

**May 2001**

**Information and incentives project:  
incentive scheme  
Update**

## Summary

Ofgem started work on the IIP following the 1999 price control review of the distribution businesses of the fourteen Public Electricity Suppliers (PESs). The project has focused on improving the way in which price controls are reviewed and implemented. In the first instance it has looked at improving the quality of information collected from distribution businesses and defining the outputs that Ofgem intends to include within the IIP incentive scheme.

The main focus of the work going forward will be to strengthen the financial incentives on companies to deliver the appropriate quality of supply. This will be done by introducing an incentive scheme linking financial rewards and penalties to quality of service performance.

It is important that the process for taking this work forward is transparent and that key issues and dates are highlighted in advance. To help meet this objective this document sets out the work that Ofgem intends to undertake on the IIP over the next 18 months.

The document explains that there are two main workstreams to the project:

- ◆ developing the reporting and audit framework for the IIP; and
- ◆ developing the framework of the incentive scheme that will operate from April 2002.

This document follows on from the consultation paper which was published in January 2001 setting out Ofgem's initial thoughts on developing the framework of the IIP incentive scheme.

The document also sets out, in broad terms, the work that Ofgem intends to undertake in developing the overall price control framework up to the next price control review in 2003/04. Undertaking this work prior to the next review will help:

- ◆ provide the distribution businesses with clearer incentives; and
- ◆ improve the transparency of the price control review process.

The document also includes a summary of responses to the January 2001 consultation paper and the arrangements for a workshop that Ofgem intends to hold to discuss the development of the incentive scheme.

Initial proposals on the framework of the incentive scheme will be published in June 2001. Ofgem will collect interim data from the companies on different components of quality of service in October 2001 to help develop the detail of the incentive scheme. Final proposals on the reporting framework and the incentive scheme will be published in December 2001, along with the associated licence modification that will be required to implement the incentive scheme.

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# 1. Introduction

## *Background*

- 1.1 Ofgem started work on the IIP following the 1999 price control review of the distribution businesses of the fourteen Public Electricity Suppliers (PESs). It was clear from that process, that the way in which the price controls of distribution monopolies were reviewed and implemented could be improved. In particular IIP looked, in the first instance, to improve the quality of information collected from electricity distribution businesses. The focus of the work going forward will be to strengthen the financial incentives on the distribution businesses to deliver the appropriate quality of service. This will be done by introducing an incentive scheme linking financial rewards and penalties to quality of service performance.
- 1.2 A new reporting framework for the IIP has now been implemented through a licence condition that has been included in the licences of the PESs. This sets out the information that Ofgem intends to collect under the IIP and provides for a regular audit of that information and the associated measurement systems. The first year of reporting under the IIP began on 1 April 2001.

## *Purpose and structure of this document*

- 1.3 As explained in the summary it is important that the process for taking work forward on the IIP is transparent and that key issues and dates are highlighted in advance. The main purpose of this document is to provide more detail on the work which Ofgem intends to carry out over the next 18 months. It also provides a summary of responses to the January 2001 document.
- 1.4 The overall timetable set out in the January 2001 document remains unchanged. The key documents and meetings going forward are summarised in the table below.

**Table 1: Overall timetable for IIP**

| <b>Timing</b>      |  |
|--------------------|--|
| <b><u>2001</u></b> |  |
| June               | IIP initial proposals document published       |
| November           | Letter to distribution businesses and meetings |
| December           | IIP final proposals document published         |
| <b><u>2002</u></b> |  |
| February           | Section 11 notice on IIP incentive scheme      |
| April              | Incentive scheme operational                   |

1.5 This document provides further details on the work and content of each document including:

- ◆ the work programme for developing the reporting and audit framework for the IIP – Chapter 2;
- ◆ the work programme for developing the framework of the IIP incentive scheme - Chapter 3;
- ◆ the work programme for developing the survey of customers' views of the quality of telephone response that they receive when they contact the distribution business – Chapter 4; and
- ◆ the scope of the work that will be undertaken in developing the way in which price controls are reviewed and implemented up to the next review in 2003/04 – Chapter 5; and
- ◆ a summary of responses to the January 2001 consultation paper - Appendix 1.

***IIP workshop***

1.6 Ofgem intends to hold a workshop in May 2001 to discuss the development of the incentive scheme. Ofgem considers that, at this stage of the project, the workshop should focus on a small number of key issues and that attendance

should be based around those who have a particular interest in the development of the IIP. Ofgem intends to invite representatives from the distribution businesses, the National Grid Company and Transco, other respondents to the January 2001 consultation paper, other regulators, academics with an interest in the development of the IIP and energywatch. Ofgem will write to potential attendees in due course, setting out the arrangements for the workshop in more detail.

