July 2001

Information and incentives project

Summary of May 2001 IIP workshop

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1. Introduction

In its May 2001 Information and Incentives Project (IIP) update document on developing an output based incentive scheme Ofgem indicated that it would hold a workshop to discuss some of the key issues arising from the development of the incentive scheme. This was held on 24 May 2001. This document provides a summary of the main points raised at the workshop.[1]

There were 24 attendees at the workshop from a wide range of backgrounds – PES distribution businesses, electricity and gas transportation companies, a supply business, consumer representatives, other regulators and academics. A list of attendees is in Appendix 1.

The workshop was split into three parts:

- a series of presentations from some of the distribution businesses on the key issues for the incentive scheme;
- the use of smaller working groups to discuss the issues raised by the presentations and others that had been identified beforehand by Ofgem; and
- the use of a plenary session where each working group presented their findings.

[1] A copy of this document along with the slides used by Ofgem and the companies at the presentation are available on the website (www.ofgem.gov.uk)

Company presentation

The following companies were invited to give a presentation at the workshop:

- ScottishPower – incentive schemes and price controls;
- TXU Europe – incentive schemes and price controls;
- United Utilities – the mechanics of an incentive scheme; and
- Western Power Distribution (WPD) – disaggregation and normalisation.

Working groups

Each working group had a chairman from Ofgem and a reporter nominated by Ofgem. The chairman and reporter for each group are shown in the table below. Ofgem gave each working group a list of issues that could be considered for discussion in the working groups – these are in Appendix 2.

Table 1: Chairmen and reporters

Working group	Chairman	Reporter
A	Joanna Whittington (Ofgem)	Peter Roper (Scottish and Southern Energy)
B	John Scott (Ofgem)	Colin Gardner (SEEBOARD)
C	Andrew Walker (Ofgem)	Dave Miller (Northern Electric Distribution Limited)

Summary of comments and suggestions from the working groups

This is a summary of the proceedings of each working group and the presentations made by the reporters at the plenary session. It may not reflect all the views that were expressed and does not necessarily represent the views of Ofgem.

Working group A

The group started by discussing the different ways in which an incentive framework for quality of service could be designed. It was pointed out that the starting point for the incentive scheme should be customers' willingness to pay for improvements in quality of service. This could then be used to develop the incentive framework for the companies – for which two broad alternatives were identified:

- for Ofgem to set the targets for quality of supply improvement that companies are expected to meet and to outline how they should get there; and
- for Ofgem to set the targets for quality of supply improvement but allow the companies to choose their own approach to meet the targets.

There was one suggestion that there was no need for an IIP incentive scheme as incentives on quality of supply were already adequately covered by the main price control and other regulatory mechanisms.

It was thought that customers' willingness to pay would vary across customers depending on the level of service presently experienced. For example, customers living in an area that has a relatively large number of interruptions to supply, may place a higher value on improvements in service than customers living in areas where supply was more reliable.

One suggestion for setting targets and incentivising performance for companies was to use a benchmarking approach. It was pointed out that all companies could benefit from an increased use of comparative assessment.

A contrary view was that it was not appropriate to use comparative assessment, although judicious use of benchmarks could be used to inform price control reviews. It was suggested that although the normalisation of performance across companies would be desirable because it made it easier to make comparisons, it was unlikely that a model could be agreed upon. As a result it would be difficult to base the incentive scheme on comparative assessment. It was pointed out that while comparative assessment could be appropriate for setting targets it should not be used to determine adjustments to revenue as this would create additional uncertainty regarding investment decisions.

The group indicated that it was important to think about the incentive scheme in the context of the main price control and in particular how the next review will be undertaken. A contrary view was that the IIP was separate to the main price control and that decisions driven by the incentives created by the IIP could be separated from those driven by the price control. It was also pointed out that quality of service performance also needed to balance the short term against the need to ensure the longer term health of distribution network assets.

The group discussed whether improvements to quality of service could be delivered without the need for additional capital expenditure. The group broadly agreed that some improvements could be delivered for little additional cost but that there was generally a trade-off between cost and quality.

Working group B

The group discussed the relationship of the IIP to the main price control. A number of the representatives suggested that the incentives created by the main price control were more important than those created by the IIP incentive scheme. It was argued that uncertainty over the next price control review meant that the IIP incentive scheme may not change the behaviour of the companies. A contrary view was that the level of uncertainty regarding the price control review was not sufficient to distort incentives under the IIP. It was pointed out by some of the group that there would be ways to improve the quality of service to customers without incurring a significant amount of additional expenditure. For example, the use of performance rankings, even without direct financial incentives, could push management to seek out and deliver further improvements in quality. It was suggested that the IIP incentive scheme would generate these incentives on the distribution businesses.

The group discussed whether putting 2 percent of revenue at risk to the incentive scheme would create sufficiently strong incentives on companies to improve the quality of service to customers. One view was that the IIP might divert resources from improving the quality of supply for worst served customers to areas where it may be easier to improve quality. The group agreed that it was important that companies had sufficient incentives for worst served customers. It was pointed out that the proposed new overall and guaranteed standards on multiple interruptions would provide customers with protection, and companies with incentives, in this area.

