformance (i.e. R). This would be a modification to a special licence condition. (Q and R) would not be defined in detail in this licence condition, but rather in the IIP incentive scheme licence condition itself.
IIP incentive scheme licence condition	This would be a new standard licence condition in Part C of the standard distribution licence, and would include details on: • The purpose of the incentive scheme; • Any relevant definitions; • Mechanics of the incentive scheme, including how (Q and R) will be calculated; settlement arrangements and the process for reviewing the incentive scheme.
Targets for the number and duration of interruptions to supply. The incentive rate	As the targets and incentive rates will be specific to each relevant licence holder, it may be appropriate to include these as a modification to a special licence condition. An alternative would be to set them out in the standard licence condition as an amended standard which means that they are subject to the same modification procedure as a special condition.

Settlement arrangements

4.5 The July 2001 document explained that the incentive scheme could be settled on an annual basis or that any adjustments to revenue could be 'rolled over' and taken into account in setting the next price control in 2004/05. The proposed framework and mechanics for the IIP incentive scheme would seem to suggest that the latter is more appropriate. For example, the arrangements for rewarding outperformance mean that it will not be possible to say with certainty, until the end of the existing price control, what the impact of a company's performance under the IIP incentive scheme will have on the amount of revenue it can collect from its customers.

4.6 It is important that the settlement arrangements that are put in place are transparent to distribution companies, suppliers, consumers and other affected parties. Once Ofgem has received IIP information from the companies at the end of the reporting year and its consultants have undertaken the audit, it will publish information on companies' performance under the incentive scheme. This will include information on whether a company has met its interim targets for the number and duration of interruptions to supply as well as its ranking for the speed and quality of telephone response. Based on this information Ofgem will indicate the 'notional' revenue adjustment that a company has accrued for its performance under the IIP incentive scheme. Companies will not be required to make an actual reduction in charges until the beginning of the price control period.

4.7 It will not be possible to say with certainty what the final adjustment to revenue for performance under the IIP incentive scheme will be until after the end of the 2004/05 reporting year, i.e. after the next price control comes into effect. One approach would be to make an estimate of the adjustment for the purpose of setting the next price control. This would be based on actual performance for 2002/03 and 2003/04 and an estimate of performance for the year 2004/05. Any differences would then need to be reconciled following the audit of IIP information in summer 2005 and reflected in distribution charges for 2005/06. In rolling forward any adjustments to revenue it will be necessary to take account of inflation and interest.

Issues for consideration

4.8 Ofgem welcomes views on any of the issues raised by this Chapter and in particular on:

- the framework for the IIP incentive scheme licence condition; and
- the settlement arrangements for the incentive scheme.

Appendix 1 Calculating the incentive rate

Introduction

1.1 This Appendix sets out how Ofgem will calculate the incentive rate that will be used in the IIP incentive scheme. The incentive rates set out in Table A1 are based on the amount of revenue that will be exposed to the incentive scheme and each output measure as outlined in Chapter 3.

Deriving the incentive rates

Step1

1.2 The first step in deriving the incentive rate is to calculate the starting position of each company. The July 2001 document explained that this would be calculated by taking companies' average performance over the period 1995/96 to 1999/00. This is shown in Table A1.

Step 2

1.3 Given a starting position and a final target for 2004/05 it is possible to derive a performance band for each company – which is the difference between the starting point and final target. This is shown in Tables A2a and b.

Step 3

1.4 Tables A2a and b show that there are significant differences across companies in the size of the performance band. These range from 3 to 27 per cent for the number of interruptions to supply and from 6 to 59 per cent for the duration of interruptions to supply. This means that some companies would lose the full amount of revenue exposed to the output measure for only a small deviation from the target. Chapter 3 explains that a more appropriate approach would be to use a common performance band for all companies – which would be the average performance band in Table A2a and b (i.e. 14 per cent for the number of interruptions to supply and 24 per cent for the duration of interruptions to supply.) This would mean that all companies could deviate from their target by the same percentage before they lost all of the revenue exposed to the output measure.

1.5 The first calculation in deriving the company incentive rate is multiplying the final target by the common performance band (percentage) to derive the implied 'worst performance'. The incentive rate is then derived from dividing the amount of revenue exposed to the output measure (in 2004/05) by the difference between the final target and the implied worst performance. This is shown in Table A3.