***Responding to this document***

- 1.7 If interested parties would like to respond to this document they should do so by 4 June. Comments should be sent to:

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London  
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Email [cemil.altin@ofgem.gov.uk](mailto:cemil.altin@ofgem.gov.uk)  
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- 1.8 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](http://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. The reporting and audit framework for the IIP

### *Introduction*

2.1 The first year of reporting under the new IIP licence condition began on 1 April 2001. The licence condition sets out the information that will be collected and allows for a regular audit of that information and the associated measurement systems. Further work needs to be undertaken in developing these arrangements. This work can be broken down into two main areas:

- ◆ developing and undertaking the audit of IIP information and companies' measurement systems; and
- ◆ developing the reporting framework for distribution businesses including reviewing existing reporting requirements with the aim, where appropriate, of ensuring consistency and removing duplication.

### *Audit of IIP information and measurement systems*

2.2 There are three main areas of work associated with the audit workstream over the course of the next year:

- ◆ a review in 2001 of the progress that companies have made on changing their measurement systems;
- ◆ developing the audit framework that will be used in 2002 to audit data collected in 2001/02; and
- ◆ undertaking the audit in 2002 of data collected in 2001/02.

### **Review of progress on changing measurement systems**

2.3 Ofgem has specified minimum levels of accuracy that companies must meet for reporting on two key IIP output measures - the number and duration of interruptions to supply. In order to meet the required levels of accuracy companies will be making changes to their measurement and reporting processes over the course of the next year. The extent of these changes will differ across companies depending on the existing quality of their systems. The

review will focus on the progress that companies are making including examining any future plans and timetables that are in place. This work will provide the distribution businesses with feedback on the changes that they are making. It will be important to identify any areas where a company's progress (or plan) is not consistent with it being in a position to meet the required levels of accuracy from April 2002. Ofgem intends to undertake this review around October 2001.

### **Developing the audit framework**

2.4 The covering letter to the February 2001 version of the Regulatory Instructions and Guidance (RIGs) explained, in broad terms, how the audit of IIP information and associated measurement systems will be undertaken in 2002. This audit will assess whether companies meet the required levels of accuracy for reporting. It is important that companies understand in advance how the audit will be undertaken. This will help to inform decisions on making improvements to measurement systems. Key issues that need to be considered include developing:

- ◆ *the type of checks that will be carried out on companies' measurement and reporting processes* – Ofgem highlighted a number of different types of checks that will need to be undertaken on companies' measurement systems. It will be necessary to develop these in more detail and to identify the key aspects that the audit will focus on;
- ◆ *the way in which the outputs from the measurement systems will be audited on an ongoing basis* – It is important that a company's measurement systems are able to report accurately on an ongoing basis. Ofgem's initial thoughts on how this part of the audit should be undertaken were outlined in the covering letter to the February 2001 RIGs. Further work will be undertaken to develop this part of the audit in more detail; and
- ◆ *how other IIP information will be audited, including information on the speed of telephone response* – Ofgem has not specified levels of accuracy for the reporting of other IIP information, although it is important that the information that is submitted is consistent with the

instructions and guidance contained in the RIGs. Companies will also be required to provide an estimate of the accuracy of their reporting on short interruptions to supply. In developing the audit framework it will be necessary to consider how consistency against the RIGs will be assessed and the way in which the auditors will test the reasonableness of companies' stated levels of accuracy for reporting on short interruptions.

- 2.5 Ofgem intends to complete this work on developing the audit framework by July 2001. As part of this process Ofgem intends to meet with all the companies jointly to discuss the audit framework in more detail.

#### **Undertaking the audit**

- 2.6 Ofgem's appointed auditors will carry out the audit of IIP information and measurement systems in 2002 using the framework that has been developed. The main aspect of the audit will be to assess whether companies meet the required levels of accuracy – including quantifying the extent to which a company passes (or fails). Ofgem expects that the auditors will produce an audit report around July 2002.

#### ***Developing the reporting framework for distribution businesses***

- 2.7 There are three main areas of work associated with this workstream:
- ◆ reviewing the existing reporting requirements on distribution businesses in the light of the work undertaken so far on the IIP;
  - ◆ developing information templates that the companies will be expected to use to submit IIP information; and
  - ◆ deciding on the most appropriate way for Ofgem to report on companies' performance under the IIP incentive scheme.

#### **Reviewing existing reporting requirements**

- 2.8 In addition to reporting under the IIP there are a number of related reporting requirements that the distribution businesses must meet including:

- ◆ Condition 6 (9 in Scotland) statements on network performance – which includes detailed information on various aspects of network performance such as reliability; and
- ◆ performance on Guaranteed and Overall Standards of Performance (GOSPs) – which sets out how companies have performed against the GOSPs including the number of payments made under the Guaranteed Standards scheme.

2.9 Distribution businesses also publish annual Quality of Supply reports. These reports set out information on the quality of supply delivered by a distribution business to customers in their authorised area. Ofgem has put in place overall reporting guidance that the companies are expected to meet in producing these reports.

2.10 The Utilities Act 2000 also requires distribution businesses to produce a long term distribution development statement. The National Grid Company already produces a similar statement which identifies major expansion plans and projects. The form and content of the distribution development statement are being considered by Ofgem.

