Developing Network Monopoly Price Controls

Response to Ofgem Open Letter of 13 March 2003

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EXECUTIVE SUMMARY

Ofgem has set a challenging timetable for the price review. The timetable provides little scope for slippage and it is therefore vitally important that all parties work together to ensure delivery and enable the production of robust final proposals within the available timescales.

Ofgem's consideration of uncertainty and incentives is welcome and we remain supportive of the approach adopted to date through the working groups. However the Frontier Economics reports are theoretical in nature and leave open questions regarding the practical application of the developed principles by Ofgem. They do not resolve the issue of regulatory uncertainty for companies in important areas such as output regulation and distributed generation and offer little economic analysis on options to balance incentives.

On the specific issues raised in the open letter this response concludes that:

- The decision making framework is unclear as to the mechanisms Ofgem could adopt to address uncertainty.
- A form of cost pass through mechanism (capex in the RAV and appropriate opex allowances) is the most appropriate mechanism for dealing with distributed generation in the short to medium term.
- An incentive scheme for efficiency should be balanced for capex and opex out-performance and affect the company's enterprise value in exactly the same manner.
- The focus for the forthcoming price review must be on refining the operation of IIP, as applied to the existing output measures, rather than extending the range of output measures.
- Further work is required to investigate the drivers of total cost, assess the appropriate definition of total cost and the validity of its results.

Much remains to be addressed in order that a satisfactory conclusion to the development stage of the Review can be presented in the May-03 Principles paper. Nevertheless our response to the February Consultation Update Document and this response outlines our support for Ofgem's proposals on incentives for efficiency.

We have developed our thinking on a mechanism that ensures that the company's preferences between expenditure options is aligned with economic efficiency objectives and protection of customers' interests. We look forward to an opportunity to discuss these proposals further with Ofgem.

1. INTRODUCTION

1.1 This document is the response of SP Transmission & Distribution to the Ofgem open letter of 13 March entitled “Developing Network Monopoly Price Controls and the Next Price Control Review of the Electricity Distribution Network Operators (DNOs)”.

1.2 The following sections outline our response specifically to the timetable, work plan and the two reports by Frontier Economics.

2. DRAFT TIMETABLE AND WORKPLAN

2.1 This opportunity to comment on the draft timetable and work plan is welcome. Early sight of the timetable allows DNOs to plan their allocation of key resources over this demanding period, as it is clear from the proposals that the scope of activities within the Review is extensive. It is important therefore that these challenging target dates are achieved to ensure that all stages of the Review receive sufficient and appropriate attention.

2.2 The linkages between the Ofgem workstreams and how the outputs will be used are not clear. However the plan appears to indicate that the success of each stage is contingent on satisfactory completion of the previous stage across all the workstreams.

2.3 For example, much of the proposed content for Ofgem’s May-03 Principles Paper appears to be dependant on output from the Ofgem working groups and Ofgem’s consultants. However, assessment of the reports from Frontier Economics suggests that significant progress is still required to complete the first stage satisfactorily i.e. the development stage.

2.4 This response highlights areas where we have additional analysis to help progress the development stage to satisfactory conclusion and this compliments our response to the February Consultation Update Document.

3. REGULATORY MECHANISMS FOR DEALING WITH UNCERTAINTY

Decision-making framework

3.1 While the Frontier report on Dealing with Uncertainty sets out lots of criteria and steps in its decision-tree framework, it is unclear as to the outcome in terms of the mechanisms that Ofgem could adopt to address uncertainty. There is no guidance on how to deal with different levels of imperfect controllability, separability etc. There is also no real sense of the ranking that needs to be applied to these different criteria given that a number of them may point to opposing policy implications.

3.2 Frontier places excessive emphasis on asymmetry in the diversification argument which will result in a failure to include the impact of risks on debt premia. The argument set out in the report implicitly suggests that even expected losses which are recovered through increased profits elsewhere in the market are 'acceptable': this is not the case and indeed would not be consistent with efficient prices and investment levels for individual companies. In addition, there may be significant equity problems with an approach which causes individual firms to bear substantial uncontrollable shocks.

3.3 Furthermore, the diversification argument becomes less clear-cut when much of the equity is held by various parent organisations, including some in the public sector. Investors therefore cannot hold shares in all DNOs.

Severe Weather Exemptions

3.4 In this example, Frontier does not appear to come to any meaningful conclusions. It restates the debate regarding how much exposure DNOs should face for severe weather and the need for incentives to encourage better network resilience and the concern that DNOs continue to face substantial uncertainty. However, to move the debate forward, proposals on the right risk balance and actual mechanisms to deliver this are necessary.

3.5 Ofgem must clarify the interpretation and application of the relevant regulations through its forthcoming determinations. The confusion surrounding the variety of interpretations of the current exemptions to Guaranteed Standards and the subsequent high level of disputes are of significant concern.

