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Dear Adrienne,

DEVELOPING NETWORK MONOPOLY PRICE CONTROLS

Thank you for allowing us to comment on the recently published report “Developing Network Monopoly Price Controls”. EIC welcomes the opportunity to give you our opinions on both reports published by Frontier Economics and in particular its relevance to the next Distribution Price Control Review and the Distributed Generation project.

Set out below are EIC’s views on the main issues for consideration highlighted in Ofgem’s open letter.

Dealing with uncertainty

EIC welcomes the approach taken by Frontier Economics and believes the decision-making process is a useful, albeit simplified, tool in assessing the best regulatory response to sources of uncertainty. In the run up to the next Distribution Price Control Review, it is important to try to provide clarity and transparency in the decision-making process. EIC supports Ofgem’s attempts to do so.

Increased cost of capital versus Incentives based mechanism

We believe that the development of distributed generation should not lead to an increase in the cost of capital, despite the fact that Distribution Network Operators (DNOs) will face a degree of uncertainty, as the risks faced are no greater than those faced at the opening of the market in the mid-90’s.

EIC accepts that an incentive-based mechanism is, in all likelihood, the most appropriate way of encouraging Distributed Generation (DG). We also believe treating DG-related costs as part of the general price control is likely to be the best way of preventing gaming.

Strength of incentives

We recognise that Ofgem will face difficulty in deciding how strictly it should apply control of the costs for connection of DG. A tight cap on expenditure for connections would be sure to result in a halt in DG connections. Likewise, EIC is concerned by the ‘0.5p/KWh’ figure currently being suggested by DNOs as a reasonable incentive to encourage greater uptake of DG.

Whilst we appreciate that a high unit rate incentive may encourage DNOs to connect a greater number of DG in the first five years and would therefore provide Ofgem with the information to set a more reasonable incentive scheme in the 2010 Price Control, EIC believes this 'big bang' approach proposed by DNOs would put too great a financial burden on consumers. A balance must be struck between offering generous incentives to encourage DNOs to connect DG and controlling the costs too rigidly, so as to discourage most DG connections. EIC believes a sliding scale or stepped incentive mechanism per unit of DG connected may reward DNOs sufficiently for the uncertainty while ensuring they do not make an excessive return.

Incentives

Balanced benchmarking of operating and capital expenditure

EIC agrees that the current regulatory mechanisms provide an incentive to capitalise operating expenditure. A form of Total Cost regulation should be considered, as it should not be impossible for Ofgem to calculate a complex benchmark with detailed analysis. This will ensure an even-handed treatment of each of the components.

Periodicity

EIC agrees that the length of time that incentives are run for should be de-coupled from the length of the regulatory period. This should mean that the DNOs no longer have an incentive to make all their efficiency savings in the first few years of a price control. However, if this were to be done, Ofgem would need to set out criteria beforehand for reviewing and re-opening the incentives if necessary. We believe that stability, transparency and most importantly predictability in distribution pricing are vital and de-coupling the incentives from the regulatory period may help achieve this.

Cost versus Quality

We agree that stepped incentive schemes may encourage a more uniform level of quality across DNOs. It is important to set targets specific to a minimum level of quality as the Information and Incentives Project (IIP) has intended. However, EIC believe that a greater number of outputs could be monitored, specifically relating to industrial and commercial businesses. Combined with outputs already measured, these may provide Ofgem with a better method of highlighting DNO inefficiency. These measures of quality might include, separation of the number of business and domestic customer minutes lost, voltage irregularities, or other technical faults that business customers frequently raise concerns over.

EIC is relatively indifferent towards the use of relative or absolute incentive schemes. As long as the right outputs are measured and incentives are set at the right level, we believe that comparisons with *ex ante* targets or other DNOs are not so relevant. It is important to ensure that companies achieve an efficient level of costs, but also any sign of efficiency or drop in quality is highlighted quickly.

We trust that you find these comments helpful. Meanwhile, if we can be of further assistance, please contact either myself or my colleagues in the Market Analysis team on (01638) 554935.

Yours sincerely,

Matthew Williamson
Utilities Market Analyst