2.11 Ofgem is also considering the scope and form of any environmental reporting requirements on the distribution businesses as part of its work on developing the Environmental Action Plan.

2.12 It is important to consider the linkages between the various reporting requirements and whether there is any unnecessary duplication in the information that distribution businesses will be required to provide. It will also be necessary to consider whether there are any areas where definitions or reporting guidance needs to be made more consistent. Ofgem intends to complete this work for the December 2001 final proposals document. The final proposals will include any changes to the existing reporting requirements on distribution businesses. These arrangements will then apply for the 2002/03 reporting year.

### **Developing information templates**

- 2.13 To help improve the consistency of reporting over time and across companies Ofgem intends to develop standard “templates” that the companies will use to submit IIP information. It will be important to ensure that the templates are consistent with the definitions contained in the RIGs. These templates will need to cover all the information that is outlined in the RIGs and specified in the IIP information licence condition.
- 2.14 Ofgem intends to develop the templates in the same timescale as the audit framework (by July 2001). Companies will be given an opportunity to comment on a draft version of the templates before they are finalised. Ofgem will need to consider whether the templates should be included in the RIGs in due course.

### **Reporting on performance under the IIP by Ofgem**

- 2.15 Ofgem will need to put in place arrangements for reporting on the performance of individual distribution businesses within the IIP incentive scheme. The January 2001 document explained that the most appropriate way of reporting on performance will be influenced by the settlement arrangements for the incentive scheme. It will also be necessary to consider other information which Ofgem receives and whether there are benefits from having a more overarching approach to reporting covering a number of areas, including network performance, regulatory accounts, Guaranteed and Overall Standards of Performance and the IIP.
- 2.16 Ofgem intends to publish its initial proposals in this area in the June 2001 document. Detailed arrangements will be set out in the December 2001 final proposals document.

### ***The use of consultants***

- 2.17 Ofgem is in the process of recruiting technical auditors to undertake the audit of IIP information and associated measurement systems. One set of auditors will be retained to look at all of the companies. This will help ensure consistency in approach. It will also help to identify differences in the way in which information is collated across companies. The auditors will also be required to assist in developing the audit framework and the information templates that will

be used to collect IIP information. They will also review the progress that companies have made in improving their measurement systems in 2001. Ofgem expects that the auditors will begin work in May.

***Timetable***

2.18 Table 2 below sets out a high level timetable for the work outlined in this Chapter.

**Table 2: Outline timetable for developing the reporting and audit framework**

| <b>Timing</b>      | <b>Area of work</b>   |
|--------------------|---|
| <b><u>2001</u></b> |   |
| 1 April            | Companies start collecting data under IIP   |
| June/July          | <ul style="list-style-type: none"> <li>◆ Ofgem develops information templates</li> <li>◆ Audit framework developed, including meeting with distribution businesses</li> <li>◆ Begin review of reporting requirements</li> </ul> |
| September          | Final version of information templates issued to distribution businesses  |
| October            | Review of progress on changes to measurement systems  |
| December           | Final proposals on IIP and other reporting requirements   |
| <b><u>2002</u></b> |   |
| May                | Companies submit full year IIP information  |
| June               | Audit of full year IIP information  |

### 3. Developing the incentive scheme

#### *Introduction*

- 3.1 The January 2001 consultation paper set out a number of key issues that will need to be considered in developing the incentive scheme which will operate from April 2002, including:
- ◆ the mechanics of the incentive scheme and in particular whether companies' performance is assessed on an absolute or relative basis;
  - ◆ the settlement arrangements for the incentive scheme; and
  - ◆ the best way of taking account of differences in performance arising from inherent or inherited differences in networks.
- 3.2 Ofgem intends to develop its thinking in the areas outlined above over the course of the coming months. It will be necessary to assess the impact of the various options for the mechanics of the incentive scheme on the incentives that are provided to the distribution businesses. Ofgem will also need to be sure that arrangements are consistent with its powers as set out in the Electricity Act 1989 and the Utilities Act 2000. Where necessary Ofgem will seek advice on the legal issues associated with the incentive scheme. This Chapter explains how Ofgem intends to take this work forward. A broad timetable for the work is at the end of the Chapter.

#### *Mechanics of the incentive scheme*

##### **Absolute and relative performance**

- 3.3 The January 2001 document explained that there were two broad frameworks on which the incentive scheme could be based – a system where a company's performance was assessed on the basis of its own performance or relative to its peers (or some combination thereof).
- 3.4 Ofgem intends to publish its initial proposals in this area in the June 2001 document. In the light of responses to that document it will then be necessary to

develop the arrangements in more detail for the December 2001 final proposals document.

- 3.5 Ofgem will also consider the responses to the January 2001 document and any views expressed by companies or other interested parties at the workshop in May 2001.

