Developing network monopoly price controls

A Response by British Gas Trading

Author : Roddy Monroe

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Response from British Gas

1. Introduction.

British Gas is grateful for the opportunity to respond to Ofgem's initial consultation on developing network price controls. As British Gas is active in both the pipes and wire markets we have a vested interest in the ensuring that the development of price controls provides the incentives to ensure long term system security and the delivery of a good level of service to consumers.

To that end we fully support Ofgem's aims outlined in this consultation which aspire to improve the framework of price controls, increase the consistency, where appropriate, and to lay the foundations for the next distribution price control.

Recognising that this is Ofgem's initial consultation we have limited our response to high level comments, firstly outlining our general views with regard to monopoly network price controls and then discussing, in further detail, our views pertinent to the forthcoming distribution price control review.

2. General Principles

We endorse the development of a generic approach for undertaking price control reviews and agree that this will help to ensure that reviews are carried out in a consistent way for all network companies and increase the level of transparency in the regulatory process. However, we recognise that the current difference between the gas and electricity models, reflect the corporate ownership of the different elements of the supply chain, the physical differences in the product, history, and even Ofgem's own historical differences (Offer and Ofgas).

We acknowledge that the price control framework for the gas and electricity monopoly networks are substantially similar with the main difference being the existence of system operator (SO) incentive schemes for gas and electricity transmission which have been implemented to meet industry specific issues. We also agree that they have worked well in providing companies with the incentives to improve efficiency whilst maintaining a good quality of service to the consumers.

We see a continuing need for the RPI-X approach as the future development of effective competition in monopoly networks is not practical, however we believe that incentive regulation has limitations which will need to be addressed.

The challenge for Ofgem now is to maintain incentives for the network companies to continue to deliver effective and efficient networks. We see two areas of risk to this challenge. Firstly, it is imperative that the price control mechanism continues to provide the incentives for companies to deliver both capital investment and operational efficiency savings. Secondly, and arguably a more difficult challenge, is to provide the incentives which avoid the over or under expenditure of capital.

These challenges must be met without creating distorted or unintended incentives or imposing excessive burdens on network companies.

With regard to efficiency savings, a deficiency of the current mechanism, which allows companies to keep savings only for the remaining duration of that review period, is that the incentives to find efficiency savings may be weaker towards the end of the 4 or 5 year price control periods. It is important that companies are encouraged to make decisions based on sound commercial or economic decisions rather than on accounting decisions designed to obtain a more favourable outcome. We support the roll over approach adopted by the water regulator where any savings are kept by the company for a prescribed length of time irrespective of when they are achieved. This has been proven to smooth out peaks and troughs in capital investment and we believe that this principle should apply to both operational and capital efficiency savings.

To complement the incentive mechanisms we also recognise the need for Ofgem to ensure that any efficiency savings are real and have been achieved without the degradation in the quality of service to consumers or reduced spend on maintenance. We believe that this may be monitored, and protected against, by identifying a wide range of indicators which inform on quality and serviceability.

With regard to developing the price control mechanism to provide incentives to encourage companies to invest capital at the efficient level, we see this as a more difficult challenge. Although we accept that there is a link between the quality of the network performance and investment, monopoly networks are comprised of relatively long life assets where their inherent flexibility may obscure neglectful investment and this situation may not become apparent for many years. Also there is not a direct link between the quality of the service provided and capital maintenance expenditure as performance is a consequence of many factors, for example management processes and local geographical conditions.

We accept that this disjunct between network expenditure and quality of performance has been recognized for some time and the moves that Ofgem has made to improve the quality of information and the measures to provide the incentives for long term investment through the information and incentives project (IIP) are to be welcomed.

We will be interested in seeing the results from the IIP to see how successful this scheme has been. We believe that the output measures already identified can be extended to cover other service and cost improvements for distribution. In addition, it should be considered whether IIP should be applied to electricity transmission and gas transportation regulation.

Because the identification of clear links between expenditure and quality of network performance are hard to identify we would recommend that Ofgem promote the development of risk management models to assess the potential impact of deterioration in asset performance on future levels of service. Ofwat's paper on maintaining serviceability (MD161) provides a reasonable view on this. This would address the risk that regulators may make decisions in their price reviews on the appropriate level of expenditure on assets on the basis of inadequate information.

We believe that regulatory uncertainty may increase the cost of financing new investment and therefore generally support any measures that can make the consultation process more open and transparent. Measures introduced at the outset of the review that will help reduce the perception of uncertainty include the clear identification of new capital spend and the publication of the assumptions and financial models underlying the price review decisions.

We also believe that there may be merit in extending the period of the price control beyond the normal 5 year period to provide greater cost certainty and to allow for the better long-term management of networks.

