

December 2001

Information and incentives project

Incentive schemes:

Final proposals

Executive summary

This document sets out the final proposals for a quality of service incentive scheme for electricity distribution companies to apply from April 2002. The quality of service provided by electricity distribution companies is important for industrial, commercial and domestic consumers alike. The proposed incentive scheme links directly the quality companies deliver to consumers to the amount of revenue they can collect. This will provide them with clear and predictable incentives to help deliver a good quality of service to consumers.

The incentive scheme has been developed as part of the Information and Incentives Project (IIP) which started in December 1999 following the last distribution price control review. The IIP is designed to address a number of concerns with the distribution price control framework and in particular to strengthen the incentives on companies to deliver the appropriate quality of service to consumers. Ofgem committed to introducing an incentive scheme from April 2002. These proposals fulfil Ofgem's commitment.

The incentive scheme is made up of four main components:

- ◆ a mechanism that penalises companies annually, up to 1.75 per cent of revenue, for not meeting their quality of supply targets (as measured by the number and duration of interruptions to supply);
- ◆ a mechanism for rewarding companies who exceed their quality of supply targets for 2004/05 based on their rate of improvement in performance up to that date;
- ◆ a commitment to rewarding frontier performance in the next price control period; and
- ◆ a mechanism for rewarding or penalising companies annually, up to a maximum of 0.125 per cent of revenue, for the quality of their telephone response provided to consumers and a commitment to introduce targets for the speed of telephone response in April 2003.

The incentive scheme will apply from April 2002 to March 2005, i.e. over the remaining period of this price control. In order to introduce the incentive scheme,

companies and Ofgem have carried out a considerable amount of work to improve the robustness of quality of supply data, the deficiencies of which were identified during the first year of the IIP. The incentive scheme is being introduced during a price control period and must be consistent with the approaches adopted as part of the last price control review. As part of the next price control review, the framework of the incentive scheme will be reviewed to take account of any lessons learned over the next two years and to make use of the more robust quality of supply data that will be available.

The final proposals have been developed following extensive consultation with the distribution companies and other interested parties. Taken as a package they reflect an appropriate balance of risk and reward for the companies. They also provide important protection to consumers, as there will be direct financial incentives on quality of service delivery in electricity distribution. This represents an important improvement in the way which price controls work and will provide valuable experience for the companies, consumers and Ofgem. Each distribution company has until 29 January 2002 to decide whether or not it is minded to accept these proposals.

Comments on the proposed licence modifications required to implement the incentive scheme are also invited by 29 January 2002.

The final element of the IIP is the development of the price control framework for the next price control which begins in April 2005. Assuming the incentive scheme is accepted work will begin on this part of IIP early in 2002 with a view to concluding the work by the end of 2002.

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1. Introduction

Background

- 1.1 The Information and Incentives Project (IIP) was started in December 1999 following the last distribution price control review of the fourteen (ex-Public Electricity Supply) electricity distribution companies. The project was designed to address some of the weaknesses, which had been associated with the existing framework of price regulation. The objectives of the project are to:¹
- ◆ strengthen the incentives on the electricity distribution companies to deliver the agreed quality of output and to value better changes in the quality of output;
 - ◆ improve the incentives to achieve efficiency savings throughout the control period and in a way which minimises discrimination between operating and capital expenditure; and
 - ◆ reduce regulatory uncertainty and risk by increasing openness and transparency between reviews as well as at the time of reviews.
- 1.2 During the first year of the project, the focus was on the quality of service information collected by the distribution companies and in particular on defining the outputs to be incentivised and ensuring that these were measured accurately and consistently across companies. The second year of the project has focused on putting in place an incentive scheme for the period 2002/03 to 2004/05. This document sets out the final proposals for the incentive scheme.
- 1.3 Further work will be carried out next year on developing the framework of price controls for network monopolies and in bedding down the new arrangements for measuring and incentivising quality of service. Taking this work together represents a significant step towards meeting the original objectives of the IIP. The results of this work should provide a firm and clear framework for undertaking the next price control review.

¹ Letter to the Chief Executives of PES Distribution Businesses, December 1999.

The IIP incentive scheme

- 1.4 The quality of service provided by electricity distribution companies is important for industrial, commercial and domestic consumers alike. The proposed incentive scheme links directly the quality companies deliver to consumers with the amount of revenue they can collect. This will provide them with clear and predictable incentives to deliver the appropriate quality of service to consumers.
- 1.5 The incentive scheme is made up of four main components:
- ◆ a mechanism that penalises companies annually, up to 1.75 per cent of revenue, for not meeting their quality of supply targets (as measured by the number and duration of interruptions to supply experienced by consumers);
 - ◆ a mechanism for rewarding companies who exceed their quality of supply targets for 2004/05 based on their rate of improvement in performance up to that date;
 - ◆ a commitment to rewarding frontier performance in the next price control period; and
 - ◆ a mechanism for rewarding or penalising companies annually, a maximum of 0.125 per cent of revenue, for the quality of their telephone response provided to consumers and a commitment to introduce targets for the speed of response in April 2003.
- 1.6 The incentive scheme has been developed over the last year during which time three consultation papers have been published and one workshop held with distribution companies and other interested parties. Ofgem also met with each of the distribution companies in November before producing these final proposals. As a result of this extensive consultation process and dialogue the initial proposals, which were published in July 2001, have been refined to develop a set of final proposals which as a package represent an appropriate balance of risk and reward for companies. The proposals also provide important protection to consumers regarding the quality of service they receive from the companies.

- 1.7 The incentive scheme is being introduced during a price control period. This has meant that in developing the proposals, it is necessary to take account of the conclusions from the last price control review, and in particular the existing targets for the number and duration of interruptions to supply for 2004/05. In order to introduce financial incentives on outputs, it is important that they are capable of robust measurement. The companies and Ofgem have worked hard to achieve this objective with the introduction of a common set of definitions and some significant changes to their measurement systems. In some cases companies have anticipated that this will result in significant changes to their reporting of number and duration of interruptions to supply.
- 1.8 The effect of these constraints and uncertainties means that there are components of the incentive scheme, set out in these final proposals, which are only likely to be a feature for the period 2002/03 to 2004/05. As part of the next price control review, further work will be carried out to develop a revised incentive scheme for the period from 2005 onwards, taking into account lessons learned over the next two years and with the benefit of a more robust set of quality of supply data.
- 1.9 The incentive scheme focuses on strengthening incentives on companies to deliver a good quality of service to consumers over the rest of this price control period. It is also important that companies have in place appropriate policies and practices regarding the longer-term performance of the network. Ofgem recently outlined its intention to develop an asset risk management survey, for gas and electricity network operators, to gain a better understanding of how management policies and practices relate to the longer term performance of the network.² Companies also have statutory duties and functions regarding the safe operation of the network.

² "Asset risk management in electricity and gas networks – a proposed survey and its interaction with the Information and incentives project" November 2001.

Purpose and structure of this document

1.10 This document sets out final proposals on:

- ◆ the incentive framework for quality of service, including a description of how companies will be rewarded for exceeding their targets and penalised for failing to meet them (Chapter 2);
- ◆ the mechanics of the incentive scheme, including the amount of revenue to be exposed to the incentive scheme, the incentive rates for each company, and the way in which telephone response performance will be assessed (Chapter 2 and Appendix 2 and 3);
- ◆ the targets that distribution companies will be expected to meet for the number and duration of interruptions to supply over the rest of this price control period (Chapter 3 and Appendix 3); and
- ◆ the way in which the incentive scheme will be implemented, including a revised draft of the incentive scheme licence modifications (Chapter 4 and Appendix 4).

1.11 The document also includes an outline of the work to develop the audit framework (Chapter 5); details of the review of quality of supply reporting requirements on distribution companies (Chapter 6); an outline of next year's work on developing the framework of price regulation for network monopolies (Chapter 7); and a summary of responses to the July and November documents (Appendix 1).

Next steps

1.12 Each distribution company will need to decide by 29 January 2002 whether it is minded to accept the final proposals set out in this document. If the distribution companies accept the proposals then it will be necessary to finalise the licence modifications set out in Appendix 4 so that the incentive scheme can be implemented from 1 April 2002. In this event, Ofgem would expect to publish a final version of the licence modifications for consultation around the middle of February 2002. If any distribution companies do not accept these proposals,

Ofgem will expect to make a reference to the Competition Commission, which will consider these matters and report in due course.

- 1.13 Any comments on the licence modifications required to implement the IIP incentive scheme should be sent by 29 January 2002 to:

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London
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Fax 020 7901 7075
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2. Framework and mechanics of the incentive scheme

Introduction

2.1 The July 2001 document set out Ofgem's initial proposals on the framework and mechanics of the IIP incentive scheme. In the light of responses to this document, Ofgem published an update document in November 2001, which set out its further thinking in a number of key areas, including the way in which:

- ◆ companies would be rewarded or penalised for their performance under the incentive scheme;
- ◆ incentive rates would be calculated;
- ◆ exceptional events and variability in data would be treated; and
- ◆ a performance ranking for the speed and quality of telephone response would be developed.

2.2 Respondents to the July and November documents commented on these and a number of other issues. This Chapter sets out Ofgem's final proposals in the light of these comments.

Rewarding outperformance

Summary

2.3 The November update outlined an overall incentive framework for quality of service, which consisted of:

- ◆ an incentive scheme that penalises companies annually, up to 1.75 per cent of revenue, for not meeting their quality of supply targets for the number and duration of interruptions to supply during this price control period;³

³ The way in which Ofgem intends to assess telephone response performance under the IIP incentive scheme is discussed below.

- ◆ a mechanism for rewarding companies who exceed their targets for both the number and duration of interruptions in 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.

2.4 Ofgem indicated that a number of important issues needed to be considered in developing this framework, including:

- ◆ the targets for the number and duration of interruptions to supply for the first two years of the incentive scheme (2002/03 and 2003/04);
- ◆ the base year from which to assess companies' rate of improvement;
- ◆ the way in which the rate of improvement in performance is linked to the reward payment; and
- ◆ whether the reward for outperformance should apply to all of the output measures.

Views of respondents

2.5 Distribution companies welcomed the proposal to include a mechanism for rewarding outperformance under the incentive scheme. A number of specific points were raised including that:

- ◆ more than 2 per cent of revenue should be made available for the potential reward for outperformance;
- ◆ it would be more appropriate to use a prorata payment for outperformance based on the achievement of agreed percentage improvements;
- ◆ the base year (or base level of performance) that is used for assessing companies' rate of improvement should not penalise those companies that have already made improvements in quality of supply, or that are outperforming their 2004/05 target; and

- ◆ it would be appropriate to extend a mechanism for rewarding outperformance to the telephone response output measure.

2.6 British Gas Trading (BGT) argued that it would not be appropriate to introduce a purely symmetric incentive scheme. It suggested that there should not be rewards for outperformance as better performance could be achieved without companies incurring more expenditure. It also suggested that greater use should be made of relative comparisons of performance. Energywatch argued that there should be no automatic reward for outperformance, but that a financial reward based on companies' rate of improvement in performance would be appropriate. It also argued that the reward for outperformance should cover all of the output measures and that the maximum reward available should be limited to 2 per cent of revenue.

Ofgem's view and final proposal

2.7 It is important that distribution companies have appropriate incentives to outperform under the incentive scheme. Providing no financial reward for outperformance would not provide an appropriate balance of risk and reward. The amount of revenue that is available as a reward has been considered in the context of the other components of the incentive scheme, and in particular the profile of targets that is being used for the first two years of the scheme. On balance, Ofgem considers that a maximum one-off reward of 2 per cent of revenue is appropriate. In November Ofgem set out its concerns about using the 2004/05 targets for the number and duration of interruptions to supply, which had already been met by a number of companies, as the sole basis for rewarding outperformance. Ofgem considers that, within this price control period, the most appropriate mechanism for providing this incentive on the number and duration of interruptions to supply is by rewarding the rate of improvement that companies achieve over the duration of the scheme. Rewards for outperformance on telephone response are discussed in paragraphs 2.24 to 2.32.

Setting the base level of performance

2.8 Ofgem recognises that in setting the base level of performance it would not be appropriate to penalise unduly those companies that had already exceeded their 2004/05 targets. On this basis, Ofgem will set the base level of performance, so that where actual performance for the number and duration of interruptions to supply in 2001/02 is:

- ◆ above (i.e. worse than) the final target for 2004/05, the base level of performance will be actual performance in 2001/02; and
- ◆ below (i.e. better than) the final target for 2004/05, the base level of performance will be the 2004/05 target.

2.9 Performance data for 2001/02 will not be available until the end of May 2002, after which it will need to be audited. This means that there will need to be a process to enable the interim targets to be included in the incentive scheme licence condition. Ofgem's proposed approach for achieving this is set out in Chapter 4 and reflected in the revised draft of the incentive scheme licence condition in Appendix 4.

Linking the rate of improvement to the reward payment

2.10 In the light of consultation responses received, the reward for outperformance will be based on the achievement of predetermined percentage improvements in performance. In determining the size of the percentage improvement which will result in companies being able to collect the maximum reward available, Ofgem has had regard to:

- ◆ the average improvement in performance required by companies to meet their targets over the duration of the incentive scheme based on a forecast of performance in 2000/01;
- ◆ the required improvement in the number and duration of interruptions to supply applied in setting the 2004/05 targets as part of the last price control review where a range of 5 per cent to 10 per cent was used; and

- ◆ over the three years of the scheme, companies on balance can be expected to have a greater impact over the duration of interruptions rather than the number of interruptions to supply.
- 2.11 The rate of improvement, from the base level of performance, that would be required to receive the maximum reward for outperformance will be:
- ◆ 15 per cent for the number of interruptions to supply; and
 - ◆ 20 per cent for the duration of interruptions to supply.
- 2.12 Companies that meet both their targets, but where the rate of improvement is less than this, will receive a prorata reward payment. This is reflected in the revised draft of the incentive scheme licence condition in Appendix 4.
- 2.13 In the final year of the incentive scheme (2004/05) the total maximum reward for outperformance will be capped at 2 per cent of revenue across all of the relevant output measures. The size of the reward attached to each output measure reflects the ratio in the incentive scheme. This means that the maximum one-off reward available for the number of interruptions to supply is 0.6 per cent and to the duration of interruptions to supply it is 1.4 per cent.