#### **Treatment of revenue and expenditure**

- 3.6 It will be necessary to consider how any revenue that companies collect under the IIP incentive scheme is treated in setting the next price control in 2005. For example, it may be appropriate to place a "ringfence" around any IIP revenue so that it is not taken into account when setting the base level of allowed revenue under the revised price control.
- 3.7 Ofgem also needs to consider the most appropriate way of ensuring that the form of the incentive scheme does not create any perverse incentives on distribution businesses or lead to an undue level of uncertainty. For example, the arrangements should not create an incentive on distribution businesses to incur a level of expenditure that is more than the efficient level required to operate and maintain the network or that leads to a higher quality of service than customers are unwilling to pay for. One way of doing this would be to outline how capital and operating expenditure will be treated in setting the new price control in 2005.
- 3.8 Ofgem expects to publish its initial proposals in these areas in June 2001 and final proposals in the December 2001 document.

#### **Settlement arrangements**

- 3.9 The nature of the settlement arrangements that will be required for the incentive scheme will depend on whether companies are assessed on their absolute or relative performance. It will be important to consider the broad form and timing of the settlement arrangements in the June 2001 document. It will then be necessary to develop the detailed processes and arrangements for the December 2001 final proposals document.

## Measuring performance

- 3.10 The January 2001 consultation document explained that there were a number of ways in which the performance of the distribution businesses under the incentive scheme could be measured. This included using starting positions or end targets. It will be necessary to consider the impact on the incentives provided to distribution businesses of the different options that are available and whether there are any practicable reasons why one approach is preferable to another. Some of the relevant issues for taking this work forward are discussed below.

### *Setting targets/starting positions*

- 3.11 The January 2001 document indicated that the IIP incentive scheme is not a re-opener of the existing price control and that as such any targets would be broadly consistent with those already agreed under the price control. There are three reasons why the existing targets may differ from those used for the incentive scheme:

- ◆ *changes in definitions of output measures and improvements in measurement systems* – changes in definitions and improvements in measurement systems mean that the targets that were set for the number and duration of interruptions to supply need to be reviewed. The distribution businesses will be required to complete a questionnaire assessing the impact of these changes using guidance notes that Ofgem will draw up. The completed questionnaire will be reviewed by Ofgem and will be one input for making changes to the existing targets. Ofgem intends to collect this information during October 2001. This process may need to be repeated after companies have completed making the major changes to their measurement systems and if there are subsequently any significant changes to the definitions in the RIGs;
- ◆ *normalisation of output measures* – it is important that the incentive scheme creates equally strong incentives on all companies – both under an absolute or a relative scheme. This suggests that, under either approach, it will be necessary to normalise for factors outside of the direct control of a distribution business that impact on its network

performance relative to other companies. The January 2001 document outlined that it may be appropriate to take account of inherent and inherited factors in setting targets. Ofgem is aware that the industry has undertaken a significant amount of work on looking at how High Voltage (HV) circuits can be disaggregated into groups that have similar characteristics. Ofgem intends to review the work of the industry and consider how this can be used as a basis for normalising output measures. Ofgem will publish its initial proposals on the approach to normalisation in the June 2001 document.

Ofgem will collect information from the distribution businesses to undertake the normalisation process during August 2001. Any companies that are unable to provide the necessary information by this stage will be required to provide a sample of the information that they do have available. Ofgem will produce standard templates and guidance notes that the companies will be expected to use to submit the information.

#### *Collecting interim IIP information*

- 3.12 To help populate the incentive scheme with data (to set targets/starting positions) it will be necessary to collect some IIP information part way through this reporting year. Ofgem expects that this information will cover the number and duration of interruptions to supply and the speed of telephone response. The information will be assessed to see that it has been collated in accordance with the RIGs and to highlight any areas of inconsistency across companies. Ofgem expects to collect this information during October 2001. Ofgem will draw up standard templates and guidance notes that the companies will be expected to use to submit the information.

#### *Measuring performance on the quality of telephone response*

- 3.13 The January 2001 document explained that it may be difficult to set targets on the quality of telephone response that is provided by the distribution businesses. Chapter 4 explains that the customer survey on the quality of telephone response will be based on a number of closed questions focusing on key aspects of the telephone service. Ofgem will need to consider the most appropriate way

of measuring the performance of distribution businesses in this area. For example, it may be appropriate to assess companies based on the average score from the questions in the survey. It will also be necessary to consider the best way of measuring companies' performance on the speed of telephone response and how this relates to the results from the survey. Ofgem intends to publish its initial proposals on the way in which performance on the quality of telephone response will be measured in the June 2001 document. Final proposals will be published in December 2001.

### **Exposure of revenue**

3.14 It will be necessary to consider how much of the previously announced limit of 2 per cent of regulated revenue per annum (which is around £4 million per company each year) should be exposed to the incentive scheme as a whole and to each of the individual output measures. In coming to a decision on how much revenue to expose to the incentive scheme from April 2002 it will be necessary to balance the following considerations:

- ◆ the robustness of information that is collected;
- ◆ the strength of the incentives provided to distribution businesses to focus on the quality of service that is delivered to customers; and
- ◆ the possible creation of perverse incentives if companies expect a different amount of revenue to be exposed to the incentive scheme in the future.