Electricity Distribution

Distribution accounts for between 25% to 30% of the electricity supply costs and is therefore an important cost element for customers. Whilst Distribution Businesses have made some efficiency and cost improvements which have been passed through to the industry and the end consumer it is not obvious that the improvements in efficiency levels achieved have been to the same extent as the Transmission Market Sector. Distribution costs still remain as the second largest cost element in the electricity bill.

We recognise that the RPI-X Price Control mechanism has proved successful in regulating the Distribution Businesses cost bases and believe it can be improved as discussed earlier. However, we are not concienced that the RPI-X mechanism on its own will meet all the needs of the industry at the next review. We believe that complementary mechanisms will be need to be developed in parallel to deal with such issues as:

- promoting the growth of distributed generation,
- influencing a greater reduction in the level of losses to the industry
- ensuring the networks move from a passive to an active managed system.

Incentivising Distribution Businesses to encourage and support the growth of distributed generation must be seen as a priority within the new pricing regulation to meet government and environmental targets.

We believe that Ofgem should also consider whether other means may be more appropriate to regulate distribution costs. An incentive based approach (profit and loss sliding scale) may be an alternative means that could be adopted and applied for certain aspects of distribution services and may prove a more cost effective approach. A similar approach has been applied successfully to NGC's System Operator costs which has resulted in increased efficiency savings to both NGC and the industry. We look forward to reviewing how successful the approach has been for the LDZs.

Since typically most of the costs of distribution systems relate to capacity rather than commodity consideration should be given as to whether the method of charging should be based on a network capacity cost basis. We observe that the pattern of peak demands is an important factor in determining distribution costs and in managing the network efficiently. We therefore conclude from this that efficient management of peak demand by customers and the consequential deferral of distribution reinforcement should enable Distribution Businesses to reduce forward distribution costs and prices. It is our view that end customers have a major role to play in achieving improved capital efficiencies. In particular, we believe that the adoption of customer choice of maximum capacity could deliver major benefits.

One way to encourage Distribution Businesses to make efficient use of their networks is through the promotion of customer choice in maximum capacity to domestic customers. We would expect in future, and as a result of making capacity information available, that distribution businesses would be able to reduce their costs if they were to allow customers to exercise such choice in their peak distribution requirements. If distribution companies provide capacity information in respect of customers this may assist in determining if customers actually utilise the amount of generic capacity that peak load is set aside for them. It therefore follows that if a customer's demand is much lower than the capacity set for them, that distribution companies may in the long term wish to reduce their network asset requirements, and customers could in turn benefit from a reduction in charges. This may provide the potential for distribution businesses to reduce their stock of distribution assets.

In addition the level of capacity and investment needed for electricity distribution networks may have reduced by the behaviour of customers and the advances in technology in white goods. For example, more customers are likely to have taken up energy efficiency schemes such as loft insulation, wall cavity insulation and purchased products that are more energy efficient like energy saver light bulbs, cookers, fridges and heating appliances.

If distribution businesses were to actively consult with customers (i.e. suppliers and directly connected large consumers) and involve them in the provision of their set of services and charges then this could enable distribution companies to achieve further cost savings and efficiencies. In particular, by driving through efficiencies in network demand control management, the capacity that needs to be available for end customers and through the reassessment of their operational and capital activities. It should be noted that NGC hold regular meetings which the industry are invited to, to review and discuss their charging methodology and their cost structure. This has allowed a greater understanding of the transmission charging basis and given industry parties the ability to challenge underlying cost assumptions and better plan and budget for their own cost basis. No similar transparent process is adopted by Distribution Businesses with their system users and we would welcome them moving to a more open, transparent and customer focused regime.

At the very least we expect the Distribution Businesses to begin to offer a choice of services and to provide the information to allow users to be better informed about the services received and on the improvements planned or undertaken for network performance.

We note that Ofgem consulted on the structure of electricity tariffs towards the end of 2000 and is intending to follow this up shortly. Progress towards addressing the large variances in costs between the distribution businesses and the other areas highlighted for improvement have been slow in coming.

The high level objectives of the price control should also consider the implications of the establishment of new licenced distribution businesses and how regulation will apply to these Companies.

It is not clear to us following the introduction of the new licences last year whether there is clear and distinct business separation and a detached cost base allocation between distribution and transmission activities in Scotland.

We support making the arrangements for transmission regulation in Scotland consistent with that of England and Wales and recognise that the majority of this work will be taken forward under the British Electricity Trading and Transmission Arrangements. Furthermore we support improving the existing framework of price controls for all network monopoly companies to increase the consistency in approach and application in the setting of the price controls.

3. Conclusion

We welcome the approach and steps identified in the consultation and would endorse making transparent details of the modelling and analysis work undertaken and in seeking the views from customers (both end customers and suppliers) throughout the process.