Table A1: Calculating starting positions (Step 1)

Company	Starting position[1]	
	Number of interruptions[2]	Duration of interruptions[3]
Eastern Electricity	74.9	67.7
East Midlands Electricity Distribution	87.9	79.6
London Power Networks	36.8	48.8
Manweb	54.6	74.6
GPU Power Networks	135.8	122.0
Northern Electric Distribution Limited	90.3	87.5
NORWEB	63.2	74.4
SEEBOARD Energy	88.0	78.4
Southern Electric Power Distribution	73.9	62.1
Western Power Distribution (South West)	99.5	88.9
Western Power Distribution (South Wales)	180.7	177.4
Yorkshire Electricity Distribution	80.9	57.7
SP Distribution	72.7	100.2
Scottish Hydro-Electric Power Distribution	157.7	226.7

Note:
1 Average performance for 1995/6 to 1999/00.
2 The number of customers interrupted per 100 customers per year.
3 Average customer minutes lost per customer per year

Table A2a: Calculating performance bands - number of interruptions per 100 connected customers (Step 2)

Company	Starting position	Final target (2004/05)	Perfomance band (absolute)[1]	Performance band (%)
Eastern Electricity	74.9	68	6.9	10
East Midlands Electricity Distribution	87.9	85	2.9	3
London Power Networks	36.8	30	6.8	23
Manweb	54.6	43	11.6	27
GPU Power Networks	135.8	116	19.8	17
Northern Electric Distribution Limited	90.3	83	7.3	9
NORWEB	63.2	55	8.2	15
SEEBOARD Energy	88.0	78	10.0	13
Southern Electric Power Distribution	73.9	65	8.9	14
Western Power Distribution (South West)	99.5	81	18.5	23
Western Power Distribution (South Wales)	180.7	152	28.7	19
Yorkshire Electricity Distribution	80.9	78	2.9	4
SP Distribution	72.7	65	7.7	12
Scottish Hydro-Electric Power Distribution	157.7	140	17.7	13
AVERAGE				14

Note:

1 The unit is numbers of customers interrupted per 100 customers per year.

Table A2b: Calculating performance - duration of interruptions (Step 2)

Company	Starting position	Final target (2004/05)	Perfomance band (absolute)[1]	Performance band (%)
Eastern Electricity	67.7	64	3.7	6
East Midlands Electricity Distribution	79.6	71	8.6	12
London Power Networks	48.8	40	8.8	22
Manweb	74.6	58	16.6	29
GPU Power Networks	122.0	96	26.0	27
Northern Electric Distribution Limited	87.5	77	10.5	14
NORWEB	74.4	64	10.4	16
SEEBOARD Energy	78.4	67	11.4	17
Southern Electric Power Distribution	62.1	55	7.1	13
Western Power Distribution (South West)	88.9	56	32.9	59
Western Power Distribution (South Wales)	177.4	117	60.4	52
Yorkshire Electricity Distribution	57.7	54	3.7	7
SP Distribution	100.2	71	29.2	41
Scottish Hydro-Electric Power Distribution	226.7	195	31.7	16
AVERAGE				24

Note:

1 The unit is average customer minutes lost per customer per year.

Table A3a: Calculating the incentive rate - number of interruptions per 100 connected customers (Step 3)

Company	Final target (2004/05)	Implied worst performance	Difference	IIP revenue[1]	INCENTIVE RATE[2]
Eastern Electricity	68	77.4	9.4	1.3	**0.14**
East Midlands Electricity Distribution	85	96.8	11.8	1.1	**0.09**
London Power Networks	30	34.2	4.2	1.0	**0.25**
Manweb	43	49.0	6.0	0.7	**0.12**
GPU Power Networks	116	132.1	16.1	1.1	**0.07**
Northern Electric Distribution Limited	83	94.5	11.5	0.7	**0.06**
NORWEB	55	62.6	7.6	1.0	**0.13**
SEEBOARD Energy	78	88.8	10.8	0.7	**0.07**
Southern Electric Power Distribution	65	74.0	9.0	1.4	**0.15**
Western Power Distribution (South West)	81	92.2	11.2	0.8	**0.07**
Western Power Distribution (South Wales)	152	173.1	21.1	0.6	**0.03**
Yorkshire Electricity Distribution	78	88.8	10.8	1.0	**0.09**
SP Distribution	65	74.0	9.0	1.2	**0.14**
Scottish Hydro-Electric Power Distribution	140	159.4	19.4	0.7	**0.04**

Note:

1 The amount of revenue exposed to the output measure uses the information outlined in Chapter 3 and forecast base price control revenue from the December 1999 distribution price control review final proposals document. All figures are in £ million in 2000/01 prices.