Rewarding frontier performance in resetting targets

- 2.14 The November update explained the importance of incentivising frontier performance (i.e. to incentivise companies to be the best) and that Ofgem intended to achieve this by rewarding frontier companies with targets that were less demanding in terms of future improvement than for companies further from the frontier. Ofgem is committed to rewarding companies in part on frontier performance.
- 2.15 To measure a quality frontier, a number of factors will need to be considered, including the development of a model to take account of (topographic and demographic) differences in the areas each company serves. Ofgem and its consultants have been developing such a 'normalisation' model. The basic framework of the model works by adjusting companies' actual performance to take account of network characteristics (e.g. the length of overhead line and underground cables) and the customer density in the area that they serve.

- 2.16 In September Ofgem asked the distribution companies to provide data so that the normalisation model could be populated and tested. An initial version of the model has now been completed, but this will need further work to take account of concerns about the data that has been used and to look at whether there are any additional factors that need to be taken into account in normalising performance.
- 2.17 To take this work forward, Ofgem intends to publish a report early next year describing the work carried out to date. This will be followed by a workshop in February with the distribution companies.

Assessing telephone response performance

Summary

- 2.18 The November update explained that telephone response performance is being assessed by two measures – the speed of response and the quality of telephone response as measured by a survey of consumers' views being carried out on behalf of Ofgem by Accent. The main features of Ofgem's proposed approach were that:
- ◆ the speed and quality of response would be assessed separately;
 - ◆ companies would be penalised if they have a level of performance that is below the average of all other companies, where the size of the penalty would be graduated so that companies that were further away from the average would lose more revenue than companies closer to the average; and
 - ◆ statistical uncertainty regarding the results from the survey could be dealt with in the way in which the performance ranking was derived.

Views of respondents

- 2.19 The distribution companies have raised a number of concerns regarding the proposed approach to assessing telephone response performance. Several companies argued that the proposed scheme should reward above average

performance and not just penalise it. With respect to the speed of response they argued that:

- ◆ it appears that not all companies are measuring the speed of response on a consistent basis despite the definitions and guidance set out in the Regulatory Instructions and Guidance (RIGs)⁴, which means that it may not be appropriate to expose any revenue to this output measure; and
- ◆ it is not appropriate to use a relative performance ranking, particularly for the speed of telephone response, as companies could be incentivised to invest in new telephony equipment even if they were delivering a satisfactory level of service to consumers. A number of companies have argued that companies should be assessed against absolute targets for the speed of telephone response.

On the quality of telephone response:

- ◆ there were concerns expressed regarding potential bias in the survey results, including that:
 - there could be bias against companies with more sophisticated automated telephony systems as the survey did not include those consumers that may have received a satisfactory response from automated messages;⁵
 - there could be bias against companies depending on their geographic location as consumers have different expectations about the level of service that they expect companies to deliver; and
 - consumers' views of the quality of telephone response provided by a company could be biased by their recent experience of other factors, including whether they experienced long and more frequent interruptions to supply; and
- ◆ it was not appropriate to expose the amount of revenue that had been indicated as companies did not know how they were performing under

⁴ "Regulatory Instructions and Guidance" February 2001.

⁵ For reasons of data protection, some consumers cannot be included in this survey.

the survey and as such they did not have enough time to react to the incentives created by the performance ranking.

- 2.20 Both BGT and energywatch suggested that the distribution companies should be able to provide historic information on the speed of telephone response and that this could be used to set targets for each company. Energywatch wanted to see, in time, greater weighting attached to the quality of telephone response.

Ofgem's view and final proposal

Speed of telephone response

- 2.21 The profile of calls experienced in electricity distribution makes it difficult to compare telephone speed of response with other industries. It is clear from the initial data that companies have submitted on the speed of telephone response and the interim review of IIP information (undertaken by Mott MacDonald/British Power International), that there remain issues regarding the way in which companies are measuring the speed of response. Ofgem has provided some additional guidance on the way in which companies should measure the speed of telephone response in the revised version of the RIGs, which has been published along with this document. This should help to ensure that companies are measuring the speed of response on a consistent basis. It will not be possible to assess whether this is the case until the first audit of IIP information is undertaken in summer 2002. On this basis, Ofgem does not intend to expose any revenue to the speed of response output measure in the first year of the incentive scheme. Ofgem still intends to publish a ranking of companies' actual speed of response in the first year of the incentive scheme. This will help to ensure that some incentive is provided to companies in this respect.
- 2.22 Ofgem considers that there are significant benefits that can be gained from assessing companies on their relative performance. For example, it helps to ensure that companies have a continual incentive to focus on quality of service even if they have met targets that have been set by the regulator. At this stage, it is unclear what the range of performance is for the speed of telephone response and whether it is appropriate to expect companies to be able to improve their performance relative to their peers. On this basis, Ofgem intends to set absolute

targets for the speed of telephone response. Following the audit of telephone speed of response in the first year of the scheme, Ofgem will set targets taking into account existing levels of performance, the scope for improvement in the remaining two years of the incentive scheme, and the robustness of the underlying data.

- 2.23 Ofgem is presently minded to set companies an absolute target for the average speed of response and then to measure their performance against the target over the year. Companies could then be penalised up to the maximum amount of revenue that is exposed to the speed of response depending on the difference between their actual performance and the target. Companies will be consulted on the setting of the target for the speed of telephone response and will have the opportunity to accept or reject the licence modification that will be required to introduce the target into the incentive scheme.

Quality of telephone response

- 2.24 Ofgem wants to create incentives on companies to improve the quality of their telephone response. Given that there is not the same issue as applies to the existing quality of supply targets, it is appropriate to incentivise outperformance on the quality of telephone response by including rewards within the scheme for above average performance.
- 2.25 Ofgem has looked at the relationship between companies' survey results and the factors that companies have argued could lead to the introduction of bias. This showed that there does not appear to be any significant relationship between these factors and companies' performance under the survey. For example:
- ◆ there is no evidence to suggest that companies with more sophisticated automated telephony systems perform worse under the survey in comparison to companies that make more use of telephone operators to deal with enquiries from consumers;
 - ◆ the geographic location of a company does not appear to have any impact on the survey results as there is an even geographical spread of companies (e.g. northern, central and southern companies) amongst the performance ranking; and

- ◆ there does not appear to be any significant correlation between the quality of supply that a consumer receives (measured by the number and duration of interruptions to supply) and companies' performance under the customer survey.
- 2.26 Appendix 2 provides a summary of the results that have been returned by the survey so far based on three months' of interviews with consumers.
- 2.27 It is important that the survey allows companies to:
- ◆ understand how they are performing on an ongoing basis; and
 - ◆ assess the impact of any initiatives that they have introduced to improve their performance.
- 2.28 It will be more difficult for companies to assess, on a statistically robust basis, how they are performing on an ongoing basis in the first year of the incentive scheme.⁶ This is because it will only be possible to provide companies with their performance on a rolling (12 month average) basis from September 2002 onwards.
- 2.29 In the light of these issues Ofgem intends to reduce the amount of revenue that is exposed to the quality of telephone response output measure in the first year of the incentive scheme. This is reflected in Table 1 below on the exposure of revenue to the incentive scheme.
- 2.30 The performance ranking will penalise companies that have a level of performance that is below the average of all companies and reward companies whose performance is above average. Companies that are further below (or above) the average will lose (or gain) more revenue. This will be achieved by using an incentive rate, which will specify the amount of revenue that a company will lose or gain for each 'unit' they are away from the average.
- 2.31 In calculating the adjustment to revenue for performance under the survey, the following steps will be followed:

⁶ The survey has been designed to be statistically robust once populated with 12 months data.

- ◆ **Step 1** - calculate the average performance score for each company and the average across all fourteen companies (i.e. the industry average performance score). In calculating the average performance score for a company, each of the four main questions which form the basis of the survey will be weighted equally (see Appendix 2 for more details);
- ◆ **Step 2** - add the standard error to their actual performance score to obtain the 'deemed performance' score. This will be a one-way adjustment, i.e. the actual performance will only be increased by the standard error;

- ◆ **Step 3** -

for companies whose performance is below the industry average performance score:

- divide the amount of revenue that *each* company has exposed to the quality of telephone response measure by the difference between the *industry average performance score* and the *lowest deemed performance score*, i.e. the score of the lowest ranked company; and

for companies whose performance is above the industry average performance score:

- divide the amount of revenue that *each* company has exposed to the quality of telephone response measure by the difference between the *industry average performance score* and the *highest deemed performance score*, i.e. the score of the highest ranked company

This will produce company specific incentive rates; and

- ◆ **Step 4** – calculate the adjustment to revenue for each company by multiplying the incentive rate by the difference between a company's deemed performance and the industry average performance score.

- 2.32 Appendix 2 shows an example calculation for the revenue adjustment under the survey using notional data.

Exposure of revenue to the scheme

Summary

- 2.33 The November document outlined the profile of revenue that Ofgem intended to expose to the incentive scheme as whole. This indicated that, given potential uncertainty associated with the data in the light of changes to measurement systems, it was prudent to limit the amount of revenue exposed to the IIP scheme in its first year of operation (2002/03).

Views of respondents

- 2.34 Most of the distribution companies agreed that it would be appropriate to reduce the amount of revenue exposed to the incentive scheme as a whole in the first year of its operation. Some suggested that the increase in exposure in subsequent years should be more gradual. One distribution company argued that performance on the duration of interruptions to supply is more volatile than the number of interruptions and that as such relatively more revenue should be exposed to the latter.
- 2.35 British Gas Trading argued that the full 2 per cent of revenue should be exposed from April 2002 to help ensure that distribution companies had appropriate incentives regarding the delivery of quality of service. Energywatch suggested that it would be appropriate to reduce the amount of revenue exposed to the incentive scheme in the first year.

Ofgem's view and final proposal

- 2.36 Ofgem recognises that a balance needs to be struck between the amount of revenue that is exposed to the incentive scheme against the robustness of the data and targets upon which the scheme will be based. Ofgem's IIP auditor has indicated that, at this stage, there are no significant issues regarding most of the data used in the incentive scheme.

2.37 Ofgem recognises that performance on the duration of interruptions to supply appears more volatile than that on the number of interruptions to supply. However, distribution companies have more influence over the duration of interruptions to supply, particularly in an incentive scheme that lasts for only three years. In the light of these considerations, Ofgem's final proposals on for the amount of revenue exposed to each output measure is shown in Table 1.

Table 1: Exposure of revenue to the incentive scheme output measure

	2002/03	2003/04	2004/05
Amount of revenue 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, of which:	<u>0.1</u>	<u>0.25</u>	<u>0.25</u>
<i>Quality of response</i>	0.1	0.125	0.125
<i>Speed of response</i>	-	0.125	0.125

Interruptions included in the scheme

Summary

2.38 The November update indicated that Ofgem intended to include in the incentive scheme all interruptions that a company experienced from the following sources:

- ◆ pre-arranged outages;
- ◆ outages of embedded (i.e. distributed) generators – although the impact on the number and duration of interruptions to supply would be monitored; and
- ◆ all other sources, including third party damage.

2.39 Ofgem also proposed to exclude the impact of interruptions sourced from the National Grid Company (NGC) and other connected networks from the number of interruptions to supply, and to include only ten per cent of the impact on the duration of interruptions to supply.

Views of respondents

- 2.40 Distribution companies generally argued that interruptions sourced from distributed generators should be excluded from the incentive scheme. It was suggested that there was little that companies could do to mitigate on consumers of the impact of these outages connected to the distribution network. Distribution companies also argued that they could do little to mitigate the impact of faults sourced from NGC and other connected networks, without significant interconnection within their own networks. One company suggested that any increase in the level of competition for connections should also be taken into account.
- 2.41 British Gas Trading argued that the inclusion of a proportion of the impact of faults from transmission and other connected systems would provide incentives to reduce the impact of these faults on consumers. Energywatch indicated that all interruptions should be included within the incentive scheme although it recognised that faults on transmission and other connected systems should be treated differently. NGC, in response to the recent Ofgem consultation paper on setting multiple interruption standards of performance for electricity distribution companies, recognised that faults on its network could lead to consumers of a distribution company experiencing an interruption to supply. It also indicated that it would continue to work with distribution companies to help ensure that the effects from transmission system faults are minimised.

Ofgem's view and final proposal

- 2.42 The impact of interruptions sourced from distributed generators and NGC and other connected networks is implicitly included in the existing targets for the number and duration of interruptions to supply. This is because the targets were derived by applying a specified percentage improvement in performance to the 10-year linear historic trend. In any event the impact of distributed generation on quality of supply over the next three years is likely to be small and could also be positive. Ofgem will consider as part of the wider project on distributed generation what incentives this places on distribution companies with respect to quality of supply. It will also be considered as part of the work programme for developing price controls on network monopolies, as outlined in Chapter 7.

- 2.43 With respect to the impact of faults from NGC it is important that distribution companies retain incentives to liaise with NGC to seek ways of mitigating the impact on consumers. Excluding the impact of faults from the incentive scheme entirely may risk creating perverse incentives on companies to respond efficiently to these faults when they arise.
- 2.44 In the light of these issues, Ofgem's final proposal on which interruptions to include in the incentive scheme is set out in Table 2.

