Electricity Distribution Price Control Review – Second consultation – December 2003

A Response by British Gas Trading

Authors	:	Tahir Majid / Roddy Monroe
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GENERAL COMMENTS

British Gas Trading (British Gas) welcomes the opportunity to respond to Ofgem's consultation in respect of the 'Electricity Distribution Price Control Review – Second consultation' and is happy for this non-confidential response to be placed in the Ofgem library.

Wherever possible this response uses the heading and section numbering used in Ofgem's document.

DETAILED COMMENTS

3. Form, Structure and Scope of the price controls

Form and structure of the price control

Revenue drivers

3.4

We understand that under the existing price controls the revenue driver is 50% weighted to the number of units distributed with the remaining 50% fixed as it is related to a predetermined projection of the number of consumers.

3.9

We have concerns that as the current weighting of the units driver gives enhanced incentives for the theft element of losses, this position may be unsustainable if the losses incentive is increased. If the losses incentive is enhanced, to avoid distortions between different elements of the losses incentive and to potentially avoid the incentive received by DNOs (hence cost increase to customers) being greater than the value of loss reduction to customers (value of energy lost), ideally the units driver should be reduced to zero and replaced by some other revenue driver. See paragraph 3.83 for our further thoughts on the losses incentive.

We also believe that Ofgem should review whether pre-determined customer numbers is appropriate going forward and consider whether actual customer numbers might prove to be a more appropriate measure.

Finally, we are unaware how, if at all, revenue drivers (growth) impact upon capex allowances. This area would benefit from the publication by Ofgem of further details in the next update document.

The scope of the price controls

NGC exit charges

3.11

We welcome Ofgem's consideration of DNO incentives in this area. As a general rule, DNOs should be incentivised for all costs that they have some control over. The benefits of incentive regulation over cost pass-through in instances where companies have some control over costs are well recognised. The location and size of NGC connection assets, and the timing of the introduction of new or replacement assets is clearly partly within the

control of DNOs. Consequently, it is appropriate to replace the existing pass-through of costs with some form of incentive.

Because many assets are already in place it may be appropriate to introduce incentives on the costs relating to new and replacement assets only, this is analogous to capex incentives on new expenditure. It is our understanding that over the next few years NGC expects to replace a higher than normal number of its connection assets, making the introduction of DNO incentives in this area timely. The incentives could either be of the standard RPI-X form or if there is considerable uncertainty as to costs and volumes then some hybrid-type incentive could be considered similar to that being proposed for distributed generation.

The treatment of costs in this area will need to appropriately interact with incentives with regards to distributed generation to the extent that additional volumes of distributed generation negate the need for additional connection capacity from NGC's system.

EHV charges

3.22

As for NGC exit charges, DNOs have some control over EHV charges. Consequently, DNOs should be incentivised in this area. The existing inclusion of these costs within excluded services provides weak incentives to efficiency. DNOs are incentivised to maximise revenues rather than deliver efficient costs.

3.26

DNO arguments are far from convincing. There is cost and volume information on EHV connections over a long period of time. If it is possible to introduce incentives for distributed generation, where there is very little historical information and the future costs and volumes are so uncertain, it should be relatively easy to introduce incentives for EHV, or for that matter other areas of excluded services. Similarly, there appears little to support the argument about inclusion within the price control and weakening locational signals, especially as these arguments are not valid for distributed generation where similar arrangements are likely to apply.

3.31

Ofgem has observed that EHV charges have fallen broadly in line with price control assumptions. However, we note that in general terms DNOs have significantly out-performed other price control assumptions.

Non-contestable connection charges

3.41

For similar reasons to those expressed earlier in relation to NGC exit and EHV charges, we support the need to include connection charges within the main price control. In particular, we support the need for <u>all</u> of Ofgem's options: -

- Where feasible, open up more areas of the market to competition, ensuring that the market operates effectively;

- Provide some form of price control protection for non-contestable charges either by including them in the overall price control or through a separate price/revenue cap, including any appropriate standards of performance; and
- Introduce guidelines on charging for non-contestable services.

However, it is essential that these protections should be extended to all connection costs and not just to those areas that are non-contestable. Even in those areas of the connections market that have been opened to competition, the host DNO undertakes most connections. Consequently host DNOs are dominant in the contestable market as well as being de-facto monopolies in the non-contestable market. Only when competition has been established should these protections be removed.

This position is commensurate with Ofgem's and our own views in other areas/markets, for example: -

- The current position emerging with respect to electricity meter asset ownership and maintenance; and
- Precedent in relation to electricity and gas supply, where price control protection was only removed once competition was determined as having been established.

Views of respondents

3.44

- "Formalisation of any such arrangements within either the Electricity Act or the licence": -
  - Consideration should be given to the need for amending the provisions of the Electricity Act that enable a DNO to recover their reasonable connection costs (as incentive regulation, rather than the current effective pass-through arrangements, may be inconsistent with these provisions) and to include operation and maintenance costs within connection charges (as Ofgem has already signalled its intention to stop this practice).
- "The difficulty of establishing efficient costs for each DNO's non-contestable activities due to differing degrees of competition within each DNO's area": -
  - This does not appear to be a valid concern. The level of competition is currently very low. Moreover, the varying degree of competition was not a barrier to introducing effective supply price controls.

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- "The possibility of DNOs being left with stranded overhead costs": -
  - The introduction of competition in the area of connections has been a long and slow process, it is unlikely that DNOs will lose significant market share over the course of the next price control. Moreover, new entrants to the connections market do not have any form of protection for their overhead costs. Moreover, no form of cost stranding protection was provided in the supply markets.

Business rates

3.51

We have previously stated that we believe that, as DNOs can to a certain extent forecast and influence the level of business rates; there should be some limited incentive on DNOs to ensure that those costs are at an appropriately efficient level. The level of DNO incentive (risk) should be proportionate to the amount of DNO predictability and influence. The key to any future incentives in this area will be the new basis of calculating rates.

Hydro-benefit

3.54

We expect to write to Ofgem separately on this area as we are still formulating our views.

Dealing with uncertainty, new obligations and costs

3.57

We believe that a more formalized approach for dealing with cost uncertainty should be introduced. Whilst we acknowledge that Ofgem is not convinced that the water model is transferable because of different statutory duties and the magnitude of uncertainties, we are not convinced that the current proposal to offer some 'comfort' in relation to specific areas, i.e. lane rental, will be sufficient. As a minimum, there should be an agreed framework for how and when to log up or log down, reopen/amend controls during the control period and what elements will be revisited. The need for this framework has been recently illustrated by Ofgem's October 2003 consultation on "Transmission investment and renewable generation" where Ofgem anticipates reopening the price controls of all three electricity transmission operators. We remain unconvinced by the need to reopen all of these controls and are further concerned that Ofgem's initial proposals are biased towards companies.

We agree with Ofgem that it is preferable for ex-ante assessment of uncertainty but fail to see how this squares with their current approach to pensions.