3.15 Ofgem's decision on the weighting of each output measure will also be informed by the views of customers. As part of a wider survey, conducted by MORI on behalf of Ofgem, customers were asked to rank each of the individual IIP output measures in order of importance. The results of this work were set out in the January 2001 document.

## **Other incentive scheme issues**

### *Deadbands*

- 3.16 The January 2001 document explained that it may be appropriate to use some form of deadband within the incentive scheme which may operate such that changes in companies' performance within a certain range would not lead to any penalties or rewards.
- 3.17 In considering whether deadbands are necessary, and if so their form, it will be necessary to look at a number of issues, including:
- ◆ the different circumstances that could give rise to the need for deadbands; and
  - ◆ the impact on the incentives provided to distribution businesses.
- 3.18 Ofgem intends to publish its initial proposals on the use of deadbands in the June 2001 document. This will indicate whether the use of deadbands are appropriate and in what circumstances they will be used.

### *Perverse incentives*

- 3.19 The January document indicated that it will be necessary to consider whether the introduction of the incentive scheme creates any perverse incentives, and if so, the best way of dealing with them. A particular area highlighted was whether the existing industry arrangements for sharing resources in emergency situations will remain appropriate and allow for robust agreements going forward. If changes are likely to be required, Ofgem will put forward initial proposals in the June 2001 document.

## **Licence conditions**

- 3.20 It is likely to be necessary to introduce a new licence condition to implement the incentive scheme. This will set out the rules of the incentive scheme, including the way in which companies' performance under the incentive scheme will be assessed, how the settlement arrangements will work and how the incentive scheme could be modified at and between price control reviews.

3.21 Ofgem will write to the companies in November 2001 with a draft version of the licence condition. In the light of responses a revised version will be published in the December 2001 final proposals document. Thereafter it will be necessary to issue a Section 11 notice during February 2001 to implement the licence condition.

*Other possible licence modifications*

3.22 In the light of the work that is undertaken in developing the incentive scheme it may be necessary to consider whether any changes need to be made to the existing IIP information licence condition. If any changes are required they will be consulted on according to the process outlined in the Utilities Act 2000 and the licence condition itself.

3.23 Ofgem proposed in the September 2000 final proposals document on defining output measures that companies be allowed to collect 50 pence per customer for the additional costs of introducing a Low Voltage (LV) connectivity model. Only those companies introducing an LV connectivity model (or those that have one in place already) and that meet the required levels of accuracy for reporting will be permitted to recover the allowance. It will be necessary to consider the best way for companies to recover the allowance and whether it is necessary to make a modification to the standard distribution licence.

***Timetable***

3.24 Table 3 below shows a high level timetable for the work contained in this Chapter.

**Table 3: Outline timetable for developing the framework of the incentive scheme**

| <b>Timing</b>      | <b>Area of work</b>   |
|--------------------|---|
| <b><u>2001</u></b> |   |
| June               | Initial proposals published to include absolute and relative performance; broad form of settlement arrangements; method of measuring performance; the use of deadbands; and perverse incentives |
| August             | Normalisation of information collected  |
| October            | Interim IIP information collected   |
| November           | Ofgem writes to companies outlining draft targets/starting positions; exposure of revenue; and a draft licence condition<br>Company meetings to discuss letter                                  |
| December           | Final proposals published to include details on mechanics of the incentive scheme; reporting arrangements and revised draft of the licence condition.   |
| <b><u>2002</u></b> |   |
| February           | Section 11 notices published for incentive scheme licence condition and any changes to information and reporting licence condition.   |
| 1 April            | Incentive scheme begins   |
| July               | Possible Section 11 notice published for recovery of LV connectivity allowance  |

## 4. IIP customer survey and the quality of telephone response

### *Introduction*

- 4.1 The January 2001 document explained that one of the output measures that will be included in the incentive scheme is the quality of telephone response that customers receive when they contact the distribution businesses. This will be made up of two measures – the speed of response and a survey of customers' views of the quality of response provided by the distribution business. This Chapter outlines the work programme and timetable for developing the customer survey. The way in which distribution businesses will be required to measure the speed of telephone response is outlined in the RIGs.
- 4.2 Ofgem has recruited Accent Marketing and Research to undertake the survey. Accent will also be responsible for developing the survey questionnaire and for putting in place arrangements for collecting customer information from the distribution businesses.

### *Developing the survey*

#### **The form of the survey**

- 4.3 Accent will carry out an ongoing event driven telephone survey that will assess customers' views of the quality of telephone response provided by distribution businesses. Distribution businesses will be required to provide Accent with the details of customers which have spoken to a call operator during each week. Accent will then contact a random sample of these customers to undertake the survey. The survey questionnaire will mainly consist of a small number of closed questions focusing on key aspects of a telephone service, such as the accuracy of the information provided and the manner of the call operator staff.