Table 2: Interruptions included in the incentive scheme

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

Calculating incentive rates for interruptions to supply

Summary

- 2.45 The November update set out how the incentive rate for each company had been calculated for both the number and duration of interruptions to supply. This explained that the incentive rate was set in such a way that all companies could deviate from their targets by the same percentage before they lost the maximum amount of revenue exposed to that output measure, i.e. there is a common performance band. The November document also explained why it was not appropriate to use:
- ◆ common incentive rates;
 - ◆ common performance bands based on absolute numbers; or
 - ◆ company specific performance bands.

Views of respondents

- 2.46 Distribution companies generally support the use of an incentive rate for the number and duration of interruptions to supply although some argued that the method for determining the incentive rates should be modified. For example, some suggested that the common performance band should, depending on the company concerned, be based on either a percentage or absolute number. It was also suggested that differences in incentive rates across companies implied that there was a different underlying valuation of a change in the number and duration of interruptions to supply.

Ofgem's view and final proposal

- 2.47 The November update explained that there is not a definitive way of calculating the incentive rates. The method proposed by Ofgem means that each companies' performance needs to fall below its target by the same amount in percentage terms before they incur the maximum penalty. It considers that this is the most appropriate approach for this price control period. As part of the next price control review Ofgem will consider whether there are alternative approaches for setting incentive rates, including how it relates to consumers' valuations and the costs of making improvements in performance. The incentive rates that will apply for the incentive scheme are set out in Appendix 3.

Setting a profile of targets

Summary

- 2.48 Interim targets (for 2002/03 and 2003/04) for the number and duration of interruptions to supply were not set as part of the last price control review. The July initial proposals proposed setting annual targets to give stronger incentives on companies to focus on quality of supply on an ongoing basis. In November it was proposed that these targets would be based on performance being no worse in the first two years of the incentive scheme (2002/03 and 2003/04) than performance in 2001/02.

Views of respondents

- 2.49 Distribution companies generally supported the proposal to set a flat profile for the targets for the number and duration of interruptions to supply for the first two years of the incentive scheme. Some companies noted that it would be necessary to ensure that companies that had already beaten their target for 2004/05 should be allowed to experience a deterioration in performance in the first two years of the incentive scheme without necessarily incurring a financial penalty.
- 2.50 BGT argued that it would not be appropriate to set a flat profile of targets, based on performance in 2001/02. It argued that companies may scale back their quality of supply improvement programmes.

Ofgem's view and final proposal

- 2.51 Companies are unlikely to scale back their quality of supply improvement programmes as initiatives that companies implement can have a lagged impact on performance. Ofgem recognises that companies which have already beaten their targets should not be required to maintain performance at this level to avoid incurring a financial penalty in the first two years of the incentive scheme. To do otherwise would mean that, for some companies, the profile of targets would allow deterioration in performance in the final year of the incentive scheme. On this basis, and consistent with the approach set out in paragraph 2.8 for determining the base level of performance for rewarding outperformance, Ofgem proposes that companies will be set a profile of targets for the number and duration of interruptions to supply, so that where performance in 2001/02 is:
- ◆ above (i.e. worse than) the final target for 2004/05, targets for 2002/3 and 2003/04 will be set at the level of performance in 2001/02, i.e. all the performance improvement to meet the final target will be assumed to be delivered in 2004/05; and
 - ◆ below (i.e. better than) the final target for 2004/05, the targets for 2002/03 and 2003/04 will be the same as the target for 2004/05, i.e. the profile of targets for the three years of the incentive scheme will be flat.

2.52 This is shown in Table 3 using notional data.

Table 3: Setting interim targets

Company	Performance in 2001/02	Final 2004/05 target	Assumed target for 2002/03	Assumed target for 2003/04
A	95	80	95	95
B	55	65	65	65

2.53 As explained in paragraph 2.9 audited performance data for 2001/02 will not be available until next year. The way in which Ofgem proposes to include the interim targets in the incentive scheme licence condition is set out in Chapter 4 and reflected in the revised draft of the incentive scheme licence condition in Appendix 4.

Treatment of exceptional events

Summary

2.54 It has been argued that exceptional events, including those that are weather related, should be excluded from the incentive scheme. Some have argued that only if specific events are excluded will the targets in the incentive scheme be consistent with those set as part of the price control. The November update explained that it was not consistent with the price control to exclude all events which were more than 2 standard deviations from the historic average level of performance. It also made clear that the financial risk as a result of the incentive scheme was capped to a maximum of 2 per cent per annum. For most companies this means the financial cap will act as a constraint well before the performance for one year exceeds 2 standard deviations from the historic average.

2.55 Ofgem proposed in November that there should be certain exclusions from the incentive scheme. Views of respondents were sought on the scope of the exclusions.

Views of respondents

- 2.56 Distribution companies were very supportive of the proposal to include a mechanism for excluding the impact of exceptional events from the incentive scheme. Some companies argued that even if exceptional events are excluded further adjustments need to be made to take account of underlying volatility in performance. Companies have suggested several approaches for dealing with volatility including:
- ◆ assessing performance using a three year rolling average or by looking at the difference between aggregate performance over the three years of the incentive scheme and the sum of the annual targets; and
 - ◆ the introduction of deadbands so that companies could miss their targets by a given percentage or absolute amount before any financial penalties were incurred.
- 2.57 BGT argued that it would be appropriate to include some mechanism for dealing with exceptional circumstances, but that this should not lead to an increase in the number of claims that companies submit for the application of special treatment. Energywatch suggested that only interruptions arising from genuine exceptional circumstances should be excluded from the incentive scheme and that the application of any special treatment should be determined by Ofgem in consultation with energywatch.

Ofgem's view and final proposal

Treatment of exceptional events

- 2.58 Ofgem intends to include a mechanism for excluding the impact of exceptional events from the incentive scheme. Paragraph 12 of the draft licence condition sets out how this process will work. Companies will be required to notify Ofgem within one week of an incident having taken place that it will be seeking an adjustment to its performance data so that part or all of the impact of the incident can be excluded from the incentive scheme. At the time of the next Ofgem audit of data, the companies will be required to demonstrate to the auditors why, in their opinion, the impact of the incident should be excluded from their performance data. The auditors will reach a view on whether an

adjustment to data is appropriate based on their assessment of whether the event is exceptional. The auditors will have regard to the criteria set out below in determining whether or not an event is exceptional.

2.59 On the basis of the advice which Ofgem receives, it will decide what adjustment needs to be made to the actual performance data. Ofgem will publish as part of its annual report on quality of supply and the incentive scheme details of the companies that have applied for adjustments, including the reasons they have given and any adjustments made as a result by Ofgem. The nature of exceptional events means that it is unlikely that Ofgem will need to consider a large number of events each year. Ofgem will want to monitor how this part of the scheme operates at a company and at an overall level. In the light of this experience, it will be important to consider as part of the next price control review whether this approach is effective or whether it would benefit from further modification.

2.60 In determining whether an event is exceptional and the size of any adjustment to actual performance which is appropriate, Ofgem and its auditors will have regard to the following factors:

- ◆ *the impact of the event on the customers of the distribution business* - In addition to looking at its impact in terms of the number and duration of interruptions to supply compared to historic average performance, it may be appropriate to look at the number of faults which have resulted from the incident and the number and percentage of customers affected by the incident;
- ◆ *the predictability of the event* - There are certain events which happen so rarely (historically) that they are difficult to predict both in terms of the event occurring but also in terms of the impact that it will have on the distribution companies. For example, the fuel crisis in 2000 was an unpredictable event both in terms of its occurrence but also in terms of the speed with which it came about; and
- ◆ *the actions taken by the company to deal with the impact of the event* - Once an event has occurred companies can have excellent or poor systems for dealing with the resulting impact of the event. Ofgem and its

auditors will want to understand what companies have done to minimise the impact of the event on customers and how this accords with industry best practice. This is particularly the case for the duration of interruptions where companies arguably have more scope for making a difference in terms of the quality they deliver to customers over the period of the scheme.

Volatility

2.61 Ofgem considers that the proposals that have been put forward by the companies for addressing volatility in data can either not be easily implemented or dampen incentives on companies. It is not possible to use a rolling average to assess companies' performance under the IIP, for a number of reasons including that:

- ◆ historic data has not been audited, which is a particular issue given the impact of changes in definitions and measurement systems on reported performances; and
- ◆ it is not consistent with the way in which the interim and final targets for the number and duration of interruptions to supply have been derived.

2.62 Ofgem does not support the use of deadbands which can dampen incentives on companies to meet their targets. Ofgem has made a number of adjustments to the initial proposals to take account of concerns raised by the companies. As a package, including the revised profile of targets, incentives to exceed targets and the exclusion of exceptional events, it considers that the final proposals provide an appropriate balance of risk and reward.

Dealing with inaccurate reporting

2.63 The July initial proposals document outlined the issues that Ofgem would need to consider in the event that any of the distribution companies failed to meet the required levels of accuracy for reporting under the IIP set out in the RIGs. This included the different forms of action that Ofgem could take in the event of a failure, including the imposition of financial penalties and/or an adjustment

under the incentive scheme. This section sets out Ofgem's further thinking in this area.

2.64 It is important that companies do not benefit from the reporting of inaccurate information. Failure to meet the required levels of accuracy would be a breach of a licence condition and by virtue of the Utilities Act 2000, Ofgem has the power to impose a financial penalty in that respect. Ofgem considers that this action should be reserved for more serious breaches of the licence condition. In deciding on the severity of the breach, Ofgem will consider the following criteria:

- ◆ *the extent to which a company has failed the required levels of accuracy* – the greater the level of inaccuracy in the reported IIP information the more severe the breach of the licence condition;
- ◆ *the progress that a company is making towards meeting the licence condition and the duration of the breach* – the licence condition requires companies to report IIP information to the required level of accuracy from April 2002. The longer that a company is unable to meet the required levels of accuracy the more severe the potential breach in the licence condition;
- ◆ *the reason for failing to meet the licence condition* – if a company demonstrates that any failure to meet the required levels of accuracy is due to circumstances outside of its control Ofgem will need to take this into account; and
- ◆ *the quality of the information that can be provided* – Ofgem will not generally expect to impose a financial penalty in circumstances where a company meets the required levels of accuracy at the overall level but fails at the Low Voltage (LV) level. This is because the IIP incentive scheme operates at the overall level and as such it is more important that companies report accurately at this level. Accurate reporting at the LV level is still important as good information will be required for the efficient settlement of any claims from consumers under the proposed Multiple Interruption Guaranteed Standard, which is intended apply to electricity distribution companies from April 2002.

- 2.65 In cases where the breach of the licence condition is less severe Ofgem will make an adjustment within the incentive scheme. The nature of the failure and its severity will determine the form of adjustment that is appropriate.
- 2.66 Following the submission of IIP information by the companies Ofgem's IIP auditor will report on whether companies have met the required levels of accuracy for reporting. In the event that a company has failed to meet the required levels of accuracy, the auditor will need to consider and report on the factors outlined above. Ofgem will take this information into account in deciding on the size of any financial penalty, and/or any adjustment within the incentive scheme, that is appropriate. Ofgem would also have regard to its statement of policy with respect to imposition of financial penalties and determination of their amounts published in April 2001, and any revision of that statement.

3. Setting final targets for interruptions to supply

Introduction

3.1 The November update outlined the work that Ofgem was doing to revise the existing 2004/05 targets for the number and duration of interruptions to supply to make them consistent with the way in which distribution companies measure network performance. This work has two main elements – revising targets for:

- ◆ changes to definitions that were introduced last year to improve the consistency of reporting; and
- ◆ changes in measurement systems that companies have made or are introducing to improve the accuracy of their reporting.

3.2 Ofgem wrote to each of the distribution companies separately in November setting out initial estimates of the changes that it intended to make to the existing targets. All of the companies have had an opportunity to discuss these with Ofgem. The one-off adjustments that will be made to the existing targets lead to a revision in the targets that companies are expected to meet. This is not designed to make the targets easier or more difficult to achieve but to make them consistent with how network performance will be measured by companies in the future.

3.3 This Chapter provides a summary of the proposed changes that Ofgem intends to make to the existing targets. The revised targets are set out in Appendix 3. This Chapter also sets out the scope and process for a further limited review of the targets of some companies in 2002.

Adjusting targets for changes in definitions

3.4 As part of the work that Ofgem undertook last year on improving the information it collects from distribution companies on quality of service, standard regulatory definitions for reporting were introduced. These definitions (and associated guidance notes) are set out in the RIGs.

3.5 The November update outlined the work that Ofgem and EA Technology were undertaking to adjust the existing targets for the number and duration of

interruptions to supply to make them consistent with the revised definitions.

This has involved looking at:

- ◆ the expected (or likely) impact (or direction) of the changes in definitions on reported performance;
- ◆ whether the company estimate is consistent with, and justified by, the narrative it has provided. All of the distribution companies were required to provide a detailed supporting narrative explaining how the estimates of the impact of the changes in definitions had been derived, including the provision of any additional supporting data; and
- ◆ the estimates and narrative provided by other companies. Although there are some differences, depending on how performance was previously measured, there appears to be broad consistency in the direction of the impact on performance of the changes in definitions.

3.6 The information submitted by the distribution companies showed that not all of the changes in definitions are expected to lead to changes in reported performance and that the impact differs for the number and duration of interruptions to supply. In broad terms, the companies estimated that there would be a fall in the reported number of interruptions to supply and an increase in the duration of interruptions to supply.

3.7 It can be difficult to isolate the impact of a particular change in a definition on reported performance and in some cases companies have aggregated the impact across a number of changes. Table 4 outlines, in broad terms, which definitions have had the biggest impact on the number and duration of interruptions to supply.