Incentive Framework

3.62

Whilst we generally agree with Ofgem's proposals to introduce a fixed retention period for both opex and capex efficiency savings for this price control period, we have a number of concerns.

Firstly, with regards to the capex (and possibly opex) incentive framework, as we stated in our previous response, we believe that for a given level of incentive there is merit in Ofgem considering extending the period over which the incentive is passed back to the DNO from say the current 5 years to 10 years whilst keeping the NPV of the incentive constant. This, coupled with the eligibility test, would provide an increased incentive for DNOs to pursue real efficiency savings and not seek illusionary savings achieved through under investment. Also see our comments on Network Resilience, paragraph 4.23.

We would welcome further Ofgem clarification on the operation of the five-year rolling capex incentive mechanism in two areas: -

- Is the commitment made at the last price control consistent with allowing companies an incentive equivalent to 5 years of return plus 5 years of depreciation or the lower amount of incentive that would have been paid to DNOs for year one of the previous (DPC2) price control? Though we support the higher of the two on a prospective basis for DPC4 onwards consistent with our views on increased capex incentives, if the commitment previously given by Ofgem is commensurate with the lower of the two incentives then implementing the higher one would give DNOs unwarranted windfalls at the expense of customers. Our interpretation of Ofgem's commitment would support the lesser of the two incentive values for DPC3.
- Is the value of the incentive the same for all DNOs in NPV terms for each pound of capex efficiency or is it higher for DNOs with accelerated depreciation? DNOs have different depreciation periods for new expenditure as some DNOs received accelerated depreciation at the last price control. If the incentive were linked to the DNO specific levels of depreciation and return over 5 years then DNOs with accelerated depreciation would receive much higher incentive payments than other DNOs. Though we would support the higher incentives on a prospective basis for DPC4 onwards if all DNOs receive accelerated depreciation, our understanding of the Ofgem commitment for DPC3 would support an incentive that was the same in NPV terms for each DNO for each pound of efficiency equivalent to the return and depreciation calculated over the relevant periods equivalent to a non-accelerated depreciation basis. To do otherwise would be to give some DNOs unwarranted windfalls at the expense of customers.

3.74

The reward for an operational saving is considerably greater than that for a similar capital expenditure saving and this bias provides perverse incentives. We believe that this bias is mitigated only in part by total cost benchmarking which in any event appears unlikely to be in place for this price control review. Extending the period over which incentives would be paid to DNOs could mitigate any risks of under investment. See also our comments in paragraphs 3.62 and 4.23.

3.75

We welcome Ofgem's intention to introduce a test for eligibility to the rolling 5-yr opex incentives from the start of the next price control. However, we are disappointed that this worthwhile change is not to be introduced sooner. For example, DNO incentives would be unaffected by making this change on a prospective basis, i.e. for marginal opex efficiency improvements for 2004/5 onwards. We would ask Ofgem to consider this further.

We also welcome Ofgem's recognition that this change may allow incentives to be strengthened further.

3.76

It is important to provide appropriate incentives to frontier companies. Consequently, it is worth keeping open the option of using a multiplier for better performing companies.

3.83

Table 3.1: Current incentive framework and potential improvements

Distribution losses

In December 2003 we sent Ofgem a paper entitled "Losses incentives straw man – A worked example by British Gas Trading" providing further information on our thoughts on a revised losses incentive, described as "the proposal to implement the incentive through the capital expenditure allowance" in Ofgem's October 2003 update document.

The main points of this paper were: -

Incentive methodology

- Common calculation methodology
- Remove DG adjustment, risk mitigated by: -
  - Variable marginal loss charging methodology at demand/entry
  - In general terms increased DG will lead to windfall reductions in losses
- Ofgem to review revenue protection ASAP
- Ofgem to review changes to settlements accuracy etc
- Reduce units driver (ideally to zero) increase customer numbers driver or introduce another cost driver to compensate so that technical and non-technical losses incentives are equalised
- Value of permanent loss reduction = energy cost plus environmental externalities (say 50p/kwh)
- Efficient cost of loss reduction derived from DNO forecasts of various scenarios
- Total customer cost increase must be ≤ value of losses
- Hence if DNO forecast is less than value of losses (say 40p/kwh) then maximum cost increase should be set at level of forecast
- Otherwise if DNO forecast is greater than value of losses (say 60p/kwh) then maximum cost increase should be set at value of losses level (say 50p/kwh)

Incentive – for technical or non-technical losses: -

- Loss reduction (or increase) leads to auto increase (or decrease) in 'demand' capex allowances (say NPV 40p/kWh – maximum cost increase) i.e. increase in return and depreciation for normal depreciation period (say 33years) – a losses revenue driver
- Normal capex efficiency incentives apply – i.e. actual spend plus 50p per 100p of under spend
  - Say actual cost of losses reduction is 30p/kwh then
  - DNO revenues = Actual cost + ((Losses revenue driver-Actual cost)*capex incentive)
  - DNO revenues = 30p + ((40p-30)* ≈0.5) = 35p/kwh over 33yrs with the efficiency incentive of 5p received in the first 5 years
  - Separability not an issue here

- Cap and collar on incentive? (Say current level of losses +/- 1% change)
- However, receipt of 5-year (rolling) capex incentives dependent on achieving efficient level of losses – efficiency judged by benchmarking cost/outputs across DNOs – separability of costs likely to be an issue here (though same under current scheme)
- At next price control set losses auto increase/decrease in capex allowances at revealed efficient level (say 30p/kwh) separability of revealed costs an issue here (though same under current scheme)

Pros

- Environmental externalities internalised
- Maximum customer cost increase set by reference to lower of value of losses or forecast cost of loss reduction, hence customers will not have increase in bills after taking account of reduced energy purchase costs and might see decrease
- As normal capex efficiency incentives apply, likely to lead to further reduced customer bills after taking account of reduced energy costs
- No opportunity cost of undertaking losses reduction
- Same technical and non-technical loss incentives though flexibility to differ by DNO
- Same non-technical incentives between DNOs
- Same incentive whether capex allowance under spend or not
- Removal of arbitrary distributed generation adjustment
- Common DNO loss calculating methodologies
- Will have strong effect on behaviour via increased DNO incentives
- Will minimise DNOs' effects on environment
- Simple

Cons

- Difficult to take account of revealed level of efficient costs at successive reviews to effect value of incentive because little/no separability of costs (though this is an issue with the existing incentive and Ofgem's proposals)
- Some increased DNO risk (balanced by increased DNO reward)

We await confirmation of Ofgem's proposals for a revised losses incentive.

Price controls for metering services

3.84

We agree with Ofgem that to facilitate metering competition in electricity, and limiting the scope for cross subsidy, separate price controls for meter asset provision and maintenance services are a necessary step.

We believe that the most appropriate method to value metering assets is the market price. While we realise there may be some disparity between this price and the incumbent RAVs, we do not believe this will have a significant impact.

