

13 March 2003

Dear Colleague

**OPEN LETTER ON DEVELOPING NETWORK MONOPOLY PRICE CONTROLS AND
THE NEXT PRICE CONTROL REVIEW OF THE ELECTRICITY DISTRIBUTION
NETWORK OPERATORS (DNOs)**

Introduction

In February 2003, Ofgem published an update document on its work on developing network monopoly price controls and the next price control review of the electricity DNOs.¹ This set out Ofgem's further thoughts on ways in which the efficiency incentives provided to network monopoly companies could be improved and the key issues and objectives for the DNO price control review. This letter sets out further details on:

- ◆ a draft timetable and workplan for the DNO price control review – this is set out in Appendix 1; and
- ◆ work undertaken by Frontier Economics on dealing with uncertainty and the incentive framework for price controls² – a summary of the key points and issues for consideration from these reports are set out in Appendix 2 of this letter. The reports themselves are available on Ofgem's website.

Ofgem held a public workshop on the issues raised by the update document on 19 February. This was attended by a wide range of interested parties including monopoly companies, consumers and their representatives, suppliers and academics. The presentations that were given are available on Ofgem's website, and a summary of the main points raised at the workshop will be on the website shortly.

¹ Developing network monopoly price controls: Update document – Ofgem, February 2003

² Frontier Economics were appointed in August 2002 to provide advice on a number of issues associated with network monopoly price controls.

In addition to the issues raised in the February update document, Ofgem would welcome comments on this letter and the attached appendices. Any comments should be received by 14 April and be sent to:

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Unless otherwise marked as confidential all responses will be published by placing them in Ofgem's library or on our website. It would be helpful if responses could be submitted both electronically and in writing. Any questions on this document should, in the first instance, be directed to Adrienne Monroe or Cemil Altin (tel: 020 79017401).

Next steps

Ofgem intends to publish a further document on developing network monopoly price controls in May. This will set out Ofgem's further thoughts on issues common to all network monopoly companies including efficiency incentives and financial issues. Ofgem will then publish the first main document on the next DNO price control review in June, which will set out the background to the project, an initial regulatory impact assessment and confirm the objectives and timetable.

Richard Ramsay
Managing Director
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APPENDIX 1

DRAFT TIMETABLE FOR THE DNO PRICE CONTROL REVIEW

Introduction

This Appendix sets out a detailed timetable and related work programme for the DNO price control review.

The timetable has been developed to allow companies and other interested parties to contribute effectively to the review process. This includes allowing an appropriate amount of time to respond to consultation documents and to complete information requests. The timetable sets out a clear, logical and achievable timetable for the review, which identifies the key stages in the process, including when:

- ◆ key policy issues should be resolved;
- ◆ consultation papers will be published; and
- ◆ information will be collected from companies.

There are four main stages to the price control review. The first of these is the development stage for the review, which encompasses the work that is being done on developing network monopoly price controls and on identifying the objectives, key issues and timetable for the review. This concludes in May 2003, by when Ofgem intends to be in a position to set out its detailed thoughts on key areas of the regulatory framework including:

- ◆ the strength of incentives that companies will be provided with to achieve efficiency savings;
- ◆ how it intends to deal with the periodicity of incentives;
- ◆ how it intends to deal with any distortion of incentives between operating and capital expenditure; and

- ◆ an outline of the steps that could be taken to deal with uncertainty that DNOs will face over the next price control period, particularly in relation to distributed generation.

As part of this stage of the review work will also begin on developing the first of the two main information requests that DNOs will be required to complete and the financial model that Ofgem will use to assess the financial impact of the price control on the DNOs.

The second stage of the review will begin in June 2003 when Ofgem publishes the first main document for the price control review. This will include background to the project, an initial regulatory impact assessment for the price control review and confirmation of the objectives and timetable. During this stage of the review, Ofgem will undertake customer research to gain a better understanding of customers' preferences and willingness to pay for quality of supply and, where appropriate, other relevant outputs (including environmental). This will be an important input in defining what DNOs will be required to deliver over the period of the next price control, and will inform the basis on which companies are asked to forecast costs. It will also be necessary as part of this stage of the review to develop thinking on key policy decisions for the review, including on the incentive framework that will be put in place for DNOs to connect and utilise distributed generation. Ofgem would also expect to publish initial results on its work on assessing the historical efficiency of DNOs in March 2004. This stage of the project will be substantially progressed by December 2003, and will come to an end in March 2004.