Table 4: Outline of the impact of changes in definitions on the number and duration of interruptions to supply

	Change in definition
Number of interruptions to supply	<p><i>Definition of a short interruption</i> – this has changed from 0-1 minute to 0-3 minutes. This means that all interruptions that last up to 3 minutes are now excluded from the number of interruptions to supply.</p> <p>Impact – Depending on the network, this should reduce the number of interruptions to supply.</p> <p><i>Definition of a re-interruption to supply</i> – previously a number of companies were counting a new interruption if a customer was reinterrupted as part of the process of permanently restoring supplies. The new definition means that unless a reinterruption occurs more than 3 hours after the restoration in supply, a new interruption should not be counted.</p> <p>Impact - This should reduce the number of interruptions to supply</p>
Duration of interruptions to supply	<p><i>Definition of an incident start time</i> – Companies must now start the incident start time from the first notification (e.g. via telephone) that they receive from customers. Previously some companies were waiting until the second or third call received before recording the incident start time.</p> <p>Impact – This should increase the duration of interruptions to supply</p>

Adjusting targets for changes in measurement systems

- 3.8 The November update explained that many of the distribution companies are in the process of making changes to their measurement systems to improve the accuracy of reporting of quality of supply. Some companies have already made changes to their measurement systems and do not plan to make any significant changes this year.
- 3.9 It is important that Ofgem takes account of the impact that changes in measurement systems can have on the reported level of performance to avoid creating disincentives on companies to improve their measurement systems. The following principles have been used in deciding on whether it is appropriate to make an adjustment:
- ◆ companies should be able to demonstrate that the change in reported performance is (or will be) directly attributable to changes in measurement systems. It is important that the change in performance is

not related to a deterioration in the underlying performance of the network or the way in which companies respond to faults; and

- ◆ the impact of the changes in measurement systems was not taken into account in the way that targets were set during the last price control review, either because:
 - the impact of changes in measurement systems was already reflected in reported performance; or
 - an explicit adjustment was made to targets as part of the last price control review.

3.10 The November update also explained that any adjustments which are made should only cover changes in measurement systems 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.

3.11 A significant component of the changes that companies have made (or are making) to their measurement systems involves establishing a better link between customer information and a representation (or model) of the physical distribution network – this is often called ‘connectivity’. Among other things, a ‘connectivity model’ can allow companies to identify, with more accuracy, the number of consumers that have been affected by a fault on the network. This can mean that, all other things being equal, the level of reported performance for the number and duration of interruptions can increase.

3.12 In assessing the estimates and supporting narrative that distribution companies submitted, Ofgem has looked closely at a number of factors including:

- ◆ evidence that there has been a step change in the number of consumers affected by faults on the network and that this corresponds to the timing of the implementation of changes in measurement systems;
- ◆ that the disaggregated (by voltage level) estimates of the impact on reported performance are consistent with the nature of the changes that companies introduced (or are introducing) to their measurement systems; and

- ◆ that the impact which has been identified by the company is not as a result of other reasons, for example changes in underlying network performance, the way in which companies respond to faults or exceptional events.

3.13 In some cases companies have found it difficult to estimate the impact of the changes being made to their measurement systems on reported performance. Some companies based their estimates on the experience of other companies that have already implemented similar changes. Ofgem considers that it is more appropriate to use company specific information where it is available. On this basis it has, in some cases, used the results from work undertaken last year, on reviewing the measurement systems of each company individually, as an input in deciding on the appropriate adjustment that should be made to targets for changes in measurement systems.

Further review of targets in 2002

Summary

3.14 In the November update Ofgem indicated that it would be appropriate to have a further review of targets in 2002, but that this should be limited in scope to help ensure that an appropriate balance is reached between:

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

Views of respondents

3.15 A number of the distribution companies have indicated that because they are not implementing significant changes in measurement systems this year it is not appropriate to have a further review of targets for them next year. Some companies, particularly those making significant changes to measurement systems this year, have indicated that it would be appropriate to retain the option of a further review of targets in 2002.

Ofgem's view and final proposal

- 3.16 The estimates that companies have provided on the impact of changes in definitions appear to be more robust and in most cases based on detailed analysis. This suggests that a further review of targets in 2002 for changes in definitions could lead to additional uncertainty for companies that outweighed the benefit of any small corrections to the targets.
- 3.17 Ofgem proposes that there will be a further review of targets in 2002 for the impact of changes in measurement systems. The review will have the following form – it will:
- ◆ *be company specific* – only those companies to which the review is applicable will have the review clause reflected in their licence condition for the incentive scheme;
 - ◆ *need to take account of over and under adjustments to the targets* – it would not be appropriate to have a review that only allowed for adjustments in one direction. It is possible that the initial adjustments that have been made could be inaccurate in either direction;
 - ◆ *be possible for both Ofgem and the companies to request a review*; and
 - ◆ *be time limited* – changes will only be possible before March 2003.
- 3.18 Some of the factors that Ofgem will want to consider as part of the review are outlined in paragraph 3.12. The process is reflected in the revised draft of the incentive scheme licence condition which is in Appendix 4.

4. Implementing the incentive scheme

Introduction

- 4.1 The November update outlined the way in which the incentive scheme would be implemented including a proposed framework for the incentive scheme licence conditions and the way in the settlement arrangements could work. This Chapter sets out Ofgem's further thoughts in these areas, in the light of responses to the November update. It also explains the process that will be used for re-opening the incentive scheme licence conditions for specific factors.
- 4.2 A modification will also need to be made to the existing Special Condition B (Restriction of distribution charges) to enable licence holders to collect the one-off allowance of 50 pence per consumer for introducing LV connectivity. Ofgem's thoughts on how this should be taken forward are also outlined in this Chapter. Licence modifications to reduce duplication in reporting of quality of supply are discussed in Chapter 6.

The incentive scheme licence conditions

The framework of the licence modifications

Summary

- 4.3 The November update outlined a broad framework of the licence conditions that will be required to introduce the incentive scheme. This framework included a modification to the existing Special Condition B (Restriction of distribution charges) of the distribution licence and the introduction of a new amended Standard Licence Condition (SLC) setting out the general rules of the incentive scheme. This new amended SLC would also contain, in an annex, the company specific information on targets and incentive rates. Changes to these parts of the SLC would require the agreement of each relevant licence holder to which the change applied, as if it were a Special Condition.

Views of respondents

- 4.4 The distribution companies provided a joint response to the issues raised by the draft licence modifications. This argued that it would not be appropriate to use a SLC where it could result in changes to the amount of revenue that each company could collect under the price control. It suggested that a more appropriate approach would be to implement the incentive scheme through a Special Condition so that each licence holder would have the opportunity to accept or reject the condition on an individual basis.
- 4.5 BGT argued that the licence condition should not be implemented as a SLC as there will be a need to agree targets and incentive rates with individual licence holders.

Ofgem's view

- 4.6 Ofgem has looked at the points that the distribution companies made and considers that on this occasion it is appropriate to use a Special Condition to implement the incentive scheme.
- 4.7 Although the majority of the scheme is generic to all companies, the rules of the incentive scheme outline how companies' revenue will be adjusted, depending on their performance under the incentive scheme. As a consequence, the implementation of the incentive scheme through the licence condition (and any subsequent changes) could impact on the amount of revenue a company can collect. In these circumstances it seems appropriate that each licence holder has the right to accept or reject the licence condition. In addition, the Statutory Instrument that will be required to implement the voting arrangements and process for the implementation of SLCs has not been introduced. In future, Ofgem will want to consider whether a special condition is appropriate, in particular, if the scheme relied upon a substantial amount of relative comparison in its operation.

The scope of re-openers to the incentive scheme licence conditions

- 4.8 The arrangements for including quality of supply targets for 2002/03 and 2003/04 (based on actual 2001/02 data) in the incentive scheme requires a limited re-opener to be included in the licence of all companies. The limited further review of targets in 2002 for companies making significant changes to measurement systems this year means that it will be necessary to allow for a further limited re-opener to modify targets for some companies.
- 4.9 It is important that this process is clear and transparent and that it minimises any potential uncertainty regarding the operation of the incentive scheme. The revised draft of the incentive scheme licence conditions sets out how the re-openers will work. Table 5 provides a high level summary.

Table 5: The scope of re-openers to the incentive scheme licence conditions

Scope of re-opener	Summary of process
For all companies: To introduce targets for 2002/03 and 2003/04 on the basis of performance in 2001/02.	Audited 2001/02 data will be adjusted to take account of any exceptional events or changes to measurement systems which are not fully reflected in 2001/02 data. If performance is better than the 2004/05 target, the targets for 2002/03 and 2003/04 will be set at the 2004/05 target. If it is worse the target will be set on the basis of performance for 2001/02.
For some companies: To set revised targets for 2004/05 and if necessary 2002/03 and 2003/04 on the basis of new information about the impact of measurement systems.	Companies will provide or Ofgem will ask for additional information on the impact which new measurement systems have had. After consulting the licensee and providing reasons for the proposed change, Ofgem will specify a revised target. These changes can only be made before 31 March 2003.

Settlement arrangements

Summary

- 4.10 The November update explained that there were advantages in rolling up any adjustments to revenue that a company accrued under the incentive scheme, such that it was taken into account in setting the next price control in 2004.

Views of respondents

- 4.11 Most of the distribution companies and British Gas Trading agreed that the adjustment to revenue for performance under the incentive scheme should be

rolled up and taken into account in setting the next price control. One distribution company argued that it would not be appropriate to roll up the revenue adjustment under the incentive scheme as this could dilute incentives to companies. It suggested an annual adjustment to distribution charges would be more appropriate.

Ofgem's view and final proposal

- 4.12 Ofgem does not consider that making a one-off adjustment to revenue for performance under the incentive scheme, as part of the next price control review, will dilute incentives on companies. Ofgem intends to publish performance figures each year following the audit of IIP information, along with details on whether a company has accrued any adjustments to revenue. This should avoid any dilution of incentives. This means that companies will not be required to make changes to their charges for performance under the incentive scheme until the beginning of the next price control period.
- 4.13 As part of the next price control review, Ofgem will need to consider the detail of how the adjustment to revenue for performance under the incentive scheme should be reflected in distribution charges, as audited performance figures for 2004/05 will not be available until after the price control has been set.

Licence modification for the one-off allowance for introducing LV connectivity

- 4.14 The July document outlined the approach that Ofgem intends to use to introduce the licence modification for allowing companies to collect a one-off allowance of 50 pence per customer for introducing LV connectivity. Ofgem will propose a licence modification, where it is applicable, after the audit of IIP information in summer 2002.

5. Developing the IIP audit framework

Introduction

- 5.1 This Chapter outlines the work that has been undertaken on developing the audit framework that will be used to assess whether distribution companies meet the required levels of accuracy for reporting in compliance with Licence Condition 49 (the IIP information licence condition) of the distribution companies' licence.
- 5.2 MM/BPI has assisted Ofgem on this work and in particular on:
- ◆ developing the initial framework for the audit; and
 - ◆ undertaking an interim review of companies' measurement systems and processes, to test the audit framework and to provide feedback to companies on the progress they are making in implementing changes in systems to meet the required levels of accuracy for reporting.

Process to date

- 5.3 In order to help ensure that companies provide accurate and consistent data on quality of service Ofgem introduced a standard licence condition in March 2001 for the reporting of IIP information. This requires distribution companies to report in accordance with the definitions and guidance set out in the RIGs document and to a specified level of accuracy. The licence condition allows for this information to be audited to assess whether this is the case.
- 5.4 Ofgem published its initial thoughts on the audit framework in February 2001 in a covering letter to the RIGs. MM/BPI were appointed in May 2001 to assist Ofgem in developing the audit framework in more detail. An initial draft of the audit framework and the information template was sent to all distribution companies in August 2001 and a workshop was held in September 2001. Between October and December MM/BPI visited all of the distribution companies to provide feedback on the changes that they were making in measurement systems and to assess whether companies were reporting in line

with the RIGs. Following the review visits, each company was provided with a draft of the review team's report.

Views of the distribution companies

- 5.5 At the workshop, and in subsequent correspondence, the distribution companies voiced concerns about several features of the proposed audit framework. Concern was expressed about the proposed approach to assessing accuracy which used a ranking and weighting of key areas of reporting processes. Companies were also concerned that the draft information template, which will be used to collect IIP information, has a wider scope than the RIGs.

Summary of the findings of the interim review

- 5.6 The key finding of the interim review is that all companies visited are likely to be in a position to meet the IIP required levels of accuracy, if the systems they implement are as discussed with the teams during the review visits, and if the companies take action in respect of any weaknesses in the systems identified by the review teams. In particular the review team found that:

- ◆ all but one company will have measurement systems in place for reporting the speed of telephone response by direct measurement by April 2002. The remaining company will have interim arrangements in place by April 2002 and direct measurement by the winter of 2002. There were also concerns about whether companies were applying the definitions in the RIGs consistently;
- ◆ all companies will have in place systems that will provide network connectivity down to LV customers; and
- ◆ all companies have systems to ensure that IIP information is available to the appropriate staff and appear to have demonstrated a committed approach to training and internal auditing.