We support Ofgem's proposal to value DNO meter assets on a depreciated replacement cost basis. We have previously stated that, once the market for metering services becomes fully competitive, prices will naturally converge to reflect the current replacement cost of the meter asset. We therefore accept that Ofgem's proposal will provide a level playing field for both new entrants and incumbents and remove the perverse incentive to replace meters prematurely.

We also agree that the difference between historic and replacement value should be recovered in network charges as, in total, this provides DNOs with the agreed remuneration on historical investments and also limits the exposure to the stranding of meter assets. The stranding of assets is a normal consequence of competition and we do not support the principle that the incumbents should be unfairly shielded from such competitive pressures in the metering market and we believe that this provision should be sufficient to provide the appropriate level of DNO protection.

We believe that the disparity between the RAV (based on historical cost and adjusted to take into account regulatory depreciation) and the market value will be marginal.

With regard to scope we agree with Ofgem's proposal that all meters excluding half hourly meters should be included in the competitive market.

The barriers to entry for meter asset provision (MAP), where incumbents hold a dominant position and have equipment already in place, will be considerably greater than those for meter operation (MOp). We therefore suggest that Ofgem will need to consider the level of separation required to ensure that there is no opportunity for the cross subsidy of the more competitive MOp element from the less competitive MAP element.

4. Quality of service and other outputs

Guaranteed and Overall Standards of Performance

Ofgem's further thoughts

4.6

Severe weather events

We would be concerned if the recently introduced interim arrangements were kept in place beyond the existing price control period. Our response, dated 30 December 2003, to the Ofgem consultation contains our detailed views. A summary of that response is: -

- The proposals are a welcome improvement on the current arrangements in so far as they will facilitate much prompter customer compensation in the event of relatively severe weather disruption and it is likely that compensation will be paid to a greater proportion of affected customers. However in many other respects it is not clear that the proposals are in the best interests of customers.
- British Gas is particularly disappointed that the interim arrangements have been arrived at without any proper consultation even though they have the effect of amending the price controls of all fourteen DNOs, could result in a redistribution (cross subsidy) from mainly urban to rural customers and could increase total customer costs.
- The interim arrangements sit along side but do not replace the existing Guaranteed Standards (GSs). The simultaneous operation of the GS and the interim arrangements is likely to cause customer confusion.
- As a minimum, we would expect DNOs to continue to inform suppliers of specific instances of customer compensation (as they do for GSs) and notify suppliers as to whether the outage was expected to fall under the GSs or the interim arrangements so that we are able to manage customer enquiries. We would welcome further information from Ofgem on the reporting of DNO performance.
- The existing incentives on DNOs with respect to network resilience may be compromised because of the significant proportion of DNO cost pass through combined with potential DNO perverse incentives to channel customers through the interim rather than GS compensation route. In the absence of any detailed Ofgem rationale for the introduction of the specified interim arrangements, rather than other arrangements, it is unclear that customers' best interests are being served.
- An important aspect of utility regulation recognised by Ofgem is that any material increase in customer costs as a consequence of increases in standards of performance should be supported by customers' willingness to pay. However, Ofgem's customer study on willingness to pay is not due to report its findings until May 2004.

Our concerns, in particular those relating to the practical application and operation of the interim arrangements remain outstanding.

We agree with Ofgem that there "is a need to put more robust longer-term arrangements in place as part of the price control review".

Business customers

We agree that consideration should be given to better reflecting the needs of larger business customers, via for example higher compensation for GS failure. However, it will be important to ensure that there are appropriate safeguards in place to ensure that the existing performance for domestic and smaller business customers (the vast majority of customers by number) does not deteriorate as a consequence of refocused incentives.

Automatic payments

We agree that wherever possible and cost effective, payments should be automatic. Payment-on-application mechanisms for price controlled monopoly network companies inappropriately favour companies (as they impose a barrier to compensation), reduce overall compensation levels and distort (i.e. reduce) company incentives. This problem is exacerbated by the repeated need for customers to seek Ofgem determination of compensation following storms, i.e. the numbers of customers receiving compensation in these circumstances (generally the vast majority of compensation payments during a price control period) is further reduced.

Priority customers

The definition of priority customers will require careful consideration to ensure that all relevant vulnerable groups are captured.

Scope of exemptions

We agree that the scope of the exemptions is too broad. The exemptions are open to company interpretation hence application, requiring repeated Ofgem interpretation and determination whenever there is a severe weather event. Customers often need to apply for compensation, where companies inappropriately claiming exemption refuse this; the customer has to make a further request for Ofgem determination. As noted earlier, this further reduces the number of eligible customers receiving compensation.

The scope of the existing exemptions differs between the standards and with and within IIP. These differences appear unjustified and cause further customer confusion.

Role of the overall standards of performance

Overlap

Where there is overlap between the Overall Standards (OSs) and the Information and Incentives Project (IIP) incentives, then this overlap should be reduced/eliminated and because of the superior incentive properties of IIP, it appears sensible to reduce/eliminate the relevant OSs and retain the relevant IIP incentives.

Replace all with IIP

However, we do not agree that OSs add little value. In addition to the incentives relating to publication of the company performance against the standard, it is always possible for Ofgem to take account of performance against the standard when determining the relevant efficiency of licensees at the time of a price control review. Furthermore, it is possible for Ofgem to use its Electricity Act enforcement and fining powers to secure compliance with the standard and/or deter future failure. However, as noted earlier, because of the superior incentive properties of IIP, consideration should be given to replacing all of the existing OSs with equivalent IIP incentives.

4.7

There is merit in considering differing arrangements for normal, severe and exceptional circumstances. However, defining these in a clear and simple way that removes the need for Ofgem determination whilst being consistent with customers' willingness to pay may be challenging.

Standard covering "normal weather" conditions

Subject to our earlier comments, it would be appropriate to retain the existing payment and qualifying times for "normal" circumstances.

Standard covering "severe weather" conditions

Subject to our earlier comments, consideration should be given to later qualifying times and/or different compensation levels. However, this should be considered only if: -

- A greater number of eligible customers could expect to receive compensation;
- Customers could be expected to receive that compensation quicker than they would have done during the pre-interim arrangements regime; and
- DNO incentives were not reduced compared to the pre-interim arrangements regime. For example, DNOs (not customers generally) should fully fund the costs of DNO failure.

'Semi-automatic' payments

As noted earlier, having non-automatic payments distorts/reduces DNO incentives. Consideration should be given to the costs and benefits of making more of these payments automatic as well as the Ofgem suggestion of 'semi-automatic' payments. If this is not practicable, it might be possible to mitigate some of the effects of the reduced/distorted DNO incentives. For example, the compensation levels for individual customers could be increased so that the total levels of compensation paid would be equivalent to the amounts that would have been paid under an automatic payment regime. Alternatively, an additional IIP incentive might be introduced that would have the like financial effects (hence incentives) on DNOs of automatic payments. Both of these changes would be somewhat dependent on being able to estimate the likely numbers of affected customers.

