

Innogy plc

Economic Regulation, Windmill Hill Business Park
Whitehill Way, Swindon, Wiltshire SN5 6PB
Tel 01793-893815 Fax 01793 892981
www.innogy.com

By e-mail only



Direct dial: 01793 893815
Mobile: 07989 494442
e-mail: zoe.keeton@innogy.com

14th April 2003

Adrienne Monroe
Manager – Price Control Development
Ofgem
9 Millbank
London
SW1P 3GE

Dear Adrienne

Re Developing network monopoly price controls – update document.

Innogy welcomes Ofgem's timely consideration of network price controls following the publication of the initial consultation document in August. We welcome the opportunity to comment on the proposals contained within the update document and the supporting publications produced by Frontier Economics.

Our comments are focused on four areas of the document; the application of methodologies used in transmission pricing to provide incentives on networks, the treatment of cost efficiencies, the use of output based incentives within the price control framework and the treatment of the RAB.

Consistency of price controls across networks

Innogy recognises a key consideration for the forthcoming and subsequent price control reviews is the likelihood of an increase in the volume of embedded/renewable generation which has the potential to fundamentally alter the configuration and management of the distribution networks.

Satisfying the desire for an increase in embedded generation requires two incentives, those on the potential generator to invest and those on the distribution network operator to ensure that sufficient infrastructure investment takes place. Innogy's position on the former is clear. We believe that the any support for generation technologies should be explicit and outside the existing market framework. As for the latter, we believe that there is a balance to be maintained between ensuring that the Governments Energy Policy aspirations can be achieved whilst avoiding inefficient system investment to the detriment of customers.

There is considerable difficulty in setting long term price signals at this time given the uncertainty regarding the likely pace of change caused by the introduction of distributed generation. It is conceivable that during the five year period of the next distribution price control, individual distribution networks will evolve to a varying degree from the current passive state to actively managed systems. This will be driven both by circumstances unique to each individual DNO area and unanticipated developments in generation technologies.

If this is the case, theoretically a split could be made between the active system management activities i.e. 'SO' and those more passive activities of an Asset Owner. Therefore it would seem appropriate for differing incentive approaches to be developed possibly using the current NGC arrangements as a template.

This would result in a traditional long-term price control for the Asset Owner activities but shorter-term incentives more able to be adjusted to reflect market dynamics for the System Operator activities. In practise the separation of the two activities is likely to be complex as the ratio of active versus passive activity will vary between DNO's and within networks. This will be further exacerbated by the incremental nature of connections resulting in the active management of a particular part of the network pending further capital investment, following which it may revert once again to a passive system.

Due to the complexities of this issue extensive work is still required to determine the nature of the Asset Owner / System Operator split of the Distribution networks. As such this issue would be best dealt with in the run up to the 2010 price control as part of an evolutionary progression of network management. In the meantime in order to further the debate it would be useful for Ofgem to publish their views on potential reconfiguration using the current NGC model as a template.

The Frontier Economics document "Regulatory mechanisms for dealing with uncertainty", proposes a mechanism for the treatment of distributed generation connections that factors in the uncertainties of volume and location of connections. Using their two stage model, in the long term as distributed generation becomes a core function of the DNO's operation, with well established cost drivers that can be effectively benchmarked, it would be appropriate to apply a System Operator split as detailed above. In the short term cost drivers are required which avoid inefficient system investment and reward the correct anticipation of connectees' requirements.

Innogy's views on the proposed System Operator incentives were addressed in our response to the December 2002 proposal document. We remain unconvinced that elements of the proposed arrangements are required or that they will produce the correct locational and investment signals. However there are clear distinctions that can be drawn between the Transmission System and the Distribution Networks that indicate that different approaches to incentives may be required. As we stated in our SO response, the Transmission System is an actively managed system that will be largely unconstrained with current carrying capacity unlikely to be a driver of electricity transmission investment. This can be contrasted with the distribution networks where substantial investment in network reinforcement as well as increased levels of active management are likely to be required if the Governments aspiration for renewable generation is to be met.

The mechanism proposed for transmission capacity release if applied to the distribution networks could provide signals to the DNOs to ensure that additional capacity is only built in a particular location when it is both economic and efficient to do so. By allowing a higher rate of return on revenues from the sale of incremental capacity, with a lower rate of return on capacity which remains unutilised, the incentive mechanism to both manage the network and reinforce in the correct anticipation of distributed generation connection is established. This provides the DNOs with the freedom to manage their networks and to determine which investments should be brought forward or deferred. However this mechanism may not provide sufficient locational incentives on DNOs to construct assets that support small-scale distributed generation projects.