Changes to the audit framework

- 5.7 In the light of the visits and the comments made by the distribution companies MM/BPI and Ofgem have produced a revised audit framework. Ofgem considers that the proposed changes deal with the majority of the concerns raised by the distribution companies.⁷

Stage 1: Audit of measurement systems

- 5.8 The first stage of the audit process will focus on assessing the potential accuracy of companies' measurement systems by looking at the way in which companies have counted consumers in their connectivity models and the underlying assumptions that companies have used for example on linking customer information to the network model. The auditor will then derive an overall assessment of the potential accuracy of the measurement systems.
- 5.9 The audit framework proposed in August suggested assessing the impact on accuracy of all the elements of the measurement systems, including the interpretation of the RIGs, companies' procedures, training and internal auditing. It is now considered unnecessary to estimate the accuracy of these elements in Stage 1 of the audit as their impact on the accuracy of reporting will be reflected in the actual accuracy of fault reporting. This will be assessed when auditing the sample of incidents in Stage 3.

Stage 2: Statistical analysis

- 5.10 This stage is consistent with the approach proposed in August 2001. The data on the number and duration of interruptions to supply will be processed statistically to obtain an appropriate sample to be used in the final stage of the audit.
- 5.11 Determining the appropriate sample size is based on a knowledge of which mathematical relationship, or distribution, best describes the population of events being measured. Many populations are described by a normal distribution, which is characterised by 2 parameters, the mean and the standard deviation. The best distribution for this exercise is not known and needs to be

⁷ A copy of the report produced by MM/BPI will be available on Ofgem's website shortly.

established. The appropriate sample size can then be determined given the type of distribution, the desired level of accuracy and the specified confidence limits.

- 5.12 Once the best distribution has been established, the sample size for each data set will then be determined using a 95 per cent confidence limit and either the accuracy level found in Stage 1 or Ofgem's accuracy requirements (90 per cent for LV and 95 per cent for the overall voltage level).
- 5.13 Once the size of the samples has been determined, further analysis of the input data will be undertaken to stratify the sample. This is necessary to help ensure that the sample chosen for each company is representative and takes into consideration factors outside the company's control that may have a significant impact on the accuracy of reporting. Factors that are proven to be significant will be taken into account when selecting the incidents to sample. The results from this stage will become inputs for Stage 3.

Stage 3: Audit of incident reporting

- 5.14 This stage will entail a visit to all companies and an assessment will be made as to whether:
- ◆ the number of customers affected by each incident as reported by the companies corresponds to the numbers that the companies' measurement systems identify;
 - ◆ each incident has been captured by the measurement systems by looking at customer and incident reports and by checking that logged network events relate to the relevant incident reports; and
 - ◆ incident start times, restoration stages, new incidents and re-interruptions are logged correctly, and in accordance with the RIGs definitions.
- 5.15 At the end of this stage, the accuracy of the samples will be calculated (using a 95 per cent confidence limit) and combined with the accuracy resulting from Stage 1 to find the final accuracy of reporting.

Areas for further work

- 5.16 Ofgem considers that it would be appropriate if further work is undertaken on the development of the audit framework ahead of the first audits, to be undertaken in summer 2002. This work will include assessing:
- ◆ the most appropriate distribution for data on the number and duration of interruptions to supply; and
 - ◆ the sample size that will be required to undertake incident sampling and an indication of the factors that will need to be taken into account to stratify the samples.
- 5.17 It is proposed that a pilot statistical analysis and a pilot Stage 3 audit be carried out in the new year prior to the full audits in the summer of 2002. Ofgem intends to complete this work by March 2002.

6. Reviewing quality of supply reporting requirements

Introduction

- 6.1 In the May 2001 IIP update Ofgem committed to a review of the quality of supply reporting arrangements for the electricity distribution companies. The objectives of this work are to:
- ◆ remove any unnecessary duplication in the information that the companies are required to provide;
 - ◆ enhance the consistency of definitions and reporting guidance; and
 - ◆ develop a set of Ofgem reports on distribution companies' performance, that are targeted at their consumers and other interested parties, including IIP data, information on Guaranteed and Overall Standards of Performance (GOSPs) and other information that Ofgem receives on an ongoing basis.

Most of this work will be carried out next year although a number of steps have been undertaken, as outlined in this chapter.

- 6.2 Ofgem's work to date has focused on the existing reporting requirements and in particular on the linkages between Standard Licence Condition 5 (Distribution System Planning Standard and Quality of Service) statements on network performance, information that companies are required to provide under Standard Licence Condition 49 (Incentive Scheme and Associated Information) and quality of supply reports. Ofgem has also considered what improvements need to be made to the RIGs in the light of companies' comments, the interim reviews and further thinking by Ofgem.

Existing quality of supply reporting requirements

- 6.3 In addition to reporting under the IIP information licence condition there are several other mechanisms through which quality of supply information is provided to Ofgem.

Condition 5 network performance statements

- 6.4 Under Standard Licence Condition 5 of the distribution licence companies are required to provide annual network performance statements covering security and availability of supply and quality of service. This includes information on the number and duration of interruptions, the percentage of customer supplies restored within 3 and 18 hours following and interruptions to supply, verified voltage complaints and network faults.

Quality of supply reports

- 6.5 As part of the distribution price control review in 1995 the distribution companies were asked to produce annual quality of supply reports. The reports are not provided under a licence condition. They cover a range of information including quality of supply performance at a company level and disaggregated by region, 'worst-served' consumers or parts of the network, targets for improved performance and the relationship between capital expenditure and quality of supply.

Standards of performance and services to priority consumers

- 6.6 Under the Electricity (Standards of Performance) Regulations 2001 the distribution companies are required to publish annual statements of the standards of performance they provide to end consumers, including the levels of performance achieved. The distribution companies also provide quarterly performance statements to Ofgem. These include data on the number of compensation payments made and the total value of compensation payments for each of the guaranteed standards of performance and the percentage performance achieved for each of the overall standards. In addition to providing standards of performance data, under Standard Licence Condition 23, the companies also have to report on the services they provide to priority consumers.

Views of the distribution companies and energywatch

6.7 Ofgem wrote to all of the distribution companies in October asking for their input to the initial review of reporting requirements, including their views on:

- ◆ any elements of the network performance statements which are replicated or adequately covered under the IIP information licence condition or other existing reporting requirements; and
- ◆ the future role of quality of supply reports.

Standard Licence Condition 5 network performance statement

6.8 The majority of companies welcomed the process for rationalising the existing reporting requirements on quality of supply. Some companies suggested that the information collected under the network performance statement was either adequately covered by reporting under the IIP information licence condition or standards of performance or was no longer relevant. They argued that the network performance statements were no longer needed.

6.9 A number of companies felt that reporting under the IIP information licence condition and the network performance statements should be consolidated into a single report. They indicated that several elements of the network performance statements were not duplicated elsewhere.

6.10 One company suggested that the network performance statements should be retained because they were ultimately intended for a different audience than the information that would be collected under the IIP information licence condition, but that definitions should be made consistent with those used in the IIP.

The future role of quality of supply reports

6.11 The majority of distribution companies indicated that the usefulness of quality of supply reports had been reduced because of their dual role in meeting a regulatory requirement and for providing information to consumers. They suggested that the IIP information licence condition and changes to other reporting requirements (for example regulatory accounts) would provide the majority of the information contained in the quality of supply reports. Some of

the companies suggested a number of changes that could be made to the quality of supply reports, including that they could be:

- ◆ more useful to consumers for example by producing shorter, less technical reports; and
- ◆ separated into two documents - a report with technical information for Ofgem and a shorter report for energywatch and other customer representatives.

6.12 Energywatch also suggested that the usefulness of quality of supply reports to consumers could be improved by providing companies with more flexibility to develop their form and content in conjunction with their consumers (or consumer representatives), provided that the majority of information continued to be made available through other reporting requirements.

Proposed changes to reporting requirements

6.13 Ofgem considers that there are two main areas where quality of supply reporting requirements should be simplified:

- ◆ Standard Licence Condition 5 network performance statements; and
- ◆ quality of supply reports.

6.14 In addition Ofgem considers that there should be a number of changes to the RIGs to improve the consistency of the IIP reporting arrangements and to facilitate the introduction of the IIP incentive scheme.

Standard Licence Condition 5 network performance statements

6.15 Ofgem has reviewed the data provided in the Standard Licence Condition 5 network performance statements. The majority of the information is replicated by reports under the IIP information licence condition and reporting on the standards of performance.

6.16 However, the following information in the Standard Licence Condition 5 network performance statements is not replicated elsewhere:

- ◆ the total demand lost as a result of voltage reductions and load disconnections;
- ◆ the percentage of supplies restored within 3/18 hours disaggregated by voltage level, type of circuit and by incident (for High Voltage interruptions);
- ◆ the number and capacity of distributed generators; and
- ◆ transformer capacity.

6.17 Disaggregated data on the percentage of supplies restored within 3 and 18 hours is unnecessary given the information that companies are required to report on the number and duration of interruptions under the IIP information licence condition. In addition, Ofgem has consulted on whether the 3 hour overall standard should apply from April 2002.

6.18 There is rarely any demand lost as a result of voltage reductions or disconnections. It does not seem necessary to collect this information on an ongoing basis.

6.19 Data on the number distributed generators and transformer and distributed generator capacity is not required on an annual basis for monitoring distribution companies' quality of service. Ofgem may want to collect other information in this area as part of its ongoing work on the distributed generation working group.

6.20 Ofgem considers that where appropriate the reporting burden on distribution companies should be reduced as long as it does not adversely impact on the ability of the regulatory to monitor companies' performance. In the light of the above considerations, Ofgem considers that there is scope to reduce the reporting burden and it proposes to modify Standard Licence Condition 5 of the distribution licence to remove the requirement for network performance statements where a licensee will be collecting information under the IIP information licence condition. This change would be effective from 1 April 2002.

6.21 The way in which Ofgem intends to implement this change is through a modification to Standard Licence Condition 5. This is outlined in Appendix 4.

Quality of supply reports

6.22 Ofgem recognises the points that have been made by both the distribution companies and energywatch regarding the usefulness of quality of supply reports. In addition, the majority of the information that is set out in quality of supply reports will be collected through other reporting requirements on a more consistent basis than in the quality of supply reports. This includes through the IIP information licence condition and under the new Regulatory Accounting Guidelines (RAGs).⁸ This will mean that companies and consumers will be able to make more meaningful comparisons across companies.

6.23 Ofgem does not wish to constrain innovation in the form and content of reports that distribution companies provide to their consumers on quality of supply. It considers that there would be benefits in allowing companies to develop this material in consultation with energywatch and other consumer representatives. In the light of these issues, Ofgem will not require companies to submit quality of supply reports in the future. Where companies continue to produce quality of supply reports, it will be important that they are consistent with information submitted under the remaining reporting requirements. It is also important that companies make relevant quality of supply information available to consumers if they have a query or complaint.

6.24 In terms of the remaining quality of supply reporting requirements, distribution companies will submit IIP information at the end of this financial year. As part of next year's work, Ofgem will need to consider the most appropriate way of reporting this information to interested parties.

⁸ "Electricity distribution businesses – Regulatory accounting guidelines", Ofgem, July 2001

Proposed amendments to the RIGs

6.25 Ofgem proposes to make a number of amendments to the RIGs in the light of:

- ◆ comments from the distribution companies;
- ◆ the feedback from the interim review of measurement systems and IIP information carried out by MM/BPI (Chapter 5); and
- ◆ and further work that has been carried out by Ofgem.

6.26 The proposed amendments are discussed in more detail in the covering letter to the draft revised version of the RIGs. This letter and the draft revised version of the RIGs have been placed on Ofgem's website. In broad terms, Ofgem is consulting on changes to:

- ◆ improve the clarity and presentation of the RIGs;
- ◆ remove inconsistencies between the RIGs and the template that will be used to collect IIP information from all companies; and
- ◆ include formulae for calculating:
 - the number and duration of interruptions to supply;
 - the number of short interruptions; and
 - the number of re-interruptions to supply.

The formulae will enhance the clarity of the definitions in the RIGs and ensure consistency between it and the incentive scheme licence condition.

6.27 Ofgem welcomes comments on the proposed changes to the RIGs. It expects to publish the revised version of the RIGs in February 2002.

7. Developing price controls

Introduction

- 7.1 The May 2001 update document set out some broad areas of work that Ofgem intends to undertake on developing price controls for network monopoly companies. This Chapter sets out further details including an indicative timetable.

Outline of the workstreams

- 7.2 The work will have two main workstreams that are closely related:
- ◆ *developing the price control framework for monopolies* - this workstream will look at how Ofgem sets price controls for *all* network monopoly companies (electricity distribution, gas transportation and distribution and electricity transmission) and in particular how the framework could be improved and whether there are any principles that should be consistently applied across all the sectors. Although there are a number of differences in the nature of these sectors they have important common features, namely that there is a natural monopoly in the core function, (i.e. the bulk transmission or distribution of gas and electricity), and that this core function is subject to price control regulation. In the light of this it is appropriate to consider whether there are any features of the overall framework or key principles that should be consistently applied across all of the sectors.

For example, this will include reviewing:

- price control frameworks to ensure improvements in the signals for, and efficiency of, investments in network monopolies. For example, what flexibility should be retained in price controls for companies to respond to investment signals and what impact, if any, could this have on incentives to cut costs and the cost of capital;

- the approach taken to setting capital and operating expenditure to see whether it is possible to minimise the distortion of incentives in this respect, including looking at whether it is possible to use total cost/quality models in setting price controls; and
 - whether the approach taken to estimating the cost of capital is appropriate given the investment requirements in gas and electricity transmission and distribution.