Larger business consumers

Linking the size of the payments to Distribution Use of System charges

There is merit in introducing this change, subject to the retention of the existing minimum compensation levels for domestic and business customers respectively.

Specific or revised standards of service

Any improvements in service that are not also reflected in equivalent changes for other customers should only be introduced if: -

- The changes are reflected in customers' willingness to pay;
- The additional costs of meeting the improved standards is targeted to those larger customers receiving the improvements; and

- This does not in any way reduce the incentives/performance for other customers.

An alternative might be for larger customers to contract directly with the DNO for enhanced/revised connection/restoration.

Reducing the scope of the exemptions

Industrial action

We agree that the exemption for industrial action should be removed because it is largely within the control of DNOs.

Force Majeure equivalence

We agree that it might be useful to limit the exemptions to cover standard Force Majeure type provisions. However, fully excluding the effect of severe weather in all circumstances needs further consideration. For example, if this could have the effect of materially increasing costs to customers then it should only be implemented if supported by customers' willingness to pay.

Voltage complaints

We support further consideration of tightening the timescales for investigating voltage complaints.

Removal of Overall standards and replacement with data collection and monitoring under IIP

As noted earlier, we support the incorporation of the existing OSs within the IIP with associated incentives. There would also be merit in considering increasing the range of information reported under IIP that does not have accompanying incentives, as suggested by Ofgem. However, we do not support moving all the existing OSs to reporting and monitoring only under IIP. Also see our earlier comments under "Role of the overall standards of performance"

Scope of the guaranteed standards

It is right to review the appropriateness of the existing GSs, and to consider whether: -

- They cover the right areas?
- The standards (for example timings) are appropriate? And
- The compensation amounts are still at the right levels?

However, the level of compensation payments neither equates to DNOs' real performance in the area nor indicates the need to remove the standard.

DNOs are potentially perversely incentivised to reduce the declared GS failures by agreeing ex-gratia payments with customers, perhaps even at higher levels than the GS compensation levels. This perversity is likely to have been increased by the 'within-range' adjustments applied at the last price control. One way to reduce this perversity, would be to broaden the definition of declared GS failures to incorporate those instances where, were it not for the ex-gratia payment, the customer would have qualified for the GS payment. The need to apply for many GSs also reduces the number of payments. This is

particularly the case for multiple interruptions where it is surprising that any customer would be able to pass all of the relevant eligibility tests.

Notwithstanding the previous comments, a low level of payments may either indicate that DNOs are operating at efficient levels or that consideration should be given to tightening the standards. For the former, the standard should only be removed if it is unimportant to customers otherwise DNO performance may deteriorate to unacceptable levels over time. For the latter, consideration should be given to tightening the standards either where it is supported by customer willingness to pay or DNOs could be expected to meet the improved standard at little or no cost.

New or revised standards for priority customers

It will be important to consider the additional costs of any changes in this area.

4.8

We welcome Ofgem's review of the current protection of priority customers. A priority help line for customers on the Priority Service Register, may be subject to abuse by other customers and in that instance would offer limited benefit. However, if the line is considered a useful option, it might be appropriate to trial the introduction of it prior to its formal introduction.

Reviewing IIP

Also see our various comments on IIP in the previous section "Guaranteed and Overall Standards of Performance".

Ofgem's further thoughts

Scope of the output measures and financial incentives

4.15

Distinguishing between different types of customers

There is merit in giving further consideration to the customer sub-group reporting suggested by Ofgem, this could over time ensure that particular customer groups are not disadvantaged. This would effectively ensure that there were not worst served customer sub-groups. Expanding the list to include urban versus rural customers may also be helpful.

Protecting worst-served consumers

We would support further work in this area.

Disaggregated performance

As we noted in our response to the Ofgem October 2003 update document, it was difficult to comment on Ofgem's proposals for target setting etc in the absence of the underlying information and reasoning. We hope that the expected Ofgem document in this area provides sufficient information to allow non-DNOs to comment constructively.

4.17

Move to a scheme with rewards and penalties in each year

Though IIP should be linked to customers' willingness to pay, it is important that the scheme is symmetrical in its application as this is likely to deliver the optimum company response, hence maximize customer welfare. The absence of clear willingness to pay information should not, on its own, be a reason to fail to implement a symmetrical scheme.

Smoothing out the financial effects of annual variability in performance

Use of dead-bands

Dead-bands reduce incentives and/or distort incentives within and on the margins of the dead-band. Consequently, they should only be introduced if: -

- There are no alternative mechanisms to deal with any inappropriate effects arising from annual variability in performance; and
- The need to deal with these inappropriate effects is essential.

Rolling-average performance

The use of this mechanism would require data that was: -

- At least equal in duration to the typical cycle of variability. A severe storm that can have significant effects on performance might be expected to occur every 10 or more years. Using performance less than the variability cycle could mean that those companies that experienced significant outages as a consequence of the October 2002 storms would have an inappropriately high average performance (i.e. poor performance). Conversely, companies with overhead networks that were largely unaffected by the storm would have an inappropriately low average performance (i.e. good performance).
- Comparable. The recorded performance changed quite significantly for many companies as a consequence of the introduction of new IIP definitions and the connectivity models. It is not clear that pre-IIP data is comparable with post IIP data. Hence, comparable data is only likely to be available for a small number of years.

It does not appear appropriate to use this mechanism before DPCR5 at the earliest.

IIP exceptional events

To a certain extent the current IIP scheme addresses annual variability in performance via the adjustment of reported performance to remove/reduce the effect of exceptional events. This adjustment may have some inappropriate consequences. Take the case where the majority of variability in performance is as a consequence of weather, and this effects predominantly over ground networks to a greater extent than predominantly underground networks. In this scenario, if the effects of exceptional events are totally removed from the reported performance, on average, reported over ground network performance will be lower (better) than the real long-term average performance. If the original target setting included this normal variability in performance, then the adjustments could result in the over ground company performing better under the incentive scheme than it should in absolute terms and also better than it should compared to under ground networks. Furthermore, fully removing these events from the incentive arrangements significantly

reduces the incentives on the DNO to better manage the effects of or prevent susceptibility to those circumstances.

If this type of mechanism is to persist for the next price control, one way to reduce the distortionary effects would be to base the targets on performance that includes the variability on performance (perhaps based on some longer term average), remove the effects of the exceptional event when it takes place but then add back a proportion of the long term variability. This better normalizes performance by effectively spreading the variability over a long period of time. However, this might still weaken incentives to better manage the effect of the exceptional event.

Is annual variability a real problem?