The main pieces of work for the third stage of the price review will be assessing the forecast cost information that DNOs submit, finalising work on the efficiency analysis, updating the customer research in the light of improved understanding of the cost implications and determining the financial parameters based on market conditions at the time. This stage will commence in January 2004, overlapping with the end of the second stage. By the spring of 2004, Ofgem will then be in a position to bring together the various aspects of the review so that proposals for the level of revenue that DNOs will be allowed to recover can be developed. This will be an iterative process with the publication of initial proposals in June 2004 and final proposals in October 2004.

The final stage for the price review will be the implementation stage which will focus on finalising the licence modifications that will be required to implement the price control. This will be an iterative process which will begin with the publication of an outline draft of the licence modifications in June 2004 and end with a final consultation under Section 28 of the Utilities Act in February 2005.

Once the project has finished, Ofgem intends to review the process against the criteria and objectives set out at the start of the project (see Appendix 1 of the February 2003 update document).

Table 1: Draft timetable for the Distribution price control review

Notes:

- (1) Table 2 shows the contents of the main publications (those highlighted in bold below)
 (2) All dates are provisional and will be updated as the project progresses

Date	
2003	
March	Publish draft timetable and Frontier Economics reports Consult on information request on distributed generation (21 March – 4 week period for responses) Request disaggregated quality of supply performance information
April	Initial proposals paper on structure of charges (early April) Consult on terms of reference for consumer research Request data on exceptional events (mid April) Responses due to Feb 2003 update paper and to this letter (14 April) Draft of historical business plan questionnaire (BPQ) issued to DNOs (mid April)
May	Comments due on draft historical information questionnaire (9 May) Draft Distributed Generation BPQ sent to DNOs (late May – 4 week period for comments) Principles document on developing price controls (late May, see Table 2 for contents)
June	Undertake first phase consumer surveys Historical information questionnaire issued (mid 13 June) Initial consultation paper on DNO price control review (late June) Proposals paper on Structure of Charges
July	Consult on initial findings of work on comparison of quality of supply performance Public workshop(s) on approach to the review and the BPQ (mid July) Draft of forecast BPQ sent to companies (late July)

	Distributed generation BPQ issued (late July)
August	Receive responses to initial consultation paper Comments due on forecast BPQ (late August) Publish results from first phase customer research (end August) Proposals paper on distribution losses
September	Responses received from DNOs to historical BPQ (mid Sept) Meetings with DNOs on historical information (from Sept onwards as needed) Responses received to distributed generation questionnaire (late Sept) Forecast BPQ issued (late September)
October	Update document on the review (mid Oct) Publish first draft version of financial model
November	Public workshop on review progress, focussing on output incentives (distributed generation, quality of supply, etc) Public workshop on financial model Responses received from interested parties to October update document (mid Nov)
December	Second consultation paper on the review (mid Dec) Responses received from DNOs to forecast BPQ (late Dec)
2004	
January	Meetings with DNOs on BPQ responses (January onwards as needed) Responses received from interested parties to December consultation paper
February	Bilateral meetings with DNOs and other interested parties Undertake second phase consumer survey
March	Publish policy document on the review Feedback to DNOs on responses to forecast information request
April	Public workshop on March policy document Responses received to March policy document Publish results from second phase customer research Publish revised version of financial model
May	Finalise cost projections for initial proposals
June	Publish initial proposals setting out revenue allowances – P0/Xs
July	Public workshop on initial proposals Bilateral meetings with DNOs and other interested parties Responses received to June initial proposals