3.6 In principle, it is possible to remove exemptions from Guaranteed Standards. However, it is not economic to design networks to eliminate the exposure to severe weather and consequential payments. Ofgem should accept a reasonable level of failure and allow companies to recover the costs of compensation. At the same time, companies should be encouraged to undertake the appropriate investment programmes which will reduce the exposure over time.

3.7 Removing restrictions is unlikely to avoid a large volume of disputes, as many also relate to the perceived duration of the interruption and the potential liability for consequential loss.

Distributed generation

3.8 The Frontier report discusses the different possible approaches to distributed generation, but does not undertake a clear-cut analysis of which approach to adopt under what circumstances, which serves to illustrate once more the degree of judgement required to obtain a sensible outcome from the decision-tree framework.

3.9 The report also suggests that DNO's have control over the volumes of distributed generation. Irrespective of whether it is in the DNO's interests or not, there is a licence obligation to offer terms, in a fixed time using a published methodology. We have no control over volumes and the use of a volume driver is therefore inappropriate.

3.10 One important factor DNOs can control, and on which they should be encouraged, is their ability to propose fast connection to their networks, and not hinder the growth of DG through network constraints. To that end, incentives should target proactive network reinforcement, R&D, and network availability.

3.11 In previous responses we have highlighted the need for an explicit commitment that investment to facilitate distributed generation is secured in the RAV and to an appropriate allowance for increasing operating costs resulting from increased complexity of network operation.

3.12 Considering the options proposed by Frontier, only the cost pass-through option is aligned with this requirement. While the idea of incentives for cost efficiency through benchmarking appears to be attractive it does not seem to be workable due to lack of available data in the short term.

3.13 Frontier does consider that over time more information will be revealed about cost drivers and therefore it would be possible to move towards yardstick competition. Such an approach would be made more difficult by the fact that if distributed generation technologies are unevenly spread across Great Britain, comparison for a given technology and hence benchmarking will be difficult.

4. BALANCING INCENTIVES

4.1 The focus for the forthcoming price review must be on refining the operation of IIP, as applied to the existing output measures, rather than extending the range of output measures. In particular, the price review must address the following problems associated with the current IIP incentive scheme.

Incentives for Efficiency

4.2 Our responses to the Ofgem consultation papers on 'Developing Network Monopoly Price Controls' have welcomed Ofgem's confirmation that it will allow companies to retain capital expenditure efficiency benefits for a fixed five-year period. It is correct that similar proposals are implemented for operational expenditure efficiencies, to reduce the periodicity resulting from the current price control.

4.3 Much of the discussion in the Frontier report, such as the sharing of efficiency savings and periodicity, does not appear to add anything new to the debate. There is limited modelling of specific (feasible) options for setting incentive allowances.

4.4 The report emphasises the benefits of "yardstick competition" without adequately demonstrating how such a regime could be implemented practically. It is doubtful that the necessary "robust modelling" can be developed and implemented and that the claimed stronger incentives can be achieved. In particular, the assumptions underpinning section 2.4.2 appear to be inconsistent with the information asymmetry assumed elsewhere in Frontier Economics' reports.

4.5 A scheme is required that ensures out or under-performance on capital or operating expenditure affects the company's enterprise value in exactly the same manner: i.e. the company's preferences between expenditure options are aligned with economic efficiency objectives and protection of customers' interests.

4.6 We are currently working on such a scheme that builds on Ofwat's approach to periodicity. In summary the enhanced scheme adds the following:

- A regulatory reserve which is used as a way of capturing efficiency out-performance that has been accrued but has yet to be passed on to customers
- A structural consistency of incentives by utilising the regulatory reserve mechanism to return capex efficiencies rather than through a rolling RAV

We look forward to an opportunity to discuss the detail of this scheme with Ofgem.

Total Cost Modelling

4.7 The report places a strong emphasis on top down modelling (including total cost modelling). Overall efficiency assessment must take a more balanced approach and complement the top-down approach with the results of alternative bottom up modelling, and process benchmarking. Data quality and availability issues will affect the robustness of total cost modelling for some time to come.

4.8 The report does not offer any solutions to the problem of defining appropriate sets of outputs and cost drivers to ensure that a total cost model is correctly specified and that the benchmarking methodology is statistically sound.

4.9 The report does however highlight the influence that inherited; inherent and incurred costs have as drivers of total cost efficiency. The suggestion that depreciation associated with pre-vesting assets must be included will lead to comparability problems for the Scottish companies due to different treatment at Privatisation.

4.10 We look forward to working with Ofgem through the Financial Modelling workstream to investigate the drivers of total cost, assess the appropriate definition of total cost and the validity of its results in a balanced approach.