Annual variability is somewhat a problem under the existing IIP scheme because the key financial impact of the scheme is in the final year of DPC3. To a certain extent this problem arose because IIP was not fully developed until well into the existing price control period. At the time of the last price control only the quality targets for the end of DPC3 and the overall financial impact had been developed. This allowed DNOs to argue that the quality targets implied a requirement for the end of DPC3 without any particular implied performance during the price control period. Consequently, the IIP scheme has in effect a spot target for 2004/5, with some additional incentives in intervening years to limit deterioration in performance and to maximize out-performance, though the latter is again judged at the end of DPC3. However, the effects of annual variability were mitigated to a large extent by four complimentary measures: -

- The original DNO targets were set by reference to historical performance excluding the effect of severe weather;
- The effects of severe weather and other exceptional events are excluded from IIP performance;
- Financial penalties (as well as rewards) are capped; and
- DNOs are only marginally rather than fully incentivised, i.e. DNOs receive £2.30 per customer per year via increased capex allowances irrespective of whether or not they meet quality targets, DNOs are further marginally incentivised to meet and outperform the quality targets via the IIP scheme.

These problems might be avoided if there are in effect annual targets and fully symmetrical annual incentives, i.e. have the same incentive and financial effect in each year. The advantage of this approach is that there is no weakening of incentives on DNOs to manage the effects of the exceptional type events. Moreover it would be our preference for DNOs to be fully rather than marginally incentivised to meet outputs. This is equivalent to our proposals for an alternative losses incentive scheme. See our views elsewhere in this response on fully incentivising DNOs for losses where we suggest, in effect, a losses revenue driver.

If the typical annual variability cycle, as noted earlier in our response in relation to “Rolling-average performance”, is longer than the price control period then DNOs might, in relative terms, outperform in one price control period and under perform in another period. However, the DNO should be neutral to the effect of the annual variability over the annual variability cycle. Moreover, over time one would expect that the networks would become more resilient to the effects of these events. Consequently, DNOs would be less

susceptible to differences between price control periods. There is evidence for the lessening of impact in the performance of DNOs in response to the October 2002 storms. That is, though some DNOs performed poorly when compared to the performance of other DNOs, in general the resilience of the networks in response to the storms and the subsequent reconnection of customers once their supplies had failed was better than following previous equivalent storms. Even the arguably worst performing DNO, EPN Networks, argued that its performance was better than its historical performance.

If this issue remains of concern then we would reluctantly support a marginal incentive scheme along the lines of the existing capex allowance plus IIP scheme but believe that this on its own (even without considering the effects of other possible add-ons like dead-bands, rolling average performance or exemptions/exceptions) seriously reduces DNO incentives.

Reviewing the weighting of incentives within the scheme

We agree that it will be appropriate to review the weightings of each of the components of the scheme once customer willingness to pay information is available.

Targets, incentive rates and financial exposure to the incentive scheme

4.20

Subject to customers' willingness to pay, we would support an overall increase in the risk/reward potential attached to IIP incentives.

Planned interruptions in final year of the current scheme

4.21

Changes should only be made to the current scheme if absolutely necessary because otherwise it could reduce the incentive properties of having a scheme fixed for a finite period of time, as would be the case if other aspects of a price control were amended part way through a control period.

If there are potentially perverse incentives for DNOs to inappropriately delay planned maintenance to benefit from the revenue available in the final year of the scheme for improved performance and/or any frontier performance rewards, then one way to mitigate these effects is for Ofgem to: -

- Remind DNOs of their statutory and licence obligations regarding efficiency etc:
- Pay close attention to the level of planned interruptions in the relevant years compared with other years;
- Signal at this stage that if future performance deteriorates (as inevitably it would if DNOs undertake inappropriately low amounts of planned maintenance) that this would be taken into account in assessing eligibility to future opex and capex rolling 5-year incentives payments and frontier rewards. The financial exposure of these mechanisms (hence incentive properties) is greater than the potential rewards (and hence perverse incentives) available under IIP.

We are opposed to the complete removal of planned interruptions from the final year of the IIP scheme, or for that matter from future incentive schemes. Planned interruptions (both timing and duration) are to a large extent within the control of DNOs and will over time

affect the level of future (unplanned) outages. However, we recognize that customers are more concerned about unplanned than planned outages.

We have previously suggested that DNOs should be exposed to a proportion of planned outages (effectively a reduced financial exposure compared to unplanned outages), subject to confirmation from customers' willingness to pay research, as part of a future scheme. Consequently, though we are opposed to an amendment to the existing scheme, if it is felt absolutely necessary to do so then exposing DNOs to a proportion of planned outages should be considered for the final year. However, in this instance it would also be essential to amend the final year targets to avoid making the targets easier to achieve or to carrying forward the amount of reduction into the next scheme. If this change is made it should be applied to all DNOs rather than allowing DNOs to choose either the status quo or amendment.

Allowing DNOs to choose increases the likelihood of the DNO selecting the option that allows it to outperform Ofgem's assumptions (maximizes its returns); this exacerbates information asymmetry problems and does not appear to be in customers' best interests. An example of this was where some DNOs elected not to have their IIP adjustments verified (amended) once better data/information was available. If benchmarking techniques are going to be satisfactorily used to set DNO targets then DNOs need to be operating under a common incentive as well as data framework.

Network resilience

4.26

We have commented on this issue in a number of previous responses. However, our views have to date largely unaffected the development of Ofgem's thinking and have not been reflected in any of the summaries of responses/views prepared by Ofgem. Our previous views in this area are repeated below.

For network resilience the important interactions are between the: -

- Cost efficiency incentives;
- IIP output incentives;
- Guaranteed and overall standards (in particular likely DNO financial exposure where compensation is on application rather than automatic);
- Asset risk management surveys; and
- Compliance with efficiency obligations versus likelihood of effective enforcement.

The key element of these interactions is the proposed eligibility of the rolling five-year (as opposed to the previous variable five to one year) capex efficiency incentives, i.e. DNOs should meet their quality and security obligations. This important interaction should help to ensure that DNOs do not inappropriately reduce capital expenditure at the expense of quality of supply and hence network resilience. However, there are two weaknesses in relying mainly on this approach.

First, operating expenditure as well as capital expenditure affects network resilience, for example, the extent of (or absence of) tree thinning and removal. Consequently, eligibility

to the recently introduced rolling five-year opex efficiency incentives should also be subject to the same test as that for capital expenditure.

Second, network resilience cannot always be measured over a five-year period. Network resilience can be thought of as quality of supply (an instantaneous measurement) with a time lag, i.e. quality of supply not just now but extending some time into the future. Various factors 'reveal' network resilience. The most important of these to date has been the exposure of the network to a major storm. The time between major storms is on average greater than the five-year period of a price control and the five-year capital efficiency incentive eligibility test.

As noted in our response to the Ofgem July 2003 consultation document, one way to address this particular difficulty is to pay the existing five year efficiency incentive to DNOs over a longer period of time, say ten years, whilst keeping the incentive the same as currently in NPV terms. This prolonged period of payment should not only increase the likelihood of revealing poor network resilience (allowing the opportunity to withhold eligibility to some/all of the 5-yr rolling opex and capex incentives, take account of this performance in assessing relative efficiency at a price control review and/or take enforcement action) but as a consequence should also reduce any perverse incentives on companies to reduce short term costs to inappropriately benefit from incentive payments in the short term. . That is, because there is a greater risk of companies being 'caught out' before they profit (via receipt of efficiency incentives) from inappropriate behaviour, the inappropriate behaviour is less likely to happen. This is a similar rationale to that of the recently introduced enforcement provisions of the Utilities Act.