- ◆ *reviewing the incentive framework and price control principles applying to the fourteen electricity distribution companies, ahead of the next price control review in 2003/04* – this workstream will be important in preparing the distribution companies and Ofgem for the next price control review in 2003/04. In addition to the areas of work outlined above for all network monopolies, Ofgem intends to undertake work in the following areas for the electricity distribution companies:
 - gaining a better understanding of the key issues facing distribution companies over the next price control period and beyond, and in particular on what needs to be delivered through, or incentivised by, the price control. For example, there may need to be changes to the framework of the price control to deal with (or incentivise the connection of) increased distributed generation;
 - looking at how the efficient level of operating costs and capital expenditure will be assessed. For example, should a benchmarking approach be used for assessing operating cost efficiency and what is the role of the efficiency studies that have previously been carried out by consultants appointed by the regulator;
 - gaining a better understanding of key issues underlying quality of supply, such as whether there is a need (or desire) for continual improvement in average performance and how this should be weighed against improving quality of supply at a sub-overall

level, for example for certain customer groups, such as worst served consumers;

- looking at how quality of supply targets should be set, including whether it is appropriate to set five year targets, or whether they should be set for a longer time period and what this will mean for the setting of expenditure allowances related to improving quality of supply;
- looking at how operating and capital expenditure that is used to improve quality of supply should be treated for the purpose of setting price controls. For example, should quality related capital expenditure be included in the regulatory asset base (RAB) and if so, what asset life should be assumed; and
- gaining a better understanding of the cost drivers of electricity distribution companies, including continuing with the development of the normalisation model to take account of geographic and demographic factors that are outside the direct control of companies (as explained in Chapter 2) so that more effective comparisons of network performance can be made.

Purpose of the workstreams

- 7.3 The aim of the first workstream is to improve the framework of price controls applying to all network monopoly companies and where appropriate improving consistency in the approach that is taken in setting price controls. This should help to improve the level of transparency associated with the price control process and reduce the level of uncertainty associated with the periodic review. Price controls have recently been set for both electricity transmission (for the five years commencing April 2001) and gas transmission and distribution (for the five years commencing April 2002). Conclusions which emerge from this work will be used to inform the next price control review for each of these companies.
- 7.4 The aim of the second workstream is to lay the foundations for the next distribution price control review in 2003/04. This is an important area of work as it is intended to allow the distribution companies, and other interested parties,

the opportunity to consider the key objectives and issues for the price control review ahead of the main process. This should increase the level of transparency in the price control process. This will be to the benefit of all parties, including consumers, providers of finance and the distribution companies themselves.

Way forward

- 7.5 The workstreams outlined in this Chapter represent the final stage of the IIP and they are designed to lead into the start of work on the next distribution price control review in 2003/04. Work will begin early next year on identifying the key issues that will need to be considered in taking forward both these workstreams. Ofgem intends to hold a workshop(s), ahead of the publication of an initial consultation paper, to help in this process. This will be followed by an initial consultation paper, which will set out the key issues for both the development of price controls for network monopoly companies, and those relating to the next distribution price control review.
- 7.6 Ofgem then intends to hold a further workshop(s) in the summer of 2002 covering the issues raised by the initial consultation document. This will be followed by an update later in the year outlining the progress that has been made on developing the framework of network price controls.
- 7.7 Ofgem would then expect to publish a document towards the end of 2002, which would set out the scope; objectives; key issues; timetable; approach; and high level principles to be used for the next distribution price control review. The indicative timetable for this work is outlined in Table 6.
- 7.8 Ofgem intends that the document that which will be published towards the end of 2002 will represent the beginning of the main process for the price control review of the electricity distribution companies.

Table 6: Indicative timetable

Timing	Milestone
Spring 2002	Initial discussions and workshop(s) with interested parties
May 2002	Initial consultation document
Summer 2002	Second workshop(s)
Late 2002	Document on the development of price controls
End 2002	Document on the next distribution price control review

Appendix 1 Summary of responses to July and the November documents

- 1.1 This Appendix sets out a summary of responses to the July initial proposals and the November update.

Summary of responses to the July initial proposals

- 1.2 Ofgem received 14 responses to the July paper, including all distribution companies, Transco, British Gas Trading (BGT) and energywatch.

Proposed overall framework for the incentive scheme

- 1.3 Respondents generally welcomed the proposal to introduce an absolute incentive scheme. A number argued that the proposal to introduce a relative scheme for telephone response would effectively penalise two thirds of companies even if their performance was acceptable.
- 1.4 Distribution companies argued that it was important that the incentive scheme included a mechanism for rewarding outperformance. They suggested that the lack of a reward for outperformance could be interpreted as a re-opening of the price controls. Two distribution companies argued that company performance should be assessed on a relative basis, as this would provide strong incentives on companies to improve continually performance.

Approach to making adjustments for changes to definitions and measurement systems

- 1.5 Companies argued that it is important that the existing targets for the number and duration of interruptions to supply are adjusted to take account of changes in definitions and measurement systems.

Definition of interruptions

- 1.6 The majority of distribution companies argued that Ofgem should exclude the impact of faults sourced from distributed generators and the transmission system faults from the incentive scheme. It was argued that the inclusion of these interruptions would introduce additional risk.

Exposure of revenue

- 1.7 Those that commented broadly supported the weightings attached to each of the customer service measures. However, some companies suggested that because of uncertainties regarding the robustness of data the amount of revenue exposed to the incentive scheme should be increased over time.
- 1.8 One company argued that it would be more appropriate to use a 'wooden' dollar scheme for this price control period, i.e. not expose any revenue for the first three years of the scheme.

Performance assessment methods and methods for setting incentive rates

- 1.9 There was a mixed response from distribution companies as to the appropriate method of calculating the incentive rates. The majority of those that responded agreed that common performance bands should be adopted, although there were differences as to whether they should be based on common absolute numbers or percentages. Some suggested that common incentive rates should be applied across all companies

Dealing with annual variability and exceptional circumstances

- 1.10 Those distribution companies that responded argued that the effect of extreme weather should be excluded from the scheme, as distribution networks are not designed to withstand all types of weather.
- 1.11 A number of approaches were identified for dealing with extreme weather including removing the impact of a specified number of the worst incidents or days over the course of the year and removing incidents that lead to a level of interruptions beyond a given deviation from the average performance level. However, one respondent indicated that such an approach is open to gaming unless a rigid and auditable set of rules is established.

Implementation of the incentive scheme through licence modifications

- 1.12 Those that responded broadly supported Ofgem's proposal for implementation of the incentive scheme through a licence modification of the price control formulae.

Summary of responses to the November update

- 1.13 Ofgem received 11 responses to the November update, including all the distribution companies, British Gas Trading (BGT) and energywatch.

Approach to rewarding outperformance

- 1.14 Distribution companies generally welcomed the proposal to reward outperformance, and some supported the use of the rate of improvement in performance for deciding how much reward companies should receive.
- 1.15 The majority of companies continued to argue for a symmetric scheme based on beating targets.
- 1.16 BGT indicated that it was not in favour of distribution companies being able to increase distribution use of system (DUoS) charges as a reward for outperformance. It went on to argue that if charges were to increase, these must be measured against customers' willingness to pay for the improvements.
- 1.17 Energywatch supported the view that there should be no automatic reward for outperformance, and that allowing a reward based on the rate of improvement would be an appropriate approach. It considered that rewards for outperformance should cover all of the output measures in the IIP.

Interruptions to be included in the incentive scheme

- 1.18 Distribution companies generally disagreed with Ofgem's proposal to include interruptions from distributed generators in the scheme. The majority argued that these interruptions should continue to be excluded from the scheme until such time that the potential impact that distributed generation could have on network performance is better understood.
- 1.19 One respondent agreed with Ofgem's proposal, suggesting that it might encourage dialogue between distributors and distributed generators. A further respondent suggested that it would be beneficial to review the situation again in 2005 in the light of further knowledge of the development of distributed generation. Distribution companies argued that interruptions attributable to

transmission faults and faults on interconnected networks should also be excluded from the scheme in the current price control period.

Revising existing targets

- 1.20 Those that responded generally supported both Ofgem's approach to revising targets in the light of changes in definitions and measurement systems, and the further review of targets intended in 2002. A number of these highlighted the importance of transparency and consistency in the process. One respondent disagreed with the intended review in 2002, suggesting that it would increase regulatory risk and that it should only be carried out where it has not been possible to agree the estimated impact of changes in definitions and measurement systems.

Setting the incentive rate

- 1.21 A small number of companies argued that both common performance bands and common incentive rates should be applied or that a combination of absolute and percentage performance bands should be used.
- 1.22 A number of companies suggested that a more appropriate way of deriving the incentive rates would be to base them on customers' willingness to pay for improvements in quality of supply.

The setting of a profile of targets

- 1.23 Distribution companies generally supported the proposal to set a flat profile for the number and duration of interruptions to supply for the first two years of the incentive scheme. Energywatch also supported this approach. BGT did not support the use of a flat profile as it felt that this would weaken incentives on companies to improve quality of supply in the first two years of the scheme.

Treatment of exceptional events

- 1.24 A number of companies argued that there might be circumstances that affect the ability to deliver the appropriate quality of service, but which are outside of management control. Foot and mouth disease and the fuel crisis were cited as examples. These respondents argued that the incentive scheme should alleviate

the risk to companies of such events, by making some adjustment within the scheme.

- 1.25 The majority of companies supported the proposal to introduce a mechanism for dealing with exceptional circumstances into the licence condition for the incentive scheme, provided that it was robust. A number of these suggested that it would be the company's responsibility to claim for exceptional circumstances, and for Ofgem to evaluate and verify these claims. Energywatch considered that only interruptions arising from exceptional circumstances should be considered for exclusion from the scheme. BGT also supported the use of a mechanism for dealing with exceptional circumstances.

Assessing telephone response performance

- 1.26 Distribution companies raised a number of concerns regarding the proposed approach to assessing telephone response performance. A large number were concerned that the results of the quality of telephone response survey may introduce a degree of bias, and as such the results may not be robust.
- 1.27 There was also concern raised with regard to inconsistencies in the way companies measure the speed of response. Some companies suggested a more appropriate approach would be to set targets for the speed of response. It was also suggested that the amount of revenue exposed to telephone response should be reduced.
- 1.28 Another company argued that if a relative approach were introduced, it should be symmetric with an opportunity for companies to earn additional revenue if they perform well.

Framework for the IIP incentive scheme licence condition

- 1.29 Distribution companies disagreed with the proposal to introduce the incentive scheme via a standard licence condition. They argued that modifications of the price control conditions should be implemented through a special licence condition so that each company had the opportunity to accept or reject the modifications.

Settlement arrangements for the incentive scheme

- 1.30 The majority of companies agreed with the approach for rolling up the IIP revenue adjustments into a one-off adjustment at the beginning of the next price control. One respondent argued that the scheme should be settled annually.

List of Respondents to the July initial proposals and November update

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

British Gas Trading
energywatch
Transco (responded to July only)

Appendix 2 Summary of the IIP customer survey

- 2.1 This Appendix provides a summary of the survey results after three months' worth of interviews with consumers and an example calculation, using notional data, of how performance could impact on revenue. The survey is designed to be statistically robust at the 95 per cent confidence level over the whole year of the survey. This may mean that, at this stage, it is not possible to say with certainty that the performance of one company is better (or worse) than a company ranked below (or above). This is because the standard error around an observed level of performance may overlap with the standard error around the level of performance of another company. The standard error falls as more interviews are undertaken and Accent has indicated that the survey will provide statistically robust results in the coming months. Given these considerations, the survey results set out in this Appendix have been presented on an anonymous basis.
- 2.2 The survey is based on a small number of questions regarding the quality of telephone response that has been provided by a distribution company when they have been contacted by a consumer, i.e. it is an event driven survey. Only those consumers that have actually spoken to a telephone operator are included in the sample that is surveyed. The four main questions that are used to assess the performance of a distribution company cover the following areas:
- ◆ the usefulness of the information that the company provided;
 - ◆ the accuracy of the information that the company provided;
 - ◆ the politeness of the member of staff; and
 - ◆ the willingness of staff to help.
- 2.3 Consumers were asked to assess company's performance in these areas, based on a five-point rating scale, (where 1 is equal to very dissatisfied and 5 is equal to very satisfied). The scores on these questions have been used to derive the overall ranking of performance. Each question has been given an equal weighting in deriving the ranking. Table A1 sets out companies' rankings based on their scores over the first three months of the survey. Only those consumers

who answered all four of the questions are included to help ensure consistency when comparing companies' performance.

- 2.4 Consumers were also asked to identify key areas of satisfaction or dissatisfaction with the telephone response that a company provided. Some initial results in this area are also set out below in Table A2.

Table A1: Overall performance scores under the customer survey

Ranking	Company	Average performance score
1	A	4.56
2	B	4.38
3	C	4.35
4	D	4.34
5	E	4.33
6	F	4.32
7	G	4.30
8	H	4.30
9	I	4.29
10	J	4.23
11	K	4.13
12	L	4.15
13	M	4.04
14	N	3.98
AVERAGE		4.27

Table A2: Main areas of satisfaction and dissatisfaction with the telephone response provided

	Percentage of consumers ¹
Main areas of satisfaction	
Operators polite and efficient/helpful/friendly	53
Immediate/fast response provided	18
Information provided was useful/accurate/what was wanted	14
Main areas of dissatisfaction	
Took too long to get through/was on hold/got cut off	24
Operators have unhelpful manner	20
Not enough/inaccurate information	18

Note:

- 1 Consumers were asked why they were either satisfied or dissatisfied with the telephone response that they had been given. Percentages will not add up to one hundred due to some areas being excluded as only a small percentage of consumers mentioned it as a factor.

2.5 Table A3 below sets out an example of how the revenue adjustment for quality of telephone response will be calculated based on the steps outlined in Chapter 2.