Innogy believes that the most economically efficient approach would be to base distribution tariffs for the higher voltages, where new generation is most likely to connect, on similar principles to those currently employed by NGC for transmission tariffs. The ICRP (Investment cost related pricing) model used to provide appropriate locational signals for generation and

demand connecting to the transmission system could be extended to the more actively managed voltages of the distribution networks, which we envisaged to be limited to 132kV and possibly 33kV. This would give electrical depth to the present geographic breadth of the model. In this manner distribution tariffs could be constructed on a basis that would provide efficient siting signals for embedded generation thus minimising the need for new investment in the network. It would also ensure consistency between transmission and higher voltage levels of the distribution networks that will increasingly be required to operate in a similar manner.

Innogy recognises that neither of these approaches will provide sufficient locational incentives on DNOs to construct assets that support the smallest-scale distributed generation projects. Ofgem outlined proposals concerning micro-generation, in the Structure of electricity distribution charges up date document (October 2002). This stated that “customers installing micro-generation should not face any additional connection charges, unless work was required because of their unusual or abnormal load, but that they should be subject to a distribution use of system tariff which reflects the cost and benefit they create”. As such it is already anticipated that reinforcement costs at this level will be smeared across the entire DNO’s network, with investment based upon the standard rate of return. The work currently being undertaken by DGCG (Distributed generation co-ordinating group), in particular Workstream 4, will provide the mechanism for calculating the described tariff, which will incentivise the limited requirements for active management at this level. Realistically however, we do not anticipate significant growth in generation at the low voltage level, particularly within the scope of the next price control period.

Incentives for cost efficiency

Innogy welcomes the proposal to introduce of fixed retention periods for efficiency savings. The current mechanism of periodicity distorts the timing of companies’ efficiencies savings, thereby undermining the true levels of efficiency that could be achieved.

The base model for this is well established within the water industry. This mechanism could be further improved by the adoption of three of the modifications outlined by Frontier Economics. Any negative incentive allowances would be carried forward to offset future positive allowances in the same regulatory period. There should be combined floors on opex & capex incentive payments to prevent distortions between the two. Finally incentive payments should be smoothed over a regulatory period to even out price changes as incentives reach the end of the retention periods. This would provide increased price predictability for suppliers and generators.

Although there is a breakeven point beyond which the customer ceases to benefit as the saving retained by the company outweighs the incremental saving induced, incentives are strengthened by increasing retention. The retention period allowed should be modelled on the length of time benefits would be retained in a competitive market, Innogy recognises that timescales may vary for different incentives.

We believe that the next 5 year price control is only the start of a process that will see distribution networks change significantly. There may, therefore, be a need for the treatment of each incentive, including the retention period, to be reviewed on an ongoing basis as the demand / generation mix of the DNO’s networks and the resultant impacts become crystallised.

Incentives and price control framework

Innogy support Ofgems view that strong efficiency incentives should be maintained via the RPI-X price control mechanism, with specific output incentives governing issues such as connection of distributed generation, quality of service (IIP) and losses.

We wait with interest the results of Ofgems proposed research concerning consumer requirements versus their willingness to pay. Based upon the views expressed at the recent workshop we anticipate that the results will be polarised into the views of I&C customers who will value a higher standard of service that reduces voltage fluctuations and interruptions and those held by domestic customers who will be more reluctant to pay for additional reinforcement, whilst requesting improved outage information.

Innogy do not believe that the two tiered service level proposed by some I&C groups would be beneficial. In addition to large-scale investment, it would create an additional administrative burden on the DNO's and result in the inefficient use of resources when outages occur. Consumers unlike DNO's have the opportunity to insure against the consequences of interruptions. This provides a more efficient solution allowing consumers to assess their own exposure and mitigate this accordingly.

We believe that the DNO's guaranteed standards should be limited to those constraints which are reasonably foreseeable and a force majeure clause should remain within their connection standards.

The IIP incentive mechanism, introduced in 2002, is seen as a firm basis for the efficient delivery of quality. The price control review provides an opportunity to extend the current quality variables based upon interruptions & telephone responses, to include additional output incentives. These should include the transparency of information concerning constraints within a region; improved information systems to provide updates when outages occur and the speed of response to request to connect.

Treatment of the RAB

If current meter asset provision (MAP) charges are used to disaggregate network and metering assets within the RAB, network assets become under-valued as MAP charges are artificially high compared to market levels. In addition the current compensation mechanism for stranded assets allows DNO's to recover lost MAP revenue from network charges; thereby removing the incentives for the DNO's to address the disparity between MAP charges and the market price of meters.

Innogy believes that the asset base should be segregated to reflect contemporary metering asset value. This will encourage DNOs to reduce their MAP charges to market levels, avoid significant transitional removal and installation costs, assets will not be stranded (although their value will be reduced) and market decisions will be free of artificial incentives; leaving Metering businesses (MAMs, DCs & DPs) free to concentrate on those areas where competition will generate immediate and sustainable savings.

I trust you find these comments useful. Should you wish to discuss any of the issues raised in greater detail please contact me.

Yours sincerely

Zoë Keeton
Economic Regulation