Any assessment of DNO efficiency, especially eligibility to the rolling capital efficiency incentives should take account of DNO performance before and in response to the storms in October 2002.

Though there is merit in monitoring inputs, we do not believe that incentivising inputs is at all appropriate. The monitoring of inputs can provide useful information to help support the changes noted above.

We complement Ofgem for adopting our suggestion that eligibility to the five year rolling opex incentives should, like capex, be subject to a test. However, we are disappointed that this will not be introduced until DPCR5. There is still the opportunity to adopt this change on a prospective basis, without undermining incentives, for incremental opex out performance from the start of the next regulatory year. We believe that this change can make a valuable contribution to network resilience.

Asset risk management survey

The existing asset risk management surveys look for evidence of policies and procedures, but not at their quality (fit for purpose) nor how/whether they are implemented by the business. A useful extension of the existing surveys, perhaps as part of the price control review (rather than annually) would be to make those missing assessments.

Improving the ability of the network to respond to exceptional events

Statistical relationship between weather, faults and the number of consumers interrupted

There is merit in considering this further to help Ofgem perform ex-post assessments of performance/efficiency.

Input based approach

We only support measurement/monitoring of inputs to allow Ofgem to perform ex-post assessments of performance/efficiency complementing the existing incentives and the changes suggested in this response. Incentivising inputs is a retrograde step as it will stifle innovation and reduce the future potential for genuine efficiency improvements.

Ability of a company to respond to a severe weather event

4.30

Financial incentives related to a restoration time profile

There is merit in the simplicity of these proposals though it is not clear what the cost or customer willingness to pay implications might be. This option should be considered further.

Ex-post performance assessment

Ofgem notes that this is similar to the assessment performed by Ofgem under the IIP when considering the exclusion of events. However, this is also similar to the study commissioned by the Department for Trade and Industry (DTI) following the storms of October 2002. We assume that this report also formed a key component of Ofgem's determination of compensation levels for customers. Though we recognize that in some instances only one or two companies would be affected, hence it might be difficult to compare performance and/or define efficient behaviour; the DTI report would provide some information on an appropriate level of performance.

Management of communications during an event

4.31

We agree with the need to provide good communications during an event.

4.32

There may be good arguments for retaining some of the exemptions relating to severe weather for general network performance (for example, networks were not built to withstand severe weather and removing exemptions might lead to a significant cost increase that might not be supported by customer's willingness to pay). However, these arguments do not relate to the performance of telephone systems. Telephone systems and other communications are not per se affected by the weather. The existing IIP exemptions relating to telephone response should be removed. The standard Force Majeure type protection should be sufficient for DNOs in this area.

We accept that there could be inequities between DNOs if the IIP exemption was removed whilst the existing relative performance scheme was retained. However, as we note elsewhere, we support Ofgem's intention to move away from a relative scheme.

Incentives for telephone response

Scope of the consumer survey

Because of the possible extension of the survey to those customers that receive an automated response and the non-exclusion of telephone performance (communications)

during an "event", for example during a storm, it may be appropriate to retain the existing level of the incentive for the time being.

Form of the incentive under the survey

We would support the move to DNO specific performance targets (assessments). However, as for other aspects of price controls, DNO specific targets and performance should continued to be informed by industry-wide performance (benchmarking).

Survey bias

This may be a problem under the existing form of relative scheme. However, if company specific targets are used then differing customer expectations need not be a problem if the costs of meeting those differential service standards are supported by customers' willingness to pay. Being able to (required to) meet differing customer expectations should be seen as a virtue rather than a problem.

Automated messaging

We would welcome the extension of the survey to those customers that receive an automated message as a fairer way of assessing company performance and better assessing the performance actually delivered to customers. However, if this is not practical then an appropriate speed of telephone response may provide a partial solution.

Incentive for the speed of telephone response

We would welcome the extension of the incentive arrangements to speed of telephone response. However, if this is not practical then an extension of the telephone survey to those customers receiving an automated message and a question for all customers taking part in the survey about the speed of telephone response may provide a partial solution.

Combining quality and speed of telephone response

There is merit in considering this further.

Environmental outputs

A "significant minority" does not appear to provide very strong evidence for further under grounding. We would be concerned if additional costs were incurred, against a background of rising costs for customers generally, when this was not clearly supported by customers' willingness to pay. The likely significant levels of distributed generation with its associated costs and the work being done on reviewing losses incentives may be sufficient to meet reasonable environmental objectives and expectations.

5. Distributed Generation

Assessment of cost and other information

5.5

We remain convinced that it is essential to independently verify and/or benchmark the level of costs produced by DNOs. The work undertaken to date does not provide this necessary level of comfort for the potentially significant costs. Many DNOs do not have a particularly strong track record of providing realistic costs assessments.

Incentive framework for distributed generation

We remain supportive of a hybrid-type incentive mechanism. However, our preference would have been to link the partial pass-through and supplementary revenue driver to a simultaneous payment once the distributed generation materialized rather than the current Ofgem proposal to have partial pass through paid at the time of the expenditure irrespective of if/when the distributed generation materialized.

Ofgem's further thoughts

5.16

"on average can earn a return which is more than their allowed cost of capital for other investments – but which is not excessive";

No justification has been provided for introducing incentives to connect distributed generation that are equivalent to providing relatively high rates of return (7.5% or 15% greater than Weighted Average Cost of Capital), though even this estimate is based on an out-turn higher (£50/kw) than companies' own average estimated cost forecasts (£44/kw). Historically, many companies' own capital expenditure forecasts have been materially too high.

Furthermore, as for any other capex expenditure, we would expect an annual efficiency (X) factor in two parts: -

- Nature of work – DNOs costs would be expected to rise more slowly (relative to inflation) than the rest of the economy; and
- A residual post-privatization effect – the pent-up efficiency available to DNOs as a consequence of their previous government ownership.

Both of these components are supported by the Cambridge Economics report on DNO efficiency recently commissioned and published by Ofgem.

Finally, as distributed generation is largely moving from a small/residual to a mainstream activity with potentially significantly increased quantities of DG connections, DG costs could be expected to exhibit similar properties to those of any other new technology or obligation (i.e. learning curves relationship). That is, the efficiency improvements would be likely to be even greater than other 'business as usual' activities.

Taking all of these factors together would imply that companies could be reasonably expected to earn exceptionally high rates of return. We are concerned that the proposals, as currently described and justified, do not appropriately balance the interests of electricity

distribution companies and customers. We would ask Ofgem to reconsider this area and to provide justification for the quantum of incentives chosen.

5.17

The comparison with the capex incentive is not wholly correct. For overspends, DNOs face up to 100% cost exposure.

Operating and maintenance (O&M) costs

We would expect the addition of relevant efficiency factors as per our earlier comments on DG capex costs.