2 The incentive rates are in £ million per interruption per 100 connected customers in 2000/01 prices.

Table A3b: Calculating the incentive rate - duration of interruptions (Step 3)

Company	Final target (2004/05)	Implied worst performance	Difference	IIP revenue[1]	INCENTIVE RATE[2]
Eastern Electricity	64	79.4	15.4	3.3	**0.21**
East Midlands Electricity Distribution	71	88.1	17.1	2.7	**0.16**
London Power Networks	40	49.6	9.6	2.6	**0.27**
Manweb	58	71.9	13.9	1.8	**0.13**
GPU Power Networks	96	119.1	23.1	2.8	**0.12**
Northern Electric Distribution Limited	77	95.5	18.5	1.7	**0.09**
NORWEB	64	79.4	15.4	2.4	**0.16**
SEEBOARD Energy	67	83.1	16.1	1.8	**0.11**
Southern Electric Power Distribution	55	68.2	13.2	3.5	**0.26**
Western Power Distribution (South West)	56	69.5	13.5	2.0	**0.15**
Western Power Distribution (South Wales)	117	145.1	28.1	1.5	**0.05**
Yorkshire Electricity Distribution	54	67.0	13.0	2.5	**0.19**
SP Distribution	71	88.1	17.1	3.1	**0.18**
Scottish Hydro-Electric Power Distribution	195	241.9	46.9	1.8	**0.04**

Note:

1 The amount of revenue exposed to the output measure uses the information outlined in Chapter 3 and forecast base price control revenue from the December 1999 distribution price control review final proposals document. All figures are in £ million in 2000/01 prices.

2 The incentive rates are in £ million per customer minute lost per customer in 2000/01 prices.

Appendix 2 Draft IIP incentive scheme licence conditions

Introduction

2.1 This Appendix provides an early draft of the licence modifications that will be required to implement the IIP incentive scheme, including an explanation of how the modifications will work. This allows distribution companies and other interested parties an opportunity to comment on the licence modifications ahead of the final proposals document when Ofgem intends to publish a revised draft of the licence modifications. The final proposals will also include other relevant licence modifications, including that required to implement the one-off 50 pence per customer allowance for introducing LV connectivity.

2.2 There are some areas of the licence modification that have not been drafted, mainly where the policy is still being developed through consultation. This includes the reward for outperformance, the adjustment to revenue for the speed and quality of telephone response, and the treatment of force majeure. In the light of responses to this document these will be included in the revised draft of the licence modifications.

Framework of the licence modifications

2.3 Set out below is an explanation of the framework for the licence modifications, which follows the principles set out in Chapter 4. A more detailed explanation is set out following the draft licence modifications:

- there is a modification to the existing Special Condition B (Restriction of distribution charges) to allow price control revenue to be adjusted upwards or downwards depending on performance under the incentive scheme and the outperformance scheme;

- there is a new standard licence condition which includes the detail of how the adjustments to revenue will be calculated, relevant definitions and how the incentive scheme will operate over this price control period; and

- an additional table, which includes the targets for the number and duration of interruptions to supply, the incentive rates and the amount of revenue to be exposed to each output measure. Chapter 4 explained that this table could take the form of a modification to a special licence condition or an amended standard licence condition.

Incentive scheme draft licence modifications

Special Licence Condition modification

In Special Condition B (Restriction of distribution charges) in paragraph 1 for the existing formula there shall be substituted

$$M_{dt} = P_{dt} + PN_{dt} + Q_{PCR} + R - PM_{dt} - K_{dt}$$

and after paragraph 2 insert –

"2A For the purposes of paragraph 1

Q_{PCR} in the relevant year commencing on 1 April 2005 is the amount derived from the formula set out in paragraph 2 of standard licence condition 50 (Incentive scheme: calculation of charge restriction adjustment) and in any other relevant year is zero.

R in the relevant year commencing on 1 April 2005 is the amount derived from the formula set out in paragraph 3 of standard licence condition 50 and in any other relevant year is zero."

New Standard Licence Condition

Condition 50:Incentive Scheme: Calculation of charge restriction adjustment.

1. The purpose of this condition is to establish the incentive scheme referred to in the principal condition so as to provide for adjustments to the charge restriction conditions relating to the performance of the licensee in achieving targets for quality of supply and [the reward scheme].

2. For the purpose of the charge restriction conditions

$$Q_{PCR} = \frac{\left(1+\frac{RPI_t}{100}\right)*\left(1+\frac{I_t}{100}\right)*\left[Q_{t-1}+\left(1+\frac{RPI_{t-1}}{100}\right)*\left(1+\frac{I_{t-1}}{100}\right)*\left[Q_{t-2}+\left(1+\frac{RPI_{t-2}}{100}\right)*\left(1+\frac{I_{t-2}}{100}\right)*Q_{t-3}\right]\right]}{D_t}$$

3. For the purpose of the charge restriction conditions

R = [reward scheme]

4. For the purpose of paragraph 2, and subject to paragraph 8, Q is derived for each relevant year from the formula

$$Q = \max\left[(q_1 + q_2 + q_3 + q_4), -\frac{TRL}{100} * BPCR\right]$$

5. For the purposes of paragraph 2

RPI_t is defined as in paragraph 3 of special condition B (Restriction of distribution charges) for licensed distributors in England and Wales or special condition C for licensed distributors in Scotland.