#### **The survey process**

- 4.4 It is important that the process for transferring customer information from the distribution businesses to Accent is robust, otherwise it may not be possible to undertake a sufficient number of surveys on a regular basis. Ofgem intends to

monitor closely the process side of the survey and will receive regular progress reports from Accent. These reports will highlight the number of completed surveys that have been undertaken and identify any problems with the data transfer process.

- 4.5 Ofgem held a meeting on 24 April to discuss the survey with all of the distribution businesses. Prior to the meeting Accent produced a draft report outlining the questionnaire for the survey and the arrangements for the transfer of customer information. Accent will finalise the report in the light of comments from the distribution businesses. The distribution businesses will then be given time to put in place the necessary arrangements to transfer data to Accent. Once these arrangements have been tested Ofgem expects that the survey will begin during May 2001.

#### **Reviewing the survey**

- 4.6 Ofgem intends to review the progress of the survey on an ongoing basis during this reporting year. This will allow an opportunity to consider whether any changes need to be made to the scope of the survey or the design of the questionnaire. Ofgem expects that Accent will produce a report during the summer of 2001 that will include a summary of companies' performance in the first few months of the survey and indicate whether any changes should be made to the survey process. In the light of responses to this report Ofgem will consider whether it is appropriate to make any changes to the survey.
- 4.7 A final report on the survey for the reporting year 2001/02 will be produced around May 2002. This will include a more detailed analysis of each company's performance for the whole year.

### *Timetable*

4.8 Table 4 below sets out the broad timetable for taking work forward on the customer survey.

**Table 4: Broad timetable for the customer survey for the reporting year 2001/02**

| <b>Timing</b>      | <b>Issue</b>  |
|--------------------|---|
| <b><u>2001</u></b> |   |
| May                | Companies put in place data collation and transfer arrangements<br>Test of transfer arrangements<br>Survey begins |
| Summer             | Review of the survey arrangements and summary of company performance  |
| <b><u>2002</u></b> |   |
| May 2002           | Final report on company performance   |

## 5. Developing price controls

### *Introduction*

- 5.1 The January 2001 document outlined some broad principles for the way in which the framework of price regulation as applied to electricity distribution businesses could be developed leading up to the next price control review in 2003/04. It also set out in broad terms the incentive framework that applies to distribution businesses under the present regulatory arrangements.
- 5.2 In the light of responses to the January 2001 document this Chapter sets out the work that Ofgem intends to undertake in this area leading up to the next price control review in 2003/04.

### *Views of respondents*

- 5.3 Most respondents were supportive of the need to undertake a review of the application of price controls to electricity distribution businesses. There were mixed views about whether the framework outlined in the January 2001 document was practicable. Some of the distribution businesses indicated that a number of issues needed to be considered, including:
- ◆ how efficiency will be assessed in setting the next price control;
  - ◆ how capital and operating expenditure that was incurred to improve quality of service would be treated;
  - ◆ how output targets will be set for future price control periods; and
  - ◆ whether there would be any additional adjustments to revenue, such as the within range adjustments used in the last price control review.
- 5.4 There were differing views on the scope of work that should be undertaken before the IIP incentive scheme is introduced. One distribution business argued that the IIP should focus on the wider issues arising from a review of the price control framework. Others suggested that the work on IIP would provide an important basis on which to build going forward to the next price control review.

### *Forward work programme*

- 5.5 The January 2001 document outlined the importance of introducing the IIP incentive scheme from April 2002. Ofgem does not consider that delaying the introduction of the scheme would be in the best interests of consumers. Chapter 3 indicated the importance of removing undesirable uncertainty and avoiding perverse incentives. The January 2001 document also explained that there are a number of ways of dealing with other types of uncertainty such as that caused by the quality of information that is collected. On this basis Ofgem intends to introduce the incentive scheme from April 2002.
- 5.6 The January 2001 document explained that there are a number of important aspects of the price control framework that could be developed leading up to the next review in 2003/04. This work cannot be undertaken before the publication of final proposals on the IIP in December 2001 but it is important that a forward work programme is put in place. There are a number of important issues that Ofgem intends to focus on. These include:
- ◆ developing a total cost function and a total quality function;
  - ◆ the way in which efficiency will be assessed in setting the next price control;
  - ◆ the treatment of capital expenditure and its relationship to the Regulatory Asset Base (RAB);
  - ◆ the way in which quality can be incorporated more directly into the price control mechanism and how any new targets for quality of service will be set; and
  - ◆ the underlying cost drivers of the distribution businesses.
- 5.7 These are all substantial areas of work and will require an ongoing commitment of resources from the distribution businesses and Ofgem. Undertaking this work prior to the next review will help:
- ◆ provide the distribution businesses with clearer incentives; and