Table A3: Example calculation of the revenue adjustment for performance under the customer survey

			B	C	$C/(Y-A)=D$ or $C/(A-X)=D$	$B-A=E$	$E*C$
Company	Actual average overall performance score	Standard error	Deemed average performance score	Amount of revenue exposed (£m)	Incentive rate (£m per unit of score)	Difference between deemed and industry average score	Adjustment to revenue (£m)
1	4.3	0.2	4.5 (Y)	0.3	0.5	0.65	+0.3
2	4.1	0.15	4.25	0.2	0.3	0.4	+0.1
INDUSTRY AVERAGE	3.85 (A)						
3	3.5	0.25	3.75	0.2	0.8	-0.1	-0.1
4	3.4	0.2	3.6 (X)	0.2	0.8	-0.25	-0.2

Appendix 3 Revised targets and incentive rates for interruptions to supply

3.1 This Appendix sets out further details on the adjustments that have been made to companies' existing targets for the number and duration of interruptions to supply to reflect the changes in definitions and improved measurement systems that companies have, or are in the process of, putting in place this year. It also sets out the incentive rates that will be used in the scheme

Revised targets for the number and duration of interruptions to supply

3.2 Chapter 3 outlined the work that has been undertaken in assessing the adjustments that should be made to the existing 2004/05 targets for the number and duration of interruptions to supply for three factors - changes in:

- ◆ measurement systems implemented prior to 2001/02 particularly those made in the last price control period;
- ◆ measurement systems that are being implemented this year; and
- ◆ definitions that were introduced in April 2001.

3.3 The November update explained that the existing targets had been calculated 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 was derived from a ranking of companies' absolute performance in (1997/98 or 1998/99) and their rate of improvement.

3.4 In deriving the adjustments to the existing targets which are being applied now Ofgem has not recalculated the trend performance or produced a revised a ranking of companies' absolute performance and the rate of improvement. If this had been done it would have led to some companies being set targets that were harder to achieve, while others would have been set easier targets. This would not have been appropriate within this price control period. Ofgem has consistently argued that the purpose of revising the existing targets is to make sure that they are consistent with new methods used by companies to collate

information on network performance. On this basis, the adjustments have been applied as a series of one-off adjustments to the existing targets.

3.5 Table A4 and A5 sets out the final adjustments that have been made to each company's existing target for the number and duration of interruptions to supply.

Table A4: Proposed adjustments to the existing targets for the number of interruptions to supply

Company	Existing 2004/05 target	Proposed changes to existing target			TOTAL CHANGE (%)	Revised target for 2004/05
		For historic changes in measurement systems (%)	For 2001/02 changes in measurement systems (%)	For 2001/02 changes in definitions (%)		
Eastern Electricity	68		5.3		5.3	71.6
East Midlands Electricity Distribution	85.0			-4.4	-4.4	81.3
London Power Networks	30.0		2.3		2.3	30.7
Manweb	43.0	13.2	0.5	-3.5	9.9	47.2
GPU Power Networks	116.0	23.6	2.2	-10.8	12.9	131.0
Northern Electric Distribution Limited	83.0		8.8	-7.9	0.9	83.7
NORWEB	55.0		5.8	-6.1	-0.3	54.8
SEEBOARD Energy	78.0	16.0	0.3	-5.1	10.4	86.1
Southern Electric Power Distribution	65.0		34.2		34.2	87.2
Western Power Distribution (South West)	81.0		3.7	-4.3	-0.6	80.5
Western Power Distribution (South Wales)	152.0		4.1	-3.5	0.5	152.8
Yorkshire Electricity Distribution	78.0		5.3	-8.7	-3.3	75.4
SP Distribution	65.0	3.0	0.4	-1.2	2.2	66.4
Scottish Hydro-Electric Power Distribution	140.0			-3.5	-3.5	135.1

Note:

1 Three steps are required to calculate the revised target. The first step takes the existing target multiplied by the percentage change for historic changes in measurement systems. The second step produces the sum of the percentage changes for changes in measurement systems and definitions in 2001/02. Step 3 multiplies the resulting percentage by the figure from step 1 to derive the revised target. The total percentage change can be derived by comparing the revised target and the existing target.

Example calculation

ScottishPower

Step 1 $65 * 1.03 = 66.95$

Step 2 $0.4\% - 1.2\% = -0.8\%$

Step 3 $66.95 * 0.992 = 66.4$

Table A5: Proposed adjustments to the existing targets for the duration of interruptions to supply

Company	Existing 2004/05 target	Proposed changes to existing target			TOTAL CHANGE (%)	Revised target for 2004/05
		For historic changes in measurement systems (%)	For 2001/02 changes in measurement systems (%)	For 2001/02 changes in definitions (%)		
Eastern Electricity	64.0		5.7		5.7	67.7
East Midlands Electricity Distribution	71.0				0.0	71.0
London Power Networks	40.0		4.0		4.0	41.6
Manweb	58.0	12.7	0.7		13.4	65.8
GPU Power Networks	96.0	18.4	2.4	0.5	21.8	116.9
Northern Electric Distribution Limited	77.0		11.2	6.2	17.5	90.5
NORWEB	64.0		6.1	0.5	6.6	68.2
SEEBOARD Energy	67.0	10.5	0.6	0.1	11.3	74.5
Southern Electric Power Distribution	55.0		50.0	5.6	55.5	85.5
Western Power Distribution (South West)	56.0		9.8	2.0	11.8	62.6
Western Power Distribution (South Wales)	117.0		8.7	1.7	10.4	129.2
Yorkshire Electricity Distribution	54.0		6.6	-2.1	4.5	56.4
SP Distribution	71.0	22.8	0.6		23.5	87.7
Scottish Hydro-Electric Power Distribution	195.0			0.4	0.4	195.8

Note:

1 See Notes to Table A4.

3.6 In looking at Table A4 and A5 the following points should be kept in mind:

- ◆ a number of companies have previously implemented significant changes to their measurement systems and have indicated that they are not implementing any further changes that will lead to a material impact on reported performance. This means that the adjustment for measurement systems in 2001/02 is small or not applicable. For these companies a change has been made to reported performance for the historic changes in measurement where this is appropriate;
- ◆ a large number of the companies are making significant changes to their measurement systems during this year which they have indicated will

lead to a large impact on reported performance. This means that there is no adjustment to targets for historic changes in measurement systems but in many cases a significant change in 2001/02; and

- ◆ the impact of changes in definitions can vary across companies depending on how network performance was previously measured and due to the characteristics of the network itself, including the nature of protection equipment that is used. For example, the change in the definition of a short interruption will have a different impact depending on the extent of underground cable and its associated protection equipment.

Incentive rates

- 3.7 The November update set out how Ofgem calculated the incentive rates that will apply to the number and duration of interruptions to supply. In the light of the issues discussed in Chapter 2, Table A6 and A7 confirms the figures set out in the November update. For the first year of the incentive scheme, where the amount of revenue exposed to these output measures is reduced, the incentive rates have been adjusted to reflect the reduced amount of revenue exposed to the scheme (as set out in Chapter 2).

Table A6: Incentive rate for the number of interruptions to supply

Company	Incentive rate for 2002/03	Incentive rate for 2003/04	Incentive rate for 2004/05
Eastern Electricity	0.07	0.14	0.14
East Midlands Electricity Distribution	0.05	0.09	0.09
London Power Networks	0.12	0.25	0.25
Manweb	0.06	0.12	0.12
GPU Power Networks	0.03	0.07	0.07
Northern Electric Distribution Limited	0.03	0.06	0.06
NORWEB	0.06	0.13	0.13
SEEBOARD Energy	0.03	0.07	0.07
Southern Electric Power Distribution	0.08	0.15	0.15
Western Power Distribution (South West)	0.03	0.07	0.07
Western Power Distribution (South Wales)	0.01	0.03	0.03
Yorkshire Electricity Distribution	0.05	0.09	0.09
SP Distribution	0.07	0.14	0.14
Scottish Hydro-Electric Power Distribution	0.02	0.04	0.04
AVERAGE	0.05	0.10	0.10

Notes:

- 1 The incentive rates are in £ million per interruption per 100 connected customers in 2000/01 prices.
- 2 The incentive rate for 2002/03 has been calculated by dividing the amount of revenue exposed to the number of interruptions of to supply in 2002/03 by the amount of revenue exposed in 2004/05 and multiplying this by the 2004/05 incentive rate, e.g. $(0.25/0.5) \times 0.14 = 0.07$.

Table A7: Incentive rate for the duration of interruptions to supply

Company	Incentive rate for 2002/03	Incentive rate for 2003/04	Incentive rate for 2004/05
Eastern Electricity	0.09	0.21	0.21
East Midlands Electricity Distribution	0.06	0.16	0.16
London Power Networks	0.11	0.27	0.27
Manweb	0.05	0.13	0.13
GPU Power Networks	0.05	0.12	0.12
Northern Electric Distribution Limited	0.04	0.09	0.09
NORWEB	0.06	0.16	0.16
SEEBOARD Energy	0.04	0.11	0.11
Southern Electric Power Distribution	0.10	0.26	0.26
Western Power Distribution (South West)	0.06	0.15	0.15
Western Power Distribution (South Wales)	0.02	0.05	0.05
Yorkshire Electricity Distribution	0.08	0.19	0.19
SP Distribution	0.07	0.18	0.18
Scottish Hydro-Electric Power Distribution	0.02	0.04	0.04
AVERAGE	0.06	0.15	0.15

Notes:

- 1 The incentive rates are in £ million per customer minute lost per customer in 2000/01 prices.
- 2 The incentive rate for 2002/03 has been calculated by dividing the amount of revenue exposed to the duration of interruptions to supply in 2002/03 by the amount of revenue exposed in 2004/05 and multiplying this by the 2004/05 incentive rate, e.g. $(0.5/1.25) \times 0.21 = 0.09$.

Appendix 4 Draft licence modifications

- 4.1 This Appendix sets out a revised draft and explanation of the incentive scheme licence modifications in the light of respondents' views on the version published in the November update.
- 4.2 Key additions to the incentive scheme licence modifications published in November include:
- ◆ details on the way in which performance on the quality of telephone response will impact on revenue;
 - ◆ a mechanism for rewarding outperformance; and
 - ◆ a process for the treatment of exceptional circumstances.
- 4.3 Also set out in this Appendix is a proposed licence modification to ensure that companies which are required to report under the IIP information licence condition are exempt from submitting quality of performance statements under standard conditions.

Incentive scheme revised draft licence modifications

Special Licence Condition modification

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

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

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 special licence condition G [in Scotland H] (Incentive scheme: calculation of charge restriction adjustment) and in any other relevant year is zero.
- Z_{PCR} in the relevant year commencing on 1 April 2005 is the amount derived from the formula set out in paragraph 3 of special licence condition G in Scotland H] and in any other relevant year is zero.”

New Special Licence Condition

Condition G [in Scotland H]: 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

$$Q_{\text{PCR}} = \left[\left(1 + \frac{l_t}{100} \right) * Q_{t-1} \right] + \left[\left(1 + \frac{l_t}{100} \right) * \left(1 + \frac{l_{t-1}}{100} \right) * Q_{t-2} \right] + \left[\left(1 + \frac{l_t}{100} \right) * \left(1 + \frac{l_{t-1}}{100} \right) * \left(1 + \frac{l_{t-2}}{100} \right) * Q_{t-3} \right]$$

3. For the purpose of the charge restriction conditions

$$Z_{\text{PCR}} = \left(1 + \frac{l_t}{100} \right) * Z_{t-1}$$

4. For the purpose of paragraph 2, and subject to paragraphs 10 and 12, Q is derived for each relevant year from the formula

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

5. For the purposes of paragraph 3, Z_{t-1} is derived from the formula

$$Z = \min \left[(z_1 + z_2), \frac{\text{TRL}}{100} * \text{BPCR} \right]$$

6. For the purposes of paragraphs 2 and 3

l_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*) [paragraph 2 of special condition B] (*licensed distributors in Scotland*)).

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

$$q_1 = \max \left[\left(\min((T_1 - C_{I_{IS}}) * \text{PIA} * \text{IR}_{1,0}), -\frac{\text{RL}_1}{100} * \text{BPCR} \right) \right]$$

$$q_2 = \max \left[\left(\min((T_2 - \text{CML}_{IS}) * \text{PIA} * \text{IR}_{2,0}), -\frac{\text{RL}_2}{100} * \text{BPCR} \right) \right]$$

$$q_3 = 0$$

If DQTR is less than or equal to MQTR, q_4 shall be derived from the following formula:

$$q_4 = \max \left[((\text{DQTR} - \text{MQTR}) * \text{QIR}_1), -\frac{\text{RL}_4}{100} * \text{BPCR} \right]$$

If DQTR is greater than MQTR, q_4 shall be derived from the following formula:

$$q_4 = \min \left[((\text{DQTR} - \text{MQTR}) * \text{QIR}_2), \frac{\text{RL}_4}{100} * \text{BPCR} \right]$$

subject to in each case the qualification that if, in the relevant year commencing 1 April 2004, the sum of z_1 , z_2 and q_4 is greater than $\frac{\text{TRL}}{100} * \text{BPCR}$ then the value determined by the following formula shall be substituted for q_4 for that year:

$$\left(\frac{\text{TRL}}{100} * \text{BPCR} \right) - z_1 - z_2$$

where:

T means (subject to paragraphs 8 and 9) 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 in 2000/1 prices;

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 and Z in the year commencing 1 April 2004) has the value of 2;

PIA (being the price index adjustor) has the value 1 in the year commencing 1 April 2000 and in each subsequent year is derived from the following the formula:

$$\text{PIA}_t = \left(1 + \frac{\text{RPI}_t}{100} \right) * \text{PIA}_{t-1}$$

Where it refers to the relevant year for the purpose of which the calculation falls to be made and $t - 1$ refers to the year prior to the year t

RPI_t is defined as in paragraph 3 of special condition B (Restriction of distribution charges) (*licensed distributors in England and Wales*) [special condition C] (*licensed distributors in Scotland*);

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

$$\text{BPCR} = \text{PUM} * \text{GR} * \text{PID}$$

where PUM, GR and PID for each relevant year are as defined in special condition B (Restriction of distribution charges) (*licensed distributors in England and Wales*) [special condition C] (*licensed distributors in Scotland*)

CI_{IS} is derived from the formula:

$$\text{CI}_{IS} = \text{CI}_1 + \text{CI}_2 + (a * \text{CI}_3) + \text{CI}_4 + (b * \text{CI}_5)$$

where

a and b are zero

CI₁, CI₂, CI₃, CI₄ and CI₅ are derived from the formulae for each of those terms set out in Annex 2 to the Regulatory Instructions and Guidance.