Other Issues

5.34

Strategic Investment

The proposed incentive structure already provides, to some extent, for strategic investment as expenditure provides companies with a return immediately, i.e. prior to the DG actually arriving, with the additional/enhanced return being received once the DG arrives.

As noted elsewhere in this response in relation to IIP/outputs, we do not favour companies choosing which of the hybrid options they prefer. Company choice maximizes DNO out-performance opportunities at customer's cost. It should be for Ofgem to propose an appropriate scheme for each company, after taking account of all the relevant information.

Interactions with other areas

To the extent that DG reduces the need for other investment/costs, e.g. additional NGC exit capacity, then the price control framework should take account of those avoided costs.

Registered Power Zones and Innovation Funding (RPZ & IFI)

We continue to be unconvinced of the rationale for these proposals. We look forward to the expected development of an RIA for this area of work. Our views are contained in previous responses to Ofgem price control consultation documents, in particular our response to Ofgem's July 2003 RPZ and IFI consultation.

6. Assessing Costs

Capex

We understand that in DPCR3, Ofgem focused primarily on a bottom-up approach to assess future capex allowances, based on asset condition and age surveys. Although we understand an efficiency factor was applied to these forecasts we do not believe that any top down regression benchmarking was used to determine company specific catch-up targets nor was a general efficiency improvement (X) factor used. Ofgem confirmation of the approach used at DPCR3 would be appreciated.

We are concerned that bottom-up assessments of future allowances will always tend to an over-estimation. Our views are supported in the Europe Economics report 'PR04 - Scope for Efficiency Improvements: Uncertainties and Measurement Issues' sponsored by Ofwat, where they conclude that *"All bottom-up studies suffer from limited foresight bias, in that they do not take into account efficiency improvements whose nature cannot be foreseen at the time of the study. This is likely to be a significant downward bias for efficiency improvement projections over an extended period of time"*.

Our concerns that capex allowances may have not been subjected to the full potential of efficiency incentives are supported to some extent by Ofgem's statement that during the existing and previous price control periods, companies have typically out-performed Ofgem's assumptions of capex.

We appreciate that robust capex top down modelling may not be achievable for this price control as there appears to be a significant problem regarding data consistency provided by the DNOs. We also acknowledge that, data inconsistency aside, there are many problems associated with modelling of capex and these include:

- Differences in accounting practices;
- Normalising capex lumpiness;
- Differentiating between future and current benefits of capex expenditure;
- The time lag associated with serviceability improvements resulting from capex expenditure; and
- The inherited level of serviceability of pre-vested assets.

Whilst acknowledging these problems we agree with the view expressed in a recent OXERA paper that concluded that the situation facing Ofgem is comparable with that faced by Ofwat in 1993 and there is a considerable effort now needed to develop a comparative efficiency approach for capex. To that end we would like comfort that Ofgem is introducing the necessary measures to capture the relevant data so that in DPCR5 robust top down capex modelling can be achieved

We also believe that, data consistency aside, there is merit in Ofgem attempting to employ these techniques for DCPR4 and that an approach similar to that employed for opex modelling at the last review, where to accommodate lack of data confidence, the efficiency frontier was set by the 2nd most efficient company, could be similarly employed with comparable catch-up rates of 75% over the same number of years used at DPCR3.

Our preferred approach for DPCR4 would be for Ofgem to use the higher of top-down and bottom-up benchmarked costs with an additional annual efficiency (X) factor in two parts: -

- Nature of work – DNO costs would be expected to rise more slowly (relative to inflation) than the rest of the economy; and
- A residual post-privatization effect – the pent-up efficiency available to DNOs as a consequence of their previous government ownership.

In line with our comments in section 6 on Distributed Generation, we would additionally like to see a higher value of X applied to all significant new obligations or costs, as we would expect the usual learning curves relationships to imply greater cost reductions for the first few years.

We note that the CEPA report commissioned by Ofgem does not have a readily available value of X that can be applied directly to capex expenditure.

We do not agree with the CEPA report's general observation that there is little expectation of the recently observed exceptional out performance of DNOs continuing into DPC4. Some of the pessimistic indicators of future efficiency used by CEPA were recently dismissed by Europe Economics in a recent report on water efficiency for Ofwat as not been relevant to the efficiency of UK privatised utilities. We support those conclusions. Most commentators agree upon the post-privatization effect and that the number of years since privatization is somewhat irrelevant. The more important factor is the strength of the incentive regime combined with time. The recent exceptional out-performance of DNOs has coincided with the strengthening of DNO incentives. As DNO capex incentives have only very recently been strengthened via the introduction of the rolling capex incentive regime from 2000/01, we would expect the magnitude of the recent capex out-performance to be maintained for some time. Consequently, we would expect this to be reflected in any value of X.

Opex

Our preferred approach for DPCR4 would be for Ofgem to use benchmarked top-down costs with bottom-up benchmarked costs used as a cross-check only with an additional annual efficiency (X) factor in two parts: -

- Nature of work – DNO costs would be expected to rise more slowly (relative to inflation) than the rest of the economy; and
- A residual post-privatization effect – the pent-up efficiency available to DNOs as a consequence of their previous government ownership.

As for capex we would expect: -

- A higher X factor for material new obligations and costs; and
- The magnitude of the recent exceptional out performance of price controls to be maintained into DPC4 especially as opex incentives have only just been materially strengthened by a move to 5-yr rolling incentives from 2003/4.

The top-down modeling should use upper quartile company (or 2nd company if using independent comparators/groups). The use of upper quartile costs should ensure that erroneous or illusory frontiers would not be used. There is no rationale for the use of average costs.

The P0 cut should be commensurate with the out-turn costs. With the greater development of the top-down modeling since the last price control, Ofgem should be able to confidently provide inefficient companies with greater than 75% catch-up to the upper quartile cost level over a shorter number of years than was used at DPCR3.

Total cost analysis

Ideally some form of total cost modeling/benchmarking should be undertaken.

Benchmarking techniques

We continue to support a range of techniques. Ofgem's preferred approach of using COLS and DEA appears sensible although we have concerns that DEA tends to favour companies.

Inclusion of quality of supply in the analysis

We continue to support the use quality to inform efficiency assessments.

Mergers

We continue to question the validity of benchmarking at licensee level. See our response to the October 2003 update document for further information. We believe that the most appropriate form of benchmarking is by independent comparators/group.

RAV Roll forward

We reiterate the need to take account of effective 'disposals' as a consequence of the chosen company structures and transfers that took place as part of the "transfer" scheme pursuant to the recently introduced Utilities Act.

7. Financial issues

The financial ring-fence

7.3

We agree with Ofgem that although the existing financial ring-fencing licence conditions have worked well, the emergence of highly geared structures raises questions including whether the existing arrangements provide adequate protection from companies transferring debt into the licensed business and the extent to which borrowing takes place at arm's length.