I_t means that interest rate in relevant year t which is equal to the average specified rate (as defined in paragraph 3 of special condition A (Definitions and Interpretation) for licensed distributors in England and Wales or paragraph 2 of special condition B for licensed distributors in Scotland).

6. For the purposes of paragraph 4, for each relevant year

$$q_1 = \max\left[(\min((T_1 - CI_{IS}) * IR_1, 0)), -\frac{RL_1}{100} * BPCR\right]$$

$$q_2 = \max\left[(\min((T_2 - CML_{IS}) * IR_2, 0)), -\frac{RL_2}{100} * BPCR\right]$$

$q_3 = \max$ [telephone quality]

$q_4 = \max$ [telephone speed of response]

where:

T means (subject to paragraph 7) the target (having the appropriate subscript) specified for that relevant year in the table in Annex A;

IR means the incentive rate (having the appropriate subscript) specified for that relevant year in the table in Annex A;

RL means the maximum percentage of price controlled revenue exposed to each output measure (having the appropriate subscript) specified for that relevant year in the table in Annex A;

TRL (being the maximum percentage of price controlled revenue exposed in calculating Q in each year) has the value of 2;

BPCR (base price control revenue) is calculated by the formula;

BPCR = PUM* GR*PID

where PUM, GR and PID for each relevant year are as defined in special condition B (Restriction of distribution charges) for licensed distributors in

England and Wales or special condition C for licensed distributors in Scotland

CI_{IS} is derived from the formula:

$$CI_{IS} = CI_1 + CI_2 + (a * CI_3) + CI_4 + (b * CI_5)$$

where

a and b are zero

CI_1, CI_2, CI_3, CI_4 and CI_5 are derived from the formulae for each of those terms set out in the Annex to the Regulatory Instructions and Guidance.

CML_{IS} is derived from the formula:

$$CML_{IS} = CML_1 + CML_2 + (c * CML_3) + CML_4 + (d * CML_5)$$

where

c and d each have the value [0.10]

$CML_1, CML_2, CML_3, CML_4$ and CML_5 are derived from the formulae for each of those terms set out in the Annex to the Regulatory Instructions and Guidance

7. If, having regard to the criteria and assumptions stated in the conclusions document and to the report of the examiner in respect of information collected during the relevant year commencing on 1 April 2001, the Authority considers that any of the targets (T) specified in Annex A are materially inappropriate, it may after consulting the licensee and providing reasons for its decision, by notice to the licensee specify a revised target or targets in respect of any one or more relevant years and Annex A shall be modified accordingly provided that no such notice may be given after [31 December 2002].

8. Where the report of an examiner specifies that the level of accuracy of any specified information used for the purpose of any formula in this condition is less than the level of accuracy specified for such information in the Regulatory Instructions and Guidance, the Authority may, after consulting the licensee and having regard to the reasons and evidence for the failure to achieve the relevant level of accuracy provided to the Authority by the licensee, by notice to the licensee specify the amount which shall be used in respect of that information for the purposes of that relevant formula.

9. A notice under paragraph 9 of the principal condition in relation to the Annex to the Regulatory Instructions and Guidance may only specify a date for the purposes of paragraph 9(a)(i) which would be permitted if paragraph 10 of that condition applied.

10. [force majeure.]

11. [reward scheme.]

12. In this condition:

(1) “the principle condition” means standard licence condition 49 (Incentive Scheme and Associated Information) and words and phrases defined for the purposes of the principal condition shall have the same meaning in this condition;

(2) “the conclusions document” means a document issued by the Authority in [ ] 2002 entitled” [ ];

(3) terms defined in the charge restriction conditions and used in this condition shall have the meaning given to them in the charge restriction conditions on [1 April 2002];

(4) the mathematical conventions specified in the annex to the Regulatory Instructions and Guidance shall apply to the formulae in this condition.

Additional table (Annex A)

Relevant year Commencing:	**1 April 2002 (t_{-3})**	**1 April 2003 (t_{-2})**	**1 April 2004 (t_{-1})**
T_1			
IR_1			
RL_1	0.25		
T_2			
IR_2			
RL_2	0.5		
RL_3	0.125		
RL_4	0.125		

Explanation of the licence modifications

2.4 Set out below is a more detailed explanation of the licence modifications. The numbering follows the paragraph numbering above for ease of reference.