CML_{IS} is derived from the formula:

$$\text{CML}_{IS} = \text{CML}_1 + \text{CML}_2 + (c * \text{CML}_3) + \text{CML}_4 + (d * \text{CML}_5)$$

where

c and d each have the value [0.10]

CML₁, CML₂, CML₃, CML₄ and CML₅ are derived from the formulae for each of those terms set out in Annex 2 to the Regulatory Instructions and Guidance

DQTR deemed overall performance score in the survey of quality of telephone response as referred to in the RIGs is derived from the formula:

$$\text{DQTR} = \text{AQTR} + \text{SE}$$

where AQTR is the actual annual aggregate overall performance score based on all assessed attributes in the survey of quality of telephone response provided to the Authority by the company carrying out that survey and SE is the standard error of the overall performance score in that survey of quality of telephone response.

MQTR is the mean actual annual aggregate overall performance score in the survey of quality of telephone response of all distribution service providers.

QIR₁ the penalty rate for below average performance for the quality of telephone response) is derived from the formula

$$\text{QIR}_1 = \frac{\text{RL}_4 * \text{BPCR}}{100 * (\text{MQTR} - \text{WDQTR})}$$

where WDQTR is the lowest deemed overall performance score in the survey of quality of telephone response across all distribution service providers.

QIR₂ the reward rate for above average performance for the quality of telephone response is derived from the formula

$$QIR_2 = \frac{RL_4 * BPCR}{100 * (HDQTR - MQTR)}$$

where HDQTR is the highest deemed overall performance score in the survey of quality of telephone response across all distribution service providers.

8. Where the Authority determines, after considering the report of the examiner and making any adjustment under paragraph 9, 10 or 12 or to take account of changes in measurement systems [as identified in Annex 3 of the document issued in December 2001], that the value of C_{LIS} and C_{M_{LIS}} in respect of the year commencing on 1 April 2001:
 - (a) is equal to or less than T₁ or T₂, as appropriate, in respect of the year t-1 in Annex A, the target in respect of each of the years t-2 and t-3 for the purposes of Annex A shall be the same as the target for the year t-1; or
 - (b) is greater than T₁ or T₂, as appropriate in respect of the year t-1 in Annex A, the target in respect of each of the years t-2 and t-3 for the purposes of Annex A shall be the same as the amount so determined in respect of the year commencing on 1 April 2001.
9. [If, having regard to the criteria and assumptions stated in the conclusions document, specified information and other information provided by the licensee, the Authority or the licensee considers that either of the targets T₁ or T₂ specified in Annex A in respect of year t – 1 is materially inappropriate, the Authority may after consulting the licensee (and shall following a request in writing by the licensee) and providing reasons for its decision, by notice to the licensee specify a revised target (or where the licensee has served a request, specify the existing target or a revised target) in respect of that year and may as a consequence if appropriate specify a revised target also in respect of years t-2 and t-3 and Annex A shall, if appropriate, be modified accordingly provided that no such notice may be given after 31 March 2003.]
10. 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.
11. A notice under paragraph 9 of the principal condition in relation to Annex 2 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.

12. Where

- (a) the licensee considers that its performance in respect of any matter used for the purpose of calculating Q in paragraph 2 has been materially and adversely affected by an exceptional event;
- (b) the licensee has notified the Authority of such event within 7 days of the date upon which the licensee considers such effect has ceased;
- (c) after the end of the relevant year in which that event occurred, the examiner has reported to the Authority in respect of such event and its effect;
- (d) the licensee has provided such further information, if any, as the Authority may require; and
- (e) the Authority is satisfied that the event notified under sub-paragraph (b) is an exceptional event having regard to the criteria and examples contained or referred to in the conclusions document,

the Authority may, by notice to the licensee, direct that, for the purpose of calculating Q in respect of that relevant year, the constituent data relevant to that event shall be adjusted as specified in that direction.

13. For the purposes of paragraph 5 and 7, for the relevant year commencing 1 April 2004

z_1 shall be equal to zero if CI_{IS} is greater than T_1 or CML_{IS} is greater than T_2 . Otherwise it shall be derived from the following formula:

$$z_1 = \min \left[\left(\max \left(\frac{PICI}{15} * \frac{RLOP_1}{100} * BPCR, 0 \right) \right), \frac{RLOP_1}{100} * BPCR \right]$$

z_2 shall be equal to zero if CI_{IS} is greater than T_1 or CML_{IS} is greater than T_2 . Otherwise it shall be derived from the following formula:

$$z_2 = \min \left[\left(\max \left(\frac{PICML}{20} * \frac{RLOP_2}{100} * BPCR, 0 \right) \right), \frac{RLOP_2}{100} * BPCR \right]$$

where

BPCR is as defined in paragraph 7 of this condition;

PICI (percentage improvement in the number of customers interrupted) is derived from the formula:

$$PICI = \left(\frac{BCI - CI_{IS}}{BCI} \right) * 100$$

where BCI is T_1 for the relevant year commencing April 1 2002 and CI_{IS} is as derived for the relevant year commencing 1 April 2004.

PICML (percentage improvement in the duration of customer interruptions) is derived from the formula:

$$\text{PICML} = \left(\frac{\text{BCML} - \text{CML}_{\text{IS}}}{\text{BCML}} \right) * 100$$

where BCML is T₂ for the relevant year commencing 1 April 2002 and CML_{IS} is as derived for the relevant year commencing 1 April 2004; and

RLOP means the maximum percentage of price controlled revenue exposed in the reward scheme to each output measure (having the appropriate subscript) specified for that relevant year commencing 1 April 2004 in the table in Annex A;

14. In this condition:

- (1) "the principal 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" []; and
- (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].

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	0.5	0.5
RLOP ₁			0.6
T ₂			
IR ₂			
RL ₂	0.5	1.25	1.25
RLOP ₂			1.4
RL ₄	0.1	0.125	0.125

Explanation of incentive scheme licence modifications

- 4.4 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 [C in Scotland] (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 (Z_{PCR}). 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 Z_{PCR} take a value of zero in all other relevant years apart from that commencing 1 April 2005.

The term outperformance has been relabelled as Z_{PCR} to avoid confusion with the R_{dit} term.

New Special Licence Condition

- 1 This paragraph sets out the purpose of the new special licence condition.
- 2 This equation has been modified to remove double counting of inflation. 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 interest.
- 3 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 the accrued adjustment for outperformance for the previous relevant year ($t-1$) for interest.
- 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 Special 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 0.85 per cent of

revenue by the caps on the adjustments applying to the individual output measures.

5 This paragraph provides a cap on the positive adjustment that can be made to revenue for outperformance in the relevant year commencing 1 April 2004. The cap works such that the maximum positive adjustment is the lesser of the sum of adjustments for outperformance for the number and duration of interruptions (z_1 and z_2) or the maximum amount of revenue exposed to the incentive scheme $\left(\frac{TRL}{100} * BPCR\right)$, which is defined in paragraph 7 of the New Special Licence Condition. TRL always has a maximum value of 2.

6 This paragraph defines I.

7 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 cap ensures that there cannot be a positive adjustment to revenue, while the collar 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_1 or T_2) and performance under the incentive scheme (CI and CML) multiplied by the price index adjustor and 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 defines the adjustment to revenue for the average telephone response time. This will be equal to zero until an incentive scheme for the average telephone response time is introduced by means of a licence modification.

q_4 defines how the adjustment for revenue for the quality of telephone response is calculated. The adjustment to revenue is calculated by multiplying the difference between the company's deemed overall performance score and the mean overall performance score across all companies in the survey of quality of telephone response by the appropriate incentive rate. (QIR_1 where the company's deemed overall performance score is less than or equal to the mean performance score and QIR_2 where the company's deemed overall performance score is greater than the average performance score.) This is subject to a cap of $+RL_4$ per cent of base price control revenue and a collar of $-RL_4$ per cent of base price control revenue.

A smaller positive value may be substituted for q_4 to ensure that the sum of the reward for outperformance on the number and duration of interruptions and any positive adjustment to revenue for the quality of

telephone response do not exceed 2 per cent of base price control revenue.

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

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.

PIA is the price index adjustor, which is required to adjust the incentive rates from 2000/1 prices to prices for the relevant year.

RPI the percentage change in the retail price index as defined in Special Condition B [C].

BPCR is base price control revenue and is calculated as defined, which cross references Special Condition B (Restriction of distribution charges) [C] 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 CI₁ to CI₅ (and CML₁ to CML₅), which will be defined in Annex 2 to the Regulatory Instructions and Guidance (RIGs) document.⁹ 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 2, paragraph 2.44 of this document. The weighting factors *will not* be included in the RIGs, which specify how actual performance should be reported.

DQTR is the company's deemed overall performance score in the survey of quality of telephone response. It is calculated by adding the standard error of the company's overall performance score (SE) to the company's actual overall performance score based on all assessed attributes in the survey of quality of telephone response (AQTR).

MQTR is the mean actual overall performance score across all companies in the survey of quality of telephone response based on all assessed attributes.

QIR₁ is the penalty rate for below average performance for the quality of telephone response. It is calculated by dividing the revenue exposed to the quality of telephone response output measure by the difference between the mean actual overall performance score (MQTR) and the lowest deemed overall performance score (WDQTR).

⁹ 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.

QIR₂ is the reward rate for above average performance for the quality of telephone response. It is calculated by dividing the revenue exposed to the quality of telephone response output measure by the difference between the highest deemed overall performance score (HDQTR) and the mean overall performance score (MQTR).

- 8 Company targets for number and duration of interruptions in years t-2 and t-3 will be set on the basis of company performance in 2001/02. This paragraph allows the audited 2001/02 data, which will not be available until July 2002, to be used. This is discussed in paragraph 2.51 and 4.8 of the document.
- 9 This paragraph allows for a review of targets (T) (on the initiative of Ofgem or the licensee), in t-1 depending on information collected, where notice by the Authority can be given no later than a specified date. Consequential adjustments to T in t-2 and t-3 can also be made. This paragraph will appear in only some the licences with the agreement of the company and regulator. This is discussed in paragraphs 3.14 to 3.18.
- 10 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.
- 11 This paragraph prevents modifications to Annex 2 of the RIGs (see above) before the next price control review takes effect, unless all affected distribution licence holders agree.
- 12 The impact of exceptional events can be excluded from the incentive scheme. This paragraph sets out the process by which this will happen.
- 13 This paragraph defines the outperformance reward scheme. z₁ and z₂ define how the adjustment to revenue for outperformance on the number and duration of interruptions to supply will be calculated. If a company fails to meet its 2004/5 target for the number or duration of interruptions it will not receive any reward for outperformance (z₁ and z₂ will be equal to zero.)

If the company meets its 2004/5 target for the number and duration of interruptions then the reward for outperformance for the number of interruptions is calculated by multiplying its percentage improvement in the number of interruptions relative to the base year by the amount of revenue exposed to the outperformance scheme for the number of interruptions $(\frac{RLOP_1}{100} * BPCR)$ and dividing by 15.

The adjustment to revenue is capped at RLOP₁ per cent of base price control revenue and there is a collar to ensure the adjustment to revenue is not negative.

This ensures that if the company achieves a 15 per cent reduction in the number of interruptions relative to the base year it will receive the maximum adjustment to revenue. If the company achieves a smaller reduction in the number of interruptions it will receive a pro rata adjustment to revenue.

If the company meets its 2004/5 target for the number and duration of interruptions then the reward for outperformance on the duration of interruptions is calculated by multiplying its percentage improvement in the duration of interruptions (PICML) relative to the base year by the amount of revenue exposed to the outperformance scheme for the duration of interruptions ($\frac{RLOP_2}{100} * BPCR$) and dividing by 20. The adjustment to revenue is capped at RLOP₂ per cent of base price control revenue and there is a collar to ensure the adjustment to revenue is not negative.

This ensures that if the company achieves a 20 per cent reduction in the duration of interruptions relative to the base year it will receive the maximum adjustment to revenue. If the company achieves a smaller reduction in the duration of interruptions it will receive a pro rata adjustment to revenue.

BPCR is defined as before.

PICI is the percentage improvement in the number of interruptions relative to the base year.

PICML is the percentage improvement in the duration of interruptions relative to the base year.

RLOP is the maximum percentage of price control revenue exposed to the outperformance scheme for each output measure.

14 This paragraph sets out further relevant definitions.

Annex A

This table sets out values for T, IR, RL and RLOP for each output measure and for each relevant year.

Standard Licence Condition 5 modification

In Standard Licence Condition 5 (Distribution System Planning Standard and Quality of Service), after paragraph 4, there shall be inserted:

5. Paragraph 2 shall not apply to the licensee in respect of any period during which standard condition 49 has effect.

6. Paragraph 3 shall not apply in respect of a previous financial year during the whole or part of which standard condition 49 had effect.

Explanation of modification to Standard Licence Condition 5

The modification to Standard Condition 5 (Distribution System Planning Standard and Quality of Service) is designed to ensure that companies which are required to report under Standard Condition 49 are exempt from producing quality of performance statements under Standard Condition 5.