August	Review and incorporate 2003/04 out-turns
September	Publish update document (early Sept) Responses received from interested parties to update document (end Sept / early Oct)
October	Bilateral meetings with DNOs and other interested parties Publish final proposals on review (P0/Xs/review of IIP) and revised licence modification (end Oct)
November	
December	Companies indicate whether they are willing to accept the new price controls
2005	
January	Produce revised version of licence modification for consultation
mid February	Final consultation on licence modifications
March	
1 April	New price controls implemented
Early Summer	Publish review of the price control review process for consultation
Autumn	Publish final report on the price control review process

Table 2: Draft contents of consultation paper by workstream for DPCR4

Workstream (Ofgem lead)	May-03 Principles Paper	June-03 1 st Consultation	October-03 Update Document.	December-03 2 nd Consultation	March-04 Policy document	June-04 Initial proposals	September-04 Update document	October-04 Final Proposals document
Scope, Form and Efficiency Incentives (Cemil Altin)	<ul style="list-style-type: none"> Retention periods for efficiency (strength and periodicity) Propose approach to Scottish transmission review 	<ul style="list-style-type: none"> Set out detailed retention mechanism Consult on potential form and scope issues (metering, connections, EHV, revenue drivers, hydro-benefit, etc) 	<ul style="list-style-type: none"> Update for responses to June paper Note implications of structure of charges and losses projects 	<ul style="list-style-type: none"> Proposals on form and scope of metering control Proposals on other form and scope issues (revenue drivers, EHV, hydro-benefit, etc) 	<ul style="list-style-type: none"> Finalise form of incentives Conclusion on form and scope of price control (and separate controls if needed for metering, EHV, etc) 			
Costs (Carl Hetherington)	<ul style="list-style-type: none"> Discuss approach to total cost modelling 	<ul style="list-style-type: none"> Set out approach to assessing efficiency Publish outline of historical BPQ Explain approach to developing scenarios for forecast BPQ 	<ul style="list-style-type: none"> Report on responses to historical info request Publish outline forecast BPQ 	<ul style="list-style-type: none"> Set out overview of normalised historical costs and provide initial comparison Update approach to efficiency analysis 	<ul style="list-style-type: none"> Report on efficiency analysis on 02/03 Report on forecast BPQ responses and set out initial views 	<ul style="list-style-type: none"> Set out initial cost projections 	<ul style="list-style-type: none"> Take account of comments and actuals in 03/04 	<ul style="list-style-type: none"> Final cost projections

Workstream (Ofgem lead)	May-03 Principles Paper	June-03 1 st Consultation	October-03 Update Document.	December-03 2 nd Consultation	March-04 Policy document	June-04 Initial proposals	September-04 Update document	October-04 Final Proposals document
Quality of Supply and other outputs (including environmental) (Chris Watts)	<ul style="list-style-type: none"> Update view on customer preference methodology 	<ul style="list-style-type: none"> Set out approach to developing quality of supply regulation 	<ul style="list-style-type: none"> Discuss key survey results Initial results of work on comparing QoS Initial thoughts on scope of incentives, target setting and exceptional events 	<ul style="list-style-type: none"> Initial thoughts on changes to standards of performance Report responses to October update Further thoughts on incentivisation other outputs 	<ul style="list-style-type: none"> Analysis of costs of improvement Initial proposals for GOSPs Update on IIP incentive scheme scope and targets Initial proposals on other incentives 	<ul style="list-style-type: none"> Consultation on draft SI and determinations for GOSPs Proposals for form of incentive scheme, targets and incentive rates (quality and other outputs as appropriate) 	<ul style="list-style-type: none"> Take account of comments and actual performance in 03/04 	<ul style="list-style-type: none"> Final proposals for revised incentive scheme
Distributed Generation (DG) (Min Zhu)	<ul style="list-style-type: none"> View on consistency of principles with transmission Interim view on cost recovery to 31/03/2005 (logging up) 	<ul style="list-style-type: none"> Summarise views on potential scope and impact of DG Approach to incentive mechanisms Potential for national cost recovery mechanism 	<ul style="list-style-type: none"> Report responses to info request Analyse costs of DG Initial view on proposed incentives and cost recovery 	<ul style="list-style-type: none"> Analysis of incentives Proposals on form of incentives for connection and utilisation of DG 	<ul style="list-style-type: none"> Confirm structure of charging / incentive and cost recovery 	<ul style="list-style-type: none"> Firm numbers for incentives 	<ul style="list-style-type: none"> Take account of comments 	