- ◆ improve the transparency of the price control review process.
- 5.8 There are a number of drivers that may have an impact on the framework of price controls and the incentives applying to distribution businesses. These include:
- ◆ the Social Action Plan;
  - ◆ the Environmental Action Plan - including the incentives on companies to reduce electrical losses; and
  - ◆ the legislative framework.
- 5.9 In undertaking the next price review it will be important to consider the impact of any changes in these areas on the framework of the price control.
- 5.10 In addition to the drivers identified above there are two other main areas of ongoing work that are relevant:
- ◆ **embedded generation** - A joint government and industry working group published a report on embedded generation in January 2001. Ofgem published a response to this report in April 2001. This indicated that Ofgem initially intends to focus on a review of the structure of incentives in the light of the new statutory duty on distribution businesses to facilitate competition in generation. A working group will also be set up to consider the issues raised by the report. It will be important to ensure that any issues arising from this new working group are fed into the wider review of the framework of incentives on distribution businesses described above. It will also be necessary to consider whether there are any interim adjustments that need to be made to the existing arrangements ahead of the next price control review. The potential impact of embedded generation on the framework of the IIP incentive scheme may also need to be considered; and
  - ◆ **developments in metering** – Ofgem published a document in March 2001 outlining its strategy for the metering market. This indicated that it may be necessary to consider an interim modification to the existing price control if a Public Electricity Supplier intends to sell its metering

assets. Ofgem has indicated that it intends to publish proposals later this year on how such a modification could be made. As part of the next price control review in 2003/04 Ofgem will consider whether it is appropriate to set separate price controls for metering activities.

### ***Timetable***

- 5.11 Ofgem intends to start work on the areas outlined above from the beginning of 2002. It is important that certain areas are progressed as a matter of priority such as the treatment of capital expenditure and its relationship to the RAB. Ofgem intends to scope out this work in the coming months and will provide a more detailed timetable in the December 2001 final proposals document.

## **Appendix 1 Summary of responses to January 2001 consultation paper**

- 1.1 This Appendix sets out a summary of responses that were received to the January 2001 consultation paper, which outlined Ofgem's initial thoughts on incentive schemes. 16 responses were received and a list of respondents is set out below.

### **Price control review objectives**

- 1.2 Respondents broadly agreed with most of the objectives of price controls that were identified. One respondent suggested that the price control should include an objective relating to the sustainability of prices. It was argued that customers are paying charges that may not reflect the longer term cost of operating and maintaining the network as some assets have been (or are nearly fully) depreciated.
- 1.3 A significant number of the distribution businesses argued that it was not appropriate for them to gain or lose by reference to their relative performance. This was a view that extended to the framework of the IIP incentive scheme (see below).

### **The scope of price controls**

- 1.4 Respondents broadly supported Ofgem's view of the boundary for price controls and that it was appropriate for matters such as safety and the environment to be incentivised through other mechanisms. One respondent suggested that the impact of embedded generation and competition in connections should be considered in taking work forward on the IIP.

### **Developing the framework of price controls**

- 1.5 Most respondents were supportive of the need to undertake a review of the application of price controls on electricity distribution businesses. There were mixed views about whether the framework outlined in the document was practicable. Some of the distribution businesses indicated that a number of issues needed to be considered, including how efficiency will be assessed in setting the next price control; how capital and operating expenditure that was

incurred to improve quality of service would be treated; how output targets will be set for future price control periods; and whether there would be any additional adjustments to revenue, such as the within range adjustments used in the last price control review.

- 1.6 There were differing views on the scope of work that should be undertaken before the IIP incentive scheme is introduced. One distribution business argued that the IIP should focus on the wider issues arising from a review of the price control framework. Others suggested that the work on IIP would provide an important basis on which to build on going forward to the next price control review.

#### **The aims of the IIP**

- 1.7 Respondents generally supported the aim to reinforce the quality of supply targets agreed as part of the price control although most of the distribution businesses disagreed with the aim to inject more competitive relative assessment. It was suggested that there were other ways of overcoming the problems associated with the periodicity of price control reviews by improving the way in which price controls are reviewed and implemented.

#### **Relative and absolute performance**

- 1.8 There was strong support from the majority of the distribution businesses and some of the other respondents for an incentive scheme based on absolute performance. It was argued that it was not appropriate to introduce a relative incentive scheme as it would not be possible to compare performance on a robust basis; that it would create additional uncertainty regarding investment decisions that could lead to companies having little incentive to improve performance; that it would not be possible to normalise companies' performance for factors outside of their direct control; and that it could lead to customers paying more for a quality of service that they did not want to receive.
- 1.9 A small number of respondents, including some of the distribution businesses, supported an incentive scheme based on some form of relative performance. It was suggested that this would provide incentives to companies to continually seek out cost effective strategies for delivering improvements in quality of

service. It was also suggested that it was possible to deal with problems associated with the willingness of customers to pay for improvements in the quality of service by setting a cost ceiling and quality floor within the incentive scheme.