A number of different views were expressed on whether a relative or absolute model should be used for the incentive scheme. One set of views was that the risk for the distribution businesses associated with the incentive scheme would be limited by the allowed cost of capital underlying the existing price control and that the companies should be expected to manage this risk through a relative model. It was pointed out that this would avoid the regulator having to set targets for quality of supply. An alternative view was that an absolute scheme would deliver more certainty to companies as targets would be clearly defined. A further view was that it may be possible to develop an incentive scheme that was between the relative and absolute approach, for example by using comparative assessment to reset targets for future years. It was suggested that this would mean that the targets for each company would be known in advance and that the incentives to continually improve perfomance would be maintained.

Other issues that were raised included the treatment of merged distribution businesses within the incentive scheme. It was also argued that some adjustments would need to be made under the incentive scheme to take account of exceptional circumstances that impact significantly on a companies' performance from year to year. It was felt that these events were not representative of underlying performance.

The group generally agreed that the robustness of the relative model was dependent on the quality of the normalisation process that would make it possible to compare performance across companies. One view was that using the normalisation model to set equally challenging targets for quality of supply would make it easier to compare efficient behaviour across companies. It was felt that this normalisation process would need to be undertaken on both cost and quality. A different view was that there was no single correct trade-off between cost and quality and that each company’s different operating environments would dictate a different cost for a given level of service. It was agreed that the results and underlying data from the normalisation process should be made publicly available.

Working group C

The group were in agreement on the need to ensure that that the IIP was fully integrated with the incentives arising out of the main price control. It was suggested that the incentives created by the main price control may be greater than those delivered by the IIP incentive scheme. It was agreed that the package of incentives created by both regulatory mechanisms needed to be looked at together.

It was agreed by the group that improvements in quality of service could be realised without significant additional expenditure, although there was a trade-off that would have to be made at some point. One view was that there was always a trade-off if an improvement in quality of service meant that an opportunity to cut costs had been foregone.

It was agreed that in time it would be necessary to look at customers' willingness to pay for improvements in quality of service – in order to assess the amount of revenue to put at risk to the incentive scheme and to inform any new targets for quality of supply. It was suggested that this could be influenced by the present level of service that customers were receiving. It was agreed that the level of quality desired by customers could also differ depending on whether they were domestic, commercial or industrial customers. On this basis, larger customers may be more willing to pay for improvements in the level of service that they received.

The issue of incentives to focus on worst served customers was also raised. It was suggested that the IIP may focus incentives on improving average quality of service across the whole customer base, rather than on those customers that experienced the worst level of supply.

The group discussed the approach to normalisation in some detail although no concensus was reached on whether it should focus on demographic and topographic factors or differences in the networks operated by companies. There was one view that if one input to the normalisation model was circuit length companies may have a perverse incentive to increase the length of the circuits to which customers were connected.

A large number of the group thought that an absolute model for the incentive scheme would be better than one focusing on relative performance. One view was that under an absolute scheme explicit targets for improvement could be set in specific areas, whereas under a relative model the incentives on companies to improve would be across all outputs, regardless of whether there was a need to improve. Some of the group felt that under a relative model the incentives on companies to share best practice would be weakened and that this would not be to the benefit of the industry more widely. These members also suggested that under a relative model companies would face additional uncertainty regarding their investment decisions.

A contrary view was that a relative incentive scheme would be a good way of providing a reward for companies that outperform targets without increasing prices to customers. Some of the group suggested that if an absolute model was implemented there would need to be some mechanism for rewarding outperformance, for example allowing prices to customers to be increased. An alternative view put forward was that allowing customer prices to increase could be interpreted as a re-opening of the existing price control.

Appendix 1 List of Attendees

Event Chairman – Richard Ramsay (Ofgem)

Group A - Joanna Whittington (Ofgem chairman)

Tom Weyman Jones	Loughborough University
Lorraine Barric	University of Salford
Bob Cotterill	Civil Aviation Authority
Pauline Green	East Midlands Electricity
Peter Roper	Scottish & Southern Energy
Mike Boxall	United Utilities
Andrew Spencer	Yorkshire Electricity
Brian Sequeira	British Gas Trading

Group B - John Scott (Ofgem chairman)

Catherine Wadams	University of East Anglia
Sue Cox	Ofwat
Lewis Dale	National Grid Company
Andy Phelps	GPU Power
Colin Gardner	SEEBOARD
Paul Bircham	TXU Europe

Group C - Andrew Walker (Ofgem chairman)

Luca Lo Schiavo	Italian Regulatory Authority for Electricity and Gas
John Meehan	BG Transco
Judith O'Leary	Energywatch
Robert Friel	London Power Networks
Simon Bucknall	ScottishPower
Bob Parker	Western Power Distribution
Dave Miller	Northern Electric Distribution Limited
Sir Keith Stuart	Ofgem (Non-Executive Director)

Appendix 2 Issues for discussion at IIP May 2001 workshop

2.1 Set out below are the issues for discussion that Ofgem had identified prior to the workshop.

Overall approach to setting price control

- What are the interactions between a price control and a quality of supply incentive scheme?
- What risks should companies be expected to manage?
- In order to generate strong incentives on companies to deliver the appropriate quality of supply what features need to be incorporated into an incentive scheme?

The mechanics of an incentive scheme

- What are the strengths and weaknesses of the relative and absolute schemes as outlined in the January document?
- How can companies be remunerated for outperforming targets? Is it desirable?

Disaggregation and normalisation

- What is the role of comparative assessment?
- In seeking to normalise physical measures of network performance what factors should be taken into account?