Although we question Ofgem's intention not to impose substantial strengthened financial ring-fencing arrangements, we agree the need to clarify the position on how existing ring fencing would be enforced in the event of a marked deterioration in the credit position of a DNO. In the cited case, where the credit rating of the UK parent of Aquila was reduced to below investment grade, Ofgem was able to impose a cash lock up on dividend distributions out of Aquila, and the process requiring Ofgem's consent before any such distribution was allowed worked well. We therefore agree that it would seem appropriate that this arrangement should be codified into all DNOs' licence conditions. Whilst we have no preference of the three options regarding trigger points outlined we note that they all rely on the judgement of credit rating agencies rather than Ofgem's judgement.

The cost of capital

7.18

With regard to the adoption of employing a pre or post taxation policy, as we have previously stated, whilst we acknowledge a pre tax cost of capital provides important incentives to companies to manage their tax liabilities efficiently, we have concerns that it is also partly responsible for the trend for companies to move toward a higher leveraged structure irrespective of the efficient equity / debt structure. We do not believe that this will necessarily prove beneficial in the long run and recognize the established concerns relating to the:

- Increased risk of responding to financial shock;
- Reduction in innovation and risk-taking reducing the knock on effects on yardstick competition;
- Increased risk of systemic failure; and
- Reduced ability to raise new borrowing.

We therefore support Ofgem's intention to introduce a company specific tax liability allowance, as this will lessen the incentives for companies to move to inappropriately high levels of debt.

Treatment of pension costs

7.64

We understand that pensions are at the forefront of some companies' concerns and that funding pensions is difficult when there are volatile capital markets.

We are also aware that this problem is not trivial and extends across all utility companies. We believe that in the water industry from the work undertaken for PR04, initial estimates are that pension costs stand to add an additional 3% to industry operating costs.

Appendix 3 Pension Guidelines

With regard to the principles set out in the June and October papers and contained in Ofgem's Appendix 3 we offer the following comments.

First bullet point - We believe that whilst companies' pension arrangements are a matter for their management, in setting price limits, Ofgem should allow efficiently managed companies to finance their functions which includes the efficient costs associated with providing pensions as part of a competitive remuneration arrangement.

Second bullet point - We agree that each price control should make allowance for ex ante cost of providing pension benefits accruing during the price control period as with other opex forecast costs. However we do not understand why the subsequent outturn should not be treated as any other opex over or under performance. If the perceived company risk is too high then a similar approach to that of distributed generation could be adopted which still maintains an element of incentive regulation. If we understand the proposals correctly, and Ofgem allow effective cost pass through of pension costs, we see this as a retrograde step and one that will not lead to an efficient outcome i.e. it will be to the detriment of customers.

Third bullet point - We agree that pension costs should be assessed using actuarial current best practice.

Fourth bullet point - We do not understand the rationale behind the decision for selective retrospection to compensate for the over or under provision for one component of a price control review. This appears to be at odds to the established principles of incentive regulation and, if adopted for pension costs, could set a dangerous precedent. Whilst we acknowledge that the extent to which previous out performance is difficult to quantify, it is likely that companies have benefited from the strong performance of the capital markets up to DPC3. We accept that allowances for pension costs may have increased as a result of changes to pension safeguards and lower growth forecasts but believe that to allow for deficits accrued during the previous control period to be unsymmetrical. DNOs, when accepting a price control review, explicitly accept the risk of out and under performance of that deal.

We also believe that, although natural monopolies, DNOs should not be unduly protected from the realities of the market place. At British Gas, like elsewhere in the competitive market, we have had to respond to the fall in equity markets and resultant pension deficit by considering the need for reducing the pension benefits available and / or requiring employees to contribute more, we do not see why DNOs should be shielded from such considerations.

Fifth bullet point - We do not understand why one component of opex deserves to be singled out and made an essentially cost pass through item. We believe that this removes the incentive properties of RPI-X and will lead to an inefficient outcome. There are different levels of trade-off decisions that companies make when deciding upon the efficient level of pension to be offered to its employees; trade-off between pensions within

other employee benefit costs, employee costs verses other opex and ultimately between opex and capex. It appears that Ofgem's proposals will reduce incentives for companies to efficiently structure these trade-offs by perversely incentivising companies to have little or no regard to pension costs. Effective pass through of pension costs, whilst other aspects of costs retain incentive properties, could perversely incentivise DNOs to increase pension costs (at no cost to themselves) whilst reducing other costs (in the process inappropriately retaining windfalls from illusory efficiencies funded by customers via the existing incentive mechanisms).

Sixth bullet point - We agree that only the liabilities of the regulated business should be taken into account when assessing the costs of providing pension benefits.

Seventh bullet point - We agree that companies should be expected to absorb any increase (or decrease) in costs associated with severance arrangements.

With regard to the framework Ofgem intends to use to determine ex ante pension cost allowances, whilst not convinced that this is necessarily the appropriate way forward, we offer the following views: -

- We accept that as pensions costs form one element of the general employment cost basket and boundary issues (arising from the relationship between current salary and future pension), there is sense in benchmarking general opex efficiency and not pension costs as a stand alone exercise.
- We also accept that where best actuarial practice is followed Ofgem should not need to challenge companies' valuation of schemes and we believe that where these valuations fall within a price control period, logging up or down of any changes is the preferred option.

With regard to adjustments to ensure that the allowance for pension costs is consistent with the principles set out in the June and October papers and building on the points outlined above, we offer the following comments: -

Allocation between price controlled and non-price controlled activities.

7.75

We agree with Ofgem's proposals relating to the approach to identify active members (still employed) and non-active members (retired) between those that relate to the network monopoly business and those that relate to the remainder. With regard to pension fund assets, we also agree that a similar method is appropriate to allocate these. However, we have concerns that asset deficits may have resulted from historic inadequate funding by DNOs and believe that a test is required to identify that the appropriate level of contributions have been made and that the resulting deficit is genuine and not as a result of inadequate funding.

Over or under provision

7.80

As noted in paragraph 7.75, and with regard to over or under provision, we see the important issue here as being whether an appropriate level of funding took place in keeping with good industry practice rather than whether contributions matched allowed levels of pension costs. This approach is consistent with our view that output regulation

should apply to pension costs as part of the opex allowance and there should be symmetrical treatment of gains and losses.

Early retirement deficiency costs

7.85

We agree that allowances for future pension costs should exclude the impact of early retirement deficiency costs resulting from redundancy. As we stated in our previous response, where a deficit has resulted from such programmes we do not believe that these costs should be borne by customers if the company has retained the benefits resulting from increases in efficiency. Operational efficiency is the net effect of the short-term reductions in (manpower) costs offset by any increase in pension liability and companies should not benefit in the short term from the former without being responsible for the latter in the long term. There are parallels with the likely effects of differing approaches to capital expenditure, where there may be short-term reductions in costs that cause longer-term increases. Any assessment of efficiency in respect of pensions costs (as for capital expenditure) within the context of total employee costs needs to take a longer-term view.

Tahir Majid & Roddy Monroe/Regulatory Affairs/British Gas/ 16.02.2004