### **Normalisation**

- 1.10 A number of respondents expressed strong reservations about whether and how companies' performance could be normalised for factors outside of their direct control. It was argued that the normalisation process was unlikely to take account of all topographic and demographic differences across networks. Some distribution businesses also argued that it was necessary to take account of other factors such as some investment decisions that had been taken after privatisation and differences in the severity of weather inherent in different authorised areas. One respondent commented that it would be difficult to evaluate the validity of the normalisation process before collecting robust and consistent data. Another respondent commented that the normalisation process could lead to large errors in adjustments to the output measures.
- 1.11 A smaller number of respondents including some distribution businesses argued that it was possible to develop a robust normalisation process that set equally challenging targets for all companies. One distribution business indicated that the work undertaken by the industry as a whole on looking at disaggregated network performance provided a strong basis on which to develop the normalisation process. Another respondent commented that normalisation would benefit customers and assist in the development of the framework for the next price control.

### **Settlement arrangements**

- 1.12 Most of the respondents that supported the use of absolute performance argued that the incentive scheme should be based on transactions between a company and its own customers rather than between companies. They generally supported the approach whereby distribution business collected 100 per cent of allowed revenue at the beginning of the year and then, depending on performance in the incentive scheme, retained the full amount or made a rebate to their customers of up to 2 per cent.

- 1.13 Respondents that supported the use of relative performance argued that the incentive scheme should be based on some form of transaction between companies.

#### **Measuring performance in the incentive scheme**

- 1.14 A number of respondents favoured setting pre-determined final targets and measuring performance against these targets rather than using starting positions.
- 1.15 A number of respondents expressed concern with the use of league tables to compare companies' performance on the quality of telephone response. One respondent argued that league tables did not take account of the magnitude of the difference in performance between one position and another. It suggested that it would be more appropriate to put companies into a number of bands depending on their performance where each band resulted in a pre-determined adjustment to revenue. Another respondent suggested that it would be inappropriate to use league tables until there was a better understanding of the performance of each company. A small number of respondents suggested that Ofgem should set targets for the speed of telephone response based on companies' existing systems. One respondent suggested an alternative approach would be to base company targets on best practice from other industries such as gas or telecoms.

#### **Setting targets**

- 1.16 A number of respondents indicated that in setting any targets for the number and duration of interruptions to supply it would be necessary to take account of improvements that had been made to measurement systems and changes in the definition of output measures.

#### **Deadbands**

- 1.17 Some respondents suggested that the use of deadbands could overcome problems associated with volatility in performance caused by factors such as severe weather and inaccuracies in data. One respondent suggested that if deadbands were used it would be important that their scope was reduced over time. Another respondent commented that the use deadbands should be reviewed after the first year of operation of the incentive scheme.

- 1.18 A number of respondents opposed the use of deadbands. It was argued that they could lead to a weakening of the incentives provided to distribution businesses and could add an unnecessary level of complexity to the incentive scheme.
- 1.19 Two respondents argued that a separate incentive mechanism should apply in instances of severe weather. It was suggested that companies could be incentivised on the speed of restoration of supply once it was recognised that the weather was severe.

#### **Expose of revenue to the incentive scheme**

- 1.20 Most of the distribution businesses argued that the amount of revenue that is exposed to the incentive scheme should be phased in over time. It was argued that it would not be appropriate to expose the full 2 per cent of allowed revenue before the audit of IIP information and measurement systems was completed in 2002. A smaller number of respondents, including some distribution businesses, argued that the full 2 per cent of allowed revenue should be exposed to the incentive scheme from April 2002. It was suggested that to do otherwise could weaken incentives; lead to additional uncertainty and potentially create perverse incentives on the companies. One other respondent suggested that it was unlikely that exposing 2 per cent of revenue to the incentive scheme would be sufficient to significantly alter companies' behaviour, but that it recognised the objective of not re-opening the existing price control.
- 1.21 One respondent suggested that the weighting attached to each output measure within the incentive scheme should be a mechanistic process based on the establishment of a hierarchy of indicators. Another respondent commented that the weighting for each output measure should reflect customers' willingness to pay for improvements in the quality of service in each area. Some respondents argued that the amount of revenue exposed to the quality of telephone response should be limited (or should be kept at nothing) until the measure was fully established and the information that is collected is robust.

### **The reporting framework**

- 1.22 Respondents generally supported the proposal to review the reporting requirements on the distribution businesses with the aim of removing unnecessary duplication and ensuring consistency.

### **The IIP and Guaranteed and Overall Standards of Performance (GOSPs)**

- 1.23 There was support for the proposal to consider the relationship between the IIP incentive scheme and the GOSPs. One respondent commented that it was important that the relationship was clarified as soon as possible given the potential for 'double jeopardy'. One respondent suggested that it may be appropriate to set up an industry working group to consider the review of the existing GOSPs and the new standards that were part of the distribution price control final proposals.

## List of respondents

### Distribution businesses

East Midlands Electricity  
GPU Power UK  
London Power Networks  
Northern Electric Distribution Limited  
SEEBOARD Plc  
ScottishPower  
Scottish & Southern Energy Plc  
TXU Europe Distribution  
United Utilities Plc  
Western Power Distribution  
Yorkshire Electricity

### Others

British Gas Trading  
Office of the Rail Regulator  
Professor Lorraine Baric  
Transco  
Yorkshire Water Services Limited