Modification to special licence condition

The modification to paragraph 1 of Special Condition B (Restriction of distribution charges) is designed to allow for distribution charges to be adjusted depending on performance under the incentive scheme (Q_{PCR}) and the outperformance reward scheme (R). Chapter 4 explained that there will be no adjustments to price control revenue until the end of this price control period, and as such, Q_{PCR} and R take a value of zero in all other relevant years apart from that commencing 1 April 2005.

New Standard Licence Condition

1 This paragraph sets out the purpose of the new standard licence condition.

2 As the adjustment to price control revenue will only take place in the year commencing 1 April 2005, which is defined for these purposes as the relevant year (t), it is necessary to roll forward accrued adjustments to revenue for previous relevant years (t_{-1}, t_{-2} and t_{-3}) for inflation and interest.

3 To be drafted following completion of the consultation on rewarding outperformance.

4 This paragraph provides a cap on the adjustment that can be made to price control revenue in each relevant year. The cap works such that the maximum negative adjustment is the lesser of the sum of adjustments for performance for each of the specified output measures (q_1 to q_4) or the maximum amount of revenue exposed to the incentive scheme $\left(\frac{TRL}{100} * BPCR\right)$, which is defined in paragraph 6 of the New Standard Licence Condition. TRL always has a maximum value of 2. This means that no more than 2 per cent of price control revenue can be exposed to the incentive scheme as a whole in each year of this price control period.

In relevant year t_{-3} (2002/03) the adjustment to revenue will be defined by the sum of q_1 to q_4. This will be implicitly capped at 1 per cent of revenue by the caps on the adjustments applying to the individual output measures.

5 This paragraph defines RPI and I.

6 This paragraph sets out the definition of the remaining terms that are included in the formulae in the New Standard Licence Condition.
q_1 and q_2 define how the adjustment to revenue for performance on the number and duration of interruptions to supply will be calculated. There is a cap and collar within the definition. The collar ensures that there cannot be a positive adjustment to revenue, while the cap specifies the maximum negative adjustment that can be made to revenue. The negative adjustment to revenue is the lesser of:

- the difference between the target (T_1or T_2) and performance under the incentive scheme (CI and CML) multiplied by the incentive rate (IR_1 or IR_2), for each relevant year; and

- the maximum amount of revenue exposed to the output measure (RL_1 or RL_2).

q_3 and q_4 to be drafted following completion of the consultation on telephone response.

T, IR, RL are defined in this paragraph and values for each relevant year are set out in the additional table.

TRL is the maximum amount of revenue that can be exposed to the incentive scheme as a whole and which always takes a value of 2 per cent.

BPCR is base price control revenue and is calculated as defined, which cross references Special Condition B (Restriction of distribution charges) where appropriate.

CI_{IS} (and CML_{IS}) defines how the number of interruptions to supply (duration of interruptions to supply) will be calculated for the purposes of performance under the incentive scheme. It is derived from the sum of CI_1 to CI_5 (and CML_1 to CML_5), which will be defined in the Annex to the Regulatory Instructions and Guidance (RIGs) document.[7] Given that *'actual reported performance'* and *'performance under the incentive scheme'* will differ there is a weighting factor applied to the relevant sub-category of CI_{IS} and CML_{IS}. These weighting factors are consistent with the approach set out in Chapter 3, paragraph 3.27 of this document. The weighting factors *will not* be included in the RIGs, which specify how actual performance should be reported.

7 This paragraph allows for a further review of targets (T), depending on information collected in the year commencing 1 April 2001, where notice by the Authority can be given no later than a specified date. This implements the approach set out in paragraph 2.13 of this document.

8 This paragraph allows the Authority to make an adjustment to information required for a relevant formula if a company fails to meet the required level of accuracy for reporting as set out in the RIGs. Ofgem published its principles on dealing with companies under such circumstances in the July 2001 document.

9 This paragraph prevents modifications to the Annex to the RIGs (see above) before the next price control review takes effect, unless all affected distribution licence holders agree.

10 To be drafted following completion of the consultation on force majeure.

11 To be drafted following completion of the consultation on rewarding outperformance.

12 This paragraph sets out further relevant definitions.

Additional table

This table sets out values for T, IR, RL for each output measure and for each relevant year. As explained above the location of this table could be in a special licence condition or an amended standard licence condition.

[7] Distribution companies have had an opportunity to comment on these definitions and it is Ofgem's intention to include them in a revised version of the RIGs to be published along with final proposals.