DNO Working Group – Incentive Framework

Meeting 1 – Summary

11 September 2002

Atendees:	Cemil Atlin (Ofgem)	Paul Eveleigh (EME)
	Adrianne Monroe (Ofgem)	Garth Blundell (SP)
	Gary Craig (Ofgem)	Bob Westlake (WPD)
	Paul Bircham (EPN)	Tahir Majeed (LPN)

This working group on Incentive Framework will focus on three main areas.

1. Incentives to invest in the network and help to ensure the security of supply.
2. Incentives provided to companies to operate more efficiently.
3. Balancing such efficiency with improvements in the quality of service.

It was decided the best way to begin the group was to review the previous price control. We then moved on to look at Opex , Capex and other incentive mechanisms. We concluded the group by briefly examining balancing incentives for efficiency with improvements in the quality of service.

Review of the 2000 Price Control

How Efficiency was assessed?

A) Opex - 3 Broad Strands of Work

- Regression
- PKF
- Peter Warry

Regression

- Corrective Ordinary Least Squares (COLS) – Composite Variables vs Operating Cost
- COF (Composite Sized Variable $_{CUL}$) i.e. Standardisation of Costs as DNOS had different methods of collating costs.
- Derived Efficiency Frontier (Using Eastern / Southern)
- Fixed Intercept (£25m – PKF / PW)
- Unconstrained Intercept – Final Proposal (Went through at £23m compared to the £25m of the constrained intercept.)

PKF

- Business Plan Questionnaire (BPQ)
- Standardised Costs – Ongoing
- Benchmarking – Process / Activities / Structure
  - Series of process style benchmarks benchmarking DNOs against each other and other U.K. companies
  - Benchmarking on: wages, procurement, engineering costs, raw materials etc.
  - Point in time / Future efficiencies

- Ofgem Adjustments
  - Separation of businesses (Supply > Distribution)
  - Allocation/Recharges

- Final Output
  - Efficient Level of costs for each company (Ofgem used OLS)
  - Went with the higher of the 2 – which in majority of cases meant Ofgems regression.

- Every company compared to a hypothetical efficient 'average' company.
  - Companies that outperformed on some benchmarks tended to under perform on other benchmarks.
  - All of an individual companies benchmarks were taken together to give an aggregate of normalised averages

Peter Warry

- Strategic Advice
  - Qualitative / Subjective / Commentary
  - He came up with the £25m fixed level of costs
- Visited DNOs and reported on competence
- Internal Report for Ofgem
- No Systematic Application – 'Comfort Factor'

B) Capex (PB Power)

- No systematic assessment of efficiency
  - Does this in itself create incentives?

- Work focused on efficient future Capex
  - Hugely complicated model –asset based minimum equivalent value (Repex)
  - Model popped out Capex numbers – Company Specific Issues, Quality of Supply Issues, Benchmarking adjustments.
  - Load Related Capex – driven by demand growth

- Looked at overall levels of Capex and no one overspent ⇨ Incentive works.

- Relationship between Opex and Capex – not applicable

<u>Incentive Framework Under the New Price Control</u>

<u>Incentives to Efficiency</u>

A) Opex - 5 Year Review (Duration)

<u>Factors Within the Price Control</u>

- Retention Period (100%) – No sliding scale and company keeps all Opex
- Reducing balance - Incentives over time i.e. Percentage of Opex passed on to customers.
- Lack of Frontier Reward
  - Glide Path
  - 1% Within Range Adjustment
  - Constant Frontier – Extended Duration
  - No incentive to extend the frontier – **Except to be efficient**

- Revenue Profiling – Cash flow management

<u>Factors Outside the Price Control</u>

- Shareholders Expectations
- Bond Markets
- Stakeholders / Trade Unions / Staff Morale

All of these factors are dependent on **timing** and the impact they will have on **risk.**

B) Capex

<u>Factors Within the Price Control</u>

The factors effecting Capex are exactly the same as those facing Opex (above) apart from:

- S.T. Commitments fixed for 5 year retention on Capex (Uncertainty over efficiency approach may reduce this)
- How robust is the Capex model?
- CoC – Strong both ways (Caps and Collars)

<u>Factors Outside the Price Control</u>

The factors effecting Capex outside the price control are exactly the same as those facing Opex (above).

Other Incentive Mechanisms / Properties / Cost Drivers

A) Within the Price Control

Losses

- Increasing Efficiency - Buying loss saving assets vs Saving Capex
- Marginal impact on Opex / Capex Efficiency
  - Little incentive to invest

IIP

- Opex Efficiency e.g. Faster / More Efficient Restoration
- Can Increase Opex / Capex
  - Conflicting incentives. However, they may not be the wrong incentives to use

Overall Standards / Guaranteed Standards

- Leads to costs increasing

Regulated / Unregulated Boundary

- Incentive to increase excluded service revenue
  - This impacts on regulated costs

Treatment of Mergers

- Mergers Policy in General
- Mergers Savings

Others

- Tariff Baskets
- Structure Charges
- Volume Drivers
- Bad Debts – Minimise Costs
- Environmental / Social Factors
- Distributed Generation

B) Outside the Price Control

- Lane Rentals
- Wage Rates etc.

Balancing Incentives for Efficiency with Improvements in Quality of Service

- CoC
- IIP
- Certainty of Treatment for Investment Expenditure
- Statutory / Licence etc
- How close to ultimate efficiency / best practice
- Periodicity e.g. Target Period
- Treatment of IT Expenditure – Opex efficiencies
- Customers expectations

What Behaviours do we Want to Incentivise?

- Efficiency
- Least Cost / Price
- Security of Supply – Short to Medium Term
- Environmental Commitments
- Social Commitments

The ranking attached to the above behaviours governs the incentive framework. This is one of the main issues the forthcoming government white paper deals with.