Workstream (Ofgem lead)	May-03 Principles Paper	June-03 1 st Consultation	October-03 Update Document.	December-03 2 nd Consultation	March-04 Policy document	June-04 Initial proposals	September-04 Update document	October-04 Final Proposals document
Financial (To be determined)	<ul style="list-style-type: none"> Proposed approach to cost of capital, tax, financial structure issues Principles for assessing pension costs 	<ul style="list-style-type: none"> Initial view on assessment of tax and depreciation Initial view on financial ratios and framework of financial model 	<ul style="list-style-type: none"> Update for comments Determine approach to disposals (First draft model published in October) 	<ul style="list-style-type: none"> Initial proposals for historic RAV Update on pensions and tax in light of historic BPQ Determine whether to use pre-tax or post-tax cost of capital 	<ul style="list-style-type: none"> Propose cost of capital range Initial view on approach to replacement capex and depreciation Set out tax allowance or method of calculation 	<ul style="list-style-type: none"> Finalise cost of capital range and propose value Finalise financial indicators and propose test values Projections of RAV and of all financial costs (Second draft model published in April) 	<ul style="list-style-type: none"> Update ratios and cost of capital for comments and for market movements 	<ul style="list-style-type: none"> Finalise all components Publish model and data
Other		<ul style="list-style-type: none"> Partial Regulatory Impact Assessment (RIA) Revised timetable and workplan 				<ul style="list-style-type: none"> Draft RIA Outline draft of licence modifications 		<ul style="list-style-type: none"> Final RIA Revised draft licence modifications

APPENDIX 2

ISSUES ARISING FROM THE REPORTS PRODUCED BY FRONTIER ECONOMICS

Introduction

Frontier Economics was appointed by Ofgem to provide advice on certain aspects of the regulatory framework. Its work has focused on:

- ◆ ***dealing with uncertainty*** – in setting price controls Ofgem must come to a view about the efficient level of costs that a company will incur and that in doing so it must consider a number of variables that may impact on the future costs of a company and its ability to meet the outputs required of it. It is important to consider how the regulatory framework should deal with the different uncertainties that companies face. The work of Frontier Economics has looked at the key issues that need to be considered in dealing with uncertainty. These issues have been considered in the context of the uncertainty raised by distributed generation for the regulatory framework for the DNOs; and
- ◆ ***the existing framework of incentives applying to network monopoly companies*** – a number of issues have been raised about certain aspects of the incentive framework for network monopoly companies including the incentives to achieve efficiency savings and provide a good quality of service to consumers. The work of Frontier Economics has looked at whether improvements could be made to the incentives provided to network monopoly companies.³

The work that has been undertaken by Frontier Economics does not represent Ofgem policy. It is one input that will be considered by Ofgem in developing its thoughts on network monopoly price controls.

³ Details of the work that Frontier Economics has been undertaking are set out in Appendix 1 of the February 2003 update document on developing price controls.

Issues for consideration

Ofgem would welcome views on any of the issues raised by the reports produced by Frontier Economics and particularly on:

Dealing with uncertainty

- ◆ the decision making framework that has been developed to identify the most appropriate regulatory response to dealing with uncertainty, including its application to the various examples identified; and
- ◆ the best way of dealing with the uncertainty caused by distributed generation.

Incentives

- ◆ the most appropriate balance between the strength of efficiency incentives provided to companies and the reflection of efficiency savings in prices paid by consumers;
- ◆ whether there should be any difference in the strength of incentives provided for opex and capex savings;
- ◆ the most appropriate way of incentivising companies to deliver a good quality and security of supply to consumers – including ways in which the existing IIP incentive scheme for the DNOs could be improved;
- ◆ dealing with periodicity of incentives including the applicability to electricity and gas of the approach used by other regulators;
- ◆ the most appropriate way of defining capital expenditure for a model of total costs; and
- ◆ how quality (and other outputs) could be best incorporated into an assessment of companies' efficiency.